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# JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

## Instructors' Notes

**Editors**

**Inge Nickerson, Barry University**
**Charles Rarick, Purdue University, Calumet**

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# LETTER FROM THE EDITORS

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

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

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

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

Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

# 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.*

## INSTRUCTOR'S NOTE

This case is aimed primarily towards an undergraduate audience. The case is appropriate for courses in international business, entrepreneurship, and strategic management. In such classes, the preparation time for students should be about two hours in order to read the case and prepare answers to the discussion questions. Depending on the course, one might expect the instructor to lead a one hour class discussion focused on the course material while addressing the concepts of the social responsibility of business, the fair trade versus free trade dichotomy, and creative suggestions to help *MayaWorks* manage its future.

The case is also appropriate for discussion in a current business issues class or introduction to business class to spur a class discussion meant to introduce students to the concepts of social entrepreneurship, social responsibility of business, and problems of economic development in the poorest parts of the world. In an introductory class, the preparation time for students should be one half hour (to read the case) and an hour of class time to introduce the concepts.

## CASE ANALYSIS

**Question 1: Are the concepts of social justice and business at odds?**

The question is deceptively straight forward, however, it could generate a lengthy and fruitful discussion. In the Western world of the Judeo-Christian tradition, several centuries ago, when the size of local populations finally grew large enough to allow for division and specialization of labor, those who worked hard and were aggressive, innovative, or lucky would garner a higher income than others, and eventually would become "businessmen", able to hire others and organize production to reap large profits. In those early times, the influence of the religious institutions was uncontested: these businessmen were devout enough to turn in a significant percentage of their income to their temple or their church. The temples and churches would then use these funds to distribute to the disadvantaged, thereby ensuring that a certain social justice prevailed across the spectrum of society.

With the advent of the industrial revolution, the magnitude of possible profits became so large that greed and personal interest often won out: businessmen might still make large donation to their temple or church, but they stopped giving a straight percentage. Businessmen often sought to leave a legacy by establishing huge trust funds for a defined purpose, but the purpose was rarely that of redistribution of income and social justice, it was more to insure that their name would live on through their legacies. They would create an art collection or a musical symphony orchestra, or they would build a large building complex (hospital, university, etc.) to bear the name of the patron.

Within the last fifty years or so our world has become global rather than local, thanks to the communication and transportation technologies, and the plight of the truly disadvantaged in the world has become better known. The disparities of income between groups of people within a country and across nations have become more striking because of easier access to information. This knowledge has been the motivation for socially conscious people to take action. These people are not necessarily personally wealthy, nor do they necessarily work under the umbrella of their religious institution. They seek to make a difference to a small group of people they have identified and feel they can help. They may organize as a non-for profit organization, or operate for profit. They understand that economic underdevelopment is not remedied through vast wholesale subsidies programs from richer nations to poorer nations, but rather through small scale, hands-on training of individuals, by individuals, to teach members of a disadvantaged group how to take advantage of their skills and talents.

These bright, innovative, socially minded, business savvy individuals place their talents at the disposal of less educated, less lucky individuals, advise them, organize them, sell their wares, and generate business profits that allow them to make a living for themselves while paying a fair living wage to their disadvantaged employees. The goal here is to serve the cause of social justice, helping others become financially independent, and able to send their children to school in good health so they might find their own productive place in the global arena. It is business, its success is measured by its profitability, but it serves the cause of social justice as it helps reduce poverty in the world and helps bring about more educated citizens in the world. While capitalism may at its core be centered on self-interest, there is a long history, and a growing movement, to combine the benefits of capitalism with the needs of the least advantaged.

It could be argued that one of the greatest social injustices is to prohibit individuals from being able to capitalize on their abilities and skills. Economic freedom is not per se at odds with social justice.

Some additional reading on the subject:

M.Yunus (2008). Creating a world without poverty: Social business and the future of capitalism. Perseus Books Group.J. Elkington, P. Hartigan, and K. Schwab (2008). The power of unreasonable people: How social entrepreneurs create markets that change the world. Harvard Business School Publishing. S. Hart. (2007). Capitalism at the crossroads: Aligning business, earth, and humanity. Wharton School Publishing.

