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LETTER FROM THE EDITORS

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

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

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

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

Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

MAYAWORKS: WEAVING THREADS OF ENTREPRENEURSHIP IN GUATEMALA

Charles A. Rarick, Purdue University Calumet
Kasia Firlej, Purdue University Calumet
Martine Duchatelet, Purdue University Calumet
Lori Feldman, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns social entrepreneurship. Secondary issues examined include social justice and strategic direction. The case has a difficulty level of four, appropriate for senior level students. The case is designed to be taught in one class hour and is expected to require three hours of preparation by students.

CASE SYNOPSIS

This case explores the strategic direction of a small U.S. organization devoted to helping the Mayan population of Guatemala. MayaWorks is an organization that is attempting to create a sustainable market for the traditional crafts produced by Mayan women in the impoverished parts of the country in the central highlands. This social enterprise is attempting to help capitalism advance its social agenda. The organization faces many challenges as it tries to sow the seeds of entrepreneurship in Guatemala and is searching for strategic direction to continue and grow the organization.

> *"Thanks to my friends in the U.S. I know that we will have a market for our products."*
>
> *"Thanks to Maya Works, I know that I will have steady work and I can work at home and take care of my children."*
>
> Mayan artisans in Guatemala

INTRODUCTION

In a nondescript building in Chicago a handful of selfless and dedicated people work to improve the lives of the Mayan population of Guatemala. The MayaWorks headquarters in Chicago is part office, part warehouse, and all heart. The small staff and its volunteers who work at this not-for-profit organization are trying to improve the lives of the women of Guatemala who produce handicrafts by promoting and selling their goods in more developed markets and economies. Handicrafts produced in Guatemala sell at very low prices in the country of origin, but can command much higher prices in countries like the United States, Canada, and the countries of Europe. MayaWorks hopes to empower the Mayan women of Guatemala and promote their version of social justice. The Mayan of Guatemala have suffered poverty, discrimination, and civil war in one of the poorest countries in the Americas.

GUATEMALA

Located in Central America, Guatemala borders Mexico, Belize, Honduras, and El Salvador (Figure 1). Guatemala was a colony of Spain for three centuries during which time the Spanish essentially enslaved the Maya to work on large plantations. While the conquistadors are long gone from Guatemala, the country remains divided between the Maya and the ladino (non-indigenous) population. The two groups even speak a different language, with the ladinos speaking Spanish, and the Maya speaking Cakchiquel, or one of the other 23 Mayan languages.

FIGURE 1
MAP OF CENTRAL AMERICA

Source: University of Manitoba

Guatemala has a population of over 14 million, more than half being of Mayan decent. The per capita GDP of Guatemala is $4,900 on a purchasing power parity (PPP) basis, but the income of the country is very unevenly distributed. Much of the population lives on less than $2 a day, giving Guatemala one of the most uneven income distributions in the Americas. According to the World Bank, "*Poverty in Guatemala is high and deep, and the country has remarkably unequal distribution of income, resources, and income*." Guatemala ranks only above Haiti on the U.N.'s Human Development Index of countries in the Americas. Tensions between the rich and poor has resulted in many problems for Guatemala and contributed to the poverty of the indigenous Maya. While the country is now a democratic republic, the country's history is filled with military dictatorships, revolutions, coups, and bloody internal conflict. Since the turbulent times of the 1980s, things have improved in Guatemala. For the most part the country is at peace, however, violent criminal activity continues to be a problem in Guatemala, especially in its capital, Guatemala City. Guatemala, along with other Central America countries is part of the Central America Free Trade Agreement (CAFTA) and benefits from trade from the United States. The United States is the country's largest customer for its exports of coffee, bananas, sugar, clothing and other textile products. With a low level of education found among the Guatemalan people, there exists a need for assistance in helping the population enter the global marketplace. Guatemala is ripe territory for social entrepreneurship.

SOCIAL ENTERPRISE AND SOCIAL ENTREPRENEURSHIP

The Austrian economist, Joseph Schumpeter, wrote in the 1940s that the function of an entrepreneur is to "revolutionize the pattern of production." Today social entrepreneurs are taking that pattern and attempting to produce social change by using capitalism and market principles. Social entrepreneurs must have the same qualities as non-social entrepreneurs such as business knowledge, resourcefulness, creativity, innovation, and a market focus. It has been said that where social entrepreneurs differ is that they are motivated not by the "deal" but by the "ideal."

The distinctions among social entrepreneurs, non-government organizations or NGOs, charities, and social enterprises are not always clear. Social entrepreneurs generally have a stronger profit focus and are sometimes referred to as people who seek to "do well by doing good." These for-profit social enterprises (FOPSEs) make a profit from their operations and help achieve social goals as well. Some FOPSEs use their profits to subsidize charities, others do not. Rather than simply subsidizing inefficient operations, many social entrepreneurs aid the less fortunate by helping them enter the market economy. The term social enterprise is a broad description of an organization that engages in commerce, but cares more about causes. All of these different types of organizations seek to promote a social cause, often helping the disadvantaged. University Of Michigan professor of strategic management and author of the book, *The Fortune at the Bottom of the Pyramid*, states that the residents of less developed countries should be viewed as customers, not charity cases. This view could be expanded to one in which these people are viewed as not only customers but also providers of human capital for mutual gain.

Executives without Borders is one such organization that tries to help residents of less developed countries create and build businesses. This organization pools talent to provide its services much like Doctors without Borders does in the medical field. It matches interested business executives and former executives with needs in less developed countries in order to produce a stronger and more efficient global economy. Another interesting enterprise is an organization called Apopo. The organization began as a humanitarian operation in Africa to use African pouch rats, who are gifted with a superior sense of smell, to sniff out land mines in former war zones. Apopo attempted to raise funds through its Adopt-a-Rat program, however, the program gained little support. With the help of consultants and student interns from Oxford University, Apopo decided to run the organization as a business. Apopo has found that its rats can be profitably employed in cargo inspection and detection of certain diseases. The profit earned from these activities can be used to fund the mine clearing operations which suffer from a lack of support from the marketplace. These two organizations have been successful using different models of social enterprise and entrepreneurship.

MAYAWORKS

MayaWorks is a promoter, a facilitator, a provider of training, and a charity. MayaWorks does not seek to make a profit but, helps others to make a profit and promotes a social goal. The story of MayaWorks began in 1990 with one suitcase filled with place mats woven by widowed Mayan women who lost their husbands during the violent social unrest in Guatemala during the 1980s. Pat Krause who worked with Behrhorst Partners for Community Development envisioned the idea of giving poor women of Guatemala economic power through income generating businesses. The first suitcase of Mayan goods carried by Pat Krause, who would become the founder of Maya Works, quickly sold and a business model was formed. Maya Works was officially incorporated in 1996 as a not-for-profit organization. During the early years of the organization, goods were brought back or shipped to the U.S. and stored in the home of Pat Krause in Connecticut. Eventually the operations were moved to Chicago as one of the early participants in the project moved with her husband to that city. In its first 10 years of operation MayaWorks returned over $1.2 million to the hardworking Guatemalan artisans in their network. Artists in the MayaWorks network live and work in Chimaltenango, San Marcos, and San Atitlan (Figure 2). Access to the capital and main market is somewhat limited for these artisans.

Figure 2
MAP OF GUATEMALA

Source: Michigan Tech University

A staff of three and many volunteers work in the Chicago headquarters to continue the vision of Pat Krause and other women supporters.. MayaWorks is headed by Jeannie Balanda who worked as a Peace Corp volunteer in Guatemala and who holds two graduate degrees – one in business administration and one in non-profit management. She has been with the organization for about a year and is assisted by a marketing specialist and a product development officer. The operations in Guatemala are run entirely by Guatemalan women, giving them a sense of ownership and control. The basic mission of MayaWorks to improve the lives of the women of Guatemala through social enterprise has not changed since its founding. As the organization grew it developed a more detailed and somewhat expanded mission statement, but is currently in the process of revising its mission to refine its focus as a non-profit organization.

MISSION STATEMENT

> To create a space in the global marketplace for the coming together of Guatemalan and North American women. This shared market place opens an opportunity for Maya women, their families and communities to achieve economic security and for North American women, their families and communities to participate in economic justice. The primary tool to achieve this mission is sales in the United States of artisan products created by Mayas within the principles of Fair Trade.

A manifestation of the mission is a woman in Guatemala by the name of Eufemia. Eufemia was only able to attend school for two years. She married at the age of 16 and had three daughters. By the age of 21 she was widowed. Without the support of a husband, Eufemia was forced to work in the fields for very long days with her children at her side. Her children did not attend school on regular basis and life was very difficult for the family. With the help of MayaWorks, Eufemia was able to become an entrepreneur, using her weaving skills to make marketable products. She earns more money and is able to send her children to school, including one child in Spain who is studying to be a nun.

MayaWorks distributes a large variety of Mayan handicrafts (Figure 3) including some newer product ideas with a more contemporary design. MayaWorks sells Mayan bags, Mayan beads, clerical stoles, jackets, scarves, table runners, aprons, place mats, wall hangings, Mayan fabric by the yard, and many other items. One might be surprised to discover that MayaWorks' biggest seller is the Kippah or Yarmulke demonstrating how the organization fills a very specific niche market. MayaWorks recently introduced a baby line including diaper bags, bibs, and baby booties in order to diversify its portfolio of offerings. Gift certificates can also be purchased, along with customized conference items. Conference item prices are determined by quantities ordered and appeal to groups who have an interest in social justice and Fair Trade. Goods are sold online at the organization's Web site (www.mayaworks.org), as wholesale items to other retailers, and through a network of volunteers who sell the items in their homes, stores, schools, and churches all on consignment. Maya Works' revenue comes mainly from these consignment sales and constitutes 43% of total sales, 36% from online sales, 4% of sales are conference items, 3% of sales in Guatemala, and the remaining revenue from wholesale transactions, donations, and study tours of the Maya Works facilities and surrounding areas. Promoting the concept and building a network of people who can sell the items continues to be a critical element in the success of MayaWorks. In order to facilitate this MayaWorks conducts periodic study trips to Guatemala, open to the public, in order to promote their cause and to raise revenue. The tours provide a 10 day visit to the western highlands of Guatemala where participants can meet the Mayan artisans and learn about their culture. Site seeing of Guatemala is also part of the tour package. The cost of the tour is approximately $1,400 plus airfare. From mayaworks.org, one can sign-up for a study tour, buy products, make a donation, arrange to host a sale, and read the organization's newsletter.

FIGURE 3
MAYA WORKS PRODUCTS


Kippah $9


Book Bag $18


Maya Beads $9


City Bag $45


Apron $28


Conference Bag


Mayan Fabric $20 yard


Clerical Stole $40


Jacket $60

Shipping and handling charge are $6.95 per order. Orders normally are shipped within two business days. Goods arrive to customers in U.S. via UPS in about a week.

In addition to providing a marketplace for the handicraft products, MayaWorks also provides scholarships to the children of the artisans, and technical training to the artisans themselves. Since many of the Mayan women speak only the local Mayan language, Spanish classes are also offered to help the women integrate into Guatemalan society and to be better able to negotiate with Spanish speaking suppliers of yarns and threads. MayaWorks also provides micro-loans to artisans for supplies and equipment as way for women to have alternative income and to inspire women to get involved in other income generating projects such as agricultural ventures.

An important value of Maya-Works is Fair Trade. MayaWorks belongs to the Fair Trade Federation and abides by its principles. MayaWorks attempts to ensure that the women of Guatemala earn a fair price for their products, even if this produces a higher price than charged by competitors.

The Fair Trade Federation
Principles

- Paying a fair wage in the local context
- Offering employment opportunities for advancement
- Providing equal employment opportunities for all people, particularly the most disadvantaged
- Engaging in environmentally sustainable practices
- Being open to public accountability
- Building long-term relationships
- Providing healthy and safe working conditions within the local context
- Providing financial and technical assistance to producers whenever possible.

Not all sellers of indigenous crafts follow the principles of Fair Trade, however, MayaWorks feels that it is an important part of their mission. The organization ensures that it stays true to its mission by allowing all operations in Guatemala to be run by natives. This is not the case with many other not for profit organizations. Maya-Works faces a number of competitors. They compete with organizations similar to themselves such as Mayan Traditions, Mayan Treasures, and De La Selva. Mayan handicrafts can even be found on ebay, and Chinese manufacturers are beginning to copy indigenous products to capture niche markets. Many such items can now be found in U.S. retail shops such as Pier 1 and others. Maya Works does not currently sell its products on ebay, but is considering using social networking as a means of increasing awareness and expanding sales. Currently MayaWorks has little funding available for promotional activities.

Other issues that face not only MayaWorks, but many similar organizations, are employee turnover, limited budgets, and the constant need for outside funding. Being such a small operation, Maya-Works benefits from few economies of scale and is not able to handle very large orders. With the current cadre of Guatemalan artists numbering under 200, large market opportunity would not be able to be achieved. In addition, the current economic environment is causing difficulties for Maya-Works. Sales are now lower than expected and there exists a greater need for external funding. As the dedicated members of Maya-Works continue their struggle for social justice and the empowerment of Mayan women, they are faced with uncertain economic times and strategy formulation.

DISCUSSION QUESTIONS:

1. Are the concepts of social justice and business at odds? Explain.
2. What are the strengths, weaknesses, opportunities, and threats of MayaWorks?
3. What strategy recommendations would you make to MayaWorks in order for the organization to continue to fulfill its mission and prosper?

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CHARISMA SHOE COMPANY CASE ANALYSIS

Joan Brumm, Texas A&M University-Texarkana
Larry Davis, Texas A&M University-Texarkana
Edward Bashaw, Arkansas Tech University

CASE DESCRIPTION

The primary subject matter of this case concerns market analysis, market segmentation, and market strategy. The case has a difficulty level appropriate for senior level courses. The case is designed to be taught in three class hours and is expected to require six hours of outside preparation by students.

CASE SYNOPSIS

Charisma Shoe Company is based on an actual company. The company is one of the few remaining U.S. shoe manufacturers. Their children's division contains four brands of shoes for infants to twelve year olds. The company faces competition from foreign manufacturers and declining sales in their children's division. The board decided to hire an outside marketing company. They also voted to commit the resources necessary to bring the Children's Division sales levels. The marketing consultant's recommendation is for Charisma to change the branding in the children's division and develop a family branding strategy using the Charisma name as the central theme that ties each individual brand together.

CHARISMA SHOE COMPANY INTRODUCTION

Based on an actual company, all names, places, and dates of Charisma Shoe Company have been changed to protect the actual company's identity.

CASE ANALYSIS

Situation Analysis: Where We Are Today

Charisma Shoe Company based in Holt, Louisiana is a privately held leading manufacturer of footwear. Successor to a New Jersey based Footwear Company's southern division, David Charisma established Charisma Shoe Company in 1972. In 2001, the company decided to expand their product line and purchased The Children's Division. Charisma produces adult and children's brands and unbranded shoes for specific retail partners. Charisma Shoe Company sells approximately five million pairs of shoes annually.

Charisma's top selling division has been the unbranded shoes for major retailers accounting for 60 % (three million pairs) of their yearly sales. The Women's Division accounts for approximately 20% of sales (1 million pairs) and Children's Division for the remaining 20% of sales (1 million pairs) per year.

After many successful years of sales, the Children's Division has been experiencing a continuing decline in sales for the past four years. Children's 2008 sales declined to below 2003 sales levels. The Children's Division contains four brand name shoes, Saddles, Christy Charisma (formerly the Little Katie brand), Excellence, and TJ's. Their best performing brand name shoe, Excellence, experienced a 1.3 % loss in sales in 2008 after significant sales gains in each year since 2003. Charisma's nine key accounts in their Children's Division that represent almost 37% of total sales in 2008 have also been suffering in declining sales.

Christy Charisma's declining sales has caused the most concern for the company. In 2007 David Charisma and the board hoped by renaming the Little Katie line to Christy Charisma, after his daughter, their customers would feel a more personal family connection to the line. In the six-year reporting period, the Christy Charisma line's sales peaked in 2004 at 715,073 pairs. Each year since then the lines sales volume has continually declined. Sales for 2008 of only 357,499 pairs represented just fewer than 50 % of 2004 total sales. (Table 1 contains the sales information for the Children's Division from 2003 to 2008).

When the board of directors met to discuss the declining sales in the Children's Division, David Charisma stressed the importance the division had for the company overall. As a first step, the board decided to hire an outside marketing company. They also voted to commit the resources necessary to bring the Children's Division sales levels up to 2004 levels and beyond. These decisions marked a pivotal point in the division's history.

Table 1
The Children's Shoe Division*
Sales History – Pairs of Shoes

Year	Excellence (infants)	TJs** (2-5 yrs) Boys/girls	Saddles (6-12 yrs) Boys	Christy Charisma*** (6-12 yrs)	Total Sales	% Change
2003	58,993	102,528	360,800	584,065	1,106,386	-
2004	110,016	109,301	401,662	715,073	1,336,052	+20.76%
2005	148,557	145,884	357,636	572,072	1,224,149	-8.38%
2006	158,364	152,509	393,694	518,112	1,222,679	-0.12%
2007	163,979	160,230	454,748	442,515	1,221,472	-0.10%
2008	161,819	128,555	382,822	357,499	1,030,695	-15.62%

* The Children's Division includes infants and children casual, girls dress, and sandals
**TJs include boys ***Changed to Christy Charisma from Little Katie in 2008

Following the board meeting, David Charisma met with marketing consultants to discuss the company's philosophy and the challenges facing a domestic shoe manufacturing company. Charisma Shoe Company is one of but a handful of shoe brands that remain in the U.S. as domestic shoe producers. Increasing consumer demands for a broader product range and competing manufacturers employing low-cost labor in foreign manufacturing facilities are challenges that Charisma faces. Like most U.S. based shoe manufacturers, Charisma imports some components from abroad. In their Children's Division, approximately 55 % of all shoes are made from overseas components or completely manufactured abroad.

David Charisma believes the key to surviving as a domestic manufacturer today is keeping your employees happy and going to great lengths to establish a positive corporate culture that permeates every inch of Charisma Shoe Company. David Charisma summed up the results of this culture-building effort when he said "We have a relatively stable workforce willing to do just about anything asked of them, because they realize the company is working on their interests as well as its own." Charisma Shoe Company is proud that they have second generation employees.

Mission Statements

Corporate: Charisma Shoe Company stands for value and integrity in today's footwear manufacturing. Product integrity, highest quality, value, comfort, and latest styles are put into every pair of Charisma Shoe Company's products. Charisma Shoe Company's socially responsive mission is to recognize and satisfy the interests of all its stockholders, consumers, retailers, employees, shareholders, and their communities.

Divisional: - Mission Statement for the Children's Division: Charisma Children's Division sets the standard for premier children's brands, with orthopedically correct design, fashion innovation, and parent-friendly merchandising.

Current Product Positioning

There are two critical elements in the selection of a child's shoe, style and fit. Charisma produces the finest children's shoe in their price point. Charisma is one of a few manufacturers that make children's shoes available in both width and length. The mother's ability to select the proper width and length shoe for her child (as well as the construction) drives the level of quality. However, this design requires some level of training for the retail sales associate to be able to properly fit a child's foot. A sales associate not properly trained in fitting a child's foot for both width and length will not understanding the role that both measurements play for optimal comfort. This lack of training can result in missed opportunities for a sales associate to fit a child in a pair of Charisma's.

Increasingly important to footwear buying moms and older children is style, real or perceived. The biggest issue voiced by retailers about Charisma's lines is a perceived lack of style, with the Christy Charisma line being the weakest.

The company's efforts to separate branding in the Children's division have resulted in brand confusion and a lack of a cohesive look (i.e. not knowing Excellence, TJ's, Saddles, and Christy Charisma are each a Charisma Shoe line). The Christy Charisma line, formally Little Katie, is relatively unknown among retail partners and consumers. The change of name one year ago and lack of brand meaning to retailers and consumers likely explains some of the declining sales in the line.

Customers

Retail Partners

Charisma Shoe Company's low employee turnover provides their retail partners continuity in dealing with their wants, needs and concerns. Charisma excels at delivering good service is the areas of return policies, trunk shows, and retail sales associate training. Being one of the few manufacturers that make shoes available in both width and length, sales-associate training is critical. With a high turnover among retail sales associates, a shoe manufacturer willing to make a commitment to help train and educate new sales associates can be a significant advantage for retailers.

The recent sales decline in the Children's Division may cause pressure on the company to lower the price to retailers in order to reach sales minimums. Brands not meeting sales minimums may also lose retail visibility, compounding the already declining sales. Another threat of sales decline is erosion in the confidence that retailers have in Charisma. This would be a particularly tough reality for Charisma to face due to their reliance on retailers for support.

Consumer

Charisma & Company feels their average consumer base is mom's with household income of approximately 50K or higher with children between the ages of 8 months to 12 years. The company has not had a specific consumer profile developed for them from a marketing database.

Around age five, children start identifying favorite brands of consumer products, such as footwear. Between the ages of six and seven the parent's influences during a purchase decreases and by time the child reaches first grade media has the most influence over their purchasing selection followed by store visits.

Internet Sales

The growth of the Internet is perhaps the biggest business and social development in the last 50 years. With e-commerce growing in just about every industry, the question for many companies is not if, but when. The Internet is changing purchasing patterns and information gathering behaviors. Fifty-three percent of women said they never buy online, but use the “net” for pre-purchase browsing.

Competition

Competition in premium children’s footwear market is stiff. The Children’s Division competes with products across all categories of price points just below and price points up to approximately $20 more in certain categories. Charisma Children’s Division also has to vie for the mom’s loyalty to their brand and their retail partners as well.

Stride Rite, based in Massachusetts, is a leading supplier of children’s footwear and casual footwear. With promotions of their children’s footwear line being the “right choice” for growing feet and brand awareness, they are Charisma Children’s Divisions number one competition.

February 2009, Stride Rite revealed plans to increase their marketing expenditures to 8 % of sales, helping to rise their overall brand positioning. Stride Rite’s marketing plans include a combination of national and regional advertising, a variety of retail support materials, bonus gifts for the consumer, discount promotions, and pre-seasonal sales. They also developed a monthly retail marketing and promotions events calendar for their retail partners that will allow the retailer to tie into Stride Rite promotions. Along with Stride Rite’s new marketing plans they have a successful ongoing marketing program that reaches new mothers and weds them to the Stride Rite brand.

Elefanten, a German Children’s Footwear company that competes in the higher-priced rang has been making efforts to maintain a line of lower-priced footwear. According to their findings, American parents are more concerned with the price of a shoe than Europeans.

Elefanten provides print ready artwork to retail partners to use in local and regional advertising. They also utilize in-box information reply cards to reach moms who purchased a pair of their shoes. Elefanten mails catalogues twice yearly to consumers who reply to the in-box cards or request information through their website. A survey of specialty retailers suggests that the reply cards and catalog marketing programs does drive consumers to retail stores already preferring the Elefanten line. In 2008, Elefanten USA increased its advertising budget by 30 %.

Dr. Martens brand is capitalizing on its popularity in the teen and young-adult market to increase its penetration into the children’s (age 4-12) market. Dr. Martens is increasing national advertising presence and maintains aggressive in-store, point-of-purchase efforts across all categories.

Weebok, the children's division of Reebok, is running print ads showing pictures of their Weebok clothing and footwear lines in parenting magazines with the tagline "head to toes." Last year, Weebok conducted a mass mailing to 7,000 independent retailers around the country to reacquaint buyers with the brand. Weebok also sent a $5-off postcard to 70,000 Sears' customers.

Current Marketing

David Charisma and the board agree that the company needs to put more time and resources in marketing. Currently, Charisma Shoe Company does not maintain consistent planning, budgeting, or execution of marketing strategies. This may have resulted in retail partners lacking the belief that the Children's Division of Charisma helps them increase store sales through traffic building promotions or consumer brand-awareness efforts.

Their current Web page only provides Charisma Shoe Company information. The company's web page neither provides information that can help mothers make better shoe-buying decisions nor offers entertainment for children.

The "Big Idea"

After analyzing the information Charisma provided them, the marketing consultant's commendation is for Charisma to change the branding in the children's division and develop a family branding strategy using the Charisma name as the central theme that ties each individual brand together. When a company carries different bands under one main division it is vital that retailers and consumers recognize and associate the brands with the company. Charisma's relative lack of resources compared to their larger counterparts, does not give them the luxury to deeply develop four brands. However, the Charisma name, as a word mark is extremely attractive. It is short, memorable, and highly brandable. A family brand strategy will allow the company to position four brands under the Charisma family brand umbrella.

Challenges Going Forward

Since Charisma & Company purchased controlling interest in The Children's Division in 2001, that division has demonstrated no activity in effective market research, strategic planning, or a focused company direction. A consequence has been a slide in the Charisma Children's Division shoe sales volume every year since 2004. By 2008, sales volume had declined to less than 50% of that in 2004. Before the company can expect to reestablish a successful volume of sales, it must have a formal assessment of its position through the performance of a SWOT analysis and other related research as a foundation for developing an effective strategic marketing plan.

THE MATTSAKA KOI AND EXOTIC FISH FARM COMPANY CASE

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CASE DESCRIPTION

The case deals with the inventory decisions in an aqua farm setting. Primary issues of this case are inventory policies and their associated costs. The case has a difficulty level of 3, junior level. The case is targeted to operations management, inventory management, and supply chain management courses. The case is designed to be taught in 1 class hour and is expected to require 1 hour of class preparation by students.

CASE SYNOPSIS

The Mattsaka Koi and Exotic Fish Farm case addresses the inventory issues faced by Kioshi Mattsaka. Kioshi is forced to consider demand forecasting and inventory policies when the largest customer places an order for 6"- 8" Koi and the company does not have enough Koi in that size to fill the order. This sparks the discussion about what inventory policy to use and whether to consider multiple customer service levels.

CURRENT SITUATION

Kioshi Mattsaka, owner and president of Mattsaka Koi and Exotic Fish Farm Company, opened his office door for Professor Henry Lee, a professor of operations and inventory management at the nearby state university. Dr. Lee had been recommended by one of Kioshi's employees to study the fish farm's current problems with their inventory of fish stocks. Kioshi explained that recently they had experienced a stock-out of Koi for their largest customer – a costly and humiliating situation, since Mattsaka Koi Farm prided itself on high quality customer service and product quality. The two gentlemen nestled into the office sofa and Kioshi began to detail the company history, operations, organization, and current dilemma.

COMPANY BACKGROUND AND HISTORY

Kioshi Mattsaka arrived in Valdosta, Georgia from Osaka, Japan in June 2003. Kioshi's family had raised and marketed Japanese Koi and other exotic fish in Japan for three generations. He wished to begin a Koi and exotic fish farm in the United States for he believed the U.S. was a potentially significant market for the sale of such fish for indoor aquariums, outdoor ponds, and even the restaurant trade. Restaurants would use such fish in aquarium or fish pond displays, dinner entrees, and for the increasingly popular sushi offerings.

To begin his dream Kioshi obtained a mortgage and purchased a 27-acre farm 17 miles west of Valdosta, Georgia. Kioshi believed that this location provided a similar, warm climate to southern Japan (favorable to the Koi and tropical fish), had clay soil needed to establish pond bottoms, provided a good water source, and had land reasonably priced. While the farm had a man-made pond to capture rainwater for farming, Kioshi had twenty-five more shallow ponds constructed. Each standard pond is approximately one-third acre and is two to three feet deep. The five breeding ponds are smaller – only six by twelve feet. This number of ponds would allow Kioshi the flexibility to stock each with different fish and occasionally drain and clean them individually; one pond could be emptied, drained, cleaned, and restocked, while the others would be maintained on a rotating basis. Five ponds would each be reserved for growing imported Japanese Koi, domestic Koi, goldfish, exotic fish, and a restaurant stock or bait fish (Baltimore minnows).

FISH POND SET-UP, OPERATION, AND DELIVERY

The ponds are two to three feet deep to provide sufficient depth to discourage four-legged and winged predators, such a blue herons, easy standing room for fish consumption. Drainpipes in each pond keep the water level and least six inches from the top of the one-and-one half to two foot banks. This helps to prevent overflow in heavy rains and helps deter land-based predators easy access to the pond banks. One quarter-inch rat wire covered with plastic fastened over the drain pipe inlets prevents the fish from slipping through.

The ponds are cleaned once annually on a rotating basis. All vegetation is cleaned out and they are allowed to remain dry for at least several weeks in order to eradicate harmful insects and injurious marine life.

The fish spawn all summer, but the first spawning around the end of May is usually the best. Before this time the breeders (usually in a ratio of two males to each female) are placed in the smaller ponds. These ponds must by free of all vegetation, otherwise the females will lay eggs among the vegetation. Another “holding” pond, without fish, is readied for the eggs. Since the breeding pond is without vegetation the females lay their eggs onto the only vegetation available - trays covered with Spanish moss. The males fertilize the eggs almost immediately. A complete spawning from a healthy, mature female produces from 15,000 to 20,000 eggs. The removal of the egg laden moss from the breeding pond to a larger holding pond is ongoing and may take several weeks. The eggs and baby fish must be removed to a separate pond, as other larger fish, even their parents, may devour them.

On average about seventy percent of goldfish and Koi turn gold. The other thirty percent retain their original dark olive color; they are sold as Baltimore minnows to sporting goods stores or bait shops.

Goldfish and Koi can be ready for market in as little as three months after hatching. To grade the fish for size and color Kioshi uses an oil-covered table similar to a pool table with a hole in each corner. The fish are dumped upon the wet table surface – sized and judged for color – and then pushed through the proper holes into water-filled containers. This does not harm the fish since they can survive for a short period out of water as long as their gills are wet.

Depending on the size of the order the fish are delivered to local dealers by tank truck, which can hold eight large separate tanks for larger orders, or by trucks holding large tins for small orders. For small orders the fish are poured from the tin into a net and then to a water-filled can at the store and from there transported to the store's aquarium. For larger orders the fish can be pumped from one or more tanks on the tank truck.

Kioshi also contemplated raising aquatic plants along with the fish for additional profit. Anacharis, cabomba, water lilies, and water hyacinths are in the greatest demand. Kioshi has even heard that some water plants, which mature rapidly in such fertilized water, can be sold as feed to hog farms, which are very prevalent throughout the Southeast U.S.

The purchase, construction, stocking, and marketing of Kioshi's new business required two years, but in 2006 the Mattsaka Koi and Exotic Fish Farm Company was ready to begin commercial operations. In total Kioshi anticipated raising 300,000 fish annually. The company would be operated as a wholesale fish supplier selling fish from current stocks and importing unique varieties from Japan, Vietnam, and Thailand, when requested. Thus, the company operated as both a raise-to-stock and custom import order shop. (1Much information for this section was obtained from, "A Goldfish Farm in Virginia",http://wwwprofitfrog.com/profitable-hobbies-articles/raising-goldfish.htm.)

