Volume 20, Number 1

Print ISSN: 1078-4950
Online ISSN: 1532-5822

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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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*.

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Shih Yung Chou, University of Texas of the Permian Basin

Herbert Sherman, Long Island University

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SWEET PEAS STITCHERY: A CASE OF A START-UP MERCHANDISER-PART A

Kathleen H. Gruben, Georgia Southern University
Leslie B. Fletcher, Georgia Southern University

CASE DESCRIPTION

The primary subject matter of this case concerns accounting. Secondary issues examined include entrepreneurship, marketing, retail management, and merchandising. The case is appropriate for freshman, sophomores, or juniors in a core course of financial accounting or marketing, entrepreneurship, retail management, and fashion merchandising.

This case will take approximately one class hour. It will not require students to do any outside preparation. It will challenge their logical thinking skills, knowledge of basic accounting for merchandisers and require them to apply their basic business knowledge.

CASE SYNOPSIS

Imagine quitting your secure job to open a new business on a mere $10,000 in a time of economic uncertainty. Neither you nor your partner has any experience in the industry or as entrepreneurs. You are running on blind faith that your initial capital investment will be enough for the business to survive and generate enough revenue to draw a paycheck within the first six months of operation. This case provides an overview of the operations of such a business that opened in 2011. Several things are considered in this case, including the risks of an inexperienced entrepreneur starting a new business during a time of high unemployment and difficult economic times. The odds of success are against the owner because of her limited funds, unemployment rates, and high failure rate, what the Small Business Administration calls death rate, of new businesses. With no experience in and little knowledge of accounting, it's easy for the owner to fail to recognize when her "accountant" and "CFO" submit financial statements that are incorrect and do not make sense, which happens in this case. It requires students to recognize the errors in the company's financial statement, analyze the statement, provide insight to the owner, and give recommendations.

SWEET PEAS STITCHERY

IN THE BEGINNING

Early in 2011, Abby Adams and her best friend, Beth Rossi, confided to each other that they were very frustrated with their lives. Adams, an Administrative Assistant for a local manufacturer, and Rossi, a Middle School teacher in the public school system, found that their positions restricted the amount of time they could spend with their families. Soccer games, after school birthday parties, dance lessons and so much more had to take a back seat to their careers if they wanted to get ahead. Having to miss so many of their children's activities caused much frustration and disappointment to them and their children. They just weren't able to be the kind of employees, wives and mothers they believed they should be. They felt confined by their traditional jobs and overwhelmed by their family responsibilities. There had to be a better way.

The two women's jobs and the stresses of motherhood were even starting to strain their marriages. Both were married to professional men and had children of elementary school age. However, their husbands, Mark Adams and Dave Rossi, were beginning to feel like third wheels in their own homes. Their wives were spending all their time on their jobs and with the children, leaving little energy for the husbands. Could the two households get by without the wives' income? Neither man thought so. But a way to get their marriages back on track, short of asking their wives to quit their jobs, had to exist. This simply was not the type of relationship either of the men envisioned when they said "I do." Both had imagined their wives picking the children up from school, taking them to their activities, and having a warm family dinner ready when the husbands returned from work each day.

What the husbands didn't know was that their wives were thinking the same thoughts, but were actually trying to do something about the common problems. Abby and Beth were meeting weekly at the local coffee shop to brainstorm their futures. They had the same goals: (1) to work flexible hours to enable them to spend time with their husbands and children and (2) to provide additional income for the family. They soon realized that they would not reach those goals if they stayed in their current jobs so the women decided to become entrepreneurs and start their own business. The questions became what business and how much money would it take to get the business started? Each woman could scrape up $5,000 without hurting the family, but not much more. What kind of business could start on a mere $10,000?

Abby had a business administration degree, but had never taken any classes related to entrepreneurship; Beth was an education major with no business classes at all. Both women, however, were artistic, creative, and enjoyed sewing. Could they create a business venture that utilized those common skills and capitalized on Adams' business background? They individually pitched the idea to their husbands who reluctantly came on board; both men were still concerned about the loss of income to the family and retained nagging doubts about the possibility of their wives succeeding.

With the go-ahead from their husbands, the two women redoubled their efforts to conceptualize a home business that would be profitable. They quickly settled on a custom sewing/personalization business. But how should it be structured? Home parties? A company sales force? A retail storefront? Which structure could work without a large investment of capital and how would they be able to pay any potential employees or sales people? Abby and Beth had so may questions yet they pitched their business idea to their husbands and both men agreed to support their wives in the new venture.

What Beth and Dave Rossi did not know is that Mark Adams had serious doubts about the business. In fact, he gave an ultimatum to Abby: if she didn't bring in a paycheck equal to half of her current salary after one year in business, she would have to leave the business venture and rejoin the traditional workforce. Abby wasn't concerned. She believed that she would be able to start drawing a paycheck after six months of operations.

Abby and Beth formed their partnership on a handshake and a contribution each of $5,000 to provide the partners a $10,000 initial capital investment. Abby quit her job, but Beth had to finish out the school year so her work was limited to nights and weekends. Their business, Sweet Peas Stitchery (SPS), was founded in April 2011. SPS is a home party business that sells and monograms purses, bags, home décor, and much more. The women can monogram virtually anything that can be sewn; the custom stitching is offered as part of the merchandise cost. Could the women succeed?

CHALLENGES

BUSINESS SKILLS

As with many small businesses, the partners faced many more challenges than either imagined. The first challenge came from the type of business they opened and the misfit between their backgrounds and the business concept. Adams was an outstanding student, but was similar to most marketing students when it comes to attitudes about courses such as finance, accounting, or quantitative analysis. Along with her peers, she believed that the numbers oriented and operational courses were not something she would use in a marketing position. As a result, she studied hard, made her grades, and purged the quantitative information either after exams or upon completion of the course. Little did she know how important that information would become in 10 years. For Rossi it was not a situation of refreshing her memory and sharpening her skills; she was more like a fish out of water.

Neither Adams nor Rossi had experience in either retail or sales much less buying, inventory control, accounting, or any of the other functions required for running a successful business. Although Adams took a sales class while earning her business degree, she found that she was rusty there. Some knowledge, working or educational, of retailing, entrepreneurship, or sales is a key element of success for any entrepreneur, especially one in a venture like SPS. The lack of experience does not mean that the two women were doomed to failure. It simply means that they would have to work a little harder than their peers to accomplish their goals. Do the partners have the necessary business skills and acumen?

CAPITALIZATION

The partners' second challenge came from eliminating a steady income and embarking on a new business venture in a time of high unemployment and economic uncertainty. A risk is almost always associated with leaving guaranteed income before having another job. In this case, the women had another job, but not guaranteed income. Without proper research, they had no idea when SPS would generate enough revenue, not to mention profit, for the women to draw paychecks.

The expectations for personal income after six months was driven by the length of time the women's spouses were willing to support them. With an investment of only $10,000, any pay they drew needed to come from the revenue generated and potential profits. One problem with this type of thinking is that Adams and Rossi didn't consider the realistic revenue that could be generated with such a conservative investment. Using a retail mark-up method and taking keystone, the customary 50 percent mark up for this type of product, only gave them the sales potential of $20,000 initially, without considering the machine(s) they needed to customize the product and any other expense such as travelling to market to purchase inventory.

The potential revenue SPS could generate depends on the amount of cash available for purchasing stock and inventory turnover. Specialty retailers average 6 – 8 turns a year (CSI Market 2013), which means SPS can realistically expect to sell $60,000 - $80,000 a year if the $10,000 investment did not have to pay expenses too, which is not realistic. If the company generated that level of revenue it could not afford to pay the owners for the first year, certainly not within the first six months, because any potential profit would need to be reinvested in inventory. Are the partners undercapitalized?

THE UNEMPLOYMENT RATE

A third challenge for Adams and Rossi is the unemployment rate, which can be viewed as either positive or negative. If it is viewed from the perspective that the business will become a statistic as part of the high failure rate for small business startups, the outlook for the owners is negative. The women left secure, paying jobs at a time of high unemployment. If the business fails, either or both women may have difficulty finding gainful employment. However, with a high unemployment rate, SPS should have an easier time recruiting women consultants (sales representatives), which is SPS's target market. According to Adams, the primary purpose of establishing the company was "to empower women to honor their commitment to their families while giving financial flexibility to their lives." This power will give the consultants the ability to offer their families opportunities to fulfill dreams. They operate the business on a “family first” philosophy. Could Adams and Rossi recruit enough consultants to generate the necessary sales levels for the business and the partners to be profitable?

According to the SBA (2013), the leading causes of small business failure are: lack of experience, unexpected growth, poor location, personal use of business funds, poor inventory management, poor credit arrangement management, and over-investment in fixed assets. Many of these describe the situation at SPS so the odds of success are stacked against them. Can Adams and Rossi beat the odds?

THE START-UP PHASE

In April 2011 SPS was open for business. That spring it was housed in a bedroom of the Adams’ house, so Abby and Mark paid the company’s rent and utilities. The partners had just Abby’s one sewing machine capable of stitching monograms onto a range of fabrics. Therefore, they purchased a second one, used, so that both women could sew simultaneously and would have a back up if one machine broke down. They hired a friend to build a website for SPS, hoping to generate customers without having to spend money on advertising. SPS generated some revenue by custom embroidering items for friends but cash was not generated on a daily basis or in an amount large enough to be considered significant. In other words, no chance for drawing paychecks from cash generated existed that spring.

Both women worked diligently through the first few months, although Beth was limited to non-school hours during the first two months. Abby and Beth soon began to disagree about running the business. Beth felt like her opinions carried no weight since she didn’t have a business background. Abby felt that Beth was dragging her feet on recruiting consultants and expanding the business. Both women were feeling pressure from their husbands to start bringing home a paycheck. After all, their wives were working longer hours than before to make the business viable and still weren’t able to spend time with them or the children. From their perspective, things had gone from bad to worse: Abby and Beth were even busier and more stressed now, but on top of that things were financially tight at home because of the non-existent paychecks.

By late July things reached a crisis in the Rossi household. Dave and Beth realized that paychecks from SPS would not be arriving any time in the near future and they needed Beth to go back to work at a traditional job. Therefore, unbeknownst to Abby, Beth started looking for a fall teaching position and was fortunate enough to find one. Beth didn’t think that she could hold down two jobs plus her family responsibilities so she decided to approach Abby with the possibility of her leaving the partnership.

Abby was stunned by Beth’s announcement that she wanted out of the partnership so that she could go back to teaching. Even though she understood Beth’s financial insecurities, her belief in SPS was greater than her fiscal fears. Reluctantly, Abby agreed to buy out Beth’s share of the partnership and to dissolve it, leaving her as the sole owner of Sweet Peas Stitchery with very little capital left.

THEN THERE WAS ONE

Similar to a ship, Adams knew that she could not captain her business without a crew to run it so she hired her first "Sweetie" (consultant or sales representative) in August 2011, shortly after becoming its sole proprietor. She also moved SPS out of her home and into a small storefront. She hoped that her "Sweetie" would host home parties and attract more customers in an adjacent state. Her ultimate goal was to make this a party plan type of business where women would have the opportunity to gain their own financial freedom. She had just taken her first step toward that goal. One little step was enough for her because "a journey of a thousand miles begins with one step" (Lao-tzu ancient Chinese philosopher).

In the fall, Adams found that the business would not survive without an infusion of money. She and her husband Mark invested the $40,000 they had saved to build a new house. Mark then leveled with Abby. Neither he nor she would invest any more money in the business; SPS was going to have to make it on its own. Additionally, since Abby had been unable to draw a paycheck after six months as promised, he gave her until January 31, 2012 to start paying herself. His third action was an ultimatum: if she was unable to help support her family financially and emotionally, he would consider divorce.

Abby reeled from Mark's demands, but knew that he wasn't bluffing. She also knew that the current balance of $42,000 in cash and capital wouldn't be enough to "right her ship" and make SPS a profitable business. She made the bold decision to solicit investments from her family and very close friends. She decided to sell up to 25 percent of the business, arbitrarily valued at $200,000, to the investors, her silent partners. This would leave Adams with 100 percent control of the business operations, but only 75 percent ownership. The 11 investors each own between 0.5 and 12 percent of the company. The purchase amount was $2,000 for a one percent interest so the investors invested between $1,000 and $24,000 individually. More importantly, an additional $50,000 was infused into the business by investors, totaling $100,000 cash invested overall.

The number of consultants grew from 1 to 34 by the end of 2011. Sweeties were recruited through word-of-mouth, home parties, and the website. To become a Consultant (the first rung on the six-step team building ladder that tops out at Executive Director), the Sweeties had to complete and sign a contract and buy a starter kit for their home parties. Consultants receive a 20% commission on all sales; there is also an incentive program designed to increase income to the consultant and sales to SPS. This wasn't enough for Abby to start drawing a paycheck. What else could she do?

Mark Adams was true to his word. He could see that he had lost his wife to her new business that seemed to be successful yet was not profitable, for some unknown reason. He filed for divorce and custody of their children in February of 2012. Stunned, Abby did not contest the divorce but fought for custody of her children. The court's final ruling came in August 2012 – Mark and Abby were divorced and shared custody of their children equally. They lived together six months after the divorce. Abby had depleted their personal funds so much that Mark could not afford to move out.

THE GROWTH PHASE

Adams buried herself in her work and her children in the spring of 2012, while she adjusted to being a single mom and entrepreneur. The business started to take off in April, after she received the final recommendations of a student project done at a local university. The students improved the company's website and assisted in developing social media sites. Once the company was visible, the number of "Sweeties" doubled in a month and continued to grow throughout the year. By the end of 2012, SPS had in excess of 500 consultants. Business was so good that through the 2012 holiday season, it ran sewing shifts around the clock on four machines to keep up with demand.

In the summer 2012 Adams again moved SPS to a larger facility in an office building to accommodate the growth in consultants and product demand. She bought her third sewing machine; the fourth was purchased in the fall. She also faced the fact that she could no longer run the business and keep track of the financial records. She hired two friends to serve as SPS's accountant and CFO.

The problems are that the accountant did not record any of the financial information until the end of December 2012. The CFO has no experience in corporate finance or accounting. He is currently in sales at a local bank; his degree is in marketing. A financial statement was prepared by the accountant and approved by the CFO. From well over a quarter of a million dollars in gross sales revenues, SPS is almost breaking even. Not bad for a company that is less than two years old; however, Abby did not understand why she is losing any money at all if she has money in the bank, is able to continue purchasing inventory, and is able to pay the commissions to her "Sweeties".

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THE WAL-MART STORES, INC.: AN AMERICAN DREAM THAT TOUCHED THE WORLD

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Marie Palladini, California State University, Dominquez Hills
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Throughout my career, I've always emphasized performance. And I'm really proud of the performance of our team around the world and the results Wal-Mart delivered for fiscal year 2010 in a year challenged by a difficult economy in all of our markets. Our results reflect the underlying strength of our business and our strategies to improve shareholder value.

Michael T. Duke
President and Chief Executive Officer
Wal-Mart Stores, Inc.

CASE DESCRIPTION

In 2011, Wal-Mart grew through the opening of additional stores across the United States and other countries. While the company sales were strong, the U.S. operating income was sluggish with a mere 3.1% growth versus a 5.5% growth in the previous year. Looking for additional growth opportunities, Wal-Mart planned to open convenience stores (c-stores) in a number of markets including urban and rural markets both in the U.S. and in its international segments.

This case is intended to demonstrate how Wal-Mart used its distinctive competencies and competitive advantage in the marketplace; what challenges it encountered; and what strategies it should adopt to sustain growth.

CASE SYNOPSIS

Can a teen named "most versatile boy" by his high school classmates become the leader of the world's largest corporation? In America, everything is possible, especially when that same teen believed "high expectations are the key to everything" (Bio True Story, 2013). As a star quarterback (Hickman High), Eagle Scout, and with a degree in Economics from the University of Missouri, Sam Walton was an enigma. Married 49 years to the same woman, and a father of four, this ardent huntsman and recreational enthusiast, retained a humble image favoring his red Ford F150 pickup (vintage 1979) with which he drove to work. However, as a man of business, Walton, known as Mr. Sam, was an unconventional yet strategic retail pioneer.

Mr. Sam was innovative, decisive, and perceptive. Walton believed among other values that to be a successful in business one must "swim upstream." He advocated a company should "Go the other way. Ignore the conventional wisdom. If everybody else is doing it one way, there's a good chance you can find your niche by going in exactly the opposite direction" (Walton, 1993, n. p.). Finding this niche is exactly how Walton built an empire even surpassing the famed Sears, Roebuck & Company in 1991. In fact, while the U.S. GDP plummeted between 1990 and1991, and the country's economy was stalled for nine months drudging through a recession, Wal-Mart managed to increase its sales by at least 40% (bio True Story, 2013).

Most recently, Wal-Mart has weathered well the economic storms of the past decade, taking no financial losses. In 2011, although Wal-Mart sustained growth, it did so only through the opening of additional stores across the United States and other countries. Further, while companywide sales were strong, the U.S. operating income was sluggish with a mere 3.1% growth versus a 5.5% growth the previous year. Looking for additional growth opportunities, Wal-Mart planned to open convenience stores (c-stores) in a number of markets including urban and rural markets both in the U.S. and in its international segments.

Thus, as the best positioned retailer in the world, Wal-Mart's strategic plan and business model were based on a productivity loop of low prices and low operating costs, which retained its competitive advantage as the low price leader. It was deemed a powerhouse in and of itself. As the number-1 retailer in the world, the company employed 21.1 million associates in more than 8,970 stores. Wal-Mart's international division, which comprised 26% of its sales, experienced a fast growth pace. Wal-Mart readily surpassed Europe's Carrefour, Metro AG and Tesco combined. It was the number-1 retailer in Canada and Mexico and operated in Asia (owning 95% of the Japanese retailer SEIYU), Africa, Europe, and South America. Although Wal-Mart easily sustained its position as the number-1 retailer in the world, the state of its competition deserves analysis.

The continued impressive gains in Wal-Mart business were attributed to Wal-Mart's use and refinement of basic skills in purchasing, customer service, and logistics, which surpassed its competition. Additionally, Wal-Mart's logistics were stronger and more efficient than those of other large companies were. Indicia of the strength of Wal-Mart's logistics were based on a sophisticated distribution system with 14 computerized facilities and a large fleet of over 6,500 trucks. As far back as 1989, then CEO Glass noted that Wal-Mart's distribution system was one of the critical elements of its success. The massiveness of Wal-Mart's operation coupled with a very efficient distribution system allowed it to continuously have a price advantage over its competitors.

Following the Wal-Mart spirit of optimism and hard work, CEO Duke shared the vision of "Building the Next Generation Wal-Mart," at the 2010 annual shareholders' meeting. He delineated four key strategies to put forth the company's continued conveyance of Sam Walton's vision and continued growth into 2015. These strategies focused on global expansion, the retail market's challenges and solutions, social responsibility, and the continued strength of the Wal-

Mart culture (McShane, 2010). Duke explained that to become a larger global company, Wal-Mart had to continue to expand upon its philosophy of serving its customers as though they were patronizing a local store and needed to take advantage of its extremely competitive global supply chain.

Nevertheless, the question remains – can Wal-Mart continue to implement strategic plans while at the same time sustaining effective dividends and profits. The short-term answer is yes given that Sam Walton vision for retaining low prices and giving back to the community continues to this day. However, the long-term answer is yet to be determined.

Keywords: Wal-Mart, Wal-Mart Stores, Inc., Walmart, Wal-Mart Strategy, Sam's Wholesale Club, Sam Walton, Buy America Strategy, Low Cost Strategy, and Competitive Advantage.

THE WAL-MART STORES, INCORPORATED

Business prowess and the application of competitive positioning mobilized Sam Walton in 1962 to develop and subsequently catapult Wal-Mart into a very prosperous retail and merchandising enterprise. Utilizing the self-serve merchandise model positioned the titan retailer to become America's most profitable and influential business profile (CNN Money, 2011a). Wal-Mart's growth plans were laudable, but the question becomes can Wal-Mart continue to grow at this rate?

Citing the importance of competitive advantage, scholars have argued that organizational attributes that create value such as low cost and achieve distinction such as outperforming competitors are strategies that facilitate profitable performance (Porter, 1980; Powell & Dent-Micallef, 1997; Peteraf, 1993). Such differentiation has given Wal-Mart the capacity to gain a competitive edge and as such perform in the retail industry at a higher level than its contenders.

Wal-Mart earned the prestige of being listed among the top 20 of the "Most Admired Companies" by *Fortune* Magazine (see Table 1) (CNN Money, 2011b). This level of accomplishment represented all industries. Indeed, *CNN Money* rated Wal-Mart Stores as the number one General Merchandiser of 2011 (see Table 2) (CNN Money, 2011b).

Strategic and decisive planning has retained Wal-Mart as both a phenomenon and a business leader with numerous tactical merits. Indeed, Wal-Mart has weathered well the economic storms of the past decade, taking no financial losses. Rather, this behemoth retailer has survived several economic downturns with an advantage and actually sustained growth, being able to leverage prices and provide strong dividends to its shareholders (Wal-Mart Annual Report, 2011). Nonetheless, such profitable dividends did come at a cost. While its international endeavors experienced growth, U.S. stores experienced losses since late 2009 (Wal-Mart Annual, 2011). Nevertheless, in the past decade (2000-2010) Wal-Mart retained an annual growth rate of 12.3% (Wal-Mart Annual Report, 2011).

Table 1
World's Most Admired Companies 2011

Rank	2011 Most Admired Companies		
1.	Apple	**11.**	Wal-Mart Stores
2.	Google	**12.**	IBM
3.	Berkshire Hathaway	**13.**	General Electric
4.	Southwest Airlines	**14.**	Walt Disney
5.	Procter & Gamble	**15.**	3M
6.	Coca-Cola	**16.**	Starbucks
7.	Amazon.com	**17.**	Johnson & Johnson
8.	FedEx	**18.**	Singapore Airlines
9.	Microsoft	**19.**	BMW
10.	McDonald's	**20.**	American Express

(CNN Money Fortune 500, 2011a)

Table 2:
Most Admired General Merchandiser 2011

Rank	2011 Most Admired General Merchandiser		
1.	**Wal-Mart Stores**	**6.**	Macy's
2.	Target	**7.**	Dollar General
3.	Nordstrom	**8.**	Family Dollar Stores
4.	Kohl's	**9.**	Sears Holdings
5.	J. C. Penney	**10.**	Dillard's

(CNN Money Fortune 500, 2011b)

In 2011, although Wal-Mart sustained growth, it did so only through the opening of additional stores across the United States and other countries. Further, while companywide sales were strong, the U.S. operating income was sluggish with a mere 3.1% growth versus a 5.5% growth the previous year (Newcomb, 2011). Looking for additional growth opportunities, Wal-Mart planned to open convenience stores (c-stores) in a number of markets including urban and rural markets both in the U.S. and in its international segments.

Thus, as the best positioned retailer in the world, Wal-Mart's strategic plan, and business model is based on a productivity loop of low prices and low operating costs, which will retain its competitive advantage and continue as the low price leader.

COMPANY BACKGROUND

Wal-Mart laid claim to 4,413 stores in the U.S. Of these 3,822 were regular Wal-Mart centers, while 609 were Sam's Clubs wholesale stores (Newcomb, 2011). This number more than doubles to 9,667 once other locations in North America, South America, Asia, Europe, and more recently Africa are added (see Table 3) (Wal-Mart Annual Report, 2011). As of 2011, total locations equated to 2,100,000 employees. This was a monumental increase from Wal-Mart's 1962 founding based on Sam Walton's business model developed as early as 1945 with 15 small town five-and-dime stores (Wal-Mart Data Sheet, 2011).

In the U.S. Wal-Mart, sales were represented by groceries (54%) and general merchandise including entertainment (12%), hardlines (i.e. department store products) (11%), apparel (7%), home (5%), health and wellness (11%) articles (Hoovers, 2011; About.com, 2012). The international sales division represented 26% of sales. Both Canada and Mexico identified Wal-Mart as its number one retailer, whereas, in European locations Wal-Mart outnumbered its competitors such as Carrefour, Metro AG, and Tesco. Asia operations were similarly strong. Indeed, in Japan Wal-Mart owned 95% of the Tokyo based Seiyu Group, which operated shopping centers, grocery, and department stores (Hoovers, 2011).

Sam Walton built partnerships and developed a vision for Wal-Mart with the force of action behind his belief that low prices would lead to better living for customers. The "Beast of Bentonville" has had phenomenal growth since its humble beginnings and has taken the retail industry to a revolutionary level, while retaining its discount/low price business model (Bianco & Zellner, 2003).

Table 3:
Wal-Mart Numbers Worldwide

2011 Wal-Mart Store		**Stores per country**
North	U.S.	4,431
America	Canada	329
	Mexico	1,880
Latin	Brazil	487
America	Chile	291
	Costa Rica	185
	Guatemala	182
	El Salvador	77
	Argentina	66
	Nicaragua	64
	Honduras	60
Asia	Japan	413
	China	344
	India	7
United Kingdom		536
Africa*		315
Wal-Mart International		5,236
Wal-Mart Stores, Inc.		9,667

*Africa includes South Africa (290), Botswana (10), Ghana (1), Lesotho (2), Mauritius (1), Malawi (2), Mozambique (1), Namibia (3), Nigeria (1), Swaziland (1), Tanzania (1), Uganda (1), and Zambia (1) (Wal-Mart Corporate Data, 2011)

Because of its wide assortment of products, Wal-Mart U.S. store had a consumer base of more than 140 million. It has been reported that at least 82% of American consumers have purchased product from the retailer at least one time (Bianco & Zellner, 2003). The reason for such high consumer loyalty is that Wal-Mart carried household staples without which consumers cannot do. The need for low priced commonplace items such toothpaste, detergent, tissues, and even milk encouraged consumers to flock to Wal-Mart. While there, why not purchase the latest CD or DVD. Indeed, Hollywood productions found Wal-Mart accounted for 15% to 20% in all sales of the audio/video market (Chiou, 2009). Thus, Wal-Mart's strategy of low prices tended to mirror what consumers desire; stock it at a low prices in proximity to where consumers live, and in so doing communicate the ease of purchase.

VISION AND SPIRIT OF SAM WALTON: A BUSINESS NESTOR

Wal-Mart's global mission was to save people money so they could live better (Wal-Mart Stores, 2011a). This was Sam Walton's vision when he opened the doors to the first Wal-Mart in 1962 and continued to be the focus of its day-to-day operations. Wal-Mart's organizational structure, decision-making, and leadership format allowed it to successfully carry out this mission. Wal-Mart's strong corporate governance framework was based on the values that Sam Walton placed in the company from its inception. Every rule and philosophy at Wal-Mart was based on a core value of respect – for the customers, the associates, and the suppliers. Known as 'Mr. Sam' by Wal-Mart associates, Sam Walton exemplified a number of values, including hard work, discipline, modesty, unpretentiousness, and frugality. These values have been retained throughout Wal-Mart's organizational history. Walton also had a strong desire for his employees to be motivated, inspired, and happy to work for Wal-Mart (Cascio, 2006).

Samuel Moore Walton (1918-1992), founder of Wal-Mart may not have imagined a conglomerate nearly 50 years ago when he opened the first Wal-Mart, in Rogers, Arkansas (Walton, 1993). Born and raised in Oklahoma in the uncertain years after World War I, young Walton was raised in a farming family infused with hopes and dreams, yet structured by the value of hard work and perseverance. At the young age of three, Sam tiptoed into the back row of a schoolhouse and listened to lessons for several hours (Walton, 1993). Such values and behaviors influenced and developed Sam's management style framed around the nexus of servant leadership. Convinced of the importance of meeting the needs of others, Sam was driven to become healthier, unfettered, and more autonomous in his leadership development.

After his brother James Lawrence (aka Bud) was born, the family sold their property and moved to Springfield, Missouri, when Sam was school age. The Walton parents believed their sons would receive a quality education more so in the city than on the farm. In the mid-1930s, with the economy improving out of the Depression, Sam was involved in nearly every school club and activity including sports. He was senior class president and even delivered the graduation speech on the topic of leadership (Wal-Mart History, 2011a).

Sam Walton was the first in his family to attend and graduate with a college degree. Soon after obtaining his bachelor's in economics from Columbia University, Sam was drafted and served in the U.S. Army Intelligence Corps with the rank of Captain. Between attending college, working, and military service, Walton managed to get married. Sam and Helen eventually had four children. They were married 49 years when he died in 1992. Although in different cities and prior to his military service, both Sam and Bud secured jobs with the J. C. Penney Company. Their exposure to trade gave them a taste of the retail industry (Wal-Mart History, 2011a).

Post World War II America was full of hope in the late 1940s and early 50s given the economy had shifted from a military focus to a consumer driven emphasis. Walton was no less filled with hope than the American purview given that he took a single five-and-dime franchise store in 1945 and developed a business model that resulted in 15 stores by 1962. With the belief "that the shopkeeper's success is entirely up to . . . the customer," Walton cemented his success with a formula to insure low prices every day (Wal-Mart History, 2011a). Such a conviction turned the retail industry on its head and influenced both employees and consumers.

Story after story has been told of Walton's generosity, humor, and business prowess (Wal-Mart Stores, 2011a). Nevertheless, while Walton was a man of means, he managed to live prudently driving a symbolically American vehicle. The favored red and grey 1979 Ford F150 pickup was proudly driven with dents, rust, and Sam's dog, Ol' Roy's paw tracks. This manifested Sam's humility and frugality, which he embodied and embraced throughout his life (Walton, 1993). Yet regardless of his unpretentiousness as the head of hundreds of discount stores, Walton still managed to top *Forbes* magazine 1985 list of the 400 richest Americans (Los Angeles Times, 1985) (See Appendix A for Wal-Mart historical timeline).

FINANCIAL RESULTS

In fiscal 2011, Wal-Mart delivered an outstanding financial performance. The company earned \$419 billion and paid back \$19.2 billion to its shareholders through dividends and share repurchases. There was no previous precedence of such payout in the history of the Wal-Mart (Wal-Mart, 2011a).

Wal-Mart officials stated that while its team was working hard to improve its conditions significantly, it also planned to pay better gains to people who invested in its stocks (Wal-Mart Stores, 2011a).

While Wal-Mart net sales increased by 3.4% in 2011 to \$419 billion, its operating income increased by 6.4% to over \$25 billion (Wal-Mart Store, 2011b). The company-diluted earnings per share from continuing operations rose 12% to \$4.18 (Wal-Mart Stores, 2011b; Investopedia, 2013).

Wal-Mart closed out its fiscal 2011 with \$16.39 billion in net income, which was a 14.33% in net income growth over 2010 (Hoovers, 2013). With \$11 billion in free cash flow in

2011, the company delivered a 25.11% return on equity. Its stock price grew to $56/share in 2011 up from $47/share in 2007 (Wal-Mart Stores, 2011b).

In 2011, Wal-Mart's assets totaled over $180.6 billion; up from $46.9 billion in 2007. Its retained earnings grew by 115% and its total liabilities and equity grew 119% over the same five-year period, from $151.5 to $180.6 billion. Additionally, its shareholders' equity rose from $61.5 billion in 2007 to $68.5 billion in 2011, and its total retail units increased to 8970 in 2011 up from 6809 units in 2007 (see Tables 4 and 5).

Wal-Mart has improved its gross profit margin over the years, from 23.40% in 2007 to 24.70% in 2007 (see Table 5)

Table 4:
Wal-Mart Consolidated Balance Sheets, 2007-2011 As of January 31, (Amounts in millions except per share data)

	2011	2010	2009	2008	2007
ASSETS					
Current assets:					
Cash and cash equivalents	**$7,395**	$7,907	$7,275	$5,492	$7,767
Receivables, net	**5,089**	4,144	3,905	3,642	2,840
Inventories	**36,318**	32,713	34,511	35,159	33,685
Prepaid expenses and other	**2,960**	3,128	3,063	2,760	2,690
Current assets of discontinued operations	**131**	140	195	967	-
Total current assets	**51,893**	48,032	48,949	48,020	46,982
Property and equipment:					
Land	**24,386**	22,591	19,852	19,879	18,612
Buildings and improvements	**79,051**	73,657	73,810	72,141	64,052
Fixtures and equipment	**38,290**	34,035	29,851	28,026	25,168
Transportation equipment	**2,595**	2,355	2,307	2,210	1,966
Construction in process	**4,262**	5,210	-	-	-
Property and equipment	**148,584**	137,848	125,820	122,256	109,798
Less accumulated depreciation	**(43,486)**	(38,304)	(32,964)	(28,531)	(24,408)
Property and equipment, net	**105,098**	99,544	92,856	93,725	85,390
Property under capital leases:					
Property under capital leases	**5,905**	5,669	5,341	5,736	5,392
Less accumulated amortization	**(3,125)**	(2,906)	(2,544)	(2,594)	(2,342)
Property under capital leases, net	**2,780**	2,763	2,797	3,142	3,050
Goodwill	**16,763**	16,126	15,260	15,879	13,759
Other assets and deferred charges	**4,129**	3,942	3,567	2,748	2,406
Total assets	**$180,663**	$170,407	$163,429	$163,514	$151,587
LIABILITIES AND EQUITY					
Current liabilities:					
Short-term borrowings	**$1,031**	$523	$1,506	$5,040	$2,570
Accounts payable	**33,557**	30,451	28,849	30,344	28,484
Accrued liabilities	**18,701**	18,734	18,112	15,725	14,675
Accrued income taxes	**157**	1,347	677	1,000	706
Long-term debt due within one year	**4,655**	4,050	5,848	5,913	5,428
Obligations under capital leases due within one year	**336**	346	315	316	285
Current liabilities of discontinued operations	**47**	92	83	140	-
Total current liabilities	**58,484**	55,543	55,390	58,478	52,148
Long-term debt	**40,692**	33,231	31,349	29,799	27,222

Table 4:
Wal-Mart Consolidated Balance Sheets, 2007-2011 As of January 31, (Amounts in millions except per share data)

	2011	2010	2009	2008	2007
Long-term obligations under capital leases	**3,150**	3,170	3,200	3,603	3,513
Deferred income taxes and other	**6,682**	5,508	6,014	5,087	4,971
Redeemable non-controlling interest	**408**	307	2,191	1,939	2,160
Commitments and contingencies					
Equity:					
Preferred stock ($0.10 par value; 100 shares authorized, none issued)	**-**	-	-	-	-
Common stock (*)	**352**	378	393	397	413
Capital in excess of par value	**3,577**	3,803	3,920	3,028	2,834
Retained earnings	**63,967**	66,357	63,650	57,319	55,818
Accumulated other comprehensive income (loss)	**646**	(70)	(2,688)	3,864	2,508
Total Wal-Mart shareholders' equity	**68,542**	70,468	65,285	64,608	61,573
Non-controlling interest	**2,705**	2,180	-	-	-
Total equity	**71,247**	72,648	65,285	64,608	61,573
Total liabilities and equity	**$180,663**	$170,407	$163,429	$163,514	$151,587

* $0.10 par value; 11,000 shares authorized, 3,973 and 4,131 issued and outstanding at January 31, 2008 and January 31, 2007, respectively.
* $0.10 par value; 11,000 shares authorized, 3,925 issued and outstanding at January 31, 2009.
* $0.10 par value; 11,000 shares authorized, 3,516 and 3,786 issued and outstanding at January 31, 2011 and January 31, 2010, respectively.
(Wal-Mart Annual Reports)

Table 5
Wal-Mart 2011 Financial Review (Five-Year Financial Summary)
(Dollar amounts in millions, except per share and unit count data) As Adjusted

As of and for the fiscal years ended January31,	**2011**	2010	2009	2008	2007
Operating Results(1)					
Net Sales	**$418,952**	$405,132	$401,087	$373,821	$344,759
Net Sales increase	**3.40%**	1.00%	7.30%	8.40%	11.60%
Comparable sales in the US (2)	**-0.60%**	-0.80%	3.50%	1.60%	2.00%
Wal-Mart U.S.	**-1.50%**	-0.70%	3.20%	1.00%	1.90%
Sam's Club	**3.90%**	-1.40%	4.90%	4.90%	2.50%
Gross Profit Margin	**24.70%**	24.90%	24.20%	24.00%	23.40%
Operating ,selling, general and Administrative expenses as % of net sales	**19.30%**	19.70%	19.30%	19.00%	18.50%
Operating income	**$25,542**	$24,002	$22,767	$21,916	$20,552
Income from continuing operations attributable to Wal-Mart	**15,355**	14,449	13,235	12,841	12,224
Net income per share of common stock:					
Diluted net income per common share from continuing operations attributable to Wal-Mart	**$4.18**	$3.73	$3.35	$3.15	$2.93
Dividends declared per common share	**1.21**	1.09	0.95	0.88	0.67

Table 5
Wal-Mart 2011 Financial Review (Five-Year Financial Summary)
(Dollar amounts in millions, except per share and unit count data) As Adjusted

As of and for the fiscal years ended January31,	**2011**	2010	2009	2008	2007
Financial Position					
Inventories	**$36,318**	$32,713	$34,013	$34,690	$33,235
Property, equipment and capital lease assets, net	**107,878**	102,307	95,653	96,867	88,287
Total assets	**180,663**	170,407	163,096	163,200	151,274
Long-term debt, including obligations under capital leases	**43,842**	36,401	34,549	33,402	30,735
Total Wal-Mart shareholders' equity	**68,542**	70,468	64,969	64,311	61,298
Unit Counts					
Wal-Mart U.S. segment	**3,804**	3,755	3,703	3,595	3,488
Wal-Mart International segment	**4,557**	4,099	3,595	3,093	2,733
Sam's Club segment	**609**	605	611	600	588
Total units	**8,970**	8,459	7,909	7,288	6,809

(1) Effective May 1, 2010, the Company implemented a new financial system for its operations in the United States, Canada and Puerto Rico. Concurrent with this implementation and the increased system capabilities, the Company changed the level at which it applied the retail method of accounting for inventory in these operations. The retrospective application of this accounting change affected both segment and consolidated operating income, as well as consolidated net income for all comparable periods presented.

See "Notes to Consolidated Financial Statements" Note 2: "Accounting Change".

In addition, Wal-Mart reclassified certain revenue and expense items within its consolidated statements of income for financial reporting purposes. The reclassification did not affect consolidated net income attributable to Wal-Mart. The changes were effective February 1, 2009, and were reflected for fiscal 2010, 2009, and 2008.

(2) Comparable store and club sales include fuel. Fiscal 2008 and fiscal 2007 comparable sales include all stores and clubs that have been open for at least the previous 12 months. Additionally, for those fiscal years, stores and clubs that are relocated, expanded, or converted are excluded from comparable sales for the first 12 months following the relocation, expansion, or conversion. Fiscal 2011, 2010 and 2009 comparable sales include sales from stores and clubs open for the previous 12 months, including remodels, relocations, and expansions. Fiscal 2008 and fiscal 2007 comparable store and club sales do not reflect reclassifications effective February 1, 2009, as noted above.

(Wal-Mart Annual Report, 2011b)

SALES RESULTS

As it released its 2011 Annual Report on April 18, 2011, Wal-Mart announced that its sales for fiscal 2011 totaled $421.8 billion (The Street, 2011). Wal-Mart U.S. net sales exceeded $260 billion and delivered strong operating income and expense advantage. Its operating income grew 3.1% to approximately $20 billion. Wal-Mart U.S. owned and operated more than 3,800 stores and over 617 million square feet of selling space in fiscal 2011 (Wal-Mart Stores, 2011b) (see Table 6 for sales comparison by segments).

Michael Duke, President, and Chief Executive Officer of the Wal-Mart Stores, Inc. charged, "We were simply not satisfied with the net sales results in Wal-Mart U.S. last year. The team is implementing an aggressive plan to reinforce our commitment to EDLP (Pricing strategy that promises consumers the lowest available price without coupon clipping) and to offer a broad merchandise assortment and presentation that's even more relevant to customers" (Wal-Mart

Stores, 2011a, n. p.). Michael Duke identified his top priority for the upcoming year, which was "to work with Bill Simon, CEO of Wal-Mart U.S., and his team to achieve positive comparable store sales (Wal-Mart Stores, 2011a). At the same time, there's a tremendous opportunity to grow in the United States through supercenters and new formats, such as Wal-Mart Express™, in urban and rural markets" (Wal-Mart Stores, 2011a, n. p.).

As indicated in Table 6, Wal-Mart consolidated net sales increased by 3.4% and 1.0% in fiscal 2011 and fiscal 2010, respectively, when compared to the previous fiscal year. Net sales in fiscal 2011 were a result of Wal-Mart's continued expansion activities. In fiscal 2011, it added 3.4% of additional retail square feet (Wal-Mart Stores, 2011b). In addition, foreign currency exchange rates played a favorable role in fiscal 2011 sales growth. It added an approximately $4.5 billion (Wal-Mart Stores, 2011b). In fiscal 2011, Wal-Mart had a 0.6% decline in total U.S. comparable store and club sales (Wal-Mart Stores, 2011b).

Table 6
Growth Net Sales 2007-2011 (Dollar amounts in millions) with Fiscal Years Ending January 31

	2011		2010		2009		2008		2007	
	Net Sales	**Percent of Total**	Net Sales	Percent of Total	Net Sales	Percent of Total	Net Sales	Percent of Total*	Net Sales*	Percent of Total
Wal-Mart U.S.	**$260,261**	**62.1%**	$259,919	64.2%	$256,970	64.0%	$238,915	63.9%	$226,294	65.6%
Wal-Mart Intl.	**109,232**	**26.1%**	97,407	24.0%	96,141	24.0%	90,570	24.2%	76,883	22.3%
Sam's Club	**49,459**	**11.8%**	47,806	11.8%	47,976	12.0%	44,336	11.9%	41,582	12.1%
Net Sales	**$418,952**	**100%**	$405,132	100%	$401,087	100%	$373,821	100%	$344,759	100%

* Authors noted minor figure differences when checked the various annual reports. These differences could be a result of a later financial reconciliation and or audit. Authors were not able to confirm.
(Wal-Mart 2011 and 2009 Annual Reports)

In fiscal 2010, the net sales increases resulted from increased customer traffic, continued global expansion activities, and the acquisition of the Chilean subsidiary-Distribucióny Servicio S.A. de C.V. ("D&S") in January 2009. Said net sales were offset primarily by a $9.8 billion unfavorable currency exchange rate that affected Wal-Mart's International segment and adversely affected by price deflation in certain merchandise categories in its U.S. segment (Wal-Mart Stores, 2011b).

As growth of its US division has slowed, Wal-Mart's sales were expanded abroad. Wal-Mart International continued to be a growth segment in 2011. It contributed to 26% of the overall total sales, generated a 12% net sales increase, and added approximately 8% net more selling space with the addition of 458 new units (Wal-Mart Stores, 2011b). On the other hand, Sam's Club contributed a little more than $49 billion that is 12% of the total company's net sales with a 3.5% increase over its 2010 net sales.