**Question 2: What are the strengths, weaknesses, opportunities and threats of MayaWorks?**

Strengths:

- Exotic appeal of the goods.
- Uniqueness of the goods
- Ease of adopting new wares to changing customer tastes
- Proximity to the U.S.
- Professional business competence in the U.S.
- MayaWorks has a great impact on the Mayan people: targeted assisted group is made of women artisans: research shows economic development resides in the hands of women because they use their income to feed and educate all their children, males as well as females.

Weaknesses:

- Small size of the producing group.
- Small output.
- Expensive logistics costs associated with transporting finished goods to the Chicago warehouse, then shipping to the final consumer.
- Employee training needed to maintain the quality of the product.
- Its success eventually will create its own demise: as employees are able to pay for their children's education, these children are likely to become adults who seek other more technology oriented and better paid occupations.

Threats:

- Political instability of the region.
- Cheap Chinese (or Indian, or African) imitations.
- Current economic crisis affecting disposable incomes of the target market
- Internet sales by competitors.
- Strong reliance on Word of Mouth networks

Opportunities:

- Internet sales of MayaWorks products.
- Focus on quality versus cheaper, coarser imitations.
- Use of social networking tools in order to educate about the cause of Maya Works
- Expand range of product offerings
- Tap into other wealthy markets: such as Canada, Europe
- Tap into new wealthy niche markets: quilters, interior decorators, etc.

**Question 3: What strategy recommendations would you make to MayaWorks in order for the organization to continue to fulfill its mission and prosper?**

1. **Expand production.**

Increase the pool of producing artisans in Guatemala: currently, *MayaWorks* employs women from three cities. Clearly it could be tapping the help of women in more cities even if more training is needed. Given the threat of cheap imitations, quality is the key. Chinese cheaper imitations might use colored threads whose colors are more garish and that might bleed when handled or washed. *MayaWorks* could identify women whose family status allows them to travel to other cities to do training. A conflict exists when one considers that following sound business practices and growing the scope of the organization might steer MayaWorks to stray away from its original mission- helping to end the cycle of poverty for indigenous Mayan women in Guatemala.

2. **Expand geographical markets.**

Although its mission specifically states a "coming together of Guatemalan and North American women", it does not preclude *MayaWorks* from selling its wares in other parts of the world, such as Europe where such goods are very desirable.

3. **Identify selling venues.**

There are several very wealthy niche markets that meet in specific venues. Quilters come to mind: quilters abound in the US and in Europe. In the US and Europe, quilters no longer work to make practical objects for their family use, but any number of professional women and retirees have taken up quilting bas a hobby and are willing and able to spend considerable sums of money to satisfy their fancy. For example, check the websites of the American Quilters Society, the National Quilting Association, the European Quilt Association, etc. These associations meet several times a year in very large venues (for example, the Rosemount, IL. Convention Center or the Paducah, KY Convention Center, etc.). Thousands of participants come to view the quilt exhibitions and to buy quilting, embroidering, sewing supplies and cloth that are plied by hundreds of vendors. The *MayaWorks* textiles would do very well there as do those of similar social enterprises such as Zimbabwe's *Tambani* that serves the Venda people in the mountains of Northern South Africa and Zimbabwe. (www.tambani.co.za). Other specialized trade venues might be the Furniture and Furnishing trade shows where *MayaWorks* cloth products might be viewed by interior decorators for curtains, cushions, wall hangings, etc.

4. **Continue to diversify its wares through innovations.**

*MayaWorks* has done a splendid job expanding its line of products. It might look to niche markets to guide expansion into other decorative applications (for interior decorations and for quilting for example.) The practice to bring groups of visitors to Guatemala to awaken an interest in the region and its inhabitants is a very good one. One might spark up some interest by asking the tour visitors to suggest new products or new usages for the products with a monetary price to the best suggestion over a certain time period: per tour, per season, per year?

5. **Create alliances with similar groups of women textile workers across the world.**

This would allow the artisans to share awareness and kinship among workers of other cultures. This would allow the business executives o exchange ideas about non-traditional marketing, possibly to refer to each other on each other web sites. Such groups of social enterprises exist throughout the developing world: *Tambani* mentioned above is one of them.

6. **Encourage the most creative workers to come up with signed creations.**

Certainly the current appeal of the *MayaWorks* products is its rendition of traditional local patterns. Eventually though, especially if *MayaWorks* should decide to expand its markets by appealing to interior decorators, discriminate, upscale customers in the US and Europe, possibly fashion designers, some of its artisans might be encouraged to come up with new patterns in vibrant Maya colors, or traditional patterns in different mixes of colors or new creations altogether. This would help fight the cheap Chinese imitations too. More value could further be created by identifying the artists behind the most appealing designs.