COMPANY ORGANIZATION

Most aquacultural companies such as Mattsaka are small, often family run, and employee very few employees. Kioshi's wife and two teenage children assisted with the business bookkeeping and operations. In addition a year earlier Kioshi added two fulltime workers to assist with the daily tending of fish feeding, fish and pond water quality and disease control, breeding operations, collecting fish for distribution, and shipping. However, with sales growing Kioshi brought in several relatives and friends from Japan to assist with the business. He hired a cousin, Aiko Oshima, as sales and advertising manager, Toshi Masuko, as the new company accountant and purchasing manager, Saburo Yoshida, a nephew with experience in inventory planning and distribution management, and Equchi Ishimura, a friend and experienced zoologist to manage the fish and pond quality and disease control program. This program included ascertaining the quality of: current fish stocks, ongoing breeding operations (fish species could not be mixed or contaminated in the breeding operation), purchased (incoming) fish stock, fish feed, and pond quality - including water and soil surfaces, and predator control.

PRODUCTS AND CUSTOMERS

There are many varieties of Koi, goldfish, and exotic fish. Some varieties of Japanese Koi are listed in Table 1. Kioshi prices his Koi individually by type, size, and appearance, but other fish such as goldfish are priced merely by size and type.

Most fish are sold to pet shops and large box stores, but some are purchased by restaurants and sushi bars both for aquarium or pond displays. In total Mattsaka had 37 reliable customers with over 100 different shipping locations. One of Kioshi's largest customers was the Fish and Reptile Pet Store Company, which was a nationally franchised pet store company. This firm had 53 franchised store locations throughout the United States and Canada. Most were located in medium and large cities. Kioshi could arrange for deliveries from his fish farm to any eastern or midwestern U.S. or eastern Canadian location or directly from foreign sources, such as Japan, when necessary.

Table 1
Varieties of Japanese Koi1

Doritsu	Bekko	Asasgi	GinRin Kohaku
Kawarimona	Kikari	Goshiki	Kahaku
Komonryu	Kuyaku	Goromo	Gin Matsuba
Sanke	Orenji Ogon	Platinum Ogon	Ochiba
Tancho	Tancho Sanke	Showa	Shusui
Utsuri	Yamabuki Ogon		

1Source: Forever-Mango.com

To fulfill customer orders fish are netted from the appropriate pond(s). The openings of the pond-wide net determines the size of the fish to be caught. For large orders entire ponds can be emptied by netting the fish or draining the water to a sufficiently low level where the fish could be caught by hand nets. For large orders the fish are transported in trucks or trailers equipped with fish tanks augmented with water recirculation equipment, temperature controls, and oxygenation equipment. Self contained, battery -powered fish tanks can also be loaded on aircraft for air delivery.

The lead time for land shipments by the Mattsaka Company usually require 1 to 3 days. Air freight can be used to expedite orders and were received in 1 to 2 days, depending on order size and destination.

NEW PROBLEMS, OLD CUSTOMERS

Last Tuesday, Aiko, the sales and advertising manager, beamed with pride as she entered the warehouse, which served as administrative quarters, testing laboratory, and tool, chemical, and feed storage. "Well, I just sold a truck load of 6" (6" to 8") domestic Koi to the Fish and Fowl Pet Store chain", she remarked with pride. "Good, but how much 6" butterfly Koi does that leave us with?" questioned Kioshi. "That is a very popular size for that variety", he added. "I do not know, but there are still some of that size and smaller ones left in the #2 pond", Aiko said. In recent months the company has had difficulty in forecasting demand for the medium size and larger Koi and exotic fish. And with the warmer months approaching demand was certain to increase as more pet stores would increase their stocks and restaurants would replenish their outdoor ponds and indoor aquariums for customer interest. Watching the meandering fish in aquariums and ponds amused the customers and lessened their perception of waiting for table seating or order preparation.

At that point Saburo, the inventory and distribution manager, stepped inside to record that pond #2 was down to 20% of fish capacity or about 200 Koi. No sooner had Saburo reached his desk than a computer order from the Fish and Reptile Company (FRC) (Mattsaka's largest customer) filled his computer screen. They were ordering five hundred 6" to 8" domestic Koi; a large tank truck would be needed for delivery in 2 days. Saburo knew that they did not have 500 domestic Koi remaining in the size FRC wanted. The other tanks were filled with smaller Koi, breeding fish, other fish types, or empty for cleaning in preparation for the "busy season". It would require nearly three and one-half months for the smaller, 4" to 6" butterfly Koi to grow to the 6" - 8" size. What could they do?

Kioshi, Aiko, and Saburo gathered in the main office to think this through. They were fairly certain they could produce about 200 of the needed 500 Koi. But the other 300? They did not want to lose such a valued customer. Kioshi decided to call Ron Thompson at FRC to explore some options and negotiate an agreement. After a 20 minute discussion FRC would accept several options: (1) accept the 200 full size fish and 300 smaller 4"-6" Koi at a considerable discount or (2) accept the 200 full size fish and 300 other 6"-8" Koi Mattsaka would have to subcontract from a competitor fish farm. After some calculations and discussion Kioshi agreed to the first option.

After closing his cell phone Kioshi turned to Aiko and Saburo and exclaimed," We handled this crisis, but I do not like how we settled this problem. This was expensive in both dollars and our reputation for outstanding customer service. Saburo, what is our policy on stocking or breeding our Koi to supply our customers?" Saburo hesitated, then remarked, "We dedicate five ponds to constantly breed the fish varieties. Two ponds are dedicated to butterfly Koi and other varieties of Koi – one pond for the smaller sizes 4" or less and another for the largest sizes. Four ponds are dedicated to each of the other fish varieties. It is not uncommon for one or more ponds to be empty occasionally for cleaning.

We try to replenish our stock from our breeding programs. If we cannot, we order from other domestic or overseas fish farms the type and number of fish we need to replenish a variety. It takes about two months before we can move fish from the breeding pond to another pond. Replenishing a variety from another fish farm can take from 3 days to one month. When we receive an order, regardless of the customer, we check our inventory supply; if we have the fish in stock we prepare the fish for delivery and adjust the inventory record for that fish stock. If we do not have an adequate supply of fish, we try to negotiate some agreement, but this does not happen very often. However, it does seem to be occurring more often as our reputation grows and sales expand. I am not certain how much money or future business we lose by not being able to satisfy customer orders – especially with our largest customer. We try to turnover (sell) as many ponds of fish as possible in a year, regardless of which customers may be short on some orders. It is sort of "max sales revenue by first come-first sold" strategy. It is expensive to just keep feeding these fish! We have considered digging more ponds to give us more flexibility, but have never reached a final decision as to how many more ponds to create or how we would allocate the fish to them."

CURRENT DILEMMA

Kioshi now turned to Dr. Lee and related, "Henry, that is the picture of what we do and the inventory problem we face. While we know a great deal about raising exotic fish, we are lost on how to approach this inventory shortage problem. What should I do?" After several moments of deep pondering, Dr. Lee replied,

"Kisohi, you obviously have a mismatch between customer demand and your fish supply – particularly for your largest and most profitable customers. This is made more difficult because you sell a product that cannot simply be produced quickly to satisfy demand by using overtime or adding employees. Your inventory is not manufactured, it is grown. I believe there are several issues we need to consider in more detail. Let me list them for you:

Is "maximizing the number of ponds sold" the best strategy. I mean does that really maximize your profits?

- While you must keep records on the size of each fish order, do you ever analyze the patterns of sales demand for each fish type? for each customer?
- Are all your customers equally important to you - to your bottom line, to your profits?
- Have you ever analyzed how much profit you make per customer over each year?
- Are you trying to satisfy all your customers equally or should you prefer some customers over other? In other words should you attempt to provide the same customer service level to all your customers?

I think we need to ponder these questions as a starting point."

QUESTIONS:

1. Saburo remarked that the company's sales policy was to,"..turnover (sell) as many ponds of fish as possible in a year, regardless of which customers may be short on some orders." Does this sales policy really maximize profit? Does this policy affect other decisions such as inventory policy and customer service policy? Comment on the pros and cons of this current sales and economic policy or objective. Suggest an alternative company sales/customer policy that could possibly aid with the current dilemma.

2. What inventory cost should Mattsaka consider in developing inventory policies?

3. Does Mattsaka inherently consider customer fill rates? Should they?

4. What inventory policy is Mattsaka inherently using?

5. What alternative inventory policies could Mattsaka use?

6. How could they allocate fish to ponds to help with their inventory stockout problems?

7. What might be a plausible, if not efficient, solution for Mattsaka in managing his inventories given the possible stock-outs for key clients?

REFERENCES

"A Goldfish Farm in Virginia", http://www.profitfrog.com/profitable-hobbies-articles/raising-goldfish.htm., Pages 1-5.

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STRATEGIC MANAGEMENT: THIS TIME ITS PERSONAL

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CASE DESCRIPTION

The primary subject matter of this case concerns the individual-level application of elements of the strategic management process. This process includes the scanning of the environment, analysis of alternative courses of action based on information gained from the scanning process and the formulation and implementation of individual career strategies based on that process. Secondary issues examined include an examination of the career effects of following both sound and flawed decision-making processes relating to career decisions. The case has a difficulty level appropriate for junior or senior level business students. The case is designed to be taught in 1-3 class hours and is expected to require 1-2 hours of outside preparation by students.

CASE SYNOPSIS

This case contrasts the career decision-making processes of three very good friends that attended university together – Kitty, Nancy and Teresa. They first met when they were all enrolled in the same strategic management class and worked together as a group. After graduation, they were all hired by the same company. Kitty and Teresa are still with the same company and are doing very well. Nancy has recently lost her job with the company as a consequence of restructuring and has accepted a position with a company that will take her to a different part of the country. The case takes place at a farewell dinner for Nancy hosted by Teresa and Kitty.

The case describes the two very different paths taken by the three friends to manage their careers to this point. All three began work in the same division with their employer – selling consumer electronics to medium and small retailers. Nancy transferred from the consumer products division to the automotive products division without considering the strategic position of that division. In contrast, Teresa & Kitty carefully considered the strategic position of the various divisions of the company before transferring to the division with best prospects for growth. While her friends continued to do well in their division, Nancy is paying a heavy price for not paying attention to some very important changes that were taking place in the company.

Kitty and Teresa used logic-based principles of the strategic management process in their own personal career development decisions – with significant positive results. Nancy, on the other hand, utilized career decision-making criteria that were based on personal convenience and intuitive appeal. The case provides a clear description of how the strategic management process has tremendous utility for the individual-level career decision-making process as well as management of the organization.

CASE

It might be an enjoyable Friday after work "happy hour" for most patrons of the La Aguila Vuela Cantina, an upscale urban Mexican restaurant. However, for one patron it was not very happy at all. Three long time friends and coworkers had gathered one last time to say goodbye. One of them had recently lost her job in a corporate reorganization and had taken a lesser paying position in a small company that was located in a different part of the country.

Teresa, Kitty and Nancy were classmates and graduated from an undergraduate business administration program offered by a prestigious public University. Once they arrived and were seated by the hostess, the conversation started by reminiscing about the many happy times they shared as undergraduates. They met as a result of being assigned to the same student group in their capstone strategic management class. The student groups in this class were each required to prepare an industry analysis. The group held weekly meetings at a local coffee shop to prepare for their presentation at the end of the semester. The group members really got to know each other during these meetings which resulted in the three classmates forming a close friendship that continued after graduation. After graduation, all three were hired by the same consumer electronics division of a foreign manufacturing company as salespersons based at the company's U. S. headquarters. Their positions involved selling consumer electronics to small and medium size retailers.

After approximately three years with the consumer electronics division, Nancy transferred to the automotive division. Her primary reason for the transfer was the availability of frequent travel to the Detroit area that salespersons in the automotive division enjoyed. Many of Nancy's relatives lived in the Detroit area and she made frequent business trips that allowed her to visit them. After Nancy transferred to the automotive division, Teresa and Kitty remained at the consumer electronics division until opportunities arose in the sales department of the medical equipment division. The medical equipment division had experienced substantial growth and increased importance of to the overall performance of the company and they wanted an opportunity to be part of that success. Their strategy proved to be successful. Since they started working in that division they had both enjoyed increased responsibility and greatly increased compensation. Nancy, on the other hand, had recently learned that the automotive division was being sold and she was one of many division employees that would not be needed by the buyer. Today was Nancy's last day with the company.

The reminiscing next turned to their strategic management course professor, George Aboye. He was an older, distinguished gentleman from the South who brought a folksy, storytelling style to his lectures. The professor was very encouraging and supportive, but he did not mince words when it came to warning students about the challenges of the current competitive business environment. He believed in the benefits of the strategic management process and provided many examples about how the process not only benefits the organization, but can also be used by individuals in the organization to strategically manage their career. Many of the professor's colorful lectures and stories about his experiences were still topics of conversation among these friends and former classmates.

After talking about their college days and the great experiences they had shared after graduation, Nancy felt it was time to discuss her current situation.

Nancy: I am not looking forward to moving and starting over with another company. I bought my home a couple of years ago and I don't think it has appreciated enough to cover a sales commission. I may actually lose money. Moving is a real hassle! I have been a good employee. It just doesn't seem fair to be treated like this. You two are very lucky to be able to have kept your jobs.

Teresa: Actually, it really wasn't luck.

Nancy: What do you mean?

Teresa: Do you remember two years ago when you couldn't attend the University homecoming weekend because you were in Detroit visiting relatives? Kitty and I ran into Professor Aboye at the College of Business Administration's homecoming barbeque. He asked how we were doing and we told him we were salespersons for the Consumer Electronics Division. He reminded us of the usefulness of the strategic management process for managing our careers with the company. He asked us if we had analyzed how our division fit in the overall strategic plan for the company. We replied that we didn't really know.

Kitty: I still remember his parting advice: The marketplace doesn't care who you are or what you want. The marketplace consists of entities acting in their best interest. You would be well advised to pay close attention to the activities of the marketplace and manage your careers accordingly.

You know, that advice really got me thinking about which division within the company provided the best opportunity for growth and profitability in the marketplace which would, in turn, present the best opportunity for each of us to advance our careers.

Teresa: We decided to follow our own individual strategic management process in planning our future with the company. We started by scanning the environment and looking at the forces both inside and outside the industries in which the company participates. Next we performed a separate SWOT analysis for each of the company's divisions. Not only did we assess the strengths, weaknesses, opportunities and threats, we also looked at each division's competencies, market position and level of competition in their industries. Finally, based on these factors, we ranked the various divisions as to their likelihood for future growth and profitability.

Kitty: Our assessment concluded that the medical division had the best prospects for growth and profitability. The margins are higher for the medical division than the other divisions. The aging population is a very significant demographic factor supporting growth. We informally met with senior managers in all the divisions and the consensus was that the medical division was the best positioned for future success. That division had developed several core competencies related to medically-related products. These competencies included designing and manufacturing very innovative portable medical equipment for first responders. The market for these products primarily consists of public fire departments that provide EMT services. In addition, the division had developed competencies in supplying several major types of disposable medical supplies to the hospital and large clinic markets through a propriety inventory management and order fulfillment system. These competencies were somewhat distinctive because many aspects of their operations are protected by fairly recent patents granted to the company.

Teresa: In addition, several recent actions by the board convinced us that they were favoring funding the expansion of the medical division at a much higher rate than the other divisions. The last three senior vice presidents that were hired were hired for the medical division, while the senior vice president positions in the other divisions remained unfilled. The last board member added is a CEO of a medical equipment company. The R & D budget for the medical division has been increased three years in a row, while the R & D budgets for most of the other divisions had been reduced.

Nancy: What did you conclude about the automotive division?

Teresa: Frankly, we felt the automotive division was the weakest link in the company. The division's major customers were the U.S. auto companies. These companies were losing market share to their foreign competitors and in the best of times were only marginally profitable. The people in the central office accounting department we talked to were getting a little anxious about the credit exposure to those auto companies because of the weakness of their balance sheets. They also informed us about people from outside the company that were reviewing the financial records of the automotive division which they thought might suggest that another company was possibly performing due diligence. Our contacts in the central office HR department told us that the most recent vacant positions in management for the division had remained unfilled for quite a while. We concluded that these were clues that led us to speculate that the company was looking to divest itself of the automotive division.

Nancy: I wish you had shared that information with me.

Kitty: Actually, we did try to talk to you about this process before we started it. It was the weekend we went to the "Legends of Disco" tribute concert. We were having dinner at our favorite Cuban restaurant. We talked about the need to make good career choices and the effort it takes to carefully do that planning. All you wanted to talk about was how your job with the automotive division provided you with a wonderful lifestyle including the opportunity to visit family in Detroit at the company's expense. Although we felt that you should have been paying more attention to changes the automotive division was going through in both internal and external environments, we were glad to see you were happy with your life.

Teresa: Even though the process of scanning the environment and picking the division that we felt was best positioned for future growth and profitability was very challenging, the process of implementing our strategy to transfer to that division was a great deal more difficult.

Nancy: I am interested in just how you two managed to transfer to the medical division.

Kitty: We followed a strategic process similar to the process we used to identify the division we wished to target. We started by doing a SWOT analysis at the individual level. We listed our strengths and weaknesses and matched those against the opportunities and threats facing the medical division. The results of our individual analyses were remarkably similar for both of us. Our strengths included extensive experience in electronic products, mastery of the various accounting and sales management software used by the company and familiarity with previous new product rollouts in the consumer electronics division. Our primary weakness was a lack of knowledge about most medical supplies. We concluded that, based on our strengths and weaknesses, we should pursue a position in sales for the new products for the first responder market. We decided to first investigate what electronic products the company might be considering for the first responder market. Next we needed to identify which individuals might be good sources of information about new product development in the medical division.

Teresa: We started with people we knew in the consumer electronics division that had transferred to the medical division. You probably remember that Professor Aboye had recommended that we aggressively build social networks within our places of employment as soon as possible. We didn't realize at the time how valuable that advice would turn out to be. During our first few years with the company we all attended several company functions and many unofficial after work gatherings. Two electronic engineers that we met at some of those functions, Frank and Jimmy, transferred about a year ago to the medical division, so we invited them out to lunch.

Nancy: I remember them. Frank's hobby was restoring old cars and Jimmy enjoyed water sports. They were both very friendly and helpful.

Kitty: They haven't changed a bit. We met them for lunch and they made us aware of what projects involving electronic medical equipment would be forthcoming. Frank mentioned that they had been working on a development team that successfully miniaturized many of the devices carried in ambulances and had been awarded patents for them. As a result the company began exploring ways to leverage that technology into smaller versions of medically-related consumer electronics products such as glucose and blood pressure measurement devices. Jimmy added that a new marketing team would likely be formed to launch these two new streams of products.

Teresa: Armed with this information, we set up an afterhours get together with two other former colleagues, Jill and Jennifer, who transferred to the medical division three years ago. Jill was promoted to senior sales manager for veterinary products for the Western U. S. region. Jennifer is currently a senior sales manager for dermatology products for the Northeast U.S. region. They both confirmed some of what Frank and Jimmy had told us. Jill and Jennifer informed us that one of their colleagues, Jack Levy, had been picked to head the new first responder product division. The company was still investigating whether to market the glucose and blood pressure measurement equipment to consumers, but no decision had been made to proceed further on that initiative.

Kitty: We asked them if they would present our resumes to Mr. Levy and serve as references. They said they would be glad to.

Teresa: Our next task was to craft our resumes to fit what we felt would differentiate ourselves in a positive way from our likely competition for the job. We first highlighted all the product launches in which we participated. We then described in great detail how familiar we were with the company's operations and systems. Our pitch to Mr. Levy, implicitly suggested by the detail in the resumes, was that we would be a safe choice because of the depth of our relevant experience.

Kitty: We also educated ourselves concerning Mr. Levy's experiences in the company that are relevant to his position with the new first responder equipment division. To the extent we had shared company experiences with Mr. Levy, we highlighted these in the cover letter submitted with the resume and referred to them in the interview.

Teresa: When we first met with Mr. Levy after we were hired, he indicated that his selection criteria did indeed include relevant experiences within the company and that came across very clearly in our resumes. In addition, the references we listed included many individuals that we met during our social networking activities that were in senior positions with the company and were also known to be acquaintances of Mr. Levy. Mr. Levy contacted each of the references and indicated that the information about us given by our references was the most important feature that differentiated us from other applicants.

Kitty: Now that we have been working in the division for a few months we have decided to evaluate the relative market acceptance of the various product offerings in the division by product and by geographic area to date. We anticipate that because of the similarity of the product offerings, the division will eventually organize based on geographic territories rather than product type. We also anticipate that, because of the higher levels of first responder funding in major cities, sales will be relatively higher in the Northeast and Mid Atlantic regions because of the higher number of large cities. Teresa has volunteered to travel to meet with the larger fire and police departments in the Mid Atlantic to introduce the new products and I have volunteered to do the same in the Northeast. Our goal is to be the sales manager in those regions.

The conversation came to an abrupt halt as the cantina's Mariachi band began performing a five song set including "Guadalajara," "La Cucaracha," "Mexico Lindo y Querido," "La Bamba" and ending with a particularly enthusiastic rendition of "El Mariachi." As the waiter delivered a fresh basket of chips, bowls of salsa and another round of beverages, Nancy resumed the conversation by being critical of what seemed to her to be calculated behavior by Kitty and Teresa.

Nancy: You two seem fairly obsessed with planning your careers. There is a lot to be said for living your life one day at a time. I have to feel just right about something before I move ahead.

Teresa: How do you "feel" about losing your job and having to move?

Nancy: What a cold thing to say to someone in my circumstances! I thought you were my friends.

Teresa: We are your friends, and we want what is best for you. That is exactly why we want you to stop making the same decision-making mistakes.

Nancy: What do you mean?

Kitty: Let's think back on our history of making big decisions. The first big decision all three of us made was where we decided to attend college. All three of us made this decision because we wanted to be at least 100 miles away from our parents and because the University had a winning football team. Consider our decision-making process. We decided to spend in excess of $100,000 and four years of our life at a University based on the fact that it was the right distance away from our parents and it had a good football team. If I was grading our decision-making process, I would give each of us an "F"!

Teresa: Now that we have the benefit of hindsight, a major objective of the investment of time and money in our college degree was to qualify us for better career opportunities. We should have scanned alternative universities with that criterion in mind. We also could have visited several universities and met with one or two of their business faculty about their programs and the jobs their graduates were getting. We could even have contacted managers that were friends of our parents and the HR departments of a few large employers in our area to get their feedback about which universities seem to prepare their graduates better than others.

Teresa: I suspect you did not do a lot of due diligence before you accepted your new position and didn't consider many other alternatives.

Nancy: Actually, I saw three jobs on a website that I might be qualified for and applied by e-mail. The first company that responded interviewed me over the phone then paid for my flight to the company headquarters for a personal meeting with Ann Vogel, the sales manager. She made me an offer at the conclusion of the meeting and I accepted. The other two companies responded the following week, but by then I had already accepted the offer.

Kitty: What did you find out about the company before you accepted the offer?

Nancy: I had a really positive feeling about them. Ann seemed very nice over the phone and when I met with her. They paid for me to stay in a fairly new Holiday Inn. Also, they had a nice suite of offices that overlooked a little lake in the middle of an industrial park.

Teresa: What will your job entail?

Nancy: That is the best part. I get to keep traveling to Detroit and calling on the same auto industry customers.

Kitty: What products will you be selling?

Nancy: The company is only about six months old. They plan to sell certain auto parts to the manufacturers. I think most of the parts are imported from a company in Asia.

Kitty: Is your company a division or subsidiary of this manufacturer, or does it simply buy the parts and sell them to the manufacturing customers?

Nancy: I am not really sure. Is it important to know that?

Kitty: Companies that are importers and wholesalers have the ability to switch to other manufacturers if necessary. Such companies are likely to be owned and managed by domestic individuals. If it is owned by the manufacturer, its existence rests on the decisions of the foreign owners. It will likely have an organizational culture that reflects the culture of the manufacturer. That may not be a culture that is a good fit for you.

Teresa: Clearly you did not research the ownership and governance structure of the company before you agreed to work for them. I guess there is no point in asking if you researched them enough to perform a SWOT analysis on the company so you could assess their competitive position with respect to their competition. I'll bet you didn't consider what other industries might present better long term opportunities for someone with your education and experience. If you were to find a position locally you wouldn't incur relocation costs and expenses involved in selling your home. Did you consider options in other industries that might be available locally? We have information from a variety of sources that this area will experience exceptional growth in the medical services industry.

Nancy: I really wanted to stay in the auto industry because I feel comfortable dealing with people I already know.

Teresa: The point is that your future relates to both your resources and the future performance of your employer in its industry. Your feelings and your comfort level do not pay the bills.

Kitty: Did you research your new hometown before you agreed to take the job?

Nancy: Not really. I saw a little bit of the town going to and from the airport in the taxis. It looked fine.

Kitty: Have you checked into the cost of living there?

Nancy: Not yet.

Teresa: I guess it doesn't matter now. You are committed.

Nancy: You two are into planning way too much. I'll get by just fine.

Teresa: If you want to spend your life just getting by, then keep doing what you are doing. You keep making the same mistakes by making decisions intuitively and not taking the time and effort to gather information and properly analyze it before making major decisions. We have definitely learned that the principles of the strategic management process that help large organization successfully achieve their objectives can also help individuals reach their career objectives as well. At the individual level, the process includes objectively assessing the realities of the marketplace and our own capabilities and personal resources. This objective assessment results in making career decisions based on marketplace realities, rather than wishful thinking or short term personal convenience. That is what we have strived to do, and it has worked well for us. It can work for you too. We wish you the best in your new position. I hope you will keep in touch and join us each year at the Homecoming barbeque.

After a final toast to Nancy's future success, the three friends and former coworkers bid each other good night. As they each drove to their residences Teresa and Kitty speculated as to whether Nancy would ever do a better job of decision-making and what news she would bring when they met next at homecoming. While driving home, Nancy speculated as to whether Ann Vogel would be furnishing her with a company car.

M&D SUPPLY CASE A: "STUFF HAPPENS"

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CASE DESCRIPTION

A devastating fire and terminal cancer! Sometimes key decisions are forced by stochastic circumstances. M&D Supply is currently one of the premier hardware and industrial supply stores in Southeast Texas with four outlets. During its forty-three years, the company has succeeded against heavy odds. These include changes in the market, recessionary trends, competition from national chains and personal tragedies.

A series of case studies will highlight the entrepreneurial spirit and business acumen that has enabled M&D Supply to overcome its challenges. M&D Supply case "A" focuses on entrepreneurial behavior in response to challenge and adversity. It examines a family's path to business success despite overwhelming personal and professional odds.

Secondary issues include strategies and tactics that were employed to reposition the business in response to declining market conditions. This case has a difficulty level that is appropriate for a senior level free standing or capstone course in entrepreneurship or small business management. The case shows that accurate recognition of a target market opportunity is a key consideration for success. During the late 60's and early 70's, Case A sees the company changing its focus from farmers and ranchers to individuals interested in a wide range of hardware products for the household.

Choosing and aligning with the right partner is important for a business of any size. Case "A" illustrates that the partnership with Ace Hardware was instrumental in providing M&D Supply with brand name recognition and an efficient supply chain.

Students are provided an entrepreneurial dilemma requiring them to develop, analyze, and prioritize the entrepreneur's alternatives. Case "A" requires students to perform a SWOT analysis of the business and while considering the main character's personal dilemma, recommend a course of action. Students should also develop a plan to align the business with its market opportunity.

CASE SYNOPSIS

Jack Dyson moved to Southeast Texas in 1955 to partner with venture capitalists G.F. Mitchell and E. W. McCown. Mitchell and McCown owned numerous businesses related to the Southeast Texas agricultural industry, including farm production, aerial seeding, and fertilizer *production and distribution. The two desired to own a farm machinery company and were seeking a partner who could operate the business. They partnered with Jack and opened Farm Machinery Company. The business operated successfully and was sold soon after G.F. Mitchell died. Building on their 10 year partnership, Jack Dyson, Mary Mitchell (G.F.'s widow) and E. W. McCown decided to incorporate M&D Supply.*

M&D Supply's business-to-business concept targeted farmers and ranchers. Secondary markets included consumers with large properties and institutions whose responsibilities included maintaining large tracts of land. The store's product mix included maintenance, repair and operations supplies necessary to sustain agricultural, beef, and other farm production activities.

The Farm supply business in Southeast Texas was segmented. National chains like Sears Roebuck, White's, and Western Auto and independent operations such as True Value Hardware offered a limited number of agricultural products and a low level of service. Dyson and his partners were confident their product mix, experienced staff, and familiarity with customers offered a value proposition that yielded sustainable competitive advantage.

The store turned a profit during the first two years. However, by 1969, a decline in the region's agricultural sector began a sustained trend of diminishing business conditions that put farmers and ranchers out of business. M&D Supply's financial performance reflected shrinking numbers in its target customer sector, necessitating that Dyson considers change.

INTRODUCTION

Jack Dyson's fledgling business, M&D Supply, was just a small metal building with bare concrete floors, an open ceiling, and florescent strip lighting, but for many farmers and ranchers in the community, this humble environment was HOME. Comforting smells of rubber tires and leather goods mingled with cigarette smoke, coffee and farm chemicals. Customers clad in khaki pants and shirts or bib overalls gathered around the long plastic table in the back, sipping coffee from a huge urn shaped like a Harvest King Tractor filter or chugging nickel cokes from glass bottles. The talk centered on rainfall, rice, the price of beef, politics, and the screwed-up younger generation. The atmosphere was Deep South, laid back, good ole boy. People browsed and did business as well as sharing their lives with each other. Jack loved the store, from the saddles and bridles to the cattle prods and stock tanks, to the tractor tires and mud grips to the spurs, boots, and horehound candy. It was in his blood and he yearned for M&D Supply to be successful as a resource for the community he called his own. However, Jack had weighty matters on his mind in the spring of '71 - M&D Supply was struggling. Harking back to his years in the implement business, Jack had initially figured his store's merchandise should reflect a farm supply orientation. Turns out he was wrong. The region's agricultural sector took a nosedive, and customers interested in tractor tires and horse chow was dwindling.