COMPARABLE STORE AND CLUB SALES

Wal-Mart used the comparable store and club sales as an indicator to measure the performance of its existing U.S. stores and clubs for the year relative to its previous. See Table 7 for the results of its comparable store and club sales, including fuel impact, for the fiscal years ended January 31, 2007 through 2011 (Wal-Mart Stores, 2011b).

As shown in Table 7, the total U.S. comparable store and club sales decreased during fiscal 2011. While its comparable sales was increased by 3.5% in fiscal 2009; its store and club sales in the U.S., including fuel, decreased 0.6% and 0.8% in fiscal 2011 and 2010 respectively (Wal-Mart Stores, 2011b). Wal-Mart explained the reason as "due to deflation in certain merchandise categories and lower fuel prices. As we continue to add new stores in the United States, we do so with an understanding that additional stores may take sales away from existing units" (Wal-Mart Stores, 2011b, p.17).

Table 7
Wal-Mart's Calendar Comparable Store and Club Sales (Fiscal Years Ended January 31)

	2011	2010	2009	2008	2007
Wal-Mart U.S. *	**-1.5%**	-0.7%	3.2%	1.0%	1.9%
Sam's Club**	**3.9%**	-1.4%	4.9%	4.9%	2.5%
Total U.S.	**-0.6%**	-0.8%	3.5%	1.6%	2.0%

* Comparable store sales is a measure which indicates the performance of Wal-Mart existing stores by measuring the growth in sales for such stores for a particular period over the corresponding period in the prior year.
**Sam's Club comparable club sales include fuel.
(Wal-Mart 2011 and 2009 Annual Reports)

Wal-Mart estimated the negative impact on comparable store sales because of opening new stores as approximately 0.8% in fiscal 2011, 0.6% in fiscal 2010, and 1.1% in fiscal 2009 (Wal-Mart Stores, 2011b).

THE COMPETITIVE LANDSCAPE

The retail industry has been defined as the composition of companies that sell merchandise to customers. Retail customers were known to drive the level of expected customer service as evidenced through their spending habits. A strategy employed by every retailer has been the ability to fulfill whatever service was demanded by the consumer. A prime example in today's economy was the fact that consumers shopped in retail stores that appealed to convenience and price sensitivity. The busy lifestyle of value conscious consumers was evidenced by the fact that they were spending less time in stores. Retailers became aware of this and realized that on-shelf availability of merchandise was critical to business success. These changes in consumer spending habits caused general merchandise stores such as Wal-Mart to become revenue leaders in the retail industry (Chiles & Dau, 2005). In addition, industry trends in the retail market tended to relate to the relative maturity of the industry. Primarily, a number of stores were constantly competing for attention from U.S. consumers. Secondly, because of a weak economy and demographic changes, consumer spending grew slowly.

Most significant was the fact that Americans were not as interested in shopping as they might have been in the previous 10 years. Finally, shoppers looked for value and migrated to those retailers that offered the best price/value options. Wal-Mart reinforced this movement via its everyday low price motto that consistently offered discounts. Based on its size Wal-Mart was able to gain tremendous power with manufacturers who provided the giant corporation discounts that allowed for continued low pricing (Asaeda, 2007).

In the retail market, Wal-Mart was deemed a powerhouse in and of itself. As the number-1 retailer in the world, the company employed 21.1 million associates in more than 8,970 stores. This included close to 700 discount stores, 3,290 Wal-Mart Supercenters in the U.S. and ASDA in the UK, and 610 Sam's Club warehouses. Wal-Mart's international division, which comprised 26% of its sales, experienced a fast growth pace. Wal-Mart readily surpassed Europe's Carrefour, Metro AG and Tesco combined. It was the number-1 retailer in Canada and Mexico and operated in Asia (owning 95% of the Japanese retailer SEIYU), Africa, Europe, and South America (Hoovers, 2011). Although Wal-Mart easily sustained its position as the number-1 retailer in the world, the state of its competition deserves analysis. Its top three competitors included the European company, Carrefour, the membership warehouse store, Costco, and the "chic" discount store, Target Corporation. Please refer to Table 8 for the 2010 Wal-Mart's Competitive Comparison with its top three Rivals.

CARREFOUR, S.A. (CARREFOUR)

Carrefour (French for "crossroads") is the world's second largest retailer behind Wal-Mart, and a distant second, as a competitor. Its operations included 15,600 stores under a number of banners that ranged from hypermarkets (Carrefour), supermarkets (Carrefour Market), convenience stores (City, Express), discount stores (Ed, Minipreco), to cash–and carry outlets (Promocash). Carrefour's retail stores were located in approximately 35 countries in Europe, Latin America, and Asia. Over 5,400 Carrefour stores were in France, accounting for 40% of its sales. In 2000, a $16.3 billion merger between Carrefour and Promodes, a food store that operated more than 6,000 markets, allowed it to gain its position as the number-1 European retailer (Hoover, 2011).

The numbers alone indicated that Carrefour was a distant competitor of Wal-Mart. When additional organizational features were compared, Wal-Mart's proven success motto to save people money so they can live better readily distinguished it from Carrefours's "smaller is better" philosophy in retail as well as its "greener" hypermarket model.

COSTCO WHOLESALE CORPORATION (COSTCO)

In the wholesale warehouse store market, Wal-Mart had serious competition from Costco Wholesale Corporation, the largest wholesale club operated in the United States. Costco consistently surpassed Wal-Mart's Sam's Club. Costco operated approximately 565 membership warehouse stores in about 40 states and Australia, Canada, Japan, Mexico, Puerto Rico, South Korea, Taiwan, and UK.

Costco warehouse stores provided discount pricing on about 4000 products that included the gamut of alcoholic beverages, fresh food, pharmaceuticals, appliances, and tires. Some membership options included services in addition to products, such as car and homeowners insurance, real estate and mortgage services, and travel agencies. Competition was intense, considering the fact that there were over 1200 warehouse clubs across North America. In FY 2009, Costco experienced its first sales decline, attributed to serious competition and the recession in the U.S. Similar to Sam's Club, in order to shop at Costco, a customer must purchase a membership. Costco ventured into groceries, and in 2009, food and sundries comprised more than 50% of its total sales. This made it the third largest grocery seller in the U.S., preceded by Wal-Mart and Kroger. Similar to Wal-Mart and Target, Costco planned to expand its e-commerce business, Costco.com (Hoovers, 2011).

Different from Wal-Mart, Costco's business model included a feature to sell a limited number of items. While a Costco warehouse would uncommonly and easily stock 4,000 different types of items, it would limit brand availability for example having only four brands of toothpaste. Wal-Mart, on the other hand, stocked more than 100,000 types of items, and had as many as 60 sizes and brands of toothpaste. By limiting the number of options, Costco could increase the sales volume of each item, which allowed it to obtain deeper bulk discounts from its suppliers. In the warehouse retailer market, Costco was number one in market share, which accounted for about half of the sales in the industry. Sam's Club was number two and accounted for close to 40% of the market (Cascio, 2006).

TARGET CORPORATION (TARGET)

Wal-Mart's competitor Target Corporation is the #2-discount chain in the US, with its moniker of cheap, yet chic. Target operated approximately 1,750 Target and SuperTarget®, (grocery-carrying) stores in 49 states, in addition to its online business, Target.com. Target was known for offering more fashionable merchandise than Wal-Mart or Kmart (Hoovers, 2011). Target had been a key performer in the retail sales market, but recently posted slower sales and earnings growth than expected. Some-store sales were down in 2009 (by -2.5%) and in 2008 (by -2.9%) (Hoovers, 2011). Target's stronghold in apparel, home furnishings, and décor, continually decreased since 2007. Merchandise that included electronics, entertainment, sporting goods and toy sales were deemed flat. However, sales of consumables and household essentials rose as concerned consumers continued to only purchase the basics. Target took advantage of the new frugality among its customers and copied from Wal-Mart when it opened new layouts that allocated more space to food, especially its house brands Archer Farms and Market Pantry. Target also started offering fresh produce in 2009, and challenged Wal-Mart more openly on price.

Historically, Target distinguished itself from Wal-Mart and other discounters by using exclusive private-label merchandise from big name designers. Target's highest profile collaboration was with Isaac Mizrahi, a fashion designer who was a stable part of its repertoire since 2003. Sales from Mizrahi's fashion line garnered close to $300 million each year for Target, giving credence to its cheap fashion label. The arrangement with Mizrahi ended in 2008 when he left Target and moved to Liz Claiborne. Target operated only in the US until the company recently revealed plans to enter Canada beginning in 2013 with over 100 stores. Target acquired leases to 220 Zellers stores and hired its chief marketing officer to oversee its Canadian operation. Target may have one less competitor in Canada due to the purchase of the Zeller leases, but will still have to deal with the large-scale force that is Wal-Mart (Hoovers, 2011).

Table 8
Wal-Mart's Competitive Comparison (Top Three Rivals)

2010	Wal-Mart Stores Inc.	Carrefour	Costco	Target
Sales Revenue	$408,214.0B	$121,273.0M	$77,946.0M	$65,357.0M
Gross Profit	103,557.0B	26,335.7M	9,951.0M	19,774.0M
Profit Margin	25.4%	21.7%	12.8%	30.3%
Inventories	33,160.0	9268.4	5638.0	7179.0
Total Assets	170,706.0	71,097.0	23,815.0	44,533.0

*The competitive retailers do not have the same fiscal year ending
(Hoovers, 2011)

WAL-MART GROWTH STRATEGIES

Corporate strategies can be the primary reason for the success or failure of an organization. Organizational strategy is the process that guides a corporation by providing direction for its goals and strategies of its functional components. If goals are thought of as a corporation's destinations, then strategies are the roadmaps to reach the destination. They provide focus for a company's decision-making (Stevenson, 2012).

Wal-Mart articulated a growth strategy accomplished through the company's new and different retail venues such as Wal-Mart Express, comprised of 30,000 square feet or less, with planned locations throughout metropolitan areas as well as in farming and rural communities (Wal-Mart Stores, 2011a). Wal-Mart's international segment experienced high growth in FY 2011 while it added 8% more selling space with the addition of 458 new units. It also realized a 12% net sales increase in 2011 and approximately 4.5 billion dollars. Sam's Club realized a

3.5% in sales growth in 2011 with a goal for 2012 to attract new members by offering a number of new and improved member services (Wal-Mart Stores, 2011a).

In its 2011 Annual Report, Wal-Mart CEO Duke shared his own thoughts as well as those of the executive board regarding the company's current and future business strategies. Duke indicated that his number one priority was to attain "positive comparable store sales." He communicated that the United States offered prospects for growth in alternative setups such as supercenters and Wal-Mart Express™ venues in metropolitan and rural areas alike (Wal-Mart Stores, 2011a). Duke elaborated on the position of the board with goals to make a major effort in the global market. He applauded Dough McMillon, CEO of Wal-Mart International and the profound growth of the company's international segment. Duke stated that a 12% net sales increase was realized during 2011 and the international segment added 458 units, which accounted for an 8% increase in selling space, with the expectation of continued improved future returns (Wal-Mart Stores, 2011a). CEO Duke shared his confidence with the results of Sam's Club, Wal-Mart's wholesale division and added that the top priority for Sam's Club was increasing membership numbers via enhanced experiences for members. Duke expounded on the status of Sam's Club and commented that it needed new ideas and an improved business model to stay competitive for all of its stakeholders (Wal-Mart Stores, 2011a).

No corporate strategy would be complete without consideration of the state of technology in the retail market, which included improved competencies of the everyday Wal-Mart customer. Wal-Mart's strategic considerations related to technology's impact on price transparency and its continued focus to ensure everyday low prices. Wal-Mart U.S. leveraged multi-channel innovations like Site-to-Store®, Pick-Up-Today, and Fed-Ex®, which provided shopping options for customers. Site to Store is a free service that lets customers ship an online order to any Wal-Mart store in the contiguous United States. It provides easy access to tens of thousands of items, many of which are not available in its stores (Wal-Mart Site to Store, 2013). Pick-Up-Today is another free service that allows customers to order store items online and pick them up at their Wal-Mart store that same day (or the next day if the order is placed after 6:00 p.m. local time) (Wal-Mart, Pick-Up-Today, 2013).

Wal-Mart also expanded its FedEx Site to Store service from Los Angeles and Boston to include additional locations in New York, San Francisco, Chicago and Washington D.C. The program lets customers purchase items that are usually only offered online, and have the items shipped free of charge to a FedEx Office location through its Site to Store service. This service gives customers who do not live near a Wal-Mart store access at a nearby FedEx location (Wal-Mart Stores, 2011a). Concerning technology, of utmost importance in its strategic issues was its web presence in a large number of the fifteen countries where Wal-Mart was expanding, but was not physically present. These strategic initiatives allowed Wal-Mart continued leveraging of its resources, maintenance of low costs, and ensured increased speed to its markets (Wal-Mart Stores, 2011a).

Included in Wal-Mart's strategic planning for Sam's Club was its goal to help members who shopped there make smart choices. Members indicated they wanted more offerings in produce, meat, and bakery, so Sam's Club added over 100 new fresh items with plans to add even more. Sam's Club also added services to its pharmacies that included free monthly health screenings in response to the growing importance of wellness among its members. Finally, contemporary and exciting brands were added in important categories such as jewelry, technology, and entertainment. Technological innovations inside of Sam's Club warehouses included free wireless networks and the ability for Plus Members to access personalized eValues through kiosks. A smart phone application or online access was also available to Plus Members markets (Wal-Mart Stores, 2011a).

Shortly before Duke became the new CEO, Wal-Mart announced a new plan – Project Impact - designed to give its stores a fresh look and make them better places to shop. Stores were freshened up with a cleaner and brighter look, along with a new slogan, "Save money. Live Better." One of Project Impact's goals was to reduce the number of items sold in stores in an effort to reduce clutter. However, the idea backfired because customers bought fewer products. Later, after Duke assumed the role of CEO, he discovered downed sales and acted very quickly to remedy the condition. Initially, Duke brought back a number of dropped items and further revised the Project Impact process (O'Keefe, 2010).

CEO Duke also focused on building an updated and newer Wal-Mart generation in order to re-energize U.S. business. This strategy required the company to move forward on social issues that have hovered over it for years, to recruit and develop new leaders to implement Dukes' vision, and to rebuild Wal-Mart's success in the U.S. in growing markets such as China and India. In order for Wal-Mart to meet the expectations set by Wall Street over the next five years, it must increase its profits by an overwhelming \$3.68 billion. A comparison of Fortune 500 companies clarified this by explaining that this is greater than 463 of the companies on the 2010 list. Sales were expected to top half a trillion dollars. What this meant for Wal-Mart was a plan for huge expansion in overseas markets such as China, India, and Brazil, as well as a new cadre of store managers and executives. CEO Duke reflected on this growth, yet determined that in the past company's executives could simply turn to Sam Walton for leadership. However, because of the enormity of Wal-Mart global operations, turning to just one leader is no longer adequate. Indeed, Duke validated that the company needed "hundreds of Sam Walton's, many of them in China, Brazil, and other countries around the world" (O'Keefe, 2010, para. 38).

The continued impressive gains in its business were attributed to Wal-Mart's use and refinement of basic skills in purchasing, customer service, and logistics, which surpassed its competition. The primary reason for such an outcome was based on Wal-Mart's focus on purchasing abilities and use of buying power to outdo terms negotiated by its competitors. Some analysts regarded Wal-Mart's purchasing practices as being too tough on manufacturers. Others viewed it as an example of the company's ability as a leader in its predictable goal to make the economy more efficient. Michael J. Silverstein, a senior vice president at the Boston Consulting

Group observed that although Wal-Mart was tough in its negotiations with its suppliers, it was nevertheless truthful and straightforward during the process. This process pushed manufacturers all over the world to enter into valid international competition (Lohr, 2003). In addition, Wal-Mart's logistics were stronger and more efficient than those of other large companies were. Indications of the strength of Wal-Mart's logistics were based on a sophisticated distribution system with 14 computerized facilities and a large fleet of over 6,500 trucks (Shaw, Schneier, Beatty, & Baird, 1995). As far back as 1989, then CEO Glass noted that Wal-Mart's distribution system was one of the critical elements of its success (Huey, Smith, & Morrow, 1989).

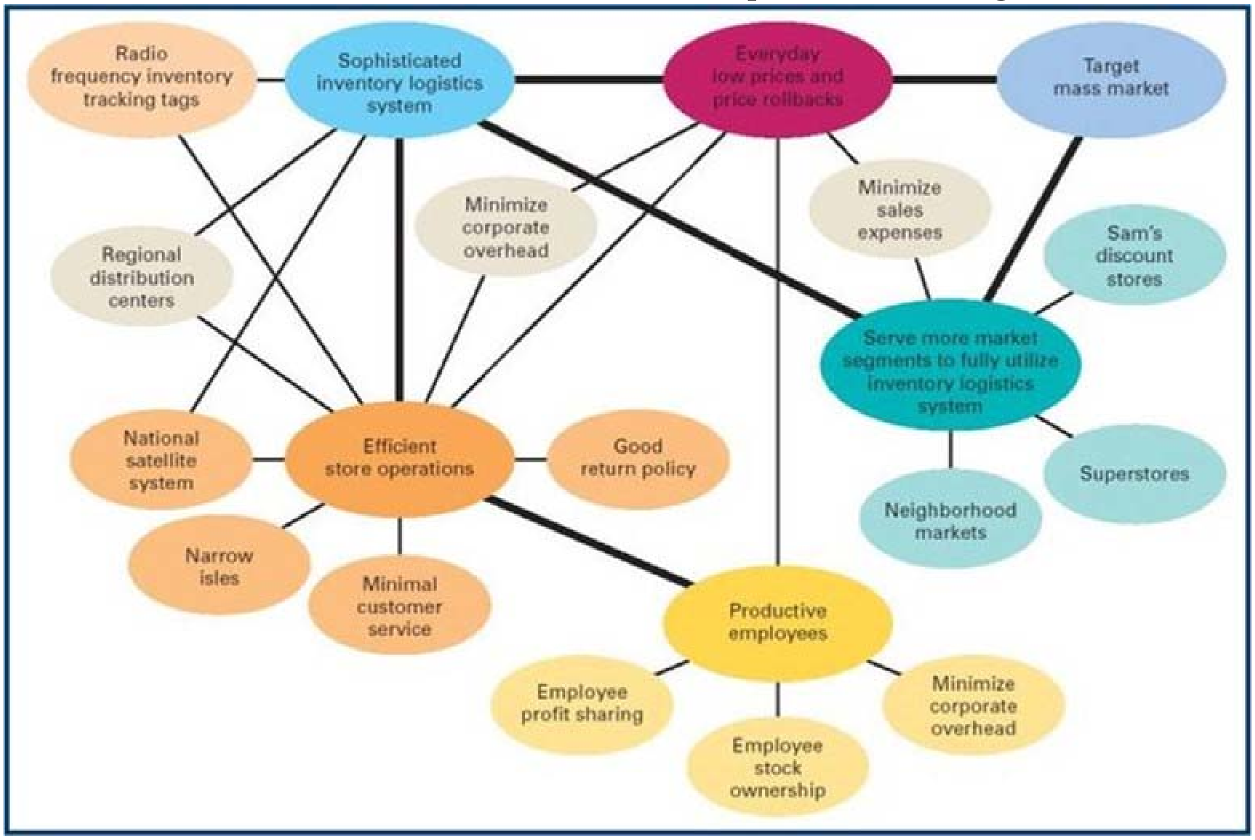
The massiveness of Wal-Mart's operation coupled with a very efficient distribution system allowed it to continuously have a price advantage over its competitors. Because Wal-Mart purchased large volumes of goods, it put itself in a position to demand the best price and terms from its suppliers. It had a very advanced distribution system that allowed it to move merchandise from a warehouse through its checkout line more efficiently than any other retailer in the world did. Wal-Mart's goal was to be the price leader in all markets, and it was able to meet this goal through huge sales volumes, a full-proof distribution system, and the best terms from suppliers. Since 1988, Wal-Mart's expansion included Supercenters that provided a large selection of groceries. Grocery sales per supercenter placed those at Wal-Mart close to twice the sales volume of Super Targets. When the supercenters were first opened, Wal-Mart sold limited quantities of groceries and grew to hold the position of the largest grocery retailer in the U.S.

Chain management with many divisions such as Wal-Mart required efficiency in management and strategic decision-making. Such aspects of efficiency were needed to streamline operation, indeed crucial more so to the megatropolistore than it would be for any other large retailer (Mortizt, 2005). Existing as a megatropolistore required planning and execution of innovative initiatives.

BUSINESS MODEL

While Figure 1 suggests a number of strategic yet specific choices, in reality this model represents thousands of calculated and tactical decisions, which have resulted in retaining a low-price business model. To create and sustain a low-cost structure, a number of strategies continued to serve the needs of the organizational and to generate cost leadership and differentiation.

Figure1
Walmart's Business Model and Competitive Positioning



Source: Hill, C.W. & Jones, GR (2010: 152). Reproduced by permission from Cengage.com

First, locating stores, regardless of size, in townships where few to no low-cost competitors operated ushered Wal-Mart into choice locations. Next, by reducing delivery costs through supply chain management and managing product development, Wal-Mart systematically reduced costs to customers. Finally, through performance management, Wal-Mart tasked managers at all levels including customer service, sales, flow, logistics, and materials management to implement cross-functional efficiencies to sustain a low cost/price profile. Wal-Mart's strategic decision-making was specifically geared to a low-cost structure. Table 9 suggests Sam Walton's multi-level strategies have anchored and sustained the company's competitive positioning. The basic formula of buying manufactured goods as inexpensively as possible has differentiated this retailer from its competitors. Such a competitive advantage resulted in serving the needs of customers in different segments.

However, not by low pricing alone has this model been successful. A product's attributes targeted to a mass market satisfied wants, desires, cravings, and especially customer's needs. Being responsive to customer groups and market segmentation allowed Wal-Mart to meet and satisfy customer needs at many levels including some niche markets. Given that customers choose merchandise based on price as well as how certain products differentiate from others, Wal-Mart was able to satisfy customers' needs. Thus, profitability is maximized when value is created by differentiating costs and pricing.

Wal-Mart's distinctive competencies are decisive because the goal is to evaluate "who" the customer is and "how" each will be satisfied. Competing for customers is fierce in any retail market. As such, Wal-Mart's task was to ensure optimization of its position against its rivals. If, as Sam Walton believed lower costs equate to lower prices, then taking decisive action to compete for customers is both logistic and efficient. Thus, a recurrent focus on innovative and operational efficiencies developed into a systematic cost reduction methodology. Taking nothing else into account, Wal-Mart's rivals cannot compete at the same level.

GROWTH CHALLENGES

Growth challenges at Wal-Mart were exponential, not to mention other challenges relating to social, logistics, and legal issues that permeated an organization of its size and complexity. The growth of a business of the enormity of Wal-Mart, which included over 8500 stores and 2.1 million employees, could be incomprehensible to many.

In its 2011 shareholder meeting, CEO Mike Duke announced that comparable store sales growth was the number one growth priority for Wal-Mart's three operating divisions. This was in addition to new store growth through disciplined, yet productive, capital spending. The company forecasted sales growth between 5% and 7% for fiscal year 2013. Duke explained, "We continue to prioritize growth, leverage, and returns in our commitment to increase shareholder value" (Business Wire, 2011a, para. 4). It is important to keep in mind that Wal-Mart's business model was built on a promise that customers can rely on the company to provide low prices every day leading to customer loyalty and higher sales.

For fiscal year 2013, Wal-Mart U.S. planned to build new stores and remodel older stores, with a goal to add between 210 and 235 new units expanding retail space by approximately 14 to 15 million square feet. The predicted increase in Wal-Mart U.S. square footage from FY12 to FY13 was the result of a larger percentage of new supercenters compared to prior years, as well as growth in the number of medium and small format stores. Supercenters provided one stop shopping for customers and allowed for large returns. They continued to be the primary growth vehicle for Wal-Mart U.S. and the company pointed out a large number of potential Neighborhood Market opportunities with plans to open between 80 and 100 medium to small formats next year. In addition to comparable store sales growth and the addition of new stores, Wal-Mart continued to study the success of the Express store format, with plans to open six additional stores in FY 2013. During the next year, Wal-Mart planned to build more square footage, but for less money. The company announced its plans to decrease U.S. construction costs by 10% while gaining advantage on cost of remodeling. New stores, without any impact from acquisitions, are expected to account for between 26 and 28 million square feet next year as compared to an additional 24 to 25 million square feet projected for this year (Business Wire, 2011b).

In respect to its international growth, Wal-Mart's priorities included continued investment in China, Brazil, and Mexico. The company focused on driving growth and improving its overall returns. Wal-Mart's new stores anticipate growth of between 26 and 28 million square feet next year as compared to an additional 24 to 25 million square feet projected for the past year (Business Wire, 2011b). Finally, Sam's Club expects to add between 10 and 15 new, expanded, or relocated clubs within the U.S. during the next year, with about half of its capital dedicated to remodeling (Business Wire, 2011b).

Wal-Mart's growth plans are laudable, but the question becomes can Wal-Mart continue to grow at this rate? Is the goal for comparable store sales growth in addition to plans to add more supercenters, more Sam's Clubs, and additional square footage in its international sector a recipe for success?

APPENDIX A: WAL-MART HISTORICAL TIMELINE

Decade	Event
1940s	1945 ~ with experience working at J C Penney, Walton operated variety stores in Newport, AK.
1950s	1951 ~ Sam opened Walton's 5&10 in Bentonville, AK with the belief "that the shopkeeper's success is entirely up to . . . the customer." Walton cemented his success with a formula to insure low prices every day. Walton developed a business model that resulted in 15 stores by 1962.
1960s	1962 ~ Sam Walton opened first discount store Rogers, AK 1968 ~ Opened stores outside of Arkansas in Missouri and Oklahoma 1969 ~ the Wal-Mart Stores were incorporated giving the organization the protection of a legal corporation.
1970s	1971 ~ operated in five states (Arkansas, Kansas, Louisiana, Missouri, & Oklahoma) 1972 ~ listed on New York stock Exchange as (NYSE: WMT) 1973 ~ opened stores in Tennessee 1974 ~ opened stores in Kentucky and Mississippi 1975 ~ 7,500 associates across 125 stores (sales at $340.3 million) ~ acquired Mohr-Value stores and opened in Michigan and Illinois ~ After a visit to Korea to improve importing partnerships, associates introduced to the now famous Wal-Mart Cheer (an energetic and teambuilding practice that has been copied or adopted by many other team based retailers) 1977 ~ acquired Hutcheson Shoe Company; introduced automotive, jewelry, and pharmacy division 1979 ~ opened in Alabama for total of 276 stores and 21,000 associates (sales at $1.248 billion)

1980s	1980-88 ~ opened distribution center in Palestine, TX and stores across the south 1987 ~ contracted and installed the Wal-Mart Satellite Network (the largest and private communication system in the U.S.) 1988 ~ bar-code scanning available at 99% of stores ~ Acquired Supersaver, Inc. and opened first supercenter in Washington, MO. ~ opened in east coast states for a total of 1,198 stores and 200,000 associates (sales at $15.9 billion)
1990s	1991 ~ opened stores across eastern seaboard and entered the international market in Mexico City 1992 ~ Sam Walton, age 74 passes away; expanded store openings into northwest and Puerto Rico 1993 ~ international division established with separate presidential leadership ~ acquired Pace Warehouse Clubs and entered the wholesale market. ~ opened stores in Rhode Island, Washington, Alaska, and Hawaii in 49 states 1994 ~ acquired Woolco stores in Canada and opened stores in Hong Kong and additional stores in Mexico 1995 ~ Bud Walton passes away; expanded into all 50 states with store openings in Vermont; International openings in Argentina and Brazil total of 948 stores, supercenters, and wholesale clubs in U.S. and internationally; with 675,000 associates (sales at $93.96 billion) 1996 ~ enters the China market through partnership agreement 1999 ~ acquired Interspar stores in Germany and joint ventures in Korea for a total of 1,140,000 associates (sales at $105 billion)
2000s	2005 ~ with stores on several continents serving 138 million customers per week for a total of 6,200 units, 1.6 million associates, and sales at $312.4 billion 2006 ~ acquires partial ownership of retailer Seiyu in Japan. ~ charitable contributions of more than $415 million to 100,000 nonprofits worldwide 2007 ~ joint venture with Bharti a chain management operation in India and opened stores in Brazil for a total of 3,000 units in the International division 2008 ~ Sam's Club celebrates 25 years with 590 units in U.S. and 100 internationally 2011 ~ Nationwide and internationally 9,667 stores and sales at $419 billion (not including Membership) (Business Wire, 2011b)

Wal-Mart Corporate History Timeline (Wal-Mart, 2011a)

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ANDREW MASON & GROUPON, INC.

Todd A. Finkle, Gonzaga University

CASE DESCRIPTION

This case examines the life Andrew Mason and the company he co-founded, Groupon, Inc. It has a difficulty level two. It is appropriate for undergraduate entrepreneurship and small business students. The case can be taught in a 75 minute course period. The case preparation time is approximately two hours. The case focuses on entrepreneurship and the problems facing Andrew Mason and Groupon in 2012.

CASE SYNOPSIS

This case takes place in late 2012 and examines Andrew Mason, the co-founder of Groupon, Inc. and his journey to build his company. Mason was just reelected by the Board of Directors to remain as CEO of the company despite the stock price being down approximately 80% from its IPO in 2011. Groupon was once the fastest growing company ever. Now, Mason he had to figure out how to turn the company around.

INTRODUCTION

On November 29, 2012, Andrew Mason just got approved by the Board of Directors of Groupon, Inc. to remain the CEO of the company despite its poor performance. Since Groupon went public in November, 2011 at $20 a share, its shares were down nearly 80%.

Investors lost faith in the five-year-old Internet company once touted for transforming local business advertising by marketing Internet discounts on everything from spa treatments to dining. Analysts questioned whether Mason had enough business experience to run a fast growth company with thousands of employees across the globe. Europe had been a particular problem as its debt crisis sapped demand for higher-priced deals and merchants balked at the steep discounts Groupon offered there. Groupon and rivals in the daily deals business, like Amazon.com-backed LivingSocial, have been forced to revamp their business models as daily-deal fever waned. Groupon had lost money in the third quarter of 2012. LivingSocial, Groupon's biggest competitor, cut almost 10 percent of its staff this week (Barr, 2012).

As Mason walked along the waterfront in Chicago, he pondered what direction the company should take. At one time, Groupon had an offer from Google to be purchased for $6 billion however the company passed on the deal. Now the company was struggling to survive.

Mason had to figure out what strategic direction the company should take in order to survive and grow in the future.

ANDREW MASON & GROUPON, INC.

Andrew Mason, who recently turned 31 years old, was the co-founder of the internet company Groupon. Mason had a casual style and was a very humble person. He had a great deal of creative energy, was stubborn, and looked at problems in different ways. Mason started showing signs of being an entrepreneur at a young age. Born in Pittsburgh, he painted house numbers on curbs and bought candy at retail stores to resell to classmates in the lunchroom as a kid (Briggs, 2010). Mason started a Saturday morning bagel delivery service when he was 15 years old (Coburn, 2010). He coined his small business with the name Bagel Express and served many local houses and businesses in his childhood town of Mount Lebanon, a suburb of Pittsburgh, Pennsylvania. Mason later made money in high school repairing computers. After high school Mason moved to Illinois to attend Northwestern University where he graduated with a degree in music in 2003 (Coburn, 2010). Mason claimed that not only did being a music graduate from Northwestern benefit him but also being in a rock band undoubtedly helped him to achieve success. According to Mason, "Being in a band makes you learn how to disagree with people and hold onto a kind of uncompromising belief. You have to stick to doing what you believe is right. I think that is probably core to the culture of this company" (Cutler, 2010).

Prior to Groupon, Mason worked in web design at several Chicago-based startups. He assisted in the start-up and promotion of a number of online businesses in the late 90's and early 2000's. He worked for venture capitalist and serial entrepreneur Eric Lefkofsky, who co-founded the start-up, Starbelly.com, which was sold to a company for $240 million right before the dot-com bust of January 2000.

Mason returned to school in 2006 to work on a degree from the University of Chicago's Harris School of Public Policy. While on scholarship there, he began to experience problems with his cell phone provider. He started to brainstorm for an idea for a website devoted to promoting change based on a large number of participants desiring the same thing. Mason was offered $1 million to fund the implementation of his idea by Lefkofsky (Coburn, 2010). He immediately dropped out of school to pursue this idea and started developing what would become ThePoint. ThePoint was a web platform that allowed anyone to write a campaign exhorting others either to do something (stage a demonstration) or give money to a cause (make Election Day a national holiday) (Coburn, 2010).

Due to a lack of profitability, Mason ended up innovating ThePoint. Mason noticed that the site's most popular campaigns involved group buying so he decided to create a sub-business on the site dedicated to this concept. This was the beginning of Groupon, which launched its first offer – a two-for-one pizza deal – on October 22, 2008. Twenty-four Chicago residents bought the deal, and Groupon was off and running. After six months of operating solely in Chicago, it expanded to Boston, New York, Toronto and Washington, D.C. (Etter, 2011).

Groupon's foremost objective was to provide its members a website that allowed them collective buying power or "power in numbers". Groupon was a service that offered consumers select discounts to local businesses, categorized by city. According to Mason's 2010 interview with Charlie Rose, each discount, presented in the form of a coupon purchased from Groupon, "offered a big discount of 50% or more" for items from these local businesses (Mason, 2010). Participating businesses can be anything from spas to movie theaters, restaurants to art studios, and virtually anything in between. However, in order for consumers to obtain coupons for these businesses, Groupon required a minimum number of people to purchase the coupons; hence the term collective buying power. Collective buying power also benefited these local businesses as well. By establishing a minimum performance level, these businesses could guarantee that enough customers would purchase their coupons in order for their side of the deal to be worth their time, money, and effort. In doing this, Mason was able to make the claim that through Groupon, "for the first time, local businesses got performance based marketing. They only paid when these customers walked in the door. We got them in the door then it was up to them to give them an amazing experience." (Mason, 2010)

By the end of 2009, after only 14 months, Groupon had 1.8 million subscribers (Groupon, 2011). In 2010, the company expanded into several new cities each month in addition to international expansion. It received and rejected multi-billion dollar offers from both Yahoo! and Google in late 2010 (Harris, 2010) and closed the year with 50.5 million subscribers (Groupon, 2011).

Groupon's growth has continued at a torrid pace into 2011; the company had more than doubled its subscriber count in the first half of 2011, reporting 115.7 million subscribers as of June 30, 2011. In the two and a half years from January 1, 2009 to June 30, 2011, over 23 million different customers purchased a Groupon and over half have purchased more than one. In 2011, the company went public at $20/share making the company worth $30 billion. By 2012, the company reported that it had 11,471 employees with sales of 1.6 Billion.

INDUSTRY

Groupon competed in the discount group buying service industry, or the "social group buying" industry that was characterized by "daily deals." This was an emerging industry that Groupon single-handedly brought back into the limelight after it had all but died online by early 2001. Groupon had some group buying coupon competitors/Groupon clones that generated excellent traffic at times but not necessarily revenue or profit like Groupon did. Their biggest competitor was LivingSocial of which Amazon.com was an investor. LivingSocial had a market value of $3 billion as of 2011. Other competitors included YouSwoop, Scoop St., BuyWithMe, Tippr, Gilt Groupe and DailyCandy, all of which offer daily local deals. Google has been building and beta-testing a Groupon clone called Google Offers, something they began after Groupon rejected their offer to purchase the company.

GROUPON'S STRATEGIES

Groupon employed a multi-country, multi-regional strategy that tended to focus on getting people to buy into currently popular or potentially popular products/services from vendors in their urban area and online merchants. Groupon formed many temporary alliances with businesses in order to gain access to offerings for its own members and thus bring in revenue worth up to 50% of the deal purchase price. These businesses may be thought of collectively as Groupon partners and were vital for the continuation and success of Groupon's business. Groupon also had its vendors/partners sign a year-long contract that locked them into getting placement with Groupon and no one else during that time. Groupon also had a highly efficient and very active sales team that tended to stay ahead of Groupon's competitors and worked hard to get quality deals for Groupon members.

Groupon employed largely the same strategies throughout its very short life which included: broad market penetration; clever, interesting, e-mails that promoted each Groupon; simple, core technology that focused on delivering e-mails that contained Groupon pitches and processed transactions quickly for deals that reached the tipping point; encouraged word-of-mouth and paid referrals (in Groupon dollars) while simultaneously engaged in mass marketing/advertising to bring in new members (especially for newer markets overseas); maintained affordability of all deals offered by Groupon (price sensitivity), and possessed a large, growing group of talented staff who acted as salespeople, writers, and brokers for Groupon.

To diversify its product base, Groupon launched Groupon Goods in 2011 as a forum to sell discounted products. Groupon Goods had a diverse product mix. The offering was a quick success as Groupon sold $2 million worth of goods in its first week. Goods surpassed $200 million in revenue during the second quarter of 2012 and the marketplace is expected to sell between $600 million and $800 million worth of goods this year (Stambor, 2012). That would place Groupon among the largest North American online retailers. For the sake of comparison, Saks Direct is No. 38 in the *Internet Retailer Top 500 Guide* with Internet Retailer-estimated 2011 online sales of $748.6 million and Abercrombie & Fitch is No. 45 with online sales of $552.6 million (Stambor, 2012).

GROUPON IN 2012

The average Groupon user was a single female between the ages of 18 and 34. More than half of them had college degrees, and two-thirds of them made between $50,000 and $100,000 (Coburn, 2011). Although there were many critics of Groupon, there were also an abundance of success stories. Wendella Boats, located on the Chicago River, was one of those success stories. They sold 19,850 coupons for their Chicago River architectural boat tour for $12 a ticket when the tour was normally $25. The director of operations for the company mentioned that the deal with Groupon significantly helped the company's cash flow due to receiving their cut of the deal up front. Other success stories included: 9,258 Groupons sold for $5 in pizza that was worth $10,719; Groupons sold for $185 in teeth whitening services that was worth $600; and 1,269 Groupons sold for $50 at a denim boutique that was worth $125.

The managing editor of the website Bundle, provided a critical look of Groupon based on her website's findings. The website dealt with tracking consumers and their relationship with money. She called it the "cult of Groupon," in which those that subscribed to Groupon's daily deals were addicted to the daily hit and sometimes people wound up buying coupons that seemed attractive due to the savings but were not really needed. A similar issue dealt with customer loyalty. Businesses used Groupon in an attempt to expand their customer base. For example, restaurants wanted users of Groupons to turn into regular diners. However, Groupon's customer base oftentimes was merely seeking the best deal, only to move on to the next best deal. Also, due to the nature of Groupon, some restaurants became overwhelmed by the coupon diners which led to an overall loss on the deal. This was especially problematic for restaurants when coupon users were basing their tips for meals on the discounted price of the meal. Groupon has since addressed this issue and reminded its customers to tip the restaurants based on the menu price.

One other major concern with Groupon was its lack of profitability. They have been caught using questionable accounting methods which have consequently made the corporation look better off than it actually was. Another concern for investors stemmed from when Groupon initially filed papers. Founders and early employees sold a huge amount of stock instead of holding on to it. This could be a bad indication that the company has already reached its peak.
The average Groupon subscriber spent $18 in the first half of 2011 compared with $21 in the first half of 2010 (McNaughton, 2011). There was also a possibility that the competition was affecting margins. There were lots of companies trying to compete in the same market such as DealSwarm, DealOn, DealFind, GoDailyDeals, YourBestDeals, etc.

It was well documented that Groupon required strategic partners to offer a minimum 50 percent off the deal they came to terms with. In addition, Groupon's take (the amount of revenue it kept on each Groupon it sells) was at 41 percent as of the first 9 months of 2011 which was down slightly from 43% in 2009. That margin was being squeezed further in 2012. Essentially what this means for the merchants that are dealing with Groupon is that they must be willing to sell their product or service at a price that is 25 percent of the listed price (*Forbes*, 2012). This posed a threat for Groupon because there was a chance that other companies could find ways to take a percentage that was less than Groupon's which would be more attractive in the eyes of the merchant because they would be able to keep more money in their own pockets.

An additional threat is that merchants got fed up with sites like Groupon and refused to use them. In one instance, "Ms. Bengel of Wellpath said, "Every day, we get an e-mail or phone call saying, Can we match someone else's price? We're not Wal-Mart" (Streitfeld, 2011). A study by researchers at Harvard and Boston University also discovered that the long-term reputation of the merchant may be at risk. The researchers in the study found that fans of daily deals were on average hard to please. What does that mean exactly? Well, "after they ate at the restaurant or visited the spa, they went on Yelp and grumbled about it. This pulled down the average Yelp rating by as much as half a point" (Streitfeld, 2011). Since this audience is so critical of the merchant, it in turn puts the merchant's reputation at risk when offering a Groupon.

Despite these issues in 2012, Groupon still maintained 50% to 55% of the industry's market share followed by LivingSocial with 20% to 25% (Pepitone, 2012).

GROUPON'S PROBLEMS IN 2012

One critical problem facing Groupon was the ease of replication in regards to their business model. Groupon had to ensure that it remained attractive and profitable for all of its partner businesses that it worked with to bring deals to the consumer. Groupon faced many threats from foreign markets where they had limited or no experience (e.g., Australia, India, Japan, and elsewhere). Groupon was then pressured into either expending more resources to gain a foothold in those markets or perhaps paying top dollar to acquire a first-mover advantage.

Groupon's biggest future competitor will be Google Offers. However, Google has yet to establish themselves in any meaningful markets the way both Groupon and LivingSocial have done. This puts Google Offers to a lower tier until they can prove themselves in this new business.

Another problem with Groupon was that the merchants that they were doing business with were failing to get any brand loyalty which was what many of them were hoping to accomplish with the Internet coupon site. Instead, coupon users were drawn to the company for the one time and once they used their coupon say for a day at the spa, they just looked for a deal at a spa somewhere else (Streitfeld, 2011). The reason behind this inevitable disappointment with retailers was that customers on the site realized that they would never have to pay full price again. On the other hand, merchants were told that these coupon deals would lead to new customers that would stick around and pay full price (Streitfeld, 2011).