# 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. Secondary issues examined include entrepreneurship and small-business management. 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.*

## INSTRUCTOR NOTES
## SUGGESTED TEACHING PLAN

The suggested teaching plan includes five sequential steps: (1) performing a SWOT analysis to identify the Strengths/Weaknesses/Opportunities/Threats of the company, (2) identifying the distinct competencies and the unique characteristics of the business and its Children's Division shoe line; (3) specifying recommendations and action steps that would lead to a competitive advantage; (4) developing a strategic marketing plan; and (5) developing promotion strategies.

## ASSIGNMENTS AND ANALYSES

1. **Determine the strengths/weaknesses/opportunities/threats (SWOT analysis) of the company and the current marketing situation faced by the Children's Division of the company?**

A SWOT analysis will help students identify some of the weaknesses in the Children's Division that led to the significant decline in shoe sales beginning in 2005 and extending to 2008. Student teams/groups are recommended to perform the analysis. The professor should provide a SWOT sample and template as a student guide through the process.

As the SWOT analyses are completed, class discussion should first identify the weaknesses within and external threats to the company. The SWOT analysis should also help to identify the things that Charisma Shoe Company does well, and, possibly more significant, the things that it does not do well. The core reasons that the Children's Division is unprofitable need to be identified.

Another suggestion is to have discussion of the benefits that Charisma children's shoes offer customers. Student teams should recognize that shoe purchase decisions are psychological and emotional as well as objective. Students should also discuss the Charisma children's shoe competitive environment.

The chart below shows a completed SWOT analysis for Charisma Children's Division. Students should be able to list at least three items in each category.

| **Charisma Shoe Company<br>SWOT Analysis** | |
|---|---|
| Strengths<br>1. Good service to retailers<br>2. Quality-Fit-Value<br>3. Family involvement and ownership<br>4. Loyal employees<br>5. Care for retail partner and consumer<br>6. Solid channel of distribution<br>7. Good brand name recognition/potential<br>8. Sufficient capacity in manufacturing to support growth<br>9. Biggest U.S. shoe manufacturer | Weaknesses<br>1. Product focused<br>2. Perceived lack of style<br>3. Lack of intimate knowledge of a rather narrow target market<br>4. Brand confusion<br>5. No Cohesive look (i.e. shoe box)<br>6. Lack of traffic building promotions<br>7. No marketing discipline (i.e. make plans/budgets and stick to them)<br>8. Information only web page<br>9. As an anchor brand name, Christy Charisma is an unknown entity |
| Opportunities<br>1. Older mothers with more discretionary spending<br>2. 50% of kids shoe market in sneakers<br>3. Kid's are bought shoes every three months<br>5. Retailer desire to partner with manufacturer on marketing planning to drive traffic<br>6. Private label branding<br>7. Cross branding with non-compete kids brands (i.e. Gymboree)<br>8. Educate high turnover retail sales associates<br>9. Increasing diffusion of Internet usage among target audience | Threats<br>1. Stride Rite, Elefanten, and various style brands<br>2. Self-service attitude of retailers<br>3. Deep pocket competitors with big marketing budgets<br>4. "Forced" margins from sell-through minimums<br>5. Selling down in sizes of well known adult brands<br>6. Erosion of confidence by retail partners in the Children's Division due to declining sales<br>7. Widening production cost differential between foreign and domestic<br>8. Widening retail price differential between service and self-service retailers<br>9. Potential loss of retail visibility from not reaching sales targets |

2. **Identify the distinct competencies and the unique characteristics of the business and its Children's Division shoe line.**

Distinct competencies are those processes and attributes of an organization creating a unique position relative to its competitors among the targeted market. This mixture should be a design for success that, in combination, creates a unique persona for Charisma Shoe Company. Three possible factors that students should consider are that it is a family owned business; the shoes are American made, and their superior fit including length and width of the shoes.

3. **Establish appropriate recommendation and action steps that would lead to a competitive advantage.**

Charisma Shoe Company and its Children's Division should attempt to establish its niche based on a competitive advantage. This may be based on some uniqueness of its shoes or a service quality that is only available through its company. Things to consider include an exclusive or unique distribution channel or system. The company should try to create a competitive advantage that could not be easily duplicated by a competitor company. A core competence is a critical foundation of a company's competitive advantage but the differentiation may be difficult to sustain as competitors sometimes attempt to imitate them. The company should commit to protect its distinct competencies from challenge in order to, subsequently, protect its competitive advantage.

