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LETTER FROM THE EDITOR

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

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies.

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

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

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CASES

FORD MOTOR COMPANY V. LANE: THE FIRST AMENDMENT TAKES A VIRTUAL RIDE IN A MUSTANG

Edward J. Schoen, Rowan University
Diane Hughes, Rowan University
Phillip Lewis, Rowan University

CASE DESCRIPTION

The primary subject matter of this case is the clash between court imposed protection of intellectual property and First Amendment protection of expression via the internet, more specifically the constitutionality of an injunction prohibiting an individual from promulgating information about Ford products on his web site. The case also provides insight into the fiduciary obligations owed by employees to their employers and the application of those obligations to the misappropriation of trade secret information.

Secondary issues examined in the case are the effectiveness of marketing strategies in promoting the formation and operation of web sites to encourage the creation of a virtual community of customers to assist the company in the design of the next generation of its products.

This case has a difficulty level of two or three, and is best utilized in a sophomore or junior level Business Law/Legal Environment or Principles of Marketing course. In the former instance, the case can be used to illustrate how companies can take steps to protect their intellectual property from employee misappropriation. In the latter instance, the case can be used to integrate legal issues into a discussion of the development of effective marketing strategies. The case can be taught in a one-hour session and requires two hours of preparation.

CASE SYNOPSIS

A life-long devotee of Ford Motor Company and an ardent admirer of its vehicles, Robert Lane launched his own web page to provide tips on restoring cars and to promulgate Ford Motor Company news releases describing its products. In an effort to encourage the formation of consumer groups and to gain insight into their needs and wants, Ford gave Lane access to its press release web site. Lane was soon invited to attend company sponsored events where he came into contact with Ford employees. As his familiarity with Ford employees grew, Lane received packets of documents anonymously delivered in manila envelopes with various Ford return addresses, and he posted information about the documents on his site. Many of the documents were marked "confidential," "proprietary," or "copyright protected." As the burden of supporting his web site grew more onerous, Lane suggested to Ford that it sponsor his undertaking. When Ford demurred, Lane became angry and posted confidential Ford documents and information to his web page. Ford

responded with a lawsuit and quickly obtained a temporary restraining order prohibiting Lane from using, copying or disclosing any internal document of Ford.

This case, which analyzes the constitutionality of imposing a "prior restraint" on Lane's First Amendment right to communicate information via the internet and demonstrates how the courts are beginning to grapple with the impact of the communications revolution, represents a significant part of one skirmish--the clash between the commitment to the freedom of speech and the press, and the protection of commercial innovation and intellectual property.

Careful discussion of the case should enable the students to better understand (1) the nature and value of intellectual property, such as trade secrets, copyrights and trademarks, and the steps companies take to protect such property; (2) the legal and ethical obligations imposed on employees of a corporation to protect their employer's property; (3) the effectiveness of marketing strategies which promote the creation of consumer groups that band together on the web; (4) the extension of First Amendment protections to internet communications; and (5) the nature of the First Amendment prohibition of "prior restraints."

FORD MOTOR COMPANY v. LANE

Robert Lane has been enamored with Ford Motor Company since he was in the seventh grade and read about its founder, Henry Ford, and his desire to bring affordable transportation to the masses. Henry Ford became Lane's idol, and he read extensively about him and the company he founded. Lane purchased his first car - a black 1969 Mustang Mach I - when he was a junior in high school, and he continued to restore old Fords throughout his teenage years. As a student in Orlando Community College from 1992 to 1996, he wrote eight guides about restoring old Fords and the intricacies of locating the right parts.

When his wife, Sharon, a flight attendant, was transferred to the Detroit area in 1997, Lane jumped at the opportunity to locate in the Dearborn area, a few blocks from Ford's headquarters building. That same year, Lane launched two web sites: (1) fordbookstore.com in which he published his Ford restoration guides and books listing the specifications of Ford models prior to 1973, and (2) fordworldnews.com, in which he posted company issued press releases and wrote about Ford's media events.

Lane requested and received from Ford authorization to access Ford's press release web site so that he would write about Ford products on his own web site. Lane was also invited to attend company sponsored events through which he came into contact with Ford employees. One such event was a Ford Mustang club meeting, whose agenda he posted on his web site, and in which he met the members of Ford's Mustang team. As his familiarity with Ford employees grew, Lane received packets of documents anonymously delivered in manila envelopes with various Ford return addresses, and he posted information about the documents on his site. Many of the documents Lane received were marked "confidential," "property of Ford," "proprietary," or "copyright protected."

Ford's encouragement of interest in its products is consistent with its long-term efforts to gain insight into consumers' needs and wants and to foster a sense of community and camaraderie among its customers. Such groups can provide the company with important information about the type of product its customers will demand in the future. Hence it was not unusual for Ford to cooperate in the formation and operation of web sites in order to encourage the creation of a virtual community of its customers to assist Ford in the design of the next generation of its products.

Exploring the possibility of commercializing his web sites and charging subscriptions fees for accessing posted information, Lane suggested to Ford that it might consider sponsoring his efforts. The company acknowledged that it would be willing to talk about the project, but made no commitment. Instead, as the flow of information about Ford products increased, Lane began to receive requests from Ford's lawyer to remove a link to another Ford-related site, to change the name of his site, and to remove certain articles from his site. Lane complied with these requests.

On October 30, 1998, Lane wrote Ford a letter in which he advised Ford that he possessed several "sensitive" photographs, including one of the upcoming Ford Thunderbird, which were provided by one of Ford's employees. The photos showed pictures of Ford products that were confidential and had not been released to the public. In an ensuing letter dated November 3, 1998, Lane explained that his web site had become too big and expensive to operate by himself and asked if Ford would consider taking it over or sponsoring it. Lane also threatened to publish materials on his web site that Ford would find "disturbing." In both letters, Lane threatened to encourage Ford employees to disclose confidential information. Ford representatives met with Lane and asked Lane to obtain Ford's approval prior to posting any Ford documents on the Internet. Lane agreed to do so.

When Ford failed to respond to his request to sponsor his web site, Lane became angry because, in his view, Ford's demands that he modify his web site amounted to censorship which, absent Ford's commercial support, it had no right to impose. Thereafter, Lane posted forty Ford documents on his web site, rather than just mentioning them in his articles. Such documents included materials with high competitive sensitivity, such as charts detailing Ford's plans for complying with federal environmental standards and an article contending that the powertrain of the 1999 Mustang Cobra was underpowered.

Ford representatives informed Lane that Ford employees are bound by a confidentiality agreement. In the standard employment agreement signed by all Ford employees, each employee agrees "that papers, records and plans generated . . . for my employer are my employer's property and I am not to make any unauthorized disclosure or retain copies of them." Ford's Standards of Corporate Conduct manual also provides: "Every employee is obligated to maintain the confidentiality of Ford's business information. This obligation survives even after your employment with Ford ends." Ford employees are also bound by Ford Directive C-110 which states:

> *Ford develops and acquires substantial amounts of information and makes that information available to its employees for use in their work. This information, which may be embodied in documents, electronic data or other forms, is a valuable asset and belongs to Ford . . . . Unauthorized disclosure of Ford's information can damage Ford's competitive position and reputation. In no case should an employee make such unauthorized disclosure, use it for their personal benefit, or keep it beyond their term of employment without express permission.*

Hence, Lane knew that the Ford employees who gave confidential documents to him were breaching their duty to Ford. Moreover, Lane acknowledged the confidential nature of the Ford documents when he posted them on his web site.

The Mustang Cobra article posted on Lane's web site surprised Ford, and triggered its concern about what information might follow. Ford's lawyer again contacted Lane and asked him to remove the Cobra article. Lane declined. While Lane later met with the lawyer, no agreement was reached, and the Cobra article remained on Lane's web site. Approximately one month later, a Ford lawyer telephoned Lane and warned him a lawsuit would be filed against Lane by Ford the next morning. Lane spent the next several hours scanning documents and posting them on his web site. By the next morning, he had added about 100 more documents to the site, including part of the document on which the Cobra article had been based and Ford's plans to develop technologies - such as diesel engines for personal-use trucks, continuously variable transmissions, and hydrogen-fueled engines - to improve the fuel economy of its trucks by as much as 15% and to meet tougher proposed federal tailpipe-emission rules..

Ford executives feared that the revelation of such plans could hurt Ford by tipping competitors to specific steps Ford contemplated in offering cleaner vehicles and by providing regulators and environmentalists with ammunition to demand even stricter environmental standards. Ford also contended the plans were contained in internal documents that were stolen from the company.

On August 25, 1999, Ford initiated the predicted lawsuit against Lane in U.S. District Court in Detroit. In its complaint, Ford asked for a preliminary and permanent injunction prohibiting Lane from violating the Michigan Uniform Trade Secrets act, as well as copyright and trademark law, by posting proprietary documents and trade secrets about Ford on his web site. Ford also accused Lane of copyright infringement, statutory conversion, intentional interference with contractual relations, misappropriation of trade secrets, trademark infringement, and unfair competition. In addition, Ford alleged that Lane's use of the Ford logo on his web site gave the impression that Ford sponsors or authorizes Lane's web site, and that Lane solicited and received trade secrets in breach of the employee confidentiality agreement.

Lane argued that he did nothing illegal to obtain the information he posted to his web site, that he has a First Amendment right to publish it, and that a court order prohibiting his publishing the information on the web violates the First Amendment. Like some internet advocates, Lane also contended that the internet should remain free to provide information about products, pricing, quality and customer satisfaction to anyone, anywhere and anytime, and that any information that impacts on such issues should be available to everyone, not just insiders.

The Federal District court granted Ford's request for a temporary restraining order prohibiting Lane from operating his web site through September 7, 1999, as which time a hearing would be held to determine if a preliminary injunction should be issued. The temporary restraining order provided:

Robert Lane ... [is] enjoined and ordered as follows:

> A. *Defendant is restrained from destroying, despoiling or electronically deleting or erasing documents in his possession originated by or for Ford Motor Company.*
>
> B. *Defendant is ordered to file with the Court, and serve upon Ford Motor Company, within ten (10) days, a sworn statement (1) identifying with particularity all documents within his possession, custody or control which were originated by or for Ford Motor Company, (2) the source (by name or description) of each document, and (3) provide details as to how defendant Robert Lane acquired each document.*
>
> C. *Defendant is restrained from (1) using, copying or disclosing any internal document of Ford Motor Company (including the information contained therein), (2) committing any acts of infringement of Ford Motor Company's copyrights, including unpublished works known by defendant Robert Lane to have been prepared by a Ford Motor Company employee within the scope of his or her employment, or specially ordered or commissioned by Ford Motor Company, if not an employee, (3) interfering with Ford's contractual relationship with its employees by soliciting Ford employees to provide Ford trade secrets or other confidential information.*

The Court also ordered the Lane to show cause why the temporary restraining order should not be entered as a preliminary injunction. Lane filed a response to Ford's motion for a preliminary injunction, in which he agreed to the entry of a preliminary injunction in the same form as the temporary restraining order, except with respect to section C(1) above. A copy of the temporary restraining order was forwarded by Ford's lawyers to Lane's internet service provider, CommuniTech Inc., which shut down Lane's site because of Lane's use of copyrighted material was contrary to its terms of service.

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PORTER-CABLE: 90 YEARS OF MAKING POWER TOOLS

Wilburn Lane, Lambuth University
P.Michael McCullough, University of Tennessee at Martin

CASE DESCRIPTION

The primary subject matter of this case concerns the decision-making of Porter-Cable, maker of power tools since the early years of the twentieth century. Perspective is gained through historical and industrial comparative analyses. The case would be most applicable for an undergraduate or graduate capstone class in management or marketing. The case is designed to be taught in 2 ½ class hours and would require about three hours of out of class time, consisting mainly of reading the case and reading Marketing Warfare by Ries and Trout (1986).*

** Ries, A. & Jack, T. (1986). Marketing Warfare. New York: McGraw-Hill.*

CASE SYNOPSIS

Like many of its current competitors in the power tool industry, Porter-Cable began as a small machine shop in 1906. Under the insightful leadership of Art Emmons, Porter-Cable became a major portable power tool business, focusing on the professional wood worker. This remained its focus until the company began to diversify into lawn and garden equipment in the 1950s. The company was sold to Rockwell Manufacturing in 1960. Rockwell changed the name on the products to Rockwell, entered the consumer DIY (Do it yourself) market, and tried to compete head on with Black and Decker, the giant in the consumer power tool market. After 20 years of lackluster performance Rockwell sold its Porter-Cable Power Tools Division to Pentair Corporation. Pentair immediately re-established the Porter-Cable name and began focusing on power tools for the professional wood worker. The products were distributed through traditional professional power tool channels. In the 1990s, Porter-Cable changed their manufacturing process, empowered their employees, broadened their product line (Dustless Drywall Sander and later pneumatic nailers) and began to distribute their products through home centers, as well as through the traditional channels. The decisions of the past 20 years (and more specifically the last 10) have resulted in sales growth that is exponentially greater than that of the industry.

HISTORY OF POWER TOOLS

Man's ingenuity in fashioning tools for labor is indeed a major theme in history. Records indicate that people were using stone, copper and iron tools two and a half million years ago.

Motorized and electric tools have added so much efficiency, excitement, power and speed that such tools developed in the twentieth century helped turn work into a hobby for millions of Americans.

The first tool to use a source of power other than simple human movement was invented by a Shaker sister named Tabatha Babbit in 1810. She observed how labor-intensive two-man hand saws were and decided a circular saw would increase speed and reduce labor required to cut timber into logs. The original circular saws were first powered by a hand crank and later by a water wheel.

In 1884, a blacksmith named William Mack Dement sold his patent for the first solid-stem metal drill bit to a bartender to cover a $20 whiskey debt. The tavern owner, Charles Irwin, built the first portable electric power drill in 1895, only 16 years after the invention of electricity. C.E. Fine, a German engineering firm, adapted Irwin's drill into one powered by a DC motor and a chest plate, against which the user leaned to add force.

Duncan Black and Alonzo Decker conceived of a pistol grip electric drill in 1914, when they happened to look at a Colt automatic pistol laying on the table where they were sipping coffee and discussing ideas for a portable electric drill. They were able to design the tool and begin its manufacture in 1916. The Irwin augur bit, first developed by Charles Irwin, continued to be produced in Germany until a train ran through the manufacturing facility in 1969, and the plant was shut down.

R.L. Carter invented the portable router in 1919, by reworking an electric barber tool. The router allowed woodworkers to add craftsmanship to the finish of their wood products. Router bits cut into the surface of wood. In 1923 the first scroll saw was developed and manufactured by the Delta Company, a company that remains viable in the industry today. They sold their scroll saw for $6.

Henry Ford enlisted the services of inventor A.H. Peterson to produce a lighter electric drill to be used by those working on the assembly lines in the Ford plants. The drill Peterson developed weighed only five pounds. A version of this drill was later sold to a man named Siebert who started the Milwaukee tool company in 1924. The drill made by Milwaukee was called the hole-shooter.

Around the same time a man named Edmund Michel witnessed the brutal labor involved in cutting sugar cane in Louisiana. He decided, as had Babbit before him, that a motorized circular saw would make this job go a lot easier. The saw he developed was powered by a malted-milk-mixer motor. This saw, called the Skilsaw, weighed 10 pounds and sold for a whopping $160, which would be around $1500 in today's money. The saw would only last seven or eight hours and would have to be reworked, but despite such price and quality issues, the saw was such a labor-saver that people bought them.

In 1926, a young inventor named Art Emmons working for Porter-Cable designed and built the first portable belt sander. This tool would be the biggest selling tool for P-C for years to come. But it was not their first tool. Porter-Cable's first tool was the electric pencil sharpener, invented in 1906.

In the 1920s and 30s, tool salesmen would actually take generators out to job sites so they could demonstrate their power tools where electricity was not yet available. The salesman had to convince workers they should invest in power tools for when electricity became available, surely a tough sale.

Sears featured power tools in its catalog for the first time in 1928, which caused people to begin dreaming of the time when they might be able to invest in labor-saving tools for building and agricultural needs. However, the stock market crash of 1929 saw a major downturn in the power tool industry, so bad that Al Decker, Jr's father brought him in and told him that he would have to be the first person laid off by Black and Decker, since he could not lay off others with his son still working.

Despite the tough economic years of the 1930s, and to some extent even due to them, the industry revived and companies like Porter-Cable and Black and Decker continued to sell their portable electric drills, saws, routers and sanders. They did well in part due to the effort of hardworking sales people and because the tools helped so much in the New Deal work projects going on all over the country. In 1932 A.J. Dremel developed a small master tool that he claimed was actually a 100 tools in one. All the user had to do was change an attachment and what was once a router became a drill and so on.

All of the power tool companies found a way to help in the war effort. P-C sold hundreds of floor sanders, while Black and Decker made their impact with their ¼ inch drill. It was also during this time that the do-it-yourself market began. Since most of the plumbers, electricians and repairmen were fighting in the war, people were encouraged to do things for themselves, which meant they needed tools to use.

It was 1946, when Skil-Bosch produced the first jig saw and 1961, when Black and Decker made the first cordless power tool, a drill powered by a 4.8 volt nickel-cadmium battery. Throughout the sixties and seventies companies dealt with the problem of batteries not lasting more than a few hours and having to be recharged often. They also were faced with the problem of their tools being prone to shock the user.

It was not until the 1980s that companies came up with more powerful batteries and began insulating the motors inside the tools. These more powerful, double-insulated tools made it possible for people other than just experienced builders to use the tools without hassle or fear of electric shock.

The bi-centennial celebration of 1976 is also credited with boosting public interest in do-it-yourself home projects, since at this time many people decided it would be a good idea to fix up old structures to preserve them for subsequent generations. The tool industry was also boosted when in 1971 lunar astronauts used a Black and Decker drill to take soil samples eight feet deep from the surface of the moon. In 1978 the home-improvement show, "This old House" with Bob Villa first aired, which was a hit with those who were seeking to get increasingly involved in doing their own repairs and add-on jobs around the house.

Today, battery power has increased to as much as 24 volts from the original 4 ½ volts. Not only that, but pneumatic tools, such as nailers and staplers have come into the market. These tools are powered by fuel cells, battery packs worn by the user, compressed air, and in some cases by force supplied by the user to augment the power of the tool. Even Tim the tool-man Taylor, Tim Allen, has gotten into the business by creating his own line of tools manufactured by Ryobi.

GENERAL OVERVIEW OF TOOLS COMPETITION

Porter-Cable, perhaps the oldest of all the power tool firms, has only recently entered the home-center market, after years of targeting a narrow but solidly loyal professional customer. They face the challenge of retaining the loyalty of professionals while trying to appeal to the weekend warrior. After all, in this world of job-specific tools, one of the great sources of pride of workmanship is an expressed understanding of the nuances of difference between a Black and Decker versus a Porter-Cable saw. It's understandable how a builder might become angry when informed that highly respected De Walt tools are made by Black and Decker, a brand most widely associated with the nonprofessional market.

Porter-Cable began in 1906 as a small machine shop in Syracuse, New York, when R.E. & G.G. Porter and F.E. Cable started making the first electric pencil sharpener. By the time they invented and mass-produced the world's first portable belt sander, a number of other companies had joined the market. Duncan Black and Alonzo Decker added to this most American of pursuits by making the first power drill in 1914 and adding the now ubiquitous pistol grip in 1916. Despite the dominance of the male as both producer and consumer in this market, it is interesting to note that a woman actually invented the circular saw, which was originally built and mass-produced by Skil, beginning in 1920.

Art Emerson of Porter-Cable, one of the most prolific inventors of power tools, developed the portable sander in 1926. That was soon followed by the jigsaw, invented by Albert Coffman, working for what is now Bosch. The proliferation of power tools has been both a cause and effect of the enormous building effort that has marked the 20th century in the United States.

Over thirty companies make products in the 3546 SIC code, power tools. In 1997, Black and Decker the largest producer for the do-it-yourself market sold over $1.2 billion of power tools. Milwaukee, Makita, Skil-Bosch and Porter-Cable round out the top five, with Porter-Cable selling $150 million, mostly to the professional market.

The power tool industry has been made up of a few of the same names for nearly a hundred years. This is a mature industry that nonetheless continues to see product innovation. Let us look more closely at the competition.

Black and Decker/DeWalt

In 1914, Black and Decker developed the first power drill and since has gone on to launch hundreds of new products. De Walt is the industrial market division of Black and Decker and is headquartered in Hampstead, Maryland.

Black and Decker is the overwhelming leader in power tools for the commercial market, the do-it-yourself home-repair customer if you will. Interestingly, many of the Black and Decker products are sold to professional customers with a DeWalt label. In 1961, Porter-Cable introduced its line of Big 10 cordless drills, named for the 10-volt battery pack worn around the operator's waist. The charge lasted for all of about five or six minutes, but that was enough if you were on a utility pole.

Black and Decker produced the first power drill in 1915 and other tools followed. In 1924, Edmond Michel invented the first electric handsaw, later made by Skilsaw. Porter-Cable made the first portable belt sander in 1926 and then a helical-drive circular saw in 1929.

Recently, 1999, Skil Power Tools increased the strength of power tools to 18-volts. Black and Decker launched a 14.4-volt cordless circular saw and a unique two-position pivot driver that permits drilling at an angle for hard-to-reach spots. Black and Decker's Pro-oriented DeWalt and Skil's counterpart Bosch both added 24-volt cordless products.

Milwaukee

Milwaukee Electric Tool Corporation, founded in 1924, has its headquarters in Brookfield, Wisconsin, with distribution in Olive Branch, Mississippi and an electronics division in Peewaukee, Wisconsin. Here is some of what Milwaukee Tools says to distinguish themselves from the competition. "As the only electric tool manufacturer in the United States exclusively targeting the professional too user, Milwaukee's reputation is based on producing very reliable, durable and high-quality power tools and accessories." They state that they manufactured the first lightweight, one-handed ¼" drill the "Hole-Shooter." In later years Milwaukee designed the first self-contained reciprocating hacksaw, the Sawzall and a unique, space-efficient right angle drill, clearly targeting the construction industry as Milwaukee's major market. They were purchased by Atlas Copco, an international industrial company headquartered in Stockholm, Sweden, in 1995.

Skil Bosch

An inventor named Edmond Michel stood in a sweltering Louisiana sugar cane field watching the men slashing away at the thick red stalks with machetes. He decided there had to be a better way. It was this realization that inspired the invention of what was to become the world's first electric handsaw. Around this time, a Minneapolis land developer named Joseph W. Sullivan was traveling to Florida to investigate business opportunities, when he read about Michel's invention. He was so intrigued by the possibilities of this new idea that he spontaneously changed his plans and headed to New Orleans to talk to Mr. Michel. After further development of the machine, on July 1, 1924 the two men incorporated the Michel Electric Handsaw Company. Michel left the company in 1926 and the company was renamed Skilsaw, Inc.

Innovations made by Bosch

Skil-Bosch has pioneered double insulation, an important safety feature. They have even improved double insulation to full insulation by replacing aluminum gear cases with polyamid gear cases. They also introduced the first grease pack hammers. These require less maintenance and have longer life than oil bath hammers. Other advancements include the introduction of the first adjustable, orbital action jig saws. Bosch also patented and produced the first rotary hammers with SDS plus drive system, now the standard for small hammers. They also patented and pioneered the spline drive system for larger rotary hammers, now the standard in North America. And finally, they introduced first electric random orbit sanding tool in the U.S. First to introduce the 4 1/2" Mini-Grinder in the U.S. market, now the most popular sized grinders.

Makita

Their first portable tools were portable electric planers, introduced in 1958. But Makita's dedication to the idea of uncompromising quality was born some eighty years ago. Since then, Makita has become a leading designer and producer of a broad range of portable electric power tools, including saws, planers, drills, hammers, grinders, sanders, as well as pneumatic tools and outdoor power equipment.

By following the same uncompromising standards and principles since establishing their U.S. operation in 1970, Makita's sales have grown steadily upwards in the U.S. And backing up that quality has been a determined dedication to service and delivery.

On September 20, 1984, Makita Corporation of America broke ground in a 75 acre tract of land along Route 23 in Buford, Georgia. Now, in a 430,000 square foot facility, approximately 1000 American workers combine traditional American know-how with 80 years of Makita research and development to produce 65 models of Makita tools. The facility has built over 20 million tools and represents a plant investment of more than $100 million.

Sales information

Makita founded in 1973, (although Makita electric had existed since 1915 in Nagoya City, Japan) had $210 million in sales for the fiscal year ending in 1997, with 650 employees. Black and Decker had almost $4.6 billion in sales with 21,800 employees, but when using only power-driven handtools are counted, they had $1.3 billion in annual sales (1997) with 6000 employees. Pentair, Porter-Cable's parent company had $1.9 billion in sales with 10,500 employees. Milwaukee Electric Tool Corp. had $430 million in sales with 2200 employees.

Table 1
Market Share Portable-Electric Tools

Company	Market Share
B& D/DeWalt	36%
Skil-Bosch	14%
Milwaukee	12%
Craftsman	11%
Makita	10%
Porter-Cable	8%
All others	9%

Table 2
Market Share Pneumatic Nailers and Stablers

Company	Market Share
Senco	26.9%
Porter-Cable	23.1%
Paslode	18.9%
Stanley-Bostitch	16.8%
Hitachi	4.5%
Craftsman	3.9%
All others	5.9%

Table 3
1997 Power-driven Hand Tools Sales Figures

Company	Sales in millions
Black & Decker	1,226
Milwaukee	430
Porter-Cable	248
Makita	210

Table 4
Early Claims to fame

Company	Invention	Year
Porter-Cable	Electric pencil sharpener	1906
	Portable belt sander	1924
	Helical-gear circular saw	1926
Black & Decker	Electric drill	1914
	Portable drill	1961
Milwaukee	Lightweight one-hand drill	1924
Skil	Electric handsaw	1924
Makita	Portable electric planers	1958

Table 5
Age of company

Company	Year Founded	Current Information
Porter-Cable	1906	Owned by Pentair
Black & Decker	1910	Also build DeWalt Tools
Makita Electronics	1915	Makita Power Tools 1973
Milwaukee	1924	Owned by Atlas
Skil	1926	Now Skil-Bosch

PNEUMATIC NAILER COMPETITION

Stanley-Bostitch

As a young man in 1843, Frederick T. Stanley founded The Stanley Works -- a small company that manufactured hinges, bolts and other door hardware in a one-story wooden building in New Britain, Connecticut. His vision was to create a hardware company with unsurpassed customer service, product innovation and integrity -- and to offer products that would become the first choice among professionals around the world. With the early success of this mission and an increasing demand for his high-quality goods, Mr. Stanley began exporting his products in the 1870s.

Shortly after the turn of the century, his rapidly growing business established its first production facilities outside the U.S., helping Frederick Stanley begin to realize his worldwide mission. Soon after, The Stanley Works expanded its international operations by acquiring Stanley Rule and Level, the largest U.S. manufacturers of hand tools, founded in 1857 by a relative of Mr. Stanley. By 1920, Stanley brand tools and hardware were preferred, and could be found, on every continent.

Today, over 150 years after Frederick T. Stanley first opened his doors for business, Stanley is one of the world's most recognized and trusted brand names for tools, hardware, doors and home decor products. Staying true to Mr. Stanley's principles, The Stanley Works continues with expansion and diversification, offering over 50,000 different products for professionals, industry and consumers.

Stanley's 1998 sales exceeded $2.72 billion and its global presence is firmly established with 114 manufacturing and distribution facilities covering every major region of the world. Stanley products are sold globally through distributors and retailers, including thousands of retailers in the U.S. alone.

Senco

Cincinnati-based Senco Products Inc. was founded in 1948. Today, SENCO is one of the world's leading manufacturers of pneumatic fastening systems. Their product lines include tools, fasteners, accessories and service. They sell their product through authorized dealers, distributors and sales representatives in North and South America, Europe, Asia and Australia. Their product innovations include:

- *The first fully automatic pneumatic fastening tool*
- *The first pneumatic tools capable of driving different sized nails and staples,*
- *End-loading magazines*
- *An adjustable depth-of-drive feature*
- *An EZ Clear feature for clearing jams*
- *Lubricant-free tools*
- *A corrosion-resistant finish*
- *A roofing coil nailer with* an exclusive straight-driven system.

HISTORY OF PORTER-CABLE

The Early Years of Porter-Cable

The Porter-Cable Company was founded by R. E. Porter, G. G. Porter, and F. E. Cable in 1906. It began as a small machine shop in Syracuse, New York. In the beginning they built mostly stationary tools. In 1910, Porter-Cable built their first portable tool.

The company was sold to J. R. Ridings in 1914. Although Ridings was not a machinist, he was a very good businessman. Under Ridings leadership, Porter-Cable became one of the largest makers of power tools in the United States, and the Ridings family would retain ownership for fifty-six years. Some of Porters' relatives have indicated that neither the Porters nor Cable benefited from the success that was to come to Porter-Cable. It is said that the Porters and Cable died virtually broke.

The Art Emmons Years

A big turning point occurred in the business when J. R. Ridings hired Art Emmons in 1919. Emmons was hired as the second engineer in the engineering department. He did not have an engineering degree, but did have some drafting skills. Emmons left Porter-Cable in 1920, but returned as chief engineer in 1921 and remained in that capacity for the next forty-three years. It was Emmons uncanney ability to design new and better products that made Porter-Cable a major player in the power tool industry. At the end of his career, he held over 50 tool-related patents.

Porter-Cable introduced the world's first portable belt sander in 1926. To emphasize it portability, it was called the "Take About." This sander was revolutionary because it allowed the worker to take the tool to the work rather than requiring the work to be brought to the tool. Also, it could some jobs that previously had to be done by hand. The labor saving was extraordinary according to the testimonial letters.

Emmons used a unique approach to develop new products. Rather than working in a lab or a machine shop designing new products that interested the engineers, Emmons would visit job sites to find out the types of tools end-users needed and the kind of improvements they would like to see made in existing tools. One of the suggestions Emmons received was to build a lighter-weight and easier-to-use circular saw. Skil had developed a circular saw a few years earlier, but it used a worm-drive technology that made the saw heavy and cumbersome to use. In 1929, Porter-Cable introduced the first helical-gear circular saw from which all other helical saws were developed.

This saw was five pounds lighter than the worm-drive saw and much easier to use. By the 1950's Porter-Cable had over 50% of the professional circular saw business in the United States.

In many ways, Emmons was ahead of his time. In 1931 he developed a dust collection devise to go on the Take About portable sander, but the lack of appreciation for this feature delayed the success of this process for many decades. Unlike many companies during the depression, Porter-Cable did really well. They continued to offer innovative products that saved the end-user time and money. Also, they were very generous with their employees offering insurance plans, stock options, and on-site recreational facilities.

Like many companies during World War II, much of their work was devoted to helping the war effort. They made motors for torpedoes and parts for helicopters, as well as, their tradition tools. They noted in their 1947 annual report that during World War II the United States Government had provide funds to help them upgrade their machinery. So Porter-Cable came out of the war with new machinery and a resolve to return to their roots in the portable power tool industry. In 1953, Porter-Cable introduced the Porta-Band. This was the first portable band saw. This saw is now a mainstay for plumbers, electricians, and contractors around the world. In 1956 Porter-Cable marketed the first bayonet saw with orbital blade action.

The innovations continued into the early 1960's. Porter-Cable introduced the first high-speed orbital sanders in 1963. The Model 330 used a ¼ sheet of sand paper and the Model 505 used a ½ half sheet of sand paper. These sanders revolutionized the sanding of wood.

Until the 1950s, Porter-Cable concentrated on portable power tools, mainly for woodworking purposes. But, in the 1950's they broaden their interests. They built one of the first riding lawn mowers and developed the rotary tiller. Also, they begun to manufacture gas powered chain saws. By the late 1950's Porter-Cable was facing serious financial problems because they were not able to sell their riding lawn mowers and rotary tillers. They had no distributions system for these products. They had incurred large tooling costs to develop and manufacture these products, and the sales volume was not sufficient. In addition, they were hit with several serious law suits regarding the safety of their chain saw. The money they had invested in the lawn and garden equipment and the liability they incurred in the chain saw business left them in a weakened financial position. They sold the rotary tiller technology to Troy Bilt and their very profitable floor sanding technology to Clarke. Today both of these firms are very successful in these industries.

The Rockwell Years

Facing serious financial problems, Porter-Cable began looking for someone to acquire them. The Rockwell Manufacturing Company had begun diversifying into the power tool industry. They had purchased the Delta Power Tool Company several years earlier. Delta made stationery tools like table saws. Porter-Cable was an established leader in the professional customer market of the portable power tool industry, so it seemed a natural progression for Rockwell to enter the portable power tool business. In 1960, Porter-Cable was purchased by Rockwell Manufacturing. Some of the executives at Porter-Cable became executives in the Power Tool Division of Rockwell Manufacturing; however, other key executives were hired by Black and Decker. In the early 1960's Rockwell Manufacturing made the decision to enter the DYI (Do-It-Yourself) consumer market and to compete head on with Black and Decker the industry leader. As a result of that decision, Rockwell Manufacturing had five different plants making power tools or components by the mid 1960's. They removed the Porter-Cable and Delta brand names from the products and replaced them with the Rockwell name. They tried to compete in every product category and catered to the consumer market rather than the professional power tool user.