Jack sat in his ’67 GMC step-side pickup, staring at the cheesy blinking arrow that pointed to M&D Supply, and pondered what to do. With a wife and three hungry kids to feed, he had to find another way to create value and get new customers. M&D Supply had the good fortune of being located on high traffic thoroughfare. How could he fully leverage its favorable location? Finally it came to him. Hardware! Just plain hardware! People always needed hammers and nails and lawnmowers. The retail hardware market was underserved, as the farm supply market had been, and retail customers were growing in number due to the region’s expanding energy industry. His primary focus would be geared to a new target consumer, while continuing to serve his cherished agricultural sector.

Jack knew about the hardware distribution channel. Independents bought from wholesalers, then resold what they bought to consumers. Selling to consumers would mean changing M&D Supply from a volume focused business-to-business concept to a more value driven business-to-consumer model.

A few of the wholesalers, like True Value, were dealer-owned co-ops. Such entities united retailers under a common name to simulate the buying efficiencies of national chains. Co-ops also emphasized a common store identity. They were bound together by their names and advertising efforts. Jack knew a growing number of consumers were reading and hearing about stores affiliated with a co-op called Ace. Ace used direct mail circulars and catalogs, as well as radio and television with one goal in mind, to convince the American consumer its members had the best prices, best quality, and best service. Peers at a recent farm supply show were considering joining Ace and told Jack he should too. They liked the fact that Ace was established and big enough to command manufacturers such as Stanley and Black and Decker to give Ace dealers the same price they gave to large retailers Sears and Western Auto. Jack liked that too, plus the fact that Ace was owned by its dealers, meaning any profits earned would be distributed to members, including M&D Supply. Jack grabbed the notepad off his dashboard and made a note: CALL ACE HARDWARE!

Within a month, Jack contracted with Ace. He liked Ace Hardware’s brand recognition and national advertising that tagged Ace Hardware as “The Place with the Helpful Hardware Man.” Thanks to Ace, traffic-building advertising programs were now available at a lower cost.
A few of Ace’s practices were troublesome. Jack disliked the merchandise purchasing process. He had been accustomed to dealing with traditional wholesalers who provided representatives to recommend products and place orders. This necessitated the hiring of Harry Christian, an experienced buyer, recently forced out his own business by a big discount store in another market. Deliveries were also problematic. Ace’s rapid growth strained their distribution system. Lacking a distribution center in the south, deliveries from Chicago were erratic and sometimes required unloading during the middle of the night.

On the plus side, Ace proved itself a lean operation, providing merchandise at much lower costs than traditional wholesalers. This gave M&D Supply the opportunity to price competitively and increase its gross margin. In a few months’ time, Jack had re-invented his company as an Ace Hardware store. Best of all, customer counts increased, reflecting growing consumer traffic. Business began to build.

ISSUES

In the fall, following a battery of medical tests, Jack got the diagnosis no one wants to hear – CANCER. His Doctors in Houston stopped just short of delivering a death sentence, but Jack saw the Grim Reaper lurking in the shadows.

Then one night, less than three months after the cancer bombshell, Jack got the call no one wants to get – FIRE! By the time Jack and his family jumped into his 67' GMC pickup and roared to M&D Supply, flames had melted the tin roof of the building and were leaping ten feet into the sky. Firemen from three units fought their way into the building by chopping a hole in a large rear sliding door and then unlocking it. But as they made their way inside, many were blinded and overcome by smoke from the burning tires at the rear of the store where the fire had started. Again and again firemen called for more oxygen tanks. Twenty minutes after the first alarm, a second alarm went out and two more fire engines arrived. Thousands of feet of water hose snaked around the building as 40 men battled the blaze. An hour later, most of the flames were extinguished. Jack stood with his head bowed, tears rolling down his cheeks, his dreams literally in ashes. At sunrise the next day, Jack returned to survey the damage and found the rear interior of the store including offices containing vital business records, completely destroyed. As a result, Jack had no idea how much money he had, how much he owed, or how much was owed him. A thick layer of tire soot covered everything. Later, a call to the insurance company confirmed what he suspected - M&D Supply was pitifully underinsured. Only half of the 50,000 in damages would be covered. Jack was forced to liquidate the inventory and start over. The owner of the local True Value Hardware dropped by, in sympathy and with an insulting offer to buy M&D Supply for pennies on the dollar. Jack planned and executed a fire sale. The sale ran for a month, drew huge crowds, and brought both greedy vultures eager to take advantage of misfortune and kind longtime customers, lending a helping hand.

Both Jack's investors elected to move on. They were maturing in age and scrutinizing their portfolios. Progress with Ace had not come fast enough, and they were uncertain about the viability of the new concept. They declined to invest in re-opening the business and walked away. Having dodged bullets on Iwo Jima several decades before, Jack decided his present situation wasn't the worst he'd faced. He determined to beat cancer, bring his company out of the ashes, and make it the best hardware store in Beaumont!

Between chemotherapy treatments, Jack hit the streets looking for a lender. His initial efforts proved unsuccessful; then his fortune changed. A favorable medical report that his cancer was in remission and a call from a kind-hearted local banker helped him secure a SBA loan. Things looked hopeful. But shortly before M&D Supply's grand re-opening eight months later, Jack learned his cancer was back with a vengeance, the tumor inoperable. He sat in his 71' F-

150 with his head in his hands. Bad things were happening. If the doctors were right his time was short. Should he liquidate? Sell to Harry? Sell to the owner of the local True Value? Or could he position the business to survive beyond his earthly existence, as a family legacy? His fondest wish was to leave a thriving business to pass on to his son. But how could he do it?

STONEHAM COUNTY: THE IMPACT OF PUBLIC POLICY ON WIND POWER ECONOMIC DEVELOPMENT

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CASE DESCRIPTION

The primary purpose of this case is to explore public policy issues and economic development at the community level. The case can be used to explore the intricacies of complex decision making with respect to cost analysis in the economic development goals of local communities and the tradeoffs of long-term environmental and community relationships. The case has a difficulty level of three. The case can be used in a course on Strategic Policy. The case can be presented and discussed in two to four class periods depending on the number of issues considered. Students can be expected to spend about 10 hours of outside preparation to be fully prepared to complete the case.

CASE SYNOPSIS

As the United States strives toward energy independence, a strategic public policy emphasis on wind energy is growing. The proliferation of wind farms is fueled by a claim that wind power can reliably supply a significant and environmentally benign share of our country's growing demand for electricity. As wind farms have proliferated, however, adverse impacts of wind power are becoming clear to a growing number of citizens.

Georgina Oldman, County Judge for Stoneham County, was excited. She had just received a call from a corporation interested in the construction of wind farms in the county. The proposed 406 wind turbine farm would have a capacity of 650MW. The $750 million project would produce an estimated 10-year abated tax revenue of $15 million. The new revenue would fund badly needed services. The local economy had fallen on hard times over the past 2 decades, so the prospect of growth due to wind farms was seen another "oil boom" to the region. For the county, the call from the Shamrock Energy Inc. LLP was a timely godsend.

Judge Oldman knew that the county would have to establish a reinvestment zone and grant tax abatements. The required public hearing on the project drew a large crowd with speakers both supporting and opposing the project. Some speakers addressed the positive economic impact of the project, such as job creation, increased tax revenues, and economic stimulation. Others addressed the negative effects of wind farm development citing the impact on tourism, lost of aesthetics, noise and environmental concerns, and the potential impact on the *air force base. Having become clear that the county commissioners had much to consider, the county staff was directed to develop a cost / benefit study, analyzing both the tangible and intangible aspects to provide a recommendation regarding the project.*

STONEHAM COUNTY: THE IMPACT OF PUBLIC POLICY ON WIND POWER ECONOMIC DEVELOPMENT

Georgina Oldman, the County Commissioner Court Judge for Stoneham County was excited. She had just received a telephone call from an Irish-based corporation interested in the construction of wind farms in the county. Apparently, several landowners in the county had signed contracts of intent to lease their land to the corporation. Phases I and II of the wind farm project are expected to house 406 wind turbines for a total of 650MW of installed capacity. The total valuation of the project investment is $750 million; a potential estimated yearly unabated tax revenue of $1.25 million. The prospects for increasing county, independent school districts and water district budgets over the next 20 years would provide additional services that the various government entities had been unable to provide in previous years. Recently, voters in the county had failed to approve the district's $85MM education bonds and the $120MM water/sewer bond project. The county was left with how it would deal with getting by without the funds necessary to provide needed community services. In addition, due to the housing crisis, market values for residential homes had fallen by 18% over the past 2 years. The county could not raise the property tax assessed rate on residential property for 5 years because of mandates and caps placed on residential property tax increases by the State. For the county, the phone call from Shamrock Energy Inc. LLP was a timely godsend.

A strategic public policy emphasis on the viability of wind energy as a means to the future energy independence for the United States is growing. The proliferation of wind farms and proposed wind farms by energy companies, facilitated by political and regulatory mandates such as the Renewable Portfolio Standards (RPS) have created a "wind tsunami" across the political landscape in this country (Pew Center, 2009; Texas State Energy Conservation Office, 2010). Renewable Portfolio Standards represent the federal standard for each state to generate electricity from renewable sources. The proliferation has been fueled by a well-publicized and well financed claim that wind farms will be able to reliably supply a significant share of our country's growing demand for electricity. The campaign for wind also claims that wind energy is environmentally benign and a way to avoid the 'green house' effect emissions that are produced from fossil fuel sources of power for electricity generation. Political leaders in 'windy" states have been persuaded that wind farms will provide economic benefits, principally through lease payments to landowners, and increased property tax revenues to counties. As proposals to build wind farms have proliferated, however, the adverse impacts of wind power are becoming clear to a growing number of citizens, consumers, and taxpayers. While it is still early in the process, it is becoming clear that wind power may have adverse environmental, ecological, scenic, economic, and property devaluation impacts. For example, a study entitled "Impact of Wind Turbines on Market Value of Texas Rural Land" by Derry Gardner, Gardner Appraisal Group, Inc. (2009) indicates that on the average there is a 37% devaluation of market value due to the negative impacts caused by close proximity of wind farms to neighboring property. Indeed, Schleede (2003) concludes that it is possible that many of the claimed benefits of wind power are misleading or false, and that the true costs of wind power are higher than advertised—with those higher costs shifted from the producers to the taxpayers and electric consumers.

Although excited by the potential windfall, Judge Oldman knew that in order for the wind farm project to move forward, the county would have to establish a reinvestment zone and grant tax abatements. (A reinvestment zone is a change in the zoning classification of property; a tax abatement represents a percentage decrease in the taxable assessed value of property). In order to take such actions, a public hearing is required by law. A 7-day public notice in the legal notices section of the local newspaper alerted interested parties to the upcoming public hearing. The purpose of the public hearing is to invite comments from interested parties on the wind farm project. The commissioners would then have to vote on a reinvestment zone and any possible property tax abatements for the wind developer.

For several months prior to the public hearing, the local newspaper had published several articles in support of wind farm development touting its many "virtues." The local economy had fallen on hard times over the past 2 decades due to a drop in the oil market, and depressed housing and agricultural markets. County planners had done very little to diversify the local economy except for tourism, so the prospect of growth due to wind farms was seen by many as another "oil boom' to the region. It had even been rumored that Shamrock Energy Inc. LLP had donated money to several non-profit organizations in the local area, and several pro-wind groups were actively engaged in a well-organized public relations campaign to gain support for the proposed wind farm.

The public's interest in the wind farm project brought an unusually large crowd to the Stoneham County Courthouse, so much so that the meeting had to be moved to a larger room in the courthouse. There were many landowners present at the public hearing who were skeptical about the claims that there would be no negative impacts to the environmental view shed; the view shed is the visual aesthetic view in the surrounding area. There were concerns expressed related to the impact on tourism and land values of properties within close proximity to the wind farm. The total amount of acreage consumed by the large-scale industrial machines would be about 47,600 acres. Much of this acreage is located in the most beautiful, scenic, and historically rich part of the county. The proposed siting of the wind farm would be in close proximity to a State Park and one of Stoneham County's most frequently used lakes.

As the meeting progressed, it was apparent that tempers were rising in both the pro and against camps. Neighbors, who had once been highly cooperative and very cordial to each other, were now calling each other names such as "Nimby" and "Greedy." Some members of the audience went so far as to suggest that the landowners who were leasing their land for wind farm development were "greedy hypocrites who had put their Christian values aside for personal economic gain." Given that the community is deeply religious, the latter claim was especially stinging. Tension filled the room. Several area landowners whose properties would be dramatically impacted by the close proximity of the wind turbines both in terms of view shed and noise, spoke to these two issues. Mrs. S. R. Thompkin, a long-time resident of the county and 4th generation landowner, denounced the proposal to create a reinvestment zone and to provide property tax abatements to the wind developer on the basis of lost aesthetics and negative environmental impacts. Walter McCoy and his wife, Donna, explained that their residence would be within 317 feet of a proposed wind turbine where not only the noise would be very loud, but also there would be shadow flicker onto their property from the rotation of the blades. They also expressed concern about the possibility of developing "wind turbine syndrome." Three members of the audience representing the Tourism Bureau, the Historical Conservation Society, and the Military Affairs Bureau respectively, rose in turn to speak about the potential negative effects of wind farm development in the county.

Clifton Swisher, Executive Director of the Tourism Bureau, spoke first. He raised the concern that for the last four years, the major targeted developmental project by the Economic Development Council was tourism. The local area had used a .05 cent sales tax to help fund tourism projects, and the investment in tourism was now beginning to reap economic benefits to the community. The Economic Development Council estimated that the multiplier effect for the area from tourism has an 8-fold economic impact. The major theme advanced for tourism touted the 'frontier' and historic' qualities of the local area that was rich in both. Tourism now accounted for 7.3% of the local economy, but was targeted over the next 10 years to double. In addition, many related businesses had benefited from the growth in tourism—new construction in hotels, restaurants, and other related services. The potential loss of tourism revenues could be as much as 10%. How would the image of mile after mile of 400 foot industrial wind turbines across the landscape affect the perception of the 'frontier and historic' theme for tourism of the local area?

Sheila Sommers, Director of the Historical Conservation Society, echoed the comments of Mr. Swisher. She added that the rich cultural history of the area was a major draw for tourists. Small communities such as Railroad Gap and Cedar Gulch were not only well known for their artisans, but also for their location on the Fort Apache Trail that ran through the area. A world renowned restaurateur's steak and ribs business, the State park, lake, and aviary all would be threatened by the siting of wind turbines in very close proximity. She reiterated that these county treasures are invaluable and in high demand by tourists and locals because they were areas of the county with great scenic beauty. The open aviary, in particular, had drawn 105,000 tourists over the last 5 years because of its unique design and several endangered species. For example, individuals could take a walking tour of the natural habitat to spot many species of birds including an endangered species such as the black-capped vireo. The nesting areas of the black-capped vireo extended beyond the aviary into the proposed wind farm development zone. If the wind farm development proceeded as planned, much of the natural habitat of the black-capped vireo would be eliminated in order to place the wind turbines and the right-of-way access roads to the wind turbines. The vast amount of acreage required for the siting of the 406 turbines would destroy the scenic beauty of the landscape she argued.

Lt. Col. Royston, liaison for the air base and the Military Affairs Bureau, spoke next. The concerns he raised related to the encroachment of airspace in and around the base. Over the past decade, new commercial and residential development had occurred and was impacting the flight path of the military planes. The most desirable direction for growth of commercial and residential development is west and south of the major city in the county; this growth pattern has engulfed hundreds of acres of land close to the airbase. Lt. Col. Royston indicated that during the last round of Base Realignment and Closure Committee (BRAC) hearings 2 years ago, the airbase was almost downsized as a result of the encroachment issue. In fact, its primary competitor in South Dakota stood to gain significantly from the shift of aircraft and maintenance personnel. The South Dakota airbase made the argument that they had no encroachment issues for their base. This was a very close call for the local community given that the economic impact to the local economy from the airbase is about $460M annually. He also indicated that after the BRAC meeting, a member came up to him and said that the most important issue for base realignment and closure decisions is encroachment. According to the placement map provided to the county commissioners, 90% of the proposed wind turbines would be sited on the ridgelines in the southern and western portions of the county. The elevations for the wind turbines could reach between 3,000 and 4,000 feet; many of the low level flying sorties of the aircraft were at 1,000-1,500 feet which would put the wind turbines in the direct line of the flight path. Since the potential loss of economic benefit of downsizing the Air Force base for the community would be devastating, an estimated 8% of the total military expenditures, after the BRAC hearings the city and county passed restrictions on the amount of residential and commercial development in the area. In addition, the city and county passed ordinances that prevented any landowner from erecting a structure higher than 150 feet within the flight path zone. The base had heard from members of BRAC that these actions were viewed very positively.

Jeff Snyder, Executive Director of the Economic Development Council spoke in favor of the wind farm proposal. He indicated that the wind farm project represented not only a diversified energy business, but also the creation of more jobs for the area. In addition, the $750M capital investment by the Shamrock Energy Corporation would increase the property tax base for the county thereby increasing the tax revenue for the county, the independent school districts, and the water districts. According to the Chief Appraiser of Stoneham County, Donald Simmons, the estimated increase in the property tax base from the proposed wind farm would average $750M. "Community support favoring wind farms is essential if other corporations are to perceive a 'friendly and supportive' community environment for future wind farm development", he stated.

Given these comments, especially those of Lt. Col. Royston, it became clear that the county commissioners had much to consider. In addition to the reinvestment zone and tax abatement issues, consideration would also have to be given to granting an exemption from the building moratorium and the height restrictions. Based upon these comments, Judge Oldham moved to postpone a vote for two weeks. The motion directed the county staff to develop a cost / benefit study which would provide a recommendation regarding the project. The study is to provide information on both the tangible and intangible aspects of the proposal. A second meeting having been scheduled, the meeting adjourned.

As a member of the county staff, you have been charged with developing a cost / benefit study on the project. In order to provide the commissioners the information they need to make a wise decision, the study should provide information on both the tangible and intangible aspects of the proposal. Obviously the report should identify both the economic benefits and costs of the proposal. In addition, the analysis should go beyond "mere economic data" but should also include such elements as the significance of such factors as neighborhood relations, aesthetics, the perception of potential new businesses regarding the attitude toward development in the local community, etc. The report should end with a recommendation for action on the proposal. Since the county commissioners have almost always followed the staff recommendation in the past, you are keenly aware of the significance of this report.

Table 1
Source Contributions to Local Economy

Source	Contribution	Percentage
Military	$ 460 Million	7.5%
Hospital	$ 393 Million	8.8%
Retail	$ 2.1 Billion	47.2%
Education	$ 227 Million	5.1%
Tourism	$ 322.5 Million	7.3%
Agriculture	$ 91 Million	2.1%
Manufacturing	$ 113.4 Million	2.5%
Other	$ 867 Million	19.5%
Source: Stoneham County Chamber of Commerce, 2010		

Table 2
Estimated Economic Contribution of Proposed Wind Farm

	Jobs Creation: Payroll	Property Tax Revenue
Years 1-10	$1.5 Million (there is a 8x multiplier effect on the jobs creation number)	$15 Million (abated amount)
Source: Jeff Snyder, (2010). Economic Development from Wind Farms in the State of Texas: A Study of Property Tax Revenues.		

Table 3 Other factors Influencing Economic Development from Proposed Wind Farm	
Tangibles	
Loss of Tourism	10% loss [1]
Loss of military payroll	8% loss [1]
Loss of tax revenue due to devaluation of property	37% loss [2]
Property tax abatement Percentage	30% (Years 1-8) 20% (Year 9) 10% (Year 10) Full assessed value (Years 11-20)
Existing property tax base potentially affected	$765 Million
Intangibles	
Diminished community relationships Diminished aesthetic value to the environment Environmental losses: wildlife habitat, vegetation, and flood prone areas Potential medical conditions arising from a condition known as "wind turbine syndrome" Business climate in the community —favorable vs. unfavorable Other Considerations	
Source: [1] Stoneham County Economic Development Council, 2010; [2] Derry Gardner, Gardner Appraisal Group, Inc.	

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PENGUIN MANUFACTURING: UNSEEN LINKS BETWEEN MANAGERIAL ACCOUNTING, GAAP, AND CREDIT ANALYSIS

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CASE DESCRIPTION

This case focuses on linkages between managerial accounting techniques, the reporting requirements under generally accepted accounting principles, and the potential misunderstandings that can arise when preparers and analysts of financial statements have different understandings of the accounting process and the implications of the reported results. The specific topic dealt with in the case is how indirect costs (more specifically, the depreciation of equipment used in the production of a company's inventory) are absorbed in the production process and how those costs then appear in the financial statements. GAAP requires those costs be reported as a component of the cost of goods sold with any residual amounts incorporated in the work-in-process and unsold finished goods inventories. Companies occasionally do not adhere to this requirement, which can lead to results that can be misinterpreted by analysts. Due to the technical accounting topics covered, the case would be most appropriate for graduate students or senior accounting and finance students studying financial reporting issues or the analysis of financial statements. Although the case deals in part with somewhat arcane accounting topics, the case itself is designed to be taught in one or two class hours and is expected to only require one to two hours of outside preparation by students.

CASE SYNOPSIS

Penguin Manufacturing has been a very successful producer of high-quality machine parts. Despite the severe downturn in the economy the company has continued to expand and to generate profits and positive cash flows. The company is switching to a larger, more sophisticated financial institution that is better suited to meet its growing needs. Top management did not expect to run into any difficulties in securing financing from its new bankers and is perplexed as to why its application for credit was coming under what it believed was excessive scrutiny. Despite Penguin's strong financial statements, the lending officer assigned to the company was having problems interpreting some of the financial ratios generated in the credit analysis process and had requested some additional insights into the company's accounting processes. In their discussions it is discovered that the company has not been fully complying with generally accepted accounting principles related to assigning depreciation expenses associated with the production of the company's inventory to its cost of goods sold.

Although this improves some of the company's financial ratios, it makes other ratios appear weaker than they actually would be. After the two parties better understand how such discrepancies cause variances in the analysis of the company's financial statements, they have a clearer understanding of how to resolve their differences. Through the exercise the students will gain a better appreciation of how managerial accounting topics can impact financial reporting issues, which in turn can affect the analysis of a company's financial results.

INTRODUCTION

Penguin Manufacturing is a growing manufacturer of high-quality machine parts based in Cuyahoga Falls, Ohio. Although its results were hurt somewhat by the economic downturn during 2008 it had rebounded and generated very positive results in 2009, and was expecting even greater results in the future. Top management, particularly George Hampsted, the founder, president, and guiding force of the company, was quite proud of its operations, particularly its ability for producing high-quality goods while generating solid profits and cash flows.

Penguin is currently looking to refinance some of it operations. Its equipment is constantly in need of replacement and it appears that it is always in need of external financing to help meet the costs of maintaining its competitive advantages in a very competitive marketplace. It has mostly relied on bank financing, having had a long and successful relationship with the Julian Savings Bank that had provided the necessary resources for getting the company started. However, Mr. Hampsted believes that Penguin's future needs are beyond the capabilities of Julian and has decided to develop a relationship with a larger, more sophisticated, financial institution, Mort National Bank.

The company has recently completed its loan application, which included providing the bank with its audited financial statements, which are found in the Appendix as Exhibits 1, 2, and 3. Mr. Hampsted was shocked to discover that the bank's lending officer, Jennifer Jackson, was seriously contemplating disapproval of the loan request. Although Ms. Jackson did not have any concerns about the integrity of Penguin's owner-managers or its overall financial strength, she was concerned about what she perceived to be lackluster performance as documented by several key financial ratios that the bank typically used in conducting its analysis of new credit applicants.

Mr. Hampsted prided himself on the performance of his company. He knew from his attention to quality workmanship that the company could extract higher price mark-ups on his machine parts that was documented in higher gross profit margins than his competitors. The company's above average current ratio was touted as evidence of the amount of liquidity the company had, making it more likely that it could meet its current obligations such as any new bank financing.

Mr. Hampsted was especially proud of the cash flow margins generated by the company. The company's financial analyst, Joan Thomas, had documented how well the company was performing in this area with the help of a formula used by financial databases such as Compustat. Cash flow margin is calculated as the company's cash flow, defined as net income plus an add-back of the non-cash depreciation expense, divided by sales. Ms. Thomas had recently graduated from the local state university, one that had a solid reputation for producing quality financial analysts. In her studies she had relied on standard models and financial databases used in her business courses to calculate financial ratios and provide comparative industry data against which she could base her analysis.

Ms. Jackson has requested a meeting with representatives of Penguin to determine if there were any confounding factors that could be causing her to misinterpret or incorrectly analyze any of the company's financial results. Given the solid reputation Penguin had in the region, senior management at Mort were very interested in pursuing potential business opportunities with the company and wanted to ensure that its financial situation was properly understood before ultimately accepting or rejecting the credit application.

THE MEETING

To prepare for the meeting, Ms. Jackson provided Mr. Hampsted and his finance and accounting staff with some of the data she had collected and assessed. She had focused on the series of financial ratios most commonly used by the bank in its credit evaluations. Below is a listing of those ratios, along with the formulas used in calculating the ratios. A summary of the results of her calculations using Penguin's financial statement data as well as industry or peer averages is found in the Appendix as Exhibit 4.

- Current ratio = Current assets ÷ Current liabilities
- Quick ratio = (Cash + accounts receivable) ÷ Current liabilities
- Days' sales in receivables = Accounts receivable ÷ Sales/365
- Days' sales in inventory = Inventory ÷ Cost of goods sold/365
- Days' sales in payables = Accounts payable ÷ Cost of goods sold/365
- Cash conversion cycle = Days' sales in receivables + Days' sales in inventory – Days' sales in payables
- Cash flow margin = Cash flow from operations ÷ Sales
- Debt ratio = Total liabilities ÷ Total assets
- Net profit margin = Net income ÷ Sales
- Total asset turnover = Sales ÷ Average total assets
- Return on assets = Net income ÷ Average total assets
- Operating profit margin = Operating income (earnings before interest and taxes) ÷ Sales
- Interest coverage ratio = Operating income (earnings before interest and taxes) ÷ Interest expense
- Altman-Z score = 1.2 × Net working capital/Total assets + 1.4 × Retained earnings/Total assets + 3.3 × Earnings before interest and taxes/Total assets + 0.6 × Market value of equity/Book value of liabilities + 0.999 × Sales/Total assets.

During the meeting several points were discussed, along with a couple of revelations that likely affected the bank's analysis of the company, particularly in those areas in which Mr. Hampsted was most proud. For example, it was discovered that his formula for calculating the cash flow margin was different from the one used by Ms. Jackson, which happened to be the standard one used in the credit markets and the one used to generate the industry averages.

A more glaring item revealed during the meeting was that the company had been presenting financial statements that were not in full compliance with generally accepted accounting principles (GAAP). More specifically, this item dealt with the concept of absorption cost accounting in which companies are required to assign all costs, including indirect ones such as the deprecation of operating assets, to the cost of any inventory produced. Although the company was following the principle in terms of maintaining its cost accounting records, when it subsequently generated its financial reports, it had been reporting all of its depreciation expenses within other operating expenses rather than as part of the cost of goods sold. Ms. Jackson reported that she had read that the accounting regulators, most notably the SEC, had become increasingly concerned with companies not including depreciation expenses within their cost of goods sold.

Becoming aware of the differences in calculating the cash flow margin and the issue of the cost of goods sold not including depreciation expenses, both parties went back to try to better understand their differences of opinion over the financial situation at Penguin. They each went back to assess how these issues would change each others' evaluation of the situation, one that was not as positive as Mr. Hampsted had assumed nor not as negative as Ms. Jackson had assumed.

APPENDIX

Exhibit 1 Balance Sheet for Penguin Manufacturing (in thousands)			
Assets	**2009**	**2008**	**2007**
Cash and short-term investments	$1,420	$867	$543
Accounts receivable (net)	845	620	279
Inventory	1,798	1,556	1,435
Other current assets	287	307	324
Total current assets	4,350	3,350	2,581
Property, plant & equipment (net)	3,122	3,675	3,794
Other long-term assets	994	947	795
Total assets	$8,466	$7,972	$7,170
Liabilities and Equity			
Accounts payable	551	531	609
Accrued expenses	860	947	857
Short-term debt	359	303	238
Other current liabilities	293	276	271
Total current liabilities	2,063	2,057	1,975
Long-term debt	2,981	3,351	2,931
Other long-term liabilities	898	835	765
Total liabilities	5,942	6,243	5,671
Common stock	931	640	640
Retained earnings	1,593	1,089	859
Total equity	2,524	1,729	1,499
Total liabilities & equity	$8,466	$7,972	$7,170
Common shares outstanding	326	246	246
Year-end share price	$26.00	$15.00	$22.00

Exhibit 2 Income Statement for Penguin Manufacturing (in thousands)		
	2009	**2008**
Net sales	$8,806	$7,616
Less: Cost of goods sold	5,322	4,600
Gross profit	3,484	3,016
Less: Other operating expenses	2,608	2,504
Operating income	876	512
Less: Interest expense	207	198
Net income before taxes	669	314
Less: Provision for income taxes	165	84
Net income	$504	$230

Exhibit 3 Cash Flow Statement for Penguin Manufacturing (in thousands)		
	2009	**2008**
Net income	$504	$230
Depreciation	840	570
Other non-cash items	63	70
Net change in current assets	(447)	(445)
Net change in current liabilities	(50)	17
Cash from operating activities	$910	$442
Purchase of fixed assets	($287)	($451)
Other investments	(47)	(152)
Cash from investing activities	($334)	($603)
Issuance of common stock	$291	$0
Net short-term debt issued (repaid)	56	65
Long-term debt issued	335	507
Long-term debt repaid	(705)	(87)
Cash from financing activities	($23)	$485
Net change in cash	$553	$324

Exhibit 4 Financial Ratios for Penguin Manufacturing (based on as-reported data)			
Ratio	**2009**	**2008**	**Peers**
Current ratio	2.11	1.63	1.96
Quick ratio	1.10	0.72	1.18
Days' sales in receivables	35.0	29.7	36.0
Days' sales in inventory	123.3	123.5	105.2
Days' sales in payables	37.8	42.2	34.8
Cash conversion cycle	120.5	111.0	106.4
Debt ratio (%)	70.2	78.3	57.2
Gross profit margin (%)	39.56	39.60	30.27
Net profit margin (%)	5.72	3.0	5.0
Total asset turnover	1.07	1.01	0.91
Return on assets (%)	6.13	3.02	6.07
Operating profit margin (%)	9.95	6.72	10.34
Interest coverage ratio	4.2	2.6	4.5
Cash flow margin (%)	15.3	10.5	14.1
Altman-Z	2.82	1.95	3.15

STOCK OPTION BACKDATING AT COMVERSE TECHNOLOGY: ETHICAL, REGULATORY, AND GOVERNANCE ISSUES

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CASE DESCRIPTION

Stock option backdating involves granting stock options at a later date than shown on record to avoid taxes and recording expense. In recent years, stock option backdating schemes have been widely reported by the media. However, the regulatory, governance, and ethical ramifications of backdating have been largely overlooked in textbooks and classroom discussions in business schools. The primary subject matter of the case is to illustrate how internal control and corporate governance related weaknesses allowed the executives of a public company to perpetrate a fraudulent backdating scheme for several years. Secondary issues relate to accounting, regulatory, and financial reporting violations caused by backdating. These violations had serious repercussions. The top company executives lost their jobs, had to pay hefty fines, and even served jail time. The company had to restate their financial statements and pay back taxes with interest and penalty. It was delisted from NASDAQ and barred from paying stock-based compensation. The lesson students learn from this case is that a seemingly minor white collar crime has serious repercussions. The case has a difficulty level of four and is appropriate for senior level undergraduate students and first year MBA students. At the intermediate level, the case can be used in financial accounting, auditing, or fraud related courses. It can also be used in business ethics or corporate governance related courses at the undergraduate or graduate level. The case requires instructors to devote one class of 75 minutes or one-half of a three hour class. The preparation time outside class for students is estimated at three hours.