There should be discussion of the need for and affordability of additional research before proceeding with advertising to new targeted market areas.

All students should recognize that secondary market research is much less expensive than primary market research because the costs are shared by multiple entities. However, it does not always meet the organization's needs. Secondary research includes information obtained from studies conducted by trade associations, government agencies, business publications and other organizations.

Primary market research is particularly well suited for research areas that the organization would not want to share with others in their industry. Examples of primary research include focus groups, surveys, field tests, interviews which look at specific aspects of a company's service, customer, or product.

One competitive advantage that Charisma has as a domestic manufacturer is location which allows it to easily and quickly respond to "fill in" orders. Another advantage for the retailer is to use the flexibility offered to company buyers with seasonal orders. Additionally, retailers are advantaged by being able to maintain lower inventory levels since Charisma can deliver product to retailers much quicker than their foreign competitors.

If this case is used to address marketing research decisions, then students could be prompted to suggest the types of research that are most appropriate (surveys versus focus groups, samples of customers versus random samples etc.).

4. **Develop a 3-year strategic marketing plan for the company.**

Students should be able to develop a strategic marketing plan that includes objectives, goals, a recommended strategy, and action steps. The plan should include the following elements:

- Establishment of the criteria or standards under which the company will operate,
- An environmental (SWOT) analysis within and external to Charisma,
- An evaluation of the current market for children's shoes,
- A realistic assessment of the major competitors in the industry,

- An identification of the trends that are anticipated to influence the children's shoe market over the next three years,
- A determination of Charisma's place within the current market,
- A determination of Charisma's desired market position by the end of three years,
- Identification of the customers/target markets whose needs are most closely matched by the shoes provided by Charisma,
- Determination of attainable objectives and goals that set targets for penetration by Charisma into these target markets,
- Establishment of the strategies to be used to achieve Charisma's objectives and goals,
- Establishment of human resource accountabilities,
- Establishment of an appropriate budget, and
- Putting in place appropriate implementation and control/evaluation plans.

Possible marketing objectives in the case might include expanding or trimming its product line, targeting expanded population segments, and establishing online marketing and sales through, increased utilization of Internet technology.

5. **Develop promotion strategies for the company. Provide an estimate of the cost of each proposal.**

Marketing mix strategies include price, place, product, and promotion strategies. The main emphasis with the promotion strategy will be to develop a family brand, with Charisma as the umbrella family name for all four Charisma children's shoe brands. Keeping in mind the main promotional strategy, develop promotional strategies for each of the four Charisma children's shoe brands and state who the target audience is, mom, the child, or both.

Students can develop a number of strategies. The promotional suggestions below are just some of the many possibilities.

a. Excellence
   - Target Audience: Since one-year-olds have not developed shoe brand preferences, all promotions are aimed at mom.
   - In-box flyer: The child's first real shoe is an emotional buy for the mom. One promotion could include an in-box flyer written by the real Christy Charisma to the mom.
   - Direct mail pieces: Mail promotions to moms of new children
   - Promotion of the website: Post the web address on all literature and the shoe box.

b. TJ's
   - Target Audience: Promotions should be aimed at both mom and target boys and girls (2-to 5-years old).
   - An in-box flyer: The flyer should be aimed at mom, telling her about all the Charisma shoes lines.

c. Saddles

- Target Audience: Promotions should be aimed at mom and the boy. The shoes fit 6-12 year olds, but the promotion should be aimed at 12 year old boys.
- An in-box flyer: A flyer aimed at the boy that lets him identify with the brand and builds up the Saddle persona.

d. Christy Charisma

- Target Audience: mom and daughter
- On-the-box promotion: A story for the girl. It is better to aim at the 12-year-old (not offensive to 6-year-old) than to aim at 6-year-old (very offensive to 12-year-old).
- Website: Develop portions of the website for both mom and girl.