Rockwell learned that making products for the consumer market was quite different from making products for the industrial market. Consumers were more price -sensitive and did not demand longevity in their products. Distribution was also a major problem for Rockwell. Rather than selling the product one-on-one to the industrial customer they had to fight for shelf space in retail stores against a firmly entrenched and veteran competitor Black and Decker.

While the Power Tool Division of Rockwell Manufacturing did have some successful years, the direction of the company was changing. After a number of re-organizations, Rockwell became know as Rockwell International in the late 1970's, and they began to concentrate on the aerospace industry. With the change in focus and the lack of desired profitability, the power-tool division was put up for sale.

The Pentair Years

Porter-Cable returns to its roots

In October of 1981, Pentair Corporation, which specializes in buying businesses that are not performing as well as they should, purchased what had been the old Porter-Cable portion of the Power Tool Division of Rockwell International. Within nine months, the company had reclaimed the Porter-Cable name and began manufacturing its power tools under the Porter- Cable brand name. Porter-Cable returned to its roots making portable power tools for the professional customers who were predominantly in the wood working industry. With sales of only 35-40 million dollars, the company decided not to attempt to introduce too many new products. The goal was to have one new breakthrough product a year. One of the first products in this category was the Model 518, 3 HP Router.

This router used a microprocessor technology and digital readout that allowed the user to control the router speed to match the bit size and material being routed. This re-established Porter-Cable as a firm on the cutting edge of technology in the portable power tool industry.

In 1987, Porter-Cable introduced the first affordable plate joiner utilizing what is called the biscuit joiner technology. This made joining two pieces of wood easier. This product sold for about $200 and the competition sold for $600-800. The joiner was promoted on Norm Abram's New Yankee Workshop, and according to current Vice President of Marketing, John Chapski, "sales went through the roof."

Other companies, especially Black and Decker, began to introducecordless products as early as the 1970's, and they had been well received by their customers. In 1989, Porter-Cable introduced the Model 9850 12V Magnequench Cordless Drill.

This was the first use of rare-earth technology that delivered the most powerful cordless drill of its time. In the early 1990's Porter-Cable introduced the first electric palm grip random orbit sander.

This sander bridged the gap between the finishing sander and the belt sander. It was faster than a finishing sander and more forgiving than a belt sander. It was also much less expensive than the pneumatic sanders.

Changes in the 1990s

There were three significant changes at Porter Cable during the 1990's. The product lines were broadened, the manufacturing process was changed, and the method of distribution was expanded.

Broadening of the product lines

By the early 1990's Porter-Cable was exploring Opportunities outside the traditional electric powered wood working tools. In 1994, it introduced the first dustless drywall sander. Art Emmons' idea of a sander that collected dust finally became a commercial success.

This drywall sander removes harmful dust from the work environment as it sands the drywall. In 1995, Porter-Cable introduced the Model 444 Profile Sander. This was the first sander developed specifically for sanding profiles, moldings and odd angles. It created a totally new sanding category. In the mid 1990's, Porter-Cable obtained the patent rights to a cordless nailer, but decided that it needed to enter the nailer market in phases. It was decided that the first phase would be to introduce four models of pneumatic nailers. So in 1996, Porter-Cable introduced two brad nailers and two finishing nailers. These products were a huge success, and sales were well beyond expectations. Within a year, Porter-Cable was running a close second to Senco, the market leader in this product category.

In 1997, Porter-Cable introduced a cordless (hoseless) nailer, the "Bammer". The Bammer employed a completely different technology than any other cordless nailer on the market. It was lighter and did not require a battery or charger, but it did require the user to push the cylinder about three inches. In the test market that Porter Cable conducted, this did not seem to be a problem. But, when the product was put on the market some of the customers began to balk at the idea of having to pump the cylinder. While initial sales were great, supply could not accommodate demand, sales slowed as customers resented having to pump the nailer. The Bammer is still on the market and Porter-Cable engineers are trying to find a way to remove the need for the pumping action. While the long-term sales of the Bammer have been disappointing, the sales of the pneumatic nailers have continued to skyrocket. Porter-Cable now has fourteen different nailers in the market, including framing nailers, roofing nailers, and siding nailers. The pneumatic nailer is the fastest growing portion of their business and their market share continues to increase.

Change in the manufacturing process

In 1989, the then Vice President of Manufacturing, Jim White, announced that a team concept would be used for manufacturing the products. The program was named the American Integrated Manufacturing System (AIMS). Their slogan became People, Productivity, and Quality. The manufacturing process was divided into cells, and the members of the cells work as a team. The first two cells were established in 1990 with a goal of having the entire manufacturing process in cells by 1995.

By 1995, they had reached their goal and every manufacturing employee was a member of a cell. Today there are twenty-seven cells that handle the entire manufacturing process. When asked what he thought the greatest accomplishment in the manufacturing area was engineer, Jim Underwood, said it was the empowerment of the employees. He said that employees recognized that they should help solve a problem even if they did not create it. Each cell has goals for quality and rejects and are expected to make so many dollars worth of cost saving suggestions each year. Members of the cell are given bonuses each year based on how ell they meet or exceed their goals.

In 1999, the reject level was 1/9 what is was in 1995, the percentage of scrap was 1/5 what it was in 1995, inventory turnover has been increased, and lead time for raw materials has been greatly reduced. Underwood said that all power tool manufacturers use cell manufacturing but what sets Porter-Cable apart from the others is the culture. The empowerment of employees has lead to tremendous cost savings and a significant increase in quality.

Expanded distribution

While Rockwell did sell its products through hardware stores and other types of retailers, Porter-Cable had always sold its products through mill supply houses, construction supply houses, and woodworking specialty houses. Most of these businesses were members of the Specialty Tools and Fastener Association. The distributors would visit the job site and sell the product to the industrial customer in his work place. This was a costly process, but the level of service was high and customers were loyal.

As the DIY'ers (Do-It-Yourself) market expanded and home center began to appear, the target market and the channels of distribution began t blur. Industrial customers (the pros) were now visiting and buying products through home centers because their costs were lower than the traditional industrial channel. Also, the increase in discretionary income meant the DIY'ers could afford a higher quality product.

In 1994, Porter-Cable began to sell its products to home centers as well as through the industrial distribution channel (See Figure 1). This made Porter-Cable's products available to many more people and sales soared. There was some channel conflict on the industrial side because they could not sell the product as cheaply as the home center, which had a lower distribution cost. The decision to enter the home center market was an important decision, and today sixty percent of Porter-Cable's sales are through home centers.

Growing in a mature market

Below is a chart that shows that Porter-Cable's sales are rising at a more rapid rate than the portable tool market as a whole. Notice the jump in sales in 1997 (See Figure 1). That was the year Porter-Cable entered the pneumatic fastener market. Porter-Cable wins versus the industry and the nailer/fastener's subset of the market when it comes to sales increases from 1992 to 1999.

Figure 1
Porter-Cable's growth versus industry and fastener/nailer sales

Year	Port-Cab Sales % Increase	Ind Sales % Increase	Nailer/Fasteners % Increase
1992	22	N/A	3.37
1993	11.4	N/A	4.94
1994	21.6	N/A	4.05
1995	19.3	N/A	5.33
1996	27.5	9.62	4.81
1997	37	9.69	8.52
1998	17.3	10.02	11.62
1999	16.8	10.00	8.38
Total increase	371%	325%	64%

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HUMANA HOSPITAL - LEXINGTON: CHAOS IN I. S.

Stephen L. Loy, Eastern Kentucky University
Steve Brown, Eastern Kentucky University

CASE DESCRIPTION

This case primarily focuses on the management of the information systems function of a subsidiary organization. Secondary issues highlighted include the acquisition of a major transaction processing system (TPS) and management information systems (MIS) software, the importance of information systems quality in mergers and acquisitions. The case is appropriate for senior undergraduate and Master's students. It is designed to be taught in one to two classroom hours and is expected to require about ten hours of outside preparation by students. This requires a good understanding of management practices and systems development methodology, especially the purchase of software packages.

CASE SYNOPSIS

This "critical incident" case describes what happened in a subsidiary that depended on its parent company for information systems (IS) support and major IS decisions. The central issue of the case is the clash of objectives between parent and subsidiary. Secondary issues include crisis decision making, centralized verses decentralized IS control, importance of IS quality in purchase decisions, software evaluation by unqualified managers, IS contracts, and the influence of competitive conflict between two healthcare giants on IS decisions.

Managers from Human Hospital-Lexington (HHL) and Jewish Hospital Healthcare Services (JHHS) need to develop an implementation plan to replace HHL's transaction processing system (TPS) and management information system (MIS). The sale of HHL to JHHS depended on successful implementation. Three months before, executives of Humana Healthcare, Inc. decided to replace the software HHL leased from Humana's chief competitor, Columbia Healthcare of America (CHA). Previously, a committee of three HHL managers investigated several hospital management software packages and had recommended the purchase of the system proposed by First Data Corporation (FDC). However, Humana, Inc. executives decided to purchase a package sold by Shared Medial Systems (SMS) instead because they thought that Jewish Hospital Healthcare Services (JHHS) would be more inclined to buy HHL if the SMS package was installed.

Two weeks later, Jewish Hospital entered into a contract to operate HHL for up to seven years during which time they could buy HHL or terminate the contract. JHHS took operating control of HHL a week later and conducted a complete assessment of all functional areas of HHL, including the information systems. After reviewing the contract with SMS and the implementation

plan, all implementation activities were immediately halted until several serious problems were resolved. Humana had thirty days to act.

BACKGROUND

Built in 1983, HHL was one of the seventy-eighty acute-care hospitals owned by Humana, Inc. Humana experienced thirty years of uninterrupted growth and profitability after starting out as a nursing home operator in the 1960s. In the 1970s, Humana remade itself in response to marketplace changes by becoming the largest vertically integrated hospital management and health insurance provider in the world. The corporate culture, historically, encouraged innovation, quick response and risk taking. In 1991, while the health plan business was profitable and growing, hospital profits were declining rapidly due to reductions in Medicare and Medicaid reimbursements, rising operating costs, and declining occupancy rates due to fierce competition from outpatient centers and home health care operators. In late 1992, the Wall Street Journal ran articles describing Humana’s problems and predicting that the hospitals had to be cut loose to avoid bankruptcy. In January 1993, Humana spun off all but one of its hospitals into an independent corporation called Galen Health Care, Inc. Humana quickly recovered after the spin off and was soon in the “black” again. In 1994, Humana, Inc. was the fourth largest health maintenance organization (HMO) in the U.S. with 2.1 million people enrolled in its HMO insurance plans in fourteen states.

In April 1995, a team of managers from Human Hospital-Lexington (HHL) and Jewish Hospital Healthcare Services (JHHS) was assigned to develop a request for proposals (RFP) and recommend a new information system package for HHL. The managers were aware that their decisions could affect the sale of HHL to JHHS. It had been a tumultuous two years for Humana Hospital-Lexington (HHL) since it became the only acute-care hospital owned by Humana, Inc. In the 1980s, Humana became a vertically integrated health care provider, when it joined its HMO/PPO insurance operations with a chain of acute-care hospitals. Things turned sour for Humana in the early 1990s when bankruptcy threatened the company. To avoid bankruptcy, Humana spun off 77 of its 78 U.S. hospitals, including about fifty hospital information systems support personnel, software and system support contracts, into an independent public corporation named Galen Health Care, Inc. HHL was not transferred to Galen because Humana was in the process of negotiating the sale of HHL with the Sisters of Charity of St. Joseph (SCSJ), a publicly-owned multi-state hospital corporation. Also, Humana believed that it either had to own HHL, or sell it to someone that would provide service to its Lexington-area policyholders. In recent years, Humana's corporate policy of restricting policyholders from using other Lexington-area hospitals and "nonparticipating" physicians and Humana’s reputation for slow, inaccurate and inadequate payments had angered area physicians and hospitals. As a result, many healthcare providers in Lexington did not accept Humana-insured patients or charged higher rates for treating them.

Humana and Galen entered into an oral contract to provide information systems support for HHL for $40,000 per month for software leases and support. The contract was to be in effect for five years or until HHL was sold. Six months later, Galen was bought by Columbia Healthcare of America (CHA), a fierce competitor of Humana. CHA also gained ownership of HHL information service contract and most of its software (see Appendix). Fearing that CHA could terminate HHL's service contract, Humana executives began renegotiating the contract with CHA executives.

The negotiations were very contentious and the personal animosity grew worse when CHA executives enacted a policy to reduce the number of Humana HMO patients serviced by its hospitals, including the 77 hospitals formerly owned by Humana. Yet, despite all the bitterness, the two companies created an oral service contract that included the replacement of HHL's General Ledger software with CHA's software.

CHA entered the Lexington market with the purchase of the Good Samaritan Hospital in late 1994. This action prompted Humana executives to decide to replace the software HHL leased from CHA. A search committee of three, consisting of Humana's MIS Director, HHL's Business Manager and the newly appointed Interim MIS Director, was formed to assess hospital management software packages and make a recommendation to Humana. The committee was given the task of finding a system with all the functionality of the current system and cost less than $40,000 per month.

The committee created a Request for Proposals (RFP) and sent it to all major hospital software vendors except the largest vendor, Baxter. Baxter was excluded because it provided contracted services to CHA. Five vendors submitted proposals. After reviewing the proposals, the First Data Corporation (FDC) and Shared Medial Systems (SMS) were asked to give demonstrations of their software. The new committee was formed for evaluating the two systems. This evaluation committee included HHL's Executive Director, Chief Operating Officer, Interim MIS Director, Director of Nursing, Director of Medical Records, Director of Materials Management, Director of Pharmacy, Business Office Manager, and Accounting Manager.

The demonstrations took one day each and were conducted at different hospitals. The SMS demonstration was conducted at Jewish Hospital in Louisville and the FDC demonstration was conducted at Hardin County Memorial Hospital in Elizabethtown, KY. The evaluation team focused on the functional capabilities of the systems during the demonstrations. Even though neither sites had the Materials Management nor Clinical (Pharmacy, Lab and Radiology) modules installed, the team felt that both packages clearly provided more functionality than HHL's current system.

The evaluation team concluded its work by recommending the purchase of the FDC package because of its strong electronic funds transfer (EFT) capabilities better met the needs of the HHL Business Office and all of its other modules met or exceeded current capabilities. Their recommendation was sent to the V.P. of MIS for Humana, Inc. on January 26, 1995. On February 1, to the surprise of the evaluation team, the contract was awarded to SMS. The rationale for selecting the SMS package was based on an unannounced agreement with Jewish Hospital Healthcare Services (JHHS) to take over the operation of HHL with an option to purchase HHL in seven years. Since JHHS's hospital in Louisville was contracted with SMS as a beta site for SMS applications, it was thought that JHHS would be more inclined to buy HHL if the SMS package was installed. The process of installation of the SMS software began immediately.

INSTALLATION PLAN

The Interim MIS Director, who had previously been the Director of Materials Management and had no IS training or experience, developed a two-phase installation plan. In Phase One, the Humana IS staff would develop a wide area network (WAN). The plan called for: (1) wiring HHL with fiber optic cable, (2) linking the HHL mainframe to the Humana (Louisville) and SMS mainframes (Malvern, PA), and (3) installing a Novell local area network (LAN) within HHL. Phase One was to begin March 1 and end by April 12. Phase Two was to start on April 13, after the VTAM connection with SMS was completed. The SMS software was to be "delivered" to HHL through this telecommunications link. Once the software was copied, installation of the financial modules (e.g., Patient Management, Patient Accounting, Materials Management, General Ledger, Accounts Payable, the Pharmacy, Radiology, and Labs) and the specialized modules for cost accounting and budgeting could begin.

JHHS TAKES OVER

Two weeks into Phase One, JHHS assumed operating control of HHL. The first action taken by new operating manager was to bring in a team from JHHS to conduct a complete assessment of all functional areas of HHL, including review of the SMS contract and the implementation plan. Based upon the team's report, JHHS ordered an immediate halt to all implementation activities. The report cited numerous problems that needed to be resolved and gave Humana thirty days to act on them. Among the problems cited were:

1. *Installation plans were incomplete as to identifying roles, responsibilities, timetables, and critical success factors. There was no Gantt that specified the times allowed for the various activities and no PERT chart identifying the network or sequence of the steps.*

2. *The contract with SMS is unclear as to who is responsible for software customization and installation.*

3. *The MIS Director and staff lack the experience and training needed to install the system. Additionally, the IS staff members responsible for data entry, equipment management and IS services are under the supervision of the Director of Accounting, rather than the MIS Director.*

4. *At least six new full-time employees are needed. These include a new MIS Director, two systems analysts, two computer operators. A data entry technician and one patient account liaison person are needed to do the manual procedures involved in collections and remittance processing. The estimated additionally annual labor cost is $350,000. The current building does not have sufficient space for the additional personnel. Space will need to be rented or leased from nearby office buildings. Annual costs could be $24,000 per year.*

5. *The Humana executive who chose SMS and negotiated the service contract had lacked experience in negotiating information systems contracts and failed to seek legal or consultant advice before*

finalizing the contract. The executives also failed to consider the information requirements of HHL or the functional capabilities of the FDC and SMS products in making their decision.

6. *The service contract gives only loose costs estimates and makes HHL responsible for all installation activities. SMS is only contracted to provide minimal technical consulting services during installation.*

7. *The role of Humana in the installation, and maintenance of the SMS system is not clearly defined. Because of the heavy involvement of Humana executives and IS department managers, SMS is confused about who is their real customer. For example: for hardware issues, SMS gets its orders from Humana; and for software issues, SMS is directed by HHL. Now that JHHS is operating HHL, it is unclear who is really in charge.*

8. *Insufficient analysis of HHL's reporting needs, the space leased on the SMS mainframe is inadequate, and the development of custom interfaces between Humana's mainframe and Medicare EDI system will need to be outsourced.*

The JHHS team summarized their recommendations as follows. HHL should: (1) hire qualified IS manager and staff to install, maintain and manage the new system, (2) lease off-site office space to accommodate IS, Accounting, Finance and the Business Office personnel, (3) develop a solid implementation plan that details roles and responsibilities, (4) develop a realistic project management plan and budget, and (5) renegotiate the service contract.

ASSIGNMENT FOR STUDENTS

Answer the following questions concerning the HHL case. Use material from the textbook, other courses and your own general knowledge in writing your answers. Use a word processor to write your answers. Use the spelling checker and grammar checker to correct errors.

1. Describe the corporate culture of Humana Healthcare. Describe how that culture affected Humana's decisions regarding HHL's information system and making service contracts.

2. Why did the quality of HHL's information system cause prospective buyers to shy away from acquiring HHL?

3. Were the oral business contracts HHL made legally binding? Explain. Were they good business practice? Explain.

4. Identify the systems success factors that were present and missing in the HHL project. How could the problems described in the case have been prevented? What should Humana management do to solve the current problems and to ensure that similar problems do not occur in the future?

5. What did you learn about managing information systems and the process of purchasing a major software package from studying the case?

6. What is the proper methodology to follow in purchasing a software package for an organization? Identify the stages and activities. How should software purchase and service contracts be negotiated? What should these contracts specify?

APPENDIX

Patient Billing System (PBS)

Patient Billing System consists of the billing, collections, claims, remittances, and cashier subsystems. It also includes the Physicians Master List, the Charge Master List, various per diem contracts with physicians and insurance companies for billing, and the insurance/MediCare billing and remittances customized interfaces. These interfaces are the most significant feature of the PBS application because they provide paperless bill dropping and electronic claims, remittance, and electronic fund transfers (EFT) from both MediCare and Humana insurance (Note: 90-95% of all HHL patients are insured by MediCare or Humana). The BPS application was developed by Humana and now owned by CHA. PBS is thought to be years ahead of the similar applications in the healthcare industry.

Resource Control

Resource Control includes inventory management, supplier maintenance, purchasing, electronic data interface (EDI) links with major vendors. Developed by Humana and owned by CHA.

HUCOM

HUCOM system is a financial patient management system developed in the late 1970s. The application provides admitting functionality and patient management activities including clinical messaging, supplies for maintenance requests. It is a very old and inflexible application. Owned by CHA.

Pharmakon

Pharmakon system supports the pharmacy department and is integrated with the HUCOM system for patient management information and is used for charge control in the hospital. Owned by the HHL.

General Ledger, Accounts Payable and Accounts Receivable

General Ledger (G/L) system for HHL is split between the CHA general ledger system for patient management entries posting accounts payable, accounts receivable and Humana' general ledger for payroll. A telecommunications link used to interface G/L components. Some components owned by HHL and others owned by CHA.

3Med Codefinder/DRG Finder

HHL uses 3Med for assigning treatment codes and management of patient files.
Interfaces with the PBS. Site licence held by CHA.

TROUBLE IN TELECOM LAND: WHERE DO WE GO FROM HERE

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CASE DESCRIPTION

This case can be used in a telecommunications or a strategic management course and can use the Porter Competitive Model (Callon, 1996) for discussion. It is a junior level case and it requires minimum or no preparation time. It can be used by students in the classroom without prior preparation.

CASE SYNOPSIS

This case focuses on survival in the ever-changing telecommunications world. The challenges of the telecommunications market are numerous and critical. Changes occur at a rate that responses to market shifts are not sufficient; companies must be able to some degree speculate on the future. YourTel's growth is the classic all-American story. From humble beginnings as the Riverside Company of Riverside, Arkansas, YourTel has become a telecommunications giant by buying small telephone companies in rural America where little competition existed. In this arena, the company has amassed assets in the three billion dollar range. New obstacles have entered YourTel's market. The telecommunications industry is no longer merely land-based telephone lines. Competition has appeared from wireless communications and Internet phone services where physical location is not a factor. Players in the field are positioning themselves to become full service providers. Where mergers permeate the industry, YourTel's strategy is to buy.

SITUATION

YourTel is a company that promotes longevity. Most of the executive board has been with the company for at least fifteen years. The company tends to prefer employees from Arkansas who would tend to share the same corporate cultural values. Jordan Ashe has been with YourTel since 1972 having started as director of accounting. He was promoted to his current position of President and Chief Executive Officer in 1989. He is responsible for the continued growth that the company has sustained. Growth has been phenomenal; starting with several small rural telephone companies and growing into one of the top fifty telecommunications companies. Under Jordan's tutelage, the company has experienced ten years of record earnings until last year. Toward the end of 1999, stock prices have begun to slip and stockholders are unhappy with the decrease in earnings per share.

CEO Ashe has called an executive meeting to address the stockholder concerns. The first to arrive is Joshua Townsend who joined YourTel in 1989 as Vice President of Operations. His responsibilities include operation and management of billing and revenues, government relations, and customer service areas. He is also in charge of the company's wireless operations. He has a bachelor's degree in accounting and a master's degree in business administration from Arkansas State University. He has expressed concern in past meetings for what he terms YourTel’s timid approach to wireless communications expansion.

Townsend’s arrival is closely followed by Aaron Johnson, Chief Administrative Officer, joined YourTel in 1987 as General Counsel. His duties include responsibility for Human Resources. Johnson has a degree in law and is a member of the Arkansas State Bar Association. He has a tendency to stay outside the discussions until they affect his area of responsibility.

Blaine Blumgren, Executive Vice President and Chief Financial Officer, arrives for the meeting. Blumgren was employed at YourTel in 1985 as Vice President of Finance. He responsibilities include the negotiation of purchase agreements. He manages YourTel's accounting, treasury, financial planning and analysis, and corporate development. He has taken a lot of the heat for the slight decline in sales by the company. He believes that the new information system has had an impact of profits.

John Allenby is the newest member of YourTel's board. He joined the company in 1998 as Vice President and Chief Information Officer. He is charged with maintaining the company's entire information systems. He is not new to the telecommunications area, having previously worked for Bell and Lucent Technologies. As the newest member of the executive committee, he is still finding his way into the group. Some of the board members has shown a inclination toward caution in respect to company strategy and resist anything new which they feel is unproven. He is still defending his overhaul of the information system used by the company which, in his opinion, was badly needed. He has seen the results starting to turn around and has the figures to prove it with him. He doesn’t like to be broad-sighted so he has come prepared, as he usually does.

The company has been doing rather well. Even with the recent dip in the price/earnings ratio, the company has maintained a respectable posture. Stock prices have leveled but there is concern with the lack of exponential growth that the stockholders are accustomed to seeing, especially when other telecommunications companies are doing so well. Just wrapping up the fourth quarter of 1999, Jordan Ashe said, "YourTel finished 1999 with excellent customer growth. For the quarter, YourTel added 16,600 wireless subscribers, 38,200 long distance customers and 2,700 Internet customers.” With the whole world going "cellular," the company has decisions to be made about future growth. Ashe ponders whether past strategies will result in a continuation of YourTel’s stellar growth or if bolder approaches are needed.

BACKGROUND

YourTel started in 1947 as a group of three local telephone companies that were scattered throughout Arkansas. They faced competition from larger companies and upgrading the equipment was a critical issue. They decided to pool their resources and offer combined services to a limited area of customers in rural Arkansas. The company soon realized that the decision to combine resources was a good one and began to look for other rural opportunities. This act turned out to be a profitable venture and YourTel continued to acquire small, mostly rural, telephone companies providing service to areas that were not profitable enough for development by larger telephone companies. YourTel now has one million customers.

The company lists the following total of telephone lines as of December, 1999:

States	Number of Lines	States	Number of Lines
Minnesota	230,250	Oklahoma	39,722
South Dakota	180,512	North Carolina	32,906
Arkansas	98,551	Idaho	4,811
Louisiana	97,772	New Mexico	3,656
Colorado	85,149	Indiana	3,435
Iowa	84,305	Wyoming	3,021
Oregon	70,118	Louisiana	1,954
Montana	60,988	Arizona	1,652
Tennessee	50,134	Nevada	1,011
		Total	1,049,947

KEY COMPETITION

Until the last few years, when YourTel operated in rural America, competition was nearly non-existent. With it's entrance into the Internet and wireless world, the list of rivals contains some heady names: ALLTEL, AT&T, America Online, American Cellular, BellSouth, CFW Communications, Centennial Cellular, CenturyTel, ICG Communications, Intermedia, Communications, MCI WorldCom, Nextel, Powertel, SBC Communications, Sprint PCS Telephone & Data Systems,U S WEST, United States Cellular, and Verizon.

GROWTH STRATEGIES

YourTel has turned itself into a giant largely by buying telephone lines in areas where few other competitors had an interest. This practice has served them well in the past. The question that is foremost on the mind of Jordan Ashe is whether the company could expect continued growth for the future using the strategies currently in place:

, *Continue to concentrate on smaller markets with excellent growth potential* Develop additional telephone operations in rural and suburban markets* Offer one-stop shopping to customers for communications services*

, *Offer wireless operations in urban and suburban markets*

, *Develop networks to deliver communications services*

RECENT ACQUISITIONS AND DIVESTITURES

The company's largest acquisition was the 1997 purchase of California Telecom for $3.5 billion. In 1999, YourTel found itself needing to venture into other types of communications media and sold its interest in California Telecom Cable Inc. and Arizona Telecom Wireless Services Inc., part of the original purchase, $73.6 million. The sale was conducted, in large part, to relieve some of the debt from the original purchase and to provide a means for further expansion of cellular and wireless service. In the same vein, YourTel sold off holdings in smaller remote areas to purchase additional 150,000 telephone lines in areas where YourTel was already prominent. In the 4th Quarter 1999 Earnings Report for the company, Ashe told the world "YourTel generated cash flow of $175 million, demonstrating our ability to reduce debt and emphasizing our financial strength. We reduced long-term debt by $450 million during 1999."

FINANCIAL STATUS

YourTel's position in the telecommunications arena has been a solid one. Company growth has been extraordinary. YourTel went from a privately held corporation to the public stock exchange in 1975 and is listed as one of the top 100 companies in information technology. YourTel was added to the Standards & Poors Index in March of 1997. The chart below lists the sales and net income for the last five years.

Year	Sales	Net Income
1999	1,592,185,000	216,817,000
1998	1,565,414,000	262,064,000
1997	894,849,000	254,084,000
1996	744,130,000	128,122,000
1995	640,069,000	113,927,000

YourTel filed the following revenues at the end of the fourth quarter of 1999. A comparison with the filing for 1998 shows a continued rise in revenues in all areas except Telephone:

REVENUES		
	1999	**1998**
Telephone	254,066,000	256,599,000
Wireless	98,249,000	91,753,000
Other Operations	28,723,000	25,457,000

YourTel provides telecommunications to a small contingency of customers in any rural areas that are amalgamated into a serviceable area. YourTel has concentrated on those areas where larger companies would not have found profitable. Customers has had little choice on service providers until the present. YourTel has amassed a wide area and one million customers and, though scattered, has turned a multitude of small companies into one large company providing some of the bargaining power advantage that would not have been ordinarily possible to local providers. The logic here was to acquire areas that no one else wanted to service and acquire enough of them to make it profitable. Ashe's greatest concern is whether land-based services will remain the dominant factor in communications that it has been. His position in the past has been "if it's not broke, don't fix it." But recently he has seen the stock market price of YourTel's stock declining at a slight though steady rate. Even more alarming has been the decline in revenue of land-based telephone services.

The arrival of substitute products or services is the greatest potential threat to YourTel. With the advent of cellular phone service and the Internet, customers are no longer bound by their physical location to their telephone service provider. The introduction of long-distance phone calls over the Internet will further weaken YourTel's hold unless the company becomes a major player in that arena.

YourTel has expanding its wireless communications and the Internet services to some extent in efforts to keep its customers from choosing other providers of these services. YourTel serves as an ISP in limited areas. The purchase of InetSystems became effective October 15, 1999. InetSystems is an Internet Service Provider located in Cheyenne, Wyoming and serves 7500 customers in the surrounding communities. YourTel has also gone international in its product expansions. YourTel has procured an equity is IndiaDSL and is serving 12,000 customers in India. YourTel president Ashe says "the Indian and Asian markets show great potential for data services. This is a prime marketplace for DSL services."

Townsend, the head of wireless communications, states again (as he has in past meetings) that YourTel must look for wireless opportunities; that this is the way the whole world is going. He points out the there is an increase of 7.1% in revenues for wireless operations while the telephone services revenues returned a nearly a 0.1% decrease. He takes great care in not looking directly at Blumgren because his future plans will need the support of the Chief Financial Officer.

Allenby, the Chief Information Officer, has been advocating a change in the corporate strategy structure for more company involvement in data services. He knows that despite the modest investment in data services (called Other revenue), the increase in revenue from last year to this year is 12.8%. He tells the group that YourTel has in place an adequate wireless expansion plan and that his opinion is that data services is the next big wave to latch onto. The company has broadened its services in wireless by teaming with TelCanada to provide wireless service in Canada. “Why not look at China as a source of revenue in data services? An official in the Ministry of Information Industry has predicted that China will have 600 phone users by 2005 (E-ventures, 2000)”

Blomgren knows that while China is a huge market, he also knows that present customs there would cost YourTel a large share of any profit they might make and that ownership of any telecommunications company in China will not exceed 50% (Landler, 2000). “We could be there now and get a foothold for a time when that ownership structure changes,” Allenby counters. “Besides, the reason that we sold parts of the California Telecom purchase was to free up capital for new expansion,” he adds. Johnson, YourTel’s chief Administrative Officer, points out that the largest portion of revenue for the company continued to be from telephone services and suggests that the company may want to stay on its present course. "Besides," he says, "China may have the world's largest population but only 2 million Chinese have disposable income of $20,000 or more (Business Week, 2000).

As the members of the executive committee ponder the future of YourTel, they must do so with the realization that a concentrated awareness that the telecommunications world has drastically changed is a must survival for nearly all companies and YourTel is no exception. What worked in the past may not work in the future. Is YourTel moving fast enough in the right direction? What is the right direction?

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THE ROLLING RIVER CASINO CASE STUDY: AN ANALYSIS OF EFFECTIVE MANAGEMENT INTERNAL CONTROLS

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CASE DESCRIPTION

The primary subject matter of this case is the evaluation of effective management of accounting controls and procedures in a casino environment. The objective is to make students realize that controls and procedures may be in place but can be ineffective without management support and compliance testing. This case would be appropriate for a systems controls class, an auditing class, or an internal audit class. Level of difficulty would therefore be at the four or five level. The case is designed to be discussed in one and one-half hours and should take students no more than three hours of outside preparation

CASE SYNOPSIS

The Rolling River Casino Case focuses on a casino that has had substantial management turnover as well as employee turnover. The new general manager discovers that cash has been disappearing and suspects that the casino does not have proper controls in place to protect this valuable asset. The consultant hired to evaluate the accounting controls finds that while accounting controls have been developed and documented, the real problem is a lack of effective management controls. Effective management control is a five-step process. These steps are 1) Development of accounting controls, 2) Proper training of employees, 3) Testing for compliance, 4) Effective review, and 5) Effective communication. Students will be required to develop this process for the casino environment.