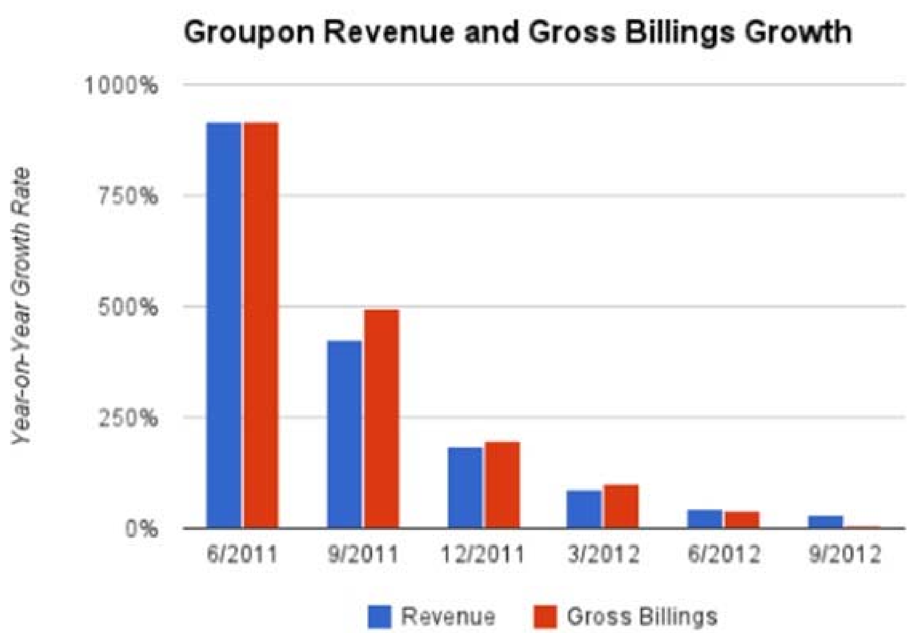
Furthermore, the co-founder of Bloomspot, Jasper Malcolmson, compared the deal offers with merchants to that of marketing subprime loans during the housing boom that led to the economic recession. According to the co-founder, "They were giving these mortgages to every consumer regardless of whether he could handle it. But sooner or later you find that you can't make great offers to people if they're not making you money" (Streitfeld, 2011). This led Bloomspot to change its main focus to merchant profitability.

In addition to the problem of brand loyalty, coupon fatigue seemed to be setting in. With the revenue generating model that Groupon created, countless other companies entered the market in hopes of creating some of their own revenue. Copycat sites by the name of DoubleTakeDeals, YourBestDeals, DealFind, DoodleDeals, DealOn, DealSwarm, and GoDailyDeals exist among hundreds of others. In fact, according to LocalDealSites.com, there were 40 active coupon sites solely in New York City (Streitfeld, 2011). The strange thing is 80 percent of subscribers to the website's daily e-mails have never actually bought a deal. Realizing this as a huge problem, Groupon made attempts to increase purchases by offering $10 off the first coupon bought. This number has since increased to $15.

As mentioned earlier, another problem for them was that although they may be growing in terms of number of subscribers, the actual percentage of those subscribers that were actually making a purchase was low. In many ways it meant that the huge sums of money that were spent on marketing Groupon paid off, but the company was failing when it came to getting the customer active with their service. The spending by subscribers was also low which presented an opportunity for Groupon. The dollars spent by customers needed to increase if Groupon expected to make a profit.

Groupon also had financial problems. The company lost about $3 million in the third quarter of 2012. In the beginning of 2011, Groupon's gross billings of $668 million were growing by over *1,400* percent year over year; but in the third quarter of 2012, the $1.2 billion in billings represented a mere 5 percent annual increase. In that same time period, the number of customers who had purchased a Groupon in the previous year rose from 15.4 million to just under 40 million. But the gross billing per customer had fallen by just under 12 percent, from $169 to $149. The year-on-year growth rate of the company's quarterly revenues slumped from 1,358 percent in early to 2011 to 33 percent in the third quarter (Zeitlin, 2012).

Exhibit 1 Groupon Revenue and Gross Billings Growth



Furthermore, Groupon's marketing expenses were going up. As a result, the company laid off 954 workers in the third quarter.

Exhibit 2- Groupon Inc. Income Statement

In Millions of USD (except for per share items)	3 months ending 2012-09-30	3 months ending 2012-06-30	3 months ending 2012-03-31	3 months ending 2011-12-31	3 months ending 2011-09-30
Revenue	568.55	568.34	559.28	492.16	430.16
Other Revenue, Total	-	-	-	-	-
Total Revenue	568.55	568.34	559.28	492.16	430.16
Cost of Revenue, Total	181.79	135.18	119.50	96.27	68.05
Gross Profit	386.77	433.15	439.79	395.90	362.12
Selling/General/Admin. Expenses, Total	358.90	388.30	400.20	410.62	367.15
Research & Development	-	-	-	-	-
Depreciation/Amortization	-	-	-	-	-
Interest Expense(Income) - Net Operating	-	-	-	-	-
Unusual Expense (Income)	2.43	-1.64	-0.05	0.26	-4.79
Other Operating Expenses, Total	-	-	-	-	-
Total Operating Expense	543.11	521.85	519.64	507.14	430.40
Operating Income	25.44	46.48	39.64	-14.97	-0.24
Interest Income(Expense), Net Non-Operating	-	-	-	-	-
Gain (Loss) on Sale of Assets	-	-	-	-	-
Other, Net	-	-	-	-	-
Income Before Tax	25.92	100.42	30.97	-25.48	-3.18
Income After Tax	-0.94	33.55	-3.59	-59.68	-14.42

Source: *Google Finance - Groupon Inc. Financials.* Retrieved December 3, 2012 from: http://www.google.com/finance?q=NASDAQ:GRPN&fstype=ii#

David Reibstein, a marketing professor at the Wharton School at University of Pennsylvania, argued that the business would eventually suffer because merchants would realize that the coupons were not a great deal. Reibstein argued that Groupon's customers were likely "price-sensitive," meaning they searched for the best deal they could find. This meant that they were not likely to turn into repeat customers. So the merchants offered a deal, sometimes at a loss, but then got little future business (Zeitlin, 2012). Moreover, companies could alienate current customers by offering coupons. For example, take a woman who had paid full price for a spa treatment and then she saw someone come in at half price off. She would feel insulted, or ripped off. Reibstein stated, "Nothing irritated people more than finding that they were paying a premium over what other people were paying. Even those customers who were perfectly willing to pay the full price for a spa treatment could get a Groupon instead, making the spa take a loss on a customer who was willing to pay full freight. The last group you want to offer coupons to are your existing customers" (Zeitlin, 2012).

Exhibit 3- Groupon Inc. Balance Sheet

In Millions of USD (except for per share items)	As of 2012-09-30	As of 2012-06-30	As of 2012-03-31	As of 2011-12-31	As of 2011-09-30
Cash & Equivalents	1,201.01	1,185.80	1,160.99	1,122.93	243.94
Short Term Investments	-	-	-	-	-
Cash and Short Term Investments	1,201.01	1,185.80	1,160.99	1,122.93	243.94
Accounts Receivable - Trade, Net	110.06	98.67	122.64	108.75	109.85
Receivables - Other	-	-	-	-	-
Total Receivables, Net	110.06	98.67	122.64	108.75	109.85
Total Inventory	-	-	-	-	-
Prepaid Expenses	121.34	116.14	101.28	91.64	103.86
Other Current Assets, Total	-	-	-	-	8.00
Total Current Assets	1,432.41	1,400.61	1,384.91	1,323.33	465.64
Property/Plant/Equipment, Total - Gross	141.44	111.44	80.88	66.43	51.78
Accumulated Depreciation, Total	-37.56	-28.15	-21.17	-14.63	-10.41
Goodwill, Net	196.98	192.02	185.34	166.90	169.15
Intangibles, Net	51.45	54.30	56.84	45.67	50.14
Long Term Investments	131.04	131.18	48.48	50.60	45.19
Other Long Term Assets, Total	117.07	121.69	135.59	136.18	24.06
Total Assets	2,032.81	1,983.10	1,870.86	1,774.48	795.57
Accounts Payable	60.02	60.36	40.62	40.92	40.60
Accrued Expenses	818.56	802.18	810.26	732.73	622.14
Notes Payable/Short Term Debt	0.00	0.00	0.00	0.00	0.00
Current Port. of LT Debt/Capital Leases	-	-	-	-	-
Other Current liabilities, Total	246.62	237.63	215.50	221.51	103.95
Total Current Liabilities	1,125.20	1,100.18	1,066.38	995.16	766.69
Long Term Debt	-	-	-	-	-
Capital Lease Obligations	-	-	-	-	-
Total Long Term Debt	0.00	0.00	0.00	0.00	0.00
Total Debt	0.00	0.00	0.00	0.00	0.00
Deferred Income Tax	28.59	25.84	12.47	7.43	4.79
Minority Interest	5.37	2.99	4.17	-1.42	-0.94
Other Liabilities, Total	74.64	74.77	75.19	70.77	39.72
Total Liabilities	1,233.80	1,203.78	1,158.20	1,071.93	810.26
Redeemable Preferred Stock, Total	-	-	-	-	-
Preferred Stock - Non Redeemable, Net	-	-	-	-	0.01
Common Stock, Total	0.07	0.07	0.07	0.06	0.00
Additional Paid-In Capital	1,459.48	1,437.16	1,401.58	1,388.25	1,414.39
Retained Earnings (Accumulated Deficit)	-672.49	-670.85	-703.18	-698.70	-633.95
Treasury Stock - Common	-	-	-	-	-808.67
Other Equity, Total	11.96	12.94	14.19	12.93	13.52
Total Equity	799.01	779.32	712.66	702.54	-14.70
Total Liabilities & Shareholders' Equity	2,032.81	1,983.10	1,870.86	1,774.48	795.57
Shares Outs - Common Stock Primary Issue	-	-	-	-	-

Exhibit 3- Groupon Inc. Balance Sheet

In Millions of USD (except for per share items)	As of 2012-09-30	As of 2012-06-30	As of 2012-03-31	As of 2011-12-31	As of 2011-09-30
Total Common Shares Outstanding	654.90	651.57	645.25	644.15	637.80

Source: *Google Finance - Groupon Inc. Financials.* Retrieved December 5, 2012 from: http://www.google.com/finance?q=NASDAQ:GRPN&fstype=ii#

Exhibit 4 – Groupon Inc. Cash Flow

In Millions of USD (except for per share items)	9 months ending 2012-09-30	6 months ending 2012-06-30	3 months ending 2012-03-31	12 months ending 2011-12-31
Net Income/Starting Line	29.02	29.96	-3.59	-297.76
Depreciation/Depletion	39.84	24.53	11.72	32.05
Amortization	-	-	-	-
Deferred Taxes	9.61	13.00	-0.88	32.20
Non-Cash Items	6.49	-15.83	30.30	100.61
Changes in Working Capital	116.17	107.38	46.16	423.34
Cash from Operating Activities	201.12	159.03	83.71	290.45
Capital Expenditures	-55.81	-39.80	-13.09	-58.33
Other Investing Cash Flow Items, Total	-86.41	-66.80	-33.35	-89.11
Cash from Investing Activities	-142.23	-106.60	-46.44	-147.43
Financing Cash Flow Items	12.78	11.83	-8.00	-7.90
Total Cash Dividends Paid	-3.06	-1.61	-0.65	-5.53
Issuance (Retirement) of Stock, Net	8.87	5.66	0.38	880.63
Issuance (Retirement) of Debt, Net	-	-	-	0.00
Cash from Financing Activities	18.59	15.88	-8.28	867.21
Foreign Exchange Effects	0.59	-5.45	9.06	-6.12
Net Change in Cash	78.08	62.86	38.05	1,004.10
Cash Interest Paid, Supplemental	-	-	-	0.00
Cash Taxes Paid, Supplemental	-	-	-	1.64

Source: *Google Finance - Groupon Inc. Financials.* Retrieved December 5, 2012 from: http://www.google.com/finance?q=NASDAQ:GRPN&fstype=ii#

THE FUTURE OF GROUPON & MASON

Since Groupon was founded, the company had grown into a major company with around 11,471 employees, millions of subscribers, and over a billion dollars in revenue in the past year alone. The reason for the success of Groupon was that the CEO and co-founder, Mason, recognized that there was an opportunity for the creation of collective buying power in order for customers to receive discounts on products and services. This simple idea would have customers interested because of the great deals they would be receiving and businesses intrigued because of the opportunity to reach a wide audience and acquire repeat customers. Unfortunately for Groupon, their model of receiving half of the sales dollars from the company offering the Groupon has yet to provide a profit. The company has continued to make necessary strides to correct this huge problem and seem to be inching closer to "righting the ship." Mason has to determine what his next moves will be to increase the profitability of the company.

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THERE *IS* ROOM AT THE INN! : A CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns ***entrepreneurship****. Secondary issues examined include* ***marketing, management and franchising****. The case has a difficulty level of three, appropriate for junior level and senior level. The case is designed to be taught in two class hours and is expected to require six hours of outside preparation by students.*

CASE SYNOPSIS:

This case study looks at a motel in a small town in Southern US that has been hit hard by the sluggish economy. Once a thriving motel, it is now caught between dropping occupancy rates and high franchise fees. The case explores different factors such as location, various expenses involved in running a motel and the difficulties in increasing occupancy. It also examines some pros and cons of franchising. The case introduces readers to issues that the entrepreneur might have no control over, such as the decline of the downtown area where the motel is located, and encourages out-of-the-box thinking to come up with a solution. While this case study looks at a specific motel, the solutions can easily be generalized to hundreds of hotels and motels facing similar problems.

INTRODUCTION:

Mr. Shah looked at the occupancy figures for the past week again, hoping there was an error in his bookkeeping. But there wasn't. This was the third month in a row where his motel had not even enough guests to cover his running expenses. He wondered if buying this motel had been a mistake. It had been six years since he had owned the Kwality Motel but he was still struggling to break even.

He pondered over what could be going wrong. He had been very careful choosing the location. Kwality Motel is strategically located on the corner of what used to be a major thoroughfare, but is still close to two Interstate highways in a mid sized town in South Texas. It has 127 rooms which include a single or double bed, a chair, a table, television and bathroom. The Hotel offers free wireless high-speed Internet access, free local calls, free coffee and breakfast and a seasonal outdoor pool as well as a children's pool.

BACKGROUND:

The original building where Kwality Motel is located was started in 1997, and has since had several owners operating the hotel under different names but most were unsuccessful due to various reasons. Raj Shah thought he could turn it around and purchased it in 2006 along with a partner. The building was then renovated, cleaned and slightly updated. The current owners decided to become a franchisee with Kwality Hotels and Motels International in an attempt to boost sales in 2007. That did not help Mr. Shah and the motel averaged a paltry twenty percent occupancy in 2012 (see Figure 1). The hotel seems to get the best business when there is either a natural disaster, such as hurricanes in October 2008, or large construction projects, causing many utility workers to stay there for a long period of time at a lower cost than most hotels in town. As part of the franchise, the hotel is only benefiting from being listed on the Kwality Hotels & Motels website and other travel websites that Kwality advertises on. The Kwality Hotels & Motels Corporation is not helping the owners of this hotel in any other way. The owner must pay a franchise fee of over $4000 a month in order to keep the franchise name. Considering the very low occupancy rates, this fee makes a further dent in the revenue making it almost impossible to make a profit.

Mr. Shah had considered his options before. Last year, he had made up his mind to terminate the franchising agreement with Kwality Hotels and Motels International when the annual agreement came up for renewal. He hit an unexpected roadblock with his bank though. His mortgage officer informed him that the bank required him to continue as a franchise rather than an independent hotel. Although the franchise name is obviously not helping the company, Mr. Shah still owes the bank over$1 million. This gives the bank a great deal of say in Mr. Shah's business decisions and unfortunately eliminates one option of reducing expenses.

Mr. Shah's thoughts went back to the location of his motel. While it was indeed easily accessible thanks to its proximity to the Interstate, it was in a part of town that had been steadily sliding in reputation and safety. Once close to a bustling downtown, it was now home to mainly commercial properties and after nightfall was frequented by mostly prostitutes and drug users. Mr. Shah had lost a lot of business by refusing to permit unsavory members of the society into his motel. But he was convinced that was the right thing to do.

As Mr. Shah drove home that day, he noticed yet another hotel just 3 miles from his. Within a 15 mile radius, there were now 9 similarly priced hotels, most of them franchises with well-known names. Unfortunately, the city did not have the potential to provide business to so many hotels and motels. There was nothing to attract tourists. The only draws were the local University, a couple of oil refineries and the occasional business traveler. Where and how could he find additional business?

POSSIBLE SOLUTIONS:

Mr. Shah's uncle suggested getting in touch with the State University in town to check if they have any resources to help the community. Mr. Shah contacted the Small Business

Development Center (SBDC) at the University and was given some ideas. It was obvious relying on tourists and visitors to town was not going to work. The SBDC studied the case and presented Mr. Shah with a report that presented him with 2 options.

1. The University, with over 14,000 students, and expecting a further increase in enrollments, could be a source of guests.
2. The town had a deficit of safe, affordable housing for senior citizens.

Mr. Shah went over the detailed report a number of times and considered both options. He could not, at this point, exit his franchising agreement with Kwality Hotels and Motels International. So he would need to continue using part of his premises as the motel. Fortunately, the layout was amenable to that since the rooms were spread out over 3 buildings in a "U" shaped structure. So he could ensure that different groups of residents would not inconvenience each other. The University had a dormitory on campus, but many students preferred to live off campus. Some of them found the dormitory too expensive at close to $10,000 for the year. Others found dormitory living too restrictive since cooking was prohibited. These students could be an ideal target segment for Kwality Motel since every room did have a microwave and refrigerator. Perhaps, a small cooktop could be installed in some rooms as well. However, the motel was 7 miles away from the University and the public transport was unreliable and spotty.

Option 2 was also attractive. The few available options in the town were extremely expensive at close to $60,000 for the year. Most senior citizens are on a limited income with social security forming a major chunk of it. Some of them are interested in moving out of their homes to a facility which did not require them to worry about cooking, cleaning, yard work but cannot afford to pay $5000 a month.

Mr. Shah and his wife ran some calculations and came up with some figures that could work for either students or seniors.

Option 1: Weekly (limited daily housekeeping):
Single King Size Beds - $220 plus tax for 1 person. $230 plus tax for two adults.
Two Full Sized Beds - $240 plus tax (1 or 2 people). $10/week for each extra person above 2

Option 2: Monthly (full housekeeping once a week):
Single King Size Beds - $820 for one adult. $850 for two adults
Two Full Sized Beds - $880 (1 or 2 people). $30/month extra for each extra person above 2

Mr. Shah asked his wife, "What should we do? Do we turn the place into an assisted living for senior citizens? Or should we go with students and turn it into an alternative to the University dormitories?" His wife said, "Don't rule out continuing to be a motel and trying to increase occupancy using aggressive marketing." Mr. Shah said, "Yes, we need to decide the best option of these three alternatives. In my opinion, however, continuing as a motel is not feasible anymore."

ECONOMICS OF APPLE IPHONE: PRICE DISCRIMINATION OR PRICING ERROR?

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CASE DESCRIPTION

The present case examines Apple's iPhone pricing decisions and provides an opportunity to review the underlying principles of several pricing strategies. The case is designed to cover a number of learning outcomes in a Managerial Economics course at the M.B.A. or upper undergraduate level and has been tested in M.B.A. Managerial Economics classes at two business schools over several semesters. The case is designed to be taught in one class hour and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

Apple has achieved a leadership position in the consumer electronics market however its launch of the original iPhone was far from smooth. The iPhone was a highly expected product that tapped into a large new market for the firm. Just over two months after the launch of the device, Apple cut its price for the 8 GB model significantly and discontinued the 4 GB model altogether. This decision was unexpected and led to dissatisfaction among early buyers and a loss in stock value. Apple had to react to the customer backlash and CEO Steve Jobs reached out to customers with a rare public apology.

The key question in this case is whether these events resulted from a pricing error by Apple or were a part of a long-term pricing strategy. The case provides an opportunity to review the conditions for successful price discrimination and evaluate the reasons for Apple's pricing decisions and consequences thereof.

CASE BODY

Apple Inc. (NASDAQ: AAPL) is engaged in "designing, manufacturing and marketing mobile communication and media devices, personal computers, and portable digital music players. It also sells a range of related software, services, peripherals, networking solutions, and third-party digital content and applications. The Company's products and services include iPhone, iPad, Mac, iPod, Apple TV, a portfolio of consumer and professional software applications, the iOS and Mac OS X operating systems, iCloud, and a range of accessory, service and support offerings. It also sells and delivers digital content and applications through the iTunes Store, App Store, iBookstore, and Mac App Store" (Reuters, 2012).

Apple has been a leader in the consumer electronics market for much of the 21st century. Such Apple products as the iPod, iPhone and iPad have become household names and set industry standards. The company typically maintains tight control over the distribution and pricing of its products.

Apple is known to rely on early adopters. By 2007, it has built a loyal customer base with such ground-breaking products as the Macintosh computer and the iPod music player. The iPhone that was introduced in June 2007 was expected to continue in the same fold.

At the time of the iPhone release its competition existed mainly in the form of RIM's Blackberry devices that had features similar to those of iPhone. The BlackBerry Pearl smartphone equipped with a camera and a media player existed since September 2006. On May 3, 2007, RIM introduced their next line of devices, the BlackBerry Curve (Research in Motion, 2007). More competition was on its way. At the end of August 2007, Nokia unveiled several new cellphones and an integrated music, maps, and games service (Nokia, 2007). In November 2007, Google released its open-source Android operating system designed specifically for mobile phones (Johnson, 2007).

Nevertheless, the iPhone was highly anticipated. Over the eleven-week run-up to the introduction date, Apple's stock price went up 35%, as seen in Figure 1. The iPhone was expected to tap into a massive new market for Apple. Apple's CEO Steve Jobs said in the 2007 MacWorld keynote address: "One percent market share equals 10 million units. This is a giant market. If you [sell] just 1% market share, you are going to sell 10 million phones—this is exactly what we are going to try and do in 2008, our first full year in the market – grab 1% market share and go from there… We think we are going to have the best product in the world, and we are going to go for it, see if we can get 1% market share – 10 million units in 2008" (Farris and Spekman, 2009).

The introduction itself, however, was far from smooth. On the opening day, June 30, 2007, the iPhone was introduced in two versions – a 4 GB version sold at $499, and an 8 GB version at $599 (see Table 1). Many people stood in lines to get their hands on an iPhone. Apple reported that 270,000 iPhones were sold in the first 30 hours of the sale.

A little over two months later, on September 6, 2007, Apple abruptly cut the price of the 8 GB iPhone by $200 to $399. The 4 GB model was discontinued altogether.

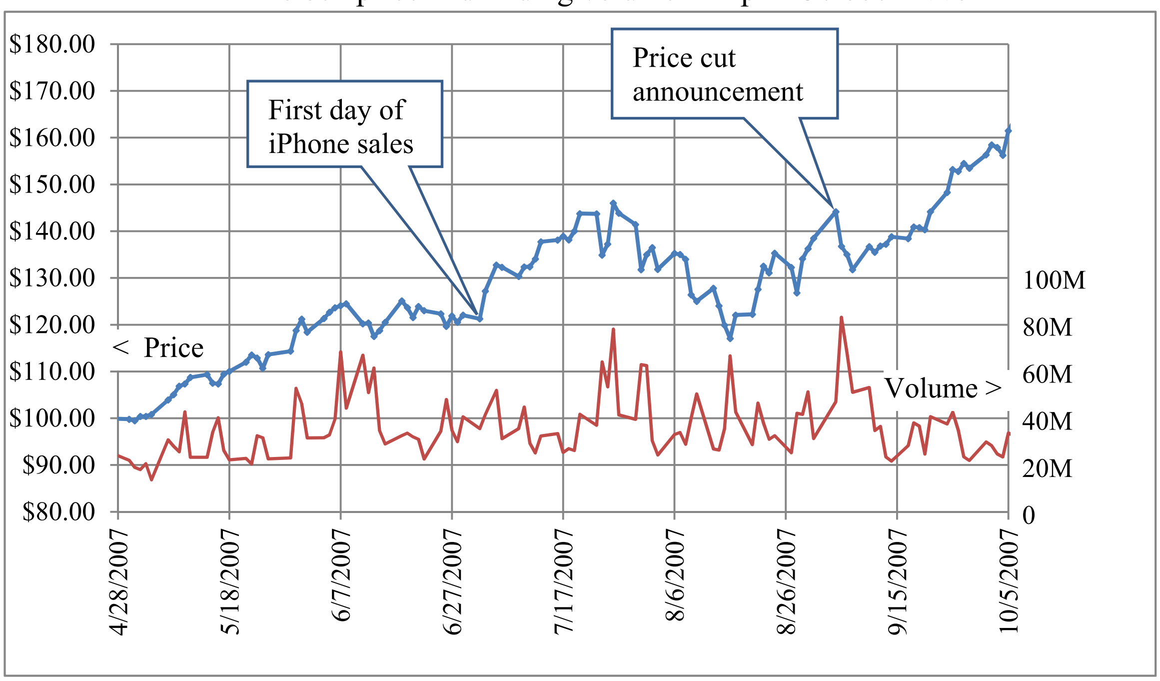
The price cut was unexpected and led to negative reports from industry analysts. A Wall Street Journal article (Wingfield, 2007a) quoted Toni Sacconaghi, an industry analyst at Sanford Bernstein, as saying it was unheard of for Apple to cut prices so quickly after the introduction of one of its new products, and questioning whether Apple could meet its sales goals in the absence of a price cut. "It can't be a bullish signal about iPhone volumes," Mr. Sacconaghi said.

Table 1 IPHONE PRICING HISTORY					
	iPhone		iPhone 3G	iPhone3GS	
Date	4GB	8GB	8GB	16GB	32GB
30 Jun 2007	$499	$599	N/A	N/A	N/A
6 Sept 2007	Discontinued	$399	N/A	N/A	N/A
11 Jul 2008	N/A	Discontinued	$199	N/A	N/A
19 Jun 2009	N/A	N/A	$99	$199	$299
7 Jun 2010	N/A	N/A	Discontinued	$99	$149

Source: AAPLinvestors (2012)

Apple's stock price fell $7.40 on the news to $136.76, and had a further decline of $1.75, to $135.01 the following day. In just two days the shares lost over 6 percent of their pre-announcement value. See Figure 1.

Figure 1
AAPL stock price and trading volume in April-October 2007



Source: Yahoo Finance, authors' calculations

Apple customers were taken aback by the price cut. While technology companies often reduce prices on their products, Apple historically introduced replacement models with changes in design and improved features instead of discounting existing models. A Wall Street Journal report (Wingfield, 2007b) stated that Apple usually made such changes about a year after a product's introduction, not two months later. Disgruntled iPhone owners said the timing of the price cut would discourage them from buying Apple products early in the future. "This is like a slap in the face to early adopters," said John Keck, an executive at an advertising agency in Detroit.

Apple had to react to the customer backlash. In a rare public apology, Apple CEO Steve Jobs reached out with a letter to all iPhone customers:

“I have received hundreds of emails from iPhone customers who are upset about Apple dropping the price of iPhone by $200 two months after it went on sale. After reading every one of these emails, I have some observations and conclusions.

First, I am sure that we are making the correct decision to lower the price of the 8GB iPhone from $599 to $399, and that now is the right time to do it. iPhone is a breakthrough product, and we have the chance to 'go for it' this holiday season. iPhone is so far ahead of the competition, and now it will be affordable by even more customers. It benefits both Apple and every iPhone user to get as many new customers as possible in the iPhone 'tent'. We strongly believe the $399 price will help us do just that this holiday season.

Second, being in technology for 30+ years I can attest to the fact that the technology road is bumpy. There is always change and improvement, and there is always someone who bought a product before a particular cutoff date and misses the new price or the new operating system or the new whatever. This is life in the technology lane. If you always wait for the next price cut or to buy the new improved model, you'll never buy any technology product because there is always something better and less expensive on the horizon.

[…]Third, even though we are making the right decision to lower the price of iPhone, and even though the technology road is bumpy, we need to do a better job taking care of our early iPhone customers as we aggressively go after new ones with a lower price. Our early customers trusted us, and we must live up to that trust with our actions in moments like these.

Therefore, we have decided to offer every iPhone customer who purchased an iPhone from either Apple or AT&T, and who is not receiving a rebate or any other consideration, a $100 store credit towards the purchase of any product at an Apple Retail Store or the Apple Online Store […]” (Jobs, 2007).

The Wall Street Journal reported the financial impact of the credits on Apple to be "very modest" given Apple's overall revenue and the number of affected iPhone users (Wingfield, 2007b). Apple’s stock price recovered quickly and showed over 20% growth within a month after the iPhone price cut.

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REENGINEERING A PUBLIC UTILITY AS AN ENTREPRENEURIAL ENTERPRISE: IMPLEMENTATION OF AN EXECUTIVE COMPENSATION PLAN

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CASE DESCRIPTION

The primary subject matter of this case concerns implementing an executive compensation plan. The focus is the Board of Directors of the Electric Power Board of Chattanooga, Tennessee, when its role as a nonprofit public utility expanded to include an entrepreneurial enterprise, EPB Telecom. With this expansion, the need for, and the role of, an executive compensation plan became critical. The case has a difficulty level of three to four and is appropriate for junior-and senior-level undergraduates. The case is designed to be taught in 1.25 class hours and is expected to require two to three hours of outside student preparation.

CASE SYNOPSIS

Executive leadership and company culture are keys to success for growth and innovation. Rewarding executive leadership and encouraging best performance through an effective compensation plan can determine the eventual success and growth of any company. This case involves the student in measuring executive performance, determining the reward system for a changing enterprise, and determining executive compensation. Can a public utility under public scrutiny adopt a private industry culture and executive compensation plan? Students will use Key Performance Indicators (KPI's) to evaluate executive performance and determine compensation levels in major performance areas.

INTRODUCTION

The Electric Power Board (EPB) of Chattanooga, Tennessee is a public utility. It was created by a private act passed by the Tennessee legislature in 1935. It was the direct result of the federal legislation that established the Tennessee Valley Authority (TVA). Chartered as a nonprofit agency owned by the City, EPB's sole purpose was to provide electric power, for the first time, to the greater Chattanooga area.

THE COMPANY

For the first sixty years of its existence (1939-1999), EPB's only product was electricity and its only function was to supply that product. The entire utility industry had a long history of operating in a noncompetitive economic environment, and EPB was no exception. The end result was archaic management tools and systems, a lack of employees with professional skills (other than accounting and engineering) and a culture that had emphasized a general lack of accountability and vision by senior management.

In 1996, with the passage of the Federal Communication Commission (FCC) Telecommunications Act, the environment of the utility industry was radically changed. The ruling permitted anyone, including public utilities, to enter into the full spectrum of the communication business. This included local and long distance telephone service, cable programming and other video services, broadcast services and services provided to schools.

A public utility could expand its operations by adding other utility services to its core business. Conceivably, one utility company could provide its customers with a complete bundle of communication services. Also in 1966, Harold E. DePriest was appointed President and CEO of EPB. He was intrigued by the possibility of EPB expanding its services and becoming a full-service utility. Before he became chief executive officer Mr. DePriest held various positions in his more than twenty-five years with EPB. He understood the utility business and the growth opportunities that would result from deregulation and the FCC's ruling. Extensive research of the market impact of the ruling verified his opinion (as shown in Table 1).

Mr. DePriest also was keenly aware of the ongoing initiatives by city officials to further the economic development of Chattanooga. His entrepreneurial and visionary instincts were stimulated. EPB had both the resources and the ability to create the type of "high tech" infrastructure needed to attract businesses to Chattanooga. In short, EPB was poised to become the economic development arm of the city. All Mr. DePriest would need was the approval of the company's Board of Directors.

EPB Telecom: The First Venture

While Mr. DePriest was considering EPB Telecom as a potential start-up, and the economic development of the region was being urged by civic leaders, a new mayor of Chattanooga was elected in 1997. Mayor Jon Kinsey was a highly successful entrepreneur with extensive experience and numerous accomplishments. Mr. Kinsey had been urged by city leaders to seek election as Mayor. It was believed that he was the ideal person–as one prominent citizen stated—to "turn the town around."

Table 1 **MARKET REACTION TO FCC UNBUNDLING ACTION***
In December, 2004 the FCC issued a ruling that was intended to encourage innovation and investment in the telecom market. However, speculation of the order's true impact in the local telecommunications industry varies as widely as the 3-2 vote split among the FCC Commissioners and Chairman. Originally, Local Exchange Companies (LES's) were required to make portions of their networks available to new carriers entering the market on a cost basis. This was intended to open the local telecommunications market to competition and therefore offer more choices for consumers. It allowed Competitive Local Exchange Companies (CLECs) to resell specific LEC facilities without making the large upfront capital investments necessary to completely duplicate the LECs' networks. The December ruling removes pricing restrictions from the incumbent providers and allows them to charge higher than cost based rates for those CLECs that include these leased facilities as part of their network design is an increase in expenses and a dramatic decrease in profitability. While the issues shaping the impact of the ruling are extremely complex, there is a 12 month transition period in the FCC order that makes the true impact on the industry still undetermined. Most vocal are those who ear the extreme pressure this decision has placed on the CLEC industry has effectively curbed competition and therefore will limit consumer choices. The ruling has been characterized as a "drag" on the economy by investors who have committed billions of dollars to companies that rely on a combination of network pieces leased from the LECs and their own network facilities in their business model. These investors now fear their investments are worthless as costs for the leased portions of their network are expected to rise dramatically making the companies potentially unprofitable. However, this would not apply to EPB as we have been preparing for this situation and have become more reliant on our own facilities over the past year rather than primarily leasing network facilities from Bellsouth. Opinions from the telecom industry support the position that the effects of the order are devastating. It is expected to create financial problems not only for telecommunications companies and their employees, but will disrupt service for thousands of businesses and consumers that rely on them. Given the importance of the cutting-edge services these small, innovative companies provide, this decision is predicted to force many out of business resulting in job losses and increased bankruptcies. There are also concerns that consumers may experience unnecessary service disruptions as their providers of choice are forced to leave the marketplace or as carriers hastily convert to new systems to avoid higher costs from the LECs. By cutting competitive carriers off from access to essential network pieces, the ruling has been characterized as truly undermining the choices for both residential and small business consumers. The most pronounced impact will be felt in metropolitan markets where competitors have gained a growing foothold, building out their networks with a combination of owned and leased components as was encouraged by previous FCC actions. Least affected are those carriers who have invested in building their own networks with limited reliance on LEC facilities and subsequent FCC actions. However, capital costs associated with extensive network investments prohibited many competitive providers from adopting this business model. In support of this premise are facts from the Small Business Administration that report that in metropolitan areas competitive carriers serve 29% of small businesses. Small businesses generate between two-thirds and three-quarters of all new jobs in the country. They represent over 90% of employers and they produce over half of the nation's private sector output. The savings they enjoy from competitive telecommunications services go straight to their bottom line. This ruling is feared to reduce those savings and jeopardize the longevity of much of this small business segment. Overall, at a national level this order will drive large expense increases for carriers leasing vital portions of their transport facilities, reduce their profits and ultimately reduce competitive choices for consumers. The FCC rules will have a profound impact on the Chattanooga market as well. Primarily we expect to see fewer choices for telecommunication services for the smaller sized business which makes up much of Chattanooga customers but not necessarily the revenue opportunity for carriers. With capital costs to serve these customers high relative to the overall return and lower economics of scale, many resellers which once served this market have pulled out and only a small few remain. Those that remain have already increased their pricing and the incumbent, Bellsouth, may do likewise in the near future. EPB Telecom will continue to make its offering available to the smaller business but with modified pricing that makes that business a worthless investment. The opportunity for local revenue growth and return on investment is in the customer market served by a carrier delivering its own switched services, in particular those that are on-net for the last mile. EPB Telecom is well positioned in this market and for the past 18 months has been executing on its strategy to grown this market sector. This has and will continue to require capital investment as the FCC rules have intended to accomplish, along with the innovative development of new services,

such as voice-over-IP. Although not the largest customer segment by sheer number of customers, the mid to large sized business offer the best opportunity to differentiate in the market and capture the largest revenue share at strong financial returns on investment.

For the next 12 to 18 months the Chattanooga market will be in a state of change as a result of the FCC rules. Not only will smaller competitors drop out of the market but Bellsouth's actions will drive the strategies of the remaining CLECs. If Bellsouth lowers its pricing to the smaller customer, we anticipate a higher than normal churn for all carriers since many carriers will be unable to compete with such a small margin. If BellSouth maintains its pricing, churn should be stabilized for at least several months. Regardless of the market movement by BellSouth, EPB Telecom is actively and aggressively moving those customers that offer attractive margins to EPB Telecom facilities where retention is higher, service is differentiated and additional revenue can be added over time. EPB Telecom believes it will continue to grow revenues while improving the overall quality of its customer base through increase retention of the base of larger customers, the addition of new on-net customers.

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Mayor Kinsey started that process by making what was then considered a bold, strategic decision. The Mayor urged the restructuring of EPB's five member Board of Directors to reflect a more proactive management philosophy. He believed this was the first step to be taken if EPB was to be an active partner in pursuing the city's growth. Mayor Kinsey knew that changing the culture of the Board would be difficult because of the member appointment process stated in the EPB Charter.

Based on the Charter, Board members could be appointed for a maximum of two five year terms. When a member's term(s) expired, the continuing members were empowered by EPB's Charter with absolute authority to name the replacements for the Board. The Charter further mandated that the proposed new members be confirmed by the Mayor and the City Council. This approval process had been considered a mere formality by previous mayors and city councils. The result was the equivalent of a self-perpetuating Board that maintained the status quo of the company by vigorously rejecting change.

Mayor Kinsey insisted that the Board must include members who were more representative of the citizens of Chattanooga and who would support the City's vision of growth. The Mayor flatly refused to confirm the nomination of any individual who did not meet those criteria. Two Board vacancies would shortly occur and this could give Mayor Kinsey the opportunity to implement his plan.

Although the sitting Board members rejected Mayor Kinsey's proposal, his position was given strong political support throughout the city. The struggle was brief. The new EPB board began to evolve as Mr. DePriest accelerated his efforts to create EPB Telecom.

The new Board enthusiastically supported Mr. DePriest as he explored various ways for EPB to enter the telecommunication arena. They agreed that EPB Telecom was the logical choice for EPB's first expansion.

In addition, financial concerns were minimal. By law, the new service could not be directly financed by EPB's assets that were derived from its electrical operations. However, EPB could loan—or guarantee a third party loan—to the new company on the basis of those assets. Success appeared inevitable: an entrepreneurial CEO, an aggressive and equally entrepreneurial Board of Directors, and collateral available from a debt-free company that had substantial financial resources.

In 2000, EPB introduced its first entrepreneurial initiative—"EPB Telecom." The new venture could "piggyback" on the electric company's physical resources (e.g., telephone poles, etc.) to assist in the startup. It was established as a separate entity from the electric company. As such, the income, expenses, losses, profit, etc. of the two companies were not comingled. However, the existing EPB Board and CEO would govern both companies.

Initially, EPB Telecom restricted the sale of its services to local area businesses. Its goal was to offer an affordable, reliable alternative to existing carriers (e.g., AT & T). The objective was to support the business community and subsequently the economic growth of the region. In addition, the new company could develop new sources of revenue to further expand EPB's entrepreneurial activities.

THE CHALLENGE

It almost did not happen. Approximately a year after EPB Telecom was launched it became obvious to the Board that there were problems with the telecommunication operation. There was no question that a market existed for the product. The business plan for the first few years was sound. The Board and Mr. DePriest agreed that the initial sluggish performance was attributable to how the business plan was being implemented by the new company's top management.

Mr. DePriest was able to isolate the problem—one that arose from the traditional culture of the utility industry. The new group of executives who had been employed to manage EPB Telecom were hired primarily because of their many years of experience in telecommunications—i.e., the utility industry. EPB employees, also from the utility industry, provided the basic business functions for the new company. Thus, both EPB Telecom executive officers and its support staff followed a management system that reflected a monopolistic operation based on a product that sold itself. This system would not work for an entrepreneurial enterprise that required competitive marketing and progressive management techniques. For the new venture to be successful, the leadership had to adopt new practices.

Concurrent with the need to change the management approach for EPB Telecom was the CEO's ongoing efforts to change EPB's culture. His intent was to create an environment that reflected appropriate business attitudes and practices. Mr. DePriest had begun this campaign even before becoming President and CEO. He strongly believed that the electric company should incorporate an entrepreneurial philosophy in all of its functions. Although the two companies that he managed had different objectives, they could both benefit from this change. It would not only provide superior service for its customers but would aid in the economic development of Chattanooga.

THE EVOLUTION OF EPB: REMOVING THE OBSTACLES

The Board agreed that changes had to be made in both companies, and made very quickly. Three major principles were mandated: (1). The Board, in conjunction with the CEO, should assume a more aggressive and hands-on role in setting policy for all of EPB's activities, including EPB Telecom; (2). EPB, and its culture, should be instilled with entrepreneurial concepts; and (3). Any changes in the operations of both companies should reflect and respect the public perception of how a utility should function, especially in comparison to other regional utilities. Commonly referred to as the "Big Five," they included Memphis, Jackson, Nashville, Chattanooga and Huntsville.

An in-depth review of EPB Telecom's start-up performance convinced the Board that the new company must: (1). Engage in competitive marketing and selling, (2). Implement faster decision making, (3). Hire experienced people, (4). Reward performance, and (5).Maintain good business systems.

The Board further mandated that these same objectives must apply to EPB, especially since the two companies shared employees and other resources. Implementing the changes in EPB's culture would be mirrored in EPB Telecom.

For the CEO to implement the above changes, it was necessary for the Board to make significant policy decisions and changes. The Board reviewed its options. Both Mr. DePriest and the Board agreed that the initial focus should be on Items (3) and (4). These would be the key to the success of EPB Telecom and future EPB ventures. Conversely, they could also be the primary obstacle to that success because of the current compensation policy. The present salary levels would not attract the type individuals needed to change the companies. The management team that had been hired to operate EPB Telecom was hired not only for their professional experience but also because their salary requirements were similar to those paid by the "Big Five" and were substantially lower than average. However, if the Board allowed salary levels to be competitive with market demand, it would be violating its mandated principle of maintaining, and respecting, the public perception of EPB's conformity with other state utilities (e.g., similar salaries, low percentage raises, similar administrative structures, same methods of establishing rates, etc.). A public assumption was that any variation by a particular utility, especially in personnel costs, would mean higher rates for the customers of that utility.

THE EVOLUTION OF EPB: THE SOLUTION

To focus on the hiring of experienced people and rewarding performance, the Board set about implementing an executive compensation plan. The purpose of the plan was three fold. First, it would serve as an incentive for achieving EPB's strategic goals in a given time period (both long-term and short-term) and it would be results oriented and the results could be measured. Second, by establishing key performance indicators both the financial and nonfinancial goals could be tied to the planned activities of the business. Third, it would motivate executives to perform at superior levels –talent management – and allow the organization to hire and retain the best people to accomplish strategic goals of EPB during this start- up period and continuing in the future.