# THE MATTSAKA KOI AND EXOTIC FISH FARM COMPANY CASE

**Roger J. Gagnon, North Carolina A&T State University**
**Marco Lam, York College of Pennsylvania**

## 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

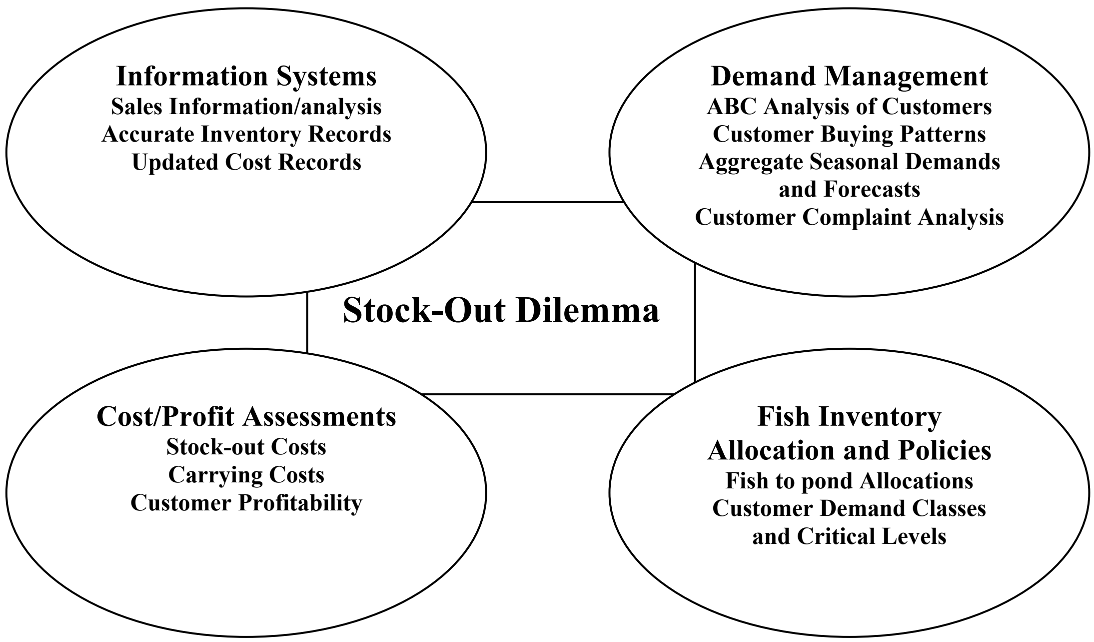
*The Mattsaka Koi and Exotic Fish Farm case addresses the inventory issues faced by Kioshi Mattsaka. Kioshi is forced to consider demand forecasting and inventory policies when the largest customer places an order for 6"- 8" Koi and the company does not have enough Koi in that size to fill the order.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

## INSTRUCTOR'S NOTES
## RECOMMENDATIONS FOR TEACHING APPROACHES

This case can be used in an undergraduate or graduate course on operations management, inventory management, or supply chain management. While the case could be used to introduce inventory concepts, it may be most effective after the students have been exposed to basic classical inventory management concepts such as the costs of carrying and ordering inventory, economic order quantities, and perhaps "basic" customer service levels. Not only is the concept of customer service levels emphasized in the case, but, the advanced notion of differential customer service levels is introduced.

The case can be used before or after students have studied demand forecasting for the case dilemma evokes the importance of analyzing demand patterns by product and by customer, but does not require the students "crunch" the data. The absence of data allows the students to concentrate on what data the companies needs to gather and analyze and for what purpose. Clearly the case shows the interrelationships among: (1) forecasts of aggregate and customer-specific product demand patterns, (2) customer-specific service levels, (3) inventory policies which govern the level of supplies, perhaps based on customer priorities, and (4) company profitability. Figure IN1 illustrates the current case inventory shortage dilemma and how the students must consider a long term solution involving, not only the company's inventory policies and customer service levels but also, its demand management approaches, customer cost/profit analyses, and information systems development.

**Figure IN1: Multi-functional Cause of Stock-Out Dilemma and Its Solution**




## SUGGESTED ANSWERS TO CASE STUDY 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.**

The current company sales policy definitely does affect the inventory policies and customer service policies – especially those customers whose orders are not fulfilled. While the current sales policy may maximize the number of ponds or numbers of fish sold, this may not maximize long run profits. This may be due to hefty stockout costs particularly for Mattsaka's largest customers. Additionally, this lack of customer service may drive customers to look for new koi and goldfish suppliers.