THE ROLLING RIVER CASINO CASE STUDY

Gary Molotov, General Manager (GM) of the Rolling River Casino, was preparing for a major strategy meeting with several of his staff. Since assuming the position of general manager two months ago, he had constantly been operating in crisis mode. His first task upon arriving had been to hire a Director of Finance. The previous one had quit the week before he had arrived. It had taken him almost a month to find the right person. He had spent the last few weeks reviewing the records of the casino for the last two years. He was concerned about some of the trends he had discovered, but he wanted input from his management people before he made any decisions. A knock at the door announced the arrival of four of his managers: Frank Dollar, the Director of Finance; Sam Suspicious, Head of Security; Patty Small, Director of Personnel, and Cary Mall, the Cage Supervisor.

Gary looked up from the papers on his desk and greeted his staff. “Good morning. Grab some coffee and take a seat at the table, so we can get started.” After everyone was settled, Gary started the meeting. “I appreciate all of you being here this morning. I know all of you have put in some extra hours the last few weeks gathering the data I requested. Patty, you can begin with your report on employee turnover and morale”.

Patty looked up from her papers and smiled. “To truly understand the current employee situation,” she began, “ you need to have some background information on the local area and casino. Rolling Rock is a small rural community of 10,000. Prior to the opening of the casino, the primary industry was cotton, which is highly seasonal. The result was a very depressed local economy with over 50% of the local community unemployed and living on welfare. The opening of the casino was perceived as a boom for the local economy. When the casino opened in the fall of 1996, it created approximately 400 new jobs.” Patty paused, before continuing. “Unfortunately, the casino has not had the positive economic benefit that was expected. Since its opening, it has had difficulty in retaining both management and staff. All the staff were hired locally, while all management personnel were hired from other gaming jurisdictions. This pattern of hiring continues after two years, as all of you know. ”

Patty glanced around the table before continuing. “I hope none of you take my next remarks personally. I am simply stating the facts, and they apply to me, as well as to all of you.” She then continued. “In many cases individuals were hired into management positions that represented a major promotion from their previous positions. None of the current management staff have been with the property for longer than a year. The most recent example of this management trend is Gary and Frank. This is Gary’s first job as a General Manager. He has been with Rolling River less than two months. Frank has been here one month, and his position as Director of Finance was a promotion from his previous job.”

“The situation with the staff,” Patty continued, “is just as bad. Historically, the gaming industry has experienced higher levels of employee turnover than many other industries. Rolling River has exceeded the industry’s turnover percentage by 40 percent,” she concluded.

“Well, Patty, your summary supports what I suspected,” Gary stated. “I’ve been in the industry twenty-five years and have worked in several different locations and casinos, but never have I seen this level of turnover. I want to hear the rest of the reports, before we start strategizing on ways to solve some of these problems.”

Gary turned his attention to Frank Dollar, the Director of Finance, and Cary Small, the cage/vault manager. “Which one of you want to talk about the operations in the cage?” Gary queried. After a slight hesitation, Cary started talking. “Gary, we have some bad news concerning the cage that we discovered just before this meeting started. The cage is $80,000 short. We have double and triple counted everything and the money is not there.”

Silence reigned in the room while everyone waited for Gary to respond to the news. “I won’t ask if you are sure, since I assume you have checked everything. The question to be answered is how this amount of money could be missing.” Gary paused, then continued when no one else spoke. “No answers? Well, we need to come up with some idea of how this much money went walking. What type of internal controls are in place in this joint that someone could walk off with $80,000? They can't be very effective." Gary snapped, showing the first signs of real irritation.

At this point, Frank spoke up. "Gary, I have only been on the job a month, but one of the first things I did was review the accounting and internal control manuals and procedures. The procedures and controls that are in place are standard for the industry."

"Well, something isn't right if this much money can simply disappear. Has anything like this happened before I started working here?"

Frank looked at Cary, who hesitated before replying. "Since the casino opened there have been several instances where the cage or the slot booths have been short, but nothing of this amount. In several of the cases, employees were terminated for theft. Since I started here six months ago, there have been some minor problems, but nothing of this magnitude. I reviewed the internal control procedures, and they are fine."

After a few minutes silence, Gary stood up. "Let's cut short this meeting. I need to think about what to do regarding this missing money." While everyone else left the room, Gary returned to his desk to ponder the problem. In spite of what Cary and Frank had told him, he had major doubts concerning the adequacy of the internal control system. However, he had no expertise in this side of the gaming operations. What he needed was an objective, outside party to evaluate the situation. After a few more minutes thought, Gary leafs through his address book and finds the number of a friend of his in Nevada who is also a consultant. A few moments later he is talking with his friend, Arnie Sleuth. After a few minutes of casual conversation, Gary gets to the reason for the call.

"Arnie, I'd like you to come down for a few days and take a look at part of the operation. $80,000 has turned up missing, and no one can give me a satisfactory explanation. I need someone with your expertise in the accounting and internal control side of the business to assess the situation."

"Gary, you're in luck. I have all of next week free. I'll fly down on Sunday and spend the week looking at your operation. In that amount of time, I should be able to find your problem."

"Thanks, Arnie. We'll pay your standard rate and you can plan on staying with me. Fly into Memphis and rent a car. It's a two hour drive to Rolling Rock from there. I'll fax you directions.

"That sounds like it will work, Gary. While you're faxing things, send me a description of the casino and of your normal cash flow cycle. I'll take a look at everything before I arrive, and will be ready to go to work."

"You've got it. I'll fax everything this afternoon. Thanks for doing this so quickly. You're a real life saver. I'll see you on Sunday when you get here." Gary hung up and immediately started compiling the information he needed to send to Arnie. By mid-afternoon, the following fax was sent.

To: Arnie Sleuth
From: Gary Molotov
Subject: Information requested

Description of Casino

The Rolling River Casino is a two-year old river boat casino located on the banks of the Mississippi River in Rolling Rock, a small rural community of 10,000 people. The casino has 328 slot machines and 13 blackjack tables spread over three floors of the river boat. The gaming on the lower level floor primarily is nickel and quarter slot machines. The middle floor has a wider mix of slot machines with the majority being quarter and dollar machines. Five blackjack tables are centrally located in the middle of the floor. Three of the tables are designated for low limit play. The top floor of the casino is designed for the high end market. The slot machines primarily are dollar machines, with a few $5 and $10 machines. Eight gaming tables are located on this level. Several of these tables are reserved for players betting $10 or more per hand.

Cash Flow in Casinos

The casino cage/vault is the center of a casino's primary cash cycle. The main cashier cage and the vault are jointly located in the lower level of the river boat. The soft count room and the hard count room are 25 yards down the hall from the main cashier door. The main cashier cage provides six functions; 1) receives funds from the count rooms, 2) provides and receives banks for the various restaurants and bars, 3) provides funds for the other cashier cages, 4) supplies and receives the banks from the other cage cashiers, 5) sends and receives funds from the various gaming departments such as slots, table games and sports betting, and 6) deposits extra cash in the company's bank account.

The casino cage holds responsibility for all cash, gaming chips, tokens, coin, personal checks, payroll checks, travelers checks and credit card cash advances. All the paperwork that is generated by the transfer of funds to and from the various departments as well as within the main casino cage are forwarded to Casino Accounting, which audits and records all the transactions . The Casino Controller receives daily reports on the results of each operation within the Casino Finance Department.

Normal Cash Flow Cycle

The normal cash flow cycle of the casino starts and ends in the main cashier cage. The casino cashier manager is responsible for the vault and all the cashier cages. The vault contains all the coin, tokens and chips held for use and as reserves. Each day, the casino cashier manager determines the needs of the main cashier cage, then transfers the appropriate cash, coin, tokens and chips from the vault. The main cashier cage then issues specific banks to the cashiers at the other casino cashier cages, bars, restaurants, gift shops, and any other function requiring a bank.

The main cashier cage also supplies various banks to other departments. The river boat has two additional casino cashier cages on the second and third floor. These cages will have a rolling balance depending on the day and shift of the week. Thus, while the cashier is given a bank from the main cage, it consist solely of currency. On a regular basis, coins, tokens, and chips need to be transferred to the other cages. Therefore, when a gaming table on the third floor needs more chips for table play, the funds are transferred from the third floor cashier cage to that pit and table.

The slot department change personnel obtain their currency bank of $2000 from the main cashier cage. Each change person also receives the key to a $10,000 slot bank located on the casino floor for which they are responsible. The bank is replenished on a regular basis from the main cashier.

Currency, chips, and coins are removed from casino tables and slot machines on a prescribed schedule. A drop team pulls the trays and drop boxes from the casino tables on a regular shift basis and sends them to the soft count room. The count team opens each box with the proper key, empties the box onto the table and verifies that the box is empty by showing the box to another count team member. The count team breaks down the funds from each table into chips, currency and paperwork and double counts everything. Double counting means that two different people on the count team run the funds though a currency counter, after the currency counter has been physically tested to prove that it is working correctly, and both agree to the amount. Finally, the funds are wrapped into the appropriate bundles and sealed.

After the currency is double counted and verified, the cage cashier manager enters the soft count room and independently verifies the amount of currency and funds being transferred to the main cage. Every member of the count room team and the cage manager sign a three part document verifying the amount of currency and funds transferred from the soft count room to the cage.

The funds from the slot drop consist of both currency and coin. Each slot machine has a currency acceptor box which accepts bills up to $20. During the drop phase, these currency acceptors are pulled out and replaced with an empty box. When coins are put into the slot machine, they fall into the slot hopper which normally holds about 300 coins. The excess coins overflow into a bucket which sits in the bottom of the slot machine cabinet. The drop team opens the bottom door, pulls out the bucket, which has a designated slot machine number, replaces the bucket with another bucket and locks the cabinet.

The currency is sent to the soft count room, double counted and bundled by denomination. The coin is sent to the to the hard count room where it is double counted. The first count is by weight. The bucket of coins from each machine is placed on a weighing machine which determines the amount of coins in the bucket. Next, the coins are placed in a wrapping machine. When all the coin is wrapped, the count team compares the weight figures with the wrapped figures for each bucket to see if there is a difference.

Once the soft count room team and hard count room team finish their count and tally their total takes, they call the main cashier. The verification and transfer of currency is handled in the same manner as the table game drop. The hard count coin is independently counted by the main cashier supervisor, then transferred to the casino vault for storage.

The bar and restaurant cashiers close their cash registers, pull their drawers, and print a register total. This total should equal the total cash and checks in the drawer. The drawer, its contents, and the register total are sent to the main cashier cage for counting and verification.

The casino cage manager reviews the total funds located in both the main cage and the vault on a daily basis. He determines the total cash needs for the next two days. Surplus funds are sent to the bank. If a cash shortage is projected, additional funds are requested from the bank.

THE CONSULTANT'S FINDINGS

Arnie started the review process by talking with casino management. He found that the majority of management believed it was difficult to attract quality employees, therefore less desirable employees were hired. The hiring of less qualified people caused the high turnover of employees. For example, Arnie and Gary had lunch at a casino restaurant, and received the wrong order from the waiter. Gary observed, "This is an everyday occurrence, but we have to live with it because the casino is unable to attract good employees."

Arnie's next step was to review the administrative and accounting internal controls manuals for the casino cages, which were located in the cage manager's office. He found no apparent weaknesses with the controls that were in place. Arnie then talked with the cage manager. "Cary, what type of training do the cashiers receive when they are new and on an on-going basis?" he inquired.

"The philosophy of the casino has been to do all training on the job," Cary promptly replied. "We believe that the best way to train cashiers is in the actual work environment. New hires are placed under a supervisor. As questions arise, they ask the supervisor."

"On the job training is one way of training employees," Arnie observed. "Are they given the internal control manuals that explain proper procedures and controls and are they tested on appropriate procedures for specific transactions?"

Cary hesitated before replying. "Well, no. Like I said, we believe that on the job training takes care of all that. It is doubtful if our employees would ever read a manual, so we don't waste anyone's time. The supervisor in the cage makes sure things are done correctly."

Arnie thank Cary for her time and proceeded to the surveillance room. There he spent a few hours observing the operations in the casino cages, the vault, and the count rooms. In a short amount of time, he observed several situations that caused him concern. For example, one of the control procedures for the cashier cage is that all transfers of funds to or from the cage required notifying surveillance and obtaining an escort (security guard). In fact, the cage procedure required that any type of funds or paper that left the cage be verified by security whether it be coins or trash. Arnie observed the cashier hand a bag full of slot cans to a slot employee without notifying surveillance or security. He also observed the day cage supervisor leave the cage with a stack of paperwork without security verifying that no funds were being removed from the cage.

Further evidence of control problems appeared with the changing of shifts. At one of the casino cages, the in-coming cashier used the count sheet from the outgoing cashier rather than verifying the count independently. When the new cashier looked in the cabinet to verify the racks of coin and chips, she failed to rotate or break down the chip racks to verify that they contained the proper number and denomination of chips.

The shift change in the main cashier cage provided more evidence of the breakdown in internal control procedures. The incoming cashier did not independently verify the total count. He took a duplicate copy of the outgoing count and agreed to it. One of the drawers contained over $2000 of foreign and mutilated coin which was not stacked in any orderly fashion. When the outgoing cashier did the count at the end of the shift, this drawer was not physically counted. Instead, the drawer count was taken from the original balance on the count sheet for that drawer. Further review found that the majority of this money had been there for over six months and only sporadically counted.

Surveillance of the count rooms further documented the breakdown in internal controls. Control procedures required that all count team members be admitted to the count rooms by security. Everyone remained in the room or no one was to be in the count rooms. The team was required to take breaks as a unit, notify surveillance before leaving and be checked by security when they left the room. These procedures were designed to prevent any employee from walking out with currency or coin. Within twenty minutes of Arnie watching the procedures in the count room, he observed three different count team members individually leave the room without notifying security or being checked. To make matters worse, they were walking in and out with various coffee cups and had these cups close to them when they were actually doing the counts of currency. Security could observe these actions via the cameras in the room, but they never called to question these actions.

After observing the cage and count room activities, Arnie interviewed the surveillance team about the role of surveillance in looking for non-compliance of controls and procedures. He concluded that the surveillance team appeared to have some knowledge about controls and procedures, but several times they were unsure of what was correct procedure. No departmental procedures and controls manuals were in the surveillance room. A review of their log sheets for non-compliance activities found almost no violations. “ John, you’re the surveillance supervisor for this shift?” Arnie asked.

“That’s correct.”

“Why doesn’t surveillance record observed violations?”

“Arnie, we use to report them, but nothing ever became of them. We felt like we were wasting our time, so we stopped. No one cared about any of the problems we identified, so we figured they were no big deal. Were we wrong?”

THE CONSULTANT'S REPORT

At the end of his first day of interviews and observation, Arnie met Gary in his office. "Gary, I've finished the job."

"Already," Gary exclaimed. "You've only been here one day."

"I only needed the one day. Here's my report on your problems and some recommendations for fixing them."

Required

Identify the problems that Arnie has identified and his recommendations for fixing them. In your analysis provide a discussion of effective management controls and procedures.

BAKING COOKIES: PROGRESSIVE LESSONS IN COST ACCOUNTING

Marcia S. Niles, University of Idaho

CASE DESCRIPTION

While baking cookies may not seem to be an obvious setting for teaching managerial accounting, it exemplifies a relatively simple production process that is easy to visualize and is familiar to many students. Because of these characteristics, the Cookies case, consisting of four related assignments, provides a venue for exploring a number of topics commonly taught in managerial accounting and can serve as a unifying element of the course.

The Cookies case takes the concepts and places them in a "real-world," relatively less structured setting (baking cookies) to enable the student to gain understanding of managerial/cost accounting issues and procedures on a deeper level and to address decisions facing accountants and managers. The assignments are designed to follow text material and each increases in sophistication. Education research indicates that we remember much more of what we do than what we hear or read, so that the hands-on experience is in itself beneficial.

The Cookies assignments have a difficulty level appropriate for sophomores and juniors; they have considerable flexibility in content and presentation. They have been used successfully for three years in an upper division non-accounting majors class and are considered by students to be enlightening and fun. The series of assignments can consume minimal class time--perhaps 10 minutes each to explain the issues and requirements. At the discretion of the instructor, additional class time can be taken after completion and grading to compare and discuss results. Assignments can be completed individually or in groups. Each assignment takes between one and three hours. There is considerable flexibility in content--several options are included in the instructor's notes.

CASE SYNOPSIS

Students from a variety of disciplines take a managerial accounting course due to its importance as a tool for effective management. For example, in a typical managerial accounting course structure, a student may read text material about, say, cost behavior describing the differences between fixed and variable costs and how to calculate breakeven. Perhaps rent is used as an example of a fixed cost, direct labor as a variable cost. For many students, mastering this material involves memorizing the concepts and working problems accompanying the text.

In contrast, the Cookies case puts these same topics into a multi-faceted set of activities that increase in difficulty. Each Cookies assignment includes several concepts relevant to topics commonly covered in a managerial accounting course. These topics include product costing, cost *behavior, breakeven analysis, flexible and static budgeting, traditional and activity based overhead application. As an example of how the Cookies assignments are structured, Cookies 1 incorporates several concepts--product costing, cost behavior and static budgeting. It sends students to the Internet (or their own kitchen) for a cookie recipe, to the grocery store to price ingredients, to their desk to calculate the direct product costs, ingredient costs per batch and per cookie and to their text to wrestle with the nature and behavior of their costs.*

The Cookies case process often culminates deliciously with actual production and consumption of the case objects!

BAKING COOKIES

The body of the case consists of a brief description of each of the four assignments. The assignments themselves are included as tables numbered 1 through 4. Note that the assignments have some aspects that are general. This helps students build judgment and decision making skills and gives students a feel for the decisions that face managers and managerial accountants.

Cookies 1 The first assignment, presented in Table 1, involves several activities that are well within the skill set of any student at the beginning of a managerial accounting class. Students must research and find a cookie recipe, which may involve using the Internet. They must go to a store and price the ingredients, giving them a feel for practical product costing. Then they must begin to think about how costs behave. This ties in well with text material covering cost-volume-profit relationships. Finally, they must do some simple arithmetic to divide costs such as five pounds of flour to their batch of cookies requiring three and a half cups of flour. The instructor may also use this assignment to de-mystify accounting and also to help students understand that *even in classes*, they need to perform a basic reality check: there have been students who initially reported a cost for vanilla of $15 used in a single batch of cookies!

Table 1

***Cookies 1**: In this assignment, you will begin to analyze costs for a simple product: cookies. You may complete this assignment, and subsequent cookie assignments, in groups of up to 4 people.*

Here are the steps in this assignment:

1. *Obtain a cookie recipe. If you cannot find one at the library or do not have one, I'll have a couple recipe books in my office or find one on the internet (for example look at www.yahoo.com/entertainment/foodandeating/recipes/cookies).*

2. *Set up a table with the following columns: Ingredient, quantity, cost and behavior (variable, fixed or mixed).*

3. *Go to a store and price the ingredients. You will have to do this in two steps. For example, flour may be sold in 5-pound quantities, and your recipe calls for 3 cups. So you'll have to calculate how many cups per pound to get the cost per cup. Include your calculations in a supporting table. Also include the name of the store at which you "shopped."*

4. *What is the total ingredient cost for a batch of your cookies? What is the cost of a single cookie?*

Cookies 2 Cookies 2 as portrayed in Table 2 continues the lessons of the first assignment with more challenging tasks. It introduces a simplified set of indirect/overhead costs to be allocated to the cookies. Cookies 2 forces the student to think through a production process and perform some work flow analysis. It then takes the student through several breakeven exercises. The concept of capacity is introduced in step 3. Students, in this step 3, must take their workflow analysis and apply it to determine capacity. The last element of the assignment introduces simple flexible budgeting. Cookies 2, as presented in Table 2, uses a single worker as the base line, and then allows students to expand to three workers, exercising their entrepreneurial skills.

Table 2

Cookies 2

1. *Use your recipe from Cookies 1. Make any adjustments you consider necessary to make your cookies more realistic or more cost-effective. Document all changes.2. Expand your product costing by assuming:*

   < *You rent a kitchen/shop for $175 a month.*

   < *You pay $.50 an hour for electricity whenever you are working, plus a $10 a month base fee.*

   < *You produce cookies 40 hours a week with your single worker making $10 an hour.*

   < *Your indirect costs, all fixed, are $400 a month.*

   < *Packaging materials cost $.03 a batch.*

2. *Determine how long it will take for each batch of cookies from start to finish. Present this in table form. Next, divide this into your available hours to determine your capacity in batches of cookies.*

3. *Price your cookies. The price per cookie should have these characteristics: it allows you to make a profit and it seems reasonable. You may add a worker to increase volume, however, you cannot expand beyond three workers in your current space. Assume you can sell all the cookies you make.*

4. *What is your breakeven?*

5. *What is your breakeven if you want to pay yourself?*

6. *What is breakeven if your ingredient costs increase 10%?*

7. *Develop a monthly flexible budget for 50 batches below breakeven, breakeven and 50 batches above breakeven.*

Cookies 3 Cookies 3 (Table 3) builds on previous assignments by exploring traditional cost allocation measures consistent with those in most managerial or cost accounting texts. Students first attach full costs to a batch of cookies using a single overhead rate. They may choose their own denominator activity. Then students use a more complex two-step allocation scheme. They divide their process into departments, allocate service costs, and then allocate departmental costs to a batch of cookies. Finally students compare the two methods. If the class is focusing on more detailed manufacturing costing, an additional step that may be useful is to have students present the flow of a cookie batch through a T-account representation, supported by journal entries.

Table 3

Cookies 3

1. *Show your supporting calculations. When you make conclusions, explain your reasoning.1. Assume we are accounting for a single month. Assume that the $400 indirect costs consist of maintenance $150 a month, depreciation $75 a month and cost accounting $125 a month. You may need to use a little imagination.*

2. *You want to know the full cost of your cookies. Design a scheme that will allocate your fixed and indirect costs to each batch of cookies based on a single overhead rate (that is, the traditional allocation system). Choose your allocation base carefully.*

3. *What is your total cost of a batch of cookies?*

4. *Now separate your cookie making process into three departments. You will use a two-step allocation process. Decide how many labor hours (and dollars) are used in each department. Assume each department has the same number or square feet. Choose an allocation base for your electricity and other indirect costs to attach costs to each of your departments. The departments will then allocate to a batch of cookies based on direct labor hours. What is your overhead rate for each department?*

5. *What is your total cost of a batch of cookies? A single cookie?*

6. *Compare your cost per batch or cookies in step 3 with your cost in step 1. Reflect on the difficulty of obtaining the two rates and the quality of information that you receive.*

Cookies 4 Cookies 4 (Table 4) brings cookie production into the new manufacturing environment and winds up the set of cases. Students must once again think through the cookie-making process as a set of activities and attach costs to the identified activities rather than to departments and subsequently assign the costs to batches of cookies. These processes may overlap those in Cookies 3, but should differ in some respects. Once again students are asked to reflect on the three methods in the two assignments. It helps them recognize that each method may result in different costs of a batch of cookies and therefore flows into product pricing decisions, production planning and profitability.

Table 4

Cookies 4

1. *Now assume that you are going to implement an Activity Based Costing (ABC) system. Think through the cookie making process and classify all the activities for making your cookies. Group them so you don't end up with more than three or four. There may be some overlap with the departments you identified in Cookies 3 but they should not be identical.*

2. *Analyze your indirect and fixed costs to determine proper activity bases for your activities.*

3. *Determine the costs of each activity that you identified in step 1.*

4. *Identify the use of each activity base used by a batch of cookies and a single cookie. What is the total cost of a batch of cookies and of a single cookie under ABC?*

5. *What are the advantages and disadvantages of each of the three methods you have developed in Cookies 3 and 4? How might the choice of method influence your selling price?*

The four cases outlined above have been used over several years in an upper division accounting class for non-accounting majors. It has proved to be a popular way of teaching the material and of showing students how accounting may be useful to them in their careers. It has been mentioned in post-semester evaluation as the best course assignment.

SOWING SEEDS FOR THE FUTURE? A CASE STUDY

Richard H. Fern, Eastern Kentucky University

CASE DESCRIPTION

This case concerns the possibility of earnings management and the related earnings quality present in Apple Computer's 1997 and 1998 financial reports. Secondary issues of efficient markets and related parties can also be addressed. The case has a difficulty level of three. It can be taught in two hours of class time and should take about three to four hours of outside preparation by students.

CASE SYNOPSIS

This case is designed to illustrate to upper-level accounting students the concepts of "earnings management" and earnings "quality". Students are asked to explain the substantial change in Apple's net income (loss) between 1997 and 1998 and the significant difference between Apple's net income and cash flow from operations. Students are required to access the SEC's EDGAR data base or visit Apple's Web site, research the finance literature, and research and apply various GAAP to a fact based situation.

There is not a definite yes or no answer related to whether Apple's earnings were actively managed. Students will need to draw their own conclusions regarding Apple's earnings, whether GAAP guidelines were applied appropriately and whether the relative quality of earnings improved or not over the two reporting years.

The case can be used in its entirety or in part as appropriate. While there are three primary areas in Apple's statements where earnings management might be discussed, the discussion could be limited to only one or two of these. The main learning points of the case are not severely compromised by limiting the scope of coverage. In addition, several side issues are brought up in the case (e.g. efficient stock market theory) that can be explored or not as necessary.

INTRODUCTION

[The following is a fictional conversation between two friends who are undergraduate accounting students.] "Hey Fred", yelled Joan excitedly. "You know that Apple Computer stock that you've been razzing me about for the past two years? Well, it just went up to $30 a share. I'll admit that it might not have been such a good investment when I bought it in 1994 at $45. But after four years, it looks like the worst is over with. I'm just going to sit back now and watch the price take off!"

"What makes you so 'up' on Apple all of a sudden?" Asked Fred. "That stock wasn't a very good buy when you bought it and it's still not."

"Well, Mr. Know-it-all", replied Joan, "check out this press release from last week:

Apple Computer reports its first profitable year since 1995! In fiscal year ended September 25, 1998, Apple generated revenue of $5.9 billion and net income of $309 million ($2.34 per basic share). This compares to fiscal 1997 results of a net loss of $1.045 billion (-$8.29 per share) on revenues of $7.1 billion. "Apple grew faster than the industry this quarter for the first time in nearly five years," said interim CEO Steve Jobs. "Apple is regaining operational excellence – exiting the quarter with only six days of inventory…" "Apple's financial position continues to get stronger," said CFO Fred Anderson.

"Come on, Joan, everybody knows that many companies are able to manage earnings to affect their stock prices. Don't you think that's what Apple's done? Let's go to their Web site and check out the income statements for the last few years."

[Later in the College computer lab:] "Look, Joan. Apple took a bath in income from operations and net income in 1996. After looking at the Apple analysis in ValueLine, I noticed that their stock price headed south in mid-1995 when the fiscal 1996 earnings forecasts started coming in. They also lost a bundle in 1997 – in fact, a record net loss for them!" (See Appendix I.) "If you look at the 1996 and 1997 earnings details, they not only had poor results from operations but they apparently decided to take a "big bath" overall in those years as well."

"What do you mean they "decided" to take an overall big bath?" asked Joan. I just thought that while things were going badly in the Mac computer business, Apple was suffering in other areas as well."

"Well, not really", commented Fred. "Some companies load up on other expenses when operations are going poorly by writing off non-operating costs that might hold down earnings in later years. Look at Apple's 1996 and 1997 earnings statements. Couldn't you almost predict a return to positive earnings in 1998? Remember how Apple's stock price took off in late 1997 and early 1998 when the coming return to profitability was anticipated? So, Joan, you should have waited until the stock was in the tank in 1996, bought in at $15 and now you really would have something to sound off about!"

"You know", replied Joan, "in accounting class we talked about the quality of earnings and the many choices and estimates available under GAAP. But, I thought it meant that GAAP choices allowed earnings to fall somewhere in a narrow range of values. Is it really so 'flexible' that it allows arbitrary booking of expenses when it is most advantageous to the company? Are stock buyers that gullible that they can't see behind those accounting gimmicks?"

Joan continued: "Dr. Robinson discussed something called an 'efficient market' theory sometime before the last test. I didn't do well on that test since I mainly bombed the efficient markets questions. What is an 'efficient' market anyway? I think it has something to do with this, doesn't it?"

"How you've kept that 3.6 GPA, Joan, I'll never know. But anyway, I think it's something about a market is efficient if the stock price fully reflects information about the company. And there's something about a strong and weak version of it also. I didn't do well on those questions either."

"But Fred, if it really was just an accounting gimmick, Apple fooled me and the entire stock market. The stock market really isn't efficient, is it?

"Man, this is really bogus! Who would have ever thought that something we had in class might have some real-life use? Don't ever tell those accounting or finance teachers that we wished we had paid attention in class. They might try even harder to make this stuff make sense. I do wish I knew more about the interactions between financial reporting, accounting choices and stock prices."

"Yeah, especially about the stock prices. How are we going to retire at age 35 if we don't make a killing in stock?'' asked Joan.

"Win the Powerball?"

[A week later.] "Hey, Fred!" yelled Joan; "Since I had such a vested interest in understanding the Apple financial information, I've done some work on that stuff we got off the Web site last week. Since you were so convinced that any resemblance between reported earnings and actual earnings is only coincidental, I decided to dig a little deeper. I went through the items on Apple's income statement between 1997 and 1998. Very interesting. Apple was in some kind of big restructuring plan during that period."

Joan continued: "I did some trend analysis comparing Apple's gross margins and SG&A numbers for 1996 through 1998 to get a handle on their earnings from operations. The real interesting stuff was in those 'Special Charges'. Actually, I'm not sure I understand this. Their recurring R & D expense dropped by almost one-half over the three years. Yet in 1997, they had a big separate charge for R & D under 'Special Charges'. What do 'Special Charges' mean anyway?"

"You're right, neither one of those makes any sense," replied Fred. "Why would a high-tech company, already taking a beating from the competition, reduce its ongoing R & D activity yet spend $375 million for 'special' R & D stuff? Tell me again why you invested in this company?"

"Well, that's not all" replied Joan. "In the *Wall Street Journal* that we have to read for accounting class, there's been a rash of articles lately about companies practicing earnings management. I also ran across some discussions that questioned the 'quality' of earnings for various companies. It has something to do with the difference in earnings and cash flows for the year or something like that."

"And, believe it or not," continued Joan, "I looked up some of the GAAP rules that apply to Apple's situation. You said last week that you thought that GAAP was so flexible that companies had a lot of leeway to do stuff and still get a clean audit opinion. I wanted to see if I could find out just how Apple applied GAAP in accounting for their acquisitions, equity method investments, and R & D costs. You won't believe some of this stuff! I'm going to use this for my paper in accounting class that's due next week."

"All right, what's the bottom line with Apple?" asked Fred. "I was right, wasn't I? While they were "restructuring" during 1996 and 1997, they dumped a lot of costs into their income statement to set up things for a nice - Surprise! - return to profitability in 1998. Right?"

[This fictionalized conversation was created purely for educational purposes. It should be used solely to highlight issues related to financial reporting and in no way is intended to represent a factual situation. The issues raised here apply to many companies whose stock is publicly traded. Apple Computer was chosen due to its name familiarity to most students.]

ADDITIONAL INFORMATION

During her research, Joan noted that Apple Computer designs, manufactures and markets microprocessor-based personal computers, peripherals, and software. The Apple Macintosh® line that currently includes the Power Macintosh, iMac, and PowerBook G3 systems was first introduced in 1984 and now generates substantially all of their sales.

Apparent from their income statements (Appendix I) and related disclosures is the fact that, as demand for Apple's products declined in fiscal years 1996 and 1997, Apple reported large operating losses. To reduce costs and adopt a new strategic direction, the Company began implementing a restructuring plan in 1996 that was essentially completed by the end of 1998. The focus was on "… reducing cost structures, improving competitiveness and restoring sustainable profitability…"; restructuring activities included the termination of employees, closure of facilities and cancellation of contracts".[1]

By examining the footnotes, Joan also discovered that coincident with the restructuring, Apple engaged in the following activities with affiliated companies:

In September 1997, Apple owned 42.3% of the stock of ARM Holdings, a privately held company in the UK that designs microprocessors. In September 1998, the Company sold 18.9% of its shares as part of ARM's initial public offering of its stock. In October 1998, the Company sold an additional 2.9 million shares of ARM.