CASE SYNOPSIS

Many companies, including well known companies such as Apple and Microsoft, have been the subject of SEC investigations in connection with the stock option backdating scheme (Henry 2006). As a result of these investigations, SEC has filed lawsuits against more than 100 companies. Comverse Technology, Inc. (CTI) is one of the high profile defendants. It is a New York based company that makes software products, systems, and related services for multimedia *communication and information processing applications. Like any other technology company, CTI liberally used stock options to recruit and retain key employees. However, its top executives also ran a secret option backdating scheme for several years.*

This case can be used to accomplish several learning objectives. First, students learn the role of stock options in aligning the interests of managers and shareholders. They also realize how accounting standards and tax codes have contributed to the tremendous growth of stock options and even encouraged backdating practices. Second, the elaborate backdating scheme orchestrated by CTI managers for pecuniary gains raises serious ethical concerns that lead to lively and sometimes heated discussions in classroom. The case can be used as a stepping stone to emphasize the importance of sound corporate governance structure and how good governance practices and effective internal controls can be used proactively to prevent this kind of fraud. This puts spotlight on the board of directors' fiduciary duty towards shareholders. The deterrence value of some of the requirements of the Sarbanes-Oxley Act (SOX), the most prominent corporate governance reform law passed in the last decade, is also relevant to this discussion. Finally, the lesson learned from the case is that though backdating is perfectly legal, hiding it has serious accounting, regulatory, and tax ramifications. In CTI's case, the heavy price paid by top management and the company vividly illustrates to students the importance of operating a business within legal boundaries.

COMVERSE TECHNOLOGY INC

Background

The case is based on CTI's proxy statements for the 1995-2005 period and the lawsuit, Securities and Exchange Commission v. Jacob ("Kobi") Alexander, David Kreinberg, and William F. Sorin, filed by the SEC in the United States District Court for the Eastern District of New York (Civil Action No. 06-CV-3844 (GJ), E.D.N.Y. August 9, 2006).

Comverse Technology, Inc. (CTI) is a New York based company that makes software products, systems, and related services for multimedia communication and information processing applications. The company's product portfolio covers four areas: advanced messaging for groups, communities and person-to-person communication; call completion and call management; management and delivery of data and content-based services; and real-time billing and account management for dynamic service environments. It sells its products worldwide with its own sales force and through several international vendors of telecommunications infrastructure equipment. The customer base of the company spans more than 125 countries and covers over 450 communication service providers including 20 largest telecom companies in the world, serving more than two billion subscribers.

CTI has two subsidiaries: Verint Systems, a provider of analytic software-based solutions for communications interception, networked video security and business intelligence; and Ulticom, a provider of signaling software for wired, wireless and Internet communications. Verint's software generates actionable intelligence by analyzing unstructured information contained in voice, fax, video, email, Internet, and data transmissions. The software is used for communication interception by law enforcement and other government agencies and for networked video security of airports, public buildings, and correctional facilities. Ulticom's Signalware software is used by equipment manufacturers, application developers, and communication service providers.(www.cmvt.com)

The company was founded by Jacob "Kobi" Alexander in 1984. Alexander also served as chairman and CEO of the company from 1987 to 2006. During 1990s and early 2000s, CTI experienced substantial growth in revenues and size. Table 1 provides select financial data for the company. Its stock was traded on NASDAQ under the symbol "CMVT" and became a component of the S&P 500 and the NASDAQ 100 indices in 1999. Like other technology companies, CTI liberally used stock options to recruit and retain key employees and to provide incentives to its executives.

Table 1
SELECT FINANCIAL DATA - CTI INC (Million $)

	1995	1996	1997	1999	2000	2001	2002	2003	2004	2005
Net Sales	137.1	197.2	280.3	696.1	872.2	1225.1	1270.2	735.9	765.9	959.4
Cost of Goods Sold	58.3	84.6	119.6	278.6	320.9	436.7	470.8	277.4	270.9	328.3
Gross Profit Margin	57.5	57.1	57.3	60.0	63.2	64.4	62.9	62.3	64.6	65.8
Net Income (Loss)	17.1	28.0	43.5	111.5	170.3	249.1	54.6	-129.5	-5.4	57.3
Current Assets	190.3	351.0	405.5	932.6	1175.5	2275.7	2397.1	2126.9	2462.3	2627.1
Total Assets	221.5	390.9	457.6	1031.4	1352.4	2625.3	2704.2	2403.7	2728.0	2925.3
Current Liabilities	35.2	58.7	75.2	225.4	326.7	415.3	366.9	360.4	321.0	487.3
Long-Term Debt	60.0	115.0	115.0	415.0	300.0	900.0	600.0	390.8	544.7	420.0
Stockholders' Equity	121.8	212.1	261.5	381.7	711.3	1236.2	1616.4	1549.7	1672.5	1794.0
Operating Cash Flow	6.7	12.5	39.7	104.3	175.2	244.5	142.2	96.8	128.6	117.0
Investing Cash Flow	53.4	-40.0	-72.1	-9.0	-474.3	-207.3	-122.4	35.9	-310.6	-57.9
Financing Cash Flow	0.6	124.3	9.2	307.8	52.1	894.1	67.0	-91.8	310.2	39.1
Source: Standard and Poor's Compustat Database										

The board of CTI ranged from 6 to 8 members including a chairman. It also had three committees- audit, executive, and compensation. Each committee typically had three members. Table 2 provides the details of board members and committee membership.

Table 2 BOARD OF DIRECTORS AND COMPOSITION OF BOARD AND COMMITTEES - CTI INC				
Name	Title	Relation with Alexander	Committee Membership	Directorship Duration
Kobi Alexander	Chairman of board and CEO*		EC, AC♦	1984-2005
Zvi Alexander	Director	Father		1989-2002
John Friedman	Director, Chairman of CC		AC, CC	1994-2005
Sam Oolie	Director		EC, AC, CC	1986-2005
William Sorin‡	Secretary and Director		EC	1984-2005
Yechiam Yemini	Director and Scientific Advisor	Brother-in-Law	EC, CC	1984-1996
Shaula Yemini	Director	Sister	CC	1999-2001
Itsik Danziger	President and Director			1998-2005
Francis Girard	Director, Vice Chairman of Comverse Network System -a subsidiary of CTI. CEO of CTI from January 1998 until January 2001.			1998-2003
Ron Hiram×	Director		AC, CC	2001-2005
Raz Alon	Director			2003-2005
David Kreinberg†	Vice President of Finance and CFO			

Source: CTI's 1995-2005 proxy statements. EC: Executive Committee AC: Audit Committee CC: Compensation Committee
* Alexander also served as chairman and CEO of Ulticom and Verint, two subsidiaries of CTI. He was forced to resign on May 1, 2006.
♦ Alexander served on AC until June 2001. ‡ Sorin also served as a director of Ulticom since 1995 and as a secretary and a director of Verint since 1999. He was forced to resign on May 1, 2006. × On December 14, 2006, Ron Hiram resigned from his position. Hiram had served as the chairman of the board since April 2006 and also served as a member of the audit and compensation committees. After his resignation, additional five new independent directors were added to CTI's board. † Kreinberg was not a director of CTI but he served as Ulticom's CFO from December 1999 to September 2001. He had also served as a director of Ulticom since 2000 and a director of Verint since 1999 until he was forced to resign on May 1, 2006.

STOCK OPTION GRANTS AT CTI

The option awards at CTI were made under a series of eight stockholder-approved company-wide stock option plans (table 3). These plans were drafted by William Sorin, corporate secretary and director of CTI. Sorin also served as general counsel to the company. Under these plans, employees could be granted either qualified stock options or "QSO" (as defined under section 422 of the Internal Revenue Code) or non-qualified stock options "NQSO" (defined as any option that is not a QSO). While option grants to CTI's employees could be structured as either QSO or NQSO, non-employee directors or employees of CTI's affiliates could only receive NQSO.

Table 3 COMPANY-WIDE OPTION PLANS - CTI INC		
Plan	Effective Dates	Shares Available for Grant
1987 Stock Option Plan	1993 -10/8/1997	33,000,000
1994 Stock Option Plan	9/16/94-9/15/2004	950,000
1995 Stock Option Plan	10/13/95-10/12/2005	1,000,000
1996 Stock Option Plan	10/31/1996- 10/31/2006	1,000,000
1997 Stock Incentive Compensation Plan	11/21/97-11/20/2007	2,500,000
1999 Stock Incentive Compensation Plan	5/13/1999-5/12/2009	3,500,000
2000 Stock Incentive Compensation Plan	9/15/2000-9/14/1010	9,000,000
2001 Stock Incentive Compensation Plan	6/15/2001-6/15/2011	9,000,000

Source: The Securities Exchange Commission

The board delegated to the compensation committee its full authority to interpret and administer the stock option plans including (i) selecting specific employees, (ii) determining the type and amount of stock option awards to be granted to such employees, and (iii) deciding the terms governing the awards. The compensation committee also determined the exercise price. The stock option plans did not permit options grants to have an exercise price less than the market price of the stock at the grant date. If the grant recipient resigned or was dismissed, all of the unexercised options were cancelled and added to the pool of options available for future awards. Cancelled options could not be awarded to others without prior approval of the compensation committee.

The company's bylaws permitted the compensation committee to approve stock option grants either at a formal meeting (at which a quorum was present in person or by phone), or without a formal meeting if all members of the compensation committee consented in writing to the adoption of a resolution known as "unanimous written consent" (UWC). From 1991 to 2001, the compensation committee approved all but one option grants by means of UWC. The UWC specified the number of options granted, the exercise price, and a vesting schedule. However, none of the UWCs were dated or contained any language indicating that members of the compensation committee should provide a date next to their signatures.

Prior to 1998, CTI granted stock options throughout the year. After 1998, at the suggestion made by the chairman of the compensation committee, company-wide grants were made only during the latter half of the fiscal year. Grants to specific employees to accommodate special situations (e.g., to lure prospective employees or to retain disgruntled employees), referred to as "one-off" grants, however, were continued to be made throughout the year.

STOCK OPTION BACKDATING SCHEME

The process of stock option grants was directed and controlled by Alexander, the chairman and CEO of the company. When he wanted to initiate a stock option grant, he determined the approximate number of shares to be granted and allotted them between each of the CTI's operating divisions and subsidiaries. The managers of the divisions and subsidiaries prepared grant lists containing the names of employees and the number of shares to be given to each employee. These lists eventually were forwarded to Sorin. Alexander decided how many shares each executive including himself would receive. Sorin consolidated the separate lists of proposed grantees into a master list, drafted the UWC, and sent it along with the master list to the compensation committee. Members of the compensation committee reviewed the grant lists and signed the UWC without dating it and returned both of them to Sorin. At some point during this process, Alexander "cherry-picked" the grant date that usually corresponded to a date on which CTI's common stock was trading at a relatively low price. Sorin then inserted the "as of" date chosen by Alexander into UWC and other grant related documents. Starting 1998, David

Kreinberg, the CFO, joined Alexander in selecting these dates. Kreinberg was a former partner of Deloitte and Touche. Prior to joining CTI, he had served as its external auditor.

After receiving signed consents from all members of the compensation committee, Sorin entered the details of each employee's grant into Equity Edge, an electronic system used by CTI to track stock options grants, exercises, and all other related information. In various quarterly in-house counsel letters to the company's outside auditor, Deloitte and Touche, Sorin indicated that corporate action sufficient to approve grants had taken place on the "as of" grant dates. These letters failed to indicate that the compensation committee did not act to approve the grants on the "as of" dates. In fact, the compensation committee was not even aware of the grants on the “as of” dates. In numerous instances, Alexander, Sorin, and Kreinberg instructed or made changes in the grant schedules by deleting or adding names and/or changing the number of shares to be granted without the knowledge or approval of the compensation committee. These changes were also entered into Equity Edge by Sorin. Once all the information was entered into Equity Edge, option agreements were sent to the grant recipients. The company used Equity Edge reports to calculate, among other things, earnings per share (EPS) and also as a source of information for option-related disclosures in its 10-Q, 10-K, and proxy statements.

BACKDATING EXAMPLE

CTI’s records indicated that a company-wide option grant was made as of October 18, 1999 awarding a total of 3,834,000 options with an exercise price of $93 per share to 1,633 employees. The lowest stock price of the quarter was also on October 18. However, the compensation committee did not approve this grant until after November 23, 1999, when Sorin sent UWC forms to the members of the compensation committee. The stock price closed at $127.06 per share on November 23, 1999. In other words, between October 18, 1999 and November 23, 1999, the intrinsic value of each option had increased by $34.06, resulting in a gain of approximately $130 million to the grant recipients.

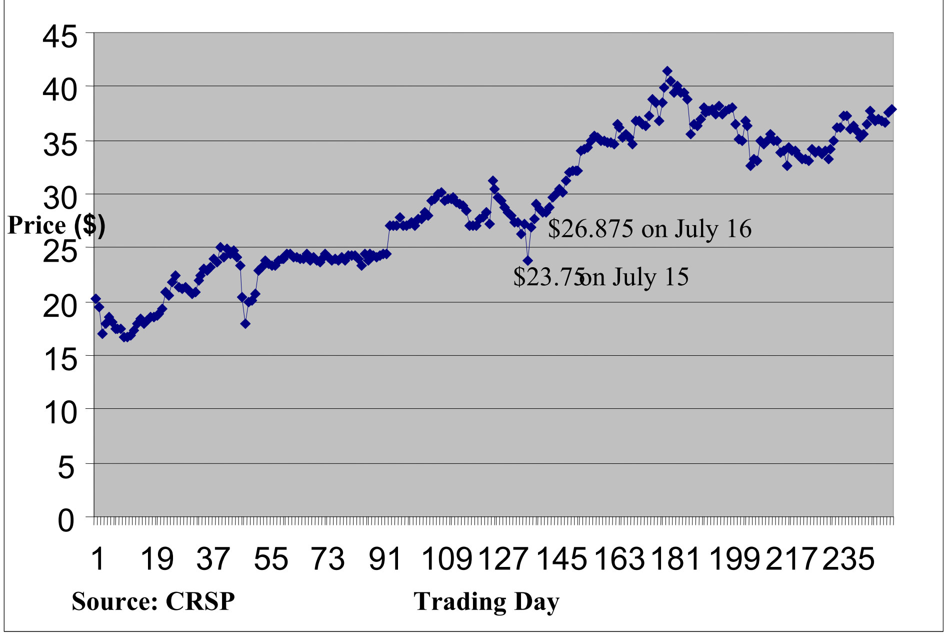
SLUSH OPTION ACCOUNT

In 1999, Alexander came up with an idea of creating a slush fund of options to increase the flexibility of awarding options to employees without getting approval from the compensation committee. He directed Sorin to open an account in Equity Edge in the name of ‘I.M. Fantom’, which was later renamed to ‘Fargo’. Initially, 3,000 approved but unutilized options from the company's acquisition of Netology were added, instead of being cancelled, to this account. To add more options to this account, Sorin created fictitious names in the master list of proposed grantees and sent it to the compensation committee to get approval. For example, as part of the company-wide grant dated October 18, 1999, Sorin made up 35 names, gave each of them his home address, and entered them in the master list with option award of about 5,000 each. The grants were kept small to avoid detection by the compensation committee. After receiving the approval, Sorin added the entire (35 × 5,000 =) 175,000 options to the Fargo account. The company did not enable the audit software of Equity Edge. As a result, the daily history of the Fargo account was not stored. From 1999 to 2001, a total of approximately 906,000 options were transferred to the Fargo account, of which approximately 187,000 were distributed. The existence of Fargo was deliberately concealed from the auditors by removing pages referencing the Fargo account from documents provided to the auditors. The account was terminated in 2002 when the Sarbanes-Oxley Act (SOX) required companies to report to SEC all option grants to the executives and officers of the company within two business days.

DISCOVERY OF BACKDATING

On March 18, 2006, based on the data provided by Lie (2005), a professor of finance at the University of Iowa, the Wall Street Journal published a list of companies that had awarded stock options to their top executives on dates immediately followed by large gains in the stock price. CTI's stock option grants were among those highlighted in the report. For example, its stock option grant on July 15, 1996 was followed by a 13% rise on the next day (See Figure 1). Another stock option grant date, October 22, 2001, coincided with the second lowest closing price of 2001. The odds that this would happen by chance were one in six billion according to a professor of statistics at Yale University (Forelle and Bandler, 2006).

Figure 1
1996 DAILY TRADING PRICE OF CTI'S STOCK



This unusual pattern in the timing of company's stock option grants led to allegations of backdating. To investigate these allegations, the board of CTI formed a special committee consisting of two independent directors. The special committee reviewed 39 separate grants of more than 82 million options to approximately 6,200 employees and consultants, as well as 22 grants of approximately 1.2 million options to eight non-employee directors of the company during 1991-2005. It found that between 1991 and 2001, almost 54 million stock options (issued via 29 grants to 5,386 grantees) were backdated to obtain lower exercise prices. The difference between the market value of CTI's stock on the actual grant date and the "as of" grant date for all exercised backdated options amounted to $71,872,650. In this, the share of the trio was $6,435,750, $1,052,734, and $1,010,424, respectively. Based on the committee's findings and recommendations, the trio was asked to resign from their positions in CTI and its subsidiaries (Maremont and Bandler, 2006).

THE SEC INVESTIGATION AND LAWSUITS

On August 8, 2006, based on the Wall Street Journal reports and data provided by the special committee, SEC launched investigations into CTI's backdating scheme. Later it filed a civil fraud and injunctive case against the trio accusing them of operating a fraudulent stock option backdating scheme and of issuing false and misleading financial reports and proxy statements. The New York state attorney also filed criminal lawsuits accusing the trio of conspiring and committing securities fraud. These lawsuits alleged that, from 1991 to 2001 Alexander, Sorin, and Kreinberg realized a gain of nearly $138 million, $14 million, and $13 million respectively from the sale of shares obtained via exercises of backdated options. Of these gains, at least $8.4 million resulted from the in-the-money portion at the time of grant. Table 4 provides details of eight backdated option grants and the share of the trio. Details of other "one-off" and regular backdated grants uncovered by the special committee are not available.

Table 4
COMPANY-WIDE BACKDATED OPTION GRANTS - CTI INC

"As Of" Grant Date	Actual Grant Date	Price at "As of" Grant Date	Price At Actual Grant Date	Total Options Granted	Total Options/ Percentage to Alexander	Total Options/ Percentage to Kreinberg	Total Options /Percentage Granted to Sorin	Total Options/ Percentage Granted to Trio
07/15/1996	09/10/1996	$23.75	$36.5	459,000	100,000/ 21.8%	17,777/ 3.9%	10,000/2.2%	127,777/27.9%
05/28/1997	06/16/1997	44.25	45.75	711,000	150,000/ 21.1%	5,000/ 0.7%	20,000/ 8%	175,000/29.8%
01/27/1998	02/19/1998	31.25	45.31	3,109,000	500,000/16.1%	35,000/ 1.1%	50,000/1.6%	585,000/18.8%
10/09/1998	10/15/1998	30.00	36.50	744,000	250,000/ 33.6%	10,000/1.3%	7,500/1%	267,500/35.9%
10/18/1999	11/23/1999	93.00	127.06	3,834,000	315,000/ 8.1%	37,500/1%	30,000/0.8%	382,500/9.9%
11/30/2000	12/13/2000	85.00	112.12	8,769,000	600,000/ 6.8%	100,0000/1.2%	40,000/0.5%	740,000/8.5%
10/22/2001	12/18/2001	16.05	20.77	9,446,000	600,000/6.4%	125,000/1.3%	27,000/0.3%	752,000/8%
Total				27,072,000	2,515,000/9.3%	330,777/1.2%	184,500/0.7%	3,029,777/11.2%

Source: The Securities Exchange Commission.

To avoid prosecution, Alexander fled to Namibia, one of the few countries which do not have a formal extradition treaty with the US. The government seized about $49 million of funds held in Alexander's Citigroup Smith Barney accounts. However, before leaving the country he managed to transfer $57 million to Israel. He was indicted on 35 charges of securities fraud, money laundering, and tax evasion. (Department of Justice Press Release 'Jacob "Kobi" Alexander, former CEO of Comverse Technology Inc., apprehended in the Republic of Namibia,' dated September 27, 2006 available on http://www.justice.gov/usao/nye/pr/2006/2006Sep27.html.) If convicted, he could be sentenced to prison for up to 25 years. On October 24, 2006, Kreinberg pleaded guilty to two felony charges- one count of conspiracy to commit securities fraud and one count of securities fraud. The conspiracy charge carries a maximum of five years of imprisonment and a fine of up to $250,000. The securities fraud charge carries a maximum of ten years of imprisonment and a fine of up to one million dollars. These charges stem from running the option backdating scheme and maintaining a slush fund of options. In a separate agreement to settle the civil charges brought by the SEC, he agreed to pay a fine of $2.4 million and is permanently barred from serving as a company director or officer.(Securities and Exchange Commission Litigation Release No. 19878/Accounting and Auditing Release No. 2497 dated October 24, 2006 available on http://www.sec.gov/litigation/litreleases/2006/lr19878.htm) On November 2, 2006, Sorin pleaded guilty to the felony charge of conspiracy to commit securities fraud. He was sentenced to prison for one year and a day. He also paid a fine of $3.1 million to settle the civil charges brought by the SEC.(Securities and Exchange Commission Litigation Release No. 19964/Accounting and Auditing Release No. 2537 dated January 10, 2007 available on http://www.sec.gov/litigation/litreleases/2007/lr19964.htm.)

In 2007, the company recorded a total of $314 million of additional compensation expense related to backdating including $49 million of income taxes, penalty, and interest charges. In addition, CTI also recorded $52.6 million in expenses related to the special committee's investigation.

GLOSSARY

- **Backdating-** To grant stock options at a later date than shown on company records.
- **Exercise**- To elect to purchase stock pursuant to an option. The option holder purchases stock from the company at the 'exercise price' regardless of the prevailing market price.
- **Exercise Date**- The date that the employee purchases stock pursuant to an option.
- **Exercise Price**- Price at which stock can be purchased pursuant to an option. The exercise price is fixed when the options are granted and is usually equal to the market price at the grant date. The options are said be in-the-money, at-the-money, or out-of-the-money, if the stock price is higher than, equal to, or lower than the exercise price.
- **Grant Date**- The date on which an option is offered to the employee.
- **Nonqualified Stock Option** (NQSO)- A stock option that does not qualify for favorable tax treatment under sections 421, 422, and 423 of the Internal Revenue Service Code. At the time of exercise, the

employee pays ordinary income tax on the difference between market price and exercise price and the employer deducts the same amount as compensation expense.

- **Qualified Stock Option** (QSO)- An option, qualifying for favorable tax treatment under sections 421, 422, and 423 of the Internal Revenue Service Code. The employee doesn't pay tax upon grant or exercise of options. If the employee sells the stock, the difference between selling price and exercise price is taxable as capital gains if the stock is held for more than a year. The employer does not get any deduction.
- **Stock Option**- A right to buy a given number of shares of a company at a stated price within a specified period of time.
- **Vesting Period**- The time from the grant date that must pass before the employee can exercise options.

SMÁRALIND SHOPPING CENTRE

Michael R. Luthy, Bellarmine University

CASE DESCRIPTION

The primary subject matter of this case concerns the development of appropriate policies governing temporary occupants (i.e. non-tenants) of a shopping centre facility. Secondary issues examined include how a property management firm strikes a balance between commercial and philanthropic interests in the community. The case difficulty level may range from a one (suitable for the Introduction to Business course enrolling freshmen and/or sophomore level students if discussion is kept relatively general) to a four (suitable for the Business Policy course typically enrolling junior or senior students if discussion is to draw on material from other business core courses). A significant factor in determining the difficulty level is dependent on the amount of pre-class preparation and/or any outside readings the instructor wishes to assign. The case is designed to be taught in either a single class hour (focusing on just the "bare bones" of needed policies to several class hours (if student teams present their recommendations). Consistent with the instructor's objectives for this assignment the number of hours of outside preparation by students ranges from one (if preparing for a one-hour discussion of the case) to three to five hours (if presentations of draft recommendations are expected).

CASE SYNOPSIS

A new, modern shopping center located in the suburbs of Reykjavik, Iceland is soon to open in the Kopavogur area. The enclosed, multi-level facility, only the second in the country, will serve both as a commercial venue as well as a natural meeting place for the local population and visitors to the area. As the opening approaches numerous requests from small for-profit firms, volunteer organizations, and other philanthropic concerns to use public areas and/or the large, open area at one end of the facility have arrived. Students (operating as surrogates for the property operations manager, Mr. Kristinn Jóhannsson) are tasked with developing a space utilization policy for non-tenants (those who wish to rent an open area called Winter Garden and others who wish to operate in the common areas for philanthropic or community building reasons). Development of appropriate policies call on students to balance the rights of the permanent, rent-paying tenants with the desire to increase mall traffic and operate the facility as a part of the larger Icelandic community.

THE PROBLEM

Kristinn Jóhannsson, Operations Manager for Smáralind Shopping Centre in Iceland, sat at his office desk. It was laid out with blueprints, tennant lease agreements, and a number of letters from local non-profit organizations and small businesses. Although the formal opening of what would be the largest shopping centre in the country was still six weeks away, he was pondering how to respond. In these letters were requests to use either the common areas of Smáralind or the Winter Garden facility. The requests ranged from a blood collection drive, to an exhibition of new model automobiles from a local motor car dealer, to a concert benefiting sunami relief in Southeast Asia.

Long-term, rent-paying tenants seek patrons to their stores. They desire so-called foot traffic (people coming to the mall) even if it isn't solely for the purpose of coming to their store. Indeed it is the mix of stores in a shopping centre that make the destination desirable for many shoppers. When commercial interests rent space in a property they consider everything from the demographics of potential customers in the area to safeguards against product or product line cannibalization by other tenants. One of their concerns is policies governing use of the facilities by temporary tenants. While temporary tenants may prove valuable by increasing foot traffic and interest from the general public they hold the potential of competing with long-term tenants if their activities, including promotions, overlap with products and services the long-term tenants offer.

With the growing number of requests to use space in Smáralind, Kristinn realized he needed to construct a non-tenant space utilization policy. It would have to balance the competitive and economic interests of the rent-paying tenants with the needs of the community. Kristinn knew that his policy would need to generate revenues for the centre where possible and increase foot traffic to rent-paying tenants while establishing the centre as a desirable destination and responsible member of the Icelandic community. Kristinn was aware that if there were insufficient protections for rent paying tenants or overuse of the facilities by other groups it would have a negative impact on tenants and the centre's occupancy rate would go down – affecting their profitability. He acknowedged that the first task would be to identify the areas the policy would address (including operations, marketing, legal, and security among others) and then progress to detailing the guidelines needed.

BACKGROUND

Smáralind will be a modern, enclosed shopping mall with shops and service companies operated on multiple floors with open common walk areas. In addition to office space in the west part of the third floor, a multi-screen movie theater will be housed in the east end of the third floor. Hagkaup and Debenhams are signed as anchor stores operating on both floors. In the walking paths that connect the anchoring stores there is space for 80 shops and service outlets (see Table 1). While many of the stores will be exclusive to the centre and feature Icelandic art and bookstores that feature Icelandic literature in foreign languages, stores will reflect cosmopolitan tastes and be recognizable to European and North American travelers. Brand names found in London, Paris and New York will be plentiful. Recognizable names such as Benetton, Zara, Hugo Boss, Body Shop, Oasis, Coast, Tous, Karen Millen, Levi's, Topshop, Dorothy Perkins, Evans, Bianco, Vero Moda, Jack & Jones, Vila, Exit, Joe Boxer, Warehouse, Karen Millen, Dorothy Perkins and Dressman will be found.

Table 1
Smáralind Shopping Centre Retailers

Store Name	Description
Adams barnafataverslun	Clothing store mostly for small children, although some baby clothes are available.
Asian Express	Buffet-style restaurant with meals for under 1000 ISK.
ÁTVR	Beer, wine, and liquor store.
BabySam	Baby clothes and supplies. Considered high quality and discounted.
Bæjarins bestu pylsur	Literally, "the town's best hot dogs."
Benetton & Sisley	Name brand clothing store, predominantly for women.
Bianco	Semi-casual shoe store, originally from Denmark.
Blend	A men's semi-casual clothing store, from Denmark.
Blómaval	Sells many kinds of plants and flowers, in addition to gardening supplies.
Body Shop	All-natural, cruelty-free cosmetics, skincare and hair care boutique.
Bossa Nova	Women's boots, leaning towards formal, mostly in leather.
Brilliant	Handmade jewel smiths. Everything in silver, gold, and diamonds.
BT	Iceland's premiere electronics store; computer needs, DVDs and games.
Burger King	Flame-broiled, not fried. They use Icelandic meat.
Byggt og búið	Discount appliance store.
Café Adesso	Cafeteria-style restaurant with light fare and coffee drinks.
Carat - Haukur gullsmiður	A goldsmith with a flair for the unconventional.
Change undirfataverslun	Underwear, lingerie and pajama store for women.
Coast	Women's semi-formal wear.
Cosmo	Women's semi-formal, with a tendency towards the high end.
CULT	Semi-casual clothing and accessories store for men and women.
Debenhams	Britain's "favorite" department store, on two levels.
Dorothy Perkins	British women's clothing store, from casual to semi-formal.
Dótabúðin	Toy store with everything from plastic army men to board games.
Drangey	High-end accessories store for men and women.
Dressmann	Men's semi-casual clothing store catering to the 30+, upwardly mobile crowd.
Ecco	Semi-casual shoes for men and women.
Exit	Children's clothing store for the offspring of the upwardly mobile.
Eymundsson	Bookstore with magazines and writing supplies.
Fatahreinsunin Hraði	Dry cleaners and full-service laundry.
Gullsmiðja Óla	Goldsmiths adding a Nordic touch to their designs.
Hagkaup	High-end grocery store with clothes, toys, books and other miscellany.
Hans Petersen	Photography supply store.
Herragarðurinn	Men's clothing store, with a particular emphasis on suits.
Hjörtur Nielsen	Fine crockery, dining ware and crystal settings.
Home Art	A gift shop featuring bric-a-brac for the home.
Hraði efnalaug	Dry cleaners and full-service laundry.