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

It is expensive to: (1) keep the fish while they are maturing, (2) order additional fish needed to replenish certain stocks and the supplies needed to sustain them, and (3) the costs incurred in ordering additional fish (at a higher cost) from another supplier in order to complete customer orders, which Mattsaka cannot fulfill. Therefore, holding, ordering, and shortage or backordering costs should be considered in establishing new inventory policies.

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

It appears that Mattsaka is not considering customer fill rates explicitly. (They are maximizing the number or ponds of fish sold.) When choosing reorder points and order up to levels Mattsaka should consider the trade-off between having too much inventory when demand is lower than expected and having too little inventory when demand is higher than anticipated.

4. **What inventory policy is Mattsaka inherently using?**

At this time, the company uses an order-point, s, and order-up-to quantity, S. This is known as an (s, S) policy. This system is frequently encountered in practice (Silver et al. 1998, p. 239). Silver et al. note that values for s and S are usually set arbitrarily. An inventory management class could address how to obtain reasonable values for s and S, by simple sequential determination of s and S or simultaneous selection of s and S (Silver et al. 1998, pp. 331 - 335). However, the optimal determinations of sand S are complex and are not intended to be the focus of the case, since insufficient cost and demand data are provided for these calculations. Having said that, for this case the order-up-to-quantity S could be either the amount needed to refill the pond currently in use to capacity or open an additional pond's capacity of like type and size koi- now grown to adequate size- for sale. It would be difficult for Mattsaka to set S as a constant since each pond could contain different quantities of koi. The s calculation would be far more difficult. One could use computer simulation to test paired values of s and S over past data and, thus, determine reasonable, if not optimal values that perform satisfactorily.

5. **What alternative inventory policies could Mattsaka use?**

Here, the instructor can introduce a variety of policies; (s, Q), (s, S), (R, S), and (R, s, S). These policies are defined by order-point, s; order-up-to quantity, S; order quantity, Q; and review period length, R. For the introductory operations management class we address the conceptual differences between continuous versus periodic review and order quantity versus order-up-to level. Table IN1 provides a comprehensive description and comparison of these four types of common inventory policies.

It is apparent that Mattsaka's inventory system is transaction based, thus signaling a continuous review system. Only when inventory reaches low levels (s) does the company respond by restocking the pond to its capacity (S) or opening another pond of like fish for sale. Therefore, we believe that the (s, S) inventory system most closely mirrors Mattsaka's current inventory policies.

Rules of thumb; for A items use (s, S) or (R, s, S) systems and for B items use (s, Q) or (R, S) systems for continuous review and period review policies, respectively (Silver et al, 1998, p. 236-41). In Mattsaka's case A items would likely be those fish that represent a large portion of company profits (40% to 80%) or are very costly to replace (e.g., premium, larger and mid-size koi). B items could be smaller koi and goldfish.

**Table IN1:**
A Description and Comparison of Inventory Policies

| Types of Inventory Systems | Description | Advantages | Disadvantages |
|---|---|---|---|
| s, Q | Continuous review ,order quantity system | Simple, especially for a two bin system | Does not take advantage of simultaneous, multiple orders |
| | | Good for slow moving stocks; | |
| | | Requires less safety stock than periodic review systems. | Can be more expensive than a periodic system for fast moving stocks. |
| | When inventory reaches s or less, order amount Q. | Fixed order quantity and thus less likelihood of error in ordering. | |
| | | Supplier knows order quantity. | May not be appropriate where individual orders are large. However, it is possible to order integer multiples of Q. |
| | | Can minimize total costs of ordering and holding inventory. | |
| s, S | Continuous review, order-up-to-system. | Can provide the total costs of replenishment, carrying, and shortage costs that are equivalent to the best (s, Q) system | Computational effort to find best (s, S) combination can be prohibitive. |
| | When inventory reaches s or less, order an amount that increases inventory up to S. | | Can have errors in requisitioning since each order size can differ. |
| R, S | Periodic review system. After a R review period order up to S. | Can review and order multiple items simultaneously, thus reducing order and shipping cost. | Since you cannot order as necessary, stock-outs can occur. |
| | | Useful for non-computerized inventory systems | To maintain the same customer service as a continuous review system, you must carry additional safety stock. |
| | | Due to required periodic review can be useful to detect spoilage or pilferage. | |
| R, s, S | Periodic review system. After a R review period check inventory level. If level is at or below s, order up to S. If inventory is above s, do not order this period. | Can review and order multiple items simultaneously, thus reducing order and shipping cost. | Since you cannot order as necessary, stock-outs can occur. |
| | | Useful for non-computerized inventory systems. | To maintain the same customer service as a continuous review system, you must carry additional safety stock. |
| | | Under general assumptions of demand and cost factors this system can provide lower total of replenishment, carrying, and shortage costs than any other system. | Greater possibility of stocking-out than the (R, S) inventory policy. |
| | | | Computational burden of computing the optimal values of R, s, and S can be burdensome |
| | | Due to required periodic review can be useful to detect spoilage or pilferage | More difficult system to explain. |