In January 1997, the Company completed its purchase of certain assets from Power Computing Corporation (PCC). Purchase terms included 4.2 million Apple shares, forgiveness of $28 million of PCC receivables, and assumption of certain PCC liabilities.

In February 1997, the Company acquired all of the outstanding shares of NeXT Software. NeXT develops and markets products designed to facilitate business applications on the Internet. Purchase terms included cash of $319 million and 1.5 million shares of Apple common stock. Tax operating loss carryforwards of $264 million were also acquired in this purchase.

REQUIREMENTS

To respond to the following items, you will need to access Apple's 1998 10K filing. It is available at Apple's Web site or through the SEC's EDGAR files (see Appendix II for information on how to access the EDGAR database.)

1. Briefly summarize the general concepts of "earnings management" and "quality" of earnings. You will need to locate several additional sources to properly summarize these concepts. Identify any sources that you use. (See Appendix III for some preliminary references to get you started.)
2. Did Apple's gross margin stay constant between 1996 and 1998? If not, why not?
3. Apple reported a net loss of $1,045 million in 1997 and a net profit of $309 million in 1998. Identify the significant revenue and expense item differences between these two years that account for this $1354 million turnaround in net results. (For example, the Cost of Sales went down by $1,251 million.)
4. Respond to Fred's question as to why a technology company such as Apple Computer might reduce research and development spending in response to increased competition? How does the Company justify such a cutback?
5. Joan and Fred found that much of the variation in Apple's earnings over the three-year period could be attributed to the Special Charges. Respond to the following:
    a) Describe the "in-process research and development" charge of $375 million in 1997. What business transaction generated this charge? How did Apple determine the size of this charge? Briefly explain.
    b) What are the GAAP guidelines related to the timing and recognition of in-process R & D costs? What alternative accounting treatment might have been applied to these costs if Apple had not determined them to be in-process R&D?
        a) What is included in the "Restructuring costs" of $217 million and $179 million for 1997 and 1996, respectively? Be specific.
        b) What are the GAAP guidelines related to the timing and recognition of restructuring costs?
6. Explain the "Termination of license agreement" charge of $75 million in 1997.
    a) Briefly describe the "Gains arising from equity investment" amount of $40 million in 1998. Be specific.
    b) Is this the proper treatment for an equity-method investment under GAAP? Explain.
7. In your opinion, is there any evidence of earnings management by Apple during the years 1996, 1997 and 1998? Be specific as to the item and why you believe that it constitutes management.
    a) Prepare a reconciliation of Apple's net income and cash flow from operations for years 1997 and 1998.
    b) Briefly explain why, in your opinion, the difference between income and operating cash was substantially smaller in 1998 than in 1997. In general, what do you think this says about a company's accounting policies?
    c) Briefly compare the relative quality of Apple's earnings for years 1997 and 1998.

APPENDIX I

Apple Computer
Consolidated Statements of Operations
(in millions, except share and per share amounts)

Three fiscal years ended September 25, 1998	1998	1997	1996
Net Sales	$5,941	$7,081	$9,833
Cost of Sales	4,462	5,713	8,865
Gross Margin	1,479	1,368	968
Operating Expenses:			
Research and development	303	485	604
Selling, general and administrative	908	1,286	1,568
Special Charges:			
In-process research and development	7	375	
Restructuring Charges		217	179
Termination of license agreements		75	
Total Operating Expenses	1,218	2,438	2,351
Operating Income (loss)	261	(1,070)	(1,383)
Gains arising from equity investment	40		
Interest and other income (expense), net	28	25	88
Total Interest and other income (expense), net	68	25	88
Income (loss) before provision (benefit) for income taxes	329	(1,045)	(1,295)
Provision (benefit) for income taxes	20		(479)
Net Income (loss)	$ 309	($1,045)	($816)
Earning (loss) per common share:			
Basic	$2.34	($8.29)	($6.59)
Diluted	$2.10	($8.29)	($6.59)

APPENDIX II

EDGAR (Electronic Data Gathering, Analysis, and Retrieval system) is the Securities and Exchange Commission’s automated collection, indexing, and disclosure file. It shows documents (e.g. annual reports and 10K reports) submitted by companies required by law to file with the U. S. SEC.

There are several methods of access to EDGAR. Direct access to the database can be found at “http://www.sec.gov/edgarhp.htm”.

In addition, there are several private search engines for EDGAR available. One of these, FreeEDGAR, is available at http://www.freeedgar.com/. The international CPA firm of Price-Waterhouse-Coopers makes its EdgarScan search engine available at: http://bamboo.tc.pw.com.

APPENDIX III

Sample references on earnings management and quality of earnings

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MODULAR MANUFACTURING IN THE AUTOMOBILE INDUSTRY: DANA LEADS THE WAY

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CASE DESCRIPTION

The primary subject matter of this case concerns operations management - specifically modular manufacturing. Secondary issues include globalization, inventory management and human resource management. This case has a difficulty level of three. It is suitable for a junior level course and can be taught in a 50 minute class with two hours of preparation by students outside of class. The case could also be used in a senior-level strategic management class to illustrate a virtual supply chain in the auto industry.

CASE SYNOPSIS

"Chrysler should sell pens and shirts - promote their brands and worry about design and direction," said Ruperto Jiminez, as he looked out the window of Dana Corporations' Campo Largo plant in southern Brazil. Jiminez, president of Dana Brazil, was reflecting on the shipment of Dana's 10,000th "Rolling Chassis" to Daimler Chrysler's Dakota truck plant three kilometers away. The year was 1999 and Dana's new plant was performing better than originally expected.

Dana Corporation, a worldwide manufacturer of components and subassemblies for trucks and cars, opened its 76,000 square foot Campo Largo plant in July 1998. The plant is something of a gamble, but probably a good one, based on the revolution going on in worldwide truck and car manufacturing and the explosive growth of the auto industry in Brazil since 1994. The rolling chassis concept attributes to Dana's long experience as a chassis supplier to Mack Truck and Chrysler's Extended Enterprise concept that began in the early 90s. It is the most advanced example of modular manufacturing in the automotive industry and has important implications for the entire structure of the industry in the next few years.

Modular manufacturing began, in the United States, at Kaiser Shipbuilding during World War II. Kaiser engineers and operations management personnel discovered that the production and launch of Liberty ships could be speeded up by pre-assembling "modules" -- sections of the ships -- and then welding them together in the final assembly phase. Kaiser engineers were very successful in this endeavor as exemplified by the lead time for final assembly of Liberty ships that got down to 4-5 days near the end of the war! Following the war, Japanese shipbuilders incorporated modular manufacturing in the construction of super tankers (for crude oil) and the cost savings allowed the Japanese to dominate this industry in a period of just a few years.

Modular manufacturing, in general, suggests that parts of the value chain may be economically "outsourced" to other firms. In many instances, the supplier firms provide prototype development, engineering, manufacturing and assembly of components and entire systems. The advantage to doing this is that the buyer is relieved of inventory management problems and costs, while the supplier firms benefit from application of their special expertise in selected parts of the value chain.

DANA CORPORATION

Dana is one of the world's largest independent suppliers to vehicle manufacturers and the aftermarket. Founded in 1904 and based in Toledo, Ohio, the company operates some 320 major facilities in 33 countries and employs more than 82,000 people. Dana reported sales of $13.2 billion in 1999. Operating profits were $678 million and Dana has not missed or reduced a dividend payment in 65 years and will pay its 249th consecutive dividend in March 2000 (Dana Corporation, 1999).

Much of Dana's recent success attributes to the Five-Point Plan that articulates the near term tactics necessary to achieve the strategic plan titled "Beyond 2000". The Five Point plan includes the following elements:

1. *Grow while focusing on returns and maintaining financial discipline.*
2. *Seek strategic, "bolt-on" acquisitions at reasonable valuations.*
3. *Divest non-strategic and non-performing operations.*
4. *Repurchase stock as the company generates cash; and*
5. *Complete integration efforts and realize synergy savings.*

Dana is organized into seven Strategic Business Units: Automotive Systems Group ($4.5 billion revenue in 1999), Heavy Truck Group ($1.9 Billion), Off-Highway Systems Group ($800 million), Automotive Aftermarket Group ($3.0 billion), Fluid Systems Group ($1.2 billion), Engine System group ($1.4 billion) and Dana Commercial Credit. The Automotive Systems Group (ASG) "houses" the Rolling Chassis plant at Campo Largo. ASG employs 26,000 people in 20 different countries. Key products, in addition to the Rolling Chassis, are axles, drive shafts, brakes, clutches steering and suspension components and systems. Their primary markets are passenger cars, light trucks, vans and SUVs. The top five customers are Daimler Chrysler, Ford, GM, Isuzu and Volkswagen.

Dana's financial performance over the last few years has been quite satisfactory; unfortunately, despite year-to-year growth in revenue and profit, the stock market has not rewarded the firm with stock price appreciation. The recent 52 week high was $45.88 and the low $20.31. The share price on July 24, 2000 was $23.56. Earnings per share in the last twelve months were

$3.46 and the P/E ratio was a miserly 6.8. The Quick ratio is 0.6, The Current Ratio is 1.15 and LT Debt/Equity is 0.88. Dana ranks No. 127 On the Fortune 500 and No.340 on Fortune's Global 500.

Quality has been an important initiative throughout Dana's history. Woody Morcott (Chairman of the Board) is known as a "quality zealot". Under his leadership, Dana has earned numerous awards for quality and innovation. In 1992, Dana Commercial Credit received the Malcolm Baldrige National Quality Award. Dana has been named among the Top 10 manufacturing firms by Industry Week magazine and Fortune magazine selected Dana as one "America's Most Admired Companies." Dana ha also been a finalist every year since 1995 for *Automotive News'* PACE award for technology innovation. *PC Week* cited Dana as one of the "Fast Track 500" firms involved in e-business.

THE AUTOMOBILE INDUSTRY IN BRAZIL

In 1997, Brazil produced 1.9 million cars and light trucks (Seikman, 1999). In 1999, sales had dropped 26% to approximately 1.4 million vehicles. Despite this remarkable slump in demand, new assembly and parts plants are being constructed at a record pace in the largest country in South America. In mid-2000, General Motors will open the "Blue Macaw" plant at Rio Grande del Sul. This plant was built to allow GM to experiment with modular manufacturing techniques outside the purview of the United Auto Workers.

Ford Motor Company is spending $1.3 billion (including government subsidies) to construct a 250,000 vehicle per year assembly facility. Fiat, VW and Audi are also adding substantial capacity in Brazil. Honda opened a Sao Paulo plant in 1997 with a 30,000 car per year capacity. Toyota, despite having made trucks in Brazil for 41 years, has only recently opened a very small plant to build Corollas. All told, the Big Four are spending $6 billion to "spruce up" existing facilities and total capital spending for autos could be as much $25 billion since 19991.

The expansion of the auto industry in Brazil attributes to the effects of Mercosur, a regional trade alliance signed into law in 1994. The Treaty of Asuncion (MERCOSUR) strengthened the national markets of Argentina, Brazil, Paraguay and Uruguay by eliminating internal duties and tariffs and providing a common external tariff. One of the considerations under Mercosur is the necessity to maintain domestic content, specifically 60% in the automotive sector.

THE ROLLING CHASSIS

The auto industry in the United States has been involved in "gut wrenching" changes in the last twenty years (Womack, Jones & Roos, 1990). As a result of rapidly increasing foreign competition and the evolution of, primarily Japanese, transplants, American manufacturers have experienced a 25% loss of market share in passenger cars and light trucks. This has led most American manufacturers to move in the direction of "Lean Production". The fundamental principles of Lean Production are:

Teamwork
Communications
Efficient use of resources and elimination of waste
Continuous improvement

Chrysler, now Daimler Chrysler AG, has focused on lean production since the development of the LH series vehicles in 1989 (Raia, 1993). The LH cars (Dodge Intrepid, Eagle Vision and Chrysler Concorde) were produced from scratch in only 39 months. Chrysler's LH team included suppliers in prototype development and, indeed, delegated design responsibilities and component sourcing to a number of suppliers. The success of this effort came to be known as the Extended Enterprise Program and has resulted in $3.7 billion in cost savings for Chrysler between 1989 and 1997 (Anonymous, 1997).

The new Dana facility, 300 miles south of Sao Paulo, Brazil, looks like an oversized clubhouse rather than an outpost of global revolution in auto and truck manufacturing (Seikman, 1999). Inside the plant, two dozen workers assemble the largest module in the auto industry today at a rate of one every 14 minutes. The rolling chassis includes the frame, axles, drive shaft, suspension, steering system, brakes, wheels, tires (mounted) and electrical circuits. Dana manages 66 suppliers, including scheduling and purchasing and handles 320 part numbers.

The assembly line for the rolling chassis consists of 12 workstations with the truck frames loaded on stands on a powered conveyor. The frames move down the line transversely with all front-end components mounted from the left and rear end components mounted form the right. The frames go down the line upside down until near the end where they are flipped with a crane to add tires and wheels. Dana then aligns the front and rear end, loads three chassis on a semi trailer for the short trip to the Daimler Chrysler Dodge Dakota plant where they are rolled into the assembly building.

Workers in the plant earn about $6,000 per year and both Dana and Chrysler estimate that the savings attributable to the Rolling Frame concept are well over 10%.

THE FUTURE

The Rolling Chassis isn't Dana's only business in Brazil. They supply front corners (suspension, wheel and steering components) to Volkswagen at Curitiba. With the recent acquisition Eichlin, Dana has the opportunity it begin supplying elastomers and tubes to Chrysler and that would boost the 33% of the chassis that Dana has to nearly 50%.

The Rolling chassis concept is, obviously "portable." New auto plants are being built around the world to take advantage of attractive factor costs and growing markets in the second and third world countries. For example, in Brazil, alone, Ford, General Motors, Renault, Peugeot and Honda have all announced new facilities with the total investment to be nearly $25 billion.

Dana has made presentations to the Japanese manufacturers and although they haven't "signed up", there appears to be some interest. It is only in the United State where modular manufacturing is having a hard time getting off the starting blocks. The UAW and even General Motors are reluctant to adopt the new supply chain strategy. The reluctance of the UAW is obvious - feared loss of union jobs.

DISCUSSION QUESTIONS

1. What is the cycle time on the Dana line? What would need to be done to *double* the output?

2. How does the Rolling Chassis concept benefit Daimler Chrysler's Dodge Dakota plant in Brazil?

3. What are the implicit risks to Dana with the Brazil plant?

4. Why is General Motors reluctant to adopt modular manufacturing?

5. Would Dana be wise to build a facility like this to serve Toyota in Japan?

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SWING 1000

Barbara K. Fuller, Winthrop University
Darcy Donevan, Owner, Swing 1000

CASE DESCRIPTION

The primary subject matter of this case concerns entrepreneurial startup and business growth decisions. Secondary issues examined include location, funding, personnel, and growth issues. This case has a difficulty level of four, appropriate for senior level course, or five appropriate for first year graduate students. Students need to be familiar with materials on managing entrepreneurial growth and private investor equity financing before working with this case. The case is designed to be taught in two class hours and is expected to require 5 hours of outside preparation by students.

CASE SYNOPSIS

A Charlotte, NC couple originally from New York with background in the travel, entertainment, and the music business opened a 1930's vintage supper club much like the Rainbow Room in New York City with fine food, excellent service and superb entertainment. The case looks at the issues they faced and the decisions they made including the long time viability of the swing movement, the club's location, how capital was raised, and finally the direction of expansion for the business. To get a good feel for the club and the type of entertainment check out the Internet site at swing1000.com.

The case traced the revival of the swing movement from the 1980's through the end of the century. Although it was a very strong movement the case acknowledges the negative affect a loss of popularity in swing would have on the business. If students are interested in Swing, the references include a book on the movement. There are several others that can be found by searching the amazon.com bookstore site on the Internet.

The club's location at 1000 Central Avenue in a renovated warehouse surrounded by a neighborhood undergoing revitalization was a risky decision by the owners. The location proved to be a blessing as well as a curse. The neighborhood attracted SBIC money, but also required additional time, strategies and resources to first attract private investors to provide additional funding for the project and then to develop individual patron interest in the concept. Since bankers would not invest in the project, the owners made a decision that equity funding was their best source of financing. The questions in the case outline reasons for using private investors rather than venture capitalist.

Expansion was the major issue in the case. The various growth options and reasons for expansion were discussed in the case. Students were then ask to evaluate the options presented, create other options if they so desired, make a choice among the options, and develop an *implementation plan. The options included using the same format and moving to another town or staying in the same town and developing a new format. Of course there is always the option of not expanding the business.*

INTRODUCTION

A couple shyly walk to the parquet dance floor as a Duke Ellington song begins to play. Their right hands touch, symbolizing the moment when romance and music meet. Her left hand moves to his shoulder, his to her waist. The dance begins.

No, it's not a scene from a sappy 1940's movie, it's a snapshot from Swing 1000, the new nostalgic nightclub at 1000 Central Ave. As soon as you walk in the art deco building with its spats-wearing manager, gourmet menu and seven-piece orchestra, it's clear this is not your average night spot.....

Men must wear jackets. That rule means the men look spiffy and the women can get dressed up as they want. From vintage dresses to sophisticated evening wear and short club dresses – the clothes are as varied as the clientele (Fortson, 1998).

This is the creative and enthusiastic description of Swing 1000 by a local newspaper reporter for the Charlotte Observer one year after it opened. Everyone who visited and experienced the club loved its atmosphere and excitement, but many questioned its future sustainability in Charlotte and especially in the Plaza Midwood area. However in three years Darcy Donavan, the mastermind behind the club, has created not only a success story, but is thinking of expansion.

CURRENT SITUATION

Darcy Donevan, president of Swing 1000, a fine dining and dance club in Charlotte, NC, sits in her Cigar Bar looking at the future direction of her business. In 1997, she successfully opened a sophisticated nightclub in an area undergoing rejuvenation about a mile from uptown Charlotte, NC. Looking back the start-up was an exciting, dynamic experience that also held many lessons in business as well as faith, hope, and perseverance. However with the club now open, profitable, and the investors seeing some return on their money, she is looking towards the future. Should she open a club using the swing format in another city such as Atlanta or develop a totally new format such as a "60's Retro Theme" in the Uptown Charlotte area? Are there other options that should be considered? The only thing certain at this point is Darcy's continued passion and commitment to the business as expressed in her first comment; "The American dream is alive and well." This is a concept that she lived by and expressed often.

THE VISION OF SWING

What is swing? Webster defined swing as "jazz music especially in its development after about 1935, characterized by the use of large bands, contrapuntal improvisation, and written arrangements for ensembles playing" (Webster). The swing movement may have its original roots starting as far back as Louis Armstrong and Duke Ellington with songs such as "It Don't Mean a

Thing If It Ain't Got That Swing." But swing didn't become a national craze until the likes of Benny Goodman and Glenn Miller in the 1030's and 1940's.

At the turn of the millimium swing was well on its way to returning to new heights of popularity. This rebirth and rise of swing dancing and music went back to the 1980's. In the early 1980's small groups of dancers began the revival but it was not until 1989 that the L. A. Royal Crown Revue began playing neo-swing. They were credited with launching the swing renaissance that became mainstream. Other musicians such as Brian Setzer Orchestra in 1992, and Big Bad Voodoo Daddy in 1993 followed their success. In addition a variety of clubs began to open on the West Coast: Club Deluxe in San Francisco (1989) and the Derby in Los Feliz (1993).

This swing mystique was further popularized by films such as "Swing Kids" (1993), "The Mask" (1994), and "Swingers" (1996). The music industry promoted the trend with the released of an album by Royal Crown Revue called "Mugzy's Move" in 1996 and a CD by Squirrel Nut Zipper called "Hell" in 1997. Even TV ads picked up on the trend as the dancers for Gap khaki pants were swinging to "Jump, Jive an' Wail." The ultimate in TV promotion was the super bowl halftime show in 1999 that featured Big Bad Voodoo Daddy.

The renaissance of swing, however, would not be complete without some mention of the dancers. Frankie Manning, a New York Postal worker, joined Erin Stevens and Steven Michells of the Pasadena Ballroom Dance Association to bring back the Lindy Hop and jitterbug steps that swept the country. The dancers span different generations from the new young hipsters to those remembering their youth and the steps they made popular back in the 30's and 40's.

From the Supper Club in New York City, and The Five Spot in Philadelphia to the Spanish Ballroom in Glen Echo, Maryland and the Masquerade in Atlanta swing has grown and flourished across the country. Liquid in Chicago, the Red Jacket in Dallas, and Hi Ball Lounge in San Francisco all provide their own style of 30's and 40's swing.

The Donevans knew the timing was right and swing was a classic. It was here for the long haul and would last over time. It was never about fads, but about dining and dancing and the time was right. They both knew that staying power was the key and believed that Swing 1000 would be successful if they could keep the business open long enough to get people to know about it. Many other swing club owners who geared their business to kids and college students have gone out of business. The saw the trend but missed the full picture of how to build the market, develop corporate sales and get repeat business in the door day after day.

BACKGROUND OF THE FOUNDER

A Charlotte couple, Darcy and Michael Donevan, started Swing 1000 in 1997. Darcy's background was in the travel business. She worked as the Director of Promotional Group Sales, which consisted of booking activities for corporate groups that included a full entertainment schedule. In Darcy's mind Swing 1000 was comparable to the full entertainment experience provided on a cruise ship where there is something for everyone.

Michael Donevan, Darcy's husband, was a radiobroadcasting consultant for contemporary music radio stations throughout the United States. Previously he was the program manager with

WEDJ and WBT-FM broadcasting stations in Charlotte, NC. He served as an advisor on marketing issues for the club. In addition, he added family, financial, and professional support to the venture.

DESCRIPTION OF THE CLUB

Swing 1000 was a fine food dining and dancing entertainment venue, a concept unique to the Charlotte area. It was located in a transitional neighborhood undergoing renovation. The building had an art deco, post World War II look that was preserved and incorporated into the renovation. Because of its character the club became a destination for all types of special events from wedding receptions, banquets, proms, and birthday parties to murder mysteries and wine tasting

Darcy and Michael wanted to offer guests an evening filled with the best food, drinks, cigars, music and dancing available in the city of Charlotte and for that matter in the southeast. The club attempted to capture the fun and essence of the big band era with the added attraction of a festive and fun-filled ambiance. The estimate bill for an evening at the restaurant including the band and a five-course meal was approximately $65.00. This is the upper range of restaurants in the Charlotte area. The club also offered an extensive wine list.

There was a $10.00 cover charge to just hangout at the bar and dance the night away without dinner. The entertainment includes a seven-piece house band as well as headliner orchestras for special occasions and holidays. Patrons could swing, fox trot, waltz or tango to the tunes of a live band every night of the week. Swing 1000 was a place where people could dine in 1930's elegance to a big band orchestra and soak in the exquisite ambiance of elegant luxury. The club was known for having the best people, the best menu, and renowned service.

EXTERNAL ENVIRONMENT

Swing 1000 opened in a positive economic environment. For numbers of years the southeastern United States including the Carolina's has shown substantial grow in population as people migrated to the area. Overall, this growth created both a larger and more diverse marketplace. A more sophisticated traveler who was used to going to places like Swing 1000 characterized the influx of new people into the Charlotte area. The demographics for the area indicated a positive growth pattern into the foreseeable future.

The management team, including Darcy and her husband Michael, were passionate about the business and believed in its success. They had experience in both the entertainment and music industries and were willing to take substantial risk with their resources to make the business happen. Like most new businesses they found a significant challenge in raising start-up capital. The private investor or angel market in Charlotte was in its infancy. Individuals with substantial wealth to invest in the business were available but difficult to reach especially for those lacking experience. However, with some persistence and experience adequate financing was raised making the venture possible.

Although most of the environmental factors look healthy, changes could occur in inflation, the employment rate, energy and utility costs, or interest rates that could in the future affect the financial outlook for the business. The other external factor that could change was the Swing craze. Was it a fad or a more significant trend that had staying power in the marketplace? Currently the Swing revival looks strong and the future for the business looked excellent. However, if Swing lost popularity the club would be negatively affected.

CUSTOMERS

The first customers to frequent the club were international residents and northerners who were transferred or moved to Charlotte. The first year was very difficult. Darcy said "Charlotte residents had to read about the club in the national publications such as *Southern Living, Entertainment Weekly*, and *USA Today* before they warmed up to the idea. The club was getting written up as the number one swing club in the country, but many Charlotteans didn't know it existed.'

Weddings, corporate parties, conventions, and special events created most of the business in the beginning. Weekends were good but weeknights were slow. The club had a very mixed clientele. Swing was making its way back into the music scene with the younger crowds yet many older people remember the original Big Band tunes from the 1930's and 1940's. Everyone who came to the club loved it. Getting them interested in the first visit was the challenge. Charlottens were used to having dinner in an hour and a half rather than spending an entire evening enjoying food and entertainment. They perceived the service as slow rather than quaint. The band started at 8:00 pm. The first two sets were dinner sets with soft music and enjoyable conversation. About 9:00 pm the dancers came in and the band became livelier.

Patrons were of all ages. Older patrons remember the original days of the big band jazz. Younger crowds in there twenties and thirties signed up for dance lessons. Banking, corporate and convention customers were looking for the hottest entertainment in the area. All found Swing 1000 a special place to celebrate with wonderful food, fabulous entertainment, and art deco styling. It provided memories or nostalgia from the past with all the amenities of today.

As things started to turn around Halloween would sell out for the Murder Mystery and Christmas would sells out without advertising. Anniversaries and birthdays became commonplace events. After three years of promotion and education in the Charlotte market the club has become a destination.

EMPLOYEES

Swing 1000 employees were selected carefully and treated with respect. Darcy's goal was to select people with whom she could communicate her dream and turn them on to that dream. From the beginning employees felt the extraordinary atmosphere at Swing 1000 and knew that this was not just another restaurant. From the chief to the waiters employees took pride in their work and had a good work ethic. In addition to selecting the right people individually, it was important to have the right match of people with everyone working together. It took several years to get all of the right people in place and to build the right relationships to make the business work efficiently. Employees were encouraged to have a sense of ownership and a positive attitude towards the job. When employees felt they were a part of the businesses overall success, they became more loyal and the turnover rate dropped.

In hiring people Darcy did not pay a lot of attention to the person's resume'. She said over and over to people she hired, "A great resume' means nothing – show me that you care." She also believed that you couldn't really pay your employees what they were worth from the beginning, so you have to count on them to stick with you and hope that you can take care of them later when the business is up and profitable.

Special benefits were also used to provide an incentive for employees to stay with Swing 1000. Darcy's philosophy was to look for your company's uniqueness and try to sell that. Based on this philosophy, she offered her staff free dance lessons every Wednesday night at the club. In addition, employees share in the commissions brought in by the restaurant's salespeople. The one thing however, that everyone understood was that service came first and it was always first rate.

COMPETITION

Swing 1000 had no direct competition located in the Charlotte area, that offers the unique combination of high quality dining, entertainment and dancing provided by the club. No establishment within a 150-mile radius of the city regularly offers live big band music. They did however compete against a variety of local and chain restaurants at the upper price level. These included: Mama Ricotta's Inc., Beef and Bottle Steakhouse, Pewter Rose, Morton's of Chicago Steakhouse, Castaldi's Italian Restaurant, Alston's Steakhouse, Providence Café, The Melting Pot Restaurant, The Townhouse Restaurant, Frankie's Italian Restaurant, Cajun Queen, Bistro 100, Marais French Cuisine, Charley and Barney's Bar and Grill, Jack Straw's, Primo Ristorante, South End Brewery, and Sonoma on Providence.

Exhibit 1: Competitive Matrix

Name of Business	Location	Sales Volume	# Employees
Bistro 100	100 N. Tryon St.	$5-$10 million	125
Frankie's Italian Grille	800 E. Morehead St.	$2.5-$5 million	70
Primo Ristorante	116 Middleton Dr.	$500,000-$1 million	14
Marais	1400 E. Morehead St	$1-$2.5 million	30
Melting Pot	901 S. King Dr.	$1-$2.5 million	30
Southend Brewery & Smokehouse	2100 South Blvd.	$5-$10 milllion	120
Morton's of Chicago	227 W, Trade St.	$2.5 -$5 million	70
Castaldi's Market & Grill	311 East Blvd.	$1-$2.5 million	35
Providence Cafe	110 Perrin Pl.	$2.5-$5 million	60
Townhouse Restaurant	1011 Providence Rd.	$500,000-$1million	16
Cajun Queen Restaurant	1800 E. 7th St.	$1-$2.5 million	30
Pewter Rose	1820 South Blvd.	$1-$2.5 million	40

PRODUCT/SERVICE STRATEGY

Swing 1000 was named in part for musical spirit and in part for its location 1000 Central Avenue. It was located in what used to be a commercial art-deco style warehouse. The building was 10,000 square feet structure, completely up-fitted with a large commercial restaurant kitchen, a large stage appropriate for big band and similar entertainment, a 1,100 square foot parquet dance floor, a knock out lighting and sound system, open restaurant seating for approximately 225 guests (400 accommodated for cocktail parties), two separate rooms for private dining and functions, and a cigar room. The atmosphere encourages patrons to spend a full evening at the restaurant for leisurely dinning, dancing, and enjoying drinks, deserts, and cigars. Other services include dance lessons, private functions, and sales of dance and restaurant-related merchandise. Music produced by a seven-piece house band plays nostalgic upbeat tune from Count Basie, Benny Goodman, Glenn Miller, Tommy Dorsey, Bobby Darren, and Frank Sinatra. Hugh lighted columns with an iris design carved in them flank the stage and line the back wall. The iris design also appears in the colorful carpet that surrounds the dance floor. The cigar room had a built in ventilation system and comfortable leather and velvet chairs and love seats resembling an old style drawing room. People came to Swing 1000 to be treated like royalty and to escape the realities of everyday life.

MENU

Atmosphere is everything at Swing 1000. An exquisite menu, candlelit tables, and excellent service all add up to an unmatchable food and entertainment experience for Charlotte or any place across the country. The menu begins with appetizers of curried quail sautéed apples and bananas, or tuna roulade with caramelized scallop mousse. Soups include lobster or red pepper bisque. Entrée are diverse and unique from grilled salmon, and roasted rack of lamb to several beef. Darcy says, “I don’t want to be like any other restaurant. Originally we had more variety on the menu, but it didn’t work. Charlotte is a steak and potato town, so we added two more steaks on the menu.” Darcy says, “I still ask the chef for the percentage of steak versus other entrees ordered on a nightly basis to make sure the mix is right for the area.”

PLAZA MIDWOOD LOCATION

Plaza Midwood was a turn of the century street care neighborhood that lies primarily north of Central Avenue near the Plaza. It was the only real town center within the city of Charlotte. In 1929 the principal businesses were Lomax and Russell (grocer), Joe Klouse (meats), Pender (grocer chain), D. C. Staton (grocer), Great A&P Tea Co. (grocer chain), R. R. Brawley (pressing club/dry cleaners), S. B. Seegers (barber), Plaza Drug Co. (drug store and soda fountain), and Stand Oil Co. (service station). Other business grew in the 30”s Cole Manufacturing Co. (seed planter factory), and Store School Supply (the current site of Swing 1000 and the start of the Miracle Mile).

The Miracle Mill was a strip of fashionable shops along Central Avenue that seemed more like a small town Main Street that an urban business center in the shadow of uptown Charlotte. Many past and present residents describe it as an urban Mayberry. However, after the war as in most parts of the country Charlotte saw suburban boom. Central Avenue was widened stealing parking spaces. New suburbs, new roads, and cheap gasoline pulled residents away from Plaza Midwood. Decline set in.