Table 1
Smáralind Shopping Centre Retailers

Store Name	Description
Hygea	Mostly make-up and perfume, with leather handbags and wool scarves.
Ice in a bucket	Accessories store featuring hairclips, bracelets etc., almost all, inexplicably, pink.
Intersport	Sports and outdoor wear for men and women.
Isis	Women's clothing and accessories, leaning towards the high end.
Ísinn	Ice cream bar with loads of toppings available.
Íslandsbanki	The Bank of Iceland – not to be confused with the National Bank of Iceland.
Jack & Jones	Men's casual wear in a "sporty" vein.
Jói Fel	Bakeries owned by television personality and baker, Jói Fel.
Landsbankinn	The National Bank of Iceland – not to be confused with the Bank of Iceland.
Levi's	Clothing store carrying the Levi's brand of shirts, jackets and jeans.
Líf og list	Dining ware, vases, and other finer household adornments.
Lyfja	One of the cheaper pharmacies in Iceland.
MebaRhodium	A store selling nothing but watches and watch-related items.
nammi.is	Candy store.
Nóatún	Half grocery store, half gourmet shop, all fun.
Oasis	Men's casual wear, in the style of Dressmann.
Office 1	A smaller version of the ultimate office supply store.
Og Vodafone	Outlet store of the telecommunications company.
Optical Studio RX	Prescription glasses and custom frames.
Optical Studio Sól	High-end sunglasses such as Oakley, as well as some sportswear.
Ormsson	High-end major appliance and electronics store.
Ótrúlega búðin	"The incredible store," a gift shop featuring small and obscure items for a drastically marked-down price.
Pizza Hut	The one, the only, from the people who brought you the "cheese inside the crust" pizza.
Retro	Casual clothing store, mostly for men, featuring Lacoste and Converse.
Saumur og merking	Towels and robes for children.
Síminn	Outlet store for the other telecommunications company in Iceland.
Skífan	The largest music store in Iceland.
Skór.is	Casual wear shoes, boots, and kids' shoes.
Smárabíó	Home of the "lúxusbíó" (the luxury theatre), where, for an added 900 ISK to the price of a regular movie ticket, you can sit in a recliner and drink liquor while watching the movie.
Sock Shop	Just socks and nothing else.
Steinar Waage	Higher end shoes for men and women.
Subway	Outlet of the fast food chain of the same name.
T.G.I. Friday's	American restaurant featuring of burgers, chicken "fingers," and ice cream.
Te & kaffi kaffihús Le Vrai Café	Probably the best coffee shop in Iceland. Coffee beans, tea, biscotti, and even espresso machines.
Tiger	Your one-stop bargain store. As everything is priced at either 200 or 400 ISK.
Top Shop	Higher end clothing store for men and women.
Útilíf	Outdoor store featuring all kinds of clothes and gear for all kinds of climes.
Vero Moda	Women's semi-casual wear.
Veröldin okkar	Sprawling children's centre for letting them tire themselves out while parents shop.
Zara	Semi-formal men's and women's clothing.
Zink	Casual wear for teens and preteens.

Edited from the Source: The Stores of Smáralind Mall A Complete Guide by Paul Fontaine-Nikolov http://grapevine.is/Home/ReadArticle/The-Stores-of-Sm%C3%A1ralind-Mall

Located in Kopavogur on the outskirts of Reykjavik, at Hagasmari 1 in Iceland's capital city, Smáralind Shopping Centre will serve the approximately 200,000 residents living in the greater Reykjavik area. Smáralind will strive to combine shopping and entertainment. It will be a place where curious people and shoppers can easily spend the day with pauses at one of the many coffee houses and restaurants, in addition to one of the best movie theaters in Reykjavík. The aim will be to create a vibrant street life environment most days of the year where the Winter Garden will be the centre of activities along with the more conventional shopping and service activities.

While competing for customers with Kringlan Mall and the stores in Reykjavík's old city center, both approximately six kilometers away in different directions, Smáralind will be the largest mall in Iceland. The centre will open Monday through Friday from 11 AM to 7 PM (until 9 PM on Thursday); Saturday from 11 AM to 6 PM, and Sunday 1 PM to 6 PM. Movie theaters in the complex will remain open one hour later Monday through Friday.

FACILITIES

The Winter Garden (see Figures 1 and 2) will be a large, open hall at one end of the shopping center which can be rented out and configured for events, concerts, and shows. It will be adjacent to the restaurants and the movie theaters in the east end of the building. A giant TV screen located in the Winter Garden will allow people to sit down and enjoy life when scheduled activities are not taking place. Several television shows may be taped there including the Icelandic Idol competition (similar to the U.S. and English versions) and Icelandic X-Factor (a talent competition similar to one seen in Great Britain).

Figure 1 Mall layout: View of Winter Garden

(used with permission of Kristinn Jóhannsson, Operations Manager Smáralind Shopping Centre for educational purposes)

In addition to the Winter Garden area, the centre has open common areas (also known as passages) within the mall property on both levels. Given the extended and somewhat harsh nature of the winter season in Iceland, combined with a culture of interaction and socializing, the mall property will become a natural meeting place for residents (see Figure 3).

Figure 2 Photograph of Winter Garden

Figure 3 Smáralind Common Areas

TASK

For purposes of this case and class discussions, you are Mr. Kristinn Jóhannsson, operations manager for Smáralind Shopping Centre in Iceland. With several weeks to go before its opening you need to develop a policy governing who, and what way, the common areas of the centre may be used by non-rent paying organizations. Further, these guidelines must address use of the Winter Garden area.

1. You should first compile a list of policy areas your document should address.
2. For each policy area, draft appropriate language that addresses who has what responsibilities (the organization vs. centre management)
3. Include in your draft language a mechanism for long-term tenants to have input for the ongoing implementation of your policy.

PHYSICIANS QUALITY CARE: "DISNEY COMES TO THE DOCTOR'S OFFICE"

Wilburn C. Lane, Jr., Union University

CASE DESCRIPTION

This case is about an urgent care clinic that has used a very elaborate differentiation strategy to establish a competitive advantage against competition that has much greater resources. The personal values and experiences of the owners play an integral part in their developing this business model and how they run the business. The industry analysis contained in this case points out the driving forces and Key Success Factors (KSF) of the walk-in clinic industry. Also, the case contains appropriate information for a SWOT analysis. The case is designed to be used in a senior level business policy or marketing strategies class. This class is designed to be taught in one class period of 50-75 minutes. The amount of time the student is expected to spend outside of class will vary from 1-3 hours based on how many of the questions in the "teaching notes" are assigned.

CASE SYNOPSIS

This is the story of an urgent care clinic that has developed a successful strategy that allows it to complete extremely well against the largest medical clinic in its community and to insulate itself from the threat of the retail walk-in-clinic. The author's childhood experience of visiting Disneyland and his continued fascination with "The Disney Way" has allowed him to develop a strategy that gives him a sustainable competitive advantage. His focus on the "experience" his patients have when they come to his clinic separates him from the competition. To enhance the patient's "experience," Physicians Quality Care has created the position of "Patient Concierge," built a movie theatre in the clinic, put in a mechanical ride for children, and bought a cappuccino machine to provide patients with free cappuccinos. His emphasis on customer service can be seen in how he hires and trains employees. As you read this case you will feel like you are in Disneyland taking a trip down "Main Street, U. S. A."

INTRODUCTION

In the 1950s little Jimmy Hoppers had a life changing experience while visiting relatives in California--Disneyland. Jimmy was wowed by the amusement park, not because it was an amusement park, but because it was not like any amusement park he had ever seen. He saw an amusement park that dared to dream, that offered things that no other amusement park offered, that parents as well as children enjoyed. Jimmy never forgot this dream, and when he decided to open his own urgent care clinic after practicing medicine for twenty-five years with a large medical group in his home town of Jackson, Tennessee, he remembered the "Disney Experience" and used it as his guide for the clinic--Physicians Quality Care. As he dared to dream, he envisioned an urgent care clinic that offered its patrons free snacks, a movie theatre, a reading library, a waiting room with "current" issues of magazines, but most importantly a courteous staff.

Before we can really appreciate Physicians Quality Care's business model, we need a good understanding of the walk-in clinic business.

WALK-IN MEDICAL CLINIC INDUSTRY

When in urgent need of non-life threatening medical care, the consumer has basically three choices--the emergency room, the private physician's office, or the walk-in clinic (Ortinau 1986). The emergency room is open 24 hours a day, seven days a week. If you have a serious, possibly life-threatening illness, it may be the most appropriate choice. The down side to the emergency room is the long wait and the added cost. You may wait in the emergency room for several hours to see the doctor, and it is likely to cost you several times more money than the other options--on average $570 versus $166 for the private physician's office and $110 for the walk in clinic (Roizen 2009). The private physician's office is less expensive, but it is also less accessible. The private physician's office is normally open from 9:00 until 5:00 p.m. Monday thru Friday, and it is often difficult to get into see the doctor in a timely manner. Barely half of the time (52%) do patients receive an appointment as soon as they want (Keckley et al 2009). The walk-in clinic is open longer hours and is designed to provide timely care for non-life threatening medical issues; and as mentioned above, they do so at a lower cost than the other alternatives.

DRIVING FORCES

There are several forces driving the explosion in the Walk-In Medical Clinic Industry. Consumers are looking for good quality at a lower cost and within a more flexible time frame (Ortinau 1986). Insurers see it as a low-cost alternative for many of the medical needs of their clients (Keckley et al 2009). Employers not only like the lower costs but the longer hours of availability means less time lost on the job (Keckley et al 2009). The policy makers (federal, state, and local governments) see it as a way to reduce overall medical costs (Kerkley et al 2009). Walk-in clinics are doing an excellent job of communicating what services they have to offer and the benefits they provide (Dant, Lampkin, and Bush 1990). Industry analysts estimate there are approximately 115 million patient visits a year that could be handled by walk-in clinics, but only a small fraction of this is currently being done in walk in clinics (Keckley et al 2009).

The stakeholders in this industry are all doing things that are making this industry grow rapidly. The patient is readily accepting this form of medical care because of its convenience and lower cost to them. They see the quality of care provided as acceptable for the services the walk-in clinic provides (Dant, Lampkin, and Bush 1990). Some observers suggest that many people no longer differentiate private physicians from walk-in clinics (Dant, Lampkin, and Bush 1990). The heightened competition in the industry has decreased the customer's ability to differentiate these providers (Martin 1988). Many private physicians are setting up walk-in clinics as a way to meet their patients' needs for these services (Dant, Lampkin, and Bush 1990). The growth in this industry and the revenue that it is taking away from emergency rooms has caused hospitals to establish walk-in clinics or to affiliate with walk-in clinics. Even, the Mayo Clinic has established walk-in clinics (Keckley et al 2009). Insurers are providing financial incentives to patients who use walk-in clinics--reduced or no co-pay for visits to walk-in clinics. The reduction in cost of the visit more than makes up for the reduction in or loss of a co-pay. Many employers are establishing agreements directly with walk-in clinics to provide basic needs for their employees. This reduces the employers' cost and because of the longer hours of availability, employees can visit the doctor's office when they are not working. In an effort to reduce the medical costs associated with their own employees, government agencies are also establishing agreements with walk-in clinics to provide basic medical needs for their employees. In addition, they are encouraging those receiving free medical services to use these clinics because it reduces the government's cost of providing these services.

CHOOSING A PHYSICIAN

While choosing a physician is very important, the decision making process most patients use is very short. In 1951, Parson stated that a majority of people choose their physician "blindly" on the basis of friends or neighbors recommendations. Little has changed over the years (Stewart et al 1989). Fifty-three percent of consumers rely upon advice of friends, relatives, or neighbors (Stewart et al 1989). Eighty-two percent use only one source of information (Stewart et al 1989). Once a physician is chosen, there is a high degree of brand loyalty (Dant, Lumpkin, and Bush 1992).

There has been a lot of research done on what attributes consumers use to evaluate their medical experiences. These attributes can be divided into two categories--affective values and instrumental values (Gilbert, Lumpkin, and Dant 1992). Below is a list of values in each category.

Affective Values

- Time spent with physician
- The way the doctor provided explanation
- Friendliness of physician
- Friendliness of the staff
- Amount of information provided

Instrumental Values

- Cost
- Physician competence

The research indicates that consumers imply competence of the physician on affective values. Interestingly, patients, who use walk-in clinics, focus on friendliness of the staff (Gilbert, Lumpkin, and Dant 1992). Therefore, one of the keys to success in the walk-in-clinic business is to have a friendly staff. The other important factor is cost (Gilbert, Lumpkin, and Dant 1992). This means walk-in-clinics need to keep an eye on their costs so they do not price themselves out of the market.

RAISING THE BAR

Walk-in clinics have done an excellent job of communicating their ability to meet the customer's needs quickly, at a reduced cost, and at a convenient time (Dant, Lumpkin, and Bush 1992). Their ability to market themselves this way has raised the bar for all medical service providers, but more importantly they have become the standard by which consumers judge medical service providers (Gilbert, Lumpkin, and Dant 1992). While it is good for the walk-in clinic to be setting the standard for the industry, it places an extra burden on them as health care providers. Patients have higher expectations for walk-in clinics than they do for either emergency rooms or private physician offices (Gilbert, Lumpkin, and Dant 1992). Fortunately, research indicates they are meeting customer expectations (Gilbert, Lumpkin, and Dant 1992).

SERVICES PROVIDED

The walk-in clinic does not try to be all things to all people. It specializes in medical services in specific areas. The common illnesses treated relate to respiratory infections; head, ear, and eye conditions; skin problems; stomach, digestive and unitary track conditions; and immunizations (Keckley et al 2009). Some clinics have broadened their coverage area by providing annual physicals and occupational services. By limiting the services they provide, walk-in clinics can minimize the equipment needed to serve the customers and the diversity of the medical staff. Both of which, reduce the cost of doing business.

CHARACTERISTICS OF THE WALK-IN CLINIC CUSTOMER

There are a number of ways in which the walk-in clinic customer is likely to be different from the person who only visits the private physician’s office. They are more likely to be younger and have a lower income and educational background (Dant, Lumpkin, and Bush 1990). They are more likely to be single, and tend to have more children at home (Dant, Lumpkin, and

Bush 1990). They rate convenience of location much higher than customers of private physicians (Dant, Lumpkin, and Bush 1990). Consumers are much more likely to use a walk-in clinic for emergencies, especially when the private physician's office is closed (Malhorta 1983 and Ortinau 1986). Consumers, who do not have a family doctor, are more likely to visit a walk-in clinic (Dant, Lumpkin, and Bush 1990). Also, they are more likely to be blue collar workers than those who only use private physicians (Carroll and Gagon 1983; Woodside et al. 1988). As mentioned earlier, the lines between private physicians' offices and walk-in clinics are blurring. More and more people are seeing the walk-in clinic as a viable alternative that provides good quality service at a convenient time and at an affordable price. As these lines continue to blur, so may the differences in the patients seen.

SEGMENTS OF THE WALK-IN CLINIC INDUSTRY

There are several segments in the walk-in clinic industry. First, there is the traditional private physician's office who has established a walk-in clinic, usually staffed with nurse practitioners, to meet the immediate needs of the physician's patients. However, many of these are open the same hours as the traditional doctor's office. Second, there is the walk-in clinic that is associated with a hospital and is designed to take some of the pressure and wait time off of the emergency room. Third, there is the stand along urgent care clinic that is not affiliated with either a medical clinic or hospital. These clinics focus on providing urgent care for non-life threatening medical needs. Sometimes they may provide expanded services like immunization, annual physicals, and occupational services for employers. The fourth type of walk-in clinic is the retail clinic. These are usually located in a retail area and are often affiliated with another retailer. These clinics may be found in strip malls or inside a big box store like Wal-Mart.

THE EIGHT HUNDRED POUND GORILLA IN THE ROOM

The retail clinic is quickly becoming the eight hundred pound gorilla in the room. These clinics offer very limited service for certain types of non-life threatening medical conditions. They usually are very small-- around 450 square feet (Keckley et al 2009). They are usually staffed with physician’s assistants and/or nurse practitioners. They have very little medical equipment. The average cost of one of these clinics is about $450,000 (Keckley et al 2009). If they are in retail stores like Wal-Mart or a Walgreens, they may receive reduced rent because of the traffic they generate (Keckley et al 2009). There has been a proliferation of these clinics since 2006. Companies, such as CVS, Walgreens, Target, and Wal-Mart have gotten in the business (Are 2008). According to Merchant Medicine, an industry consulting company, there were just 126 retail clinics in 2006, but they are estimating there will be 3,000 retail clinic by 2015 (Are 2008). PricewaterhouseCoopers Health Research Institute recognized "Health Retail Clinics" as one of the Eight Health Care Trends of 2008. Many of the early entrants in this field have been acquired or partnered with the retail medical giants in the industry. CVS has acquired MinuteClinic, and its long term goal is to open 2500 clinics (Keckley et al 2009). Wal-Mart has partnered with RediClinic and plans to have 400 "The Clinic at Wal-Mart" opened by the end of 2010 (Keckley et al 2009). Given the cost structure of these clinics, it only takes about 200-230 patient visits a week to break-even. However, industry analysts do not think the retail clinic industry has reached profitability, and they speculate that is why so many of the big retail clinic chains have been sold to other medical retailers (Keckley et al 2009). Only time will tell if they will capture enough of the market to become profitable and if their rapid expansion is justified. But, one thing is clear; they are and will continue to be a significant force in the walk-in clinic business.

Now that we have had an opportunity to examine the walk-in clinic business, let's take a look at Physicians Quality Care and go on a journey down "Main Street U. S. A."

PHYSICIANS QUALITY CARE--DREAMING THE DREAM

After twenty-five years with the largest medical clinic in his home town, Dr. Jimmy Hoppers and his wife, Melanie, decided to leave safe and secure jobs to offer the urgent care patients in the area a new experience. When they left the large medical clinic, they did not know exactly what they were going to do. They knew they wanted to open an urgent care clinic, but they did not know exactly what kind. They knew they did not want to have a retail, "Docs in a Box," type of clinic. Their first thought was to affiliate with a local hospital, but the hospital's vision and theirs did not agree, so they decided to open a free standing clinic on the edge of a large retail shopping area and adjacent to an upscale residential area. The thought was this would be the best of both worlds. They would be convenient for shoppers, and they would be close enough to the residential area to provide service when most medical clinics were closed. The land owners and real estate advisors told them they were crazy to put a medical clinic in this location because the land cost was too high. They cashed in their 401ks and with a loan from a local bank, bought 1.7 acres on the edge of this retail center for 940,000 dollars and began to dream their dream. His wife, Melanie, who is board certified in internal medicine and pediatrics, had been reading the book Good to Great by Jim Collins, this book along with Jimmy's lifelong fascination with Disney became the basis for the dream. They decided to think outside the box--"if we could do anything we could, what would we want to offer our patients." Several things came to mind. First, they wanted to offer the best service possible, so in addition to the receptionist they would have a "Patient Concierge" whose main task would not be paper work, but doing everything possible to make the patient's experience a delightfully pleasant one. If this meant taking umbrellas out to patients' cars when it was raining, helping the elderly in the door or simply reading a child a story, it was to come before the paper work. Second, they wanted to offer the patients free snacks, so they bought a cappuccino machine and a slush puppy machine to go along with traditional beverages. Third, they wanted to have something special for the patients to do while they waited to see the doctor, so they built a library where the patient could sit quietly and read, they built a 24 seat movie theatre where the patients could watch a movie while they waited, and they stocked the traditional waiting room with the most recent issues of fifty magazines. Fourth, they wanted to appeal to the child, so (following in the Disney tradition of making the parent happy as well as the child) they built a children's room with a mechanical submarine ride and a slide, as well as traditional toys. Fifth, they wanted to eliminate the need for the patient to have to go to the drugstore to get a prescription filled, so they put a kiosk in the lobby with the most common prescription drugs prescribed for aliments treated at urgent care clinics. While they do not make a lot of money on these prescriptions (three dollars per prescription), it eliminates the patient's need to go somewhere else to get the prescription they need. Sixth, to accommodate the patients who may need a rehab facility or the patients who may want to work out under the care of a medical professional, they added a fitness center called "Boomers" adjacent to the clinic. The total cost of this dream was about 1.9 million dollars in addition to the land cost. When asked how he could justify spending nearly three million dollars to open a walk-in clinic, Jimmy's response was "Got to go all in--that's what Disney did."

THE DREAM BECOMES A REALITY

On August 18, 2008, with their 401ks gone and three million dollars of borrowed money invested in a walk-in clinic, Physicians Quality Care opened its doors. The 10,000 square foot facility included seven exam rooms, a laser room and the 4,000 square foot fitness center. The clinic is open from 7:00 a.m. until 9:00 p. m. Monday thru Friday, Saturday from 9:00 until 5:00 p.m., and on Sunday from 11:00 a.m. until 7:00 p.m. The clinic is only closed six days a year--New Years Day, Easter, 4th of July, Thanksgiving Day, Christmas Eve, and Christmas Day. They employ a little less than fifty employees with about twelve employees on duty on any given day. There is always at least one doctor and one nurse practitioner on duty at all times.

When Jimmy and Melanie opened the clinic, money was obviously tight so many nights they were there staffing the clinic. When Jimmy gives you a tour of the facility, he proudly points to a storage room with bunk beds and says this is where they and the children would sleep when they were first getting started. They have come a long way in a very short period of time. In 2009, their gross revenue topped three million dollars, and 2010 promises to be even better. As of August 31st, patient flow was up 41% over 2009 year to date (See Exhibit One). Now, he is so busy running the business that he has not personally seen a patient in almost nine months. When you talk to Jimmy, you can tell by the excitement in his voice and the twinkle in his eye that the dream is coming true. Note: Exhibits are found at the end of the case.

CUSTOMER SERVICE AND STAFFING

If you ask Jimmy and his wife Melanie what is the most important thing in their business, they will both tell you customer service. Jimmy is quick to point out that most medical offices treat people as patients and not consumers. Jimmy says, "Doctors work under the assumption that the visit starts when they walk in the room. Disney assumes the ride starts when you pull in the parking lot." This means that all employees are part of the visit. Physicians Quality Care has three engrained rules for every employee:

1. If you see the problem, you own the problem. If you cannot fix the problem, you find someone who can. It is never "it's not my problem" and you never ignore the problem.
2. The presumptive answer to every question is yes. You should look for some way to answer a question in a positive way.
3. Do unto others as you would have them do unto you.

They tell the staff there is an on-stage (any time you are interacting with a patient or another staff member) and an off-stage--breaks time, etc. When you are on-stage you should perform like you are on-stage.

Before anyone is hired, they are carefully interviewed and expectations are made very clear. Jimmy is quick to point out that you have to get the right people on the bus, but once you have the right people on the bus you need to give them the freedom to be creative in doing their jobs (a reference to Jim Collins' book Good to Great). When new doctors are hired, they are told that customer service is paramount. They are given a copy of the book Good to Great and the power points from Lessons from the Mouse. Jimmy readily admits that Physicians Quality Care is not the right place for everyone to work. He said that he had three doctors that were medically good, but not good with patients and/or staff. He says they have to be good with both.

Physicians Quality Care has an on-going program to help everyone understand the environment and expectations. It may be a dinner once a quarter or some type of formal training, such as "The Disney Way" or Who Moved My Cheese." At Physicians Quality Care everyone is on a first name basis. He is referred to as Jimmy, and he makes a point to engage every staff member in a conversation at least once a day. He makes it clear to employees that "you can always push paper, but you only have one chance to be nice to someone. If you mess up the paper work, we can correct that; but we cannot correct not being nice to someone." This is why you are more likely to find the "Patient Concierge" helping an elderly person in the front door than sitting behind a front desk doing paper work. "The visit begins in the parking lot."

THE WOW FACTORS!!!

In addition to the outstanding customer service Physicians Quality Care provides, there are several physical attributes that contribute to the WOW factor. Jimmy says a lot of little wows make one big WOW. As you walk in the front door, you realize this is not an ordinary doctor's office. The abundance of glass windows allows the light to shine in providing a warm and airy atmosphere (See Exhibit Two). The open and inviting lobby with comfortable chairs makes you want to come in and stay awhile (See Exhibit Three). Once you are in the lobby you begin to look around and see that your journey down "Main Street, U.S.A" is just beginning. To your right is the Reading Room which reminds you of a cozy study in an upscale home (See Exhibit Four). To your left is the Children's Room which has a nautical theme, includes a mechanical submarine ride (it’s free), a slide, climbing toys and more traditional toys--it's almost like Christmas morning (See Exhibit Five). Next to the Children's Room is the Theatre. The Theatre seats 24 people and would make a big screen enthusiast drool (See Exhibit Six).

As you sign in, you are handed a buzzer similar to what you receive when waiting to be seated at a restaurant. This allows you to play with your children in the Children's Room, curl up with a book in the library, or enjoy a movie in the theatre without worrying about not hearing your name when it is called. While you are waiting, the "Patient Concierge" asks you if you would like a snack or something to drink-- including, gourmet coffee, a cappuccino, or a slush puppy in addition to more traditional drinks. The snack area is shown in Exhibit Seven, and the Patient Concierge's Desk is shown in Exhibit Eight.

While every effort is made to get the patient (consumer) into see the doctor as soon as possible, it is difficult for an urgent care clinic to control the waiting time, but it can make the wait more enjoyable and these are just a few ways Physicians Quality Care tries to make your wait more pleasant. The journey down "Main Street, U.S.A." may be short or long, but they make every effort to make it enjoyable.

THE BUZZER GOES OFF

When your buzzer goes off, you go to the receptionist’s desk where you are met by a nurse who greets you and takes you back to an examining room. There, the nurse does the traditional things--takes your vitals and asks the usual questions--why are you here, have you had a fever, etc. As the nurse leaves, the nurse tells you the doctor will be in soon and ask you if you need anything. If the doctor does not come in within fifteen minutes, someone knocks on the door and comes in to ask if they can get you anything. They have a rule that a patient should not be left in an examining room for more than fifteen minutes without personal contact. When the doctor comes into the room, the doctor engages you in conversation to see what needs to be done next. If tests are needed, the doctor orders the tests and comes back when the tests results are available. The doctor discusses the diagnosis with you, answers any questions you may have, and prescribes the medicine. You are told that for your convenience you can get your prescription(s) filled in the lobby if you want to, but there is no pressure put on you to do so. You are escorted to the payment desk where a courteous staff member handles the paper work. When you walk out, the patient concierge tells you, "I hope you feel better." As you get to the parking lot you think--"They were just so nice." While the "experience may have begun in the parking lot it does not end in the parking lot. Within a few days after your visit, you receive a hand addressed, individualized note thanking you for choosing Physicians Quality Care.

SELLING THE SIZZLE

As a child, Jimmy grew up in the radio and television business. His father worked in radio and put the first television station on the air in Jackson, Tennessee. Jimmy did his first television commercial at age four. He worked in radio while he was in college and until he decided to go to medical school. His ad hero was Marshall McLuhan--"Sell the Sizzle not the Steak." Jimmy is quick to point out that it is the little extras you do that make the difference. You can tell that he is not only passionate about the business but also about telling the story. He has used several different ways to get his message across. He has done a lot of advertising on television, radio, newspaper, and billboards. He personally oversees all the advertising. In addition to the traditional media, Physicians Quality Care did a fun fair just before school started last year. They had all kinds of rides and refreshments in the parking lot, and the focus of the day was school physicals. They had approximately 1500 people turn out for this event. Jimmy will tell you (just like Disney) "if you make the kids happy the parents will be happy and come back." Physicians Quality Care has a very professional looking website that explains their philosophy and the services they offer. You can visit the website at www.physicanqualitycare.com/about. You can even view the facility in 3-D. Jimmy recognizes the importance of branding and wants to be known as the Nordstrom's of the urgent care business. He has a jingle that was professionally done and has logos for each of part of the business. He realizes that community and professional involvement are also important tools in the branding of his product. He sponsored a large community fireworks show for the 4th of July weekend and presented his story at the Urgent Care Convention this past May, where he was elected to the Board of the Urgent Care Association of America.

THE LASER ROOM

When dreaming the dream, they decided to have a laser room so they could offer patients some services that might not be found in a traditional urgent care facility (See Exhibit Nine). In the laser room, they provide four types of services. First, they can do hair removal, such as permanent hair reduction or beard bumps. Second, they can use skin rejuvenation techniques to do skin tightening and wrinkle reduction. Third, they can deal with pigmented lesions, such as sun spots or age spots. Fourth, they can address vascular issues, such as leg veins and blue facial veins. While this seemed like a good idea at the time, Jimmy indicates that this has not been a profitable investment and he would probably not do this if he were opening a new clinic today.

BOOMERS

Boomers is a fitness center that is attached to the clinic. The target market for Boomers is people 40 and over. As you can see in Exhibit Ten, it has a variety of equipment designed to meet the needs of the exercise enthusiast. It is staffed with a degreed exercise physiologist, who programs the machines for each customer. One of the main reasons they decided to add the fitness center was to accommodate those who my need rehab services or have medical conditions that required or desired medical supervision while exercising. In addition, the center is equipped to help fall victims recover quickly. About 1/3 of all people over 65 fall each year. Some of these are more severe than others and require extensive rehabilitation. Physicians Quality Care has developed a great "Falls Program" to assess and rehabilitate fall victims. Jimmy indicates that at this time Boomers is not a profit center. He attributes this to a lack of time to promote the services the center has to offer. He hopes to do this in the future and is looking at trying to develop relationships with assisted living facilities that might find the center useful for their residents.