A Compensation Committee consisting of three of the five Board members was created. Its assignment was to recommend a policy that would resolve the salary compression issue. The first fact uncovered by the very diligent committee pertained to Mr. DePriest's annual raise. It appeared that, no matter what his level of performance and/or the quality of his accomplishments, his salary increment was not based on merit but rather on the average percentage (usually in the range of 2-3 percent) paid to CEO's of the "Big Five." The Committee determined that Mr. DePriest was being undercompensated on a continuing basis.

The Compensation Committee was faced with the dilemma of developing a plan that would maintain salary equity without, of course, violating parity with the "Big Five." Many meetings later, the Committee recommended that an Executive Compensation Plan (ECP) be enacted. Management could be rewarded for its performance without an increase in base salaries and without distorting the concept of parity. The Board understood that competitive incentives would be required to attract new talent and to compensate EPB's executives for their expanded operational responsibilities. Although all five Board members understood the rationale for, and objectives, of an ECP, none felt confident—or competent—to design it. Nonetheless, the ECP was a Board initiative and a Board directive. No aspect of its design, or administration, whether now or in the future would be delegated to any entity other than the Board.

The inevitable and logical conclusion was made. A consultant would be retained to aid the Board in determining the specifics of the plan, an implementation strategy, and evaluation mechanism. The consultant would report directly, and only, to the Board. Any payments made under the plan had to be directly attributable to real dollar savings within the Company. In addition, all savings had to be documented and linked to the achieved goal.

Mr. DePriest expressed his appreciation for the Board's action regarding an executive compensation plan. However, he believed that it should not be limited to the CEO, but should reward senior management for their accomplishments. He was most sincere about this request.

The Board assured Mr. DePriest that the ECP would ultimately be extended to those executives who were eligible to participate. However, the Board mandated that the ECP would first apply only to the CEO of EPB. If the Board was satisfied with the results of this initial "test case," the plan would be implemented at executive management levels in both EPB and EPB Telecom.

THE EVOLUTION OF EPB: THE EXECUTIVE COMPENSATION PLAN (ECP)

The Compensation Committee began searching for a consultant in April 2001. A management development and compensation consultant that had been in business for over twenty years was selected to assist the Board. In July 2001 the Committee recommended, and the Board approved, a contract to retain the Board's ECP consultant.

Guidelines for the Plan. The Compensation Committee had four broad directives for the consultant: (1). The total compensation of EPB's President and CEO should be, at a minimum, comparable to that of the CEO's of the "Big Five," (2). The plan should be self-funded, (3). Performance evaluation will be based upon the accomplishment of specific goals that are derived from EPB's Strategic Plan, (4). Determination of results must be based exclusively on "hard" measurable factors.

Plan Development. On September 19, 2001 the consultant presented to the Board a proposed "Executive Compensation Plan" based on the Board's directives. Included in the document was an outline of specific duties as consultant to the Board as shown in Table 2.

Table 2
SCOPE OF ASSIGNMENT*

To develop a Compensation Package for the President/CEO of the Electric Power Board that will have the similar motivational characteristics to incentive plans found in the Private Industry. The plan should create incentive for excellent performance against specific goals, while supporting the EPB strategic plan.

Phase I: Identify Key Performance Indicators

1. Consultant gathers all relevant published material (including Strategic Plan) to learn and list the specific publicly-stated objectives of the EPB.
2. Consultant interviews (by appointment) each of the members of the Board and any other designate by that group in order to begin to draw clear understanding of the Board of Directors' expectations of the EPB and its President.
3. Meet with EPB President and develop consultant's sense for the range of primary responsibilities and begin to form a list of consensual Key Performance Indicators (KPI's) as well as conflicting Key Performance Indicators.
4. Learn about each business segment of EPB and develop a list of probable KPI's for them.
5. Identify final list of KPI's (score card for President's performance) that tie directly to the Strategic Plan of the organization and more specifically, that are more elementally attached to the performance expectations of the EPB Board of Directors.
6. Meet with Committee to report, discuss and edit findings of Phase I.

Phase II: Write Compensation Package

1. Identify salary criteria, range and increase schedule including COLA versus merit.
2. Write annual bonus plan (this is considered short-term incentive). Construct target and thresholds and segregate into two primary sections: Corporate objectives and Individual objectives. Each of these objectives will be based upon the Key Performance Indicators agreed to by the Committee. Each will be measurable in quality, quantity and time.
3. Develop long term incentive plan (may include deferred compensation opportunity).
4. Meet with Committee to report, discuss and edit findings of Bonus Plan development and Long Term Incentive Plan.
5. Ownership element (could take the form of internally devised phantom stock plan keying its growth upon criteria TBD).
6. Retirement (401(k) and pension). Consultant will review both but anticipate no actual work.
7. Benefits and benefit policies. Benefits are usually administered differently with executives; this is not the case at EPB. Anticipate a number of policy practice recommendations in this area.
8. Meet with Committee to report, discuss, and edit findings of Phase II.
9. Meet with EPB Board Counsel and/or other designated persons to present and explain details of Compensation package.

Note: # 5 and # 6 resulted in a combined Compensation element

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Also recommended was a three part bonus plan that would be the basis of EPB's executive compensation plan. These elements included (1) a Short-Term Bonus Plan, (2) a Long-Term Bonus Plan and (3) a 401(k) "Mirror" Plan as shown in Table 3.

Table 3
PROPOSED EXECUTIVE COMPENSATION ELEMENTS*

A.	**Base Salary –** expected short-term compensation paid to executive for day-to-day administration of duties. Annually adjusted based upon merit and COLA.
B.	**Retirement –** fully funded defined benefit pension plan plus 401(k) which is matched deferred income.
C.	**Short-term Bonus Plan –** annual award based on specific strategic initiatives established prior to beginning of bonus period and measurable in Quantity, Quality and Time. Performance target pay-out is 25% of annual base salary (simulates profit sharing compensation element). Threshold is 5% of salary at 90% objective accomplishment. 100% bonus pays 25% of salary and 110% accomplishment awards 30% of salary. No intermittent calculations. Key Performance Indicators (bonus criteria) are generally accomplishable within one year.
D.	**Long-term Bonus Plan –** in addition to the accomplishment of the short-term bonus plan, the executive participant is eligible to receive a target pay-out of 10% of the base salary. This bonus award is credited into a long-term investment medium of the participants' choice and is fully paid out at year of retirement. This plan has a 10 year (10% per year) vesting schedule toward redemption at age 62. Key Performance Indicators (bonus criteria) are more long range in scope; however, specific elements can be completed within one year. This is a non-ERISA plan and is eligible for taxation in retirement year. The EPB will contract to elevate the gross amount in the account at retirement by 25% to help offset taxation (simulates stock option/ownership complement).
E.	**401(k) Mirror Plan –** this is a program that augments retirement and further reinforces the "golden handcuff" approach to executive compensation. This plan mirrors the contract elements and investment elections of the existing 401(k) plan. This plan is also non-ERISA, and the executive may defer up to 10% of his base salary and receive a 50 percent match by the EPB (an additional 5% of base salary), but must still be employed by EPB at retirement to receive the EPB 5% match (promise to pay for promise to stay).
F.	**Long-term Disability –** the executive will receive salary continuation paid by EPB at 100% for 130 days until long-term disability takes effect.* (60% base pay)

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With 100% completion of the Key Performance Indicators, the Executive earning $100,000 base salary would actually earn:

Salary	$ 100,000
Short-term Bonus	25,000
Long-term Bonus	10,000 (deferred)
401(k) mirror match	5,000 (deferred)
	$ 140,000

Each of the three bonus plans would include two broad categories of review: (1) Financial Objectives and (2) Individual Objectives. Each category represented 50 percent of the evaluation results. In addition, each category would have three segments: Corporate, Power (EPB) and Telecommunications (EPB Telecom). Finally, Key Performance Indicators (KPI's) in each plan would be ranked as either "A" (superior rating, in excess of the stated KPI's), "B" (an excellent rating if all KPI's were accomplished) or "C" (a good rating if 90 percent of KPI's were met). The numerical value of each rating would be: A = 300 points; B = 200 points; and C = 100 points.

As directed by the Board, the ECP was predicated upon a strategic plan being developed on a yearly basis. Each year's KPI's would be drawn from the strategic plan for that year. All aspects of the entire process required Board approval. The ECP would be placed in operation in January 2002. The consultant developed a detailed document that explained each aspect of the ECP, including options for administering the plan as shown in Table 4.

Table 4
CONTENTS OF EXECUTIVE COMPENSATION PLAN*

Section 1	Plan Overview and Explanation Scope of assignment Proposed Executive Compensation Elements Short-Term (Annual) Bonus Plan Summary Statement Long-Term Plan Summary Statement 401 (K) "Mirror" Plan Summary Statement
Section 2	Key Performance Indicators Central Themes Management KPI's (Mission, Values and Strategic Objectives) Strategic Planning KPI's Senior Management Performance Appraisal KPI's Board Members Interview Summary Notes Proposed EPB Key Performance Indicators including rating of KPI's by Frequency and Intensity KPI tracking Reports
Section 3	Short-Term (Annual) Bonus Plan Key Elements of Short-Term Bonus Plan Chart Outline Recommended KPI's and Weights Administrative Guidelines * (see section 6)
Section 4	Long-Term Bonus Plan Key Elements of Long-Term Bonus Plan Chart Outline Recommended KPI's and Weights Administrative Guidelines * (see section 6)
Section 5	401(k) "Mirror" Plan (Deferred Compensation) Key Elements of "Mirror" Plan EPB 401(k) Plan Document Administration Guidelines * (see section 6)
Section 6	Operations for Administering Executive Compensation Plan General Guidelines (rules) for EPB Executive Compensation plans Administrator Candidates
Section 7	Addendum Compensation Increase Guidelines KPI Tracking EPB Strategic Planning/"Guideline" Documents Fringe Package Summary

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The First Year (January-December 2002). Although EPB uses a fiscal year (July 1-June 30) for accounting purposes, the Board instructed the consultant to utilize a calendar year for the first year of the plan's operation. This decision was made for implementation of the plan in order to test its effectiveness. If the Board was satisfied with the results, the ECP would be converted from a calendar to a fiscal year basis. This one calendar year modification would apply only to Mr. DePriest since he was the sole participant in the plan. However, the 2003 fiscal year review would take place only if the Board was satisfied with the results of the initial plan. Future reviews would occur over the appropriate time frame (July 1-June 30).

THE EVOLUTION OF EPB: IMPLEMENTING THE PLAN

The First Phase. The KPI's Mr. DePriest prepared for January were submitted to the Board for approval. Minor changes were made by the Board. The final version of the documents with the KPI's, including the Board's rating of each objective (i.e., A, B, or C) is presented in Table 5.

Table 5
EPB EXECUTIVE COMPENSATION PLAN*
Key Performance Indicators (KPI's)
Short-Term Objectives and Board Ratings

	Board Rating of KPI's Value
Financial Objectives (50%)	
Corporate	
1. Increase valuation of EPB Company (system) each year by $6.5 million Net Plant Value (includes macro system capital upgrades)	A
2. Successfully mentor construction of and move into new EBP facility without loss of effectiveness	B
3. Successfully develop research for and exploration of a new entrepreneurial venture as measured by Board approval and plan/budget parameters (may include cable)	B
Power	
1. Write and maintain an accurate financial forecast on electric side for operating budget expenses to within 5 for fiscal year. Also maintain telecommunications financial forecast to within 10% for year one, with subsequent adjustment in year two.	A
2. Cost reduction via employee head count – Maintain annual EPB employee average at 410 or below or reduce overall internal and external labor cost	B
3. Reduce annual electrical bad debt write-off from 760k to 400k by end of budget year.	C
Telecom	
1. Grow telecommunications business to meet or exceed revised sales budget to $ 6.9 million dollars and 8,700 lines by end of budget year.	A
Individual Objectives (50%)	
Corporate	
1. Design and implement an effective diversity program focusing on both employment and vender selection. Establish and track first year diversity percentage objectives of 20% employment and 1.8% vendor diversity.	A
2. Install equitable new compensation pay system comparing all jobs at EPB against common criteria and point factoring them into a smaller number of pay grades.	C

Table 5 EPB EXECUTIVE COMPENSATION PLAN* Key Performance Indicators (KPI's) Short-Term Objectives and Board Ratings	
	Board Rating of KPI's Value
3. Mentor executive group to actively participate in Chattanooga area civic leadership (as EPB representatives). Nine managers to seek out volunteer roles.	C
4. Maintain good employee relations as measured by turnover at 12% or below and unauthorized absenteeism at 0.01% or below.	C
5. Write a succession plan – as measured by outlining senior succession, to two depth levels including internal and external sourcing.	C
6. Improve management skills of company leadership (managers and supervisors) as measured by specific core competency expectations for managers and supervisors. Also as measured by the development/placement of training programs.	C
Power	
1. Customer satisfaction – as measured by maintaining or improving the general customer survey category responses and by tracking the number of customer complaints and unresolved complaints.	A
2. Continue to improve service continuity/productivity – as measured by the number of customers out of service, (month/year), average duration out of service, percent of customer base with service per year, crew time efficiency against standard.	B
Telecommunications	
1. Revise marketing plan as needed to continue to improve market penetration	B
Key Performance Indicators (KPI's) Long-Term Objectives and Board Ratings	
Corporate	
Design and implement an effective diversity program focusing on both employment and vendor selection by design	A
Power	
Operate an efficient power business – as measured by the number of sales dollars per employee compared with "Big 5" and number of customers per employee as compared with "Big 5"	B
Telecom	
Redefine and manage transitional EPB management profile	B
**By permission of EPB Chattanooga*	

The Second Phase. In anticipation of the evaluation process, the Board had earlier agreed on the following five broad conceptual guidelines as the basis of the review.

1. The Board retains interpretative authority of all aspects of the plan.
2. For the first year of operation, the evaluation process should be deliberately flexible. Both the Committee and the Board are on a "learning curve.
3. The Board may "defer" up to 10 percent of the KPI's where appropriate. (For example, deferrals are appropriate if there are changes in external business, or other conditions that are beyond the control of the CEO and Board.) A deferred KPI is considered to be a

neutral factor, and is either evaluated at 100 percent or subtracted from the total number of KPI's reviewed.

4. The Board may substitute (or swap) a completed activity that is not stated as a KPI in the plan for a related KPI that is included in the plan. This occurs when it is evident, in hindsight, that the completed activity should have preceded the KPI included in the plan.
5. The Board will consider "intent" vs. "content" in the wording of each KPI when scoring performance.

In addition to these guidelines, and to assist the Board in the evaluation process, the Consultant prepared three documents for their use (as shown in Table 6):

1. Definitions and scoring standards,
2. Key elements of short-term bonus plans and
3. Key elements of long-term bonus plans.

Table 6 **DEFINITIONS***
Base Salary levels (salary grade ranges) will be reviewed and updated annually in accordance with changes in competitive pay levels. Actual base salaries for executives covered by the plan will be administered within the base salary grade range established for the position in a manner consistent with the Company's salary administration policies taking into account individual performance, position within the range, and length of time in job.
Annual Bonus targets (expressed as a % of Base Salary) are separately established for the executive. These Annual Bonus targets recognize competitive industry annual bonus pay practices and the varying risk/return aspects of the Company's business units and the potential contributions to bottom-line results among plan participants. The sum of Annual Bonus targets and the base salary levels established for each position provide total annual cash compensation earnings opportunities which are at or, for performance achievement beyond the established objectives, exceed third quartile total annual cash compensation competitive measures.
SCORING STANDARDS
Maximum. A "superior" rating is achieved if the participant accomplished highly challenging objectives resulting in significant contribution to the EPB. This rating incorporates 10% statistical or interpreted performance in excess of the stated KPI's.
Target. An "excellent" rating is achieved if the participant accomplishes all objectives in a timely and effective manner and overall performance for the year is good.
Threshold. A "good" rating is achieved if the participant accomplished 90% of the KPI's in an acceptable manner including all of a group of objectives that were in "B" or "C" category **By permission of EPB Chattanooga.*

The Third Phase. The Board now had the responsibility of assessing Mr. DePriest's achievements and to evaluate the effectiveness of the entire Executive Compensation Plan concept. As the basis for their review, the Board emphasized that the ECP was implemented to help achieve three underlying objectives:

1. Supporting the City's vision,
2. Reshaping the culture of EPB and
3. Building a dynamic EPB Telecom business.

Table 7 LONG-TERM OBJECIVES - RESULTS		
	Results	**Documentation**
Corporate		
Establish and maintain improved diversity objectives in the area of employment and vendor selection. Employment diversity should increase by 3% each subsequent year. (Special emphasis should be given to the managerial/ executive areas of employment.)	The number of minority employees increased 5% over the prior year. In addition, two new executives positions were filled, one minority and one female	Personnel Monthly Report
Power		
Operate an efficient power business measured by the numbers of sales dollars and number of customers per employee compared with the Big 5	Sales dollars and customers per Big 5 per employee are as follows: Chattanooga $ 822,198 364 customers Knoxville 456,205 362 customers Memphis 470,654 358 customers Nashville 721,954 331 customers Huntsville 1,016,073 785 customers	Big 5 Annual Reports
Telecommunications		
Redefine and manage transitional EPB management profile	Development the concept of Senior Management Team, meeting profile weekly to deal with future issues, both strategic and tactical. The emphasis is on identifying problems and finding solutions proactively. As we reduce employee levels throughout the company, higher levels of cooperation, teamwork and sharing of resources will be a necessity. The next step is to move to team leadership at both the divisional and departmental levels. For the foreseeable future, team management will be the standard management format at EPB. Training in team leadership has been provided at all levels, and standards for group meetings and participation have been established. EPB Telecom is currently being reviewed and reorganized, with the objectives of 1) enhancing marketing and strategic planning skills, 2) improving sales performance and 3) instituting team management as Telecom is brought into the mainstream of EPB. An experienced consultant has been brought in and intensive investigation of all areas of performance has been undertaken. Problem areas have been identified and solutions are being implemented. Goals are 1) increased sales, 2) increased revenue growth, 3) deeper market penetration, 4) improved business systems and 5) reduced costs - company-wide.	
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These three goals were always in the forefront as the Board reviewed, and “scored,” Mr. DePriest’s KPI accomplishments. Table 7 presents the results of Mr. DePriest’s long-term performance with short term results shown in Table 8. Assume that you are the newest entrepreneurial board member and you are to assess Mr. DePriest’s performance. Based on the information provided, and using the format of the Rating Form provided (Table 9), how should the Board “score” each KPI? Indicate you numerical score and the rationale for each decision. Give special attention to your explanation of scores that exceeds the “A” category or falls within the “C” category. The rational is important as the board should be prepared to explain its final decision to the city.

Table 8
SHORT-TERM OBJECTIVES – RESULTS*

	Results	**Documentation**
Financial Objectives:		
Corporate		
Increase valuation of EPB by $6.5 million net plant value	Plant value increased by $7.4 million	Financial report
Successfully mentor construction of and move into new EPB facility without loss of effectiveness	Construction began April environmental issued successfully addressed with city and state. To control overall costs: a. Design changes to foundation were made; b. City has agreed to pay the additional design and construction costs due to changes c. Lighting and control systems for building were successfully bid with 10% minority participation	
Successfully develop research for exploration of an entrepreneurial venture as measured by board approval and plan/budget parameters (may include cable.)	Plan developed and obtained board, city council and state approval for EPB internet division as basic organization for Metronet.	
Power		
Write and maintain an accurate financial forecast on electric side for operating expenses to within 5% for fiscal year. Also, maintain telecommunications financial forecast to within 10% for one year, with substantial adjustment in year two.	Electrical operating expenses through December are 3.89% below budget	Electric system change in net assets; EPB telecommunications system change in net assets
Cost reduction via employee head count	EPB electric system full-time and temporary employees began at 414 and ended at 408, averaging 409. Contract forces were reduced early in the year and remain at low levels	Personnel monthly report
Reduce annual electrical bad debts write-off from $760,000 to $400,000 for the budget year	Electrical bad debt for calendar year was $204,415 due to bankruptcy.	Bad debt report
Telecom		
Grow telecommunications business to meet or exceed revised sales budget of $6.9 million	Telecom sales revenues for the budget EPB annual report year were $604,047,000 and lines sold and lines sold were 11,004. Lower revenues reflect FCC actions resulting in substantial loss of access revenue discounting to deal with competitive pressures from both Bell and 16 other CLEC’s now competing with us, and significantly lower line charges ($32.00 vs. $45.00)	Epb Annual Report
Individual objectives		
Corporate		
Design and implement an effective diversity program focusing on employment and vendor selection. Establish and track first year diversity percentage objectives of 20% employment and 1.8 % vendor diversity	Employment diversity is 21.6% excluding summer students and interns, and 22.2 including them. Last year diversity was 20.5%. Female employment stands at 35.1% compared to 34.7% one year ago	Personnel monthly report
Install equitable new compensation pay system comparing all jobs at EPB against common criteria and point factoring them into smaller number of pay grades	This objective was not addressed due to decision to institute a major reorganization and to identify and hire an hr executive. Progress was made in terms of developing and implementing a new performance appraisal system; and initiating the development of productivity measures by department and work area. An hr executive was identified and hired.	

Table 8
SHORT-TERM OBJECTIVES – RESULTS*

	Results	**Documentation**
Mentor executive group to actively participate in Chattanooga area civic leadership (as EPB representatives). Nine managers to seek out volunteer roles.	EPB executive participation in Chattanooga area civic leadership is now at an all time high with membership in the 14 organizations with one or more participants.	
Maintain good employee relations as measured turnover at 12% or below and unauthorized absenteeism at 0.01% or below	Turnover was 8.3%. Unexcused absenteeism for the year was 0.002% (two employees for one day each.)	Personnel monthly report
Write a succession plan – as measured by outlining senior succession, to two depth levels.	A succession plan has been developed for two levels senior executives.	EPB senior management succession plan
Improve management skills of company's measured by specific core competency expectations for managers and supervisors and development/ placement of training programs	Areas of improvement were identified by the senior team; managers attending monthly classes for 18 months. All managers have attended 7 training sessions led by president and executive vice president. All managers have attended 6 sessions on our union agreement, grievances and relevant issues.	Managers & leadership as supervisors reports – a. regular use of new techniques and b. decreases in non-emergency overtime; bad debts and abandoned call rates; employee turnover and customer service levels are up.
Power		
Customer satisfaction – measured by maintaining or improving the general customer survey category responses and by tracking the number of customer complaints and unresolved complaints.	Overall customer satisfaction increased from a score of 62 to 64 on our annual survey. The percent of customer rating EPB an excellent value remains at 48%, well above the average score of 37% for all utilities surveyed by our vendor. Additional surveys also high ratings.	EPB customer satisfaction and value survey
Continue to improve service continuity/ productivity measured by the number of customers out of service month/year), average duration out of service, percent of customer base with service per year, crew time efficiency against standard	EPB crew efficiency increased from an average of 92% to an average of 107%; even though lightning and related weather was three times as severe during the period than in previous periods. Our outage performance was excellent.	System reliability statistics
Telecommunications		
Revise marketing plan as needed to continue to improve market penetration	EPB received a complete marketing study outlining a "customer intimacy" marketing strategy. A "brand recognition and propensity to buy" study was completed along with several focus groups designed to examine appropriate marketing strategies. Sales training has developed and implementation of our new strategy has begun.	Local college plan

Table 9 EPB EXECUTIVE COMPENSATION PLAN* Key Performance Indicators (KPI's) Rating Form				
	Board Rating of KPI's Value	**Measurement Value**	**Percent Completed**	**Score**
Short-Term Objectives and Board Ratings				
Financial Objectives (50%)				
Corporate				
Increase valuation of EPB Company	A	300		
Successfully mentor	B	200		
Successfully develop research	B	200		
Power				
Write and maintain an accurate financial forecast	A	300		
Cost reduction via employee head	B	200		
Reduce annual electrical bad debt write-off	C	100		
Telecom				
Grow telecommunications	A	300		
Subtotal		1600		
Individual Objectives (50%)				
Corporate				
Design and implement an effective diversity program	A	300		
Install equitable new compensation pay system	C	100		
Mentor executive group to actively participate in Chattanooga area civic leadership	C	100		
Maintain good employee relations	C	100		
Write a succession plan	C	100		
Improve management skills of company leadership	C	100		
Power				
Customer satisfaction	A	300		
Continue to improve service continuity/productivity	B	200		
Telecommunications				
Revise marketing plan	B	200		
Subtotal		**1,500**		
Long-Term Objectives and Board Ratings				
Corporate				
Design and implement an effective diversity program	A	300		
Power				
Operate an efficient power business	B	200		
Telecom				
Redefine and manage transitional EPB management profile	B	200		
Subtotal		**700**		

THE TRILATERAL MBA: AN APPROACH TO INTERNATIONAL EXCHANGE OF STUDENTS

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Ronald G. Cheek, University of Louisiana Lafayette

CASE DESCRIPTION

The primary subject matter of this case is the development and implementation of a joint graduate program involving schools from multiple countries. Secondary issues examined include funding, business models, and evaluation of joint international programs. An innovative MBA program involving students and universities from three North American countries is presented. Other issues include the adapting of curriculum and using funding sources for these types of programs. Students reading the case are faced with a critical decision at the end of the case including whether the joint international program can continue and in what format.

The case has a difficulty level of five, appropriate for first year graduate level or above. The case is designed to be taught in one hour following appropriate introduction of the key issues involved. The case is expected to involve one hour of student preparation.

CASE SYNOPSIS

The face of internationalization of universities is changing. Students are opting for more programs where they earn a degree at an international institution. Universities are adopting new and innovative programs to retain high achieving students who have the ambition and drive to study outside of the U.S. While universities understand the importance of increasing the internationalization of their students, they also understand the importance of doing so at a cost neutral or relatively low cost method. This case examines the experiences of a U.S. institution, a Canadian institution, and a Mexican institution as they design and implement a joint program using the "twinning" approach. It examines some of the internal and external challenges that arise in internationalization efforts today.

While this case centers on the experiences involving an MBA program, the issues involved are easily adapted to other international and/or joint programs. This case can be centered on many different facets – curricular design, financing, development and balance of exchange programs, benefits and costs to students and a university of exporting and importing students, the role of grants in internationalization efforts, student recruiting, and selecting the appropriate exchange model.

INTRODUCTION

Higher education professionals are constantly looking for ways to improve the learning opportunities for students. One objective, especially in business education, is to provide additional opportunities for global learning. This can be done in numerous ways, including short term study abroad opportunities, semester long exchange opportunities, recruiting international students to be integrated into the domestic classrooms, and modification of the curriculum to include more global issues. When dealing with graduate management education, the opportunities are more limited than with undergraduate programs, primarily due to the shorter time frame for these programs. In addition, students in the US are much less likely than students from other countries to take part international study programs. As leaders of graduate programs in higher education, you are faced with the task of providing international education for your students while maintaining budget and curricular priorities. This exercise presents a relatively novel way of providing the opportunity, especially for US students, by developing a three-country cohort program for an MBA.

In 2002 you and the program directors from several schools from Mexico, Canada, and the U.S. met to discuss ways to expand the international efforts of their schools. The goals were to expand student opportunities for postgraduate education, strengthen their ties at the undergraduate level, expose their students to different cultures, increase language training and proficiency, and expand collaboration between the members of the faculty at their institutions. Since the North American Free Trade Agreement (NAFTA) was born only eight years before to lessen the economic barriers between these three countries it seemed natural for Mexico, Canada, and the U.S. universities to discuss ways to lessen educational barriers.

As a result of these discussions, a “Trilateral MBA” (TMBA) was created in an agreement between universities in each of these the three NAFTA countries. A cohort of students would spend one semester at each of the three schools as the major part of their individual MBA program. The program would be made available to entering full-time MBA students. Upon completion of their program students would receive an MBA from their home school and a certificate offered jointly by the three schools. The program was designed as a twinning program – a one-to-one exchange of students between universities. Students simply would pay tuition for each of three semesters to their home institution. They would attend the two foreign schools under an exchange agreement.

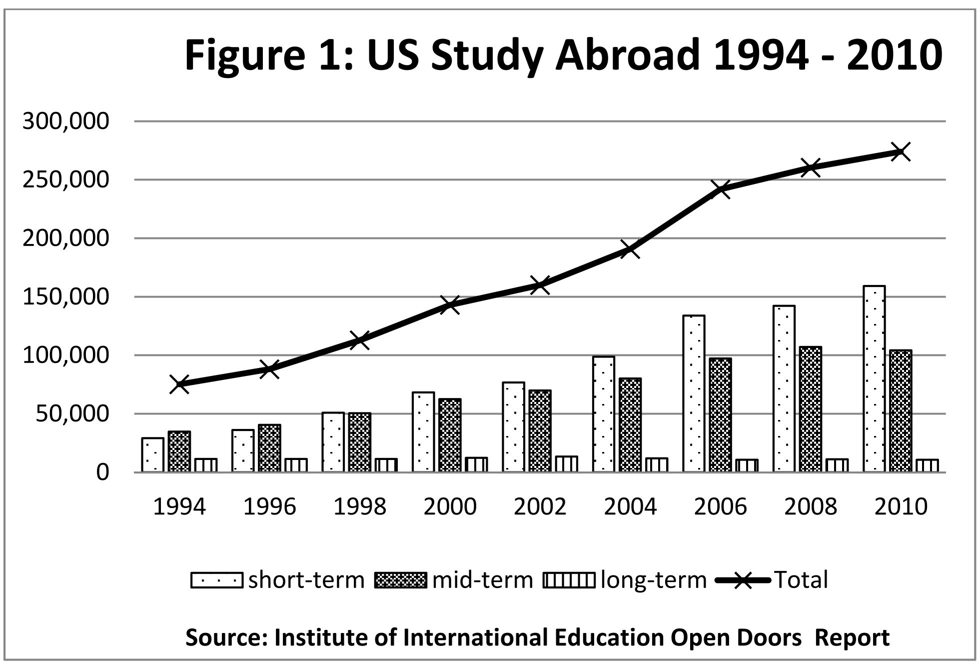
Students would spend the fall term in a French-speaking province in Canada, the spring term in the U.S., and the summer term in Mexico. The language of instruction for all students would be English. One institution from each country was chosen by the planners. Students would be required to complete the graduation requirements from their home institution. Students would be allowed to also take additional classes in their home institution in their native language – English, French, or Spanish. All students would also participate in language training and cultural immersion programs while not in their home country.

You presented the opportunity to the graduate faculty at your institution and they decided to undertake this program on a trial basis. The administration at your university was supportive of your participation. Your institution modified the course offering rotation in their program to fit the TMBA model. In order to meet the needs of the TMBA, your faculty developed a specialized course in international accounting.

TRENDS IN US STUDY ABROAD

A record-high 276,495 students from universities in the U.S. studied abroad for some period of time during the 2010 academic year (Institute of International Education, 2013). This number has more than doubled since 1998 with most of the growth in the short-term (summer or up to 8 weeks) and mid-length (1 semester) programs. However, that number may be reaching a plateau because the number of U.S. students studying abroad grew only 1.3% in the 2010 academic year compared to 2009. Though the number of U.S. college students who study abroad has increased dramatically over the past three decades, only 1 in 100 college students take advantage of a study abroad opportunity in any given year.

There are two general effects to observe about enrollments. First, there has been a tremendous demand for U.S. study-abroad programs in recent decades. Second, the increase in demand may have leveled off. This is shown in Figure 1.



One exception to the plateauing trend is the increase in the number of U.S. students pursuing their entire degrees abroad. About 46,000 U.S. students are studying abroad for their entire degree in 2011, up 4% from 2010 (Institute of International Education, 2013).

The U.S. students who study abroad are particularly attracted to short programs. About 38% of U.S. students who studied abroad did so during a short summer term and another 13 % studied abroad for eight weeks or less in some other term during the year; only about 4% study abroad for a calendar or academic year (McMurtrie, 2012).

The top destinations for U.S. study abroad programs are, in order, the UK, Italy, Spain, France, and China (Institute of International Education, 2013) as shown in Table 1. Study-abroad students change their target countries based upon external events. For instance, last year the biggest drops in study abroad trips were to Mexico (-42%) and Japan (-33%). The declining interest was likely due to drug-related violence in Mexico and the tsunami in 2011 in Japan (McMurtrie, 2012).

Table 1
Top Destination of US Students Studying Abroad 2010 - 2011

Rank	**Destination**	**2010/11**	**%**
1	United Kingdom	33,182	12.1
2	Italy	30,361	11.1
3	Spain	25,965	9.5
4	France	17,019	6.2
5	China	14,596	5.3

Source: Institute of International Education Open Doors

A classic literature review on the benefits of study abroad listed four primary gains from the perspective of the student, "greater awareness of cultural relativity, increased open-mindedness, broadening of horizons, and new insights into one's own self" (Marion, 1980). Three major reasons for internationalization from the perspective of higher education have been recently stated: 1) interest in international security, 2) maintenance of economic competitiveness, and 3) fostering of human understanding across nations. (Aigner et al, 1992).

A fourth reason might be added: the financial rewards to the institution. Internationalization has both direct and indirect financial aspects. Direct financial considerations for institutions of higher education in the US, and several other nations, is increased tuition from foreign students. The "selling" countries are the large English-speaking nations and some EU countries. The "buying" countries are Asian and Latin American middle-income countries and the poorer nations that lack capacity to meet growing demands (Altbach and Knight, 2007).

However, the rate of enrollment growth in study abroad programs has eased. Allan E. Goodman, the president of the Institute of International Education, says colleges should not blame study abroad's sluggish growth entirely on the weak economy. Goodman says, instead, institutions need to make the study-abroad options more accessible to more types of students and offer them earlier than in the junior year. "We have the wrong paradigm" (McMurtrie, 2012).

The strong increases of U.S. students in the shorter study abroad opportunities over the past decades may indicate that higher education is expanding the "go to…" programs where students from the US visit, tour, and do limited study in a host country. These "one-off" or even repeated opportunities serve a certain set of purposes. However, there may be a need for more programmatic or structural approaches formalizing relationships between institutions.

Recent structural innovations have been the creation or expansions of face-to-face and virtual modes to deliver education to students in their home countries through twinning, franchising, articulation, validation, and joint or double degree arrangements. Some colleges and other providers are establishing a physical presence through branch campuses, independent institutions, teaching and testing centers, and acquisitions or mergers with local or host country colleges and universities (Altbach and Knight, 2007).

EXCHANGE MODELS

Collaborative international programs may be designed in many different ways, or a mix.

1. Direct enrollment – students pay tuition at the institution where they are taking classes. This option works well if the cost of tuition is comparable at the participating institutions.

2. Continuing Education/Outreach – a more recent model for entrepreneurial programs at some institutions is where programs are operated by an arm of the university with more flexibility at funding and tuition. Under this process, differing tuition may be allowed, providing a mechanism for balancing exchanges without suffering significant financial loss.

3. Twining programs – an exchange, where students pay tuition to their home institution while studying at a host school. Therefore, each student from one country is "twinned," for accounting purposes, with a student from the second country. A number of parameters can be adjusted in such agreements. For instance, a 3:3 ratio might be a part of a bilateral agreement between a U.S. and Mexican university where each sends and receives three students. However, an American university might be willing to accept six Mexican students for every three it sends to Mexico (6:3) for a variety of reasons, such as increasing diversity or strengthening language programs. Sources of funding outside the twining model may supplement the program (grants, incentives, endowments, etc.).

4. Balanced twining program – a special case of twinning which requires a balance between incoming and outgoing students, either on a yearly basis or on a rolling basis. Either the ratios are always even, such as 3:3, or specific remedies are negotiated to keep the program in balance. For instance, if there is an imbalance between incoming and outgoing students, the institutions may settle the difference by making payment from the school with a surplus of outgoing students to the school with a surplus of incoming students.

5. Hybrid – a mixture of these approaches may be employed.

Some speculate that there might be thousands of twinned programs (Altbach, 2007). Not all twinned programs are between institutions in two different countries since domestic twinning programs also exist. However, the estimate of thousands does suggest that there are many small agreements between many schools.

PROGRAM CHALLENGES AND HISTORY

In order for the TMBA program to be successful, several barriers relating to funding and curriculum had to be overcome at each institution. Each school operated under different business models and each had their own curricular process.

Under the TMBA program each institution operated under its own and separate business model. The Canadian school required a minimum enrollment of three tuition paying students in order to break even. It offered special classes for the U.S. and Mexican students through a Continuing Education/Outreach model coupled with a twining approach. This allowed them to cover the cost of hiring adjunct faculty to teach in English since the school ordinarily teaches classes in French. The Mexican school, due to funding, needed to offer the courses in the summer term. This provided them the funds to offer the specialized classes necessary in English. The U.S. school employed a twining model and needed a two-to-one (or 1:1:1) balance between the incoming and outgoing students to meet the twining requirement at their institution.

Each institution worked with the appropriate university, accrediting, state, and federal agencies in order to assure curricular requirements were being met. There was need to closely coordinate the rotation of courses offered at each institution. Each institution provided cultural and language studies, either as part of the curriculum or as extracurricular activities. While none of the institutions made a significant change to the graduation requirements of their students, they adopted mechanisms to fit the joint curriculum into their existing frameworks. Major differences between the curricula were handled internally – the school in Mexico required an internship and a thesis. Students from Mexico and Canada completed distance learning courses at their home institutions while studying away. The U.S. institution adapted the curriculum to fit the programs already in place.

At the time the program was developed, your institution along with the Mexican institution were at the end of a North American Mobility (NAM) grant. The Canadian and your institution were in the planning year of another NAM grant. A third NAM grant was secured by these partners four years later. These grants provided student funding for U.S. and Canadian students to help balance the cost of study at their home institution and the host institutions in Canada or the U.S. Institutional and personal funding was necessary to supplement the cost for U.S. and Canadian students studying in Mexico.

Year one (academic year 2003) saw seven participants; four from Mexico, two from Canada, and one from the U.S. It was anticipated that participation would be low for the inaugural year given that the program was launched less than one year after the development. Each school was positioned to operate despite financial loss. For the U.S. school, there was an imbalance of -1.5 students for the year. The second year (2004) of the program saw enrollments necessary for balanced twinning. There were three students from each of the programs. In the third year (2005) three U.S., three Canadian, and four Mexican students participated. This increased the imbalance of the U.S. school by .5. The Mexican participation dropped in the fourth year (2006) to two students, and that for the U.S. and Canada increased to four and five respectively. The U.S. school saw a surplus of 0.5. However, in the fifth year (2007) no U.S. students participated, but five joined from Canada, and four joined from Mexico.

About the time of the fifth generation press reports about drug violence in the Mexican border states became more prevalent and soon afterwards the U.S. Department of State issued its first travel warning for Mexico. Under U.S. Department of State guidelines, a travel warning is issued for an entire country and not for specific areas. The Canadian government issued travel advisories for specific states in Mexico. The state in which the participating university in Mexico is located has never been mentioned by either the U.S. Department of State or the Canadian government information as being an area where problems have occurred. In fact, the Mexican city has a reputation for low crime.

Each institution had internal policies in place that restricted travel to locations where their respective governments advised against travel. Since the state in Mexico was not included in the Canadian travel advisory, this did not pose an internal obstacle for the Canadian students. However, the nature of the U.S. travel warning set into place a process at your university that required significant administrative hurdles to allow student participation in the program.

Given the US Department of State travel warning issued for Mexico, you needed to work with its administration to allow student participation in the program in Mexico. This was done in consultation with the U.S. Department of State, the university counsel, and the international office. Students were required to sign a copy of the travel warning along with acknowledgement that they should avoid travel to any areas mentioned as being particularly volatile.

Table 2: TMBA Participation by Year

	Student From		
Year	**US**	**Mexico**	**Canada**
1	1	4	2
2	3	3	3
3	3	4	3
4	4	2	5
5	0	4	5
6	1	4	4
7	3	5	3
8	0	5	1
Total	**15**	**31**	**26**

Given this situation, you were able to recruit only one participant for the sixth year (2008). This student joined four each from Mexico and Canada. The group in the seventh year (2009) had three U.S., three Canadian, and five Mexican students. In the seventh year (2010) there were no U.S. students, one Canadian, and five Mexican students. Press reports regarding violence in Mexico harmed recruitment of students. Parents and potential students objected to traveling to Mexico because of safety concerns. Such objections led to a total lack of U.S. applications. Only one Canadian enrolled. Data concerning the student participation is shown in Table 2. In order to balance, your school must have one student going out for each two students coming in (total), reflecting the fact that you collect two semesters of tuition while your students are away.

PROGRAM EVALUATION

The literature regarding study abroad programs suggests programs be evaluated on the success of 1) cross-cultural competency, 2) language acquisition, 3) value added to the student learning experience for participating students (employability, increased earnings potential, etc.), 4) value added to regular MBA students not part of the TMBA cohort but who interact with TMBA students, 5) expansion and enrichment of the institution's curriculum, and 6) increased collaborative options for faculty and staff.

While participation from your school was low, the success of the program based on the items listed above was positive. The addition of the cohort of students to the classes at your institution was met with great enthusiasm by the students, faculty, and administration. The participation of this cohort in classroom discussions and within the university community greatly enhanced the learning within the classroom and offered an outstanding exercise in understanding cultural differences and the impact they have on business decisions. The benefit was felt not only by the participating students but also by the students and faculty who were not mobile through the program.

The TMBA program was successful from the reports of student and faculty participants. Students who were not in the TMBA cohort but were in classes with TMBA students also reported positive experiences through interaction with students from different cultures. The experiences and insights added to these classes greatly enhanced the understanding of international business and culture. Each of the institutions developed new courses and/or adapted existing courses to meet the needs of this program. Graduates of the program have gone on to work with international corporations.

Your institution billed your MBA program for the tuition of the students your university is in deficit from the program. Given the declining numbers, the external conditions, and other considerations in this case, the three institutions are faced with the decision about what they should do. Should they continue, modify, or discontinue the Trilateral MBA?

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SOUTH CAROLINA DEPARTMENT OF REVENUE: MOTHER OF GOVERNMENT DYSFUNCTION

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CASE DESCRIPTION

This case describes a successful spear phishing attack, the factors that precipitated it and the response to the crisis by top management. The primary issues concern the mismanagement of information systems security by top management, the conflict in goals between executive management and the information security professionals, and crisis response.

This case may be used to highlight several different perspectives. One perspective involves the management of information systems and information systems security, a second involves information silos, and a third concerns crisis management. This case is suitable for graduate and advanced undergraduate management information systems classes. The case has a difficulty level of five. Students should spend from ten to fifteen hours outside of class analyzing the case, depending on the breadth and depth of the analysis the instructor desires.