Exhibit 2: Dinner Menu

Starters

Fried Oysters **9.75**
....fried select oysters over roasted corn blinis
and serve with an Ancho chili cream fraiche
Mushroom Vol-Av Vent .... **.6.95**
....a flaky puff pastry cup filled with assorted
mushrooms bound with cream & butter
Crab Cake **12.95**
....a rich jumbo lump crab cake lightly breaded
and sauteed served with remoulade sauce
Smoker Trout Terrine **7.25**
....smoked trout with cucumbers, radishes and a
horseradish crème fraiche

Soups

Lobster Bisque **9.25**
....a lobster reduction bound with cream and
butter served with crawfish tails
Red Pepper and Tomato Bisque **8.50**
....flavored with applewood smoked bacon and
served with a roasted corm and parmesan crouton
Cashew Pork and Mushroom Soup **6.95**
....slightly sweet with hints of ginger & red pepper

Salads

Roasted Pepers with Shrimp & Pesto **8.95**
....served warm over seasonal greens with.
roasted pignolia nuts & balsamic vingar
Lardon Salad .
topped with applewood smoked baconlardons. Rouefort
Cheese and Roma tomatoes
Red Cabbage Salad **8.75**
....tossed with spinach, garlic, shallots, toasted
walnuts, bacon and balsamic vinegar

Pasta

Penne Puttanesca del Mare .... **.23.50**
....penne pasta in a spicy Neapolitan sauce with
shrimp, salmon & crayfish (as appetizer $11.95)
Pesto $ Sun-Dried Tomato Fettuccini **16.95**
....vegetarian pasta with basil pesto & sun-dried
tomatoe cream sauce (as appetizer $6.95)

Entrees

Grilled Lamb Rib Chops **28.50**
....braised in rosemary and red wine, served
with garlic cream potatoes
Filet Mignon **29.95**
....grilled beef tenderloin served with portabella
mushroom, burgundy mushroom demi glace
and garlic cream potatoes
Grilled Ribeye **26.95**
....served with brandied red onion over garlic
cream potatoes and topped with a light
peppercorn sauce
Pork Chops **24.95**
....a 12 ounce pork chop with mashed sweet
potatoes with a bourbon molasses sauce
Grilled Salmon **25.95**
.....glased with a whole grain dijon mustard served
with carmelized red onions, sun-dried tomatoes,
and a tomato beurre blanc
Gingered Seasame and Cashew Tuna **27.25**
....sashimi tuna loin encrusted with seasame seeds
and crushed cashews served with gingered
orange beurre blanc and a tomato chutney
Lump Crab Cake .... **.30.95**
....two rich jumbo lump crab cakes pan sauteed
served with a remolade sauce

Then in the late 1970"s, investors and young home buyers seeking solid inexpensive housing began to move in and fix up the neighborhood. In the 1990's thanks to a renovation plan spearheaded by the nonprofit Plaza Central Development Group and the city of Charlotte, Plaza Midwood began showing signs of prosperity. In 1995 a new library branch opened at Central and the Plaza. The city put $1 million into new sidewalks and crosswalks of brick pavers and Victorian styling street lamps.

By the late 1990's many of the houses had been renovated. There was a nucleus of architecture there, and the city hoped to build more urban-scale buildings next to the sidewalks to blend in with the influence of the past decades. The city also encouraged development that protected the area's diversity. Both the economic development committee and the city leaders felt that area's strength would come from attracting more unique, local businesses like those already there, including Nova's Bakery, Swing 1000, Fuel Pizza, and Johnson's Beer Company. High-density development following the established architecture and unique zoning of the past decades was key to the success of the area.

Plaza Midwood even with the revitalization effort continually presented challenges. It was a part of Charlotte's City within a City area. This enterprise zone had a combination of neighborhoods that range from fragile and threatened to stable. The Plaza Midwood neighborhood was classified as stable, which means that the quality of life was high compared to other neighborhoods in the area. However, it bordered several neighborhoods, which ware described by a UNC Charlotte Urban Institute study as threatened by higher crime rates, and other problems from a lack of economic development to physical decay. The city's vision is for the Plaza Midwood village to serve as a hub for all the surrounding neighborhoods: Chantilly, Elisabeth, Commonwealth-Morningside and Belmont.

Darcy lived in the Plaza Midwood neighborhood and was president of the Friends of Plaza Central. She realized that inter-city areas such as this offered a lot of opportunity if the diversity of the area could be maintained. She became part of the grass roots effort that worked for change through a close alignment with city government and real estate developers. In fact, Darcy became the pied piper of Central Avenue and the Plaza Midwood area. When she first saw the site that would become Swing 1000 she said, "the building spoke to me." To show her commitment to the area she signed a long-term lease for the site. The location of the club off the beaten path in an urban area, one mile from the city caused many eyebrows to raise questioning the viability of the business. But Darcy had a strong vision that kept her focused. She had lived in the Plaza Midwood area for 12 years and that gave her a passion and understanding of the neighborhood. She also saw urban revitalization efforts paying off in other neighborhood projects such a Dilworth and the SouthEnd. These neighborhoods emerged as significant growth areas and she felt that the time was right for the Plaza Midwood area. Darcy wanted to show people that she had confidence in Plaza Midwood and proved it by being willing to do something really innovative there. Swing 1000 proved to be an important piece of the new "town center" that worked to bring life back a number of old storefronts along Central Avenue. (See Exhibits 5-6).

PROMOTIONAL STRATEGY

Darcy utilized a variety of media to promotion the swing concept and the club. Direct mail post cards and monthly activity schedules were sent to all past customers. The club also purchased databases of potential customers using zip-code demographics matched to the clubs target market. Additional direct mail efforts were focused on uptown Charlotte businesses in an effort to promote the use of the restaurant facilities for business-to-business functions. Direct sales efforts included the bartering of services and the use of promotional tie-ins with corporations. In 1999, Darcy filmed a Christmas Show for WTVI, the local public broadcast station, that was picked up nationally by 80 cities from San Francisco to Chicago giving the club wider promotional coverage.

Publicity proved to be an effective means of getting the word out about the club. Articles in upscale publications such as *Southern Living*, and *USA Today* gave the club a national reputation before many Charlottens supported the venue. A combination of the Plaza Midwood location and the need to educate people about the concept of the supper club presented a challenge especially in the beginning. It took a real belief in the idea and some creative promotion in the early stages to make it work. The non-traditional customer including the international community, convention visitors, corporate events, weddings, and special events kept the doors open until individual Charlottens learned about and embraced the idea. Much of the excitement came through world of mouth. If a patron visited the club and experienced the atmosphere, they were hooked.

Headliner bands were used to develop a reputation for the club. Headliners did not make money on the evening on which they appeared. The number of reservations that packed the house could not cover the $5,000 to $6000 a night cost. But, the headliners got the name and quality of the club's entertainment out in to the community. Headliner bands could have sold out three times the number of seats available. In reality these bands served as an excellent marketing tool to increase name awareness. When people could not get seats for the headliner band, often they booked for evenings that were open with the house band. The reputation of the headliner band was transferred over to the club as a whole, thus increasing overall reservations. In fact, 75 percent of the clients could not believe the caliber of the bands appearing in Charlotte. For the small business owner it is hard to track benefits from promotional dollars spent. But, immediate results could be traced to booking a headliner band. Sales were immediate. It brought people to the club not only for that night but also for future bookings.

Another promotional tool that worked was advertising in specific publications to attract niche markets. Advertising in *Carolina Bride* produced immediate results that could be measured. The ads required the bride to call to the club to find information or to book the club. The number of wedding receptions increased significantly and Darcy immediately knew the ad had worked based on the number of calls she received after placing the advertisement. Arbitron ratings from sales representatives were not very helpful in measuring the success of an advertisement. As a small business owner, Darcy, preferred to have media that could be tracked more effectively through feedback such as the phone ringing and getting people in the doors. (See Exhibits 3-4).

FINANCING THE CLUB

To finance the business, Darcy believed that all she needed to do was to go to the bank and take out a loan. However, she quickly found out what the comment "Ignorance is bliss" meant. Reality set in with her first visit to the bank. In Darcy words, "Banks don't lend new start-up restaurants money." With this first lesson under her belt she set out to educate herself about how to raise capital. She attended a SCORE seminar, talked with lawyers, and began to find the people she needed to make the vision a reality. The business plan became an important resource.

Using individuals in the business community that she knew such as attorneys, accountants, and other business associates she began to approach private investors or angels with her business plan. This type of financing required the help of an attorney who understands securities laws that regulate the sale and distribution of stock. A Limited Liability Company (LLC) was created which allowed qualified people to investment from $10,000 to $50,000. These investors lent their positive reputations to the venture, helped to attract additional funds, and directly supported the business through patronage from themselves and their friends. Private investors were sought as a source of funding because of their willingness to fund small-untested business ideas. In addition they were easier to secure than venture capitalist and didn't need daily participation in the business operations. On the other hand, the investors had high expectations and wanted a substantial return on their investment.

Financing for the club included raising equity capital for renovation and obtaining a bank loan for working capital. Darcy sought out investors for an initial offering of not more than 40 percent of the outstanding shares of the company for an amount of $400,000. Investors were to receive an 8 percent return on their money. Darcy and Michael Donovon would own 56 percent of the shares for a contribution of $125,000 and sold the remaining 44 percent. The club eventually found 17 investors and raised $400,000 in equity. The location proved to be beneficial in attracting money from Bank of America's Small Business Investment Corporation (SBIC). They took an equity position in the company and purchased 10 units. She also received a loan with the help of a Small Business Administration guarantee.

A major portion of the capital was used in the renovation of the building. Construction was going to cost $1 to $1 ½ million for just the renovation of the building. Net retrofitting and renovating the building became a sizable challenge. At one point the project was $250,000 over budget. So Darcy put on a hard hat and became her own general contractor. She surrounded herself with people who wanted to help make her vision happen. She used other small business people who got into what she was doing rather that larger established contractors. She brought down the costs to $700,000 for everything. She describes the construction: "It was like a barn raising. On my 40th birthday there was a surprise party. It consisted of friends with paintbrushes in hand working to make it happen. We worked day and night.

Break-even took a year and a half. In 1999, the club made money and in 2000 started paying back the investors.

FUTURE DIRECTIONS

In three short years Darcy had lived through opening a Swing Club in the Plaza Midwood area of Charlotte. In the beginning many people including bankers, investors, members of the business community, and folks in her own neighborhood felt she was crazy to move into an area that was threatened by economic blight and physical decay. But, the rent was pretty good and she had a vision. She could see the stage area, the art deco columns, and the sheet energy coming from the walls. Her husband even questioned her choice of sites when he first saw the building, but supported her fully when he realized that she had a vision. At this point she realized the importance of having a strong family bond and having your family behind you. Many things happen some totally unexpected but Darcy's philosophy became "You just make it happen. You get knocked down and you just get up again." By working with her family she feels that she has passed onto her children the message that whatever you dream you can fulfill it if you keep on trying." Her passion for the concept, the music, and the neighborhood all came together in her vision of Swing 1000. So where does she go from here?

Alternative 1: Open a Swing Club using the same prototype in the Atlanta, GA area.

This would require Darcy to find a location in an upscale Atlanta neighborhood that would support a Swing Club. Although she had a prototype for development of the club, she would need to learn the unique characteristics of the Atlanta market. Many of the subtle nuances that she was familiar with in Charlotte from living in the neighborhood for 12 years would not be in place. She would have to build a new demographic profile and database of customers. The Atlanta market was larger. There was more competition with another Swing Club in the city. There were additional entertainment venues available as substitutes. Time away from the Charlotte club and her family were also considerations in opening the business. In addition, the issue of raising capital would have to be addressed. Should she continue to seek private investor capital or move to venture capitalist?

Alternative 2: Open a new venue such as a Retro 60"s Club called the "Big Chill" in the Uptown Charlotte area.

The uptown Charlotte area had grown significantly with the increased number of arts and sports events occurring in the city. The NASCAR, NFL and NBA have all held major uptown events thus increasing the need for new venues. However, the present Swing club was only a mile away from the uptown area raising the question, "Can Charlotte support two theme supper clubs with entertainment nightly aimed at the upper scale market?" In addition there were a number of upscale restaurants in the uptown area offering significant competition. This alternative would also have to be supported with a large capital investment that would have to be raised through angels or venture capitalist. The Retro 60's theme proposed for the new venue was untested. Did it have the staying power of the Swing revival?

SHENANIGANS TOYS AND PARTIES

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CASE DESCRIPTION

The primary subject matter of this case involves strategic management and organizational change in a small business environment. This case is appropriate for use with level three or four and is designed to be taught in one to two class hours. It is expected to require three to four hours of outside preparation.

CASE SYNOPSIS

Shenanigans Toys and Parties is a small business that specializes in unique children's books, toys, and parties for children. This case focuses on the various challenges encountered by the small business owner in running a business that faces a very competitive environment and the ability to choose the appropriate organizational structure and goals to meet those challenges. The major problem with this type of business concerns being able to continue to provide unique products and services in an industry where change is constant and beating the competition is necessary.

The initial task for the student in this case is to review the current organizational structure along with goals and strategies in place. Students can use the information provided to analyze the challenges and opportunities faced by this small business, and develop strategies for future growth.

THE BEGINNING

Kelly Kazek, owner of Shenanigans Toys and Parties, did not start as an entrepreneur. Her career began as a writer and newspaper reporter. However, because of long hours and short pay, she returned to her hometown and went to work as a technical writer. This job satisfied her financial needs, but left her missing the creativity of free-lance writing. She took a part-time position at a local newspaper writing the local teen page. This gave her an opportunity not only to write creatively, but also to work with young people, which she enjoyed very much.

Soon after beginning her new jobs, Kelly met the owner of a children's bookstore in the area, and found that she was looking for a partner. This intrigued Kelly, who decided she wanted to embark on a new adventure, that of being an owner in the Tiggywinkle's Bookstore.

After having an opportunity to evaluate her new business partnership, Kelly found that the store needed to broaden its customer base. The partners soon began offering children's parties, which involved personalizing the parties to the customer's wishes using various themes, by sending personalized invitations and thank-you cards. Though the store and the parties were successful, Kelly was aware that the store's downtown location limited customer traffic and exposure. When the other partner offered to sell her interest, Kelly accepted and subsequently moved the business within a few months to a busy, growing area nearby.

With the change in locales, Kelly decided to make several changes. She rented two units in a small shopping plaza along a busy highway. One side of the store was devoted to children's books and unique toys and the other side was reserved for parties. The new store was renamed Shenanigans Toys and Parties and has been in operation for approximately eighteen months. This case will discuss the many obstacles encountered in this type of business, various goals and strategies, as well as the organizational structure.

STRATEGY AND STRUCTURE

As a small business, the structure of Shenanigans is by nature limited and flat. Kelly Kazek, the owner, performs the manager function and has one assistant. Several part-time workers are also employed. These part-time employees are available for working parties and also other various duties. While Kelly makes the management decisions, regarding such issues as planning and inventory control, employees are encouraged to offer input and ideas. Employees are informed about plans and goals and are cross-trained to insure that all jobs can be covered at all times. An employee rewards program has been instituted, offering cash bonuses to employees for developing successful ideas to improve business.

Kelly began to think about the goals she had set for her business with her recent move. She decided that even though her business was small, she still needed a mission statement. She decided it should be, *"To offer unique toys to children, while providing a service to parents and children of a fun, personalized party, where the child is the 'star'.*" Several marketing strategies have been developed to follow this mission. The business offers specialty lines of toys that other discount and department stores do not have. As an example of unique books, books can be created from photographs and drawings of any child with special captions and stories. In creating personalized parties, provision is made for exclusive use of the party room for each group booking a party. Children may play with their friends undisturbed by other groups, which is not always the case with other businesses that allow parties. The child receives a personalized cake to carry out the theme of the party. In addition, the child who is being honored may place his or her fingerprints on the wall with their name and date underneath. A children's karaoke and use of an indoor antique carousel add to the event. In addition to birthday parties, playtime parties are also available. Finally, Shenanigans offers a Doll Hospital, where children may bring broken dolls for repair, or adopt a doll that has been donated.

A MOVING TARGET

Change has become a daily part of business for Shenanigans since the move. To keep the customers already served, flyers were sent to notify them of the change of business address. Once in the new location, new inventory was ordered and a new system was needed for tracking and monitoring sales and inventory. To conserve finances, Kelly contacted her brother, who was a software developer, and asked him to design a program to be used on the current store computer. The software was designed to track inventory pricing, stocking, sales, and employee information. The software allows new modules to be developed as needed.

In addition to books, toys, and parties, several changes have occurred in products and services offered. Shenanigans tries to take advantage of the latest fads, as well as, selling items that are made available because of children's movies and television shows, such as stuffed animals and characters. Yo-yos have become extremely popular again and are offered in a wide selection. The store also began renting movies and a module was added to the inventory system to track the movie inventory. This also allowed those who rented movies to be added to the customer database and provided a basis for a customer mailing list for special events or sales.

While inventory changes as fads come and go, the party room has grown in its number of attractions also. Shenanigans constantly needs to remain competitive. The carousel and children's karaoke, mentioned earlier were added to provide a different experience.

Another new service was made available recently when Kelly opened a booth in a local mall to sell Easter baskets and toys. This was considered by Kelly to be a rather risky venture because of the cost of overhead both for the booth and for hiring someone to oversee it. It was hoped that some profit would be made from sales, but also that the exposure would lead to new business at the present store. The booth had an area showing pictures of the store, of available parties, and offered flyers that described the experience at Shenanigans. The venture was very profitable and many new parties were booked as a result of this exposure.

GOOD NEWS, BAD NEWS

As in any small business, change can have a profound effect. The effects are immediate and can be quite damaging. However, there are several strong points for this business. One of these is that it has strong management that is not only willing to take risks, but also believes in planning to insure the future of the business. Kelly has avoided most of the problems that could have occurred. Another strong point is the feeling of camaraderie among the employees. Each employee feels involved with decision-making, which has led to a knowledge that the employees have contributed to the success of the organization. The owner has created a team that is not afraid to change. A third strong point is the use of changing technology to make running the business easier. The business has changed from writing receipts and using a cash register to an automated transaction and computer-based inventory system.

To summarize, products, services and associated strategies have changed frequently to increase the customer base and customer satisfaction. Organizational structure has changed little to this point and cultural changes have been few, but as new employees are hired, care must be taken to insure that new employees realize the importance of providing a special, unique service. While there is much good news to indicate that this business is thriving, the bad news is that because this market changes so rapidly, the owner must be constantly ready to implement change. This requires much attention to detail, to planning, and to input from employees and customers.

THE DILEMMA

Shenanigans has met the challenge of being able to change, and continues to do so as new problems occur. Several new competitors have opened in the area in the past few months. Kelly has focused on offering products and services that are not available elsewhere. Product lines continue to change, as demand requires. Shenanigans has thus far been able to change to meet the new challenges by using new strategies such as product development, market development, and innovation. As competition increases, the business must continue to remain proactive in their planning efforts to pursue new customers and markets, new products, and new services. Kelly continues to study past sales trends, observing toys with which children are currently playing, watching children's television shows for new products, and reading industry trade magazines to assist with planning.

Will this small business owner be able to meet the demands for success by developing fresh ideas and options for customers, and continue to create a service that will remain in demand and bring in repeat customers?

A THIEF AMONG US

Treba A. Marsh, Stephen F. Austin State University
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CASE DESCRIPTION

The primary subject matter of this case concerns the review of internal controls in a religious setting. This case has a difficulty level of four: appropriate for senior level. The case is designed to be taught in one class hour and is expected to require three to five hours of outside preparation by students. The case is appropriate for an auditing class or a governmental/not-for-profit class.

CASE SYNOPSIS

This case provides the opportunity to consider the story of a church and evaluate its internal controls. The church is planning to build a new sanctuary and needs to borrow $10,000,000. The church leadership has requested a review of the internal control procedures in preparation for an external audit required by the lending institution. Internal accounting controls usually present special problems for nonprofit organizations. The students are required to discuss the case environment and the need for internal controls. Additionally, the students are to present to the Oversight Committee a nontechnical overview of the essential elements of an internal accounting control system and describe the framework of a basic control system for an organization with limited accounting and financial personnel. The objectives of the case are to provide an explanation of internal controls and emphasize their importance to all organizations, including not-for-profit organizations.

BACKGROUND

Pine Grove is a typical college town. During the fall and spring semesters, the town swells to a population of 42,000, but during the college breaks, 30,000 residents slow to a more humane pace. Entertainment centers around the university and includes collegiate sports, fine arts events and sorority and fraternity activities. Additionally, Pine Grove is home to many churches including the New Faith Church. New Faith is a typical charismatic, growing Southern church in need of a new building. The church staff includes three people: Jonathan, the pastor; Thomas, the youth director; and Sarah, the secretary. These three divide church work. Jonathan, the pastor, is in charge of the church much like a CEO is in charge of a business. Thomas, the youth director, takes charge of all matters dealing with the youth group and serves as music director. Sarah, the secretary, handles everything and answers the phone. She manages the office and does the bookkeeping for the church. She writes and signs all checks and records them in the ledgers.

Jonathan, the pastor, sees the church growing at a record pace. Members are pushing for a new building, one that will seat 1,000 during church service. Jonathan is nervous about the money pledged for the new building, especially since the debt on the old building is not paid off. He is trusting, and sees good in everyone, yet lacks business sense. To compensate for his lack of business sense, he claims that he is a good judge of character and has established a faithful Financial Oversight Committee. The Financial Oversight Committee serves as his business advisors, yet Jonathan maintains final control over all financial matters.

Thomas also has a lot of control within the church. He is responsible for everything associated with the youth group, young adult group and music ministry. Therefore, he plans trips, conducts Sunday School, and co-leads worship services on Sunday mornings. Planned trips include Christian rock concerts, youth waterpark trips, the annual ski-trip, church camps and retreats. He has to work out all the details and transportation for each trip. However, collecting money for the trips is Sarah's responsibility. She helps budget the trips and collects money from the young people. She also reports on monies collected and spent for each trip. She writes the checks, signs them, collects the money, and records everything in the ledgers.

THE PROBLEM

All three staff members of New Faith have been employed by the church for 20 years. The church has no national affiliation; therefore, is not accountable to any organization other than themselves, the members, and the bank (for the last building program). As membership has increased, so too have activities, monies collected, monies spent, and daily phone calls. The number of people on the Financial Oversight Committee has also increased. Many members have young families and find it difficult to attend the Financial Oversight Committee meetings on a regular basis, yet it is an honor to be selected for the committee.

On the eve of the church's twentieth anniversary, Pastor Jonathan suddenly announced his retirement in order to open a Christian bookstore and gift shop. A search committee was formed to find a new pastor. After six months, Matthew was hired as pastor of New Faith. He was an instant success.

Immediately, differences between Jonathan and Matthew were apparent to everyone. Jonathan was charismatic, trustworthy and a generalist. Matthew, on the other hand is more business-like and deals in specifics. Some say he should be concentrating on helping New Faith grow more, and leave the business side alone. Others welcome the change. Matthew was a business major in college and naturally is interested in the financial side of the church. He began his new job at New Faith by calling regular monthly meetings of the Financial Oversight Committee and demanded that financial statements and budgets be used and discussed during each meeting. Such a thing was unheard of, and many members stated that "We have never done it that way before." When some of the financials could not be produced immediately, and the budget was more like a moving projection, he decided to re-organize. The first step was to find out the current job responsibilities of each employee and the Financial Oversight Committee.

He set up a meeting with Thomas. They discussed Thomas' job and his area of responsibility. Thomas explained the duties of his job to Matthew so he could review and observe them during the week. The week went by and Matthew appeared satisfied. Next, Matthew set up a meeting with the Oversight Committee to discuss their roles in the church. They explained to him that they were in charge of the offerings every Sunday and that they alternated every week so that someone different would count the money and prepare the financial reports. When the report was prepared, they walked the money over to the main office and put it in the safe, locked the door, turned off the light and left. They claimed to be the financial backbone of the church, and convincingly stated that the church could not do without them. They seemed to enjoy what little financial control they had. Matthew thanked them for their time and for the remainder of the week, he reviewed what he was shown. The following week, Matthew met with Sarah and asked her to show him the books and explain her responsibilities. She explained how she accounted for all the transactions and then she left him alone to review the books. He reviewed the documents and crunched a few numbers.

A few discrepancies showed up in the statements and Matthew asked Sarah how she came up with the numbers. She said she recounted the money before she made the deposit slip and recorded the amount of the deposit. She also said that it was not unusual for the Financial Oversight Committee to count the money incorrectly; most just did not seem to take it seriously, and were usually in a hurry to beat the crowd at the Sunday buffet. Most of the discrepancies were attributed to recording mistakes. Matthew went back to his office and pondered the situation. He knew about internal controls and how important they were in business. However, in a small town church, with well-trained, trustworthy employees, were they really that important? Not only that, the church could not afford to hire an outsider to keep the books.

The next month, Matthew became more concerned. Without anyone knowing, he set out to watch the activities of everyone for a week just to make sure everything was running as smoothly as it seemed. He watched Thomas plan youth activities and trips. He watched Sarah and the Oversight Committee. All seemed trustworthy. Each Sunday, after church, the Financial Oversight Committee member counted the offering money, filled out the financial report, and placed the money in the safe. The next morning, Sarah removed the money from the safe, re-counted it, and made the deposit. Discrepancies were still present. One Sunday, after the money was placed in the safe, Matthew went to the office and counted the money for himself and documented the results. He returned the money to the safe and left. The next morning, when Sarah arrived, she took out the money and deposited it in the bank. She stapled the bank receipt to the report and proceeded with her day. Around lunchtime, Matthew took out the bank receipt and noticed that the number he counted was different from the one that was deposited and was also different from the one recorded by the member of the Financial Oversight Committee. What a mess! Money is missing and fingers point to everyone with access to the safe, including Matthew.

SURVEY RESULTS

This case is based upon a real theft that occurred. To ascertain the likelihood of such a theft and the types of internal control procedures currently in place in local churches, we conducted a survey of thirty randomly chosen churches in a small rural area. (See Exhibit 1 for a copy of the survey instrument.) We received a 33% response rate from this survey. Although our survey did not reach even one-percent of the churches in America, we came up with some interesting results. Exhibit 2 shows the results of various types of internal controls used by these churches.

Some intriguing percentages are those of annual audits conducted and effective training of personnel. Fifty-percent of the churches responding do not conduct annual audits. Fifty-percent reported conducting annual audits, and thirty-percent indicated that a member of their church does the auditing. Only ten-percent of the churches reported having an independent CPA perform an audit at anytime. Fifty-percent of the churches responding do not provide effective training of personnel. It is difficult to maintain an adequate system of internal control when employees are not properly trained in procedures for processing transactions.

Our survey pointed out the need for strengthening the controls over disbursements. Thirty-percent of the churches did not have dual signatures on checks or use pre-numbered documents. In addition, thirty-percent of the churches reported that all check signers do not inspect supporting documents before signing checks. Furthermore, twenty-percent of the churches permit the pastor to count the money collected, sign checks and keep financial records.

Several internal control procedures were found to be in place in all of the responding churches. These procedures included depositing all cash in bank, keeping cash in a protective container when at church, maintaining contribution records for members, providing members with periodic notices of their contributions, marking and retaining all voided checks, marking supporting documents paid when checks are issued, obtaining approval of invoices, checking invoices for accuracy, and locking facilities when not in use. These findings may indicate that churches have improved their internal control systems due to widespread reporting of embezzlement and misappropriation of funds in religious organizations in recent years.

Out of the churches that responded, it was interesting to note that thirty-percent said they have incurred some sort of theft or fraud in their church in the last three years. Each church instituted controls to avoid these thefts from reoccurring. These controls ranged from installing a security system to installing a new internal control structure within the office. A promising sign that churches are understanding the importance of internal controls is reflected in the ninety percent reporting their use of segregation of duties. However, this should be one hundred percent if the churches want to institute a complete internal control structure.

CONCLUSION

Effective systems of internal control are important for both profit and not-for-profit organizations. Although religious organizations may believe that their members are honest and completely worthy of trust, it is difficult to ignore the numerous examples of improprieties in religious and other not-for-profit organizations that have been reported in recent years.

QUESTIONS

1. How do trust and internal controls correlate?

2. What steps can be taken to segregate duties when money is not available to hire additional personnel?

3. A profit motive is present in business entities and internal control systems help ensure accountability to shareholders. Is there a similar motive present in churches and do internal controls ensure accountability to members? What role does national affiliation play in financial matters of the church? Should members be allowed to perform audits?

4. Present the Oversight Committee with a nontechnical overview of the essential elements of an internal accounting control system.

5. List the people who had ample opportunity to take the money. Choose whom you think committed the crime.

Exhibit 1
Internal Control Questionnaire

Please answer the following questions about the internal controls within your church. You may contact others in order to obtain the answers to these questions.

Are the accounting records and the underlying internal controls audited annually? Yes No

If yes, who performs the audit?

___An independent CPA
___Person(s) within the church
___A CPA who is a member of the church
___Other

Is the pastor prohibited from counting money, signing checks, keeping financial records? Yes___ No___
Is the handling of offerings always controlled by at least two people? Yes___ No___
Is all cash deposited in the bank? Yes___ No___
Is cash kept in a safe, lock box, or similar protective container when at church? Yes___ No___
Are contribution records maintained for members? Yes___ No___
Do members receive periodic notices of their contributions? Yes___ No___
If yes, how often are notices sent?
Are at least two signatures required for all checks? Yes___ No___
Are all voided checks marked and retained? Yes___ No___
Are supporting documents marked "paid" when checks are issued? Yes___ No___
Do all check signers inspect all supporting documents before signing? Yes___ No___
Does a qualified person approve invoices for goods/services before payment is made? Yes___ No___
Are invoices checked for accuracy before being paid? Yes___ No___
Are facilities locked when not in use? Yes___ No___

What kind of internal controls do you use within your church?

___Timely preparation of documents
___Pre-numbered documents
___Segregation of duties
___Effective training of personnel
___Reconcile documents
Other:___________________________

In the last three years, has your organization experienced any kind of fraud, embezzlement, or theft?

Yes___ No___

If yes, briefly describe what happened?

Briefly discuss how you "fixed" the problem?

Exhibit 2
Percentage of Churches with Controls in Place

Control Question	Percentage
Accounting records and underlying internal controls audited annually.	50
Pastor prohibited from counting money, signing checks and keeping fin. records.	80
Handling of offerings always controlled by at least two people.	90
All cash deposited in bank.	100
Cash kept in safe, lock box or similar protective container when at church.	100
Contribution records maintained for members.	100
Members receive periodic notices of their contributions.	100
Two signatures required for all checks.	70
All voided checks are marked and retained.	100
Supporting documents marked “paid” when checks are issued.	100
All check signers inspect all supporting documents before signing.	70
A qualified person approves invoices for goods and services before payment is made.	100
Invoices checked for accuracy before being paid.	100
Facilities locked when not in use.	100
Timely preparation of documents	80
Pre-numbered documents	70
Segregation of duties	90
Effective training of personnel	50
Reconcile documents	100

A RUSSIAN INVESTMENT THAT ENDS UP IN THE COURTS NOT IN THE MONEY: THE CASE OF BLACK SEA ENERGY LTD.

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CASE DESCRIPTION

The primary subject matter of this case concerns country risk analysis. Secondary issues examined include assessing political and economic risk, incorporating risk in the investment decision process, reducing exposure to country risk and comparing the risk of different projects. The case has a difficulty level of three and is appropriate for both junior and senior level courses. It is designed to be taught in one class hour and it is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

In 1996, Black Sea Energy Ltd., a Canadian oil exploration firm, formed a joint venture with Tyumenneftegaz, a subsidiary of Tyumen Oil Co., Russia's fourth largest intergrated oil company and 90 percent owned by the Russian government. This joint venture, known as Tura Pertroleum Company, had the potential to produce large gains for both the Canadian and Russian partners. Black Sea would contribute the necessary technology and Tyumenneftegaz would contribute the infrastructure and the licenses for the oil and gas production of the Tura oilfield in western Siberia. Operationally, the investment was very successful. With Black Sea's contribution, the production of oil in the Tura field tripled. However, not only did Black Sea not earn any return on its investment but the investment is likely to be expropriated without compensation. The Russian courts have ruled in favor of Tyumenneftegaz, allowing the Russian partners to cancel the venture based on small administrative details. At the time of this writing, the case is still pending in arbitration at the Stockholm International Tribunal.

THE CASE OF BLACK SEA ENERGY LTD.

"It was early 1996 when international financier Robert Friedland, renowned for pocketing an estimated $500 million for his interest in Canada's Voise Bay giant nickel deposit, pitched a proposal to start a business in Russia's giant, but declining oil industry. 'At the time, it would be fair to say dispassionately that investing in Russia was chic' says Friedland, speaking from his private company's world headquarters in Singapore, where he oversees an intricate network of ventures in developing countries" (Cattaneo, 1998).

Robert Friedland went ahead and formed Black Sea Energy Ltd. Originally, the Canadian firm focused exclusively on the initiation, rehabilitation, exploration, and development of major oil properties in Russia, where the company's objective was to become one of the most significant foreign oil producers (CNW, 1997). To this end, Black Sea Energy Ltd. formed a joint venture, the Tura Petroleum Company, with Tyumenneftegaz, a subsidiary of Tyumen Oil Co., Russia's fourth largest integrated oil company in 1996. Since Tyumen Oil Co. was 90 percent owned by the state and 10% by the employees, Black Sea Oil negotiated the joint venture directly with the central Russian government. Each member in the joint venture agreed to contribute about USD 50 million. Black Sea Energy's contribution was to be made in the form of cash, new technology and expertise currently unavailable to Tyumenneftegaz. This new technology makes it possible to increase the production of established oilfields. The Russian partner's contribution consisted of infrastructure projects and the licenses for the oil and gas production of the Tura oilfield in western Siberia. "The deal was attractive because of the field's impressive oil reserves, its link to the Trans-Siberian pipeline..., and because of its large potential for incremental production through the use of Canadian oilfield technology" (Cattaneo, 1998).