OCCUPATIONAL MEDICINE

Even before they opened Physicians Quality Care, Jimmy and Melanie Hoppers got into the occupational medicine business. They bought a large enclosed trailer, stocked it with the medical equipment they needed to provide services related to occupational medicine and began providing these services to employers on site. They do a lot of OSHA testing. They do hearing, pulmonary function and drug testing and education. They do immunizations on site such, as flu shots and have an industrial hygienist who performs additional functions. As Jimmy says, "we can do pretty much anything that a company may need." In addition, they can use Physicians Quality Care to provide pre-employment physicals and meet the urgent care needs of the company’s employees. This is particularly attractive to employers because employees and prospective employees can get these services when other providers are not open--saving the employer and employee lost work time. Currently, Melanie is working with a number of employers to become their primary provider of urgent care services. She is offering to contract with employers at a rate that is less than what their costs are through an insurer, but more than she gets from the insurance company. As she sees it, this is a win-win situation for both the employer and Physicians Quality Care. There is a lot of synergism between the occupational medicine and the urgent care business. The clinic can provide many services the employer needs such as pre-employment physicals and immunizations. Also, it can meet the urgent care needs of the employer's labor force.

MANAGING THE BUSINESS

Unlike most doctors who only want to practice medicine and not worry about the business side of the practice, Jimmy and Melanie Hoppers focus a lot of their time and energy on running the business. While Melanie still sees patients, she is also out working and talking with businesses to get them to let Physicians Quality Care meet their employees' occupational and urgent care needs. Melanie is always looking for new business and new services they can provide. Jimmy will tell you that the key to the urgent care business is volume. They feel they are a lot more flexible and make decisions faster than their competition. If a business has a need in a certain area and the revenue it will generate is good, they will do everything they can to meet the need. After two years in business, they are still picking up new customers. Their urgent care business is up 41% year to date (See Exhibit One).

When you ask about an organizational chart, Jimmy will respond, "We had one in the beginning; but now everyone does whatever needs to be done. However, it is clear that both Melanie and he have found their seats on the bus. Melanie handles the medical side. She does the hiring and firing. She does the scheduling of employees and recruitment of business on the occupational medicine side. Jimmy crunches the numbers and handles the promotions. On the first day of the month, Jimmy knows exactly how many people they saw last month and how it compared to the previous month and that month the previous year. He oversees and approves (often develops) every promotional piece. They are both quick to tell you that you must control your expenses. If business is slow late in the evening, they will send someone home rather than have someone on the clock that cannot be justified financially.

Also, they are acutely aware of pricing and the importance of pricing. While they will tell you that pricing is usually set because of insurance, their promotional efforts in the urgent care business are aimed at the middle to upscale customer who has good insurance or who has the resources to pay cash--they offer a very competitive price to customers paying cash. They do take CoverKids, which is a state insurance program for children who do not have insurance; but they do not take TennCare, which is the Tennessee version of Medicaid, because the reimbursement is too low. Their location adjacent to an upscale residential area and their availability after traditional physicians' offices are closed gives them more than their share of middle to upscale patients.

It is also interesting to note how they allocate their human resources. If you look at their website you will see that the staff is broken done in to seven areas--Patient Concierge, Reception, Providers (Doctors and Nurse Practitioners, etc), Nurses, Lab, X-Ray, Billing, and Administration. Of the 44 employees who are listed on the website, eleven are in the patient concierge and reception areas. It is clear that Jimmy and Melanie not only dared to dream and built the dream, they are living the dream.

Since this is a private business and Jimmy and Melanie are concerned about the competition getting information about their business, they are reluctant to release financial information; but they have provided information regarding the number of patients seen each month as well as a comparison of present performance compared with past performance (See Exhibit One). This is the information that is most commonly found in industry research and appears to be the way the walk-in clinic industry measures success. Jimmy did share that they are on track to be profitable in 2010, which is their second full year in business. This just goes to show that if you dare to dream and are willing to work hard the dream can come true.

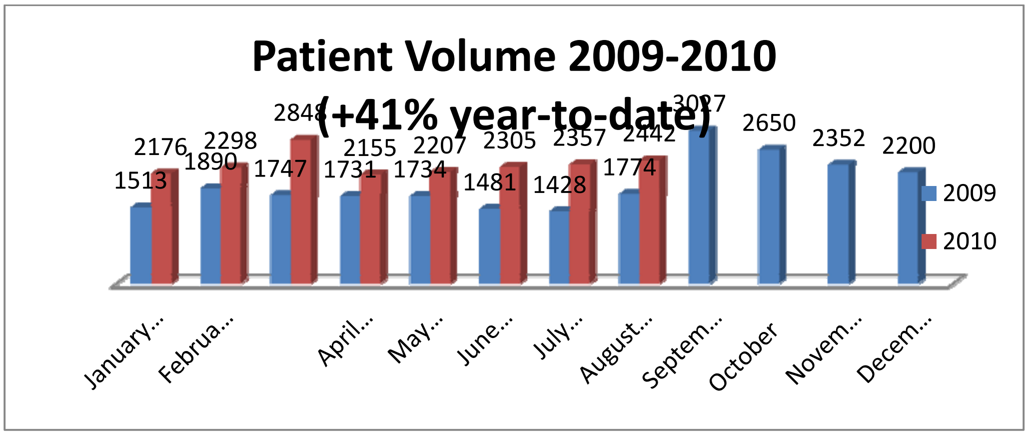


Exhibit One--Number of Patients Seen by Month

Exhibit Two--Entrance to Physicians Quality Care

Exhibit Three--Lobby

Exhibit Four--Library

Exhibit Five--Children's Play Room

Exhibit Six--Theatre

Exhibit Seven--Snack Room

Exhibit Eight--Concierge's Desk

Exhibit Nine--Laser Room

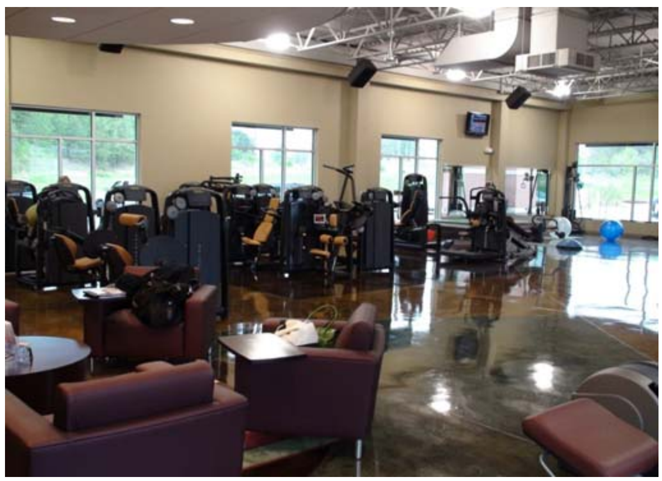


Exhibit Ten—Boomers

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AUDIT THAT RETURN!: DEVELOPING TAX ISSUES AND AUDIT JUDGMENT IN GRADUATE ACCOUNTING STUDENTS

Valrie Chambers, Texas A&M University—Corpus Christi
Sharon Polansky, Texas A&M University—Corpus Christi
N. Anna Shaheen, Sam Houston State University

CASE DESCRIPTION

The primary purpose of this case is to help the student develop judgment in assessing what items on a federal income tax return warrant further scrutiny or verification from a skeptical party such as the IRS, opposing counsel, or bank loan officer. It can be taught and used from either an audit or a tax perspective. As secondary issues, the student is exposed to the tax law for contract laborer vs. employee, car and truck expenses (including the auto insurance and auto depreciation), supplies expense, travel expense, meals & entertainment expense and other expenses. This case may be successfully introduced as a tax research case at the graduate level of accounting (Level 5), or as an undergraduate audit case (Level 4). Furthermore, when this case is adopted for use in teaching the professor is able satisfy the goals set forth by the AICPA Functional Competencies in achieving the objectives of Decision Modeling, Risk Analysis, Measurement, Reporting, and Research. The Functional competencies relate to the technical competencies which are most closely aligned with the value contributed by accounting professionals. This case is designed to be taught in three class hours and is expected to take 6 hours of outside preparation by students.

CASE SYNOPSIS

The following accounting case is derived from a real-life situation where child support was to be calculated as a fixed amount of a true and fair federal income tax return of a person who claimed to be self-employed. However, some self-employed taxpayers do not always file a correct income tax return. In this case, there are several suspicious items including the categorization of income and the existence of some questionable expenses that indicate that income for federal income tax purposes is materially understated. The student is asked to conduct the review from (one or) two perspectives, producing a file memorandum.

Using the first (tax) perspective, the student should act as a tax auditor to facilitate his role as a CPA expert witness for the plaintiff requesting the child support, identifying potential items that may be vulnerable in the event of an IRS examination, which may lead to a change in Adjusted Gross Income (AGI) for child support purposes. The student need not find the answer to questionable items, but should justify why those items aroused their suspicion. From the second *(audit) perspective, the student can address the income statement from a financial auditor's perspective, as would be typical of a loan officer or a CPA auditing a small company. The answers to the case from both perspectives are provided in the instructor's notes.*

Students are strongly encouraged to develop a sense of whether or not an income tax return is telling a reasonable financial story, or, if suspicious, what additional questions might need to be asked of the father to determine the correct amounts for the income statement.

CHILD SUPPORT CASE

When lunching with your friend, Ima Knott Lion, she mentions that she's sued her Evil Ex-boyfriend, Irving M. ("I.M.") Bogus for child support, but he's resisting saying that he can't afford any more. "He gave me $75 when he found out I was pregnant. The court wants to award a small monthly amount because I.M. says he's just barely getting by (like I'm not!), but he wears designer suits, has an expensive target-shooting hobby, writes with an expensive pen, and drives an SUV."

Using a statutory state formula, the state bases child support on income and accepts the income tax filing as proof of income unless challenged. "What does his tax return say?" you ask.

"Well, the tax return says he makes about $39,000/year AGI, but then how does he afford his more affluent lifestyle?"

On the father's tax return, the father claims two sources of income: wages as a court reporter from his services to his sister's company and trade or business income as a video court recorder for services rendered entirely to his sister's company. Attached is a copy of the father's Form 1040 and Schedule C for his business income. Examine the return excerpts given, and list any objections or areas of concern that you have, briefly supporting why you object or are concerned. Using any year's Schedule C, Form 1040, and any other needed form as a template, re-calculate the most recent completed tax year's AGI and taxable income. (It is not necessary to calculate tax due, self-employment income, or other figures below the taxable income line, because your challenge is to compute income available for child support, not to income tax.) Additionally, you are provided a schedule of business expenses by the father, for which you will be provided an opportunity to interview the taxpayer (the father) about his documentation of the expenses. Your final product should be a 1-page file memorandum with supporting documentation indicating the amount you feel is the correct AGI. Be sure to include a list of your questions regarding the list of business expenses you were provided, and indicate your reasoning for questioning any business expenses. Your list of questions can include what additional documentation may be required for the business expenses to be deductible, and be sure to correctly cite any IRS Code Sections, IRS Regulations, or court cases supporting your requests. An extra credit opportunity is available for the completion of Form 2106, and the corrected schedule of business expenses. Also, prepare a 1-page audit planning memorandum detailing information you would need to conduct a financial statement audit of the father's video court reporting business.

22222 Void ☐

a Employee's social security number: 186-99-

For Official Use Only ►
OMB No. 1545-0008

b Employer identification number (EIN): 186-98-9999	1 Wages, tips, other compensation: 35,616	2 Federal income tax withheld: 4,986
c Employer's name, address, and ZIP code: Slee Z. Sister, 6303 Ocean Drive, Corpus Christi, TX	3 Social security wages: 35,616	4 Social security tax withheld: 2,208.19
	5 Medicare wages and tips: 35,616	6 Medicare tax withheld: 516.32
	7 Social security tips	8 Allocated tips
d Control number: 186-99-9999	9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial: I.M. — Last name: Bogus — Suff.	11 Nonqualified plans	12a See instructions for box 12
6301 Ocean Drive, Corpus Christi, TX 78412	13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b
	14 Other	12c
f Employee's address and ZIP code		12d

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement **2009**

Department of the Treasury—Internal Revenue Service
For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D.
Cat. No. 10134D

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page

9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.: Slee Z. Sister, 6300 Ocean Drive, Corpus Christi, TX	1 Rents $	OMB No. 1545-0115	**Miscellaneous Income**
	2 Royalties $	2009 Form 1099-MISC	
	3 Other income $	4 Federal income tax withheld $	**Copy A For Internal Revenue Service Center**
PAYER'S federal identification number: 186-98- / RECIPIENT'S identification number: 186-99-	5 Fishing boat proceeds $	6 Medical and health care payments $	File with Form 1096.
RECIPIENT'S name: I.M.	7 Nonemployee compensation $ 40,310.00	8 Substitute payments in lieu of dividends or interest $	For Privacy Act and Paperwork Reduction Act Notice, see the **2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G.**
Street address (including apt. no.): 6301 Ocean	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	10 Crop insurance proceeds $	
City, state, and ZIP code: Corpus Christi, TX	11	12	
Account number (see instructions) / 2nd TIN not. ☐	13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15a Section 409A deferrals $ / 15b Section 409A income $	16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2009** (99) IRS Use Only—Do not write or staple in this space.

Label (See instructions on page 14.) Use the IRS label. Otherwise, please print or type. LABEL HERE

For the year Jan. 1–Dec. 31, 2009, or other tax year beginning , 2009, ending , 20 OMB No. 1545-0074

Your first name and initial	Last name	Your social security number
I.M.	Bogus	186 99 9999
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 14.	Apt. no.	▲ You must enter your SSN(s) above. ▲
6301 Ocean Drive		
City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.		Checking a box below will not change your tax or refund.
Corpus Christi, TX 78412		

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☑ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, do not check box 6a . . . . . — Boxes checked on 6a and 6b: 1
b ☐ Spouse . . . . . .
c Dependents:

(1) First name	Last name	(2) Dependents' social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
				☐
				☐
				☐
				☐

No. of children on 6c who: • lived with you ____ • did not live with you due to divorce or separation (see page 18) ____
Dependents on 6c not entered above ____

If more than four dependents, see page 17 and check here ▶ ☐

d Total number of exemptions claimed . . . . . — Add numbers on lines above ▶ 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	35,616
8a	Taxable interest. Attach Schedule B if required		8a	1,086
b	Tax-exempt interest. Do not include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	278
b	Qualified dividends (see page 22)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	1,764
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 24)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation in excess of $2,400 per recipient (see page 27)		19	
20a	Social security benefits 20a	b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	38,744

Adjusted Gross Income

23	Educator expenses (see page 29)	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	One-half of self-employment tax. Attach Schedule SE	27 125		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction (see page 30)	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction (see page 31)	32		
33	Student loan interest deduction (see page 34)	33		
34	Tuition and fees deduction. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 31a and 32 through 35		36	125
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	38,619

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 97. Cat. No. 11320B Form **1040** (2009)

Form 1040 (2009) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)			38	38,619
	39a	Check if: ☐ You were born before January 2, 1945, ☐ Blind. ☐ Spouse was born before January 2, 1945, ☐ Blind. } Total boxes checked ▶ 39a				
	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ▶ 39b ☐				
	40a	Itemized deductions (from Schedule A) or your standard deduction (see left margin)			40a	5,450
	b	If you are increasing your standard deduction by certain real estate taxes, new motor vehicle taxes, or a net disaster loss, attach Schedule L and check here (see page 35) . ▶ 40b ☐				
	41	Subtract line 40a from line 38			41	33,169
	42	Exemptions. If line 38 is $125,100 or less and you did not provide housing to a Midwestern displaced individual, multiply $3,650 by the number on line 6d. Otherwise, see page 37			42	3,500
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	29,669
	44	Tax (see page 37). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972			44	4,050
	45	Alternative minimum tax (see page 40). Attach Form 6251			45	
	46	Add lines 44 and 45 ▶			46	4,050
	47	Foreign tax credit. Attach Form 1116 if required	47			
	48	Credit for child and dependent care expenses. Attach Form 2441	48			
	49	Education credits from Form 8863, line 29	49			
	50	Retirement savings contributions credit. Attach Form 8880	50			
	51	Child tax credit (see page 42)	51			
	52	Credits from Form: a ☐ 8396 b ☐ 8839 c ☐ 5695	52			
	53	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	53			
	54	Add lines 47 through 53. These are your total credits			54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55	4,050
Other Taxes	56	Self-employment tax. Attach Schedule SE			56	249
	57	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919			57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			58	
	59	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H			59	
	60	Add lines 55 through 59. This is your total tax ▶			60	4,299
Payments	61	Federal income tax withheld from Forms W-2 and 1099	61	4,986		
	62	2009 estimated tax payments and amount applied from 2008 return	62			
	63	Making work pay and government retiree credits. Attach Schedule M	63			
	64a	Earned income credit (EIC)	64a			
	b	Nontaxable combat pay election 64b				
	65	Additional child tax credit. Attach Form 8812	65			
	66	Refundable education credit from Form 8863, line 16	66			
	67	First-time homebuyer credit. Attach Form 5405	67			
	68	Amount paid with request for extension to file (see page 72)	68			
	69	Excess social security and tier 1 RRTA tax withheld (see page 72)	69			
	70	Credits from Form: a ☐ 2439 b ☐ 4136 c ☐ 8801 d ☐ 8885	70			
	71	Add lines 61, 62, 63, 64a, and 65 through 70. These are your total payments ▶			71	4,986
Refund	72	If line 71 is more than line 60, subtract line 60 from line 71. This is the amount you overpaid			72	687
	73a	Amount of line 72 you want refunded to you. If Form 8888 is attached, check here ▶ ☐			73a	687
	▶ b	Routing number x x x x x x x x x ▶ c Type: ☐ Checking ☐ Savings				
	▶ d	Account number x x x x x x x x x x x x x x x x x				
	74	Amount of line 72 you want applied to your 2010 estimated tax ▶	74			
Amount You Owe	75	Amount you owe. Subtract line 71 from line 60. For details on how to pay, see page 74 ▶			75	
	76	Estimated tax penalty (see page 74)	76			

Standard Deduction for—
- People who check any box on line 39a, 39b, or 40b or who can be claimed as a dependent, see page 35.
- All others:

Single or Married filing separately, $5,700

Married filing jointly or Qualifying widow(er), $11,400

Head of household, $8,350

Direct deposit? See page 73 and fill in 73b, 73c, and 73d, or Form 8888.

If you have a qualifying child, attach Schedule EIC.

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see page 75)? ☐ Yes. Complete the following. ☑ No

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 15. Keep a copy for your records.

Your signature | Date | Your occupation | Daytime phone number

Spouse's signature. If a joint return, both must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no.

Form 1040 (2009)

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.
▶ Attach to Form 1040, 1040NR, or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2009
Attachment Sequence No. 09

Name of proprietor: I.M. Bogus
Social security number (SSN): 186-99-9999

A Principal business or profession, including product or service (see page C-2 of the instructions): Video Court Reporting
B Enter code from pages C-9, 10, & 11 ▶ 5 4 1 9 2 0

C Business name. If no separate business name, leave blank.
D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶ 6301 Ocean Drive
City, town or post office, state, and ZIP code: Corpus Christi, TX 78412

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶
G Did you "materially participate" in the operation of this business during 2009? If "No," see page C-3 for limit on losses ☐ Yes ☐ No
H If you started or acquired this business during 2009, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** See page C-4 and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses. ▶ ☐	1	40,310
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	40,310
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	40,310
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	40,310

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense	18	
9	Car and truck expenses (see page C-4)	9	3,837	19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see page C-6):		
11	Contract labor (see page C-4)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-5)	13	6,166	21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	7,386
15	Insurance (other than health)	15	1,878	23	Taxes and licenses	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	16,479
b	Other	16b		b	Deductible meals and entertainment (see page C-6)	24b	2,318
17	Legal and professional services	17	445	25	Utilities	25	
				26	Wages (less employment credits)	26	
				27	Other expenses (from line 48 on page 2)	27	37

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 ▶	28	38,546
29	Tentative profit or (loss). Subtract line 28 from line 7	29	1,764
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see page C-7). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	1,764

32 If you have a loss, check the box that describes your investment in this activity (see page C-7).
• If you checked 32a, enter the loss on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see the line 31 instructions on page C-7). Estates and trusts, enter on **Form 1041, line 3.**
• If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☑ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see page C-9 of the instructions. Cat. No. 11334F **Schedule C (Form 1040) 2009**

Schedule C (Form 1040) 2009 Page 2

Part III **Cost of Goods Sold** (see page C-8)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ Yes ☐ No

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 01 / 01 / 2005

44 Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:

a Business 29,114 b Commuting (see instructions) 12,000 c Other

45 Was your vehicle available for personal use during off-duty hours? . . . ☐ Yes ☑ No

46 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ Yes ☐ No

47a Do you have evidence to support your deduction? . . . ☐ Yes ☐ No

b If "Yes," is the evidence written? . . . ☐ Yes ☐ No

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

Dues		37
48 **Total other expenses.** Enter here and on page 1, line 27	48	37

Schedule C (Form 1040) 2009

SCHEDULE SE (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Self-Employment Tax

►Attach to Form 1040. ►See Instructions for Schedule SE (Form 1040).

OMB No. 1545-0074

2009

Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ►	

Who Must File Schedule SE

You must file Schedule SE if:

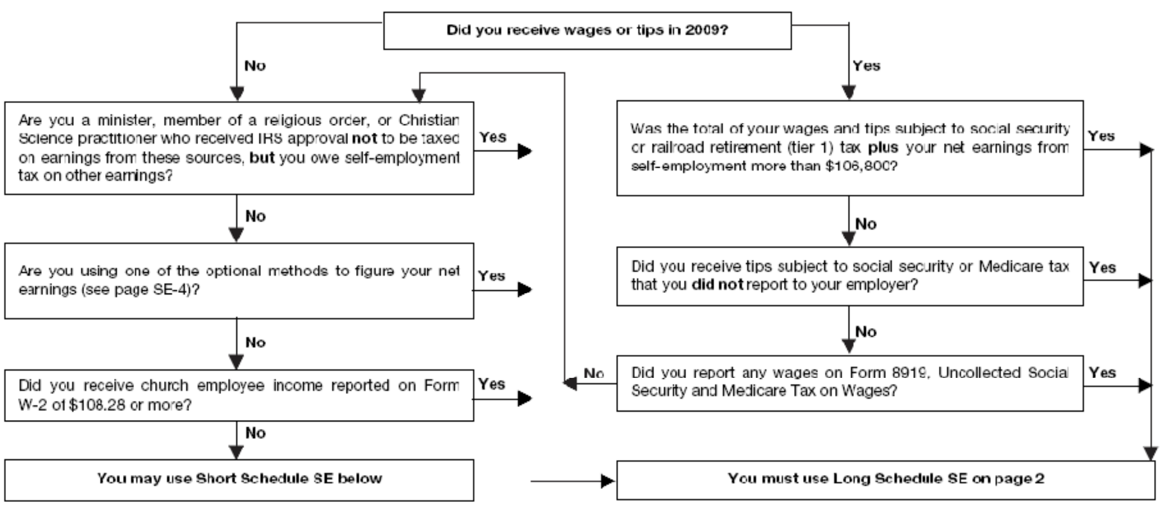
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order is **not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-4).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt—Form 4361" on Form 1040, line 56.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE,* above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	( )	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report	2	1764	
3	Combine lines 1a, 1b, and 2	3	1764	
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax . . . . ►	4	1629	
5	**Self-employment tax.** If the amount on line 4 is: • $106,800 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.** • More than $106,800, multiply line 4 by 2.9% (.029). Then, add $13,243.20 to the result. Enter the total here and on **Form 1040, line 56.**	5	249	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.50). Enter the result here and on **Form 1040, line 27**	6	125			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2009**

Expense Summary Received from Client

Summary of Conferences	Reimbursement Requests				
Car Expenses					
SUV					
auto expenses for miles traveled - gas	$3,837.00	****		supplies:	
insurance for SUV	1878.00			video tapes, etc	$7,386.00
first year depreciation for SUV:					$7,386.00
36966/3=12,332					
1/2 for first year	6166.00				
Total Auto expenses	$11,882.00				
Travel expenses:				memberships:	$37.00
Air Fare	4408.00	****			$37.00
auto expenses for driving to location-gas	6542.00	****			
Meals	2318.00				
Rental Cars and Gas	1258.00				
Hotel	3456.00				
Parking	641.00				
Misc Expenses	174.00	tolls, transp., etc****			
Total	$18,797.00				

****It should be noted no mileage reimbursement for travel by auto to other cities and other times airfare travel, due to too far to drive-but miles driven with auto for local related expenses are not listed with travel

AUTHOR'S NOTE

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THE LOS ANGELES COUNTY METROPOLITAN TRANSPORTATION AUTHORITY: INTEREST BASED BARGAINING AS AN ALTERNATIVE APPROACH TO COLLECTIVE BARGAINING

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CASE DESCRIPTION

This case serves as an educational tool for discussing and understanding the subject of collective bargaining and conflict resolution in unionized organizations. It is also intended to further engage students in the understanding of the topics of labor unions, the collective bargaining process, labor agreement negotiations, third-party intervention to conflict resolution (i.e.mediation, arbitration), and interest based bargaining.

CASE SYNOPSIS

The Metropolitan Transit Authority (MTA) had a history of difficult labor negotiations, often resulting in labor strikes by one or more of its unions. It is estimated that an extended strike in 2003 cost the region nearly $175 million. During the period leading up to the 2003 strike, the union-management relationship was described as poor. Ultimately, the strike in 2003 was settled by an impasse procedure voluntarily adopted by labor and management, referred to as "binding-nonbinding arbitration." This type of arbitration requires the two parties to submit their proposals to an arbitrator who renders a decision. Different from traditional arbitration procedures, either side can reject the decision based on a supermajority vote.

CASE

The MTA staff included more than 8,500 full-time employees, over 85 percent of whom were represented by one of five labor unions: 1) United Transportation Union, 2) Amalgamated Transportation Union, 3) Transportation Communications Union, 4) American Federation of State, County and Municipal Employees, and 5) Teamsters.

MTA experienced labor strikes eight times in the last 35 years and the relationship between the labor unions and management was considered to be adversarial. In January 2006, the MTA management and labor representatives were once again heading towards the re-negotiation of their employment agreement. MTA's Chairman of the Board, Los Angeles Mayor Antonio Villariagosa, considered the impacts of the 2003 strike and planned to meet with MTA's executive team. After the meeting, MTA's leaders worked together to develop options for the upcoming negotiations in order to change the culture of traditional labor negotiations at the agency. On the agenda of upcoming negotiations, were the following labor interests: Salary and compensation commensurate with cost of living and appropriate to the jobs performed, maintaining and improving levels of benefits, revamping day-to-day labor relations so that issues are resolved faster and more collaboratively, and opportunity to address various practices and work rules in the process. On the other hand, management's interests were: Create a survivable economic environment and eliminate the structural deficit, improve employee and labor relations, retain and recruit a professional, motivated and committed workforce, and support an "interest based" approach. Interest-based bargaining is defined as a negotiation strategy in which parties collaborate to find a win-win solution to their dispute. This strategy focuses on developing mutually beneficial agreements based on the interests of the disputants.

Interests include the needs, desires, concerns, and fears important to each side. This time both labor and management agreed to try this new approach to dispute resolution with no certainty associated with such an approach. This innovative approach, known as interest-based bargaining, required specialized training for labor and management representatives to prepare for negotiations. This training facilitated each faction to learn how to put forth its own interests.

INTRODUCTION

For almost ten years, the Los Angeles County Metropolitan Transportation Authority (MTA) had a history of contentious labor negotiations which resulted in labor strikes by one or more of its unions. An extended strike in 2003 cost the region nearly $175 million.[1] In addition to the economic impact, the area's residents who depend on MTA transportation went without access to medical care, schools, and work. Many lost their jobs due to the lack of mass transit and their inability to travel from place to place. Many of Los Angeles County's poorest residents went without health care because they had no access to doctors, hospitals, or clinics, without public transportation. The Los Angeles Times reported that cancellations were three to four times higher than typical rates for routine medical appointments at 40 community clinics that provide care to 2 million uninsured people in Los Angeles County.[2]

In preparing for the 2006 negotiations for a new contract, Mayor Antonio Villariagosa, MTA's Chairman of the Board, studied the issues, read various articles covering the 2003 bargaining sessions, and began to plan for a meeting with MTA's executive team. The failed labor negotiations in October 2003 were very fresh in the minds of labor and management at MTA. At that time, a team of frustrated MTA officials threw up their hands after making their last offer, resulting in a deadlock in the negotiations with the unions' leadership. To the disappointment of more than 400,000 commuters in the Los Angeles area, the agency announced that negotiations to get public transit running again were dead. Instead, management appealed directly to the MTA workers who had been off work for more than two weeks to end the strike.[3]

Luckily, for all parties concerned, the 2003 strike was ultimately settled by an impasse procedure known as binding-nonbinding arbitration, voluntarily adopted by labor and management.[4] This process resulted in a resolution of the matter and public transportation in Los Angeles was back in motion.

It was early 2006, and once again, it was the time for MTA to re-negotiate its three year contract with the labor unions. One new added variable was that many of MTA's 2003 negotiating team members were no longer with the agency. Fresh new faces were tasked with this mission and no one was certain where these negotiations would lead.

Between January and May 2006, MTA's leaders met to discuss how to approach upcoming negotiations as the current contract was due to expire in June 2006. Chairman Villariagosa expressed his concerns about potential economic and social impacts to the region if an agreement could not be negotiated without a labor dispute. In order to avoid another impasse and an extended strike, nontraditional negotiation strategies were considered. John Catoe, Jr., MTA's Deputy Chief Executive Officer for Operations, was given a leave of absence from his regular position to lead the negotiating team. Catoe worked with staff to develop potential approaches for the upcoming negotiations in response to the need to change the culture of traditional labor negotiations at the agency. Staff researched a number of options for the upcoming negotiation process and presented them to the Chair and CEO Roger Snoble for consideration. One of the options presented, interest based negotiation, was based on a recommendation of a staff member who read Getting to YES: Negotiating Agreement Without Giving In, by Roger Foster and William L. Ury.[5] After evaluating the options presented, Chairman Villariagosa and CEO Snoble were committed to a brand new approach known as interest based bargaining. Not everyone agreed that this approach would work, but they were willing to try. Gloria Molina, who at the time served as MTA's first Vice Chair of the Board and the Chair of the Los Angeles County Board of Supervisors later said, "the goal of this approach is to reduce the level of hostility that typically pervades negotiations of this type. And I'll admit it - I was very skeptical of this approach."[6] Amalgamated Transit Union President Neil Silver stated, "I personally didn't think this would work."[7]

THE LOS ANGELES COUNTY METROPOLITAN TRANSPORTATION AUTHORITY: ORGANIZATION BACKGROUND

The Los Angeles County Metropolitan Transportation Authority (MTA) is the nation's largest transportation agency with service to more than 9 million people in southern California within its 1,433 square-mile service area. It not only provides an extensive system of mass transit to one of the world's top economic regions and one of the nation's highest populated counties, it also serves as the transportation planner and coordinator, designer and builder.