CASE SYNOPSIS

In 2012, the South Carolina Department of Revenue (DoR) was a victim of a spear phishing attack that led to the biggest data security breach on record for a U.S. state government. This case describes how the spear phishing attack began, what the attacker did, and the conditions that made the DoR vulnerable to the attack. The attack, which resulted in the theft of confidential data on 3.8 million individual taxpayers and 699,900 businesses, was enabled by an executive decision not to spend a relatively small amount of funds for a needed information system security system. The initial response when news of the attack became public is a classic example of poorly handled crisis management.

The DoR is responsible for collecting and processing $8.5 billion of tax payments. Decisions to reduce expenses for proper safeguards to protect its computer network, databases, and taxpayer data, made the information system vulnerable to the attack. Mismanagement of the information system is a chronic problem for state governments due to their hierarchical structure and insufficient funding. The case title characterizes the incident and how it was handled as the "mother of management dysfunction." While this portrayal may be extreme, it is not made lightly. Rather, it reflects the seriousness of the incident and issues related to it.

INTRODUCTION

November 20, 2012: The Public Incident Response Report about the security breach of the Department of Revenue's (DoR) information system was released to the public. The report identified the type of attack, how it was carried out, and the assessment of the known damage. The security breach perpetrated from an unidentified eastern European country and was the largest cyber theft of data ever from a state information system in the United States (Brown, 2012).

SPEAR PHISHING ATTACK

The attack began on August 13, 2012 when the Director, Jim Etter, received an email message from someone he did not know that had an attached file. He opened the attachment which activated embedded code. The code surreptitiously installed a malware program on his office workstation, opened a backdoor port, and beaconed to a command and control web site, suspected to be in Eastern Europe or Russia. Then, the malware sent Etter's username and password (a.k.a., user credentials) to the command and control web site, and downloaded and saved several utility programs to his computer.

Two weeks later (August 27), the attacker logged into the DoR's remote access service (Citrix) using Etter's credentials and gained access to his workstation, several DoR servers, and databases. Two days later, the attacker installed a previously downloaded utility program to obtain additional usernames and passwords.

September 1, the attacker executed the utility program and attempted to obtain all Windows user credentials on six DoR network servers. Additional utilities were installed and a backdoor port established on a network server for later use.

The next day, the attacker interacted with twenty-one servers and performed various reconnaissance activities, including logging on to the application server that handles tax payment and account maintenance information. No data was retrieved, copied or damaged during this intrusion.

September 3, the attacker accessed eight servers and performed various reconnaissance activities. Again, the attacker accessed the tax payment application server, but did not accomplish anything malicious. September 4 and 11, the attacker accessed six DoR systems and performed more reconnaissance activities.

On September 12, the attacker copied database backup files to a staging directory on the database server. Then, over the next two days, database backup files were compressed into 14 of 15 encrypted 7-Zip archive files. Then, the 7-Zip files copied from the database server to a staging server before being uploaded to an undisclosed Web site. Once the upload transmission completed, the backup files and 7-Zip files were deleted from the staging server. On September 15, the attacker interacted with ten DoR systems and performed more reconnaissance activities.

October 10, U.S. Secret Service agents notified the Governor and DoR that credentials of three DoR employees and personally identifying information of South Carolina taxpayers were for sale on the Internet. Good credentials to gain access to a government system can fetch as much as $30,000 on the black market (Westervelt, 2011). The Secret Service began monitoring the DoR system and attempted to collect information about the attacker. The next day, a forensics team from Mandiant Corporation, a global information security company that specializes in cybercrime response and forensics, began working with the Secret Service to investigate the scope of the data breach and to contain it.

October 17, the attacker checked the connectivity to the staging server using the backdoor installed on September 1. Two days later, the Mandiant forensics team began remediation activities to remove the attacker's access ports (i.e., backdoors) and to detect further attacks. Between October 21 and November 20, there was no evidence of new activity by the attacker.

Full implementation of security monitoring began October 20, ten days after the state first learned about the intrusion and the stolen data, and thirty-eight days after the security breach started (Barr, 2012).

On October 30, the Governor and Jim Etter held a press conference to inform the public about the attack. The press was told that investigators did not yet know if the attacks were done by one person or a by group, and that an investigation was being conducted.

The Mandiant Public Incident Response Report (PIRR) and the state's response plan were released on November 20 (South Carolina Public Incident Response Report, 2012).

DAMAGE ASSESSMENT

Data on 3.8 million people stolen, including 1.9 million dependents;
Data on 699,900 businesses stolen;
3.3 million bank account numbers stolen;
Total cost as of December 1, 2012 was $14 million;
$12 million contract with Experian for taxpayers one year of free credit-report monitoring, hiring public relations firm and outside lawyers;
At least 33 unique pieces of malicious software and utilities to perform the attack were installed.
Attack activities included:

- One backdoor port on a network server created;
- Multiple password hash dumping tools installed;
- Multiple administrative utilities executed;
- Multiple Windows batch scripts to perform scripted actions installed and executed;
- Multiple generic utilities to execute commands against databases;
- Remotely accessing DoR systems using at least four IP addresses;
- Used at least four valid DoR user accounts, including the Director's;
- Created 15 encrypted 7-Zip archives totaling approximately 8.2 GB for total of 74.7 GB of uncompressed data;
- 23 database backup files packed in 14 zip files;
- One zip file contained about1200 files related to the sctax.org web site (S.C., 2012).

CRISIS RESPONSE

At the October 20 press conference, a high-ranking state official reported that who or how many people attacked the DoR system was unknown. The attack was described as being very sophisticated and perpetrated by someone who did not access the DoR system via the Internet, but by "… somebody that joined the conversation." (WISTV, 2012) In other words, the attacker intercepted unsecured wireless transmissions at some location in the DoR's statewide network, and assumes the identity of a legitimate user in order to obtain other users' credentials. This is type of invasion is known as a "man in the middle" (MITM) attack.

In an MITM attack, the attacker intrudes into a network to intercept the exchanged data and messages by masking as an authorized user. It involves eavesdropping on a connection, intercepting messages, and selectively modifying data. MITM can occur if there is an unsecured wireless access point. Techniques used for MITM attacks are classified by three network environment types: Local Area Network, from Local-to-Remote (through a gateway), and Remote. (Man-in-the-Middle Attack, 2008) Today, network operating systems typically incorporate a network authentication protocol called Kerberos to prevent MITM attacks. Kerberos uses "tickets" or keys to allow nodes communicating over a non-secure network to prove their identity to one another in a secure manner (What Is Kerberos Authentication?, 2003). [Note: Knowledge of the mechanics of Kerberos is not necessary for understanding the main issues of this case.]

The DoR was characterized as a hapless victim. "It was just one of those things that happens (sic). There was nothing more that could have been done" (WISTV, 2012). However, when the Mandiant forensics investigation report was released, two vulnerabilities were revealed. First, there was no dual verification login protocol to get into the system. Second, the Social Security data of individual and business taxpayers were not encrypted (Cohn, 2012).

State officials blamed outdated Internal Revenue Service (IRS) standards for not encrypting the Social Security data. "If you combined the fact that we had 1970 equipment with the fact that we were IRS compliant, [it] was a cocktail for an attack…The IRS, which we were compliant with, does not believe that you have to encrypt Social Security numbers...This is a new era in time where you can't work with 1970 equipment, and you can't go with compliance standards of the federal government" (Westervelt, 2012).

The next day, the IRS responded by issuing the following statement. "Protecting taxpayer data is our top priority at the IRS…We work closely with the states to ensure the protection of federal tax data. We have a long list of requirements for states to handle and protect federal tax information. Just as importantly, we expect the states to follow the standards of the National Institute of Standards and Technology." (Goldman, 2012)

The claim that the DoR information system is badly outdated is dubious, given that the South Carolina's online tax filing systems is ranked seventh in the nation for percentage of taxpayers filing returns online (see Table 1). Furthermore, the DoR is currently developing several technically sophisticated systems, such as the Business One Stop system, and expanding its image and data capturing abilities with high-production optical scanners.

As part of the crisis response plan, the state contracted with Experian, a major credit reporting service, to provide all affected taxpayers and businesses that had filed a return since 1998 with one year of free credit monitoring and identity protection. Citizens were urged to contact Experian.com to create a personal account and to check their personal credit report (Westervelt, 2012).

Table 1
Rank of States by Percentage of 2011 Online Tax Filing
(Source: S.C. Department of Revenue Accountability Report 2011–2012, p. 48)

Ranking	Percent of Electronically Filed Tax Returns	State
1	97%	Idaho
2	93%	Kansas, New Mexico
3	92%	Iowa, Montana, Nebraska
4	91%	North Carolina
5	90%	Kentucky, Michigan, Minnesota, Ohio
6	89%	New York
7	88%	Illinois, Louisiana, Massachusetts, South Carolina, Utah

TARGETING STATE GOVERNMENT

Organizations can protect their systems by regularly analyzing their server logs and by installing a dual password security system (Wright, 2012). However, while these safeguards are well known, many organizations, especially state and local governments, do not employ them even though the time and cost involved is relatively minor.

Breach investigation reports of state and local government computer systems typically cite insufficient funding and lack of quality IT talent as major problems. Eighty-six percent of state government chief information security officers (CISO) cite insufficient funding as the biggest barrier to addressing cyber security issues. The 2012 Deloitte-NASCIO survey reveals that 24% of CISOs believe their personnel have large gaps in competency, which was up from 17% in 2010 (NASCIO, 2012).

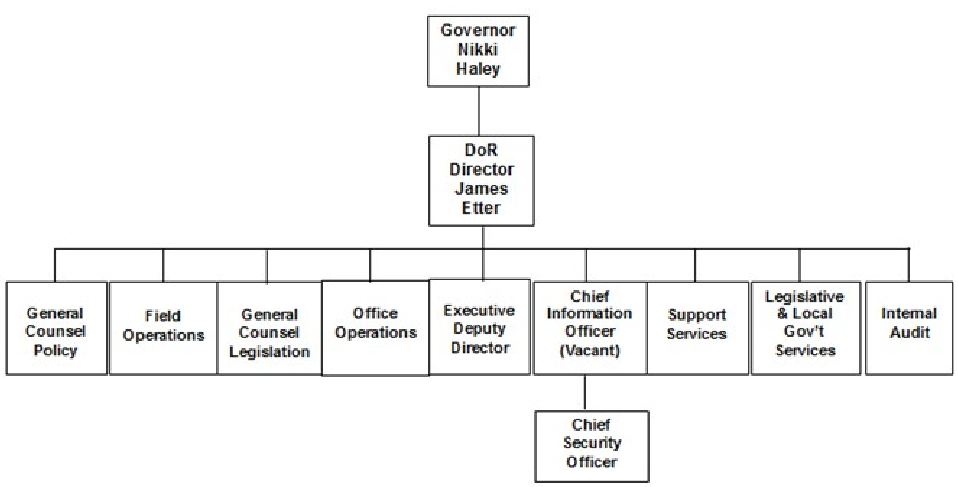
Chris Swecker, the former official with the FBI in South Carolina, while speaking at a conference on computer hacking, stated that state governments make themselves particularly vulnerable when agencies operate in "silos" rather than coordinating their information technology programs. While he wasn't privy to any details about the DoR computer breach, he stated that hackers almost always infiltrate computer systems through top executives, who tend to be clueless about security risks (Scoppe, 2012). Unfortunately, these executives are usually the ones who approve or reject the requests for security systems expenditures. "Even the best IT professionals can't protect an agency whose director prefers to hire more auditors, rather than those paranoid geeks who keep nagging about systems security" (Scoppe, 2012).

The Chief Security Officer in the South Carolina Division of State Information Technology (DSIT), James MacDougall spent the past two years encrypting state agency databases, except those in the DoR. Homeland Security grants had financed this database encryption project. An article is posted on the Information Sharing & Analysis Center (ISAC) website that stresses the need for state agencies to encrypt their data to keep it from being stolen (Barr, 2012). October is Cyber Security Awareness Month for the state government (Cyber Security Guide, 2012). The main event that month was the "Cyber Security Awareness" seminar led by MacDougall with presentations from the State Law Enforcement Division, IBM, the FBI, and cyber security firms (Potter, (2012).

CONFLICTING GOALS

The economic recession that began in 2008 severely strained the state's economy and state budget. In response, the state legislature and the new governor were committed to strict control of government spending (Tighe, 2011). Sixty-nine year old James Etter, a CPA with more than 30 years of accounting and financial management experience, was appointed the Cabinet position of Director of DoR (see Figure 1).

Figure 1: Department of Revenue Management Structure
(Source: S.C. Department of Revenue Accountability Report 2011–2012, p. 23)



As a loyal Cabinet member, Etter was committed to tight control of spending in his department (Smith, 2011). During the twenty-four months Etter headed the DoR salaries stagnated, funding for professional development opportunities was cut, and the historically low rate of voluntary employee resignations increased (Figure 2). The department's Chief Information Officer (CIO) resigned in September 2011. As of January 2013, no applications for the CIO position had been submitted by qualified applicants. The lack of interest in the CIO position might be due to the relatively low advertised salary of $126,458 (Exhibit A). By comparison, the median CIO salary in Columbia, S.C. is $154,380 (Figure 3).

Figure 2: Voluntary Full-time Employee Resignations
(Source: S.C. Department of Revenue Accountability Report 2011–2012, p. 49)

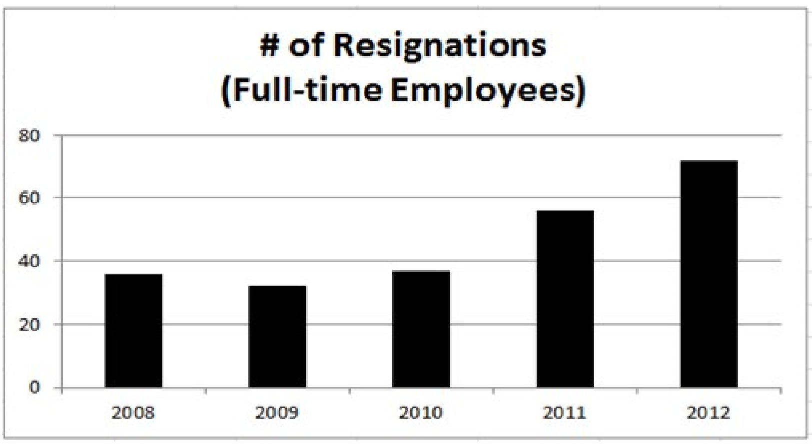
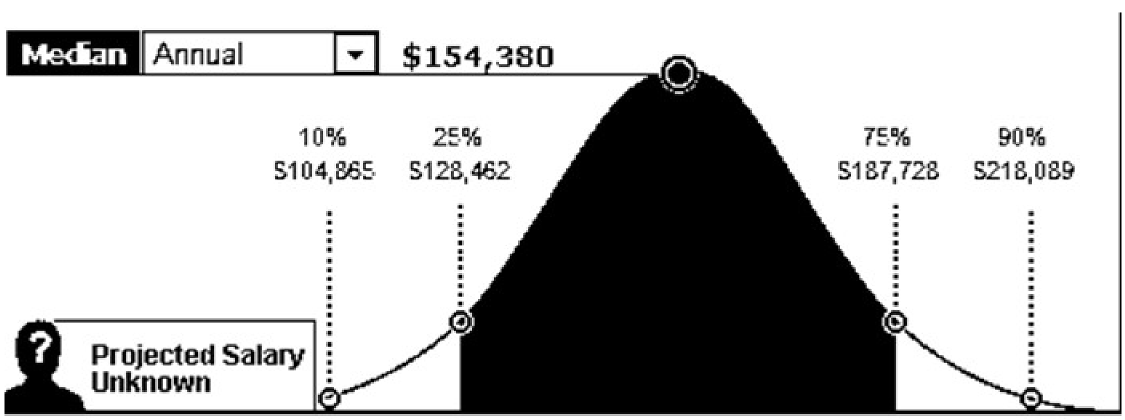


Figure 3: Salary Distribution for Chief Information Officers in Columbia, SC
(Source: http://swz.salary.com/SalaryWizard/Chief-Information-Security-Officer-Salary-Details-Columbia-SC.aspx)

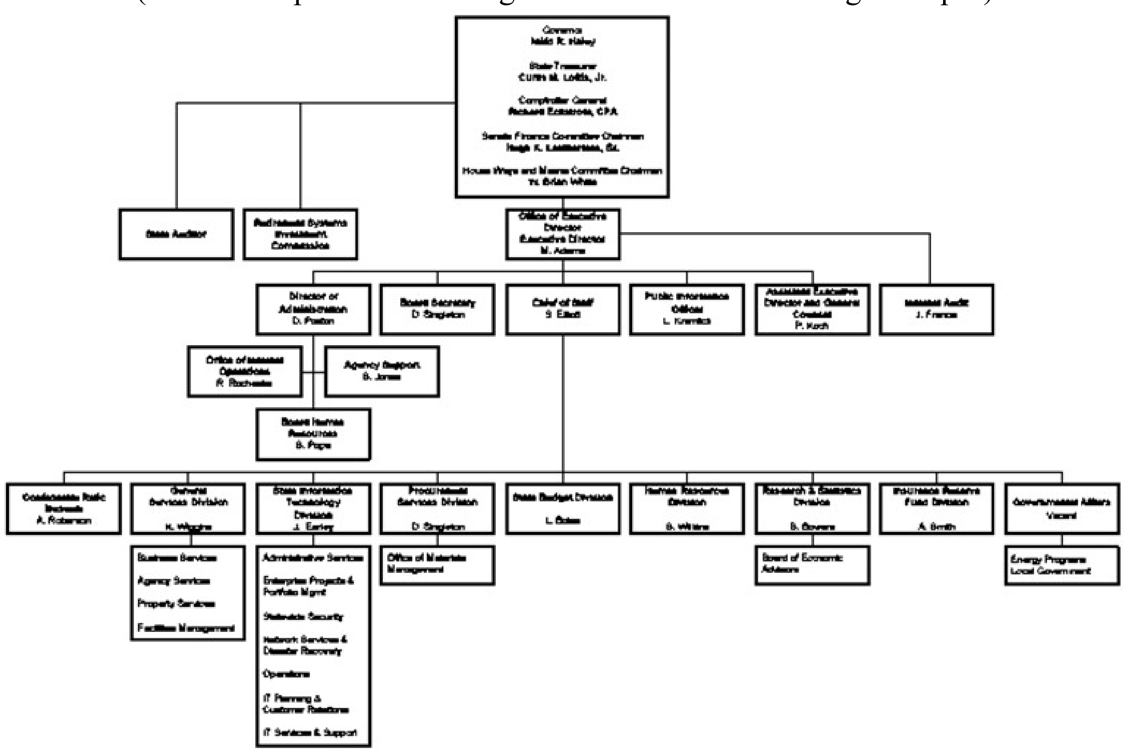


During a State Senate committee investigation of the spear phishing attack, it was revealed that both Etter and the previous DoR director, had rejected the advice of department's Chief Information Security Officer, Scott Shealy, to install the $25,000 dual password security system used by all other state government departments (Largen, 2012). Shealy told a House panel that the attack "actually wasn't very clever or hard to detect" and could have been prevented by software with a dual password protocol (Adcox, 2013). The Mandiant investigation report confirms Shealy's assessment.

A NEW BEGINNING?

Bill Blume was appointed Interim Director of the DoR to replace James Etter. In his appearance before a Senate confirmation committee, he stated his goal is to restore public confidence. To begin that process, his first act will be to spend $1.5 million to strengthen the DoR's computer security. He assured the committee that he considers security "a cost of doing business and an investment, rather than an expense" (Shain 2013).

Figure 4: Organization Chart for the Budget and Control Board
(Source: http://www.ohr.sc.gov/bcbintra/docs/BCB-OrgChart.pdf)



While Blume's plan addresses an immediate security need, it does not address the information system silo problem. The current organization structure (Figure 4) places the Director of DSIT four levels down in organization hierarchy and the Statewide CIO five levels down. This structure provides no authority to set and enforce standards for the DoR information system. Revamping the organization structure to give the DSIT and the Statewide CIO management authority over all departments will require the approval of the legislature.

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EXHIBIT A: Job Opening Announcement

(Source: http://agency.governmentjobs.com/sc/job_bulletin.cfm?JobID=583655)

STATE OF SOUTH CAROLINA Department of Revenue INVITES APPLICATIONS FOR THE POSITION OF: Chief Information Officer

OPENING DATE: 01/15/13
STATE SALARY RANGE: $68,350.00 - $126,458.00 Annually
JOB RESPONSIBILITIES:
This position is at-will and in accordance with Act 146 (H3442), incumbent will be exempt from the State Employee Grievance Act. Administers and directs all aspects of the technology needs for the SC Department of Revenue (DOR) to include ensuring appropriate security controls are in place that will safeguard digital files and vital electronic infrastructure. Ensures physical security of computing and communications systems. Provides senior leadership, vision, and direction in the planning, development, implementation, coordination, and maintenance of all programs and activities assigned to the Information Resource Management (IRM) Division, including the Agency's tax systems and SC Business One Stop. Establishes priorities and milestones in coordination with technology management staff and provides progress reports to the Agency Director and Executive Deputy Director at regular intervals. Forecasts Agency IT needs, assesses project feasibility and requirements, and makes recommendations. Identifies emerging technologies that will support the mission of the Agency, and plans their introduction into production systems. Participates in formal strategic planning sessions for the DOR. Establishes strong working relationships with Senior Management throughout the Agency and provides guidance and direction in assessing technological needs and priorities. Oversees the design, development, and implementation of new applications and changes to existing systems and software. Responsible for the development, testing, and certification of all back-up and disaster recovery procedures and plans. Maintains sound fiscal and personnel planning and management by ensuring optimum use of fiscal resources and efficient utilization of staffing resources. Advocates for employees in the IRM division and facilities career enhancement opportunities.
PREFERRED QUALIFICATIONS:
Master's degree and project management skills. Extensive knowledge of IT direction, management, and planning techniques. Thorough knowledge of IRM concepts and techniques. Thorough knowledge of IT capabilities, including mainframe client/server communications, storage, and retrieval techniques. Knowledge of cyber security requirements and printing industry practices and techniques. Leadership and delegation skills along with the ability to build and maintain strong working relationships. Professional written and verbal communication skills.

TIEN SON: GROWING A STUDENT BUSINESS AFTER GRADUATION

Joseph Trendowski, University of Evansville

CASE DESCRIPTION

The primary subject matter of this case concerns the transformation of a student-run business after graduation. The secondary issues examined include geographic market expansion and balancing technology and personal service. The case has a difficulty level of three; junior level. This case is designed to be to be taught in one to one and a half hours and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Lan Do is a member of an eight generation family business. She came to the United States for an American business education to help her family business grow back home in Viet Nam. During the fall semester of her junior year, she co-founded ViCo Fashion with friend Andrea Cadavid as part of an entrepreneurship course with Lan focusing on Men's suits. The following semester, Cody Land joined the team and helped transform Tien Son from a student business into a legitimate custom suiting option for the greater Evansville, Indiana metropolitan area. As graduation approaches, Lan must decide whether to accept a position at Vectren Corporation and continue the business part time, or devote full-time hours to Tien Son.

BACKGROUND

In 2010, Lan Do was preparing herself for an adventure that would ultimately shape her entrepreneurial future. Lan is part of an eight generation family business back home in Hanoi, Viet Nam. Lan's family opened their first custom tailored clothing business in 1891. Her ancestors first learned the craft from French colonists who occupied Viet Nam when it was a part of French Indochina. Since then, the trade has been passed down from generation to generation. Her father, Son Do, specializes in European styled men's clothing. He has been running his own business successfully for over 25 years. Lan anticipated that she would study in the US for a few years and bring back what she learned to the family business.

When Lan arrived on campus at the University of Evansville in Evansville, Indiana she instantly befriended Andrea Cadavid who was another international student with a similar passion for fashion. They both enrolled in a series of entrepreneurship courses where students are required to develop a business plan in the fall semester and subsequently run that business during the spring semester. Lan stated, “We complement each other well and show a huge interest in fashion. We had the idea of opening a business where we can sell both professional wear and underwear for men and women.”

Lan felt the entrepreneurship courses would be a great way to understand what it was like to run a business as her parents did. As she prepared to launch the business, Lan conducted primary research on the local market and was surprised to find there was a strong demand for custom made suits in the Illinois-Indiana-Kentucky Tri-State Area. She believed that this would be a great opportunity to create a successful business in the United States.

Combining Lan’s experience in the custom tailored suit industry and Andrea’s experience modeling underwear in Columbia led them to develop a fashion company named ViCo. The name ViCo comes from the names of the founders’ home countries; Viet Nam and Columbia. The original business plan called for two companies under ViCo – Tien Son Custom Suits and CaDo underwear. Despite the partners working well together, the two product lines were too dissimilar to make for a strong collaborative effort. Both partners mutually agreed to create separate companies to avoid future difficultly. Lan stated “Sometimes you have to put business before personal.”

Lan moved forward with Tien Son with a new partner, Cody Land. Cody was born and raised in Evansville before spending four years in the United States Air Force. After his deployment, he returned to Evansville to attend college. Like Lan, he is a non-traditional college student with a breadth of real life experiences that many students don’t have until several years after graduation. Besides being a Veteran, Cody had previous experience of starting his own business, Everything Auto. With Lan’s fashion sense and Cody’s business experience; the Tien Son management team complements each other well.

MOVING FORWARD WITH TIEN SON

In January 2012, Tien Son began business operations. Early on, Lan faced the same array of challenges that confront any entrepreneur. As a full-time college student from another country, Lan had limited resources to raise capital. Therefore, initial funding came from her partner Cody. He, Land invested the initial startup capital to create a website, order necessary business equipment and other startup related expenditures.

Additionally, Lan received non-monetary support from her parents back home. Her parents provided Tien Son with initial products until the company was able to be self-sustaining. Lan is grateful for that support, “It frees up our cash flow and helps to build a stronger inventory”. With the inventory support of her father, Son Do and the financial backing of Cody Land, Tien Son was able to get started.

Lan believes that suits should be just like the men and women who wear them – completely unique, not generic or mass-produced. Unlike off-the-rack suits which come in short, regular and long, each custom tailored suit is hand-cut to the customer’s exact dimensions. She feels that when a customer designs the suit to his or her taste, it truly becomes theirs. Additionally, the customer has the ability to add monogramming to personalize even further.

Tien Son distinguishes itself through exceptional customer service. Cody and Lan assist the customers throughout the order process. First, Lan personally measures all clients to get their exact measurements. Next, the customer browses though a selection of fine, hand-picked English and Italian knit suit fabrics. Tien Son creates its own designs and patterns and limits the amount of each pattern it sells to add to the uniqueness of each suit. Once the fabric is selected, the customer can fine-tune the details. The customer has the ability to select the lapel, vent, button style, collar, cuff, and pleats among other options. The customer can even add a personal monogram inside the suit jacket of up to 40 characters at no additional charge. At this stage, the customer is finished with the order. The order is then sent to Viet Nam to be created. Lan's family of tailors has honed their skills over seven generations. The tailors undergo a seven year training process before they are capable of making the completely hand-made suit. Unlike competitors products that are massed assembled to save on costs, each Tien Son suit is mapped, cut, and pieced together one-step at a time and one suit at a time by an expert tailor to ensure quality. Finally, each suit is thoroughly inspected by the expert tailor before it is shipped to the consumer. In many cases, Lan will personally press and deliver the product to ensure proper fit and customer satisfaction.

MEN'S CLOTHING INDUSTRY COMPETITION

Tien Son competes in the $8.4 billion Men's Clothing Industry. Tien Son offers a large and diverse product line. Their custom tailored suits include the Young Professionals Collection, Executive Collection, European Collection and the rotating Seasonal Collection. Their suit separates include blazers, sport coats, pants, shirts, and vests. They also provide a variety of accessories including executive sets, kerchiefs, pocket squares, silk ties, cufflinks and tie clips.

This industry has been significantly affected from the economic recession. IBIS World estimates that revenue has decreased by an average of 2.9% annually from 2007 to 2011. However, an industry turnaround is expected with growth over the next five years.

The demand within the industry is impacted by factors such as household disposable income, price, fashion trends, and seasonality. As unemployment declines, more individuals will be in the workforce which means more customers looking for men's (and women's) suits. Additionally as wages increase, customers will have more disposable income to spend on suits and suit accessories. Aside from other custom suit designers, Tien Son faces external competition from department stores. Discount stores such as Target, Sears, Macy's and JC Penny provide an outlet for price sensitive customers. At the higher end of the spectrum, consumers are less sensitive to price and more concerned with style, comfort, and brand name.

EXPANSION

Growing the business was an early challenge for Tien Son. The custom tailored suiting industry relies on personal contacts and one-on-one consultations. One of the earliest events that Tien Son participated in was the Entrepreneurial Day Fair at University of Evansville. At the event, Evansville student run businesses can showcase themselves to both the campus community and Evansville community as a whole. Faculty, staff, and citizens of Evansville were able to see the quality of the product first hand. As one visitor exclaimed, "When a suit is being made by a student, you are always worried that one sleeve will be longer than the other. This is much better than I expected". Tien Son used this opportunity to meet with prospective clients and set up personal consultations.

The next local event was held at The Hampton Inn Hotel at Evansville Airport. For the event, Tien Son had a radio advertisement produced by Communications Director Michael Armanno. In addition, they also placed a full page advertisement in Evansville Business Magazine. Customers were encouraged to stop by the weekend long event to get measured and receive special pricing. Lan and Cody both felt this event helped get the word out about Tien Son in the Evansville metropolitan area.

To continue its growth regionally, Tien Son held another event 3 hours north in Indianapolis, IN. This event was scheduled without the same marketing effort that was placed on the Hampton Inn event. Cody wanted to see how much business Tien Son would get from foot-traffic. Cody and Lan rented a booth at Greenwood Park mall in Indianapolis for $750 to use that weekend. Sales at this event were not as good as in the previous one. Indianapolis is a major metropolitan area, with a population five times that of Evansville, however Tien Son didn't have the local publicity that it had achieved back home. As a result, sales were less than they would have hoped.

Taking what they learned from Indianapolis, Tien Son rented a booth at Eastland Mall in Evansville during the Christmas season. They utilized a physical space in the mall where Lan could measure customers and take orders. They were also able to display other complimentary items such as silk ties, tie clips, socks, scarves, kerchiefs, and executive sets. Tien Son received some new customers from mall goers but not as many as they would have hoped. Cody felt that the consumers of Eastland Mall were not the same consumers that would be interested in a custom suit. Many of the mall stores retail mass produced products which is the exact opposite of what Tien Son offers customers. With this new information in mind, Tien Son decided to focus on customers by appointment.

FUTURE OF TIEN SON

With Cody Land graduating last May and Lan Do a couple months from completing her degree, Tien Son is faced with a tough decision. Cody had initially taken a full time position at Old National Bank in Evansville where he earned $31,000 per year. He was spending 40 hours a week working for Old National Bank and an additional 30-50 hours working for Tien Son. Lan was able to contribute another 20-30 hours per week to the business to coincide with her school commitments. With Cody and Lan both working part-time for Tien Son, they were generating $3,000 to $5,000 per month in sales. Just recently, Cody felt it was time to leave Old National Bank so that he could have more time to dedicate towards the growth and needs of Tien Son. The additional attention to the business paid off as Tien Son now generates $5,000 to $10,000 per month in sales. The key decision results from Lan being offered a position at Vectren Corporation that will pay her $34,000 per year.

After graduation, Lan will have to decide whether to take a job that provides a guaranteed income or dedicate her time entirely to Tien Son. In the first scenario where Lan works for Vectren Corporation, Tien Son would have guaranteed income but may be limited in its growth with one full-time and one part-time owner. In the second scenario, Tien Son would have no guaranteed income but they would have two owners that would be able to devote all of their effort to the business. This could potentially lead to much faster and potentially greater overall growth. As the decision draws closer, Lan and Cody must decide what is best for the future of Tien Son.

INFOTEK COMPUTER SERVICES & CONSULTING, LLC

Michelle L. Washington, Arcadia University
Jocelyn E. Russell, DeVry University

CASE DESCRIPTION

This case focuses primarily on marketing-related challenges faced by the owners of InfoTek. These marketing challenges are common to small business owners, particularly those who lack training and/or experience in marketing or whose personalities and personal values make the implementation of marketing fundamentals difficult. InfoTek Computer Services and Consulting, LLC is an information technology firm that helps small businesses select, install and maintain computer hardware, software, networks, peripherals and telecommunications equipment. Given the case's appropriateness for undergraduate business courses, such as Principles of Marketing or Introduction to Entrepreneurship/Small Business Management, its difficulty level is set at three. The issues and concerns of this case can be adequately addressed within a 50-minute class period. It is expected that students will require at least two hours of preparation time.

CASE SYNPOSIS

Garrett Roberts[1] dreamed of becoming an engineer but a mission trip experience the summer before college altered his plans. Instead, he earned degrees in biblical studies and worked as a Youth Pastor until his position was eliminated. His search for employment led to opportunities related to his hobby tinkering with computers. Several years later, he and Jack Pinella[1] started InfoTek Computer Services and Consulting, LLC. Although reliance on word-of-mouth has provided a solid base of satisfied customers, in recent years billable hours have gradually fallen to fewer than forty hours per week. Clients have been postponing hardware and software upgrades as cost containment efforts in order to survive the Great Recession. Garrett and Jack now encounter a crossroad of their personal values juxtaposed with a need for growth in sales and income in order to sustain InfoTek.

INTRODUCTION

Garrett Roberts, dressed in a light blue oversized t-shirt and khaki shorts, stood next to his desk in the basement of his home located in the quaint Philadelphia suburban community of Aldan, Pennsylvania. There were computer parts, documents and boxes scattered throughout the area. Along the wall across from his desk were several bookcases lined up next to one another and filled with books.

A minivan pulled up in the driveway. His wife, Stacey, and their son, T.J., had returned from their Friday mid-morning walk and run, despite the near 100 degree temperatures that the Philadelphia area was experiencing in the second heat wave of the summer of 2012. Stacey and T.J. entered the house through the back door and were greeted by Garrett and Stacey's 11 year-old daughter, Hope, who softly plunked keys on the piano in the dining room.

Given the heat and humidity outside, Garrett was glad to be in the basement where it is cooler and less humid. He had become fascinated with geothermal principles in high school when he dreamed of becoming an engineer and designing buildings that would be constructed fully underground. His son, T.J., entered the basement, "Down in the InfoTek international headquarters, huh?" T.J. asked as he chuckled. He could tell that his father was deep in thought. "Well…I just wanted to say hello", he said as he turned to go back upstairs. Garrett smiled as he considered how much time he is able to spend with his children throughout the week.

Garrett and his friend Jack created InfoTek Computer Services and Consulting, LLC in October 2003 after several years of providing mostly pro bono computer services to friends and family members. Whenever asked to describe their business, Garrett shares the 'elevator pitch' that they were advised to develop during a small business workshop that they attended shortly after their business was formed: "We help our customers with all aspects of their computer and technology needs". The business is Garrett's only source of income while Jack works full-time elsewhere and the business part-time. They have relied solely on word of mouth to grow their business and have a "solid base of customers" but now growth has slowed considerably as a result of "The Great Recession". Presently, there are less than forty billable hours of work per week for Garrett let alone billable hours for Jack.

Garrett is considering other marketing promotional strategies besides word of mouth. However, both he and Jack are apprehensive. "Neither one of us are schmoozers. Neither one of us are PR people, sales people…word of mouth has been from day one our best way of getting new customers…It is [effective] but it's also slow… I wish our customers would talk more about us. But it only comes up when it comes up". He thought to himself.

He wondered about InfoTek's future: Will they need to implement changes in order to achieve their goals of increased billable hours and growth? will change require that they promote their business using means other than word of mouth even though neither of them feels comfortable doing so? If they are able to find more customers and increase their billable hours, will Jack become willing to work the business full-time?

BACKGROUND

Garrett, one of five children, grew up in Aldan, fairly close to the home in which he, his wife and their two children now live. Growing up, he, his parents and his siblings were active members of a local non-denominational evangelical church in Aldan. Located roughly 8 miles from the Philadelphia downtown business district, the Aldan community consists of a little fewer than 24,000 residents within 2.70 square miles ("Basic Information," n.d., para.1). According to the 2010 census, over 80% of its residents are Caucasian. Among the residents that are 25 years and older, 40% are high school graduates, 25% have completed some college or earned an associate's degree and 14% possess a bachelor's degree ("Population and Races," n.d., para.1).

Median household income and housing values are $43,524 and $98,200, respectively ("Basic Information," n.d., para.1).

When Garrett was in high school he loved math as well as science and dreamed of becoming an engineer who would design and build underground buildings and structures. On June 4, 1982, the date of his high school graduation, he planned to attend a local university to study engineering but when the Fall of 1982 arrived his plans had changed. Garrett had spent the summer of that year in Maryland serving on a mission trip. Even though his experiences during the summer of 1982 were similar to previous experiences, this mission trip had a lasting impact.

Instead of studying engineering, Garrett attended a small conservative bible college located 60 miles away in a rural section of southeastern Pennsylvania. While in college, Garrett worked for his father's first business during Christmas and summer breaks. Because of his admiration and respect for his father, Garrett enjoyed working for him. "He was *so* well connected". Garrett recalls, "[Even though] my father was not a schmoozer … [or] a PR person he was getting recommended by everybody. I mean, my Dad was good…technically… and…his pricing was, you know, fair and right…So to work with my Dad was a treat…But … he never said 'You know what Garrett? When you get older you need to start your own company…He didn't push it…"

Although his father never tried to persuade Garrett to consider self-employment, Garrett recognizes that his father influenced him in a number of ways: "So my father was a pattern. I didn't consider it 'cause [at the time] I wasn't planning on starting my own business ever. But I saw what it could look like. Again my father was not [a] marketing [type], he was not [the] PR [type] but he had a skill set and he used it and thankfully…fortunate for him he had all kinds of people recommending him … [and] he did well"

After graduating from bible college, Garrett entered a three year graduate program and earned a Master of Arts in Biblical Studies. He took a year off before starting a second graduate seminary program but left after one year due to limited finances. For the next five years he worked as the Youth Pastor of a small church in Philadelphia until the church encountered financial difficulties and was forced to eliminate his position. He searched for other youth pastor positions in the area but to no avail. Garrett recalls the content of the letters he received from local churches at that time: 'Mr. Roberts, we love your education. We love your five years full-time experience but we're looking for a married man'…"That was tough on me" he continued to share. "I was mad at God…'God, I'll get married. [Just] send a woman!'… but [in the meanwhile] I had to do something".

Garrett brainstormed alternative career options and his hobby came to mind. He began to recount his experience: "My first fascination with computers was during my senior year of high school. [At school we had] a…Radio Shack Tandy TRS80. It was barely a computer but…it…impressed me what you'd get a machine to do for you…So during college I…dabbled with computers as…a hobby".

In line with his hobby, he began working for an agency that provided software and hardware support to the customers of a well-known international computer manufacturer. After a short stint with this agency, he worked for small information technology (IT) consulting companies. "What happened with that very first job as well as jobs all along the way…was God put somebody with me who knew more than I did [and] who didn't mind sharing what they knew. …that's how I got trained in areas that I didn't pick up on my own using computers as a hobby".

While he worked for one of the small IT firms, thoughts of becoming a business owner began to develop. Nevertheless, Garrett eventually transitioned into the IT department at the headquarters of a major regional chain of convenience stores located throughout Delaware, Maryland, New Jersey, Pennsylvania and Virginia.

As Garrett gained work experience in IT, friends and family members began contacting him for advice and assistance with computer issues. Garrett, who was single when he first started in IT, willingly responded to these requests but refused to accept money for his time and help. Many of these friends and family members would invite him over for dinner. These requests and dinner invitations continued after Garrett and Stacey married and then even after T.J. was born.

IN THE BEGINNING….THE STORY OF INFOTEK'S CREATION

When the calls from family and friends for technical assistance continued after Garrett and Stacey married and started a family, Stacey helped Garrett to gain perspective:

> Stacey came to me and she said '*Garrett, you know you're working 40 hours a week. And you're doing so many evenings of all these people's houses and stuff. It's taking you out of the house too much*'. She didn't say get rid of it entirely. Just reduce it. So I started pushing 'customers', if you will, to Jack...I knew him while he was in college…God had me [and Stacey] become adult volunteer leaders of the college and career youth group at…church. So Jack was… already a part of the group… He [was] going to college for chemistry with a computer minor…

Despite their age difference, Garrett and Jack became friends as a result of their common interest in computers. After Jack graduated from college, Garrett began to redirect requests for computer help from his family and friends to Jack. At the same, Jack's family members and friends were seeking his assistance for their computer-related needs. Soon, their requests for Jack's help became so overwhelming that Jack started referring his friends and family members to Garrett!

Meanwhile, working in the IT department of the regional convenience stores became untenable for Garrett. Although Garrett and his manager had similar views about how Garrett should carry out his responsibilities, the Director, to whom Garrett's manager reported, felt otherwise. Ultimately, the Director's views prevailed and Garrett was fired. "When I got fired … they did me a favor. Because that was… impetus…'cause you either look for something else…[That is,] for someone else to work for or it's like, 'You know what? This is the time!' All these other things were in line: Jack was there. Stacey was on board. We had money in the bank…I was ready…I'm like, 'God lined all this up'."

Although a number of critical factors were in place for Garrett and Jack to go into business with one another, they proceeded with caution. They met with Jack's uncle, who had owned and managed several businesses throughout his lifetime, in order to gain insights about business ownership. Additionally, Garrett consulted with a close friend.

> I talked with a friend of mine [who] is a financial advisor… He's like 'Garrett are you in a hurry to start the company?' 'No we're not in a hurry'. He's like 'Great! I want you to read these two books (The books were "Rich Dad, Poor Dad" and "Cashflow Quadrant" both by Robert T. Kiyosaki)'... I still have them downstairs [in the basement on one of the bookcases in my office]. So, I read the two books... The one book was about your thinking…it's, you know, [about how] people think like an employee or people think like an owner. Not a manager, an owner. 'cause even a manager is an employee. It talked about tolerance for risk and a bunch of other good themes that just changed [how I think]…I'm the same person but I think differently about stuff now.

After seeking advice from Jack's uncle and reading the books recommended by Garrett's friend, in October 2003, Garrett and Jack started InfoTek.