In the last decade, Russia has been generally considered to be a risky place to invest. The major risks for foreign investments stem from frequent changes in government. These changes in government lead to frequent and unpredictable changes in laws and taxes. The commercial legal framework is not well developed and private property is not well protected. Even if laws are on the books, they are often not enforced. There is frequent disagreement on the jurisdiction for different decisions between different ministries as well as different levels of government. In legal disputes, Russian courts tend to favor local firms over foreign businesses. For these reasons, the big oil firms had no investments in Russia at the end of 1996 with only the small and independent oil firms doing business in Russia. Small Canadian firms were well placed to enter the Russian market, because of their technological depth, ability to operate in cold climates, and expertise in different geological settings. In addition to the technical expertise, Clint Hussin, the president of Black Sea Energy in 1996, had more than 10 years of experience in the oil industry in Russia. He had successfully negotiated five joint ventures for Fracmaster, the largest foreign oil producer in Russia in 1996. Therefore, the firm felt that it could be successful in Russia.

Black Sea Energy Ltd. proceeded with an initial public offering after the joint venture deal was finalized. The company raised USD 80 million by issuing 23.8 million common shares at a price of USD 3.35 per share. On June 11, 1997 the shares began trading on the Toronto Stock Exchange at CAD 4.65. By August 1998 the share price had dropped to CAD 0.12. What had happened?

Operationally, the investment was very successful. With the use of western technology provided by Black Sea Energy, production at the Tura field went from about 4000 barrels/day to nearly 12,000. Financially, there was a significant drop in oil prices in 1998, combined with high Russian taxes on oil exporting firms, which caused a poor performance of the joint venture in 1998. However the most significant problem for Black Sea Energy was political. The company will likely be expropriated of its initial investment due to political problems, namely contradictory legislation and a lack of will by the government and the courts to enforce contracts.

In 1997, Tyumen Oil Co. was privatized. Alfa Group, a Moscow based firm controlled by Alfa Bank, one of Russia's top private banks bought a controlling stake in Tyumen Oil Co. from the Russian government. In the following year, the problems began for Black Sea Engery. The new owners thought that the original deal was not fair to them. Black Sea Energy first tried to resolve the differences with joint venture partner amicably. The company was hoping to settle the dispute and potentially be able to buy out the 50% of the joint venture it did not own. However, the new owners had no intention to settle with Black Sea Energy. In May 1998, the new owners applied for the cancellation of Tura Petroleum joint venture agreement and the return of its oil exploration licenses arguing that the oil exploration license was transferred illegally to the joint venture. Black Sea Energy based its argument on the regulations by Roskomnedr, the state committee on mineral deposits. According to these regulations, the joint venture was legal. In particular, these regulations allowed the transfer of licenses to companies in which the original licensee owns no less than 50% of the stock. However, Tyumenneftegaz argued that federal laws said that an oil extraction license could only be transferred to the original licensee's legal successor and not to a joint venture with a foreign firm (Rao 1999). All courts, the Ministry of Natural Resources and the arbitration courts in Russia consistently ruled in favor of Tyumenneftegaz, even though the joint venture was originally negotiated with the Russian government. An unidentified Canadian government official commented on the situation by saying "it appears ...the Russian partners are using the pretext of small administrative details... to carry out expropriation without compensation"(Wier, 1998). Robert Friedman comments on the situation more bluntly by saying, "Suffice it to say that it's not clear what it takes to buy a judge remote areas of Siberia" (Cattaneo, 1998).

In early 1999, Black Sea had explored all legal avenues in Russia. The company now appealed to Prime Minister Primakov to intervene and also published an open letter to Leonid Roketsky, the governor of Tyumen and also the chairman of Tyumenneftegaz. None of these measures helped Black Sea Energy resolve the dispute. In June 1999, Black Sea Energy Ltd. finally brought its case to the Stockholm International Arbitration Tribunal suing Tyumenneftegaz for willful breach of numerous provisions of the Tura joint venture charter. The company is seeking an award for damages of more than $43 million caused by the breach of contract and plus an unspecified amount for future damages. At the time of this writing, the case is still pending in the courts.

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GOING ABROAD: TYSON FOODS IN MEXICO

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CASE DESCRIPTION

This case is designed for international business, international marketing, or management classes on the undergraduate or graduate level. It requires a minimum of one hour outside class time. It is suggested that the instructor specify to the students whether to concentrate on the management or marketing issues present. This case works well as a team project; 1 ½ hours of class time is necessary for discussing and de-briefing the case.

CASE SYNOPSIS

This case is Internet-based; Tyson's strategy in the Mexican market and the impact of culture are the focus. The review of annual reports and other public information indicates a successful operation, but how successful will they be in dealing with cultural issues in Mexico?

INTRODUCTION

Tyson Foods is headquartered in Springdale, AK and is the world's largest poultry company with annual sales of approximately $7.5 billion and over 70,000 employees. Tyson is a diversified and fully integrated company with 75 processing facilities in the United States and overseas. Tyson has customers in more than 40 countries. It ships product to Canada, Mexico, South America, Central America and the Caribbean, Eastern Europe, the Middle East, Africa, Asia and the Pacific Rim countries, as well as Hawaii and Puerto Rico. More than 10 percent of the company's tonnage is distributed through the International Division. Tyson has direct sales offices in Singapore, Hong Kong, Indonesia, Japan, Korea, Hawaii, and Puerto Rico. Tyson Foods also has undertaken joint ventures in Mexico, Russia, the Philippines and China. This case concerns Tyson facilities in Mexico and how culture influences the business environment. An overview of Tyson Foods Inc is given.

COMPANY/PRODUCTION INFORMATION

Divisions

The divisions of the company include the following:

Poultry	*Process 2.8 billion chickens annually, leading supplier of chicken to US military, has a 33% market share of domestic market. The only entities that produce more chicken than Tyson are Brazil and China. Leading exporter of chicken to China, Japan and Russia. Has a 41% share of the retail breaded market. About 6,500 growers are under contract with Tyson to grow chickens with annual payments of $417 million. Poultry accounts for 82% of total company sales. (Tyson Foods Processing Facilities Directory, 1999).*
Seafood	*Operate one of the largest commercial fishing and at-sea processing fleets in the North Pacific and is based out of Seattle, Washington. Also operates a fish meal plant in Shanghai, China and two imitation crab meat plants in Minnesota.*
Mexican Original	*Second-largest producer of flour and corn tortillas, taco shells, and chips in the U.S. Tyson has 4 plants in AK, NC and IN that produce the products, making them the leading supplier to Mexican restaurants all over the U.S. Produces approximately 90% of all corn and tortilla products used in Taco Bell restaurants and sells product under the Mexican Original label in grocery stores.*
Swine	*Produces nearly two million hogs annually. Is currently in a joint venture with Purina Mills, Inc. to establish a commercial feed and live swine operation in the Philippines.*
Specialty Foods	*Produces entrée dinners and high-end food products to airlines industry and upscale restaurants. Has a dominant market share of the Home-Meal Replacement market under the Mallard Foods label.*
Animal Protein	*Most profitable division in the company. Recycles by-products from plants and farms into animal feed and meal.*

History

John Tyson started the company in 1931 after taking Arkansas chickens to markets in Kansas City and Chicago. Under his leadership, it became a fully integrated company. He later became a commercial feed dealer for Ralston Purina. Tyson Feed and Hatchery was incorporated and sold baby chicks and feed and transported chickens to market. Throughout the 1950's, John Tyson's company was processing about 96,000 broilers a week.

The company changed its name to Tyson Foods, Inc. in 1971, produced 72 million broilers a year and made the *Fortune 1000.* Two more acquisitions doubled the size of the company. In 1978, Tyson started raising hogs and had its first stock split (four-for-one). By the close of the decade, Tyson was producing 234 million birds per year and was the nation's largest hog producer. In the 1980's, it entered the further-processed markets and was the only company to have its product sold in all 50 states.

In 1983, Tyson acquired Mexican Original and branched out into the corn and tortilla market. The company reached the $1 billion mark and claimed the number-one poultry-producing spot, surpassing ConAgra. In 1989, Tyson fought ConAgra for the acquisition of Holly Farms and finally won after a long drawn-out court battle. The Holly acquisition doubled the size of the company again, bringing the total number of employees to approximately 48,000 and sales to more than $2.5 billion. With this acquisition, the company gained access to the beef and pork markets by taking control of Holly's processing plants. That same year, Tyson entered into an agreement with Trasgo, a Mexico-based poultry company, to create an international partnership with Mexico and Japan called CITRA.

In 1992, Tyson diversified from its core business by acquiring a fish processing company and an imitation crab and lobster company. Tyson's latest acquisition was in January, 1998 when it acquired Hudson's 11 processing plants. (www.tyson.com)

Tyson's Culture Overview

In 1992, chicken surpassed beef in per capita consumption to make chicken the most consumed meat in the U.S. Since 1960, chicken consumption has increased an average of 1.3 pounds per capita per year. The USDA estimates that between 1997-2005, world chicken consumption will increase an average of 2.3 pounds per capita per year. (Tyson Foods Annual Report, 1999) Tyson's history of growth by acquisition and expansion plans will meet the projected demands for chicken in the US. But to continue their trend of historical growth, international sales must increase at the same pace as the domestic markets become stagnant. According to some industry analysts, Tyson is one more big acquisition away from potential deregulation by the U.S. government. (During the past decade, Tyson has acquired the number 2, 4, 6, and 7 poultry companies in the United States).

International operations of Tyson Foods Objective - To tap into the world's total meat consumption. In 1987, poultry accounted for 21%, today it accounts for 29% making poultry the second most highly consumed meat protein in the world. A combination of rising global incomes in both developed and developing nations, technological advances that lowered production costs, and changes in consumer preferences have led to the increase in world demand for poultry. (Tyson Foods Annual Report, 1999)

International forecasts. U.S. exports of poultry are expected to grow from 2.6 million metric tons in 1997 to 3.6 million metric tons by the year 2005. However, total poultry consumption outside the U.S. is estimated to be nearly 38 million metric tons in 1997. Few countries have the production conditions available in the U.S. to allow them to become large exporters of chicken and most countries do not have the capabilities to produce enough chicken domestically to satisfy consumer needs. (Tyson Foods Annual Report, 1999)

International strategies. While Tyson will continue to export products to fill needs which can not be satisfied by the domestic production of various foreign countries (such as the demand for paws in China), Tyson will establish a physical presence to satisfy the need for other products. For example, fresh chicken- not the frozen product shipped by necessity from the U.S.- is preferred in almost every market. Having production facilities in foreign markets will allow Tyson to be able to supply this product without the cost and delay in exporting.

Overseas Ventures and Facilities

Trasgo in Mexico	*Majority interest in Mexican company with 3 plants in Durango*	
Kuok Group in China	*Partnership with Chinese company to build 10 poultry complexes*	
Arctic Alaska	*Shanghai*	*China fish meal plant*

FOREIGN COUNTRY/CULTURE

Mexico's Economy

The peso collapse devastated the Mexican economy and the number of unemployed workers doubled between 1993-1995 to nearly 1.7 million. An estimated 28,000 small businesses in Mexico have been destroyed by competition with huge multinationals and their Mexican partners. Real wages in 1996 were 27% lower than in 1994 and 37% below 1980 levels. Of the 1995 working population of 33.6 million, 19% work for below the minimum wage. ("Economic Policy Institute," 1997) "Pilgrim's Pride" is the only other poultry company that has a processing facility in Mexico.

While Mexico and the U.S. are neighbors, they differ in several areas that Tyson Foods should consider in deciding whether or not to conduct business in the country (see Table 1). (CIA World Factbook, 1999)

COUNTRY/CULTURAL ADJUSTMENT

History

Tyson Foods made an arrangement with the Trasgo Company in 1989 for a minority stake in their operations, becoming in 1994 the majority owner. This venture in Mexico stresses how important the international markets are to Tyson. According to Greg Huett, the Tyson-Mexico general manager, "The opportunities for expanded sales in a foreign market with a small capital outlay is the main reason Tyson made the decision for the first time to start processing chickens in a foreign country."

Facilities

Tyson operates two processing plants and one further processing plant in Mexico. The combined production for the complex is approximately 1.5 million birds a week. The products they produce vary from par fry, IQF to cut-up. No product is shipped back into the U.S. due to USDA regulations; however, some product is shipped to Japan and Eastern countries under the Tyson label. In the U.S., the USDA regulates all meats produced by having inspectors on site. A similar program is in Mexico, but it is strictly voluntary and Tyson does participate in it.

TABLE 1
United States - Mexico Comparison

Category	**United States**	**Mexico**
Climate	Mostly temperate	Tropical
Population	268,000,000 est	100,294,036 (est. 1999)
Natural Resources	Minerals, petroleum, gas, timber	Petroleum, silver, copper, gold, lead, zinc, timber
Land Use		
Arable land	19%	12%
Permanent crops	0%	1%
Permanent pastures	25%	39%
Forests/Woodlands	30%	26%
Other	26%	22%
Age Structure		
0-14 years	22%	35%
15-64 years	65%	61%
65 years and older	16%	4%
Population Growth Rate	.89%	1.73%
Birth Rate	14.6 births/1,000 population	24.9 births/1,000 population
Death Rate	8.8 deaths/1,000 population	4.83 deaths/1,000 population
Unemployment Rate	6%	10%
Literacy		
(15+ years able to read/write)		
Total population	97%	90%
Male	97%	92%
Female	97%	87%
Telephone System	Excellent	Good
Railways	240,000 km	20,567 km
Highways	6,261,154 km	249,520 km
Airports	13,396	1,415

Management Issues

The strategy in managing the plants in Mexico was to start with a few American managers (about 10), utilize their expertise, pull out and hire nationals to run the plants. Presently, there are only a few Americans left in the country who are involved in the day-to-day operations of the business. The biggest adjustment that the American managers had to make was working with the Trasgo managers. The Trasgo managers were accustomed to accepting gratuities and "gifts" from suppliers and government officials. For example, when new machinery was bought for the plant, the managers received a payment from the manufacturer. This practice was stopped but theft and embezzlement were still rampant and a part of their business culture. Within a short period of time after the merger, two-thirds of the upper management of Trasgo were replaced. Theft continues to be one of the major problems in the plants, ranging from product being taken out of the plant to the stealing of light bulbs and doorknobs. Another issue that took some adjusting to was deadlines and starting meetings on time. The Mexican culture does not get in a hurry and rush many things. Tyson managers quickly found out that the Mexicans would agree on a deadline, but were just trying to be polite and not say no.

NAFTA Overview

The NAFTA agreement involved the imports and exports of the United States, Canada and Mexico. NAFTA will phase out 90% of all tariffs among the three countries over 10 years and eliminate remaining tariffs on politically sensitive products over 15 years. Virtually all import quotas and licensing requirements will be eliminated (US Agriculture and the NAFTA: Summary). The main opponents to NAFTA are the labor unions that believe this agreement takes jobs away from American families. According to Teamsters President Ron Carey, "We're sick and tired of trade agreements that benefit big corporations instead of working families, it's time to negotiate trade deals that put people first." (Teamsters News Release, 5/29/97) There was little or no impact on the Mexican business since the majority of supplies are bought from within the country. The only benefit Tyson received was the lower tariffs when exporting dark meat from Mexico to Japan.

Operational Differences in Mexico

In the US, chickens are grown by independent farmers who are paid by Tyson. In Mexico, that is the goal but progress is slow. Presently, only 50% of the farms are contracted with the rest grown by the company. Again, theft is one of the major problems requiring the company to install fences around the farms and maintaining a 24-hour security system. In the U.S., most plants have a thirty minute break in the morning and a thirty minute break in the afternoon for lunch. In Mexico, they took a two hour lunch and worked until around 7:00 PM. The new managers met some resistance from the Trasgo people about changing the culture and customs so they did a survey asking the employees what schedule they wanted. Ninety percent of the employees wanted the two-break schedule. The only employees who wanted to continue the "siesta breaks" were the ones who had cars and could leave the plant. As far as the progress made since the joint venture started, the overall number of employees have decreased, production has increased and profits have gone up. The differences in running the plants are relatively few. Killing a Mexican chicken is the same as killing an American one except the plants down there are less automated and finding skilled workers is more difficult.

Personnel Differences

After the joint venture with Trasgo was announced, there was an internal campaign to attract managers and supervisors to go overseas. Detailed country information was posted on the company web-site and extensive interviews were conducted to try and pick the right people. From the personnel side, Tyson did not get involved or send any personnel people to Mexico. The labor laws are so different that it made sense to use nationals. The employees earn about $6.00 a day, which is, less than an hour wages here in the states. However, those wages are competitive in that area and trying to staff the plants seems to be a universal problem. Mexico is predominantly a unionized country with over half the civilian workforce belonging to a union. The Tyson plants are non union now but are constantly fighting off union organizing attempts.

Peso Devaluation

The Mexican peso devaluation was caused, primarily, by the fiscal and monetary policies of the Mexican government followed during 1994 ("The Institute of Development Studies,"). The peso crisis doubled all imported goods used in the production process and had a major impact on the profitability on the venture. Over the long term, Tyson fared better than most foreign companies in Mexico due to the joint venture status they had at the peak of the crisis.

CONCLUSIONS

Tyson Foods expansion into Mexico has been a profitable venture and future plans to grow the operations in that area of the world are promising. According to Greg Huett, "Tyson always has its hooks in the water for a good buy" and more acquisitions in foreign markets fit their future growth strategy. One of the main things learned during Tyson's first overseas venture was to not expect sudden improvement and not try and change the culture, only the business environment.

The Challenge

The challenge is how to change the business environment to successfully operate in a different culture, how to successfully manage a business in Mexico where culture is a major problem, and how to design a successful marketing plan for the product in Mexico.

Your Assignment

Determine how Tyson should conduct business in Mexico. Discuss how culture influences business decisions (for example, nepotism, theft, bribes, authoritarian leaders, time and deadlines issues, and ‘siesta breaks.’ Develop suggestion in dealing with each cultural issue listed. Develop a marketing plan for Tyson’s product in Mexico

INTERNET STRATEGY: WAL-MART'S EVOLVING APPROACH

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CASE DESCRIPTION

The primary subject matter of this case concerns creating an effective internet strategy. Secondary issues concern the consistency of a brick and mortar strategy with an internet strategy, the nature of skills necessary for effective internet strategies, the competitive advantage that can be gained with an online presence and how creative strategic alliances can enhance the value added to consumers. The case has a difficulty level of four or five, being very relevant in a capstone marketing or strategy course or for first year graduate students exploring the impact of online retailing. The case is designed to be taught in one class and is expected to require 1 to 3 hours of outside preparation by students.

CASE SYNOPSIS

Organizations often create an online presence because they think it is the thing to do. But little thought is often given on how to maximize benefits from an Internet strategy or how to enhance the value adding potential of the company with their Internet strategy. Additionally, core competencies of traditional brick and mortar retailers may not be sufficient to capture necessary market share online. To create an effective internet strategy requires proper coordination with other strategies, along with an understanding of how the Internet can reshape the playing field companies may be used to. Proper use of collaborative strategic alliances can enhance the value added to consumers as will be demonstrated by Wal-Mart.

BRIEF HISTORY OF WAL-MART STORES, INC.

"Wal-Mart", for whom does this name not sound familiar? Wal-Mart Stores, Inc. was founded in 1945, and its main offices are located in Bentonville, Arkansas. The main business field in which Wal-Mart operates is retailing through discount stores, supermarkets, specialty department stores, and restaurants. It also provides services through its family entertainment centers. Wal-Mart currently operates 1,821 Wal-Marts, 650 Wal-Mart super centers and 433 Sam's Clubs in the United States. Internationally, the corporation has over 974 locations ("Wal-Mart's 2000 plans", 1999). Additionally, Wal-Mart employs around 825,000 people. Its annual sales reach over $137 billion annually. Wal-Mart's 2000 plans for growth represent 34 million square feet of additional retail space or an 8 percent growth in square footage. Wal-Mart is famous for being a leader in offering the lowest prices to consumers. These prices are possible because the corporation has been able to efficiently achieve a low cost competitive advantage. Since 1996, Wal-Mart has decided to compete in the electronic market by launching its web site named www.Wal-Mart.com.

PRINCIPALS AND CHARACTERISTICS OF INTERNET STRATEGY

One main phenomenon that has marked the last decade is the emergence of Internet. The Internet constitutes an effective means for communicating and exchanging information. On the other hand, brick-and-mortar retailers have used the Internet as a new distribution medium. Online retailing and shopping are gaining popularity year after year. As the numbers show, from 1995 to 1998, the Internet economy grew 175 percent (Allen, 1999). It now accounts for over $300 billion in revenue and 1.2 million jobs. This is due to the convenience that the Internet brings to the consumer. The Internet has also permitted the creation of virtual retailers, which are characterized by having only an online presence, such as Amazon.com.

One reason that drives business organizations to go online is to add value to their customers by providing them with attractive and effective web sites. On the other hand, some companies use the Internet as an effective tool for exchanging information within the organization or with strategic partners, commonly known as the use of Intranets and Extranets, respectively.

In order for an Internet strategy to be effective, it must consist of several key principals and characteristics. One retailing giant that learned the importance of having an effective Internet strategy is Wal-Mart Stores, Inc. When implementing an Internet strategy, the retailer is advised to acknowledge information concerning the competitive environment. The firm carefully observes the competitors' Web sites, how they are designed, what services are offered and what differences could potentially make them successful. Wal-Mart's first Web site lacks many essential features and was not as attractive as those of its main competitors.

Only after a company's Internet strategy has been clearly formulated, can the company begin to focus on effective implementation through the design of the given firm's Web site. The appearance of the Web site is important because it will reflect the firm's image, and may often represent the only contact the firm will have with its customers. Therefore, an attractive, functional, effective, and fast-loading site remains as key elements to a successful online presence. However early on, Wal-Mart did not clearly state its objectives and strategy concerning its decision to go online. Wal-Mart's initiative of invading the Net was more due to their "jumping on the bandwagon" instead of a rational well-planned Internet strategy.

A retailer willing to achieve a competitive advantage through its online presence has to integrate the Internet into its core functions. Accordingly, the retailer is suggested to equally allocate its resources and capabilities among its departments. Wal-Mart did not quickly master or obtain the required skills in the field of electronic retailing. Consequently, Wal-Mart has undertaken several strategic moves to overcome such weakness and integrate the Internet into its competencies.

While online retailing may be different for different organizations, there may be some common caveats to Internet retailing. Dennis (1997) has identified ten basic truths of Internet retailing in order to prosper in the face of the competition. These points are summarized in table one.

Table 1: Ten Basic Truths Of Online Retailing

The Internet shifts power from the retailer to the individual: e-tailers must try to build an agency relationship and share information with the consumer.
The Internet is a new channel of distribution. In this view, the Internet tends to separate the value-added operations from the distribution function.
E-tailers should learn how to separate the value-added functions --- such as merchandising, marketing, customer service, information management, and operations --- from the distribution.
Gross margins decrease: Huge competition existing in electronic markets stimulates the phenomenon of price deflation. Retailers must figure out how to eliminate costs from operations.
A proactive Internet strategy is a necessity: Retailers are urged to more aggressively allocate money to an Internet strategy if they do not want to loose the war.
Competition is accelerating: There are no square-footage limitations in cyberspace. Each retailer is allowed to have an infinitely large store which increases competition dramatically.
Shopping in the traditional manner will continue, but only moderate Internet success from your competitors can kill your traditional retail store profitability.
Traditional retailers must consider the impact of the Internet and its consequences on their businesses and foster an appropriate Internet strategy to embrace this new way of doing business.
Management is the key: Success lies in effective execution with fresh and entirely different management perspectives which will fit with the changes in the environment.
The Internet represents unparalleled opportunities for retailers that are swift to change their way of thinking to adapt this unique distribution channel.
Adapted from Dennis (1999)

WAL-MART'S ONLINE STRATEGY: STRENGTH OR WEAKNESS?

Wal-Mart's online strategy appears to be composed of two phases. One phase concerns Wal-Mart's first entrance into the cyberspace, and a second phase concerns Wal-Mart's upgraded online strategy.

Phase 1

Wal-Mart started its e-commerce strategy in July 1996 by becoming a dot com competitor. Its first Internet experience was not as successful as the company had anticipated. Furthermore, Wal-Mart's site has yet to contribute significantly to its revenue (Corral, 1999). The major problem faced by Wal-Mart was its Web site design. Wal-Mart's Web site appeared to be prehistoric and unaesthetic, lacking catchy colors and consumer appeal. The site also conveyed a sterile and impersonal shopping experience. In short, the site was too basic, it took a long-time to load the pages, and it did not leave a lasting impression in the users' minds.

The Wal-Mart site did not look as sophisticated as some of its e-tailer competitors such as Amazon.com. It appears as if Wal-Mart had underestimated this new distribution medium, which was the Internet. The corporation did not appear to be conscientious of the importance that e-commerce was representing or of the outstanding revenues that the Internet can generate. It seems appropriate to say that Wal-Mart started its online experience without really formulating a clear strategy. It was only concerned with having an online presence because almost every business had one, Wal-Mart did not consider it as an essential marketing tool for the future.

However, failure is the mother of success. Therefore, Wal-Mart is playing catch-up fast. Wal-Mart planned to revamp its web site by the beginning of the year 2000 and reformulate its online strategy; this is demonstrated through Wal-Mart joint ventures and key decisions for its online growth.

Phase 2

This phase characterizes Wal-Mart's willingness to reformulate its online strategy through significant alliances. Wal-Mart achieved its first alliance with Books-A-Million and Fingerhut in order to compete with Amazon.com. Amazon.com is a retailer that sells books and other products online. This virtual retailer is considered to be the closest competitor to Wal-Mart.com. By joining forces with Books-A-Million, the famous book retail chain, Wal-Mart is striking directly at Amazon.com's core competencies. Fingerhut will be responsible for processing and shipping online orders, which will allow Wal-Mart to deliver books, ordered via the Internet, to millions of Americans' doorsteps. (Vogelstein, 1999). Wal-Mart made this deal because delivering products to a multitude of customers has never been part of its competencies. The competition seems to be strong between top firms like Amazon.com and the Wal-Mart.com. For example, recent research consisting of comparing thirty items of Wal-Mart's site with thirty items of Amazon.com, has shown that Amazon is charging 28 percent more for its toys and 34 percent more for its books (Adamy, 2000).

Wal-Mart's other interesting move in its strategy was to create a stand-alone company with help from venture capital advisers, Accel Partners, forming Wal-Mart.com Inc., for online operations (Seipel, 2000). Through this initiative, Wal-Mart will be able to reduce the number of states and local governments from which it is obligated to collect sales taxes. The mission statement of Wal-Mart's Internet strategy consists of taking advantage of its existing base of customers to prove to them the advantages of shopping at Wal-Mart.com. Meanwhile, Wal-Mart will encourage new online customers, without much Internet experience, to explore the new medium (Seminerio, 2000). For example, if a customer orders a picture disk from a brick-and-mortar store, Wal-Mart will give the customer free temporary online storage and reordering capabilities.

The Wal-Mart Internet Company will be based in Palo Alto, California. This will constitute an opportunity for the company. In fact, Wal-Mart will be able to recruit employees that have the skills required for the Internet field, due to its proximity to the Silicon Valley area.

Wal-Mart has good reasons for deciding to go with a venture partner. First, Accel Partner is experienced in building leading Internet businesses, which is something Wal-Mart seems to not have experience in. In addition, Accel Partner's reputation gives them the ability to attract very high-quality people who have relevant experience in Silicon Valley.

The redesigned Wal-Mart.com was launched January 1st, 2000 and it is now offering multiple products, features and services. It offers approximately 600,000 items and expects to add a pharmacy by the end of the year ("Wal-Mart to form dot com, 2000). Among the new offerings, Wal-Mart provides online travel services by offering airfare, hotel, and rental car booking capabilities. It also provides personalized e-business applications including shopping aides, store locators and maps, log-in profiles and a customized "My Wal-Mart" site which offers wish lists, gift registries, order tracking, a profile of historical purchases, a toy finder and a gift finder. At the same time, the site displays 40 specific product categories such as apparel, shoes, domestics, bedding, toys, sporting goods, optical, jewelry, electronics, cameras and appliances, paint, hardware, automotive, house wares (Collett, 2000).

Wal-Mart is also considering drive-through pick-up stations to allow online consumers to collect their online orders immediately from their neighborhood Wal-Mart. It appears favorable to personalize the site, which can constitute competitive strength. People who shop online appreciate signs of attention coming from the retailer. Because of the absence of contact while shopping online, retailers should provide some customization. As stated earlier, Wal-Mart appears to have decided to compete and win the "cyber war".

Wal-Mart's other potentially successful joint venture is one with the largest Internet access provider, America OnLine (AOL). This alliance will permit Wal-Mart to build its strengths by providing its customers with a low-price Internet access device, with which to access its own site and the services of AOL. By penetrating the mass-market via the Internet, Wal-Mart will significantly increase its advertising and at lower costs. Due to this agreement, millions of customers will be enabled to obtain affordable and convenient Internet service, thus providing access Wal-Mart's online store (Moin, 1999).

The agreement between Wal-Mart and AOL also appears to tie in the concept of leveraging resources argued by Hamel and Prahalad (1994). This concept argued that a firm's ability to leverage its resources could create a key to its competitive advantage. Concentrating resources, accumulating resources, complementing resources, conserving resources, or recovering resources are all ways a firm can leverage its resources for a competitive advantage.

Wal-Mart seems to complement its resources with those of America OnLine. This synergy includes aspects, such as the use of cross promotion to link Wal-Mart.com through AOL software. It also includes the leverage of store traffic by using radio, television, in-stores promotions and print advertising to promote both services, and the access to new market. It will also provide local Internet access to approximately 40 percent of the markets in which Wal-Mart operates, but where Internet access is not available by dialing a local number (Troy, 2000).

By teaming up with AOL and Accel Partners, Wal-Mart is conducting an excellent e-commerce strategy. Wal-Mart is poised to make a presence on the Internet, which is more worthy of the world's largest retailer than its past efforts.

Wal-Mart has closed other deals consistent with its strategic alliance Internet strategy. Kewill Systems, which develops software for managing supply chains, also made a deal with Wal-Mart. Kewill Systems will provide Wal-Mart with a system that will allow it to track, trace and ship some of its highest value packages (Daniel, 2000). This initiative shows the willingness Wal-Mart has to provide the best customer service it can afford. It will also allow Wal-Mart to track expensive items returned by customers to a store. The Kewill system will permit expensive items to be bar-coded as they are delivered to Wal-Mart via the United States Postal Service

Another agreement is between Wal-Mart and Datacolor International. This firm is known for being a leader in color management and communications technology (Daniel, 2000). Wal-Mart chose this firm to provide the corporation, its vendors, and its suppliers with precise reproduction, analysis, manipulation, and communication of color data and images. This deal will allow Wal-Mart to offer the marketplace products with a higher level of quality at a faster pace.

CONCLUSION

Wal-Mart is willing to commit to e-commerce. For almost a decade, Wal-Mart has been the number one brick-and mortar retailer due to its lowest price strategy. Once the Internet emerged, as the new and fashionable channel of distribution, Wal-Mart decided to launch its web site. Unfortunately, its online presence was not as successful as its physical presence, and its site did not generate any contribution to its revenues. Thanks to the Wal-Mart culture of being a leader in whatever it undertakes, the corporation decided to review its Internet strategy by making several strategic alliances. By focusing on the mass population and providing them with low cost Internet access, Wal-Mart is willing to establish long-term leadership with its strategy to keep a linkage between its physical stores and its online site.

The outcome of the Wal-Mart strategy has not yet proved itself due to the short period of time that has elapsed since its last strategic move. However, its strategy seems to be consistent and future-oriented. Due to its brand name, which is clearly defined in the consumer's mind, Wal-Mart.com can revolutionize the world of online retailing. Who knows, it might happen again and Wal-Mart will become the Wal-Mart of the Internet?

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A MISUNDERSTANDING OVER PREVENTIVE MAINTENANCE

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CASE DESCRIPTION

This case describes the concerns facing a Danish firm in its partnership arrangements with a supplier in Latvia. Because of differing practices and legal environments, the Danish firm is finding that a business arrangement that initially seemed very favorable may have some unforeseen difficulties. The case is intended for an introductory undergraduate course in International Business, although it could also be used at the graduate level. The case can be read and analyzed in less than an hour, and comprehensively discussed within a one hour period.