MTA OPERATIONS

MTA provides a wide variety of transportation systems ranging from bicycle paths to busses and light and heavy rail lines. The annual budget is more than $3 billion.[8] In addition to operating over 2,000 peak-hour buses on an average weekday, MTA also designed, built and operates 73.1 miles of Metro Rail service. The MTA Rail system consists of the Red Line subway system, the Blue Line, the Green Line, and the Gold Line. In total, the MTA Rail system serves 70 rail stations stretching from Long Beach to downtown Los Angeles to Hollywood, Universal City and North Hollywood in the San Fernando Valley, from downtown Los Angeles to Pasadena and from Norwalk to El Segundo and points in between. The annual boarding of the Metro system exceeded 440 million in 2006. The average weekday boarding is 1.1million.[9]

In addition to operating its own service, MTA funds 16 municipal bus operators in the region and funds a wide array of transportation projects including bikeways and pedestrian facilities, local roads and highway improvements, goods movement, Metrolink, and the Freeway Service Patrol and Call Boxes. MTA's multimodal approach uses a variety of transportation alternatives to meet the needs of the highly diverse populations in the sprawling region.

GOVERNANCE

MTA is governed by a 14-member Board of Directors comprised of: (1) The five Los Angeles County Supervisors, (2) the Mayor of Los Angeles, (3) three Los Angeles mayor-appointed members, (4) four city council members representing the other 87 cities in Los Angeles County, and (5) one non-voting member appointed by the Governor of the State of California.

STAFFING

MTA employed more than 8,500 people in a broad range of technical specialties and Services ranging from Metro Bus and Metro Rail operators and mechanics to construction engineers and safety inspectors, from transportation planning professionals to customer information agents. MTA staff included more than 8,800 full-time employees, over 85 percent of whom were represented by one of five labor unions: [10] United Transportation Union, (2) Amalgamated Transit Union, (3) Transportation Communications Union, (4) American Federation of State, County and Municipal Employees, and (5) Teamsters. The Los Angeles County Sheriff's Department provides security and patrols all Metro buses operating within Los Angeles County.

Exhibit 1 shows the type and the number of the employees represented by each union based on their job classification.

EXHIBIT 1 Employees' Represented by Union Based on their Job Classification		
Labor Union	Represented Employees	Number of Members
United Transportation Union (UTU)	Bus and rail operators	4,477
Amalgamated Transit Union (ATU)	Mechanics and maintenance clerks	2,025
Transportation Communications Union (TCU)	Clerical Workers	542
Teamsters	Security personnel	74
American Federation of State, County and Municipal Employees (AFSCME)	Supervisors	542
Non-Represented	Administrative	1,193
TOTAL (2006)		8853
Source: The Los Angeles County Metropolitan Transit Authority: Facts at a Glance. http://www.metro.net/news_info/facts.htm#P132_1648.		

MTA AND ITS DISPUTING UNIONS

The three unions involved in the 2006 MTA case were The Amalgamated Transit Union, the United Transportation Union and the Transportation Communications Union.[11]

The Amalgamated Transit Union

The ATU is the largest labor organization representing transit workers in the United States and Canada. It was founded in 1892 and is made up of over 170,000 members in 270 local unions (including ATU Local 1277, Los Angeles) spread across 46 states and nine provinces. The ATU is comprised of bus, van, subway, and light rail operators, clerks, baggage handlers and maintenance employees in urban transit, over-the-road and school bus industries, as well as paramedical personnel, ambulance operators, clerical personnel, and municipal workers.[12]

The United Transportation Union

The UTU was formed in 1969 through a merger of four transportation unions – the Brotherhood of Locomotive Firemen and Enginemen, the Brotherhood of Railroad Trainmen, the Order of Railway Conductors and Brakemen, and the Switchmen's Union of North America. Today, the UTU is a broad-based, transportation labor union representing about 130,000 active and retired railroad, bus and mass transit workers in the United States and Canada. It is the largest railroad operating union in the rail industry, and includes approximately 650 locals in North America.Membership is drawn primarily from the operating crafts in the railroad industry such as conductors, brakemen, switchmen, ground service personnel, locomotive engineers, hostlers and workers in associated crafts. The UTU's 8000 bus and transit members include drivers, mechanics and workers in related occupations. The United Transportation Union "sets the pace in national and state legislative activity, collective bargaining, and in efforts to improve safety and working conditions on the railroads and in the bus and transit industries."[13] The UTU has been instrumental in the creation of Amtrak, the formation and success of Conrail, the enactment of numerous safety laws and the promotion of employee assistance programs. UTU Local 1770 represents approximately 150 active and retired railroad switchmen in the Los Angeles hub of the Union Pacific Railroad.[14]

The Transportation Communications Union

The TCU was organized on December 29, 1899 in Sedalia, Missouri, when 33 railroad clerks gathered to form Local Lodge Number 1; of a union they named the Order of the Railroad Clerks of America. In 1919, the organization took the name Brotherhood of Railway and Steamship Clerks, Freight Handlers, Express and Station Employees (BRAC), and affiliated with the American Federation of Labor. BRAC was the largest single organization of railroad employees who devoted a majority of their time to clerical work of any description. Over time, the union welcomed into its ranks the members of a number of labor organizations, among them the Transportation Communication Employees Union (once known as the Order of Railroad Telegraphers). As more groups merged, the organization simplified its name at its 1987 convention and decided to include all of its members under the name Transportation Communications International Union.[15]

HISTORY OF LABOR NEGOTIATIONS AT MTA

MTA endured labor strikes eight times during the past 35 years. According to the Los Angeles Development Corporation, it was estimated that the 35 day long strike in 2003, cost the agency and employees a combined $82 million and, as noted before, had an economic impact to the region of approximately $175 million.[16] During the period leading up to the 2003 strike, the union-management relationship was described as poor and highly adversarial. Ultimately, the strike in 2003 was settled by an impasse procedure voluntarily adopted by labor and management, referred to as binding-nonbinding arbitration. This is defined as a process whereby both parties submit their proposals to an arbitrator. A decision is rendered, but different from traditional binding arbitration, either side can reject it by a supermajority vote. Both sides agreed to use this method to resolve the outstanding health plan issue.[17] Please refer to Exhibits 2 and 3 for the strikes' history and the economic implications.

EXHIBIT 2: History of Strikes at MTA		
Date	**Striking Union**	**Length**
Feb. -March 1972	Amalgamated Transit Union	6 days
Aug.-Oct. 1974	United Transportation Union	68 days
Aug.-Sept. 1976	Amalgamated Transit Union	36 days
Aug.-Sept. 1979	Amalgamated Transit Union: Brotherhood of Railway, Airlines and Steamship Clerks	23 days
September 1982	United Transportation Union	5 days
July-Aug. 1994	Amalgamated Transit Union	9 days
Sept.-Oct. 2000	United Transportation Union	32 days
Oct.-Nov. 2003	Amalgamated Transit Union	35 days
Source: Jean Ouccione and Jeffrey L. Rabin (2006). 3 Unions MTA Reach Rare Accord. LosAngeles Times (Wednesday, June 26, 2006).		

EXHIBIT 3: Economic Implications of the MTA Strike	
Impact	**$ Amount**
Metro operating revenue loss	$44 million
Employees	$38 million
Los Angeles County economic output	$67 million
Lost tax revenues (at all levels of government)	$24 million
Unexpected additional costs to commuters	$46 million
TOTAL	$175 million
Source: Kyser, Jack (2003). Economic Implications of the MTA Strike. A study done by the Los Angeles Economic Development Corporation, commissioned by the MTA.	

Labor and Management Positions in 2003 Strike: Examples

The two primary issues triggering the 2003 strike were 1) the rising cost of health care and 2) hourly wages for MTA mechanics.[18]

- **Issue #1**: Cost sharing of health plan expenses between MTA and ATU.
  - **Labor's Position**: ATU's mechanics wanted to protect their contract provision that provided free coverage or $6.00 a month for family plans.[19]
  - **Management's Position**: MTA wanted the mechanics to contribute a monthly fee of $207 for health care coverage and did not want to provide retiree coverage. [20] **Arbitration Decision**: Included an $80.00 a month fee for coverage, but ultimately preserved coverage for older retirees.[21]
- **Issue#2**: Mechanic's wages.
  - **Labor's Position**: Demands were not divulged.[22]
  - **Management's Position**: MTA proposed giving mechanics a 3% wage increase plus a flat increase of 81 cents per hour accumulating quarterly throughout a three year, nine month deal.[27] **Final Agreement**: Included a 2% wage increase retroactive to 2002, when the union's last contract ran out, and 2.5% increases in 2004 and 2005.[23]

County Supervisor Zev Yaroslavsky, MTA's Chairman of the Board in 2003, was quoted in a Los Angeles Times article as saying, "Let's stipulate right now that everybody was a loser in this strike . . . above all the 400,000 plus riders who depend on the MTA . . . They have suffered the most."[24] On the other hand, ATU President Neil Silver said his union needed to fight for health benefits that were being threatened. Silver stated, "I'm sorry the strike happened, but I don't apologize for it."[25]

A NEW DAY—A NEW WAY TO NEGOTIATE: INTEREST-BASED BARGAINING

The labor strike in 2003 provided an impetus to all parties to try something new in the negotiation process. A new and innovative approach known as interest-based bargaining was used when negotiations began early in 2006 for renewal of the agreement ending on June 30, 2006. A critical feature of interest based negotiations is that it's based on relationships of mutual respect and trust among the parties, in lieu of the adversarial nature of traditional collective bargaining. The 2006 negotiations between Metro and the labor unions transformed the agency.

Why did interest-based bargaining work at Metro? An interview of John Catoe as well as a review of an article in The HR Advisor, Municipal Research and Services Center of Washington, detailed the unique conditions that allowed MTA and the labor unions to achieve win-win results. Highlights from the interview and the article are discussed below.

Management Bargaining Team

In early 2006, many months before expiration of the 2003 labor contracts, Chief Negotiator, John Catoe, Jr., began to assemble an operations-focused management bargaining team composed of key managers within the agency. Many of these key operations managers had little or no prior labor negotiation experience; yet they were respected due to their strong leadership skills, professionalism, and openness to new solutions. Despite diverse backgrounds and perspectives, this team maintained respect for each other's opinions and worked together throughout the entire process, to solve problems and develop new solutions to old problems.[26] John Catoe's staff researched ways to introduce a more collaborative process, including suggestions from the book Getting To Yes, which included interest-based bargaining strategies and techniques. The team of managers liked the idea of interest based negotiations, which led them to Rhonda Hilyer of Agreement Dynamics, Inc.[27]

Management's Thorough Homework

MTA hired a management consultant to help the management team identify stakeholders, interests, and positions. By analyzing industry data, the team developed a comprehensive economic outline that included national and local settlements, inflation rates, consumer price index, local cost of living, and the actual cost of a strike. For example, Catoe was able to provide cost analysis to the Board showing that the two-tier payment program for operators was costing MTA money rather than saving money, as originally perceived.[28] The thorough industry analysis led to development of the MTA's interests, delineated below, which were agreed upon by the Board and CEO Snoble.

Management and Labor Interests

A list of MTA and Union interests were identified:

- **MTA's Interests**:
  - Create a survivable economic environment and eliminate the structural deficit.
  - Improve employee and labor relations.
  - Retain and recruit a professional, motivated and committed workforce.
  - Support an "interest-based" approach[29]
- **Labor's Interests:**
  - Maintaining and improving levels of benefits
  - Revamping day- to-day labor relations so that issues are resolved faster and more collaboratively
  - Each bargaining unit had practices and work rules they wanted to address in the process.[30]

Management's Negotiating Authority Determined In Advance

The management team established a settlement framework at least four months before the negotiations even began. Their outline and authority to negotiate up to a certain amount was approved by the Board in advance of any negotiations.[31]

Training

All members of the labor and management bargaining teams were given interest-based bargaining training prior to negotiations. This training was provided by Rhonda Hilyer of Agreement Dynamics, Inc., who also served as facilitator during the negotiations. She worked with MTA as well as ATU and UTU to help them utilize the concept of interests, rather than demands. Ms.Hilyer also provided training to Board members, MTA managers and supervisors so that they could understand and support this unique approach to collective bargaining.[32] The training program included presentation of the RESOLVE method of negotiation, developed by Ms. Hilyer and explained below. The training consisted of a 2½ day program where management and labor were in the same room to learn about the new program.

Respectful Behavior

The management team established behavior guidelines that they promised to keep throughout the process. This set of behaviors was consistently maintained, even during very difficult negotiation meetings, solidifying credibility and mutual respect. These guidelines helped transform the labor-management relationship from one of adversaries to partners. The set of behaviors is listed below:

- Show respect at all times
- Communicate openly and politely
- Use accurate information and data
- Advocate interests rigorously, but never discourteously
- Avoid surprising or undermining the other team's people or interests
- Act professionally at all times
- Listen, comprehend…then speak
- Strive to solve problems jointly
- Address problems locally, quickly
- Maintain integrity in personal and agency communications
- Make decisions with improved employee relations and customer service in view.[33]

It took restraint and patience for both sides to adhere to these rules, but they did. During the negotiations process, if either side started to stray from the behavior guidelines, Ms. Hilyer facilitator held up cards with expressions such as, "Don't Personalize," "No Shouting," written on them. [34]

Eating, Celebrating Together, and Laughter

The union and management negotiators ate lunch together on a regular basis. Team members usually brought a variety of food to the meetings, including jambalaya and tamales. People sat across from each other, eating lunch, talking about families, vacations, kids, grandkids and social interests, wanting to develop a bond. Team members stated that humor helped break the tension of the negotiations. Many reported never having laughed so much during a labor negotiation. The negotiators became real people to each other versus people across the table screaming and shouting and walking out of the session.[35]

Maximum Disclosure of Information

John Catoe and his management team went out of their way to give the union officials advance notice of issues that would probably be raised with the MTA Board or operational changes that might be considered. The management team presented data to the union representatives in a manner that highlighted settlements that were above the norm. Catoe's team went so far as to provide information that was advantageous to the union's perspective, helping to build an unprecedented trusting relationship between the unions and management. MTA's negotiation team was 100% honest and provided any requested financial documents in management's possession to the labor negotiating team members.[36]

Interests Prevailed Over Positions

As the negotiations progressed, the transition to interest based bargaining gradually resulted in the resolution of some important issues. Examples are described below:

- **Issue #1**: ATU service attendants had an issue with two-wage tiers that provided no movement from the lower tier to the higher tier.
  - **Labor's Position**: Service attendants wanted the ability to move to the higher wage tier.
  - **Management's Position**: Reduce the high rate of absenteeism among service attendants.
  - **Interest Based Solution**: Each time a vacancy occurs in the top tier, two top tier vacancies are created. The vacancies will be filled with the 2 most senior lower tier service attendants who have had no attendance violations in the past year. They will go through a 4 year progression to get to the top tier. Their progression is halted if they violate the attendance policy. [37]
- **Issue#2**: UTU Wage Order #9, a CA legal requirement that operators receive 2 ten-minute rest periods and a thirty-minute meal break.
  - **Labor's Position**: ATU wanted to make sure its members got the required breaks as well as protection from any legal proceedings regarding the wage order.
  - **Management's Position**: Be in compliance with the order, but at the lowest possible cost.
  - **Interest Based Solution:** The EOL (end of line) and other schedule recovery times would be used as the rest and meal time for the operators. These times can be provided in any time increments as long as the total time in a day meets the 50 minute minimum. This requires adjusting running and recovery times in the run. [38]

INTEREST-BASED BARGAINING IN ACTION

Prior to sitting down to negotiate the 2006 labor contract, Amalgamated Transit Union, Local 1277, President Neil Silver sent a document to the MTA, outlining a set of 27 labor demands for inclusion in the new contract. Basically, these demands were recommended changes to the ARTICLES in the 2003 contract, some of which are included below: [39]

- ARTICLE 1, Section B – Significant pay increase for all classifications.
- ARTICLE 2, Section A – Increase in the shift differentials 5% for swing and 8% for graveyard.

- New Section – All employees working on Saturday and Sunday will receive an additional 5% rate increase.
- ARTICLE 3, Section B – When working through lunch the employee will be paid 1 hour additional pay.
- ARTICLE 16, Section F – Increase bereavement time to 5 days in State and 10 days out of state.
- ARTICLE 31, Section A – Add additional floating holidays for day after Thanksgiving.
- ARTICLE 38 - Increase the employee group life insurance amount from $30,000 to $100,000. [40]

In the spirit of interest based bargaining, MTA management did not prepare for the contract negotiations with demands, but instead, responded to the list of labor demands by offering to make a presentation based on the finances of the agency. The management negotiation team presented spreadsheets and in depth analysis of MTA's budget, expenditure plans, revenues, CFO statements, and projections that included up to date expense reports.[41]

This presentation was a much different response than what historically occurred during contract negotiating sessions when management responded with a flat "no" to labor's demands.

The negotiation team members went through each one of labor's demands and the management team asked the question, "How important is this, really?"[42] With that question on the table, management referred to the financial spreadsheets, discussing how much money was available for each demand. Management explained its willingness to spend the money in a manner that was in the best interest of the union's members and the agency's employees. This sharing of mutual interests and complete honesty led to putting a final labor contract in place before the deadline, resulting in a win-win solution for labor and management at MTA.[43]

ANALYSIS OF INTEREST-BASED BARGAINING

Interest based bargaining is a form of negotiation in which each party attempts to understand the other's interests, on the expectation that it will achieve a better result by helping the opponent create a solution it sees as responsive to its own concerns.[44] Exhibits 4 and 5, below, provide a summary of traditional vs. interest-based negotiations, using the "Resolve" approach, which is explained in detail below. Interests are the reasons why something is important to a particular group (their underlying needs or concerns). Positions are unilateral demands to address one party's interests without regard to the others. The success at MTA affirms the benefits of interest-based bargaining and Resolve. Each party worked at understanding what the other really needed out of the negotiation. This good faith effort resulted in workable solutions, delineated as interests, for both MTA and its Unions.

In interest based bargaining, each party works at understanding what the other really needs out of the negotiations. This, in turn, depends on being able to question the other party about its interests, or otherwise discover what those interests really are.[45] It is possible for one party to lead into this process even if the other party initially is not cooperative. In interest based bargaining, also referred to as integrative bargaining, parties will tend to avoid taking arbitrary "positions," while still being assertive about their needs. This approach is clearly distinguishable from "traditional" or "positional" bargaining, in which the usual sequence is for one party to start unrealistically "high" and the other to start low, with successive offers narrowing the difference without either party really understanding what the other seeks to achieve.[46]

EXHIBIT 4
Contrasts Between Traditional Labor Relations And "RESOLVE" Labor Relations

Traditional Approach Tends to Result in:	"RESOLVE" Approach Tends to Result in:
Large number of issues are raised with little or no prioritization.	Smaller number of issues of highest priority brought for mutual problem solving.
Proposals and counter-proposals are used.	Concepts and problems discussed without initial written proposals.
Conflicts and disagreements are approached from an adult/child perspective.	Conflicts which arise are seen as opportunities for group problem solving from an adult/adult perspective.
Labor and management approach grievances/differences as a necessary evil.	Differences and even grievances are approached as an ongoing opportunity to improve long-term relationships.
Things approached as win/lose situations.	Things approached as win/win situations.
Process is tedious, lasting months or years, with lots of posturing.	Process takes effort and commitment to trust-building. It is energizing and rewarding for all involved.
Often involves arbitration, mediation and legal remedies.	Works through to consensus-type agreement.
Adversarial relations lead to: • Loud/visible posturing between groups • Name calling • Energy spent on justifying positions • Upset employees, managers, customers and elected officials.	Collaborative relations lead to: • Recognition and focus on common goals • Sense of team among all participants • Feeling of good will and appreciation among employees and managers that carries over to customers/officials. • Mutual sense of accomplishment.

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There is tension between the two approaches: Many negotiators believe that keeping their own side's information secret from the other party strengthens their ability to obtain a favorable deal. This is probably true in distributive bargaining, a win-lose bargaining process in which one side's gain is the other side's loss. [47]

But in order for integrative bargaining to work, information must be shared. This can often produce a better result than the result the same negotiator could have reached using traditional methods. The "catch" is that there is reason to believe that when one party aggressively uses positional methods while the other seeks interest-based solutions, the aggressive positional party will get more. One consequence is that many negotiators practice an elaborate form of "tit for tat," in which the initial object is to find out whether the opponent is willing to play by integrative principles. If the opponent won't play by these rules, the negotiator may feel safer reverting to a traditional approach.[48]

EXHIBIT 5
Contrasts Between Traditional Bargaining and Interest-Based Bargaining

Traditional Bargaining		Interest-Based Bargaining	
Pros	**Cons**	**Pros**	**Cons**
1. Generally less "table time" 2. Less time/fewer resources needed to communicate with stakeholders 3. Experts/ "mouth pieces" often used so training is not required 4. Can be efficient and non-damaging to the relationship if parties get along okay, the issues aren't difficult, and posturing/positioning isn't taken seriously	1. More caucus time and more time between meetings 2. More "laundry lists" of issues advanced with little or no prioritization 3. Posturing and game playing common 4. Information/interests often withheld 5. Name calling, vilifying 6. Promotes "us/them" 7. Energy spent justifying positions and putting out "propaganda" 8. Tends to breed "tit for tat" competitiveness 9. Process can gridlock and become tedious, lasting months or years 10. Often involves arbitration, mediation, protracted legal remedies 11. A few people control the process 12. Information void breeds mistrust/suspicion/ hostility	1. Less time generally spent caucusing and fewer delays 2. Small number of issues with more prioritization provided 3. Clearer contract language and fewer "interpretation" grievances 4. More information/interest sharing 5. Improved trust, morale and ongoing working relations 6. Strong management and strong union supported 7. Energy spent joint problem solving 8. Improved communications 9. Consistent labor-management messages result in less confusion and suspicion 10. Fosters greater sense of fairness, understanding, and satisfaction with process and outcomes 11. Respectful behaviors	1. More time spent at the table, particularly when the process is first used 2. More time or resources required to train, educate, and communicate with participants and stakeholders 3. Requires more effort to establish credibility of advocates' role 4. More effort up front by each party to determine their issues/interests

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THE RESOLVE APPROACH TO NEGOTIATING

The MTA contracted with Rhonda Hilyer of Agreement Dynamics, who developed the RESOLVE approach to negotiating. "Ms. Hilyer's wisdom and negotiation experience from both a labor and a management perspective were a tremendous help". [49] Ms. Hilyer has worked with more than 400 organizations in both the public and private sector in the United States, Canada and Europe. The RESOLVE approach shifts participants from position based negotiations (selling or imposing positions) to interest-based or joint problem solving. RESOLVE means:

1. Restate the issue in neutral terms.
2. Establish ground rules and criteria
3. State the interests/reasons: Why the issue is important to you and what your needs and concerns are.
4. Objectively restate what you heard the other participants' interests to be.
5. Let them clarify any misunderstandings about their interests and you do the same about yours.
6. Vacuum (a form of brainstorming) for satisfiers and analyze them using your criteria
7. Elicit and express agreement. Agree on specific satisfiers, defer to another time or entity or agree to disagree.[50]

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AUTHOR'S NOTE:

The authors developed the case for class discussion rather than to illustrate either effective or ineffective handling of the situation. The case is based on published secondary data and some interviews. The case, instructor's manual, and synopsis were anonymously peer reviewed and accepted by the Western Case Writers Association Conference, March 25, 2010.

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NORTH STAR PAPER CORPORATION

James C, Cleveland, The Sage Colleges
John A. MacDonald, State University of New York at Oswego

CASE DESCRIPTION

This is a case about two families caught up in a proposal to purchase new manufacturing equipment which will result in laying off a number of workers including the adult members of one of the families. The head of the other family is the plant manager who will have to make a recommendation to the home office about the purchase proposal. The case involves calculating and/or analyzing the net present value and internal rate of return for the proposed capital expense project and constructing a recommendation for the plant manager. The personalized information about the families involved in the case creates a sense of reality and context for students that encourages them to look for the weaknesses of the NPV and IRR analyses as well as come to grips with the social consequences of layoffs to a small town dependent upon the company for its jobs. All of the material in this case is fictional, but students report that they like it because it is "so real."

CASE SYNOPSIS

Publicly-traded in the over-the-counter market, with 18,000 shareholders, North Star Paper Corporation has several specialty paper manufacturing and converting facilities in North America. One of the converting locations is in a small town in northern Maine called Winterville. The company is considering investing in equipment from Canada that would automate a significant portion of the process used at the mill. If the equipment is purchased and installed, a third of the employees would be dismissed. While that is only 20 people, the mill is the main employer in the village and the economic impact would be significant.

The village is about a 2.5 hour drive north of Boston, MA. and has a population of about 1300 people. The nearest population center of more than 20,000 people is about an hour's drive away and the economy at that location is stagnant. For each dollar generated in spending through wages and benefits, etc. at the mill, the local economy is increased by $1.75. (In other words, the economic impact multiplier is 1.75, so a loss of $45,000 in wages and benefits will remove $78,750 from the local and regional economy in addition to the lost wages and benefits.) Finally, the purchaser of 20% of the output from the mill is a RV/camper construction company headquartered an hour and a half away in Maine. It has joined the "Buy Maine First" coalition and supports jobs growth in Maine.

BACKGROUND

Joe Cummings lives in Winterville, Maine, and works for the North Star Paper Corporation as a machine operator. The machine that Joe operates is one of several purchased 25 years ago that laminates layers of a special type of paper plastic, and glues to produce a building material sheet. Each machine requires a head operator, three feeders and three stackers and a maintenance person.

Joe grew up in Winterville, graduated from the Winterville High School and went to work for the company, just as his father had. Working for "the company" is what the family did.

The same year Joe began his job at North Star, he married his high-school sweetheart, Sophie. She was a year behind Joe, but she graduated from high school before giving birth to their eldest child, Clare. Twenty years later, she and Joe have three children.

Clare is now completing her junior year in college studying to become a nurse. Her younger brother Phil is a senior in high school and plans to go to college and major in Business. Bobby, the youngest, is finishing his sophomore year in high school and thinking seriously about following the family tradition and going to work for the company" when he has his diploma.

After Bobby entered school, Sophie also took a job with North Star and now operates a machine just like Joe. Together they gross about $80,000 a year and make a decent living for their family. They are able to pay Clare's tuition at the state university school of nursing and figure they can cover Phil's tuition also if he opts for the state university school of business. Altogether, the Cummings family is satisfied with its life in Winterville.

Joe and Sophie belong to the United Paperworkers of America. North Star is in the second year of a five-year contract that was negotiated with some difficulty. Although everyone at the Winterville plant gets along and management and labor communicate freely, at the time there had been some talk that the union would call a strike before a satisfactory contract was finally negotiated with the home office in Chicago. Joe has considerable seniority but Sophie has little seniority and would be laid off permanently in the event of a significant business downturn or efficiency changes at the mill.

Winterville is a small town with all the delights of small-town life. One of these is the closeness that members of the community feel with each other. Winterville has two churches: the Winterville Congregational Church and St. Peter's Roman Catholic Church. Joe grew up in the Congregational Church, Sophie in the Roman Catholic Church. The Roman Catholic community makes up most of the town; however, the congregations often do activities together.

In the summer, there are regular musical concerts in the town park. Often the musicians are local community members all of whom work for the company and call themselves the North Star Band. "They are not the best band in the country," Sophie says, "but they're ours and we love 'em."

The saxophonist in the band is Dan Douglas. Dan is the plant manager at North Star's Winterville plant. He's the boss. But Dan is also a member of the Winterville community, an elder in the Congregational Church, and known to his friends, neighbors and employees as "Dan."

Dan did not grow up in Winterville, but was sent there by North Star to manage its plant. Nevertheless, he, his wife, Betty, and their two children, Josh 17 and Amanda 10, fell in love with the town and its people and are very happy in Winterville.

Dan earned his MBA at the state university and joined a management training program at North Star. He was bright with a pleasant personality and rose quickly through the ranks of the company. He was offered the plant management position in Winterville 10 years ago and, although he was been offered other advancement opportunities, he and Betty have decided to remain in Winterville.

Betty earned her undergraduate degree in English. It was at the university that she first met Dan and they fell in love. Now she runs the county hospital auxiliary.

Josh is a senior in high school. He knows Phil Cummings because everyone in Winterville knows everyone else, but you wouldn't call them friends. They play sports together and like each other but never hang out together. Phil is more academically inclined and Josh more oriented toward sports where he has been successful on the high school hockey team and hopes to get a sports scholarship to college.

Amanda, Josh's little sister, is only 10 and is too young to have any plans. Clare Cummings used to baby sit for Amanda so the Cummings family and the Douglas family know each other even if they are not especially close.

July 1 began just as every other day. Joe and Sophie arrived at work on time, clocked in and began work on their machines. Dan arrived a short time later and began working on the reports on June production due to the home office in a week. Everyone was looking forward to the upcoming July 4th holiday and the concert in the park by the North Star Band.

Dan was well into writing the first report, when the mail arrived and with it a large envelope from the home office. He was expecting this piece of mail, which was a capital budgeting project for his evaluation. In the envelope was the following proposal. The cover letter asked Dan for his recommendation by July 8.

THE LETTER

Date: June 29, 2009
To: Daniel Douglas, Plant Mgr.
From: Brian Corbin, V. P. Operations
Re: Cretaneau 70X Laminator Capital Project

Per our phone discussions of June 27, here is the evaluation information for the machinery purchase we are anticipating. Please review and provide recommendations by July 8, 2009.

Information:
Financial:

Cost of New Equipment	$	8,974,000.00
Installation and Training	$	26,000.00
Average employee annual wage	$	35,000.00
Average employee annual benefits	$	15,000.00
Non-labor operating expenses increase	$	400,000.00
Expected annual labor increase		2.00%
Expected total marginal tax rate		40.00%

Accelerated Depreciation Schedule used for tax reporting, with straight-line used for financial reporting to shareholders. (See Split Spreadsheets for years 0-8 and 9-20 of estimated earnings and cash flows.)

$ 0.6 million in additional production output expected.

No change in the product price is expected.

No salvage value is expected at the end of 20 years.

2 trained employees needed at $60,000.00 each (including benefits)

We assume that technology and market will change enough that a new financial analysis will be needed for the period beyond the life of the machine being considered for purchase now.