INFOTEK'S SERVICES

As an information technology services and consulting firm, InfoTek helps its clients to choose computer hardware and peripherals, such as printers, as well as software applications and telecommunications equipment. Additionally, InfoTek installs, configures and maintains the aforementioned hardware and software for their clients. According to Garrett, "[our] job is to make sure that you can do your job…your computer needs to be working…your access to e-mail needs to be working…your access to the Internet needs to be working…[and] whatever else [technologically] that your boss says that you need to do your job…I'm not trying to brag, but the fact is when we come in we do such a good job…so there's not that much repair work…I kid around…when Stacey and I are talking to people I'll tell them: 'you know, when I mess up, you can't do your job that day. When Stacey [who is a nurse] messes up, you're planning a funeral!'

INDUSTRY OVERVIEW

Information technology (IT) services firms face numerous opportunities and challenges. One burgeoning opportunity involves governmental entities. As federal, state and local governmental bodies seek to lower costs, outsourcing of computer services to IT firms is becoming more common. However, most opportunities for IT firms involve corporate clients. As businesses rely more on the Internet, their need for more digital and physical security also increases. Similarly, the surge in wireless networks and devices tends to accompany the need for more IT support. Increased demand for IT services and support is also driven by clients' usage of e-Commerce and social media ("Information Technology Services," 2012). IT services firms, especially smaller ones like InfoTek, also face a number of challenges. While technological advancements like wireless connectivity and social media have created opportunities for IT services firms, fast-paced changes can make it difficult for smaller IT firms to stay up-to-date.

Additionally, the competitiveness of the IT services industry presents another challenge. InfoTek is one of over 250 Philadelphia area based IT services firms identified on an online listing of small businesses ("Philadelphia, PA Information Technology Companies," n.d.). Furthermore, IT services firms now face competition from computer hardware manufacturers and software companies that are expanding into maintenance services ("Information Technology Services," 2012).

Presently, however, one of the most critical issues for small IT firms, like InfoTek, relate to macroeconomic conditions: "Because spending for IT services comes mainly from corporate upgrades, much of it can be postponed during economic downturns" ("Information Technology Services: Business Challenges," 2012). Garrett describes how InfoTek is experiencing this challenge firsthand:

> All my customers are like this ... [They] have 45 people are on the floor. [Before the recent recession] we swapped out 15 computers every year, right? The oldest computer … was three years old and still under warranty. When these 15 computers hit three years old, we ordered 15 more, decommissioned these, brought in the new ones, right? Every year I was swapping out all this new work … we make most of [our] money on new work not repairs. Because we do stuff right the first time there aren't that many repairs to be done … [But now,] you know, 'Michelle the boss' would look at her employee and say "You know what? That computer has served you well for three years; it will serve you well for a fourth year". And then a fourth year turned into a fifth year …

Hence, InfoTek's clients have been retaining their existing computer hardware and software longer in efforts to cope with the effects of the Great Recession on their businesses. In turn, InfoTek's billable hours have gradually declined.

MARKETING

Garrett and Jack rely solely on word of mouth to promote InfoTek. Garrett provides insight into their dependence on this strategy:

> "I am an information technology consultant. THAT'S what I am. I just happen to own …half of my own business. And the same thing would be true of Jack…Neither one of us are sales people. We're not schmoozers…We're IT guys. And that's why we rely on word of mouth…We do have a website. We have business cards. But it's word of mouth. 'Cause when its word of mouth it's clearly not… [us] that's controlling that. God controls word of mouth."

CUSTOMERS

Over the eight and one half years, Garrett and Jack have built "a solid base of customers" comprised primarily of other small businesses that operate in Delaware County, the city of

Philadelphia as well as the states of Delaware and New Jersey. Clients seek out InfoTek's services so that they can operate with lean employee bases whose skills relate directly to the industry in which they compete.

> "The ideal customer", explains Garrett, "[is]… a company that is…good at what they do…For instance, we have a customer…they help people find jobs…they're recruiters. So… all their staff [are] great at being recruiters, right? They're great at making matches. [So while] there is no career path for an IT person…there is certainly a career path for a recruiter…that's the kinda customer that we do well with…lot[s] of times they have somebody at their site that can handle simple tasks, right? Swap out a mouse, swap out a keyboard. They [might be] familiar with certain error messages [that] they know what to do [to resolve]…But for the most part they bring us in because they don't have the skill set for it. Or if they do have the skill set for it, their plate is so full with other responsibilities they don't have time to get around to certain things."

Although most of their customers are local small businesses, Garrett and Jack "don't say no to residential [customers]…I believe in God and that…influences how I think…You don't know who God's going to bring into your life, either as an individual or as a future customer, through 'Mom and Dad at home'…If we were to say no to everybody residential well…what if we're saying no to a blessing or to a potential customer that would be wonderful for us?... [We] do not chase after residential customers [but] we'll take care of any paying customer".

CUSTOMER RELATIONSHIP MANAGEMENT: THE GOLDEN RULE

Garrett and Jack strive to provide outstanding customer service to their clients. According to Garrett, "I want to treat them the way that I would want them to treat me. [For example, last] Thursday [before] we went to Boy Scout camp a phone call came in at 7:30 in the morning. It wasn't a big issue. They could still do most of their work, but the boss…did something to mess up his own computer. And I'm thinking, 'Well if I don't deal with it Thursday morning I'm going 2 hours away for the rest of Thursday [and] the rest of Friday.' Now they are closed Saturday and Sunday as well and… So I'm thinking, 'Well if I don't do it now, it's not going to get done until possibly Monday.'…So I said [to Stacey], *'You know what honey? I'm going in [to the customer's office]. We are just going to get it done and I'll come back.'* Thankfully it was resolved quickly." Clearly, Garrett and Jack are committed to meeting the needs of their customers.

InfoTek's commitment to customer service diverges from their competitors who might periodically follow-up with customers. Instead, Garrett and Jack wait for customers to initiate contact. In between calls and e-mails for assistance, Garrett shares that, "I don't bother my customers. [In other words,] I don't call them once a month if I don't hear from them [to ask] "Hey are you doing anything new?"…I don't bother them that way…Typically …when [our customers] have a need, they'll send me an email message or…call me…Now if I'm there [at a customer site] and I notice, 'You know what? This server is going to go outside of the warranty.'

I'll tell them, "You are going to have to do something because if it breaks and it's not under warranty, it's going to be rough."
Garrett describes how their customer service is unique in other ways as well:

> "I brag about saying, "No" to my customers. 'Cause if you ask for something that's unhealthy for your environment I'll tell you, "No, I'm not doing it." If you insist on doing it, now we have to sit down at your desk, maybe with some other people and now we've got to figure out why you really think we need to do that. Because … [we] had a customer…they had a hard drive fail on one of their machines. [But] they used a different serial number [from another computer when they] called into the vendor [to get a replacement hard drive]…because they knew that [the broken computer]… was outside of the warranty…So they call me up, *"Hey Garrett, we called the vendor and we have a new hard drive and we want you to put it in."*…So I open it up and … it was the wrong hard drive. So I'm like, 'There is no way in the world [the computer manufacturer] would make this mistake'…So I called [the computer manufacturer's technical support], right? I'm trying to rectify this situation…*"Oh Garrett, hang up for a second."* [the customer says to me]…Then they [confess]…That's the kind of stuff that would happen…not often, but see that's the kind of stuff I never wanted to be a part of. And some people were, *"Garrett, it's just a little lie. Come on."* Well if it's a little lie then…spend $100 [to] get … the right kind [of hard drive] or decommission this machine all together and bring in something new…That's the kind of stuff that would rub me the wrong way…And I wouldn't do that kind of stuff. I'll say to my customers, "No, we are not doing that."

This commitment to integrity, on the part of Garrett and Jack, is disclosed to clients from the outset. When a potential customer is referred to them by an existing client, Garrett and Jack meet with the potential client to gain an understanding of their operations and the ways in which they use information technology. They also share details about InfoTek's services and their approach to business: "When [we] … interview a new customer, one of things that Jack and I will tell them is, "We will keep you honest. We will make sure if you have 40 people on the floor that you have 40 licenses for that software. You know 40 of everything. We'll keep you honest so that you are not pirating software."

CUSTOMER SATISFACTION

Garrett is confident that InfoTek's customers appreciate the level of service that he and Jack provide: "One of the ways that I see that is they will … phone me and tell me so [but] most of the time they will email me. They'll say, *"Thank you for doing da-da-da." "Garrett you saved the day."* …One lady calls me Mighty Mouse (Mighty Mouse was a popular American animated movie superhero that later become a Saturday morning television cartoon.). 'Remember the theme song? 'Here he comes to save the day.'"

PRICING: MARGINAL REVENUE = MARGINAL PAIN?

Another possible explanation for InfoTek's customer satisfaction might relate to its pricing strategies. Garrett shares an interesting description of InfoTek's pricing:

> "Early on…we thought we'd bill $80 an hour and we don't bill time and a half or double time… [Our] other IT friends, they bill $120 an hour…[some] bill over $200 an hour…So …$80 is not too much, but how do …[we] know that it's not too little? That's easy. It's the pain factor, right? If you are my customer and you invite me to your site and you make me sit across the desk from you and you just want to go, *"Da, da, da, da."* There's something magical about $80 an hour that deadens the pain. I can listen to you talk all you want…at $80 an hour. $79 an hour, I would feel pain, $60 an hour it wouldn't be worth me coming. There is something about $80 an hour, it's just enough, it deadens the pain…Now $120 would deaden the pain and then do some more, but I'm not sure [we]…could get that with everybody. Some places maybe … [but] I have found that $80 an hour gets me in the door."

Garrett and Jack, however, make an exception to their $80 an hour pricing when it comes to residential customers. Most often, residential customers need repair services. At $80 an hour, the average cost to these customers for InfoTek's computer repair services could approximate almost half the cost of a new computer. As a result, Garrett and Jack give a 50% discount to residential customers.

WHAT THE FUTURE HOLDS…

Garrett looked around his basement office at the books on the bookcases along the wall as well as the computer parts, boxes and documents scattered throughout. These items, artifacts of his life, prompted him to reflect: "I'm working with things that I … [have] fun with, you know… I love what I do….I mean…I'm glad to be able to help other people by getting their stuff to work for them…Things that are beyond their skill set or understanding, I'm able to come in, set it up and now they're doing whatever it is that they use a computer for… You know, it's like 'I get paid to do this?' I would do it for free anyway, you know, but I get paid to so…"
Garrett continues his introspection, "I'm not a marketing type person. I'm not a schmoozer…It's not that Marketing's not fun. It's just that I don't know how to do it or when I try to do it, I don't think I do it well. I have customers who are marketing types, they dress that way…they look great, they sound great. But there's also part of them as individual people that comes across as phony to me, you know?"

Nevertheless, billable hours are painstakingly low. Garrett recognizes that he and Jack need to figure out a way to increase them. "I['ve] thought about calling companies cold" Garrett thinks to himself, "finding a business to business customer site and just calling some people or actually visiting in person. Yes, I think it's going to have to happen. Because [we're]…going to need more billable time…We are going to need more customers and word of mouth is wonderful, but it's a little too slow. Plus, now ... [we're] eight and a half years in. I have the confidence today that I did not have 6 years ago, 7 years ago…because in my opinion there is plenty of IT work out there…[And] well, not everybody in Delaware County knows me, not by far. You know? I wish they did. If I could figure out how to make that move faster, that'd be great. But, it may come to the day where I have to visit sites and ask to talk to the office manager, shake a couple of hands. Not schmooze. 'Cause I'm not a schmoozer but just… introduce myself, introduce InfoTek. See now I can say, "We have been doing this for 8 and a half years." And then I give them a 30 second answer, "We help our customers with their computer technology needs. We support your environments so that you can do your job, using technology." So that may happen, yeah."

As he contemplates InfoTek's present condition, he wonders if it is now time for him and Jack to talk about whether or not they need to change how they market and manage their business.

ACKNOWLEDGMENTS

This teaching case was presented at the 2013 USASBE conference and may appear in the USASBE proceedings.

The authors would like to acknowledge Mr. Christopher Sarachilli and Mr. Steven Byrd for their editorial assistance. The authors are very grateful to Dr. Helen K. Black, Mrs. Christa Caruso and Ms. Holly Santanello for their altruistic and outstanding mentorship.

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THE INTERN: AN INSTRUCTIONAL CASE FOCUSING ON ETHICS FOR TAX SERVICES

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CASE DESCRIPTION

The primary subject matter of this case concerns ethics for tax services. Tax services include tax preparation, consulting, and planning. Secondary issues examined include guidance available to professionals from the AICPA code of ethics, the AICPA standards for tax services, and the Internal Revenue Service Circular 230. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in three class hours and is expected to require another six hours of outside preparation by students.

CASE SYNOPSIS

A tax practice, like any other business, strives to improve efficiency and profitability. One major difference between a tax practice and any other business is that accountants have a responsibility to service the public interest. Accountants are entrusted to be competent and to act with objectivity and integrity. These expectations sometimes are clouded by greed and self-interest. Tax practices face increasing pressure from clients to minimize tax liability and are encouraged to adopt aggressive tax positions. These demands place tax practices at risk of violating professional standards especially when ethical values are not an integral part of the company's culture. The purpose of this case is to introduce students to the applicability of the AICPA Statements on Standards for Tax Practice (SSTSs), the AICPA code of conduct, and the Internal Revenue Service Circular No. 230. The main learning objective is to develop students' analytical, ethical and research skills to better prepare them for a professional career in accounting.

BACKGROUND

When Diane received news that she was accepted at A&A LLP (A&A) she couldn't hide her excitement. She was very apprehensive at first to apply to such a large and prestigious national accounting firm. She was afraid of failing and disappointing her father. Her father was a Certified Public Accountant at B&B LLP (B&B), A&A's competitor for almost 20 years. Her father was an audit partner at his firm and was well-known and respected among his peers. From a very young age, Diane knew she wanted to follow her father's footstep. She looked up to him and dreamed of becoming a partner herself. Her father and A&A's managing partner were old acquaintances from college. When Diane received news that she had the internship at A&A out of hundreds of well-qualified applicants, she was elated. Although Diane suspected that she received the internship because of her father's friendship with A&A's managing partner, she was confident that she deserved it because of her high GPA and the letters of recommendation from her professors. Nonetheless, she felt the pressure to show A&A that she was the best and that she earned this opportunity not because of who her father was, but because of her qualities.

When Diane began her internship at A&A, her excitement wore off quickly. Other interns and junior professionals working at A&A accused her of getting the internship only as a favor to her father not because she deserved it. Diane felt uncomfortable and isolated working in a hostile environment. She would cry everyday on her drive home. Nevertheless, she wanted to prove to others that she was there because she was capable of doing the job and was just as good as others. Although her father was an audit partner, Diane was always interested in taxation and was planning to apply to graduate school right after graduation. She was also studying for the CPA exam. If this internship was successful, she would have an opportunity to jump start her career at a prestigious CPA firm. She did not want to disappoint anybody including herself.

Joseph was the senior in charge, he was young and ambitious, a graduate from the same college that Diane was attending. Within two years after being hired, Joseph quickly moved up the ranks to senior, only one step short of becoming a manager. He was charming and outgoing. Diane attributed his rapid climb in rank to his likable personality, which more than likely clients have also taken notice. Her suspicions were confirmed during a client meeting where she was asked to attend as an observer. She noticed how the client trusted and listened to Joseph's advice. To a problem that seemed hopeless, Joseph provided a viable solution within minutes which the client appreciated greatly. She liked the fact that Joseph quickly gained clients' trust and was able to provide effective solutions to their problems. Diane wished she could develop these soft skills and looked up to Joseph as her new mentor.

THE INTERNSHIP

Initially she was assigned menial work such as typing, filing, etc. Although she despised clerical work, she told herself that she would act professionally and do her best. She was flabbergasted the date they assigned her the firm's most important client, Phillip Larson's tax return. Larson was from a wealthy family. The Larsons owned a large parcel of land, approximately 11,000 acres, that was leased to a mining company for the next 100 years. Mr. Larson was the sole survivor and had wisely invested the money generated from this lease into several successful enterprises. Mr. Larson was also a well-known philanthropist who was in the board of directors of several not-for-profit organizations. He was an important and influential figure in this community. A&A had an old relationship with Larson's father and had taken care of their tax returns for as long as anyone could remember. Overall, Larson Enterprises was comprised of 40 different businesses.

Diane was assigned a subsidiary of Larson Enterprises, a very small company with total assets of less than $10 million. She was going to prepare the tax return under Joseph's guidance. She was anxiously looking forward to this task and was even more excited to work with her new mentor. She heard that the company was in the process of applying for a bank loan and was planning to use these funds for expansion. The subsidiary owned a warehouse facility which was renting to an unrelated party. When Diane came to work that morning a set of financial statements from the LLC was waiting on her desk with a post it note indicating that the tax return should be completed within two business days. At first she panicked, but after taking deep breath, sat down and picked up at the financial statements. Quickly, she made a list of additional items she need it to complete the return. She received all requested information late afternoon and stayed all night finishing up so it could be ready in the morning for review. The return was completed on time and the LLC's loan was approved. Diane was praised by Joseph and the tax partner, Mr. Abbott. Finally, she showed her superiors that she was a valuable employee and that they could count on her anytime.

A month passed when she received a call from the LLC's controller. They wanted to amend the subsidiary's return right away so they could complete Mr. Larson's individual tax return by the deadline. Diane wanted to show that she was assertive and she asked the controller to fax the statements to her directly. After lunch, she returned to her desk and found the revised financial statements on her desk. She noticed that the total assets on the balance sheet had decreased by almost 30% from the amount that was originally reported. There was a large long-term liability from a related subsidiary that was not reflected in the original statements. Diane was even more shocked when she discovered that the company had a net operating loss rather than net operating income as previously reported. She dropped on her chair and stared at the financials on her desk for what seemed like hours. She wanted to burst screaming into Joseph's office, but decided that she should ask the controller first in case an error was made. The controller reassured her that those were the correct financial statements. Diane quickly stated that they will have to inform the bank where the loan was obtained, but was interrupted in the middle of her sentence. The controller now sounded irritated and stated that Larson Enterprises goes through this same procedure every year for the last two years since Joseph began handling their account. He further stated that Joseph knew that they kept two sets of financial statements, one for the bank and another for the tax return. She tried to calm him down excusing herself for being new, and promised to clarify the matter with Joseph as soon as possible.

As soon as Diane hanged up she ran to Joseph's office holding the set of financial statements in her hand. She explained her findings and her heated conversation with the controller. Joseph listened to her carefully with an expressionless face. After she was done, he grabbed the financials from her hand and said that he was going to take care of it, that it was probably all a misunderstanding. A weight lifted off her shoulders as she left his office. She truly admired his professionalism. Three weeks later, Diane went to the copier room and met her classmate Naomi who was assisting a senior in preparing Mr. Larson's tax return. Diane glanced at Naomi's papers and couldn't believe her eyes when she saw Larson Enterprise's revised financial statements still reporting a net operating loss. She wondered if Joseph or the controller had contacted the bank to let them know that the tax return was amended. She paced back and forth and finally made the call to the bank to find out that they did not know anything about an amendment. This meant that the bank had granted a loan based on misleading information. Diane wanted to discuss this with Joseph but she knew that he had taken the matter in his own hands. She wondered if the firm's tax partner, Mr. Abbott and Mr. Larson were aware of this matter. Would they think that she was sabotaging the firm's engagement because her father worked for a competitor? Would Mr. Abbott believe her? Would this ruin her chances of future employment with the firm? What should Diane do?

GROWING TOO FAST? AN ENTREPRENEURIAL DREAM…OR NIGHTMARE

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An earlier version of this case was presented at the 2007 North American Case Research Association (NACRA) Meeting in Keystone, CO.

CASE DESCRIPTION

The primary subject matter of this case concerns Small Business and Entrepreneurship. Secondary issues examined include Strategy Development and Implementation, Exit Strategy, Marketing Strategy, and Decision Making. The case has a difficulty level of four which means that it is appropriate for senior level courses. The case is designed to be taught in two class hours and is expected to require four to six hours of outside preparation by students.

CASE SYNOPSIS

Hank Patterson and Larry Kennedy were two successful medical sales representatives in the Memphis, Tennessee area. The friends often used local caterers to feed their clients during sales pitch lunches and breakfasts. The two became frustrated with the lack of food and service quality of the local caterers. This frustration led the pair to open up their own catering business.

The first two years of operations were a rousing success, which left the partners with several difficult decisions. The central decision revolved around how the partners would respond to the rapid success of the firm.

INTRODUCTION

Hank Patterson walked back to his car after speaking to a group of aspiring entrepreneurs reflecting on the two-hour discussion that had just concluded. He had discussed how he had climbed the ladder in the medical sales industry to be a leading salesperson in his company. But what really interested his audience was Hank’s decision to start a catering business that he operated with his business partner, Larry Kennedy. The audience soaked up Hank’s description of a startup business that turned an operating profit after only two months and had grown in the past year at a rate Hank and Larry could have never dreamed. Hank thought back to the question that he knew someone from his audience was going to ask; a question that he was not totally prepared to answer. At last it came from the front row: "Have you considered quitting your job in medical sales to focus all of your attention on your growing catering business?"

Hank turned the key to his car and he heard the question ring in his head again. He knew this question had to be analyzed and answered quickly, but he was not sure where to start.

BACKGROUND

Hank and Larry were each successful medical salesmen in the Memphis, Tennessee area. The thriving medical community aided in their success but more important was their ability to understand and meet the needs of the physicians that they worked with. One challenge that they each had to face (they worked for different firms) was finding time to meet with physicians in order to promote their products. Governmental and industry restrictions had limited the type and amount of contact that medical sales reps could have with physicians. Gone were the lavish all expenses paid trips to exotic locations. What replaced them were sales pitches over breakfast or, more usually, lunch where the sales rep provided a catered meal for the entire staff of the physician's office.

Hank had used a variety of local catering services over the years with mostly disappointing results. Sometimes the food tasted good, was hot, and was delivered on time. More often than not, at least one of these ingredients was missing which caused Hank a great deal of stress and anxiety. In his mind, any food service problems reflected badly on him, even though he had no control over the situation. In conversations with Larry, they each realized how frustrating and important this aspect was to their success as sales reps.

Hank's frustrations continued to simmer until the day that Blue-Moon Barbecue failed to deliver the catering order that he had scheduled for an important client. With the food 15 minutes late Hank feverishly called the company on his cell phone only to be told, "Sorry, we forgot." This episode left Hank at his wits end. Driving home that night he called Larry expressing his frustration with the state of the catering business in Memphis. Before Hank pulled into his driveway, he and Larry had decided to explore starting their own catering business and gearing it specifically to medical sales representatives. Nine months of research and inquiry with numerous contacts in the medical sales industry led the pair to believe that a catering business that offered good food delivered with excellent customer service could work.

BUSINESS MODEL

Hank and Larry decided to enter into the catering business with the stated goal of specifically servicing the medical sales niche market due to their extensive contacts in that field. Their business would be a customer-focused one, with great service and customer satisfaction at the heart of all strategic decision-making. But while the two were accomplished salesmen, neither had any experience in formally starting a business of their own. The first question that they wrestled with was what form their business should take. They had queried other successful business people that they trusted and discovered that these associates had found success in a wide variety of business formations including limited liability corporations, S-corporations, and limited liability partnerships just to name a few. Neither Hank nor Larry had a legal background so Larry offered "Let's do some reading before we bring in a lawyer just to get a better understanding of the pros and cons of our options."

They also needed people to take care of the day-to-day operations of the business while they used their contacts to continue to drum up interest in the business. Neither of the partners had culinary backgrounds so finding a qualified, competent chef was a key decision. Additionally, they knew that they needed someone to manage the logistics of the operation from inventory control to order delivery. Hank and Larry sought to fill these two key positions and decided that once those positions were filled, they would involve the chef and operations manager in other hiring decisions.

With a plan in place for staffing the business, Hank and Larry turned their attention to finding a place that their catering business could call home. They quickly identified a golden opportunity. The location was central to the downtown / medical center area of Memphis. The location also was equipped with kitchen and cooking appliances from the previous tenant. Hank and Larry wanted the property badly but they could not decide whether or not to lease or buy the property.

FAST FORWARD: THE EXPLOSIVE GROWTH OF WORLD CLASS CATERING

Given all of these uncertainties it was, needless to say, a pleasant surprise when Hank and Larry's catering business, which they named World Class Catering, was turning a profit in its second month.

Within nine months of operating, it was clear that World Class Catering had found a strong foothold in their market. As Hank and Larry had predicted, the combination of good food delivered with great service was a formula for success.

Further, their strategic focus on the niche market of medical sales representatives had proven highly effective. By listening to their customers, World Class Catering was successfully meeting the unique needs of their market better than the competition. The food was always delivered thirty minutes early, it was served piping hot, and communication with the medical sales rep was both personal and dependable. With minimal time and resources, word of World Class Catering had spread throughout the city. Further, once a sales representative had used the company once, the likelihood of repeat business was exceptionally high due to satisfaction with the food and more importantly, the dependable service. The company's attention to customer service resulted in $450,000 in sales during their first year of operations. Hank stated, "We could do $750,000 if either of us had the time to fully dedicate ourselves to this business."

Due to the explosive growth, the company had added four more employees, one to handle accounting and purchasing, two part-time drivers, and one part-time chef. The company was serving an average of 10 groups (orders) per day, totaling approximately 250-300 people served daily. Hank and Larry projected the maximum daily business the company could manage without substantial expansion was 15 orders and 500 people served. While 90% of the business came from lunches catered through medical sales representatives, the company had begun receiving orders for breakfasts and dinners from new segments including law firms and weddings. It was clear there was sufficient market demand to support a range of new growth strategies; however, the company remained limited by its size and employee base. The current employees already were stretched, especially on busy days. As Larry commented, "you can only work people so much."

The employees also lacked a proactiveness that Hank classified as "big picture thinking." This was closely related to a lack of leadership among the employees. Hank noted that "if they were really good, they wouldn't be working for me." The partners also lamented the fact that their employees often lacked their passion and enthusiasm for the long-term success of the firm.

Another significant challenge facing the company involved fluctuating demand. Due to the company's focus on the medical sales industry, the catering business was influenced by the sales cycle inherent to the medical industry. Based on their initial experience and feedback from their sales representatives, it appeared that demand for catered lunches was greatest during the months of March to May and September to December, with lulls during the months in between. Because of these fluctuations, Hank and Larry had yet to come up with a method of estimating labor, time, and equipment capacity, and whether these key resources were being maximized.

But the greatest challenge was time. While Hank and Larry continued to provide leadership to the World Class Catering employees, they struggled to juggle the increasingly demanding challenge of a growing catering company and their full-time sales positions. They felt increasingly torn by the business, knowing that if either had more time to personally invest in the company's growth, especially promotion to new markets, there would be no end to its success. "The sky is truly the limit for this business," Hank muttered to himself, as he rubbed his head and wondered what the next step should be.

CATERING INDUSTRY AT A GLANCE

The catering industry was a large, fragmented market with constant change in market size and demand. Because of low barriers to entry and highly saturated markets with no players holding a dominant share, catering could be an attractive industry to would-be entrepreneurs with culinary leanings. As Hank and Larry found, there was also consistent demand for dependable caterers who did not use catering to supplement a stand-alone restaurant. By operating a business that focuses only on catering and not filling restaurant seats, World Class Catering was able to find a niche in the medical sales industry, but also saw expansion into other markets. The main threat of substitutes in the catering industry came from restaurants, and there was low supplier power due to the multiple sources for obtaining supplies.

STRATEGIC ALTERNATIVES FOR WORLD CLASS CATERING

Hank knew the time was rapidly approaching when he and his partner Larry would face a tough decision. It was killing him to see the enormous potential this business offered, knowing that it would take their personal involvement and entrepreneurial spirit to lead the company to the next level. Then again, he told himself, he could sit back and let the current employees manage the business at its current size, intentionally avoiding the opportunities for growth and expansion into new markets. Finally, he wondered, "Should I get out of this business altogether? Perhaps I could identify a buyer who wants to invest time and resources to grow World Class Catering into the future?" Given the heart and soul he had poured into the business throughout the past two years, making that decision would not be easy.

AN UNEXPECTED OPTION ARISES

Nearing the two-year anniversary of the opening of World Class Catering, Hank received a most intriguing call, the contents of which he then relayed to Larry. "A guy called and wants to buy us out." Larry was silent on the other end of the phone, "Are you serious?" he finally replied. Hank continued, "He has restaurant experience and he and his partners think that they can take the foundation that we have laid and run with it. They see the potential and have the time that you and I don't have. What do you think?" Larry spoke up, "It *is* about to be our peak holiday season – it just about killed us last year. I just don't know – I need to sleep on it." "Let's have lunch tomorrow," Hank said, "oh and I guess we had better come up with an asking price just in case."

KOCH RANCHES: "WHERE'S THE BEEF?!"

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CASE DESCRIPTION

A wave of concern is sweeping small businesses, such as Koch Ranches (K-R), as their current customers' age and new markets, such as the Millennials (See Appendix A), grow into their next life cycles of careers and families.

The owners of K-R, Gloria Koch Lynch, the matriarch, and her husband, Kenny Lynch, have recently learned that their children have decided to take their rightful places back at the ranch after they graduate with their degrees in Management and Veterinary Medicine.

The main product from the ranch that spreads across Frio and Medina Counties in South Texas is Angus beef. The ranch has flourished through seven generations of the Koch family and has become known for its natural, grass-fed, tender, and tasty beef.

Within the last decade, the family decided to open a country store that initially featured the fruits and vegetables grown on the ranch, but has recently started including local produce from surrounding producers.

Students will enjoy working through this case on at least two levels: (1) they enjoy tailgating and cooking outside and are truly interested in natural and organic foods, and (2) they can see themselves in the roles of the college students, Henry and John Lynch, and their parents, making decisions about what they want to do after graduation.

The case presented here has roots in an actual ranch and country store, the people presented in the case are fictitious, yet they reflect real people making decisions that may include growing the business so that it can comfortably support additional young families as children return to their roots.

The difficulty level of the case is at least 3, as the script reflects what goes on backstage, at the ranch, that will affect the lives of many people as one particular owner of the ranch brainstorms with herself through many scenarios that can grow the business large enough to provide comfortable lifestyles for two more families as their children move back home with their degrees.

As students read through the case, they can put themselves in the roles of Henry and John, planning to return home after college to contribute to the business and make it work for them. They will also get introduced to the very large United States beef industry (Appendices B and C), become aware of demands for beef in general and for natural, grass-fed beef specifically, and increase their awareness of charges for advertising fees and services (See

Appendix D). They will be made aware of the wholesome local foods that can be purchased in farmers markets and country stores and learn the inside scoop on some of the decision-making that keeps this ranch on track to develop new products and break into new markets.

International marketing and management can be discussed in the case as the readers discover that the ranch maintains an international identity as well as a domestic identity.

Brand equity for K-R is challenged to make itself known to new customers, the Millennials (see Appendix A). K-R must also investigate opportunities to grow the business through technological, genetic advancements in beef development, and an overall sound marketing plan that can embrace new types of media, messages, and markets.

CASE SYNOPSIS

The US consumer's love affair with good beef and the desire to pursue pure and natural products creates strong possibilities for niche marketing strategies for producers of grass-fed beef. The case that follows sets the potential for technology to drive marketing strategies for a small business embracing the cutting edge of a traditional industry. Right in the middle of a dynamic distribution channel is Koch Ranches where, for over seven generations, choice beef has been produced from their 4,400 acres watered by the Edwards Aquifer in Frio and Medina Counties in South Texas. The fact that natural grasses and an aquifer are key parts to the case will raise students' awareness of the roles these elements play in developing an old product, grass-fed beef that is new again addressing demands of some of the purest consumers, Millennials. As students see the main character, Gloria Koch Lynch, grasp for solutions to grow a business to be productive enough to support her own family and the families of her sons, they will be able to better understand relevance of decision making in all aspects of small business.

Gloria, now the family matriarch, has two children in college, a husband that helps with the ranch, and a diminishing market for her family's products. Koch Ranches, K-R, are known for their quality, natural, grass-fed beef. Their market has been strong, but many of their current customers have either moved away to live near their children, or have passed away. The current market knows what K-R stands for in quality and natural goodness but as this market diminishes the brand equity for K-R may also diminish.

Her children plan on moving back to the ranch once they graduate from college and start their careers in veterinary medicine and management. She and her husband, Kenny Lynch, are happy about the boys' decision, but are also concerned about how to grow their markets so that the ranch can support comfortable lifestyles for three families.

Decision points involve varying the size of the herd, changing the process that makes income from the cattle, utilizing a marketing firm that has just come on board, entering at least two new markets, changing the distribution channel and maintaining the quality and quantity of their products.

KOCH RANCHES: "WHERE'S THE BEEF?!"

BACK AT THE RANCH

She sits tall in the saddle as she rides across the acreage her family has owned and worked for over seven generations. Koch Ranch, K-R, (*pronounced Cook and K Bar R*) spans the breadth of Frio and Medina Counties near San Antonio, Texas.

"South Texas is a great place to raise cattle and make your fortune," she hears the echo of her granddad's voice as she rides.

When Gloria Koch Lynch was very young, she rode along with "Pops," his horse was always just a step or two ahead of hers.

Pops was really much like his granddad that had originally purchased the land. He even acquired the original land grant awarded by the King of Spain back in 1691 to some soldier for recognition.

Gloria is the remaining Koch from the previous generations. Her sons are fast approaching managerial and ownership positions of K-R. Henry is starting veterinary medicine school at Texas A&M, and the other, John, is scheduled to graduate with his bachelor's degree in Management in two more years from University of Texas.

Both boys come home to work the ranch on every break from school and both want to return to the ranch to raise their families.

Gloria is both delighted and concerned with their decisions to return to K-R. Sure, things are okay now. Their steady customers are loyal, they are also getting older, moving away, passing away. Their current market is diminishing just because of life, but their product is consistent.

Nothing has changed about their product. The Angus cattle are flourishing on the pastures sustained by the Edwards Aquifer. On the 4,400 acres they produce more beef per carcass weight than the industry average. It is tender and flavorful and all grass-fed. That's what makes K-R beef unique.

It is good that the Angus Association has implemented such a strong marketing campaign—Angus has brand equity. K-R Angus beef is even better because it never goes through a feed lot—just pasture.

Yes, the boys are coming home to make their livings after they finish school. "How will the ranch be able to support two more families?" Gloria thought out loud to her horse.

Everything was so simple when she was a kid. She rode horses, worked cows, planned with her dad and Pops about what was going to happen next on the ranch.

Today, she is back in the saddle to actually check on a few pastures and see what some of the hired hands do throughout the day.

She rides to the North Pasture and happens to catch Slim sitting atop of his horse, with one leg propped over the saddle horn, the horse is grazing and Slim seems to be playing on his smart phone.

When her shadow shades his phone Slim abruptly stops what he is doing, glances around to her, and says, "Miss Gloria, is that you? It has been at least a month since you have ridden to this pasture."

"Slim! I am so glad that you noticed me. Are you playing a game on that phone? Is that the phone K-R bought for you?" Gloria was trying to sound like she was in charge and that she cared about each tool that was provided each worker.

"Yes, to most of your questions," Slim responded, "but I was just checking weather conditions and market prices."

"Who did the pasture rotation plan while I was in New York?" Gloria asked.

"Kenny and I did last week, we couldn't wait for you to get back from that food thing, we had to have it then," Slim emphasized.

Gloria remarked, "Ooh, well going to that food thing is certainly no vacation and it is very frustrating to be away when there is work to be done. It is expensive too, but if you sell food products then you need to be there—the Summer Fancy Food Show, in New York City."

Gloria dreaded going each year, and each year she was afraid not to go.

"Not only is it important for the grass-fed beef products, it is imperative for the Koch Country Store. There I learn about new trends and consumer taste in fresh fruits, vegetables and other products we sell in our country store. Local producers who also sell in our store depend on me going to the Summer Fancy Food Show."

MEETINGS, MEETINGS, MEETINGS

She bid adieu to Slim and turned back toward the house. She wanted to speak with her husband, Kenny, before he left for the Texas and Southwest Cattle Raiser's meeting in San Antonio. It is a grand meeting, and she has attended it often with Pops, her dad, and Kenny. This time, though, she was staying at the ranch.

"Where have you been?" Kenny asked. "You smell like a horse, but you still look pretty," he said as he was trying to get some laughter into the conversation.

"Why thank you so much! What a compliment! Smell like a horse, really?!" she quipped.

"Hey, you still have time to get ready, pack your things, we can go to the meetings together," he continued, "We've had some really good times there, and actually attended a meeting or two." Kenny never quit with the humor.

Gloria thought, "Thank goodness he sees the humor in everything. Sometimes, though, I need him to think about the bigger picture, he doesn't know that the boys are planning to make their livings here on the ranch. They told me about their plans just after Kenny left for the cattle meetings in Panama."

"That was a trip that I wanted to make happen for me. Kenny and I must travel for K-R or we lose our international clients.

But, there were so many other things that needed to be done for the ranch. Hiring a marketing firm was one of those things that kept me here. I didn't really know what they could do for us, and I remain doubtful about their role in K-R success."

"They have done absolutely nothing about getting our web pages up and going, they seem to be stuck on traditional print media. I know how to do that, I put up K-R Facebook pages and placed the ads in San Antonio papers," Gloria concluded.

MORE FAMILIES

"Kenny, you always think of me, and I love you, but you know that I need to stay here. Since the ranch manager left, I am it. At least until I, we, hire a new one. By the way, how many people have applied?"

"Hell if I know," quipped Kenny, as he made sure that his boots were the ones he wanted to wear in San Antonio.

"Now go on, have a good time, but not too good, and make a difference for us here at K-R. We need to figure out how to squeeze more out of this place if the boys plan on living here with their families," Gloria slipped that information in just as Kenny stepped into his truck.

"Yeah, I've been thinking about that a lot lately. I'll keep my eyes and ears open." Kenny replied and turned the key to start his truck.

"Neither one of 'em is married, it will be a year or two before either of 'em will be staking out a place to build a house," he shouted out the window. "I am headed to San Antone, call ya when I get there!" Kenny said as he drove away.

ALONE WITH HER THOUGHTS

Gloria walked inside and made her way to the kitchen where she poured a tall glass of tea. She stared out the window over the grassy pastures and began to think about three families living and working together. She kicked off her boots and went into her office to review the ranch operations.

"I'll start with the mail. Hmmm. Of course the county tax appraisals have arrived. What K-R pays in county and school taxes each year would make a good yearly payroll. I will review the appraisals later."

"I see *The Register* came today—what are the Simmental breeders up to? When they started crossing with Angus to get black Simmentals, I joined their association, too. Hey, here's an article about grass-fed, natural beef. I need to read that one, it may tell me something about a new market for K-R."

K-R runs 800 head of "mamma" stock, cows, who account for a calf crop of at least 700 head, each weighing approximately 600 pounds at weaning. That is roughly 420,000 pounds of beef on the hoof—210 tons. Market value is approximately $20 per 100 pounds.

The calf crop will probably be better than 700 head, so her estimates are conservative. If K-R enjoys a 95% calf crop, then it could get as much as $912,000 this year just from selling calves that would go to feed lots.

"If we process the beef ourselves, as usual, and get an average of $10 a pound for natural, grass-fed beef, then K-R would receive about $3.42 million. That is not net, but it certainly makes me think that we should continue processing our natural, grass-fed beef ourselves and continue exclusive distribution through the Country Store," Gloria is desperately brainstorming.

"I have always wanted to get K-R natural, grass-fed beef into some of the nicer restaurants and hotels in San Antonio—Chama Gaucha Brazilian Steakhouse in San Antonio would be a good beginning. I think they have a restaurant in Houston, too. *San Antonio Woman Magazine* has the ad saying Chama Gaucha rates 29 out of 30 points by ZAGAT," she continues thinking aloud.

Gloria ponders, "Should I increase the number of calves per cow? I could cut the size of the registered herd to a quarter of my best cows (donor cows), buy recipient cows (recips) for about 25% of the price of my registered cattle, have a system of embryo transplants put into place, and generate up to 40 calves per registered cow for one season (see Resources). I will get Henry's opinion on that idea. K-R wouldn't do anything like that until Henry graduates and can save on the vet costs."

"Would I actually be able to quadruple production with fewer donor cows than I own now? And, how much will the increased production cost?" Gloria questioned. "Genetic production in cattle can increase a herd, but will it provide consistent quality in meat?" Gloria was concerned about maintaining their quality product. There may be a solution to supporting three families somewhere in that idea.

The country store is growing. Everything is seasonal, and everything is well prepared. The number of people buying produce and preserves in the country store is increasing approximately 10% per month.

The overhead for the store is a growing expense. As Gloria keeps the store open during the week days and into the evening hours, Koch Country Store is encountering more for utilities and payroll than when the store was open on weekends only. It is a success, though, based on the number of increased visitors and sales.

"Wow, I haven't even thought about new customers for us. The people my sons' ages are coming of age themselves, they are settling into careers and families, and they want something good to feed their families," Gloria started thinking about her diminishing current market, and started thinking about Millennials, the next big generation (See Appendix A).

"I need to make some decisions soon. Things can rock along like they are, and Kenny and I will have enough for a comfortable lifestyle for a few more years, but there will not be enough for three families to live comfortably if things remain as they are," Gloria thought to herself.

APPENDIX A: LOCAL CARNIVORES, MILLENNIALS

The demand for grass-fed cattle is high among the local carnivores. In so many communities where the new urban young families, Millennials, can be found, consumers have a strong willingness to pay more for produce and beef that are grown locally without super genetically modified products, i.e., hormones.

Based on beef industry reports, then, consumers prefer corn fed beef to grass-fed beef. Who cares? Seventy-one million millennial Americans care. Born between 1982 and 2004, are the generation "Millennials", also known as Gen Y, the new consumer (Wikipedia 2013).

Millennials tend to not trust industry, are optimistic, engaged, charitable, and seek to hold to values of the simple, natural trends sponsored by their 1960's counterparts (see Neil and Strauss 2010).

These consumers are "coming of age" in their generation life cycle, they are starting their careers and families, and they are making decisions about what they eat based on what they perceive is natural foods. And, of course, these consumers embrace technology. They have always had a computer and they multi task with several smart devices to constantly stay informed.

These new consumers care about their carbon "footprint" on the planet. They are many in number and willing to pay for what they perceive to be best quality food, the new consumer likes to feast upon things that are simple, original, and made the original, natural way, without all the growth hormones. The following poem by Gary Snyder in "A View with a Room," (Sierra, pp 34 – 39 – 60, July – August 2013) captures some of the millennial outlook, simple is better:

I cannot remember things I once read
A few friends, but they are in cities.
Drinking cold snow-water from a tin cup
Looking down for miles
Through high still air.

Gary speaks about natural things in his poem and in his very simple words, he captures some of the "grass roots" movement toward buying and consuming all natural products.