CASE SYNOPSIS

In this case, the manager of Dansk Wood is faced with trying to understand what has gone wrong with his seemingly favorable partnership. Dansk Wood had an agreement with a Latvian sawmill whereby the Latvian's would provide a certain quantity of high quality wood in exchange for receiving state-of-the-art Western sawmill equipment. Initial results had proven to be very favorable for all parties. The Latvian's, however, found the equipment to be rather delicate and fussy, unlike the rugged Russian equipment with which they were familiar. Because of the Latvian's concerns over liability, they were not performing what Westerners would consider to be normal preventive maintenance. Thus, the quality of output was decreasing, and the equipment was potentially being damaged from operating outside of specifications. When looked at through the eyes of the Latvian's, given the local legal environment, their decisions were entirely rational. The case illustrates how local laws and customs create differences in normal operating procedures, and how these differences lead to difficulties between business partners. The case also illustrates how different systems evolve over time, and the inter-relationships between national laws, product design, operating procedures, and culture.

INTRODUCTION

Henrik Hoss tried to relax as his six foot eight inch frame was scrunched in the seat of a 30 passenger *airBaltic* turbo-prop plane on a flight from Riga, Latvia to Copenhagen, Denmark. This had not been one of his better trips to the Baltics, and the drizzly sleety April weather hadn't helped. From his vantage point in Aarhus, Denmark, everything had seemed to be going so well regarding his company's investment in equipment for a Latvian forest products company. Dansk Wood was receiving very high quality lumber from this partner, and was able to make a substantial profit on subsequent sales to furniture makers in Northern Europe. Such good fortune was unlikely to continue, however, unless something was done about how its partner was maintaining the new equipment Dansk Wood had provided.

BACKGROUND

Dansk Wood had been in the lumber business for almost 200 years. Henrik's ancestors had been farmers in the area, but had maintained some of the land as forests. During the cold winter months, logging was done to help make ends meet for the Hoss families. Most of the high quality wood harvested was sold to craftsmen and furniture makers, while the lower quality wood was sold for firewood. Henrik's grandfather had not felt the same love for farming as his father, and had changed the focus of operations towards lumber. As the business grew, Dansk Wood began to serve more as a timber broker than a producer. It purchased logs and lumber from a variety of sources, and then by carefully sorting them into grades, would supply various furniture manufacturers across Northern Germany and Denmark with wood of the precise quality, grain, and dimensions desired. Annual sales were around 40 million USD, and profits averaged around 15%.

When markets in the western part of the Soviet Union and Poland began to open in the late 1980s, Dansk Wood quickly started scouting around for new sources of high quality, inexpensive lumber. It was getting increasingly difficult to obtain wood from Danish sources, as the Green Party and environmental groups were becoming vociferous about protecting Danish woodlands. Henrik felt his company was being unfairly targeted, but there wasn't much he could do.

> *"These people enjoy sitting around a nice wood dining table at home, having wooden bookcases filled with art and literature made from paper, and printing flyers and newsletters saying the trees should be saved. On Saturdays they rally at logging sites to protest further cutting, and then stop by a pizzeria and take their dinner home in a cardboard box."*

In Eastern Europe and the Baltic rim there were no such difficulties. Dansk Wood purchasing managers would show up at sawmills with their own trucks and personnel, and pay cash for the best lumber on hand. One of the managers of a sawmill in Lithuania told the following story:

> *"It was 1993, I think, when I first heard of these crazy Danes driving around with cash in their trucks. The first time they visited my sawmill was in early 1994. They walked into one of the sheds, randomly looked through a number of the piles of wood, and asked how much I would charge for them to take the wood from that shed. It was our best shed with a new roof, and held our best wood for drying, so I named a price that was two or three times what I would have expected to get for the wood from local customers. The man shook my hand and said 'agreed.'"*

> *"Then what they did seemed just crazy. They backed up their truck, and spent two days sorting through every piece of wood by hand. Some of the best they loaded on*

> *the truck, but the rest they just left in the shed. Then they gave me the full price I asked in cash, told me I could keep the rest, and drove away with less than 30% of what had been in the shed. I just didn't understand it.*

> *"After that we started sorting some of the wood ourselves, and setting aside the best quality with the fewest knots, cracks, and checks for these Danes. Whenever they came they would still do more sorting, but they were willing to pay even higher prices since they knew we were trying to help them."*

Dansk Wood was very pleased with the lumber they were getting from the Baltics, but realized that this was an inefficient way of obtaining the high quality wood demanded by their selective furniture manufacturers. Demand for their lumber was growing, which led them to consider other approaches for securing high quality supplies.

PARTNERSHIPS OR …?

One of the limitations of many of their Baltic suppliers was the quality of their tree harvesting and sawmill equipment. Heavy, rugged, poorly maintained Russian equipment made in the late seventies and early eighties was most common. It often leaked oil, and sawmills would usually be out of alignment. The sawmills did not have the capital to invest in new equipment, and obtaining bank loans would be difficult to impossible. Since the sawmills were primarily familiar with domestic markets that did not place such emphasis on quality, they also did not have an appreciation for how better equipment could contribute to better lumber for which they would receive higher prices.

Dansk Wood entered into discussions with several of its largest suppliers about providing them new state of the art machinery in exchange for a negotiated quantity of high quality lumber over a five year period. More sophisticated cutting, hauling, and sawing equipment would decrease the damage done to the wood, and could significantly increase the proportion of a mill's output that would be suitable for furniture manufacturers. The remainder could still be sold locally for construction work, where defects were not so critical.

The first feller-grappler for mechanized tree harvesting, and a computer controlled sawmill for cutting the lumber, were installed in a Latvian company in the Summer of 1996. Technicians from the Finnish sawmill manufacturer worked with the Latvian company throughout September, and by October markedly improved lumber was arriving at Dansk Wood's warehouse in Aarhus. During the winter no one from Dansk Wood was particularly inclined to visit Latvia and drive on the poorly maintained roads. And since the lumber being shipped was of good quality, there was no compelling reason for a visit. In March one of the purchasing managers went to Lithuania to discuss a similar partnership agreement with a regular supplier, and decided to stop by the Latvian site. What he saw disturbed him. Two weeks later Henrik boarded an *airBaltic* flight to discuss the situation that the purchasing manager had reported.

WHAT IS "PREVENTIVE MAINTENANCE?"

Henrik's arrival at the sawmill was unannounced, but Uldis Prabeks, the Latvian manager, did not appear much concerned. He talked about how the winter cutting had been going, and how nice the new equipment looked. He remarked, however, that it seemed to be rather delicate and fussy equipment compared to the Russian versions, and not nearly as rugged and durable. After a tour they returned back to the office, and Henrik commented that it did not appear that much preventive maintenance was being done on the equipment. Performing preventive maintenance was important, Henrik commented. Uldis looked puzzled. He did not know what this term meant. Henrik proceeded with a long explanation, with Uldis interrupting at various times to ask for clarification on specific points. After he had finished, Henrik asked, "Now do you understand what is meant by 'preventive maintenance'?"

"Yes," Uldis replied, "but why would I want to do such a thing. If equipment is well made, this 'preventive maintenance' just seems like a waste of time and money. Besides, doesn't it void the certification to take such actions?" Now it was Henrik who was puzzled.

Uldis went on to explain that he worked in a very dangerous industry, and many workers would get hurt each year from accidents in the forest. This was not something to be proud of, but just a fact of life. Previously when he purchased a saw from a Russian supplier, for example, it would come with a document stating that it had a certified life of 10 years. During that time if a worker was injured while using the equipment, neither his company nor the manufacturer would be liable. These things just happen, or perhaps the worker was careless. Normal state social programs would take care of the injured or disabled workers under these circumstances. If, however, Uldis allowed equipment to be used after the 10 year certified life, the legal consequences changed dramatically. A worker injured when using a machine past its certified life, even if the machine was operating correctly and the worker was in error, could hold the company liable for any injuries. It was just not considered safe or responsible to have equipment operated beyond its certified life. These laws helped to protect workers from managers who might otherwise have them using worn out and dangerous equipment.

If a piece of equipment were to break or require repair before the certified life was up, a representative from the manufacturer would have to repair it. Many times the equipment was just sent back to the factory for a complete overhaul, whereby it would receive a new certification for another 8 to 10 years. If Uldis' company were to attempt to make repairs, it would invalidate the certification and expose the company to liability. In an inherently dangerous occupation, having only certified equipment that is repaired and adjusted by factory personnel was prudent.

When this was explained, Uldis' perspective on maintenance made perfect sense. The reason the old Russian equipment was poorly maintained was because repairing worn parts would void the certification. In addition, investment in such parts would make little sense if the equipment was nearing the end of its certified life. Because of these laws, Russian equipment tended to be very rugged and durable, but could not be easily adjusted or calibrated by operators. If Henrik regularly worked under the laws and norms faced by Uldis, he would do the same thing. He would also only select very rugged and durable equipment that required little maintenance.

What to do about "his" equipment was unclear, but he felt confident that a mutually agreeable arrangement could be made. The legal issues in this situation could be worked out, and one way or another they could arrange to have "certified" technicians regularly service and maintain the equipment. This might involve sending a local employee to a certification class, or perhaps some individual who was already certified to service other logging equipment could be certified to regularly service the sawmill equipment at the Latvian plant. These would raise the costs from what had been projected, but given the large profits available for transferring Latvian hardwoods to Western European furniture makers, there was plenty of room for some additional expenses while maintaining overall profitability.

WHAT NEXT?

Henrik squirmed around in his seat to find a comfortable position. He sure hoped that Danish standards for preventive maintenance were practiced by *airBaltic*. Flying a Danish airline suddenly seemed like a good idea. He realized the root of the specific "preventive maintenance" problem lay in complex inter-relationships between the legal environment, the social welfare system, the culture, and the impact of these factors on how equipment was manufactured and maintained.

It bothered him that this operations problem was not anticipated. The worst part, however, was that he was not sure how he could have learned about the potential problem in advance. Was there any research that could have been done that would have forewarned him about "environmental" differences – socio-cultural, political, economic, legal etc. If Dansk had just done some more research, could this problem have been prevented? Since they were considering relationships with other sawmills in Latvia, Estonia, and Lithuania, would additional research be helpful?

Henrik pondered whether there was a different way to structure future relationships. Simply purchasing pre-cut lumber and exporting it had been profitable, but inefficient. To become more efficient, Henrik had decided to adopt a different mode of operations.

By structuring the arrangement with the Latvian mill purely as a swap of equipment for future production, Dansk Wood had placed itself in a situation where it was not monitoring how the equipment was being used. This situation also meant that Dansk Wood had no reason to be in regular contact Uldis and the mill employees. While this arrangement had been rational, it hadn't worked - unless they did something the equipment would be ruined and they would not have the lumber they anticipated. Perhaps if he had more fully considered other alternatives, he might have selected a different approach – one which would have given Dansk a better ability to manage "their" overseas operations. Henrik wondered if they would have been better off to have taken an equity stake, or made an outright purchase of an existing firm, or come up with some different contractual arrangement to assure good supplies of lumber from the Baltic market. He wanted to enter some sort of relationship with other sawmills before Western competitors recognized the same opportunity, but needed to consider the advantages and disadvantages of other options. A fuller understanding of the environment, and the impact on operations of different modes of entry and contracting would help him in evaluating the alternatives

RATE OF RETURN FOR MUNICIPAL ENTERPRISE FUNDS: THE CASE OF ROCK HILL, SC

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CASE DESCRIPTION

The primary subject matter of this case is the application of accounting management control principles to the enterprise fund of a municipality. The case permits discussion of the types of funds used by state and local government and, fund transfers. The decisions faced by the municipality involve the financial viability of programs, choosing among alternative courses of actions, and pricing.

CASE SYNOPSIS

The municipality of Rock Hill, South Carolina provides electricity, water, and sewer services. These activities are accounted for through an enterprise fund. Historically, the electrical system provided sufficient revenues to offset shortfalls in water and sewer services and still provide a sizable transfer to the general fund. With the movement toward deregulation of electricity the city moved to reduce its reliance on the annual transfer from the electric utility.

A rate of return policy was adopted to provide guidance as to the appropriate transfer policy for the city utilities. The goal is for each entity to meet the cost to provide service. This would include a transfer to the general fund based upon three components. First, each utility should transfer the equivalent of a franchise fee that private utility providers pay. This fee is currently 3% of gross revenues. The second component is based on the gross fixed assets of the system within the corporate boundaries. Multiplying these assets by the appropriate assessment ratio and the citywide tax rate generates a payment in lieu of taxes. Finally, the city has a budget goal of 3% of gross revenues as return on the investment in the utilities.

At the end of 1999 the City must consider the appropriate actions to take going forward. The enterprise fund is projected to end 1999 with a transfer of $3,760, 427. This is above the full cost to serve projection of $2,782,237. However, each system is not meeting cost to serve. The electric system generated $3,437,232 above the full cost to serve, while the sewer system fell $2,087, 487 short of cost to serve.

The City Council must now set some priorities for its year 2000 budget. In particular it must determine whether each system should move toward a full cost to serve basis and if so how quickly to bring about that change. The electric system still subsidizes the other utilities as well as the general fund. Should this practice be continued as long as possible?

MUNICIPAL SERVICES AND ENTERPRISE FUNDS

Local Governments often undertake the delivery of utility services through the operation of publicly owned utilities within the framework of an enterprise fund. Among the most common type of enterprise is the municipally owned electric company. Other common utilities provided include water and sewer services. The revenues, expenditures, and debt associated with owning and operating these enterprises pose a significant public finance concern for municipalities. The activities of a municipality that are intended to operate in a manner similar to a private business are accounted for in a separate fund known as an "enterprise fund." It is the intent of this separate fund to permit the treatment and operation of publicly owned enterprises to obtain accounting information similar to that available for their private counterparts.

For a municipal utility, surplus revenues can be transferred from the enterprise fund to the general fund to subsidize other operations. The extent to which the municipality is free to generate profits and transfer them to other uses will vary depending on the state regulatory environment. In South Carolina, municipal utility rates are not governed by statewide regulatory rules. Municipalities can set and change rates without regard for the regulatory bodies governing investor owned utilities. Unfortunately, this encourages the practice of adopting transfer policies to be heavily influenced by political concerns, rather than the underlying foundations of economics and governmental accounting.

One alternative that provides discipline for local government is the adoption of a policy determining the level of transfers. If a private utility were operating within the City limits, it would be required to pay franchise fees and taxes. In addition, the utility owners would have earned a rate of return on their investment. Rate of return policies when adopted would typically claim to base rates and generate transfers to achieve a fair rate of return. This case highlights the rate of return and transfer policies adopted in Rock Hill, SC. The diverse pressures facing the city operated electric, water, and sewer systems provide insight into the managerial accounting issues for municipalities.

When a governmental unit engages in activities that sell services to the general public, the unit reports on such activities with a “proprietary fund type,” specifically an enterprise fund. As the name suggests, this type of fund or activity is accounted for in the same manner as a privately owned business. Such funds use full accrual accounting and account for all assets, current and long lived, used in the generation of the revenue of the fund. The standard setting body for governmental accounting in the United States is the Governmental Accounting Standards Board (GASB). This board’s statement on enterprise fund accounting can be summarized simply: “In order to take advantage of the work done by regulatory agencies and trade associations to develop useful accounting information systems for investor owned enterprises, it is recommended that governmentally owned enterprises use the accounting structures developed for investor-owned enterprises of the same nature.” [2, Statement No. 20]

Investor owned utilities are normally regulated by the states in which they operate. The rates for charges for services are approved by the individual state’s regulatory agency. The normal process is for the regulatory agency to allow charges that will provide a given rate of return on the utility’s investment. The approach to the analysis is to compare the income for a certain period, six months to a year, prior to the rate setting hearing with the costs of the property used and to be used within a reasonable time. Usually adjustment are made to the reported income for interest, or rate of return, on equity; for refunds to consumers as a result of rate hearings; the cost of legislative-advocacy expenses; business gifts and some entertainment expenses; and other expenses that such regulatory agencies determine not to have been prudently incurred or not incurred in the interest of the public. Additionally, the utility investment amount used in the analysis, the rate base, will not include the carrying value of property donated to the utility, and depreciation expenses on such property will not be include in the allowable expenses.

MUNICIPALLY OWNED ELECTRIC COMPANIES IN SOUTH CAROLINA

The process of electricity provision involves generation, transmission, and distribution. The most visible portion of this process is the end stage of electric distribution. However, if a municipality is going to provide electric distribution, they must have a power generation provider. Many municipalities have formed joint power agencies to own or control the generation of electricity. Public power agencies permit collaboration among municipalities to own electrical generation capacity. In South Carolina, Piedmont Municipal Power Agency (PMPA) is the co-owner of Catawba Nuclear Power Plant #2. This provides nuclear power generation for the eight municipal distribution systems. By becoming part owner of a generation facility, these municipalities seek gains from vertical integration. Unfortunately, they also must accept the liabilities of becoming the ultimate risk holders for the nuclear facility.

One of the advantages to the city of operating the municipal electric utility is the potential for cross subsidization between electric customers and the tax base. In South Carolina the rate setting authority for a municipal utility rests with the city council. No further rate setting oversight is required, as is the case in some other states. Consequently, the electric utility is seen as an alternate revenue source to pay for city services. This raises the potential for the city to behave as an unregulated monopoly and to extract the maximum revenues from utility operations.

The availability of alternate revenues from utilities has been a stable source of revenues. Unfortunately for the municipalities, even though they currently operate within a protected geography, they do not operate within a complete vacuum. The Energy Policy Act of 1992 encouraged open transmission of electricity. This creates the potential for retail wheeling. Under retail wheeling customers are permitted to bypass the local utility and purchase power from a cheaper source. The potential is for the same type of competition now present in the long distance business.

Legislation has already been introduced in South Carolina addressing the deregulation of the electric utilities. The proponents of deregulation advocate immediate competition for the investor owned utilities. As the bill is written the municipals would remain protected initially, but each city would have the ability to opt into the competitive market.

This poses a couple of political controversies. First, if lower electric rates will be extended to some constituents, how will legislators explain to voters in these high cost cities why they are not also permitted to reap the advantages of competition? Second, how will each city decide whether to adopt an open market approach?

One danger from a rapid move toward deregulation is that the current fabric of subsidizations will not be thoroughly understood. Consequently, the legislator will act without fully understanding the nature of the market distortions the change will unveil. Subsidization occurs between some municipal general funds and their enterprise funds. Since they do not operate on a rate of return basis, they are vulnerable to financial strains from rapid market changes. Furthermore, there are potential subsidizations between rate classes. Not all rate structures favor the same constituencies. This may result in a subsidy for industrial customers in one city and a subsidy for residential customers in another. Politicians cannot be completely sure which constituencies may gain or lose from the regulatory shift.

The prospect of open competition for retail customers is a serious threat for these utilities. Investor owned utilities have been governed by rate of return regulation and have lower rates than the municipal systems. In addition, they produce power from a variety of sources and are not completely dependent on nuclear energy.

Table 1: Retail Rate by Class of Customer

Participant	Industrial	Residential	Commercial
Rock Hill	$6.32	$8.51	$7.98
Easley	6.39	7.27	6.39
Newberry	5.57	7.32	6.61
Gaffney	5.88	7.51	7.43
Union	5.27	6.74	6.74
Greer	5.86	6.78	8.11
Clinton	6.21	5.59	8.57
Laurens	7.31	7.97	7.31
SC Average	3.59	7.08	5.86

Source: Moody’s Public Finance, 1994

The first stages of competition are already creeping into public awareness in advance of any legislative action. At least one independent marketing company is running ads for retail customers targeted at the member utilities. The company states the intent to use the list of customers that sign up for lower rates to pressure the legislators into rapidly including all retail customers in deregulation. In Greer, South Carolina, court cases are determining the extent to which BMW and their suppliers can skirt the geographic boundaries of PMPA. Even in advance of deregulation, the PMPA cities are under pressure to lower their rates and limit their dependence on utility revenue transfers.

RATE OF RETURN AND COST TO SERVE POLICIES FOR ROCK HILL

The City of Rock Hill adopted a first step toward a municipal rate of return policy in December 1995. The resolution established a guideline for reducing the operating transfers from the utility to a level associated with what is called a rate of return policy. Operating transfers are to reflect a franchise fee at the same rate an investor owned utility would pay, a payment in lieu of property taxes, and a "rate of return" calculated as three percent of gross utility revenues.

Rate setting will continue by the same political process used in the past. The implementation of this policy is to be delayed until general fund transfers fall to match this level. The transfer reduction is scheduled to take place at two percent per year. Unfortunately, the reduction in transfers is not expected to permit a reduction in utility rates. The cost of purchased power is projected to increase at a 2.5% rate as the nuclear facility begins to retire $1.3 billion in long-term debt. The rate of return policy provides some insulation for the city budget, but it does not improve the competitiveness of the local utility.

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Requirements:

1. Is “3% of gross revenues” a reasonable calculation of rate of return on investment? Is this the manner in which a state regulatory agency would approach the calculation for the purpose of rate setting?

2. Look at the CAFR for the City of Rock Hill: (http://www.ci.rock-hill.sc.us/) and examine the general-purpose financial statement of the enterprise fund. Can you evaluate the financial statements for the activities of electric, water, and sewer services?

3. What are some of the consequences to the citizens of Rock Hill for the possible cross subsidization between electric customers and the tax base? What are some of the consequences for the commercial electric customers?

4. What personal income tax benefits could accrue to the individual citizens of Rock Hill if the electric rates were comparable with regulated electric utilities and property tax rates were raised to the levels to cover the costs of government?

5. What are the alternatives available to the City of Rock Hill to prepare for the inevitability of competition in delivering electricity to the consumers in Rock Hill? What do you suggest?

R. DAVID THOMAS AND WENDY'S: CLASSIC ENTREPRENEURSHIP

Richard Robinson, University of South Carolina
Peter Davis, University of Memphis

CASE DESCRIPTION

The primary subject matter of this case is entrepreneurship. Secondary issues examined in the case are classic strategic management issues. It incorporates the vision, its evolution, the history, marketing strategy, franchising, finances and future aspirations of the founder, Dave Thomas.

This case has a difficulty level of four and is best utilized in a senior level Entrepreneurship and/or Strategic Management Course. Depending upon the depth of the analysis, the case can be taught in three to six hours and requires a preparation time of three to six hours.

CASE SYNOPSIS

The case reiterates Wendy's history and examines it choices for the future including Internationalization, reorganization and expansion. It is an in-depth examination of the company.

Wendy's International grew from one store to over 1,800 company-owned and franchised outlets in ten short years. Between 1974 and 1979, Wendy's growth was explosive with sales, including company-owned and franchised units, growing 4,200 percent ($24 million to $1 billion). Net income increased 2,091 percent in this period from $1.1 million to $23 million. Earnings per share made substantial gains from $.12 in 1974 to $1.54 in 1979, a 1,283 percent rise. Wendy's grew to a position of being the third-largest fast-food hamburger restaurant chain in the United States, ranking behind Burger King and McDonald's, the leading U.S. hamburger chain.

Wendy's entry and amazing growth in the hamburger segment of the fast-food industry shocked the industry and forced competitors within it to realize that their market positions are potentially vulnerable. Wendy's flourished in the face of adversities plaguing the industry. Throughout the 1970's, experts said the fast-food industry was rapidly maturing. Analysts for the Wall Street Journal, citing a "competitively saturated fast-food hamburger industry," predicted in the early 1970s, that the Wendy's venture would not succeed. As they saw it, market saturation. rising commodity prices, fuel costs, and labor costs were already plaguing the fast-food industry.

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Clearly unconcerned about such commentary, R. David Thomas pushed Wendy's relentlessly. It opened an average of one restaurant every two days during its first ten years, becoming the first restaurant chain in history to top $1 billion in sales in its first 10 years.

HISTORY

R. David Thomas had an idea. He knew Americans love hamburgers. If he could develop a hamburger better than those currently offered, he believed he could use it to establish a leadership position in the competitive fast-food hamburger market. A high school dropout that found success as an Army cook, R. David Thomas loved to cook fresh hamburgers. But he detoured into chicken after the Army, where one of his early jobs was helping Mr. Harland Sanders selling chicken recipes and utensils to restaurants in the southeast. Not long after teaming with Kentucky's John Y. Brown, Mr. Sanders became "Colonel Sanders" and KFC was born. Thomas returned to Columbus, Ohio, where he became a successful KFC franchisee in the 1960s.

In November 1969, Thomas, by now an experienced restaurant operator and veteran Kentucky Fried Chicken franchisee, began to put his idea into reality when he opened Wendy's first unit in downtown Columbus, Ohio. A year later, in November 1970, Wendy's opened its second unit in Columbus, this one with a drive-through pickup window. In August 1972, Wendy's sold L. S. Hartzog the franchise for the Indianapolis, Indiana, market, kicking off Wendy's rapid expansion into the chain hamburger business. Later the same year, Wendy's Management Institute was formed to develop management skills in managers, supervisors, area directors, and franchise owners. After five years, company revenues exceeded $13 million with net income in excess of $1 million. Sales for both company-owned and franchised units topped $24 million for the same period. In June 1975, the 100th Wendy's opened in Louisville, Kentucky. Three months later, Wendy's went public. December 1976 saw Wendy's 500th open in Toronto, Canada. In 1977, Wendy's went national with its first network television commercial, making it the first restaurant chain with less than 1,000 units to mount a national advertising campaign. Eleven months later, Wendy's broke yet another record by opening its 1,000th restaurant in Springfield, Tennessee, within 100 months of opening the first Wendy's in Columbus. In 1971, Wendy's signed franchise agreements for eight European countries and opened the first European restaurant, company-owned, in Munich, West Germany. Also 1974 saw test marketing of a limited breakfast menu, a children's menu, and salad bars.

THOMAS' VISION OF A PROFITABLE OPPORTUNITY: THE WENDY'S CONCEPT

The Menu

Thomas knew from experience that a limited menu could be a key factor contributing to Wendy's success. The idea was to concentrate on doing only a few things, but to do them better than anyone else. As a result, the aim was to provide the customer with a “Cadillac” hamburger that could be custom-made to meet individual preferences.

The basic menu item was the quarter-pound hamburger made of only fresh, 100 percent hamburger meat converted into patties daily. This kept Wendy's out of head-on competition with McDonald's and Burger King's 1/10th pound hamburger. If people desired a bigger hamburger, they could order a double (two patties on a bun) or a triple (three patties on a bun). Besides having one basic menu item, the hamburger, Wendy's also decided to differentiate itself by changing its burger's design. Instead of the traditional round patty found in competing fast-food outlets, Wendy's patty was square and sized so its edges would stick out over the edge of the round bun. The unique design alleviated the frequent complaint by most people that they were eating a bread-burger. It also made more efficient use of refrigeration space, saving store operators money in the process. Other, menu decisions included the following:

< To offer different condiments to the customers: cheese, tomato, catsup, onion, lettuce, mustard, mayonnaise, and relish.

< To provide a unique dairy product: the frosty, a cross between chocolate and vanilla flavors that borders between soft ice cream and a thick milk shake.

< To serve a product that was unique in the fast-food market: chili.

< To sell french fries because the public expected a hamburger outlet to offer them.

Chili was an unusually clever menu item. First, it was an adult-oriented item not found on other fast food menus. So an adult could have a hamburger one day and return for something different, chili, the next. Secondly, chili was made over night, a slow cooking process, using the cooked hamburger meat that was not sold during the day and would otherwise be thrown out or sold to hog farmers. Since meat costs were the largest single part of Wendy's (or any chain's) cost of goods sold, using otherwise wasted meat in chili to generate additional revenue provided a "double whammy": reduced costs and increased revenue. All fast-food restaurants face a sizable problem with wasted food: burgers in heated racks not sold within 10-15 minutes are typically thrown out or sold at a minimal charge to local hog farmers. And, since most hamburger chains use pre-cooked, frozen, round hamburger patties, they cannot recycle it into chili like Wendy's which uses larger patties of fresh meat cooked on site. The bottom-line, then is that Wendy's chili created a strategic cost advantage/margin-increasing advantage in addition to adding a unique, adult-oriented product that other competitors could not easily add without disrupting their current operations and concept.

Facilities

Under Thomas' direction, the exterior style and interior decor of all Wendy's restaurants conformed to company specifications. The typical outlet was a freestanding one-story brick building constructed on a 25,000 square-foot site that provided parking for 35 to 45 cars. There were some downtown storefront-type restaurants, which generally adhered to the standard red, yellow, and white decor and design. Most of the freestanding restaurants contained 2,100 square feet, had a cooking area, dining room capacity for 92 persons, and a pickup window for drive-in service. The interior decor featured table tops printed with reproductions of 19th century advertising, Tiffany-styled lamps, bentwood chairs, colorful beads, and carpeting.

Generally, the strategy was to build a functionally modern building that would reflect the old fashioned theme. Another plus for the building design was its flexibility. With only minor changes, they could sell almost any type of food in the building. It would also he possible to change from the Gay 90s theme to another theme in just a matter of days. But the setting was to be a bit upscale and adult-oriented among fast food outlets.

The most unique feature in the building's design was the addition of the pickup window, and Wendy's was the first major restaurant chain to successfully implement the use of one. Here, Wendy's was able to gain an advantage because their units could be smaller and at the same time handle the larger amount of business volume generated by using the pickup window. The logic for implementing the use of the pickup window was that people in their cars don't fill up tables or take up a parking space. The result showed that on a square-foot basis, Wendy's units did more business than any other chain.

The building design also contributed to what Michael J. Esposito, an investments analyst for Oppenheimer & Company, has called the most impressive part of the company s operation: the delivery system. In a report recommending Wendy's as an investment, Esposito wrote:

> *In our judgment. the transaction time (time elapsed from when order is placed to its delivery to the customer) is the lowest in the industry, generally averaging about one minute. Utilizing a grill system where a constant flow of hamburgers is cooked at a relatively low temperature, a worker takes the hamburger off the grill, places it on a bun, adds the condiments ordered by the customer, assembles and wraps the sandwich. Another crew member supplies chili, french fries, beverage, and a frosty dessert, and another reviews the order and releases it to the customer.*

The Marketing Strategy

In their book, The Chain-Restaurant Industry, Earl Sasser and Daryl Wycoff stated:

> *The Wendy's strategy was described by one analyst as "selling better hamburgers than McDonald's or Burger King at a cheaper price per ounce." As he commented, it takes no more labor to prepare a large hamburger at a higher price.*

To support the higher-priced hamburger, Wendy's marketing strategy has been to stress the freshness and quality of their product. The objective of this strategy is to target Wendy's for the world's fastest-growing market segment. By offering a freshly ground, made-to-order hamburger as well as stylish, comfortable decor, Wendy's was aiming squarely at a key segment of the population: young adults with a taste for better food. With the post-World War II babies reaching their 20s and 30s, those young adults have been expanding faster than any other age group. As a result, it is thought that Wendy's success is coming not so much at the expense of the other burger chains but from having selected a special niche in the otherwise crowded market. Most agree that Wendy's basically expanded the market, and statistics from customer surveys bear out the claim. Fully 82 percent of all Wendy's business comes from customers over 25, an unusually old market for any fast-food chain. By contrast, McDonald's generated 35 percent of its revenues from youngsters under 19.

Wendy's advertising efforts have emphasized nationwide television advertising to attract this young adult market. Since 1974, Wendy's "Hot 'n' Juicy" advertising theme has been central to this effort. In the late 1970s, with its position established, Wendy's national advertising started focusing on new market segments like dinner after 4 p.m. after family meals on weekends. For some, this theme has sparked considerable attention, particularly a negative reaction to the word "ain't" and the phrase's double negative. An article in *The Wall Street Journal* (July 8, 1980, p. 29) offered another explanation: "Wendy's ads showed diners biting into its hot and juicy hamburgers and then mopping juice from their chins. But some people thought the image projected by the ad was hot and greasy. Many franchises quit advertising, in effect voting no confidence in the company's marketing plan."

Wendy's early “Where's the beef” campaign became an advertising classic which forever distinguished Wendy's from the "bread burger." Since the 1980s, R. David Thomas [Dave] has increasingly been a key, cost-effective figure in Wendy's advertising.

Franchising

In 1972, Wendy’s management made the decision to become a national chain as quickly as possible which meant growing through franchising. The franchises were awarded on an area basis, rather than single-store franchises. While McDonald's awarded franchises on a site-by-site basis, Wendy's sold whole states or large areas as franchise territories. As a result, Wendy's 10 largest franchise owners operated a total of 406 restaurants by 1979. The franchise agreements were among the most straightforward in the restaurant industry and are deliberately designed to establish a fair business relationship. They specify the number of units to be opened within a certain time frame, the area to be developed, a technical assistance fee, and a royalty of 4 percent of gross sales. They also stipulate that 4 percent of gross sales be spent for local and national advertising. Wendy’s operated no commissaries and sold no food, fixtures, or supplies to franchise owners.

To support their growing network of franchised restaurants. Wendy's franchise operations department maintained a staff of 50 franchise area supervisors who are the company's operations advisors to the franchise owners. They are charged with ensuring that Wendy's quality standards are met throughout the entire franchise network.