Fixed costs will not change since the older machines are being replaced by a single machine but that new machine requires more electricity and regular maintenance.

Finally, due to the age and proprietary nature of the machines being replaced, we see no forthcoming economic or salvage value and suggest they be put in storage indefinitely.

EC:
George Tobias, President
Arthur Scruggs, CFO

THE SPREADSHEET DATA (All Numbers in Millions)								
Year from Today - Decision Time	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Income Statement								
Increase in Net Sales	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600
OPERATING EXPENSE BREAKDOWN:								
Non-Labor Operating Expenses	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400
Labor reduction	$1.000	$1.020	$1.040	$1.061	$1.082	$1.104	$1.126	$1.149
Increased labor on new machine	-$0.120	-$0.122	-$0.125	-$0.127	-$0.130	-$0.132	-$0.135	-$0.138
Change in Fixed Costs	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
Operating Income	$1.080	$1.098	$1.116	$1.134	$1.153	$1.172	$1.191	$1.211
Income Before Non-Cash Expense	$1.080	$1.098	$1.116	$1.134	$1.153	$1.172	$1.191	$1.211
Book Depreciation - straightline	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450
Interest Expense (not included in capital budget)		$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
Labor inflation rate:	0.02							
Pre-Tax Income	$0.630	$0.648	$0.666	$0.684	$0.703	$0.722	$0.741	$0.761
Income Tax Rate:0.40	-$0.252	-$0.259	-$0.266	-$0.274	-$0.281	-$0.289	-$0.296	-$0.304
Net Income (For Financial Reporting)	$0.378	$0.389	$0.399	$0.410	$0.422	$0.433	$0.445	$0.457
Income Statement for tax purposes (see sales above)								
Operations:								
Income Before Non-Cash Expense	$1.080	$1.098	$1.116	$1.134	$1.153	$1.172	$1.191	$1.211
Depreciation Expense	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338
Accelerated 20-yr Tax Depreciation Schedule		0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750
Pre-Tax Income	$0.743	$0.760	$0.778	$0.796	$0.815	$0.834	$0.854	$0.873
Income Tax	-$0.297	-$0.304	-$0.311	-$0.319	-$0.326	-$0.334	-$0.341	-$0.349
Invest. Tax Credit (not currently available)	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
New Income (For Tax Reporting)	$1.040	$1.064	$1.089	$1.115	$1.141	$1.168	$1.195	$1.223
CASH FLOWS:								
Investment depreciable basis:-$9.00								
Net Income	$1.040	$1.064	$1.089	$1.115	$1.141	$1.168	$1.195	$1.223
Tax Depreciation	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338
Assumed Sale of Depreciated Assets								
at Book Value								
Net Cash Flow-$9.00	$1.377	$1.402	$1.427	$1.452	$1.479	$1.505	$1.532	$1.560
Cumulative inflow-$9.00	-$7.623	-$6.221	-$4.795	-$3.342	-$1.864	-$0.358	$1.174	$2.734
Cost of capital:13.75%								
Project IRR:	15.976%							
Project NPV ($MM):	$1.12	millions						

Spreadsheet Data cont.

Year from Today - Decision Time	9	10	11	12	13	14	15	16	17	18	19	20
Income Statement												
Increase in Net Sales	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600	$0.600
OPERATING EXPENSE BREAKDOWN:												
Non-Labor Operating Expenses	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400	-$0.400
Labor reduction	$1.172	$1.195	$1.219	$1.243	$1.268	$1.294	$1.319	$1.346	$1.373	$1.400	$1.428	$1.457
Increased labor on new machine	-$0.141	-$0.143	-$0.146	-$0.149	-$0.152	-$0.155	-$0.158	-$0.162	-$0.165	-$0.168	-$0.171	-$0.175
Change in Fixed Costs	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
Operating Income	$1.231	$1.252	$1.273	$1.294	$1.316	$1.338	$1.361	$1.384	$1.408	$1.432	$1.457	$1.482
Income Before Non-Cash Expense	$1.231	$1.252	$1.273	$1.294	$1.316	$1.338	$1.361	$1.384	$1.408	$1.432	$1.457	$1.482
Book Depreciation - straightline	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450	-$0.450
Interest Expense (not included in capital budget)	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
Pre-Tax Income	$0.781	$0.802	$0.823	$0.844	$0.866	$0.888	$0.911	$0.934	$0.958	$0.982	$1.007	$1.032
Income Tax Rate:	-$0.312	-$0.321	-$0.329	-$0.338	-$0.346	-$0.355	-$0.364	-$0.374	-$0.383	-$0.393	-$0.403	-$0.413
Net Income (For Financial Reporting)	$0.469	$0.481	$0.494	$0.507	$0.520	$0.533	$0.547	$0.561	$0.575	$0.589	$0.604	$0.619
Income Statement for tax purposes (see sales above)												
Operations:												
Income Before Non-Cash Expense	$1.231	$1.252	$1.273	$1.294	$1.316	$1.338	$1.361	$1.384	$1.408	$1.432	$1.457	$1.482
Depreciation Expense	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338	-$0.338
Accelerated 20-yr Tax Depreciation Schedule	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750	0.03750
Pre-Tax Income	$0.894	$0.914	$0.935	$0.957	$0.979	$1.001	$1.024	$1.047	$1.071	$1.095	$1.119	$1.144
Income Tax	-$0.357	-$0.366	-$0.374	-$0.383	-$0.391	-$0.400	-$0.409	-$0.419	-$0.428	-$0.438	-$0.448	-$0.458
Invest. Tax Credit (not currently available)	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000	$0.000
New Income (For Tax Reporting)	$1.251	$1.280	$1.309	$1.339	$1.370	$1.401	$1.433	$1.466	$1.499	$1.533	$1.567	$1.602
CASH FLOWS:												
Investment depreciable basis:												
Net Income	$1.251	$1.280	$1.309	$1.339	$1.370	$1.401	$1.433	$1.466	$1.499	$1.533	$1.567	$1.602
Tax Depreciation	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338	$0.338
Assumed Sale of Depreciated Assets												
at Book Value												$0.000
Net Cash Flow	$1.588	$1.617	$1.647	$1.677	$1.707	$1.739	$1.771	$1.803	$1.836	$1.870	$1.905	$1.940
Cumulative inflow	$4.323	$5.940	$7.587	$9.264	$10.971	$12.710	$14.480	$16.284	$18.120	$19.990	$21.895	$23.834

CASE QUESTIONS

1. If making this decision is as simple as calculating the NPV and/or the IRR of the proposed project, why has Dan's recommendation been sought by the home office?

2. What are the advantages of accepting the proposed project to the company? What are the advantages to its stockholders? What are the advantages to Dan? What are the advantages to Joe and Sophie?

3. What are the disadvantages to each of these affected parties?

4. Which factors are the most important for Dan to consider in formulating a response to the proposal? Why?

5. Write Dan's letter/executive summary to the home office giving his recommendation and a complete explanation of the recommendation.

A SMOKING DILEMMA

Steven Cox, McColl School of Business Queens University of Charlotte
James Foster, McColl School of Business Queens University of Charlotte

CASE DESCRIPTION

The primary subject matter of this case concerns the ethics of upgrading a pub's outdoor seating area to specifically accommodate smokers after the state legislature banded indoor smoking at restaurants and pubs because of the proven danger of second hand smoke to patrons and employees. The secondary issue examined concerns the profitability of the upgrade and the owner's objective of a one year payback on any investment in the pub. The case has a difficulty level of three, appropriate for junior level students. The case is designed to be taught in one hour with two hours of preparation if both the ethical and financial aspects of the case are assigned.

CASE SYNOPSIS

After the state legislature banned smoking in restaurants and bars, Jim Foster, an enterprising pub owner, was considering upgrading his outdoor area to accommodate smokers. Twenty years of pub ownership had convinced Jim that his patrons liked to smoke when they drank. While he understood the well documented hazards of second hand smoke to customers and employees, he wondered whether their protection was his responsibility. After all, customers could always go inside or choose to go elsewhere, and no one was forcing bar tenders and waiters to work at the pub. Further, there was no documented study of the harmfulness of second hand smoke in outdoor areas. Jim also needed to determine the financial viability of the upgrade regardless of the ethical issues. Jim had always thought of the outdoor area as an overflow space in the cool months and casual beer garden in the summer months. To suggest that the area was rustic was being generous, with its inexpensive canvas umbrellas, plastic chairs, and mesh tables, Jim knew that to do the upgrade right it was going to be expensive and risky on several levels. Jim needed to weigh the ethical and cost issues before making the decision.

A SMOKING DILEMMA

May was coming to an end and the bar was packed. Nothing could be better thought Jim Foster, owner of the Selwyn Pub in Charlotte, NC. However, as he looked around, he could not help but notice that there was at least one smoker at almost every table. What concerned Jim was that the state legislature of North Carolina had just passed a law banning smoking in bars and restaurants. The ban would begin on January 2, 2010, just months from now. Since the ban only affected the inside areas of bars and restaurants, with his large patio, he wondered if he could take advantage of the situation by improving the patio where smoking was permitted. Jim knew that financially, this could be a significant risk; however he thought that if he developed the outside seating area he might not only keep his current patrons but also attract smokers from the nearby pubs without patios. Jim appreciated the dangers of first and second hand smoke, and why the legislature had put the ban in place. His mother, a lifelong smoker had recently died from smoking related complications. He wondered if he had a social responsibility to discourage smoking in his pub and protect not only smokers but also the non smokers from the effects of second hand smoke. Additionally, he wondered about the effect on his staff, if he developed a smoker friendly environment on his patio, would he be putting is workers at greater risk. What should he do?

JIM FOSTER

Jim worked in an Irish Pub while attending Albany Law School in upstate New York. He loved working at the pub and bought into the notion that a pub should be a comfortable place where everyone in the neighborhood including families could come to meet friends. Upon graduation, he moved to Charlotte and began a practice. Although his practice was financially successful, he found the work less than fulfilling. When in the early 1990 a small Cuban restaurant in the affluent Myers Park area of Charlotte became available, he decided to follow his dreams and take a long term lease on the property. The property had several advantages: first, its location was in the heart of the Myers Park, an area which was considered a very fashionable place for the 25-45 professionals to live; second, the location was on a main thoroughfare enabling easy access; and third, the location had room to build an outside seating area capable of serving 100 customers. On the negative side, parking was limited during weekday working hours, however in the evenings and on weekends, patrons could use the adjacent parking lot reserved for several small businesses on weekdays. Second, inside seating was limited to 45. Finally, the kitchen was small and due to zoning regulations, expansion was not possible.

Over the past 17 years Jim's decision to open a pub turned out to be a good one. Focusing on a friendly atmosphere where young professionals could drop in and meet friends after work, or on the weekend, and families could come for a light meal, the bar quickly became popular spot. The Pub had received high marks from Sneaky Sunday, a local weekend column in the Charlotte Observer. It had even been mentioned in Kathy Reich's book Death Du Jour. The Pub focused mainly on beer rather than liquor or wine sales, and had an assortment of 25 different brands on tap or in the bottle. To avoid attracting a rowdy or non professional crowd, Jim maintained a strict policy against offering cheap beer. There were no happy hours, no dollar beer specials, and no two-for-one deals. As Jim considered the mix of regular customers he felt that the policy had worked well.

From the beginning, the Pub offered a fairly standard mix of 'pub' food. The menu consisted of salads, fried foods, wings, and pizza. Recently, Jim had been placing more emphasis on serving more appetizing food. Recently, he had taken several cooking classes at the Culinary Institute of America and collaborated with his food vendors to completely revise the menu. His hamburgers were increased by 10 ounces of the highest quality beef, chicken wings were large and after cooking sent through the pizza oven to enhance the flavor, and pizzas were hand tossed and only fresh toppings were used. In addition, fried pickles came to be a local trademark for the Pub. As a result of these improvements, Jim commented that he "thought that customers would begin to think of the Pub as a place for a bite and a drink rather than a drink and a bite."

THE SMOKING BAN

North Carolina was the 35th state to pass some form of public smoking ban for bars and restaurants. The tobacco industry had always been strong in North Carolina. Cigarettes were such a part of the history of the state that several cigarette brands were named after cities in North Carolina. Even Durham, the home of Duke University, was named after a type of tobacco. Tobacco in North Carolina was still a vital part of the state's economy. According to industry statistics, NC's tobacco crop was worth almost $670 million to state farmers in 2008.

While the effects of smoking had been well documented for more than 40 years, the effect of second hand smoke was a more recent concern. The legislation to ban smoking was led by health advocates who were concerned about the effect of second hand smoke rather than the harmful effect of smoking. By 2009, numerous scientific studies had confirmed the danger of second hand smoke to children and adults alike. The American Cancer Institute stated:

"You don't have to be a smoker for smoking to harm you. You can also have health problems from breathing in other people's smoke. Secondhand smoke is the combination of smoke that comes from the burning end of a cigarette, cigar or pipe and the smoke exhaled by the smoker. Secondhand smoke contains more than 50 substances that can cause cancer. Health effects of exposure to secondhand smoke include lung cancer, nasal sinus cancer, respiratory tract infections and heart disease."

"There is no safe amount of secondhand smoke. Children, pregnant women, older people and people with heart or breathing problems should be especially careful."[1]

In addition to concerns about customers, several recent studies had examined the effect of second hand smoke and smoking bans on hospitality workers. These studies demonstrated the significant risk of second hand smoke to hospitality workers and the positive effect of state wide bans on work place smoking.

- After New York State's smoke free law went into effect, the number of hospitality workers who reportedly experienced irritation of the eye, nose, and throat declined by 62%, 34%, and 45%, respectively. Before the state law went into effect, 59% of hospitality workers reported respiratory symptoms, such as morning cough, shortness of breath, or bringing up phlegm. After the smoke free law took effect, the number of workers who reportedly experienced morning cough dropped by 46%. (International, 2004)[2]
- Bartenders working in smoke-filled bars are more likely than other workers to report having red or irritated eyes, coughing in the morning, coughing during the rest of the day, runny noses or sneezing, and a sore or scratchy throat. (Palmersheim, 2005)[3]
- Smoke free workplaces decrease cigarette consumption in continuing smokers, as well as decrease adult smoking prevalence. Smoke free laws result in fewer respiratory symptoms in workers, and there is strong evidence that these laws result in decreased hospital admissions for heart attacks. There is no negative economic impact for restaurants and bars going smoke free. (Pierce & Leon, 2008)[4]

On signing the bill, North Carolina's Governor Beverly Perdue stated ""It's a huge marker in our state that we're serious about having a healthy North Carolina, and that we'll go to (all means) to make that happen." Jim's examination of the legislation however, revealed that it did not ban smoking in all establishments or all areas. Smoking in country clubs, non profits (e.g. VFW), tobacco shops, and cigar shops was not prohibited. More importantly, smoking in outdoor areas of any bar or restaurant was also not prohibited by the regulations. Therefore, at least for now, Jim could legally permit smoking in his patio area. He wondered however, was legality the real issue.

Jim had often commented that "I would like to make the pub smoke free, but unless all of the other pubs in the area did so, I cannot afford the risk of losing my loyal smoking customers." The new regulations had given him the opportunity to make his pub smoke free without worrying about losing customers because of it. However, as an entrepreneur, he felt that there was an opportunity to dramatically expand the pub's appeal and revenue by catering to smokers. An upgrade to the outdoor space could not only help retain his current clientele, but potentially take customers from other pubs. Still conflicted, in the end, Jim decided to investigate the cost of upgrading the patio before making a decision.

THE PATIO UPGRADE

There were both weather related and esthetic issues to consider. On the weather side, while Charlotte's winters were mild, the temperature still could drop into the teens at night, and the normal low was in the 30's and 40's from November-March. Further, the patio was not covered and while snow was typically not a problem, rain was. On the esthetic side, Jim had never tried to make the patio a destination location. There were 3 big screen TV's and inexpensive chairs and tables. The one distinguishing feature of the patio was a mature oak tree growing in the middle of the patio. Making sure that it thrived required considerable time and effort from Jim. .

Jim had always relied on his intuition and experience in making decisions about changes to the Pub. Before deciding upon whether or not to improve the patio, Jim developed an initial concept design. With this design he went to local outdoor living, electronics, and awning shops for pricing and specific product help. Jim discovered that the biggest hurdle would be designing the awning. No one in the Charlotte area had built an awning of the size and strength that would be needed to shelter such a large space. In addition, the local building inspector had no experience with awnings of this type. As a result Jim had to enlist the help of a structural engineer to design the awning and convince the city building inspector that it would be safe. Even with the structural engineer, it took over 6 months to gain city approval. Jim often said the "If I had known what it was going to take just to get approval for this project I might never have started it."

After overcoming the awning issue Jim began in earnest to design the exterior space, Jim's concept was for the pub to have a more home like feel. He wanted outdoor gas fireplaces and fire pits. These would offer not only an additional heating source, but provide an esthetic appeal. Because the night temperatures from November to March can be in the 30's and 40's Jim also wanted an efficient auxiliary outdoor heating system. He found a new infrared heating system designed to heat the patrons rather than the surrounding area. The units were very energy efficient although the initial cost was higher than traditional heaters. He also felt the addition of several more flat screen TV's to be housed over the fireplaces or under the awning would provide easy view for the customers. Further, with several TV's it would be possible to show different sporting events at the same time. Finally, Jim was considering outdoor couches, tables, chairs, and low coffee tables for in front of the fireplaces. This would continue the comfortable living theme and in colder weather, permit patrons to better enjoy the heat from the fireplaces. The total cost of the estimates for all of the improvements was $71,800-$93,000 (see Table 1). The design life of the upgrades would be five years.

Table 1
Itemized Cost of the Upgrades

Item	Cost each	Total Cost
Awning	$20,000-$26,500	$20,000-$30,000
Fireplaces (3)	$5,000-$6,000	$15,000-$18,000
Heaters (12)	$900-$1,000	$10,800-$12,000
Furniture		$14,000-$18,500
TV's (6)	$2000-$2,500	$12,000-$15,000
Grand Total		$71,800-$93,000

Given the demand for a place where customers could have a cigarette while drinking and the lack of a similar place in the immediate vicinity, Jim believed that the upgraded outdoor eating and drinking space could increase outdoor revenue by 10%-25% with little or no impact on expenses other than an equivalent increase in cost of goods sold. While Jim knew that the estimate was only based upon his experience and understanding of his customers, he was comfortable that these numbers were attainable. Since Jim self-financed all his capital improvements, his objective was to recoup his investment in the first year even though the design life of the upgrades was five years.

CURRENT REVENUE AND COST OF GOODS SOLD

Jim began looking at the profit and loss statement for the past 3 years to see if an investment of $71,800-$93,000 could be justified. Jim's revenue had been relatively stable for the past 3 years, a life time in the pub business. However, with the current economic conditions, Jim was concerned about 2010 revenue though he was currently forecasting it to be the same as 2009. Table 2 shows Jim's profit and loss statement for the past 3 years.

Table 2
Profit and Loss Statement 2007-2009
(000)

	2007	2008	2009
Sales			
Beverages	$ 1,370	$ 1,430	$ 1,360
Food	$ 380	$ 390	$ 360
Total	$ 1,750	$ 1,820	$ 1,720
CGS			
Beverages	$ 424	$ 429	$ 449
Food	$ 152	$ 160	$ 152
Total	$ 576	$ 589	$ 601
Gross Profit Margin	$ 1,174	$ 1,231	$ 1,119

Jim estimated that the patio currently accounted for 50% of total sales. He felt that the gains to the outdoor revenue could be considered incremental since some non smokers would choose to eat inside now that it was nonsmoking and some smokers would choose to eat outside.

JIM'S DECISION

Jim began to run the numbers. As he did so, however, he was still not convinced that spending at least $71,800 to make a more smoker-friendly pub was the socially responsible thing to do. He had his employees to consider as well as his patrons. The statistics on the dangers of second hand smoke were compelling, yet people do not have to smoke nor do they have to sit with people who do smoke. Before he did anything, he needed to know if the investment made economic sense. If so, then he would have to wrestle with the issue of his social responsibility when it came to smoking and second hand smoke? He almost hoped that the numbers would not support the investment, but he had to run the numbers to find out.

AUTHOR'S NOTE

This case was prepared by Steve Cox and James Foster of the McColl School of Business at Queens University of Charlotte and is intended to be used as a basis for class discussion. The views presented here are those of the case authors. Authors' views are based on their own professional judgments.

END NOTES

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GAMING SUPPLIES INCORPORATED

Jane E. Baird, Minnesota State University, Mankato

CASE DESCRIPTION

The primary subject matter of this case concerns accounting issues in a company that manufactures and sells gaming supplies. Specific issues examined include taxation and financial reporting related to exclusivity contracts, prior period accounting errors, leases, loss contingencies, and forward currency contracts. The case has a difficulty level of four, so it would be appropriate to use in senior level accounting courses or in master's level courses. The case is designed to be discussed in one to two class hours and is expected to require approximately 15-20 total hours of outside preparation by students (three to four hours per case issue). It can be utilized as an extensive course project requiring all students to research all five issues, or each of the five case issues can be assigned to a separate student team so that each team researches just one issue.

CASE SYNOPSIS

This case is designed to improve accounting students' skills in regard to researching financial reporting standards and tax law and using critical thinking to apply the accounting and tax rules and guidelines to Gaming Supplies Incorporated's (GSI) situation. GSI is a manufacturer of gaming supplies, including dice, gaming chips, playing cards, and gaming tables and equipment used in casinos. Joe Newby, a recent accounting graduate, finds himself on the GSI engagement. He is asked by his supervisors to research several accounting and tax issues related to GSI's activities, including a contract involving exclusive rights to security technology embedded in its gaming chips, an accounting error found in previously issued annual reports, new leasing contracts, and a forward currency contract. Students are asked to take on the role of Joe Newby and research these issues and formulate conclusions as to how they should be handled by GSI. The case provides students with a unique opportunity to examine real business issues and their impact on both accounting and tax reporting. Students must access the new FASB Accounting Standards Codification in order to adequately address the case issues, thereby getting exposure to the new standards format and gaining familiarity with search methods appropriate for the new format.

THE CASE: GAMING SUPPLIES INCORPORATED

Joe Newby recently graduated from University of Nevada, Las Vegas with a degree in Accounting and landed a job with a large regional accounting firm. Just back from two weeks of training for new staff accountants, Joe gets called into Phil Filer's office. Phil is one of the firm's partners and has been designated as Joe's partner mentor.

Phil: "Come on in, Joe. I want you to meet Diane Smith. Diane is the senior accountant in charge of the Gaming Supplies engagement. I'd like you to work with her on the engagement team.

Diane: "Hi Joe, nice to meet you."

Joe: "Hi. I've never heard of Gaming Supplies. What kind of engagement is it?"

Phil: "We do the audit and tax work for the company, and I want you to get some experience with both. If you've ever been to a casino, you've probably seen at least some of the products the company makes. Gaming Supplies Incorporated, GSI for short, is a publicly traded company that manufactures and distributes gaming equipment and supplies. The company's products run the gamut, from small items such as playing cards, dice and gaming chips to table layouts, roulette wheels, and gaming furniture. The company has two wholly-owned subsidiaries: one in Mexico and one in Europe. The company's sales in the United States are all handled through its corporate headquarters here in Las Vegas, while its international sales are handled through the European subsidiary. The Mexico operation is strictly manufacturing."

Diane: "There's a lot more to manufacturing casino chips and dice than you would think. A lot of cash goes through casino operations, making security controls very important in the industry. Because of the importance of security over dice, cards, and chips in a gaming environment, the production process is tightly controlled and GSI only sells these products to licensed casinos. Chips are custom-designed for each casino. In addition to cosmetic design features tailored to each casino, the chips include a choice of security features to prevent counterfeiting. For example, special pigments can be added to the chips that will appear only under UV lights, features can be embedded in the ink that will appear green when passed under a laser beam, and RFID technology can also be added to chips. RFID basically involves microchips that can be read using radio frequencies. Dice have similar security features. I'll take you out to see some of the operations when we go out to do some walk-through procedures."

Joe: "That would be great. Wait, if the manufacturing is in Mexico, does that mean we get to go there?

Diane: "Yes, but don't pack your sombrero yet—we have a lot of preliminary work to do!"

Joe: "Right—ok! How big a company is GSI?"

Phil: "The Company has close to 800 employees, with more than half of those working in the Mexican manufacturing facilities. Sales were up to $74 million last year. The company's been growing at a fairly good rate. It sells about 60 percent of is products in the U.S., although that varies from year to year, depending on where new casinos are being opened up. GSI tries to get contracts with casinos before they are even built, if it can. Once a casino buys from one supplier, it tends to stick with that supplier, so it's important that GSI gets in at the beginning. Cards and dice are replaced continuously, because the casinos will only use them for a few hours at the most. But the chips and other equipment usually only get replaced every five or more years. Even so, the majority of the company's revenues come from chip sales—anywhere from 60 to 75 percent of sales in any given year. GSI controls a large share of the market for chips. In fact, it supplies 28 of the 30 largest casinos in the U.S."

Joe: "It sounds like an interesting company. When will we start to work on the engagement? And when do I pack?"

Diane: "Well, as a matter of fact, I'd like you to start today with some preliminary research. The Mexico trip is a couple of months off. I've already had some planning discussions with the CFO, and there are some issues that need to be addressed. You'll need to do some digging in the financial accounting standards and in the tax literature. Are you up for that?"

Joe: "Sure, I'll give it a shot. What are the issues you need me to research?"

Diane: "The first issue has to do with the security features I was talking about—the RFIDs in the gaming chips. GSI has a patent on RFID technology it has used in its chips in the past, but another company has developed a more powerful but economical RFID. In January of this year, that company granted GSI the exclusive rights to use that technology in the production of gaming chips. GSI paid $150,000 for the exclusivity rights. I'd like you to research the tax and financial reporting treatment of this payment to see if it should be capitalized as an intangible asset or expensed currently. The contract grants GSI exclusive rights to the product until December 2019."

Joe: "OK, I'll get right on it. Is there anything else?"

Diane: "There are a few more issues. These will keep you busy for a while! During the year, one of the company's internal auditors discovered that prior financial statements contained errors. The company converted to a new fixed assets software system in 2007. An error apparently occurred in the conversion, causing misstatements of depreciation expense in both 2007 and 2008. Depreciation was understated in the financial statements by $54,000 in 2007 and $240,000 in 2008. Net of tax, the total effect on net income for the two years was $194,000. We missed it in our audit—the items we tested on a sample basis were depreciated correctly, but other items were not. The company's accountants were unaware of this error as well until the internal auditors discovered it during a detail test of the fixed assets this year. Net of tax, the errors would have been under our materiality threshold in both years. GSI's net income was $4,328,000 in 2007 and $2,614,000 in 2008. The company has corrected the errors by reducing the 2008 beginning retained earnings by $194,000 and correcting the 2008 beginning balances in the accumulated depreciation account and the income taxes payable and deferred income taxes accounts to reflect what they would have been had the proper depreciation been recorded in prior years. We need to double-check to see if this treatment is correct."

Phil: "The client does not want to re-issue the prior years' statements, and we would like to avoid that also. You'll need to document why a reissuance is not necessary. Since we are issuing an audit report on comparative financial statements for 2008 and 2009, we also need to verify that the correction is properly made to the beginning balances rather than being adjusted for in the 2009 income. Also, what do we do in regard to these errors for tax purposes? The tax depreciation was off by approximately $200,000 in 2007 and $75,000 in 2008. Find out if we can take a depreciation catch-up deduction on the 2009 return, or if they've just lost the deduction, or what our options are."

Joe: "OK, I think I've got it. What other issues are there?"

Diane: "In January of 2009, GSI renewed a lease on two manufacturing facilities in Mexico. The lessor company is 60 percent owned by Luis Cardero, one of the chief executives of GSI's Mexican subsidiary. The lease is a five-year operating lease for 66,500 square feet of space at $.35 U.S. per square foot, for a total of $23,275 per month, for the first two years of the lease. The rent increases to $.40 per square foot for years three and four, and to $.45 for the final year of the lease. The company has the option to elect to use more or less square footage, with rent being decreased or increased at the same rate per square foot. The company also signed a new two-year lease in 2009 for the rental of an apartment owned by Luis's brother. GSI pays $800 per month for the apartment and uses it to house its executives and other personnel visiting the Mexico facilities. The company records rent expense each month for both leases in an amount equal to the cash paid. I'd like you to verify whether or not the leases are being properly accounted for and to identify what information we need to disclose in the footnotes related to these leases."

"And there is also a lawsuit. GSI has been sued, along with many of the gaming facilities it supplies in California, alleging it failed to comply with the California Safe Drinking Water and Toxic Enforcement Act of 1986. This act requires businesses in California to issue "clear and reasonable" warnings when people are exposed to a chemical that is identified by the state as a carcinogen, unless it can be clearly demonstrated that the exposure level presents no significant risk to humans. The suit against GSI claims that its gaming chips contain lead and that it did not properly warn the gaming organizations' employees, operators, or customers. The plaintiffs are asking for $20 million. The company's attorneys are pursuing settlement options, but say they can't estimate the likelihood that a settlement will be reached or what the liability may be at this point. They do believe there is more than a remote chance that GSI will have to pay a more than nominal amount to settle the suit. GSI has already incurred around $100,000 in legal fees just fighting the suit. In the meantime, the company has placed a new warning on all the gaming chips sold in California and is exploring ways to reformulate the manufacture of the gaming chips to remove lead from the process. I'd like you to research and document exactly what disclosures need to be made in the financial statements in regard to this lawsuit. Also, find out if the legal costs incurred to date are deductible this year for tax purposes."

Phil: "There's one final issue we'd like you to research. During October 2009, the company's European subsidiary signed a contract committing it to buy approximately 1.6 million Euros in February 2010 at a rate of 1.409 U.S. dollars per Euro. This is what is called a "forward currency contract." The agreement was made with the intent of hedging the risk from exchange rate fluctuations in regard to a specific sales contract. The contract was stated in U.S. dollars. The company did not specifically designate the contract as a hedging instrument. The company recorded a current asset of $45,000, which was the estimated fair value of the contract when it was signed. A gain has also been recorded for the same amount. I'd like you to research the financial reporting standards to determine if the $45,000 should be reported in the 2009 net income and, if so, how it should be classified in the income statement. You can assume for now that the $45,000 was calculated correctly. We also need to know what to do with the $45,000 gain for tax purposes."

Diane: "You should document the results of your research in a technical memo to the files for the GSI engagement. Make sure to cite all your sources in the memo.

Joe: "OK. I'll see what I can do."

Phil: "I'm sure you'll do just fine. Diane will look over your memo when you're done and give you feedback."