A carry-over of products that Millennials grew up on, i.e., Hot Pockets, is attempting to change its image with natural, grass-fed beef, please see the following link for more:
http://www.marketplace.org/topics/business/food-and-drink/hot-pockets-heat-effort-lure-foodies#.Uf2Yb2d-Ciw.email

Appendix B: Cattle Outlook

United States cow herds continue to decline. Based on January 1, 2013, numbers, there were 29.3 million beef cows in the United States, 2.9% less than last year and more than 10% lower than the most recent peak in 2006. (see The Register, Beef Business, 2013)

With production down, though, cattle-based gross income is up by 8% over the previous year, from $63 billion in 2011 to $67.9 billion in 2012 (USDA 2013, The Register 2013).

In June 2013, the USDA raised their forecast of 2013 beef production to 25.437 billion pounds, up 1.3 percent from their May forecast, but down 1.8 percent from the 2012 actual count (*Texas and Southwest Cattleman Weekly*, June 17, 2013).

The USDA predicts 2014 beef production will be down 5.2 percent from 2013. The midpoint of their price forecast range for slaughter steers on a live weight basis is $127.50/cwt for 2013 and $132/cwt in 2014. Cattle production is going down, and price per 100 pounds (cwt), is going up (From *Texas and Southwest Cattleman Weekly*, June 17, 2013).

Many elements have driven the price for beef up. In 2011, drought throughout the Midwest and Southern States impacted beef and the products they consume. As corn fields dried and failed, the price of corn went up to over $100 per bushel, as drought continued, ranches of all sizes sold herds of cattle that would not have been sold under good conditions. Corn was scarce, the cattle population dropped, and consumers, domestic and international, demanded more beef.

According to *Beef Daily* (May 2012) The Angus cattle are lusted over in culinary circles, and the grass-fed behemoths are not the only ones. What began as a *locavore* movement that emphasized local, organic produce has grown to include the proteins on the dinner plate as well. "It's quite the renaissance right now in the Bay Area from a meat producer's standpoint," says Mark Pasternak, who owns Marin County's renowned Devil's Gulch Ranch with his wife, Myriam Kaplan-Pasternak, in tiny Nicasio, CA. "We're sold out every week." From “More Consumers Demanding Grass Fed Beef” *Beef Daily*, May 2012

The natural beef is a legitimate marketing option with incentives attractive enough to justify consideration. (Troxel 2013) Generally, ‘certified natural’ cattle have received premiums significantly higher premiums than other beef. To use the term, “natural” on a food label, the USDA requires: 1. The product must be minimally processed, 2. The product cannot contain any artificial ingredients, and 3. The product cannot contain any preservatives (see Troxel 2013 and www.USAD.gov 2013) Regarding beef, the USDA has no specific management practices during the life of the animal (www.USDA.gov 2013).

Trends driven by pharmaceutical technologies, i.e., growth hormones, enable more corn fed beef to be produced with fewer head of cattle to more prosperous consumers throughout the world. Their taste buds just crave the hormone produced corn-fed beef. After all, the hormones have been proven safe for human consumption. It makes the potential of a large market hardly possible for grass-fed beef.

Texas and Southwest Cattleman, June 17, 2013, says, “. . . the free-market system is amazingly efficient; the reason we produce corn-fed beef is that the most prosperous consumers in the world prefer it to grass-fed beef.”

Migrant Labor and GMO

Other influences in the cattle business are migrant labor and genetically modified organisms (GMOs). Recently farm groups generally approve of an agreement with the United Farm Workers that allows for hiring up to 112,000 foreign laborers to work in agriculture under a new visa program (See *The Register* 2013). "An additional 112,000 slots will open up in subsequent years until a total capped number of 337,000 is reached." (*The Register* 2013, p. 48)

Food manufacturers will soon be required to label any product containing GMOs if a bill just introduced in the United States Senate passes. "If the labels are not attached, the manufacturer would run the risk of having the product classified as 'misbranded' by the Food and Drug Administration." (*The Register* 2013, p. 48)

Currently, the bill, "Genetically Engineered Food Right-to-Know Act," has 11 cosponsors in the Senate and 22 cosponsors in the House and will have far reaching effects on consumer groups, businesses, farmers, ranchers, and fishermen. (*The Register* 2013)

Dilemma of Beta-Agonists in Beef Industry

The following is an excerpt from *Beef Daily*, August 1, 2013, in which the author sums up the dilemma presented by ideologies and responses within the beef industry regarding perceptions about use of hormones and beta-agonists:

We're operating in a different type of world today, one where issues are often created, and where competing scientific views are given equal weight regardless of their validity. The whole hormone issue has really never been about the science. It began as a trade barrier by Europe in its quest to protect its domestic cattle industry from the threat of imports. Even Europe's own scientific body found no justification for the position on growth promotants, and the World Trade Organization upheld a U.S. complaint on the issue. Nonetheless, from there, the issue has blossomed into a worldwide public relations nightmare.

One of the fastest-growing segments of our business has been natural product lines, and it's no coincidence that JBS announced this week the launch of a website promoting its premium Cedar RiverFarms® Natural Beef Program. It's almost ironic that most of the larger feed yards have almost divided their production between natural cattle and those undergoing a more aggressive approach.

APPENDIX C. National Daily Cattle and Beef Summary

National Daily Cattle and Beef Summary

Des Moines, Iowa — Wednesday, August 14, 2013

LM_XB403				
DAILY ESTIMATED CUTOUT VALUES				
	Choice	Select		
	600-900#	600-900#	Choice/Select Spread	
Cutout Values	192.35	184.7	7.65	
Change from Prior Day	2.03	1.4		
			Load Count:	
Primal Rib	299.15	275.8	Total	208
Primal Chuck	161.96	159.95	Choice	91
Primal Round	163.79	162.44	Select	73
Primal Loin	248.46	229.73	Trimmings	9
Primal Brisket	140.42	137.25	Grinds	35
Primal Short Plate	141.56	143.18		
Primal Flank	122.74	119.62		
Fresh 50% Trimmings	7	Loads @	108.99	
NW_LS441				
USDA BY-PRODUCT DROP VALUE (STEER)				
Value:	14.2	Change:	0.02	
LM_CT100				
5 AREA WEEKLY ACCUMULATED WEIGHTED AVG CATTLE PRICE				
	Head Count	Avg Weight	Avg Price	
Live Steer	34	1,450	124	
Live Heifer	0			
Dressed Steer	0			
Dressed Heifer	399	816	197	
SJ_LS710				
ESTIMATED DAILY CATTLE SLAUGHTER				
Today (est)	123,000			
Week Ago (est)	124,000			
Year Ago (act)	128,000			
Week to Date (est)	358,000			
Same Period Last Week (est)	364,000			
Same Period Last Year (act)	376,000			
Previous Day Estimated		Steer and Heifer	94,000	
		Cow and Bull	26,000	

SJ_LS712		8/9/2013	Last Week	Last Year	
BEEF PRODUCTION		(Estimate)	(Estimate)	(Actual)	
Slaughter		633,000	625,000	640,000	
Live Weights		1305	1304	1301	
Dressed Weights		795	796	794	
Beef Production (millions of pounds)		502.6	496.4	507.5	
NW_LS410					
USDA BEEF CARCASS PRICE EQUIVALENT INDEX VALUE					
		Choice	Select	Dressing Percent:	
		600-900#	600-900#	Steer	Heifer
		179.55	172.38	64.34	64.31
	Change	1	0.69		
LM_XB405					
USDA NATIONAL CUTTER COW CARCASS CUTOUT					
	160.58	Change	0.27	90% lean:	200.51
CME LIVE CATTLE					
		High	Low	Close	Change
	Aug	124.65	124	124	0.1
	Oct	128.7	128.2	128.18	0.1
	Dec	130.43	130	130	0.03
CME FEEDER CATTLE					
		High	Low	Close	Change
	Aug	154.1	153.23	153.6	-0.25
	Sep	158.23	157.08	157.45	-0.25
	Oct	160.75	159.65	159.85	-0.33

http://www.ams.usda.gov/mnreports/lsddcbs.pdf

Appendix D: Advertising Costs and Fees Currently proposed for K-R and Country Store			
San Antonio Local Newspapers			
	¼ page ad in 3 zones		
	3 months @ $1,800 per month	$ 5,400	
San Antonio Woman Magazine			
	½ page ad, distributed to 30,000 bi-monthly		
	3 insertions	$ 5,000	
ValPak			
	Coupons mailed to 60,000 households		
-	3 months @ $2,500	$ 7,500	
Social Media			
	Listing and maintenance of accounts on appropriate industry web sites, weekly posts on Facebook, Twitter, Pinterest, & LinkedIn, and e-mail Newsletter distribution, notification of specials, etc.		
	12 months @ $400	$ 4,800	
Photography for catalogs		$ 12,000	
Catalogs			
	Desk top publishing	$ 10,000	
	Holiday catalog	$ 4,000	
App			
	Production	$ 40,000	
	Maintenance	$ 3,600	
Trade Show			
	New York Fancy Food Show includes registration, supplies, and travel for one week.	$ 20,000	
			$ 112,300
Marketing consulting		$ 12,000	
	Total Advertising & Promotion Budget		$ 124,300
(See Resources)			

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RESOURCES

Based on personal experiences and knowledge of Marlene Kahla, Ph.D., Texas Department of Agriculture appointed committee member, and family ranch owner, conversations with various ranchers, both domestic and international, and seminars focused on growing herds and replicating desired traits in beef cattle through genetics.

THE RISE AND FALL OF NETFLIX: WHAT HAPPENED AND WHERE WILL IT GO FROM HERE?

Grace Allen, Western Carolina University
Dorothee Feils, University of Alberta
Holly Disbrow, Western Carolina University

CASE DESCRIPTION

The primary subject matter of this case concerns company analysis. Secondary issues include financial statement analysis, corporate strategy and international expansion. The case has a difficulty level of three and should be appropriate for undergraduate and graduate courses in investments and financial and strategic management. The case is designed to be taught in one to two class hours, with three hours of outside preparation by students.

CASE SYNOPSIS

Netflix is an innovative company that has changed the way we rent movies and watch TV shows. Its business model is based on a subscription service that provides home-delivery of DVD rentals and streaming of movies and TV shows. The company took advantage of the rapid growth in the DVD rental market, the internet and e-commerce by providing a service that the traditional brick-and-mortar retailers, such as Blockbuster, could not compete with. In 2011, however, a price hike, poor management decisions, changes in technology, and increased competition threatened Netflix, leading to a sharp decline in its share price. In this case, students analyze the fundamentals of Netflix including its financials and management decisions to help determine if Netflix's poor stock performance in 2011 was predictable as well as what the future might hold for this company.

INTRODUCTION

Rushing into the offices of Horizon Capital Invest (Note that Horizon Capital Invest, Brighton Portfolio, and the characters are fictitious) , Chris Thompson almost knocked into the CEO, Ms. Steinberg. "Whew" said Chris under his breath after apologizing to the CEO. It was the last week of April 2012 and Chris had one week left in a four month internship for this prestigious money management firm. He had spent his internship learning how to research companies for two senior analysts to whom he reported. It had been a steep learning curve for Chris, a finance major in his senior year at an East Coast university. He had been lucky to land the internship and was determined to impress the analysts at Horizon Capital Invest, a place he dreamed of working after graduation. He certainly didn't want to be late for the morning briefing. With his iPad in one hand and his coffee in the other, he glanced at the clock as he entered the conference room. Chris had 30 seconds to spare and thought to himself, "another close call. Maybe this will be my lucky day and I finally get to show what I can do." Chris greeted both analysts as he took a seat at the long table, "Good morning Ms. Hunter", "Good morning Mr. Richardson". After some pleasantries they got right to work. Ms. Hunter told Chris that they were considering purchasing Netflix for the Brighton Portfolio. Abruptly, Mr. Richardson broke in and said "I don't feel this is a good investment. The stock has plummeted over the past ten months and I would not consider it a value play." Before Chris could even begin taking notes Ms. Hunter said pretty forcefully "Come on Joe, this is a great company. Management may have made some mistakes recently but this leads to a great buying opportunity. I feel certain we will have a double digit return from this one." Mr. Richardson, a very head strong individual, wasn't about to let Ms. Hunter have the last say. He quickly responded "Maria, you're really off base with Netflix. It would be against our fiduciary responsibility to add it to the portfolio." You could see that Ms. Hunter was not going to take this lightly. Her face was red and she raised her voice a couple of levels and said "Joe, you have to trust me on this one. I know management will get its act together and we'll see a reversal in the stock price within the next quarter." Chris had been frantically taking notes but was beginning to get a bit nervous sitting between the two arguing analysts. Then they dropped the bomb shell. Mr. Richardson said "alright Maria, let's get Chris to pull together a report covering Netflix's background and the factors affecting the company this past year that could help us make a decision. I really am doubtful but I am willing to see details that will allow us to make a more informed decision." "Chris" said Ms. Hunter "can you do a report on Netflix by 9:00 am tomorrow?" Chris eagerly agreed to tackle the Netflix case knowing this might be his opportunity to show both, Ms. Hunter and Mr. Richardson, his recently enhanced research skills. After excusing himself, Chris left and headed to his cubicle with butterflies in his stomach and thought "yep this is my lucky day!"

What made this assignment even more interesting to Chris was that Netflix was a company he knew quite well. Many times he had watched a movie with his family or friends that had arrived via mail in the little red envelope. Since going to college, instead of ordering movies, he would just plug-in his iPod and stream a movie or a TV show. Chris had remembered discussing the stock in class. It was a company that had seen very impressive growth over the years because of its ability to provide what many Americans want in a fast and convenient manner: unlimited rental access to movies and TV shows via mail or on-line streaming for a low monthly subscription rate. Its' price had soared from about $180 per share in January 2011 to over $300 per share in July (Yahoo, nd). However, by the end of 2011 the price per share had dropped to $69 (Yahoo, nd) and Netflix had lost 800,000 domestic members (Form 10-K, 2012). "Wow" thought Chris "this is going to be interesting. My two bosses are at odds with each other, a company that has taken an abrupt turnaround, and less than 24 hours to prepare the report."

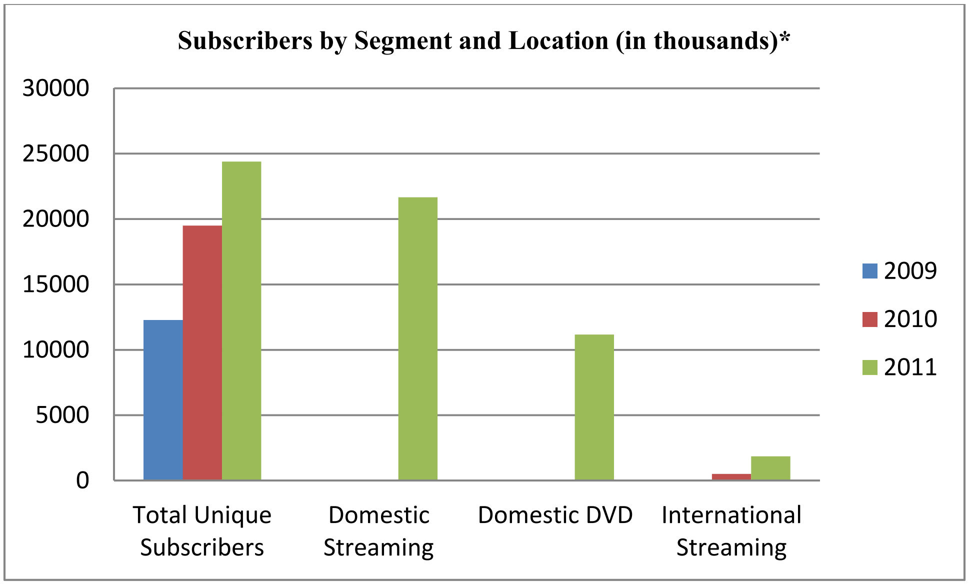
Since yesterday, Chris had been working nonstop with only a few hours of sleep. His cubicle was littered with pizza and donut boxes and half empty coffee cups. He believed he had done a thorough job researching Netflix and that Ms. Hunter and Mr. Richardson would be impressed with his report. He took one more look at the document checking to make sure that he had organized it well and there were no spelling or typo errors. Satisfied, Chris hit the print button and swung by the office to pick up the copies before heading into the conference room. Chris, a little jittery and tired from lack of sleep, took a deep breath to get his second wind and greeted his bosses cheerfully "Good Morning Ms. Hunter and Mr. Richardson. I hope you both will be pleased with my report on Netflix and that it will help you agree on whether to add it to the Brighton Portfolio. I made copies for both of you and would like to go through it with you now."

REPORT ON NETFLIX, INC.: PREPARED BY CHRIS THOMPSON

BACKGROUND

Netflix was founded by Reed Hastings and Marc Randolph in 1997 and is headquartered in Los Gatos, California. Netflix originally operated as an online movie rental store which included per rental fees and late fees. In 1999, Netflix initiated its subscription service which provided unlimited DVD rentals for a monthly fee after the company received a $30 million investment from the Group Arnault (Netflix Inc. Company Profile, 2011). Netflix began its movie recommendation system in 2000 where subscribers rate movies and Netflix used the information to suggest selections to its members. Netflix's reputation was built on its unique business model: unlimited rentals with no due date, no shipping and handling fees and no late fees. Netflix went public on May 22, 2002 with an IPO of 5,500,000 shares at price of $15.00 per share. It is listed on the Nasdaq under the ticker symbol "NFLX" (Netflix Company Timeline, nd). Reed Hastings, one of the founders of Netflix, has stayed on as the CEO of Netflix (Form 10-K, 2012). Netflix's total number of suscribers, at the time of the IPO, was 600,000 (Netflix Company Timeline, nd). The little red envelopes that became the trademark of the DVD subscription continued to pull large numbers of new subscribers into the fold year after year. In 2003, Netflix reported its first profit of $6.5 million after years of losses (Netflix, Inc., 2003). By the end of 2006, Netflix had 6.3 million members (Netflix Company Timeline, nd).

Netflix began to offer streaming as an added feature with its DVD subscriptions in 2007. Streaming, which allows movies or TV shows to be watched instantly over the internet, became increasingly popular as Netflix teamed up with electronic companies to broaden the scope of devices that could stream. At that time, streaming was available only for personal computers, but by 2008 devices such as the Xbox 360, Blu-ray disc players, TV set-top boxes and the Macintosh computer could stream. By 2009, PS3 and internet connected TVs were among the devices able to stream (Netflix Company Timeline, nd). At the end of 2009, Netflix had 12.3 million members (Form 10-K, 2012). In 2010, streaming Netflix content became available "on Apple's iPad, iPhone, iPod Touch, the Nintendo Wii and other internet connected devices" (Netflix Company Timeline, nd). In 2010 Netflix took its streaming content international by expanding into Canada. By the end of 2010, Netflix reported almost 20 million members up from 12.3 million in 2009 (Form 10-K, 2012).



source: Form 10-K (2012). *Note that there is a considerable overlap between streaming and DVD subscribers. Therefore, the number of total unique subscribers is less than the sum of domestic streaming and domestic DVD subscribers. Prior to 2011, Netflix provided only a combined streaming and DVD service.

FACTORS AFFECTING NETFLIX, INC. IN 2011

INCREASED COMPETITION AND CONTENT COSTS

By 2011, Netflix began to see competitors aggressively competing for market share (Q1 Publishing, 2011). Companies such as Hulu.com, Google TV, Apple TV, various cable companies and others were getting in on the rivalry by offering streaming. For instance, Comcast offered Streampix to its Xfinity subscribers with a base price of $4.99 per month (Gorman, 2012). Dish network and Blockbuster joined in, as did Verizon and Redbox, to offer movies and TV shows on the internet. Hulu Plus cost $7.99 per month, the same as Netflix, but also offered a limited selection of free previously run TV shows (Gadget Review, 2012). Since there are more alternatives for consumers, Netflix no longer has as large a hold on the market as it once had.

The cost of acquiring content differs for the streaming and the DVD segment. To acquire content for streaming, Netflix typically acquires and licenses content on a fixed cost basis (Form 10-K, 2012). Movie studios have been benefitting from more competitors entering the market since they have been able to charge more for the rights to stream movies and shows and thus for Netflix, the fixed cost of acquiring content for streaming is likely going to increase. Netflix likely will have to deal with rival companies as its content contracts come up for renewal and as it looks to expand its limited libraries. “Netflix’s content costs have jumped to $3.5 billion over the past several years, up from the $2.4 billion reported previously…” (Lang, 2011). The potentially severe increase in the cost of content could have a major impact on Netflix's ability to generate profits in the future.

However, the cost structure differs for the DVD segment. In the DVD segment, Netflix has many revenue sharing arrangements (Netflix, Inc. Company Profile, 2011), resulting in a variable cost model (Form 10-K, 2012). Due to the "mature state of the business" (Form 10-K, 2012), Netflix does expect healthy contribution margins from the DVD business, but also not much growth. The company expects that growth will come mainly from streaming (Wingfield, 2011b).

MANAGERIAL DECISIONS

Netflix's loyal and growing customer base was upset in July 2011 when Netflix decided to change its subscription plans and rates to better match them to the company's business segments: streaming and DVD rentals (Form 10-K, 2012). The existing subscription plans included a $7.99 per month plan for unlimited streaming and a $9.99 per month for unlimited streaming and unlimited DVDs sent one at a time. Starting July 2011, subscribers could subscribe separately to a streaming only or a DVD only plan for $7.99 each. If subscribers wanted to subscribe to both, streaming and DVDs, the subscription price increased to $15.98 per month, starting immediately for new subscribers and in September for existing subscribers (Netflix Company Website, 2011a). This change implied a 60 percent price hike for those subscribers that wanted to maintain the same level of service provided by the $9.99 plan previously upsetting many members (Wingfield, 2011a). Since many current and potential subscribers felt that the online library wasn't up to par as it lacked a wide array of new content, subscribers who preferred to stream still tended to order DVDs when they could not get a specific movie or show from the online library. Many subscribers felt that Netflix was being greedy although the price increase was a way to raise cash to increase the online library for streaming (Barnes and Stelter, 2011).

In addition, Netflix faces problems securing content for its streaming services. Negotiations with Starz failed in September, 2011 (Hollister, 2011), which meant that as of February 28, 2012 "Netflix's three-and-a-half-year-old deal with Starz …[came] to an end, and Starz's roster of classic and newer films …[disappeared] from the Netflix portfolio"(NYTBits, 2012). These films include movies from Walt Disney Studios and Sony Pictures Entertainment and were taken out of the library by the end of February 2012. The loss was a blow but Netflix has made a deal with Dreamworks for its films and television specials beginning in 2013 when Dreamworks' contract with HBO is due to expire. "The Netflix accord, which analysts estimate is worth $30 million per picture to Dreamworks over an unspecified period of years, is billed by the companies as the first time a major Hollywood supplier has chosen Web streaming over pay television" (Barnes and Stelter, 2011). The company has also been increasing its television content; however, it is not clear how well these changes will be accepted by consumers.

On September 18th 2011 Reed Hastings, CEO and Cofounder, posted a blog apologizing for not communicating the reasons behind the price hike but also announcing the splitting of Netflix into two companies. The DVD by mail service would be renamed Qwickster and would offer video games for an additional charge and the streaming component of the company would take the Netflix name. The two companies would have separate websites that would not be integrated. Reed stated, "Some members will likely feel that we shouldn't split the businesses, and that we shouldn't rename our DVD by mail service. Our view is with this split of the businesses, we will be better at streaming, and we will be better at DVD by mail. It is possible we are moving too fast – it is hard to say" (Netflix Company Website, 2011b). On October 10th, after a severe backlash, including a loss of 800,000 subscribers in the third quarter, Mr. Hasting reversed his decision to split the company. "The now aborted plan by the Netflix co-founder and chief executive to distance the Netflix brand from its DVD rental business has gone down as one of the year's biggest business blunders"(Wingfield and Stelter, 2011).

Finally, the United States Postal Service announced in December that it hopes to get rid of next day delivery for first class mail. This might cause issues for Netflix as it could slow down deliveries of its DVDs. Management will have to think about a way to deal with this potential problem, since customers might decide to go elsewhere if the DVD service were to become less convenient. Consumers are already upset about the price hike and it seems as if Netflix's focus for the future is on streaming at any cost (Wingfield, 2011b).

INTERNATIONAL EXPANSION

In 2010, Netflix decided to go international by offering streaming services in Canada. International expansion continued in 2011 as Netflix moved into 42 countries in Latin America and the Caribbean including Brazil, Chile, Columbia, Ecuador, Peru, Venezuela, Mexico, and Central America (Team, 2011). Netflix is looking for new subscribers outside the borders of the U.S. as competition is heating up in the U.S. but this move faces challenges of its own.

First, Netflix has to create an international library that would have enough content to be appealing in each country. As streaming content needs to be licensed separately for each market, Netflix faces difficulty in providing foreign subscribers access to comparable content available to US subscribers (Warren, 2011). For example, Netflix Canada has only about one third of the titles offered by Netflix USA (Huffington Post, 2011). In addition, Netflix will have to make some country specific content available. For example, Netflix would have to increase its French language content to be able to attract the francophone market in Canada.

Second, the existing digital infrastructure varies greatly from country to country but is of critical importance as a minimum of 800 kbps were required to stream movies (Team, 2011). "A MSNBC article sourcing Ibope Nielsen's report says that only 20% of Brazil's 42 million Internet users have a connection speed above 500 kbps…Latin America is also plagued by rampant video piracy…"(Team, 2011) Netflix might have issues being able to reach its full potential in these countries as its services might not be available to all interested consumers. Not only does the infrastructure vary, but also the design of the internet plans. For example, some Canadian internet providers introduced usage-based billing, or data caps. These are imposed to limit the amount that subscribers can download per month. Netflix's response to this has been to reduce the quality of videos it streams to Canadians, meaning that on average content will use up two-thirds less data to stream. (El Akkad, Krashinsky and Marlow, 2011).

Third, Netflix has to deal with regulatory uncertainty in foreign markets. For example, at the end of 2011, Canadian regulators did not require Netflix, or other internet-based movie distributors, to fund Canadian broadcast content or to adhere to other regulations required by cable and satellite companies. Not surprisingly, the competitors argued that Netflix had a competitive advantage that needed to be addressed (Argitis, 2011). The cost of operating in Canada could increase significantly, should the Canadian Radio-television and Telecommunications Commission change the regulations for internet-based movie distributors.

Finally, the international expansion has been costly, in no insignificant part due to the fact that streaming content licenses has to be paid for on a national basis. Thus, Netflix expects to run losses in the foreign markets in the short-term until a sufficiently large foreign subscriber base can be established (Form 10-K, 2012). The capital used to finance the international expansion could have been used to increase Netflix's library in the U.S. "Wedbush analyst Michael Pachter, a well-known digital-entertainment analyst, criticized what he saw as Netflix's "growth at all costs business model, "….adding that its desire to expand internationally will only cause it to incur losses for years" (Reisinger, 2012). The company's extensive "push to go international" is a risky move for Netflix. Only the future will tell whether the international expansion strategy will pay off in the long-run.

FOLLOW-UP MEETING

After going through his report, Chris sensed that Ms. Hunter and Mr. Richardson were still not on the same page. Ms. Hunter had a smile on her face and Mr. Richardson was frowning. Immediately, Ms. Hunter said "so Joe, Chris's research shows, as I have been telling you all along, that Netflix is a great company and we should add it to the Brighton Portfolio. Netflix is facing some challenges but the company is well positioned for the future." Mr. Richardson responded emphatically with "hold on a minute Maria, I am still leaning towards the opposite. In fact, I cannot even consider the purchase without a more in depth analysis. Chris, you have done an outstanding job but you need to take it a step further. Are you up to spending another day on Netflix? By the way, we don't have a lot of time to make this decision. We are meeting with the Brighton representatives next week and we want to make sure that we can justify our holdings and the portfolio is positioned to outperform our benchmark in the forward twelve months. Please summarize your analysis with your own prognosis of Netflix and be sure to back-up your opinion with facts." Chris was delighted to get such positive feedback from Mr. Richardson, someone who gave praise sparingly, but was also a bit nervous about his new assignment. He knew he could dig deeper and had the skills to synthesize the data but a lot hinged on the outcome. An exceptional job would set him up for a potential job offer from Horizon Capital Invest, a dream come true.

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MOBILE DETAILERS, INC.

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Richard Sincerbeaux, Fayetteville State University

CASE DESCRIPTION

The primary objective of the case is to reinforce the accounting cycle process by illustrating the true purpose of accounting which is to identify business transactions, record the transactions in the proper period, and communicate the results by preparing financial statements. The secondary objectives of the case are to encourage critical thinking, and strengthen student's understanding of accrual accounting principles. The case allows students to become familiar with the language of business, addressing terminology typically used in accounting such as 'issued', 'on account' and 'incurred'. The case is presented in two parts. The first part covers daily journal entries while the second part continues with the adjusting entries, financial statement presentation and closing entries. The case has a difficulty level of 2. It is suitable for either an Introductory Accounting course or an Intermediate Accounting course. If used in an Introductory Accounting course, students can complete Part A and B in approximately two hours each. If Instructors use the case as an in-class assignment or lab, four 50 minute class periods should be sufficient. If used as a review for an Intermediate Accounting course, students can completes Part A and B in approximately two and a half hours.

CASE SYNOPSIS

John Eco and Manning Stewart have just graduated from college. They have raised financing from family to start their new venture which is based upon a business plan created in college. Mobile Detailers, Inc. is a car detailing service. During their first month John and Manning tackle issues common in many new businesses. Will Mobile Detailers win the race or crash and burn?

INTRODUCTION

Mobile Detailers, Inc. (MD) was started by two business students, John Eco and Manning Stewart. John and Manning took an entrepreneur class at Fayetteville State University that required them to create a business plan for a fictitious startup company. Their business plan was so good that their professor encouraged them to make the company a reality. With the help of family and friends Mobile Detailers was born.

DESCRIPTION OF BUSINESS

Mobile Detailers was created on March 1, 2012. They offer at home and business car detailing in Fayetteville, NC. John Eco is the CEO and Manning Stewart is the CFO. Mobile Detailers provide their services for cash and on credit. Plant and equipment are depreciated using the straight-line method. Plant has a useful life of 20 years and equipment has a useful life of 5 years.

THIRD WEEK OF MARCH, 2013

John Eco walked into the office is good spirits. The first month of business was almost over and things were looking up. He saw Manning Stewart, his partner and CFO looking over the books. "Good morning Manning" John said. "What a beautiful spring day it's going to be." Manning didn't look up from the books. John asked what was wrong. "I'm just looking at all the expenses we've incurred this month." "You have to spend money to make money" John said. "That may be true," said Manning, "but we hired Sarah and David and we still have payroll at the end of the month." "We have that contract from Dreyer Auto Leasing and they paid us $36,000 in advance" John said. "But John, we can't record all of that as revenue this month" Manning said. "And our expenses will be higher than normal because of the costs to start the business." "Plus," Manning said, "even with the Dreyer contract, our revenue this month will be less than $12,000. We really need you to put that Marketing degree to use and get us some more customers." John was thinking about that and planned to visit other companies to see if he could get some additional long-term contracts. "Sand Hills Catering Company has 12 vans. Maybe I can talk them into an exclusive contract," said John. He left Manning to the books and went to prepare a presentation for Sand Hills Catering Company.

The following conversation occurred on April 2, 2013.

John:	"Hey Manning, here are the gas charge receipts from TECHO Gas for the month. The total was $585. "
Manning:	"Thanks, I need to record this as an expense for March. That reminds me, I need to record some other adjusting entries."
John:	"I remember Professor Smith talking about these. Doesn't it have something to do with a balance sheet account?"
Manning:	"and an income statement account."
	Sarah and David walk in to the office.
Sarah:	"Dr. Smith also said that an adjusting entry never involves the cash account."
David:	"I never took an accounting class. What is an adjusting entry?"
Manning:	"In order to make the financial statements accurate we have to record revenue in the period it was earned and expenses in the period it was incurred. This is accrual accounting."
Sara:	"Don't we have to do something about the cars we detailed for Dreyer Auto Leasing?"
John:	"We received the money in advance so we need to record how much revenue we earned for the month."
Manning:	"We agreed to record the revenue evenly over the six month period."
David:	"Why didn't we just record the revenue when we got the money?"

Sara:	"This is what Manning was talking about; we have to follow the revenue recognition principle."
Manning:	"We can't record the revenue until we have earned it."
David:	"Is that why we don't record the insurance when we paid for it?"
Manning:	"No, we follow the matching principle for the prepaid insurance. We have only used one month of the insurance so we can only record one month's worth of expense. Without the insurance we could not drive our trucks or do business to earn the revenue."
John:	"Sarah, you and David had better get going if you are to make it to Dreyer Auto Leasing."
	Sarah and David leave the office.
Manning:	"We got lucky when we hired Sarah and David."
John:	"They are great workers."
Manning:	"I need to remember to accrue their wages for the last week of March."
John:	"Don't forget to accrue the interest on our note also. How do you calculate that again?"
Manning:	"Simple"
John:	"What do you mean 'simple'?"
Manning:	"We use the simple interest method, Principle times Rate times Time."
John:	"How much did we have left in supplies at the end of the month?"
Manning:	"I calculated $150 of supplies left."

Just then the phone rang and John went to answer it. He came back with a big smile on his face. "We got the Sand Hills Catering contract! That's $2,700 a month" he said. "That's great John" said Manning. "How long of a contract did they give us?" "It's only for 3 months, but if they are happy they will sign a one year contract" John said.

Manning was still worried as he drove home that night. The contract with the catering company will help. He knew that the business was surviving, but they really needed another investor. His Aunt Bea considered investing but she wanted to see how they did their first month of business. Maybe it was time to go talk to her.

Aunt Bea was happy to see her nephew. Since she had not children of her own she was close to Manning and his sister Andrea. "Manning…how good to see you" she said. "How is my favorite Aunt?" Manning said. "I'm you're only Aunt" she said, smiling. They talked about the family and Andrea's new baby daughter.

Finally Aunt Bea asked how the new business was doing. "We just finished our first month of business and we already have two short-term contracts" Manning proudly said. "It's hard work but I really think we can succeed." "What are you going to do when those contracts expire?" Aunt Bea asked. Manning was ready for this question. "One of the contracts has an option to extend the contract for one year" said Manning. "And" he continued, "John is preparing a presentation for Redman Auto Dealers and several other companies. He is out of the office almost every day getting our name out there."

Aunt Bea was impressed with the two young men but she still wasn't sure if she wanted to invest some of her retirement money in the business. "Let me think about this for a few days" she said to Manning, "and I want to look at your financial statements before I make a final decision. Why don't you bring them by on Monday?"

Manning was excited as he left Aunt Beas home. He was pretty sure that they made a profit this month but he would have to work through the weekend to get the financial statements ready for Monday.

ACTIVITY FOR MARCH 2013

March 1	MD issued common stock for $50,000 cash.
March 1	MD purchased two used vans for $15,500 each with cash from Redman Auto Dealers.
March 1	MD paid $500 for one month's rent for a garage.
March 2	MD purchased cleaning equipment costing $5,000 by signing a 3 month, 12% note payable.
March 4	MD paid $2,400 for one year auto/business insurance from String Insurance Company, effective from March 1, 2012 through February 28, 2013.
March 4	MD purchased $900 for cleaning supplies. $450 in cash and the remainder on account.
March 4	MD received $36,000 cash advance from Dreyer Auto Leasing to provide monthly detailing services. The services will last for 6 months.
March 7	MD detailed 8 cars for $120 each and was immediately paid in cash.
March 9	MD hired 2 employees, David and Sarah to begin work on March 11th. Each employee will receive a weekly salary of $400.
March 12	MD detailed 8 trucks at Sammy's Firewood Delivery Service for $225 each. Sammy's Firewood will pay for the service in 15 days.
March 20	MD detailed 12 catering vans for Sand Hills Catering Company. They were paid $1,500 in cash and $1,500 on account.
March 27	Sammy's Firewood paid for detailing performed on March 12th.
March 29	Mobile Detailers Chairman of the Board Mr. John Eco declares and pays a $500 cash dividend.
March 30	MD paid employees David and Sarah for two weeks work, ending on March 24. In addition to these two salaries MD also paid John Eco and Manning Stewart a monthly salary of $3,000 each.

CREATIVITY AND CULTURE AT PIXAR AND DISNEY: A COMPARISON

Timothy D. Wise, Southern Arkansas University

CASE DESCRIPTION

This case studies the leadership and organizational dynamics of the Disney and Pixar companies and the events leading up to Disney CEO Robert Iger's offer to purchase Pixar. After analyzing the comparative histories and cultures of the two companies, students are asked to consider the advantages and disadvantages of accepting Iger's offer. If Pixar were to become a permanent part of Disney, would it lose its entrepreneurial spirit and become part of a corporate machine? If Pixar were to break ties with Disney, who would manage their marketing and distribution and how would the company have to change to handle the additional responsibilities?

CASE SYNOPSIS

In 2005, Pixar had a big decision to make. After struggling for years as a department of Lucasfilm and as an independent advertising agency and software company, Pixar had burst onto the scene in 1994 with the release of Toy Story, the first computer generated feature film. Following the film's release, the company became a publicly-traded corporation and grew into a studio large enough to produce more than one computer-generated feature at a time. The company's lucrative partnership with the Walt Disney Company gave it access to the larger firm's marketing and distribution capabilities and led to the appearance of Pixar characters at Disney's theme parks. As Pixar's characters grew in popularity, Disney saw a decline in the popularity of its own animated features, and Pixar's leaders became less satisfied with the Pixar-Disney partnership. When Disney experienced a change in leadership, Bob Iger, the newly-elected CEO, set out to not only restore Disney's relationship to Disney, but to use Pixar's creative chemistry to revitalize Disney's own animation division. He met with Pixar's leaders and offered not only to purchase Pixar but to place co-founders John Lasseter and Ed Catmull over Disney Animation and give Lasseter a role in theme park attraction development. It sounded like a "Cinderella" deal, but Catmull and Lasseter had much to consider. Many Pixar employees, they knew, would not be in favor of a Disney purchase. They were at a critical turning point in the life of their company, and the decision they made would have to be a good one.

INTRODUCTION

In 2005, the managers of Pixar Animation Studios were facing a crisis. The company's ten-year partnership with Disney was about to end, and the company had three options: draft a new agreement with Disney, find a new partner, or set up their own marketing and distribution network. (Paik, 2007, p. 285) Renewing the partnership with Disney seemed to many like an obvious choice. The arrangement had been a boon to the fledgling studio when it was first starting out. Disney had provided most of the funding (Price, 2008, p. 163) and had given Pixar's movies top flight marketing support (Paik, 2007, p. 283) in exchange for ownership of Pixar's characters and a substantial percentage of the profits. Pixar had grown, however, and had accumulated enough funds to finance its own films. (Paik, 2007, p. 283-284) Forty-five percent of the operating income for Disney's film operations came from the sale of Pixar's movies, and Disney's own marketing research showed that mothers trusted the Pixar name more than Disney. (Price, 2008, p. 5) A study of box office receipts revealed that four of the ten top-grossing "Disney" movies in the history of the company (including live action films) had been Pixar products. Pixar's *Finding Nemo*, released in 2003, was the highest grossing film ever released under the Disney banner, though Disney's own studios had not produced the film. It had broken the record formerly held by *The Lion King*. (www.thenumbers.com/movies/series/BuenaVista.php) Disney's executives, however, had refused to "give" on a number of important issues, and Pixar's managers had given up on trying to negotiate with them in 2004. (Paik, 2007, p. 285)

They were preparing to walk away from their beloved characters and start over when Michael Eisner resigned from the CEO position, and Bob Iger took over. (Paik, 2007, p. 285) Steve Jobs, Pixar's chairman and CEO, had dealt with Iger when he was at the helm of ABC television. The two of them had worked out the revolutionary arrangement of making episodes of ABC's most popular shows available to iPod users right after they had aired. (Paik, 2007, p. 288) Jobs met with Iger to discuss the future of the Disney-Pixar relationship. Iger told Jobs he wanted to purchase Pixar outright and make it a permanent part of Disney. After a long discussion, Jobs came away favorably impressed with Iger's leadership style and was convinced that Pixar should seriously consider Disney's offer. He arranged for John Lasseter, the head of Pixar's animation studio, and Ed Catmull, who was over the company's computer graphics area, to meet with Iger separately. They agreed to the meetings, but Lasseter was skeptical. (Paik, 2007, p. 287-288) He and his associates at Pixar had come a long way together, and this decision was sure to be a major turning point in the company's history.

As a young person, John Lasseter had been greatly impressed by Disney Studios. It was a library book about Disney animation that had caused him to choose animation as a career (Paik, 2007, p. 29; Price, 2008, p. 46), and the Disney-founded CalArts animation school that had given him his education as an animator. (Price, 2008, p. 47) Lasseter had been elated when Disney's animation studio had hired him immediately after his graduation from CalArts. The glow had faded, however, when he realized that the leaders of the studio were not interested in his ideas about how to make things better. Instead of welcoming the youthful enthusiasm of the younger animators they hired, they seemed to resent it. (Paik, 2007, p. 36-37) Lasseter's infatuation with the growing field of computer animation had apparently proven to be too much. Disney Animation had fired him. (Price, 2008, p. 53 and Schlender, 2006, p. 145) After his dismissal from Disney, Lasseter had joined with Ed Catmull at LucasArts and co-founded Pixar. Steve Jobs, who purchased the company later, negotiated a partnership with Disney, the same company that had fired Lasseter earlier in his career. Though Pixar's partnership with Disney had proven to be a boon for both companies, Lasseter did not completely trust the entertainment giant. As far as he was concerned, Disney had mishandled everything they had acquired in the past decade. They had, in essence, ruined everything they touched, and he did not want them ruining the company he had poured so much of his own life and creative energies into. (Paik, 2008, p. 288) He would meet with Iger and hear what he had to say, but he had serious doubts about the proposal.