Wendy's also provided the following services to their franchisees:

< Site approval procedures for locations.
< On-site inspection and evaluation by staff representative.
< Counseling in business planning.
< Drawings and specifications for buildings.
< Training for franchisees at Wendy's headquarters.
< Advice on supplies from suppliers selected by Wendy's and assistance in establishing quality control standards and procedures for supplies.
< Staff representatives to help in the opening of each restaurant.
< Assistance in planning opening promotion and continuing advertising, public relations and promotion.
< Operations manual with information necessary to operate a Wendy's restaurant.
< Research and development in production and methods of operations.
< Information on policies, developments, and activities by means of bulletins, brochures, reports, and visits of Wendy's representatives.
< Paper-goods standards.
< National and regional meetings.

The criteria used by Wendy's for franchise selection is basically simple but strictly adhered to. They look for good proven business ability. The applicant must demonstrate that he or she is interested in making profits and does not mind getting involved. Wendy's did not make their profits by selling goods and services to their franchisees. Their income came from the restaurants' sales volume. Therefore, the franchisee must be able to build sales. While well-known national franchises (e.g. McDonalds, Holiday Inns) discouraged or prohibited franchises owning competing brands (e.g., if McDonalds, then no KFC; if Holiday Inns, then no Days Inn), R. David Thomas rejected these industry norms. He reasoned, to create rapid growth via franchising, that he should choose the most experienced restaurant chain builders that he could. He wanted them to have good local supplier contacts, a strong financial capability, ideally to have access to good restaurant operating people, and to understand how franchising worked--the role of franchisor and franchisee, the importance of national advertising, the dependence of each franchise location on another to build and maintain a quality image. Thomas' answer: seek Wendy's franchises among proven, successful builders of other food franchises (e.g., KFC franchises). As his new "entrepreneurial team" in any given territory, they brought restaurant expertise, local area expertise and a capacity to understand the many strengths of Thomas' Wendy's concept if it was developed quickly.

Wendy's operates company-owned restaurants in 26 markets around the following cities:

Wendy’s Company-Owned Restaurants in 26 Markets			
Columbus. Ohio	33	Indianapolis, Indiana	15
Cincinnati, Ohio	20	Dallas/Ft. Worth. Texas	26
Dayton, Ohio	26	Houston, Texas	25
Toledo, Ohio	12	Oklahoma City. Oklahoma	12
Atlanta, Georgia	35	Tulsa, Oklahoma	12
Tampa, Sarasota	22	Memphis. Tennessee	13
St. Petersburg	15	Louisville. Kentucky	14
Clearwater, Florida	4	Syracuse, New York	10
Jacksonville, Florida	20	Harrisburg, Pennsylvania	22
Daytona Beach, Florida	10	Philadelphia. Pennsylvania	20
Detroit. Michigan	6	Virginia Beach. Virginia	15
Portland, Oregon	10	Charleston, West Virginia	14
Reno. Nevada	6	Parkersburg. West Virginia	20
Greensboro, North Carolina	10	Munich. West Germany	2
Other than Detroit, no franchises exist in these markets.			

At the end of 1979, there were 1,385 franchised restaurants operated by 161 franchise owners in 47 states and 3 foreign countries.

In a report to the Securities and Exchange Commission, Wendy's discussed the current state of its franchise program and described the franchise owners’ relationship with the company:

> *Although franchised areas exist in all states except three, areas of some states remain unfranchised. In addition, most franchise owners have the right to build more units in their franchised areas than had been constructed at December 31, 1979. At that date, no franchise owner had more than 88 stores in operation. Several franchise owners operate restaurants in more than one state.*
>
> *The rights and franchise offered by the company are contained in two basic documents. A franchise owner first executes a development agreement. This document gives the franchise owner the exclusive right to select proposed sites on which to construct Wendy's Old Fashioned Hamburgers restaurants within a certain geographic area (the franchised area), requires the submission of sites to the company for its acceptance, and, upon acceptance of a proposed site by the company, provides for the execution of a unit franchise agreement with the company to enable the franchise owner to construct, own, and operate a Wendy's Old Fashioned Hamburgers restaurant upon the site. The development*

> *agreement provides for the construction and opening of a fixed number of restaurants within the franchised area in accordance with a development or performance schedule. Both the number of restaurants and the development and performance schedules are agreed upon by the franchise owner and the company prior to the execution of the development agreement. The development agreement also grants a right of first refusal to the franchise owner with respect to the construction of any, additional restaurants in the franchised area beyond the initially agreed-to number.*
>
> *The development agreement requires that the franchise owner pay the company a technical assistance fee. The technical assistance fee required by newly executed development agreement is currently $15,000 for each franchise restaurant which the franchise owner has agreed to construct. Under earlier forms of the development agreement or franchise agreements, this fee was either $5,000, $7,500. or $10.000. However, approximately 12 existing franchise owners have the right under certain circumstances to receive additional franchise areas on the basis of the earlier $10,000 fee.*
>
> *The technical assistance fee is used to defray the cost to the company of providing to its franchise owners site selection assistance: standard construction plans, specifications, and layouts; company review of specific restaurant site plans; initial training in the company's restaurant systems; and such bulletins, brochures. and reports as are from time to time published regarding the company's plans, policies, research, and other business activities.*

From time to time, during its early years, Wendy's reacquired selective franchised operations. in 1979, the company adopted a rather aggressive approach to franchise acquisition. Of 145 new company-owned operations in 1979 (representing a 50 percent increase during the year), 84 were acquired from franchisees. This major shift to company-owned restaurant growth away from franchised growth reflects the concern for systemwide control of quality as well as the increasing competition for available locations. Granting large territorial franchises rather than single-outlet franchises was similarly practiced by Burger King in its formative stages. At Burger King, this led to franchise empires that were bigger than parent-company operations. Wendy's emphasis on company-owned growth was intended to avoid the problem that led to Burger King's decline in the late 1960s. At the same time. selling area franchises rather than single sites accelerated Wendy's 'growth and its ability to attract large, financially strong franchises with proven success in other restaurant concepts.

Finances

Wendy's revenues (see Exhibit 3) increased steadily between 1975 and 1980. Net income dropped in 1979 compared to 1978, but Thomas explained:

> *During 1979, we were informed by the U.S. Department of Labor that a review of company labor for a three-year period indicated that certain company policies had not been*

> *uniformly adhered to, and as a result, the company was not in full compliance with the Fair Labor Standards Act.*
>
> *Based on this review and the company's own investigation, we have determined that $3,800,000 should be accrued and charged against 1979 pretax income. Had this charge not been made, 1979 net income have been $25,096,000, an increase of 8 percent over the $23,215,000 originally reported a year earlier. We believe company labor practices now comply with both company policy and the act, and in addition, future compliance will not materially affect net income in 1980 and ensuing years.*

Whether the cost of labor compliance was the only cause of the abrupt slowdown in Wendy's steady increase in revenue and profit is questionable. Several factors suggest that Wendy's after a decade of rapid growth was reaching the limits of its current capabilities.

The heart of Wendy's success has been its streamlined, limited menu with primary emphasis on quality hamburger. Since 1977, beef prices have soared, as shown in Exhibit 4. And while Wendy's has responded with tighter controls and a series of price increases just under 15 percent for 1979 alone (see Exhibit 5), this has still contributed to a decline in profitability.

Further evidence suggests that Wendy's may have been reaching a plateau in its historical pattern of growth. The average sales per restaurant, which climbed steadily from $230,000 in 1970 to $688.800 in 1978, declined significantly in 1979 at both company-owned and franchised restaurants as shown in Exhibit 6. The impact on the parent company was felt in every revenue category, as shown in Exhibit 7. Wendy's continued to experience increased retail revenue (company-owned stores) and royalties (from franchises based on a percent of sales) but at a drastically slower rate. And for the first time. Wendy's experienced a decrease in technical assistance (franchise) fees.

Other evidence of a slowdown in Wendy's growth can be seen in the rate of new store openings. For the first time in its history. Wendy's experienced a decline in the rate of new store openings, as shown in Exhibit 8.

While revenue and profitability growth slowed in 1979, Thomas was confident this was only temporary. Feeling strongly that Wendy's was in a good position to finance continued growth, Thomas offered the following observation:

> *While construction money is more difficult to obtain than in the last few years, lines of credit already arranged guarantee financing of 1980 company plans to open 60 or more restaurants. We also anticipate exploring avenues of long-term debt to finance our growth beyond 1980. We believe that with $25 million of long-term debt, exclusive of capitalized lease obligations. and over $100 million in shareholders' equity, we have substantial untapped borrowing power.*

Exhibit 9 summarizes Wendy's balance sheet for 1978 and 1979.

Wendy's Future

Addressing Wendy's stockholders in early 1980, R. David Thomas offered the following thoughts about Wendy's first 10 years:

> *We are proud to be marking the 10th anniversary of Wendy's International. Inc. Just 10 years ago, in November 1969, we opened the first Wendy's Old Fashioned Hamburgers restaurant in downtown Columbus. Ohio.*
>
> *Now, after a decade of explosive growth, there are 1,818 Wendy restaurants in 49 states and in Canada, Puerto Rico, Germany, Switzerland and agreements for development of Japan, France, Belgium, Luxembourg, the Netherlands, Switzerland, Spain, Germany and the United Kingdom. In 1979, our industry was faced with major challenges, such as inflation and energy problems. Higher labor costs and rising beef prices affected Wendy's profitability and depressed profits for our entire industry. The minimum wage, which affects 90 percent of our employees, increased in January 1979 and January 1980. Ground beef prices increased to an average of $1.29 per pound in 1979, 79 percent higher than the 1977 average price. During 1979, we minimized our retail price increases with the goal of increasing our market share. This strategy, coupled with more aggressive marketing, helped rebuild customer traffic in the latter part of the year. Although holding back on price increases affected our margins, we believe it was appropriate and that margins benefited by our cost efficiencies, especially in purchasing and distribution.*
>
> *During 1979, we remained flexible and open to changing customer needs and attitudes, and we continued to take the steps necessary to achieve and support future growth and profitability, as we:*
>
> < *Tested and implemented a highly successful salad bar concept.*
>
> < *Tested a breakfast concept and other menu items.*
>
> < *Began development of the European and Japanese markets.*
>
> < *Initiated a new marketing program designed to increase dinner and weekend business.*
>
> < *Prepared to open another 250 to 300 Wendy's restaurants systemwide annually.*

EXHIBIT 3
WENDY'S INTERNATIONAL, INCORPORATED
Consolidated Statement of Income For the Years Ended December 31, 1975-1979

	1979	1978	1977	1976	1975
Revenue from Retail operations	237,753,097	198,529,130	130,667,377	71,336,626	35,340,665
Royalties	30,564,613	23,396,211	11,810,277	4,655,432	1,567,008
Technical assistance fees	2,822,500	3,540,000	2,510,000	1,560,000	622,500
Other, principally interest	2,903,261	2,685,909	1,802,691	965,521	246,901
Total revenues	274,043,471	228,151,250	146,790,345	78,517,579	37,777,074
Cost of sales	146,346,806	113,812,874	72,482,010	40,509,285	19,629,179
Company restaurant operating costs	51,193,050	43,289,285	28,088,460	14,348,150	7,292,391
Department of Labor compliance review	3,800,000				
Salaries/travel/expenses of franchise personnel	4,187,399	3,148,532	1,936,877	1,156,493	622,879
General and administrative expenses	15,741,592	13,292,845	8,191,394	4,137,226	2,581,166
Depreciation/amortization	7,355,818	5,444,092	3,767,259	2,240,215	799,876
Interest	4,357,973	3,771,878	3,215,432	2,583,876	995,410
Total expenses	232,982,638	182,759,506	117,681,432	64,975,245	31,920,901
Income before income taxes	41,060,833	45,391,744	29,108,913	13,542,334	5,856,173
Current Federal Income Tax	15,583,700	18,324.600	12,052,200	5,784,600	2,926,700
Deferred Federal Income Tax	1,303,200	1,020,800	323,700	(19,600)	(501,900)
Total Federal Income Tax	16,886,900	19,345,400	12,375,900	5,765,000	2,424,800
State and local taxes	1,077,500	1,559,700	1,296,200	694,400	298,800
Total income taxes	17,964,400	20,905,100	13,672,100	6,459,400	2,723,600
Net income	23,096,433	24,486,644	15,436,813	7,082,934	3,132,373
Net income per share	$1.54	$1.63	$1.04	$. 57	$ .29
Weighted average number of common shares	14,970,526	15,017,708	14,855,503	12,525,294	10,645,694
Dividends per common share	$0.40	$0.14	$0.125	$0.004	$0. 001

Source: Wendy's International, Form 10-K, 1979.

EXHIBIT 4
Yearly Average Meat Price Per Pound for Company-Owned Stores

1969	$0.59	1975	$0.69
1970	0.62	1976	0,72
1971	0.64	1977	0.72
1972	0.67	1978	1.02
1973	0.90	1979	1.29
1974	0.74		

And, setting the tone for Wendy's in the 1980s, Thomas said:

> *We are aware. as we enter our second decade. that we have achieved a unique position in a highly industry. It was no less difficult and competitive 10 years ago than it is today, we believe, than it will be 10 years from now. We intend to build further on our achievement of being recognized as a chain of high quality, quick-service restaurants. We will continue to produce fresh, appealing, high-quality food, priced competitively; and serve it in a clean, attractive setting with employees who are carefully selected, well-trained, and responsive to our customers.*

Similar to the way they questioned R. David Thomas' venture into the hamburger jungle, several business writers once again began to question Wendy's future. Illustrative of this is the following article, which appeared in *The Wall Street Journal*:

> *Wendy's International. Inc., is making changes it once considered unthinkable.*
>
> *Wendy's faced the choice confronting many companies when the initial burst of entrepreneurial brilliance dims: Should it stick with the original concept and be content with a niche in a bigger market, or should it change and attempt to keep growing? Wendy's chose to revamp its operations. It is adding salad bars, chicken and fish sandwiches, and a children's meals to its menu, adopting a new advertising strategy, and considering whether to alter the appearance of its restaurants.*
>
> *Some observers predict Wendy's will regret the quick changes. "This is a company that was able to convince a certain segment of the country it had a different taste in hamburgers," says Carl De Biase, an analyst with Sanford C. Bernstein & Co. in New York. "They've achieved their mandate, and anything they do now is just going to screw up the concept."*
>
> *But Robert Barney, Wendy's president and chief executive officer, says the company is "in some very difficult times right now." Among the problems: discontented franchise holders and the likelihood that beef*

prices will rise sharply again in the second half. Barney says Wendy's doesn't even “'have the luxury of waiting to see how each change works before moving to the next one.

This spring, shortly after the changes began, Thomas resigned as chief executive, saying he wanted more time for public relations work and community affairs. Thomas, who is 47 years old and will continue as chairman, had been closely identified with the old ad campaign and with company resistance to broadening the menu.

The company has been doing a little better so far this year, and franchisees say they're much more optimistic. The menu changes, they say were long overdue. "It had been suggested to everyone in the company,” says Raymond Schoenbaum, who operates 33 Wendy's outlets in Alabama and Georgia. “But the mentality wouldn't allow menu diversification before. It had to be forced on them."

Barney concedes that prior to last year "we never did a lot of planning." But that has been remedied he says, partly with a “research and development department” that will examine new menu prospects.

EXHIBIT 5

Percentage Price Increases for Hamburgers

1/l/77	0.6%	10/22/78	0.15%
3/l/77	0.3	10/29/78	0.10
12/10/77	6.0	12/17/78	3.40
3/19/78	3.0	1/14/79	3.06
4/16/78	2.5	2/25/79	3.60
5/21/78	1.8	4/8/79	0.10
7/23/78	1.2	4/15/79	0.03
10/l/78	1.7	12/16/79	4.45

Not everyone believes that tinkering with the menu will bring back customers and profits. Edward H. Schmitt, president of McDonald's, predicts an image problem for Wendy's and maintains that the company will lose the labor advantage it held over other fast-food outlets. He adds that McDonald's tried and abandoned salad bars. "It's practically a no-profit item," he says, "and it's a high-waste item."

Some franchisees complain that the new children's meal, called Fun Feast, will draw the company into a can't-win competition with McDonald's and Burger King for the children's market, which has avoided so far. "Every survey we have says we shouldn't go after that market," a franchisee reports. “Our chairs aren't designed for kids to climb on, and our carpet isn't designed for kids to spill ketchup on."

But Barney insists that Fun Feast isn't intended to attract children. He says Wendy's is try ing to remove e the adults' reason for not coming to the restaurant. "Where we tested it," he says, “we didn't sell so many of them, but we did see an increase in adult traffic.”

Wendy's may evolve from a sandwich shop into a more generalized quick-service restaurant that doesn't compete as directly with McDonald's and Burger King. " We're going to be between McDonald's and quick-service steakhouses," says Schoenbaum, the Georgia and Alabama franchise holder.

To this end, Schoenbaum says, Wendy's will reduce the abundance of plastic fixtures in its restaurants and perhaps cut down on the amount of glass. He says the glass makes Wendy's a pleasant, brightly lit lunch spot but doesn't create a good atmosphere for dinner.

Wendy's officials confirm that they are considering altering the appearance of their restaurants, hut they aren't specific. And as for whom Wendy's competes with, Barney says: "We're in competition with anywhere food is served, including the home" (The Vigor..., 1980).

SEARCHING FOR A NEW IDENTITY: 1980-1990

Focusing on a long-term growth strategy of continued U.S. penetration, international growth, and concentric diversification into the chicken segment, Wendy's management team reached 4,000 Wendy's restaurants by 1990. Several things have happened, including numerous changes at Wendy's, since 1979. This section provides 29 observations to help you see what happened at Wendy's between 1979 and 1989.

Product/Market Developments

The R&D department has helped develop quality products that will help Wendy's growing in the future. The department develops new products within these guidelines:

- Any product additions must reinforce their quality image.
- They must be profitable.
- They must expand a market base.
- They must increase frequency of visits.
- They must merge easily into their system of operations.
- They must help reduce vulnerability to beef price.

Wendy's developed and introduced in the 1980s the following products:

- The "Garden Spot" Salad Bar and Baked Potatoes for weight-conscious people.
- The Chicken Breast Sandwich to respond to high beef price and to provide variety.
- The Wendy's Kids' Fun Pack for families with children.
- Breakfast to attack McDonald's lack of variety.

The core of the strategic role of R&D is to increase sales up to $1 million a year per restaurant. In 1989, the average net sales per domestic restaurant was $789.000. representing a 28 percent increase in 10 years.

EXHIBIT 6
Average Sales per Restaurant

	Amount	Percent Change*	Amount	Percent Change*
Company	$624,000	(2.9)%	$624,900	14.3%
Franchise	618,800	(12.4)	706,000	11.7
Systemwide	620,000	(10.0)	688,800	13.0

* Percent increase (or decrease) over the same figure for the previous year.

Financial

Wendy's revenues result primarily from sales by company -operated restaurants. Royalties and technical-assistance fees from franchisees make up the other major source of revenues. In 1989, 91 percent of the $1.07 billion revenues came from retail sales, 7 percent from royalties, and 2 percent from others.

With the exception of the buns sold by New Bakery Company of Ohio, Inc., Wendy's does not sell food or supplies to the franchise owners. The New Bakery Company of Ohio, Inc., was acquired by Wendy's in 1981 and now supplies about 1,000 restaurants with buns.

Revenues went up to reach a peak in 1986 with $1.15 billion, then decreased to $ 1.06 billion in 1987 and 1988, and gained 1 percent in 1989 to reach $1.07 billion. After 1979, net income increased steadily until 1985, when it reached $76 million. Wendy's suffered from a loss of $4.6 million the next year, but its profits became positive and increasing again the following years. In 1989, net income was $30.4 million. The dip in net income of 1986 is reflected in the lower pretax profit margin, which dropped from 11.9 percent to 1.3 percent in one year.

Out of the capital expenditures in the beginning of the 80s, about 50 percent were for new domestic restaurants, 25 percent for the new subsidiary Sisters and international restaurants, and 25 percent for costs associated with the image-enhancement program, restaurant refurbishing, and computerized registers. After reaching a peak in 1985, with $222 million capital expenditures, Wendy's decreased gradually its investments to $39 million in 1989. In this last year, Wendy's spent $24 million for improvements to existing restaurants and $15 million to others' additions.

Exhibit 10 contains additional financial information summarizing Wendy's 1980-1990 results.

Operations

Wendy's marketing strategy has been to target the high-quality end of the quick-service market with primary appeal among young middle-age adults, and its philosophy of quality, service, cleanliness, and value was aimed at this key segment of the population.

EXHIBIT 7

Changes in Revenue from 1978 to 1979

	1979		1978	
	Amount*	Percent**	Amount	Percent
Retail operations	$ 39,224,000	19.8%	$ 67,862,000	51.9
Royalties	7,168,000	30.6	11,586,000	98.1
Technical assistance fees	(718,000)	(20.3)	1,030,000	41.0
Other. principally interest	(217,000)	(8.1)	883,000	49.0

* Absolute dollar increase (or decrease) over the previous year.
** Percent increase (or decrease) over the previous year.

The population of the baby boomers matures. The age range of this segment will be from 35 to 54 years old from 1980 to 1995. Also, currently 50 percent of Wendy's orders are eaten away from the restaurant. Therefore, the maturing population and the increasing demand for convenience and portability will shape Wendy's products in the future.

Wendy's is moving its exterior image further away from the brightly colored, plastic fast-food atmosphere with a new, upgraded image, which features copper-colored roof panels and decorative awnings and lightings. The company spent $18 million on remodeling restaurants in 1989.

Advertising spending has been increased. Franchise owners, in addition to spending 3 percent of their gross receipts for local advertising and promotions, have increased their contribution to Wendy's National Advertising Program (WNAP) from 1 percent in 1980 to 1.5 percent in 1985 to 2 percent in 1989. This same year, WNAP spent $55 million on advertising and promotion expenses, a 4 percent increase over 1988 spending levels.

Advertising in the fast-food burger chain industry has become more fierce since Burger King launched its now-famous comparative advertising campaign.

In the second half of 1985 and into 1986, the company's efforts and advertising were focused on implementing the breakfast program systemwide. During that period, Wendy's major competitors also began to more aggressively advertise their hamburger products. Wendy's began to see some sales erosion in its products and dayparts. As a result, the challenges Wendy's faced were intensified.

Management took decisive action in response to these issues. The breakfast program was made optional for franchise owners and retained by the company only where economically viable. Also, the company launched a realignment program in mid-1986, intended to substantially improve its operating and financial performance. The major portion of the plan involved the disposition of all marginal or unprofitable company-operated restaurants, including international restaurants and Sisters as well as domestic restaurants. The company intends to franchise the majority of the domestic restaurants, and the remaining restaurants have been closed.

Franchising

Two main thrusts appear to characterize Wendy's franchising emphasis for the 1980s: (1) enhanced operational control and support of domestic franchises and (2) expansion through international locations.

The systemwide number of restaurants reached 3,755 in 1989. But as a result of the realignment program, the number of company-owned restaurants kept decreasing from 1986 to 1989, while the number of franchises increased during the same period. However, Wendy's continues to buy franchises from time to time.

EXHIBIT 8
New Restaurant Openings: 1979 versus 1978

	Company*		Franchise		Systemwide	
	1979	1978	1979	1978	1979	1978
Open at beginning of year	348	271	1,059	634	1,407	905
Opened during the year	71	77	340	425	411	502
Purchased from franchise owners	14	---	(14)	---	---	---
Total open at end of year	433	348	1,385	1,059	1,818	1,407
Average open during year	381	309	1,235	828	1,616	1,137

*Restaurants acquired from franchise owners in poolings of interest have been included since date of opening.

To stimulate growth, the company announced a unit franchise strategy in the early 1980s. This concept enabled individuals who could not develop a multiunit franchise to join the Wendy's family. To avoid the problem that led Burger King to a decline in the 1960s, Wendy's spends an increasing time in assessing and selecting the franchised locations and managers and also provides the personnel an increasing amount of training. This reflects the concern for systemwide control of quality.

International

Wendy's established an international division in 1979, and, by 1989 there were 265 restaurants in foreign countries--87 of them were company-owned. The top 5 international markets and number of restaurants were Canada (131 restaurants), Japan (26), Spain (17), Korea (14), and the Philippines (13).

Of the fast-food industry, McDonald's is the best established internationally, with approximately 1,500 units in 32 countries (data as of 1983). They are heavily concentrated in Canada, Japan, Australia, and various parts of Europe. It is expecting to develop this international market at a rate of 150 additional units a year. Burger King had in 1983 about 300 units abroad.

There are numerous pitfalls and high risks to overseas expansion since, for instance, European per capita spending on “fast-food" is only $3.50 a year, compared to approximately $150 for each American in 1982. Also, capital investment--land and buildings--and labor consume a large part of revenues in some countries, such as West Germany. As a matter of fact, after having opened about 30 restaurants in West Germany, Wendy's decided to terminate those operations in 1987.

Wendy's strategy in international market is to be flexible in order to be successful in the face of differing eating habits and tastes. It consistently opens new international restaurants but it does not hesitate to terminate any unprofitable operations.

Sisters' Development

Thinking that the fast-food burger industry might be over-saturated, Wendy's decided to apply the principles that built its success to other segments of the industry, particularly the one of chicken restaurant industry.

Wendy's initially owned 20 percent of Sisters International and, in 1981, exercised its option to purchase the then remaining 80 percent. The Sisters' concept, to combine the self-service of the quick-food industry with the full menu and warmth of comfortable dining facilities of the traditional family restaurant, is designed to appeal specifically to the maturing, value-conscious consumer.

There were 79 Sisters open at the end of 1985. The company operated 38 of these. However, in 1987, as a result of the realignment program Wendy's sold its subsidiary to SIS CORP, Sisters' largest franchisee for $14.5 million in cash and notes.

Management Reorganization

For the first 10 years of its history, Wendy's was guided by an entrepreneurial spirit that gave the company the fastest growth record in the history of this industry. However, with the pressure of soaring beef prices, inflation, and recession, founder and former chairman R. David Thomas, who presently serves as senior chairman of the board, took the first step in 1980, when he recommended to the board that president Robert L. Barney be named chief executive officer. Barney implemented the remainder of the management reorganization program.

In 1989, James W. Near assumed the functions of CEO, president, and chief operating officer. He replaced Ronald Faye, president from 1980 to 1986, and Barney, former CEO and chairman of the board, who retired in 1989.

A new regional structure was also instituted for the Company Operations and Franchising Department, along with the Franchise Advisory Council, in order to increase communication and cooperation between company management and franchisees.

The company had 50,000 employees in 1986, but, as part of the realignment program, this number decreased to 35,000 people by 1990.

REFERENCES

* “Its Vigor Lost, Wendy's Seeks a New Niche,” The Wall Street Journal, July 8, 1980. p. 29.

EXHIBIT 9: Wendy's Consolidated Balance Sheets for the Years Ended December 31, 1978 and 1979

Cash	2,285,180	1,021,957
Short-term investments	12,656,352	27,664,531
Accounts receivable	4,902,746	3,248,789
Inventories and other	2,581,528	1,855,313
Total current assets	22,425,806	33,790,590
Land	30,916,049	23,906,365
Buildings	40,784,581	30,049,552
Leasehold improvements	16,581,947	8,954,392
Restaurant equipment	34,052,952	24,461,860
Other equipment	9,722,666	8,413,363
Construction in progress	1,751,788	2,027,570
Capitalized leases	21,865,829	18,246,427
Total property and equipment	155,675,812	116,059,529
Less: Accumulated depreciation	(20,961,702)	(13,543,473)
Total property and equipment	134,714,110	102,516,056
Cost in excess of net assets acquired	8,408,788	5,207,942
Other assets	7,152,131	2,377,648
Total cost over net assets and other assets	15,560,919	7,585,590
Total assets	172,700,835	143,892,236
Accounts payable, trade	10,174,980	11,666,272
Federal, state, and local income taxes		7,839,586
Accrued Administrative fee		664,770
Accrued Salaries and wages	2,368,244	1,970,977
Accrued Interest and Taxes	2,365,732	1,868,124
Accrued Department of Labor compliance review	3,800,000	
Other	1,576,851	739,588
Current portion long term obligations	3,891,247	2,781,671
Total current liabilities	24,177,054	27,530,988
Term debt, net of current portion	25,097,688	15,308,276
Capital lease obligations, net of current portion	18,707,838	15,130,617
Total Obligations	43,805,526	30,438,893
Deferred technical assistance fees	1,995,000	2,117,500
Deferred federal income taxes	2,027,604	664,300
Common stock	1,488,261	1,486,188
Capital in excess of stated value	34,113,173	33,962,916
Retained earnings	65,094,217	47,691,451
Total shareholders' equity	100,695,651	83,140,555
Total liabilities and shareholders' equity	172,700,835	143,892,236

Source: Wendy's International, Form 10-K, 1979

EXHIBIT 10: Selected Financial Data for Wendy's International, Inc. & Subsidiaries

(in millions)	1990	1989	1988	1987	1986	1985	1984	1983	1982	1981	1980
Systemwide Sales	3,070.3	3,036.1	2,901.6	2,868.9	2,747.2	2,694.8	2,423.0	1,922.9	1,632.4	1,424.2	1,209.3
Retail sales	922.2	973.1	976.6	987.2	1,039.3	1,033.0	877.3	671.6	565.4	450.9	310.1
Revenues	1,010.9	1,069.7	1,062.6	1,059.8	1,149.7	1,128.6	946.7	728.7	613.1	492.8	348.4
Operating Profit	115.5	84.1	107.1	81.8	136.6	176.8	166.4	129.6	104.3	76.8	54.4
Income before taxes	60.7	36.9	43.8	(11.6)	14.9	134.7	128.4	101.4	80.7	64.7	54.7
Net income	39.3	30.4	28.5	4.5	(4.9)	76.2	68.7	55.2	44.1	36.9	30.1
Capital expenditures	41.7	38.9	56.0	73.9	120.3	221.9	153.5	87.4	81.6	74.9	52.6
Total assets	757.9	779.6	777.0	786.2	814.2	853.3	656.1	542.5	- 485.0	387.4	220.3
Net Property	569.6	579.6	593.1	610.2	643.8	704.9	518.2	405.4	348.3	291.9	175.6
Long-term obligations	168.1	178.9	192.6	195.4	223.2	235.5	139.0	115.7	128.2	105.6	43.1
Shareholders' equity	446.8	428.9	419.6	412.2	424.7	443.5	364.5	308.3	264.7	201.7	125.6
Per Share Data											
Net income	.41	.32	.30	.05	(.05)	.82	.75	.61	.51	-.46	.40
Dividends	.24	.24	.24	.24	.21	.17	.15	.12	.09	.08	.08
Shareholders' equity	4.61	4.44	4.36	4.29	4.45	4.65	3.98	3.40	2.92	2.37	1.68
Market price at year-end	6.38	4.63	5.75	5.63	10.25	13.38	10.00	9.38	6.63	4.25	2.88
Ratios											
Restaurant profit margin %	12.5	8.6	11.0	8.3	13.1	17.1	19.0	19.3	18.4	17.0	17.5
Pretax profit margin %	6.0	3.4	4.1	-	1.3	11.9	13.6	13.9	13.2	13.1	15.7
Return on average assets %	10.8	7.9	8.5	2.1	4.8	21.7	24.7	23.5	22.7	24.9	311
Return on average equity %	9.0	7.2	6.9	1.1	-	19.3	20.4	19.3	19.5	22.0	26.6
Current Ratio	.90	.95	1.00	.75	.81	.44	.56	.69	.81	.61	.54
Debt to equity %	38	42	46	47	53	53	38	38	48	52	34
Debt to total capitalization %	27	29	31	32	34	35	28	27	33	34	26
Number of Restaurants Open at Year-End											
Company	982	1,031	1,076	1,114	1,206	1,135	1,014	887	802	734	502
Franchise	2,454	2,459	2,445	2.468	2,290	2,106	1,801	1,633	1,503	1,386	1,450
Company-International	88	87	97	115	129	122	43	35	2 5	14	4
Franchise-International	203	178	144	119	102	79	134	118	10 0	95	78
Total Wendy's	3,727	3,775	3,762	3,816	3,727	3,442	2,992	2,673	2,430	2,229	2,034
Average net sales per domestic Wendy's restaurant (in thousands)											
Company	832	808	793	786	765	850	874	749	687	679	65 0
Franchise	803	781	744	721	748	846	870	769	712	670	634
Total domestic	811	789	759	741	754	847	871	762	704	672	638
Shares outstanding (thousands)	96,707	96,378	96,168	95,783	95,879	92,828	91,903	91,168	87,034	80,990	75,702
Shareholders at year-end	53,000	55,000	58,000	52,000	48,000	41,000	31,000	25,000	20,000	19,000	18,000
Employees at year-end	35,000	39,000	42,000	45,000	50,000	48,000	43,000	36,000	29,000	26.000	18000

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