DISNEY'S HISTORY

In much the same way as Pixar had enthralled audiences with the first feature length computer-generated film in 1995, Disney had captivated theater-goers with the launch of *Snow White*, the world's first feature length animation, in 1937. At the cost of $1,488,422, the movie had represented yet another first for the innovative studio that had already introduced the world to *Steamboat Willie,* one of the first animated cartoons to feature synchronized sound in 1928 (Bennis and Beiderman, 1997, p. 40) (According to film historians, however, Max Fleischer had produced *Old Kentucky Home*, which also had sound, in 1926.), and *Flowers and Trees*, the first full color cartoon, in 1931. *Flowers and Trees* was also the first cartoon to win an animation Oscar. (Bennis and Biederman, 1997, p. 40) *Snow White*, which had both color and sound, made use of other innovations as well. The multiplane camera, developed by the studio, allowed Disney animators to create layered scenes with pictures of objects in the foreground and background suspended on sheets of glass at different layers of a fourteen-foot platform to create the illusion of a three-dimensional world. (Bennis and Biederman, 1997, p. 41) Further innovations followed. *Fantasia*, launched in 1941, was the first animated film to feature stereophonic sound.(Thomas and Johnston, 1981, 510-511) In years that followed, Disney would expand beyond animated features into live action film and television and into the development of its now-legendary theme parks. (Wawro, 2000, p. 112-113)

Though the company has experienced seasons of apparent stagnation when it appeared to have lost its legendary creative luster, it has repeatedly managed to reinvent itself for new generations of fans while keeping its fabled "Disney magic" alive for fans of previous generations.

DISNEY'S FOUNDERS

Walter Elias Disney had entered the animation industry when he went to work for the Film Ad Company, a firm that produced animated advertisements that were shown between films, in St. Louis, Missouri. After a brief stint in advertising, Disney opened a studio in his own garage to produce short animations called Laugh-O-Grams. Unable to stay afloat financially in St. Louis, Walt and his older brother, Roy O. Disney, moved to Los Angeles to start the Disney Brothers Studio. (Wawro, 2000, p. 110)

Of the two brothers, Walt was the creative talent behind the firm's creations and Roy, who was ten years older, was a former banker who managed the company's business side. It was their complementary strengths that made the company both innovative and successful, but Walt's flights of creative fancy sometimes clashed with Roy's practicality and financially conservative outlook. (Bennis, 1997, p. 45-46)

One example of the brothers' fundamental differences was their disagreement over the movie *Fantasia*. Walt's idea was to use a symphony as the soundtrack for a tapestry of animated visions and release it in stereophonic sound. The film would feature dinosaurs lumbering through prehistoric jungles with thundering bass accompaniment. Nubile young centaur women would frolic to the sound of woodwinds. Dancing skeletons, a huge and extravagantly detailed devil surrounded by animated flames, and a now-iconic scene of Mickey Mouse in a borrowed sorcerer's hat animating a stubborn broom would combine to create what Walt believed would be an unforgettable experience for his audience. There were practical problems, however. To give audiences the full effect, theaters would have to install completely new sound systems and the onset of World War II made theater owners hesitant to make the investment. (Thomas and Johnston, 1981, p. 510-511) Roy was less than enthusiastic. It is difficult to say for sure who was correct. The film received $83,320,000 in U.S. gross ticket sales compared to the $184,925,485 *Snow White* had brought in three years earlier. *Pinnochio*, released the previous year, had grossed $84,300,000. When ticket prices are adjusted for inflation, *Fantasia* still ranked twenty-first in all-time U.S. gross box office sales by the end of 2010. World War II prevented the release of the film in European theaters. Science fiction author Ray Bradbury remembers seeing *Fantasia* as a young person and remembers it as one of the childhood experiences that stimulated his creative imagination, (Greasley, 2001, p. 78) but most of the public never even saw the film because most theaters could not afford to install new sound systems. (Thomas and Johnston, 1981, p. 510-511) Another "crazy" project the brother clashed over was the company's entry into the theme park business. While Walt had been so captivated by the vision that he mortgaged his house to help with the financing, Roy had seen no sense in the venture whatever. He later admitted that Walt's instincts had been correct, but that he just hadn't been able to see it at the time.

One of the brothers' worst clashes split the studio between "Walt's boys," the creative staff, and "Roy's boys," the business staff. After a month of not speaking to each other, the brothers finally worked through their disagreements, and Walt presented Roy with a peace pipe that he kept on display in his office until his death in 1971. (Vischer, 2006, 112-113)

Walt's leadership style exemplified many practices that are worthy of imitation and some that are arguably less so. Though Walt relied on the creative talents of other artists for the successes of his film, his earlier films did not even list the names of animators in the credits but only the name of the studio which was, of course, his own name. A strike by Disney's animators in 1941 ended this policy, but Disney later justified his former practice in an interview by saying he had used his name as a type of guarantee to his audiences. (Bennis, 1997, p. 41) Disney's practice of taking the credit, according to Bennis and Biederman, the authors of *Organizing Genius*, parallels those of artist Leonardo da Vinci and inventor Thomas Edison who were both supported by groups of talented people who traded away their own chances at fame to work under recognized "masters." According to these authors, neither Disney nor da Vinci nor Edison was truly the "lone genius" popular culture holds them to be, but all three served as "lightning rods" that attracted others with similar talents and visions to join with them in their respective "revolutions." (Bennis, 1997, p. 35) The leaders of Pixar, as their story demonstrates, attracted their own armies of creative revolutionaries, eager to join the cause (Paik, 2007, p. 41) and, to use the phrase Steve Jobs once used, change the world. (Bennis, 1997, p. 52)

In addition to his early refusal to share the credit, another complaint some biographers lodge against Walt is that he was a stern taskmaster who drove his animators hard and was sometimes guilty of berating them in front of their colleagues. (Bennis, 1997, p. 52) One of Walt's greatest leadership strengths, however, was his investment in the development of his artists. He sent them to art classes at the Chouinard Art Institute, a prestigious art school in Los Angeles, and later developed his own art school within the studio. Ultimately, in 1961, he contributed $40 million to help with the founding of the California Institute of the Arts. CalArts, as it came to be known, quickly became one of the world's leading animation schools. (Bennis, 1997, 39-40) Many of its graduates, including Pixar co-founder John Lasseter, went to work at Disney after receiving their degrees. (Price, 2008, p. 47) Another leadership strength Disney showed was that he recognized the different abilities and interests of his animators and allowed them the flexibility to work on assignments where they would be the most effective. Paul Hollister of *Atlantic Monthly* visited Walt's studio in 1940 and wrote about the environment he found there. One artist named Emil "didn't draw ducks." He was perfectly capable of drawing Donald or any other Disney character, but preferred creating the really elegant characters like the epically proportioned devil in *Fantasia*, and was given the freedom to excel in his area of strength. (Bennis, 1997, p. 47)

Another hallmark of Disney's leadership style was that he was not afraid to bring in people who were experts in areas he knew nothing about. When he decided to build Disneyland, for example, he had the innovative idea of locating the man who had rebuilt the American Navy after the Pearl Harbor disaster and having him coordinate the process. Though a number of people had been involved in restoring the navy, they repeatedly encountered the name of Rear Admiral Joe Fowler. Disney's employees located Admiral Fowler, by that time retired, and

Disney passionately recruited him. Fowler would return to supervise the construction of Disney World in Florida in the late 1960s and EPCOT in the 1980s. (Elmore, 2011, p. 6-7) Another military leader, Major General William "Joe" Potter, who had served under President Eisenhower as the governor of the Panama Canal Zone and who had served as the executive vice president of the 1964-1965 New York World's Fair, was also brought in and placed in charge of building the park's infrastructure including the massive amount of dirt work involved in transforming 300 acres of Florida swamp into the foundation of a resort. (http://disney.go.com/...legends/joe.potter, 2011)

DISNEY AFTER DISNEY

During the years following Walt Disney's death from lung cancer in 1966, the company he had built went through a series of up and down periods. Walt Disney World in Orlando, Florida, opened in 1971. (Kurti and Gordon, 2008) Disney's animation studios continued to release cartoons, but the quality declined throughout the seventies and eighties. In 1979, animator Don Bluth left Disney and took a number of their animators with him. Bluth's studio is known for producing *The Secret of NIMH* (1982), *An American Tail* (1986), *The Land Before Time* (1988) (Paik, 2007, p. 34) *All Dogs Go to Heaven* (1989) and *Titan A.E.* (2000), and is credited by some for providing the competition that spurred the revival of Disney animation in the mid-eighties. Pixar co-founder John Lasseter, who joined the studio just after Bluth's departure in 1979, described the culture of the studio, during the era in which he was employed there, as stifling and restrictive. (Price, 2008, p. 52; Lasseter 2004, p. 46)

Roy E. Disney, the son of Walt's brother, Roy O. Disney, pushed for a change of leadership. Michael Eisner was brought in from Paramount to become CEO in 1984. (Bennis, 1997, p. 32, 33) Eisner placed Jeffrey Katzenburg over the animation area. Frank Wells, who had been considered for the CEO position, served under Eisner as COO. Wells, a Rhodes scholar, was said to have been diplomatic, even-handed, and thoughtful. (Price, 2008, p. 167) *The Little Mermaid*, released in 1989, was the first in a series of highly successful animated musicals including *Beauty and the Beast* (1991), *Aladdin* (1992), and *The Lion King* (1994). Frank Wells died in a helicopter crash in 1994. After a clash with Eisner over who should assume Wells' responsibilities, Katzenburg left Disney and joined with Stephen Spielburg and Robert Geffen to form Dreamworks SKG, the studio that would later produce *Shrek*. (Price, 2008, p. 166, 169) In the years following Wells' death and Katzenburg's departure, Disney Animation's new golden age seemed to decline. The first three films released in the new millennium [*The Emperor's New Groove* (2000), *Atlantis: The Lost Empire* (2001), and *Treasure Planet* (2002)] all yielded disappointing results in the box office. (Price, 2008, p. 228) *Lilo and Stitch,* released in 2002, was one of the few financially successful Disney cartoons released during that time period. Eisner felt that traditional cel animation was obsolete and shut down the animation studio in Orlando that had produced the film. (Price, 2008, p. 235) He also shut down the studio in Paris, and outsourced much of the animation process to the Philippines. (Tschang and Goldstein, 2010,

p. 136)

Beginning with the 1995 release of *The Return of Jafar*, the first in a series of direct-to-video features, Disney had started the practice of producing low cost, direct-to-video sequels of their most successful films. From a profit-and-loss perspective, the practice made sense. Though inexpensively produced, this first video brought in around one hundred million dollars in profits. (Price, 2008, p. 175) This practice would later become a bone of contention with Pixar, however, because the sequels were not held to the same quality standards as the features. (Price, 2008, p. 232)

PIXAR'S EARLY HISTORY AND LEADERS

Though many features of Pixar's culture mirror those of Disney during its heyday, the story of Pixar's founding and growth and the converging visions of its leaders is, in many respects, more complicated. From the perspective of its audience, Pixar Animation Studios burst onto the scene in 1995 with the release of *Toy Story*, the first feature length film produced entirely in Computer Generated Imagery (or CGI, as it is now popularly known). (Paik, 2007, p. 105) Prior to that time, very few outside the field of computer graphics had even heard of them though they had already won four Academy Awards (Three were Scientific and Engineering awards that they shared with Disney.) and had been nominated for an additional one. (Price, 2008, p. 267-268) Even in those early days, the company showed clear signs of its technical and storytelling brilliance, but where did this small and innovative company come from? To answer this question, one must venture back to the lives and visions of the company's founders.

ED CATMULL

The decades-spanning story behind the company's apparently overnight success goes back to an era when the field of computer graphics was in its infancy and much of the computer technology that is taken for granted today had yet to be invented. Ed Catmull, one of Pixar's founders, was a leading visionary in the development of that technology. Though few innovations, especially in a field as dynamic as computer science, can be completely credited to a single individual, Catmull definitely had a creative hand in the process. (Paik, 2007, p. 15; Price, 2008, p. 15; *Odysseys in Technology*, 2005)

Ed Catmull grew up in a Mormon family in Utah and, as is customary, served as a Mormon missionary during his college years. (Price, 2008, p. 12, 13, from an interview with Alvy Ray Smith) The lifestyle and values infused into him by his upbringing are still reflected, to a great extent, in the family friendly flavor of his company's films. Catmull attended the University of Utah's graduate school during a remarkable time. The school had become the world leader in computer graphics research, and Catmull's classmates included Jim Clark, who had helped start Netscape and Silicon Graphics; John Warnock, who co-founded Adobe; and Alan Kay, who had been part of the Xerox's PARC team, a group that did pioneering work in the development of object-oriented programming and graphical user interfaces. (Paik, 2007, p. 15)

Steve Jobs of Apple and Bill Gates of Microsoft both built their operating systems, as well as their fortunes, on foundations laid by the PARC group.) (Bennis, 1997, p. 84) Catmull's own contributions were the Z-buffer, a system that assigns depth to objects in three-dimensional space; texture mapping, a process that "wraps" pictures around 3D models (to give them the appearance of wood, tree bark, or flesh, for example); and a new type of mathematical surface that made it possible to build models of irregularly-shaped objects. (Price, 2008, p. 15) One of Catmull's early experiments was a 3D model of a hand opening and closing. This short animation appeared four years later in *Futureworld*, a science fiction film, in 1976. (Paik, 2007, p. 14-16).

PIXAR AT LUCASFILM

After a stint at the New York Institute of Technology where Catmull met Alvy Ray Smith and many of the other friends who would later comprise his core team, (Paik, 2007, p. 17-19) George Lucas set up a computer division at Lucasfilm to do pioneering work in computer graphics. Though *Star Wars*, released in 1977, had set revolutionary new standards in special effects technology, the film had not used computer graphics to achieve this. Even the apparently computer-generated readouts on the targeting scanners of the fighters were really old-style animations. The ships and the planets were models and laser beams were etched onto the scenes using a high quality optical system the studio had developed. (Paik, 2007, p. 19-21; Price, 2008, p. 30) Though Catmull dreamed of using computer graphics to make features films, it soon became apparent to him that computer technology would have a great deal of catching up to do before it could be used for this purpose. He estimated that it would take 100 Cray supercomputers two years to generate the images for an entire movie using the technology of that time. (Paik, 2007, p. 23)

Because it was an investment in a yet-to-be-realized future, many of the other departments at Lucasfilm viewed the computer division as dead weight. This naturally made it a prime target for budget cuts anytime the studio experienced money problems. One triumph the computer division experienced during that era was an animation clip they developed for *Star Trek II: The Wrath of Khan*. In the scene, the lead characters are watching a computer-generated simulation of an experimental torpedo, the Genesis Device, which is able to transform a dead moon into a living planet with forests and oceans. In the simulation, the torpedo strikes the moon, an explosion sweeps across the moon's surface, and mountains and oceans form before the viewer's eyes. Even though the images still had a computer-generated look, the effect surpassed anything that had been seen by audiences up to that point and, after all, it was supposed to be a computer generated image in the story itself. (Price, 2008, p. 38-40; Paik, 2007, p. 24-25) In the years that followed, the Lucasfilm computer division continued to do remarkable work in the area of computer graphics research, but Catmull and his team remained a target for budget cuts. This would ultimately lead to the company's sale and friendly separation from its parent studio. (Paik, 2007, p. 46-47)

JOHN LASSETER

While Ed Catmull might be characterized as the "technology guy" behind Pixar's revolutionary approach to animation, John Lasseter might be described as the "animation guy" of the team. Clearly this is an oversimplification because the two had some overlapping gifts and a common vision, but if one were to ask about the unique and complementary gifts each brought to the mix, Lasseter's would be in the area of animated storytelling. The son of a California Chevrolet dealer and a high school art teacher, (Paik, 2007, p. 28) Lasseter had loved cartoons from an early age and was thrilled when he realized people actually supported themselves by producing them. After high school, he attended CalArts, the school that Walt Disney had helped to found. (Price, 2008, p. 46-47) His classmates, like Catmull's, included people who would go on to become leaders in their respective fields. Tim Burton, known for his macabre style and his work on features like *The Nightmare Before Christmas* and *Batman*, is one of the most recognized names. John Musker, another classmate, would co-direct *The Little Mermaid* and *Aladdin*; Chris Buck would co-direct *Tarzan*, and Brad Bird would later direct *The Iron Giant* for Warner Brothers and Pixar's own *The Incredibles*. During Lasseter's time at CalArts, John and his classmates drove to Los Angeles for the release of the first *Star Wars* film in 1977. Even though the film featured live action and special effects, seeing it convinced Lasseter that he had chosen the right career path and triggered in him a vision of animated feature films that would stir up the same kind of excitement. As a college student, Lasseter took a job at Disneyland that fortuitously helped him in developing skills that would serve him well as an animator and as the leader of a creative team. He started out as a sweeper in Tomorrowland but was later transferred to the Jungle Cruise where he served as a river guide whose job involved telling corny jokes to guests as they passed through an animatronic jungle. That job, according to Lasseter, helped him get over the shyness he had suffered from earlier in his life and to develop the comedic timing that would be so crucial to the success of his animated features. (Paik, 2007, p. 31-32)

After graduating from CalArts, Lasseter was thrilled to get a job at Disney Animation. His enthusiasm cooled when he encountered a restrictive atmosphere where the studio managers were more interested in keeping the new recruits in line than in harnessing their creative excitement. In one conversation that served to shape Lasseter's own management style, one of the managers told him, "So, you want to be creatively in charge? I'll tell you how to be in charge. You sit down and do in-betweens for twenty years, then you can be in charge." (In-betweens are considered the "grunt work" of animation.) "I remember walking away and deciding right then that if I was ever creatively in charge of anything, I'd never say to a young artist what that guy had just said to me. In that one exchange, he killed all the enthusiasm I had to help make the project better." (Paik, 2007, p. 36) The studio, which had once had a reputation for innovation, had become stagnant. Disney's live action studio, however, did attempt something new and innovative in the early 1980s when they produced *Tron*, a story about a man who was translated into a digital world inside of a computer. The story mixed live action with computer-generated props and scenes. Lasseter and Glen Keane, another Disney animator, saw the work the studio was doing and were thrilled by the possibilities. They saw it as a computer-based successor to Disney's legendary multiplane camera. (Paik, 2007, p. 37-39; Price, 2008, p. 52-53)

When *Tron* was shown to the animation studio, however, their response to it was rather chilly. Many of them viewed computer animation as a threat to their art form and livelihood and reacted defensively. Lasseter continued to believe in the potential of computer animation and worked with some of the other animators on projects to demonstrate its potential. One was a scene from *Where the Wild Things Are* and the other was based on the children's book *The Brave Little Toaster*. (Price, 2008, p. 53) They sought out other studios to partner with on these projects. One of the studios they visited with their projects was Lucasfilm. Ed Catmull was unable to work with them at the time, but the meeting between Lasseter and Catmull turned out to be fortuitous nonetheless. (Paik, 2007, p. 39) Lasseter's interest in computer animation apparently proved to be a nettle in the sides of those who saw animation as a fad or a threat. Lasseter, to his surprise, soon found himself without a job. (Paik, 2007, p. 40)

LASSETER JOINS CATMULL

Ed Catmull heard about Lasseter's dismissal and was, as one biographer expressed it, "sorry to hear Lasseter had been let go…but not *too* sorry." A short time later , when Catmull saw Lasseter at the SIGGRAPH computer graphics conference, he invited him up to Lucasfilm's studio in San Francisco to do a freelance job for them. (Paik, 2007, p. 40) The job would ultimately result in his permanent employment with the company. Lasseter was stunned by the talented people he found working at the studio. He had encountered their names in his research of computer graphics and admired their work, but had no idea they all worked at the same place. When Lasseter asked Catmull how he had managed to pull so much talent together in the same place, Catmull told him, "I try to hire people that are smarter than myself." (Paik, 2007 p. 41) His approach, like that of Disney, had been to hire the best and let them perform. (Bennis, 1997, p. 48) Lasseter found Catmull's philosophy and the resulting culture to be a wonderfully refreshing change from what he had encountered working for Disney. He was, however, admittedly intimidated by the technical skill of the people around him. "I mean, there I was, surrounded by all these PhDs who had basically invented computer animation." (Paik, 2007, p. 41; Iwerks, 2009) Lasseter knew he could never compete with his new colleagues on a technological level, but what he brought to the mix was the eye of an artist. He also had the gift of being able to think conceptually, to picture how the parts of a project fit together into the whole. Lasseter described his working relationship to the programmers as, "the art challenges the technology, and the technology inspires the art." An early project, a short animation called *Andre & Wally B*, showed an android being chased and stung by a fat bumblebee. The robot and insect had both been chosen because their bodies were made up of fairly simple geometric shapes. For the bee, however, the animators had been challenged to design a new teardrop shape. (Paik, 2007, p. 43)

In 1984, just as Lucasfilm had hired Lasseter full time, Industrial Light and Magic, the special effects studio of which the Lucasfilm Computer Division was a part, was hired to do the special effects for a scene in the movie *Young Sherlock Holmes*. In the scene, a drugged priest has a hallucination in which the figure of a knight leaps out of a stained glass window in a church and chases him with a sword. The movie ended up being nominated for an Academy Award for Best Visual Effects. One of the most memorable aspects of the project, for Lasseter, was watching the way Dennis Muren, the film's special-effects supervisor, managed the project. Every morning the entire project team was gathered to watch "dailies" of the project's progress. Muren directed the discussion of problems to be solved and changes to be made and, Lasseter noted, *actually listened* to everyone involved. The open-dailies model would later become a central feature of Pixar's corporate creative culture. (Paik, 2007, p. 45)

In spite of the computer division's successes, many of the executives at Lucasfilm continued to see the graphics research area as a drain on company resources. Ed Catmull and Alvy Ray Smith, who had shared leadership with him since their days at New York Tech grew weary of defending the team they had worked so hard to build from downsizing efforts, and decided to take matters into their own hands. At one point, they actually went to a bookstore and bought a book on starting a business. They put together a business plan, building it around the Pixar Image Computer, which they believed was the most promising technological product they had developed at the time. Their real interest was to create computer-animated feature films, but they realized that goal was still years away. In their plan, they justified continuing their work in animation as a type of training. George Lucas had always been supportive of the group's efforts and would remain on friendly terms with them, but he was not interested in running a computer company. Catmull and Smith began seeking an investor to purchase the Computer Division from Lucasfilm. (Paik, 2007, p. 46-47)

PIXAR AFTER LUCASFILM

Though the company had originally set the sales price at $15 million for partial ownership of the company with an additional $15 million in guaranteed funding, Steve Jobs, the founder of Apple Computer, finally bought it from Lucas for $5 million with an additional $5 million in guaranteed funding. (Paik, 2007, p. 50, 52) If Catmull was the "technology guy" and Lasseter was the "animation guy," Jobs joined the Pixar leadership team as the "business guy" or, perhaps, the "money guy." As the founder of Apple Computers and, later, of NeXT, Jobs was also a "technology guy" in his own right. Jobs was so famous for the charismatic way he sold his visions, those who heard his speeches said he had a kind of "reality distortion field." (Bennis, 1997, p. 82; Price, 2008, p. 100-101) Business professor Kenneth Green aptly described Jobs as, "Kind of like a huckster, but in a good way." Jobs, who had co-founded Apple with Steve Wozniak, had long been sold on the idea that computers would change the world, and what he saw at Pixar resonated with him. Some analysts have criticized Jobs for being heavy-handed in his approach to managing Apple during the early years of the company. As a young man, still in his twenties, he had been strong in youthful enthusiasm and drive, but weak in compassion and tact. Working his employees around the clock and berating them in front of colleagues with acerbic comments like, "This sucks!" had been typical of his style in those days. (Bennis, 1997, p. 81, 82) The team at Pixar found him similarly challenging to work for. Alvy Ray Smith, Catmull's second-in-command, once got into a screaming match with Jobs. They both, according to Smith, went "completely nonlinear" with Jobs mocking Smith's accent and Smith writing on Jobs' cherished whiteboard. (Price, 2008, p. 114)

When Jobs returned to Apple, however, the challenge of leading two companies at once forced Jobs to delegate more of the leadership responsibility for Pixar's activities to the company's founders. He worked with Catmull, Smith, and Lasseter to determine the overall direction and strategies of the firm, and left it to the animation team to manage the details. Jobs later commented on the difference between managing Apple, a job that required "ten really important decisions to make every week" and "a lot of new products every month," to his approach to managing Pixar: "At Pixar," he said, "because I'm not directing the movies, there are just a few really important strategic decisions to make every month, maybe even every quarter, but they're really hard to change. Pixar's much slower-paced, but you can't change your mind when you go down those paths." (Paik, 2007, p. 282)

TOY STORY

Though Pixar earned a little bit of income from the sale of Pixar Image Computers, and advertisements for companies like Listerine, it was not enough to cover the company's fixed costs. (Paik, 2007, 56-68) For nearly a decade, Jobs kept the company afloat financially while it geared up for the animated feature film that would catapult it into the public eye the way *Snow White* had transformed Walt Disney Studios back in 1937. Not entirely happy about having to pour so much money into the company, Jobs tried to sell Pixar repeatedly while *Toy Story* was in production. He even tried to sell to Microsoft the year before the movie's release. (Price, 2007, p. 139, based on interview with Vice President Pam Kerwin) When Pixar finally had the skills and technology to produce a feature film, however, it was Jobs who negotiated the partnership arrangement with Disney that made it possible. Pixar would produce the film, providing an unparalleled combination of Silicon Valley technology and Disney-inspired storytelling. Disney would push the film through its massive marketing and distribution network, share expertise in the production of feature, and provide funding for the project for the four years it would take to produce it. (Paik, 2008, p. 283) Pixar would only earn between 10 and 15% of the profits, and Disney would own the characters, but accepted the arrangement as part of the price they had to pay for Disney's help. (Price, 2008, p. 163)

As Steve Jobs commented, "I'm convinced we would have crashed and burned on *Toy Story* without Disney showing us how to do things on the production side." Jobs also said that Pixar's partnership with Disney had "probably been the most successful partnership in Hollywood history…." (Paik, 2007, p. 283)

The production of *Toy Story*, however, was not without creative tension. Disney executive Jeffrey Katzenburg wanted a film that would appeal to adults as well as children (His studio would later produce *Shrek*.), and kept pushing Pixar to give the characters more "edge." Though biographers differ on how much blame to assign Katzenburg for Pixar's story problems, Lasseter and his team made their characters meaner and darker with each version. Working on the movie a piece at a time, they had not realized how much their movie had changed until they screened the first half to a roomful of Disney executives. Seeing the assembled film for the first time, Lasseter was embarrassed by the mean and unhappy characters he saw on the screen. (Paik, 2007, p. 89-90)

"Well, why is this so terrible?" Katzenburg asked Tom Schumacher, another Disney executive who had worked with the team on the project.

"Because it's not their movie anymore," Schumacher told him. "It's completely not the movie John set out to make." (Paik, 2007, p. 90)

Lasseter talked Disney into giving his team a few weeks to rework enough of the film to convince them Pixar could do better. Lasseter says he told them, "Let's just make the movie we want to make. We'll listen to their notes, but let's only take the ones we feel make the movie better and ignore the rest." Working at a feverish pace in a desperate attempt to save their studio, the group completely remade the first third of the film. Though rough, the new draft was enough to convince the studio of the project's merit. That "swim or sink" experience, according to Lasseter, forged the foundation for the creative process the studio still uses. The process involved a great deal of trust and, in Lasseter's words, "immense respect for what each person brought to the collaboration." (Paik, 2007, p. 91) Once the pressure was off, the group was able to get more joy out of the rest of the process.

THINKING BEYOND TOY STORY

As the *Toy Story* project neared completion, Steve Jobs began to think about the future of Pixar as a business. *Toy Story* had taken four years to complete, but a business that only put out one product every four years would be hard to sustain. In order to succeed, Pixar would need to transform itself into a full-fledged studio capable of putting out at least one feature film a year. (Paik, 2007, p. 108)

Because a project like *Toy Story* would take longer than a year to produce, the studio would have to have more than one project in the "pipeline" at any given time. Dividing the creative team would present a challenge because one of the cornerstones of the studio's creative chemistry was that everyone was involved in the projects and ideas flowed freely. John Lasseter would also have to decide what to do about the director's responsibility. (Paik, 2007, p. 111-112) Many of the great animators, Disney included, had masterminded all of their studios' projects. Would Pixar's style be dictated by the tastes and visions of a single director, a "lone genius," or would Lasseter be willing to share the director's spotlight and give other directors a chance to succeed?

Another issue was funding. Steve Jobs believed that the company should go public. Disney had put up most of the funding for *Toy Story* and, as a result, had been given more of the control and most of the profits. Jobs hoped for a more equal sharing of decision-making power on future films, but the company would not be in a position to bargain for half of the profits unless it could cover half of the production costs as well. (Paik, 2007, p. 109) Many financial analysts thought Jobs' idea was ludicrous. Who, after all, would buy stock in a company that had been in business for ten years and had never made a profit? (Price, 2008, p. 143, 148) The successful launch of Netscape as a public company, however, cooled heir skepticism somewhat.

Lasseter was resistant, at first, to the idea of putting his company in the hands of investors. The day creative decisions came to be dictated by stock prices, he said, was the day he would leave the company. "I will never ask you to do that," Jobs assured him. He told Lasseter, in essence, to just keep having fun making the movies he wanted to make. (Paik, 2007, p. 110)

Toy Story was released in November 1995 and was enthusiastically received by audiences. (Paik, 2007, p. 105) A week later, the company went public. Pixar's IPO, which raised around $150 million, was the most successful of the year, surpassing even Netscape. (Paik, 2007, p. 110) With $150 million in the bank, Jobs was able to negotiate the 50/50 partnership with Disney that he had envisioned. According to the terms of the contract, Disney and Pixar would share in the costs and profits of Pixar's next five feature films, and Disney would put the force of its massive marketing machine behind them. The characters would appear as toys, and on clothing and hundreds of other licensed items, and in Disney theme park attractions.

The successful IPO was not without its problems. Before the company had gone public, Catmull had been earning $160,000 a year while Lasseter earned $140,000. Their salaries had allowed them to live in upper middle class neighborhoods, but they had not been wealthy by Hollywood or Silicon Valley standards. The public offering had turned them and a small number of others into instant multimillionaires whereas others who had been with the company since its Lucasfilm days only shared the wealth in minimal ways. To make matters worse, a financial manager Jobs had brought in just before the IPO (to give the company credibility on Wall Street) also shared in the benefits. Pixar's long-time employees felt that it made a mockery of the company's 'labor of love' culture. (Price, 2007, p. 145, 146)

When it came to the restructuring of Pixar's creative function, Jobs and Catmull gave Lasseter the lead. The decision, they felt, should be his. Following the example he'd seen Catmull set at Lucasarts, Lasseter chose to share the creative spotlight rather than building the animation studio completely around his own visions. Orchestrating multiple projects at the same time would have been a directing nightmare anyway. For the projects immediately following, Lasseter shared the director's job with two of the animators who had worked directly under him in the *Toy Story* project. (Paik, 2007, p. 112, 113) For *The Incredibles*, he reached outside of the company and brought in a former classmate from his CalArts days. Brad Bird had been disillusioned, to some extent, by his previous experiences in the animation industry, but was absolutely delighted by the atmosphere he found at Pixar. They told him they wanted him "to bring new ways of doing things." As successful as they were, they were fearful of getting into a creative rut and becoming victims of their previous successes. (Paik, 2007, p. 236; Iwerks, 2009)

Because of the limits of computer graphics technology, Pixar's projects had had to be chosen carefully. Toys, insects, and robots had been good choices for the initial projects because they had relatively rigid faces and did not have to have lifelike hair or clothing. The fish in *Finding Nemo* did not use arms or legs to move around. The company refused to become complacent, however, and set new challenges for themselves with each succeeding project. Whereas *Toy Story* had taken place mainly indoors, *A Bug's Life* was set in an organic outdoor world with plants, dirt, water, and wind. Some scenes were populated with hundreds of computer-generated ants. (Paik, 2007, p. 119) *Monsters, Inc*. starred a monster with lifelike blue hair and a little girl with a realistically wrinkled shirt. (Paik, 2007, p. 197) *Finding Nemo* made use of water effects. (Paik, 2007, p. 212) *The Incredibles* featured a large cast of human characters. One challenge faced by computer animators is to strike a balance between realism and cartoonish exaggeration that does not make the characters look grotesque to audiences. (Price, 2008, p. 223) The studio used short features, mini-movies of about five minutes in length, as a training exercise for directors and as experiments in the use of new techniques. (Paik, 2007, p. 138, 139)

The story behind *Toy Story 2* is significant in a number of ways. In keeping with the Disney practice of the time, the sequel was supposed to have been a low budget, direct-to-video release rather than a theatrical feature film. As the project progressed, Lasseter became more and more disturbed by the idea of dividing his studio into A and B teams and releasing a project that represented anything but his studio's best work. Every project, up to that point, had been a step forward creatively and technologically over previous projects. Releasing a deliberate B-movie seemed, to him, to be a step backward. (Paik, 2007, p. 145) Less than a year before the video's scheduled release, Lasseter's team decided to completely overhaul *Toy Story 2*. Disney protested that they didn't have enough time. Marketing and distribution were already in place. By working at a feverish pace and diverting animators from other projects, Lasseter and his team managed to condense two years' work into only nine months. (Paik, 2007, p. 146)

Toy Story 2 was a creative triumph. Like *The Empire Strikes Back* and *Godfather 2*, it is considered by many to be one of the rare sequels that is actually superior to its predecessor. (Paik, 2007, p. 157) Earning $245 million in the U.S. and $486 globally, *Toy Story 2* was the second highest grossing animated feature up to that time. Only *The Lion King* had surpassed it in box office receipts. (Price, 2008, p. 186) This success, however, did not come without a price. The grueling pace of the production had pushed the animators to the point of exhaustion. Many of them suffered from repetitive motion injuries, and one was permanently disabled and had to leave the industry. (Paik, 2007, p. 157) Another exhausted animator forgot to drop his infant child off at the daycare center and left it in his car for hours. Rescue workers managed to avert tragedy, but the incident was a sobering warning to Pixar managers about the possible consequences of overworking their employees. (Price, 2008, p.184) Their animators had shown that they were willing to do whatever it took to produce an excellent product, and Lasseter told them he would never again ask them to make that kind of sacrifice. Pixar's leaders resolved that their job was to protect their team. It was up to them to safeguard their health and wellbeing for the long haul. To do this, the company instituted a wellness program. They brought in a doctor, nurse, and massage therapist on a contract basis, hired a full-time ergonomics expert, and bought new furniture that would allow artists to work more comfortably. They also offered tai chi and yoga classes in the gym of the new building. (Paik, 2007, p. 157-159) This aspect of Pixar's leadership distinguishes their leaders from many of those profiled by Bennis and Biederman in *Organizing Genius*. In aspiring to greatness, many of the members of the great groups described in the book sacrificed their personal lives for their respective dreams. (Bennis, 1997, p. 25, 26) Pixar aspired to a more sustainable model of leadership.

THE DISNEY DILEMMA

As Pixar's five-film partnership with Disney drew toward its end, Pixar's managers found themselves at a turning point. The partnership with Disney had, in many ways, been one of the most successful in the history of the entertainment industry. At the beginning of the deal, both companies had been pleased with the arrangement. As time wore on, however, the relationship between Pixar and Disney became strained. "In the early days," according to Ed Catmull, "we didn't look at the contract. And it's always a sign of a good relationship when the contract goes in a drawer, and you don't look at it. But near the end…we started to look at the contract." (Paik, 2007, p. 284)

Two issues arose from differences of opinion regarding sequels. The contract was for five films, and one issue was whether *Toy Story 2* should be counted as one of the five. (Price, 2008, p. 179) Pixar felt that it should have been included. Disney, on the other hand, did not feel that the deal should include sequels. They argued that *Toy Story 2* did not introduce a new set of characters into the Disney universe and, therefore, did not offer the merchandising opportunities of a completely original feature. Further, they argued, the film had not originally been meant for theatrical release. The contract, as a result, stretched until after the release of *Cars*. Jobs argued that *Toy Story 2*, unlike most sequels, had actually made more money than its predecessor, but Eisner was unmoved. Further, he wanted the studio to produce a third *Toy Story* film, and that one would not be counted as one of the five, either. (Price, 2008, p. 229)

Another issue was Disney's intention to release direct-to-video sequels of all of the Pixar films, with or without Pixar's approval. Pixar would be given the first right of refusal when it came to the making of the sequels, but they could not keep another studio from producing inexpensive and possibly mediocre follow-ups to their films.

"These characters are like our children," Lasseter explained, "and it just killed me to think of the people who forced *Cinderella II* into existence making sequels to our films, running our characters into the ground." (Paik, 2007, p. 285)

Another source of disagreement was the dividing of the profits. While Pixar had relied extensively on Disney's production experience and funding for the first films, the situation had changed. The company had learned quickly when it came to production techniques, and had become less financially dependent upon Disney as well. They had, in fact, provided all of the financing for *Ratattoule,* a new film that was scheduled for release in 2007. Pixar, according to the terms of the contract, received fifty percent of each film's profits with an additional amount, around ten percent, deducted to cover distribution costs. (Paik, 2007, p. 286)

The straw, perhaps, that broke the proverbial camel's back was a remark Eisner made about software piracy when he was testifying before congress. One computer manufacturer, he said, had billboards from San Francisco to L.A. encouraging users to "Rip, mix, and burn." The company responsible for the campaign, as Eisner must have known, was Steve Jobs' own company, Apple. Jobs, furious, called the president of Disney Feature Animation. "Do you know what Michael just did to me?" (Price, 2008, p. 230; Stewart , 2005, p. 383)

Jobs met with Roy E. Disney, the son of Roy O. Disney, and complained about the treatment he had received from Eisner. "I'll never make a deal as long as Eisner is there," Jobs told Disney. Roy, who had recruited Eisner back in 1984, had begun to have his own concerns about Eisner's recent decisions. (Price, 2008, p. 230; Stewart, 2005, p. 395) Those doubts came to a head in the months that followed as Eisner's supporters forced Disney to retire from the company's board of directors. Stripped of formal authority, the same man who had campaigned to have Eisner brought to Disney nineteen years earlier mounted a grassroots campaign to have him replaced. In a March 2004 shareholder meeting, forty-three percent of the company's shareholders voted against reelecting Eisner to the board of directors. A month later, Eisner told the board he would step down in two years, but ended up stepping down a year earlier than he had originally planned. (Paik, 2007, p. 285)

DISNEY'S NEW LEADER

After a formal search, the board chose Robert Iger, the former head of ABC to assume the CEO's position. After taking the job, Iger called Steve Jobs and arranged a meeting with him. The two had worked together before when ABC made arrangements with Apple to make recently aired episodes of popular programs like *Lost* available to iPod users. In the meeting, Iger and Jobs shared their concerns. Jobs wanted to make sure Pixar would have a good home that respected its leaders and its culture of creative freedom. Iger had two concerns: One was keeping Pixar in the Disney fold. He had recently returned from Hong Kong where Disney had inaugurated its new park there. As he was watching a parade of employees dressed as Disney characters, he noticed that all of the newer characters were Pixar creations. (Paik, 2007, p. 287) The numbers argued in favor of the acquisition as well. By 2004, around 45% of the operating income of Disney's film division came from the distribution of Pixar films. (Price, 2008, p. 5) Disney, Iger felt, needed Pixar for another reason as well. The creation of animated films had been a key part of Disney's make up as a company since the beginning but, somewhere along the way, it had lost its edge. This was Iger's second concern: to restore Disney animation to its tradition of greatness. Pixar, he felt, had managed to capture the spirit of creativity that had characterized Disney Animation when it was at its best. (Paik, 2007, p. 287)

As Iger had explained to Jobs, he wanted Disney to purchase Pixar, but that was only the beginning. He also wanted to place Pixar's leadership team over Disney's animation department.

Jobs was impressed with the offer and could, in theory, have agreed to a sale without consulting the rest of Pixar's leadership team. He did, after all, own 49.8 percent of the company's shares. As biographer David Price expressed it, Jobs' vote was really the only one that mattered. (Price, 2008, p. 253) Pixar's greatest assets, however, lay in the talents and expertise of its people and in the culture they had built. For the acquisition to work, Lasseter and Catmull had to support the decision as well. Iger arranged meetings with Lasseter and Catmull to discuss the details of the possible acquisition. (Paik, 2007, p. 87)

Rather than meeting with him at Pixar's corporate office, Iger drove to Lasseter's home to meet with him there. Lasseter soon warmed to Iger and found himself in agreement with him on many issues, but he pulled no punches when it came to expressing his concerns. He described the meeting in an interview:

"I said, 'I'm sorry Bob, but there's not one thing Disney has acquired in the last ten years that they haven't mishandled," he said. "How's it going to be different with Pixar?"

"Well," Iger told him. "I'm different." (Paik, 2007, p. 288)

"I really started to believing that this guy was different," Lasseter later said. "And then it started getting back into that core of me, of how much I love Disney…the Disney of Walt Disney." (Paik, 2007, p. 289)

Catmull was similarly impressed. "Bob was a totally, completely different person than we had been used to dealing with," he said. "He understood the value of animation to the studio and the importance of maintaining its quality." (Paik, 2007, p. 288)

The senior executives of both companies began meeting to discuss how a combination of the two studios could be managed. They were especially concerned with the preservation of Pixar's creative culture. The company had, after all, produced a stream of successful films and damaging its creative core would be as financially costly to Disney as it would be demoralizing to the founders. They finally agreed that, should the merger go through, the Disney and Pixar animation studios would remain in the same physical locations, but Catmull would become president of both. Lasseter, in turn, would be the chief creative officer of the two studios. He would also serve as principal creative adviser to Walt Disney Imagineering, the division of the company that designed the attractions for Disney's theme parks. (Price, 2008, p. 253) Disney ultimately purchased Pixar for 7.4 billion. (Price, 2008, p. 253) Steve Jobs had purchased the company twenty years earlier for $5 million. (Price, 2008, p. 7)

Iger's offer had been more generous than anything Jobs, Lasseter, or Catmull had expected, but they realized that not all of Pixar's employees would be enthusiastic about the idea of being bought out by Disney. Many of them had expressed their belief that Pixar was capable of operating completely on its own and felt that it should do so. Freeing Pixar from its dependence upon larger studios, however, would require a great deal of work. They would have to hire, train, and organize a staff of two or three hundred marketing and administrative people to manage the promotion and distribution of their products. Partnering with Disney had freed them from that responsibility, allowing them to concentrate on the creation of the films themselves. As an independent company, Pixar would find itself having to completely shoulder financial risks without the protection of a larger benefactor. That, too, was a serious concern. Going independent would also mean giving up the characters they had created for Disney and starting completely over with new line-up. That was also a daunting prospect. (Paik, 2007, p. 291) Was some kind of compromise possible? After offering Pixar's executives such a generous deal, would Iger even be open to a compromise like letting Pixar remain an independent firm with a contractual relationship to Disney? Such a deal would probably seem to him like a step backward.

On January 24, 2006, at 1:06 p.m., Ed Catmull sent out a studio-wide email message to all Pixar employees. They were to gather in the studio's atrium at 1:15 for an important announcement. Lasseter, Catmull, and Jobs stepped up onto the platform carrying hand-held microphones, and the room grew quiet. (Paik, 2007, 286-287) The announcement they were about to make would change the history of Pixar from that moment forward, but what would that announcement be?