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

Mattsaka could allocate ponds to different inventory (customer) classes. For example, one (or more) pond(s) of 6”-8” koi could be reserved for Mattsaka’s best customers; Mattsaka also needs to analyze and determine who are his “best customers”. Alternatively, a proportion of each (or some) ponds’ fish could be allocated for different classes of customers with higher priority customers having their proportion reserved. A further elaboration of these strategies is provided in the instructor’s notes to question #7.

While an in-depth mathematical treatment of establishing multiple (customer) demand classes is beyond the intent and scope of the case, for a further discussion on multiple demand classes one is referred to Ha (1997) and Arslan et al. (2007).

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

We note that experiencing a few stock-outs might not justify changing the company's inventory policy. However, if Kioshi could aggregate his past customer complaints concerning stock-outs by fish type and by customer (something they currently do not do) and that analysis indicate that there is a systematic problem, changing the reorder point or safety stock levels would be appropriate. Deshpande et al. (2003) discuss how not utilizing the differences in service requirements among customers is costly. Mattsaka could keep physically separate inventories or utilize the differences in service requirements by allocating certain fish to satisfy demand from their largest customers.

**Keep separate inventories (or ponds)** Many organizations have recognized that they need different inventory policies for different customer groups. Using only an aggregate service level has been shown to be costly (e.g. Deshpande et al. 2003). When the aggregate service level is too low customers will be lost. When the service level is too high for some demand classes, the company invests too much in inventory.

In practice, some companies have physically separated the inventory, while others have created different SKUs for the various demand classes. A drawback of these approaches is that the company does not take advantage of inventory pooling (Deshpande et al. 2003). Unlike a manufactured product Mattsaka cannot barcode his fish with different SKUs. However, he can separate them by ponds, reserving one or more ponds for his best customers. To offset legal challenges to this policy Mattsaka could charge his best customers a premium (higher cost per fish), establish an annual contract for this priority, have the customer complete an a priori blanket order promising to purchase a certain (minimum) number of fish per year for these reserved fish, or enter a consignment sales agreement, where the customer buys the entire pond upfront and pays Mattsaka for fish maintenance until delivery.

**Multiple demand classes** Mattsaka may be unable or choose not to separate his fish by pond. In that case another option would be to establish multiple customer demand classes to accommodate the reality that not all customers provide the same revenue or profit contribution and, therefore, may not be afforded the same customer service. The multiple demand class issue becomes important when different groups of customers, or demand classes, have different service restrictions with the supplier e.g., costs of lost sales, backordering costs, differing service level contracts.

This multiple demand class strategy could be operationalized as follows. (Please refer to Figure IN1, which assumes the company is using an (s, S) policy.) When inventory is high (between the critical level c2 and the S level – a full pond), all customer orders would by accepted. However, when the inventory level hits the critical level c2, the company rations inventory or only orders for the high(er) priority customers would be accepted and all others would be declined, backordered, or filled by subcontracts with other fish wholesalers. There could be multiple classes of customers and, thus, several critical levels (c2, c3, etc.) (e.g., Arslan et al. 2007). Hence, a company can have on-hand inventory (for some high priority customers) and backorders (for lower level customers) at the same time.

In Figure IN1 the company has two critical levels indicating it has three types of customers – general, a higher priority customer(s), and the highest priority customer(s). A common analogy to this policy that could be related to the students is the distinct reservation of airline seats dependent on customer status or priority – coach, business class, and first class. Airline boarding priorities are directed, not only according to ticket price, but also type of airline credit card held, and travel miles with the airline – platinum, versus silver versus general status. Banks can answer (or return) calls to customers based on your importance to them as a customer (determined by reviewing your accounts with the bank – "Nations Bank Is Taking Calls of Most-Profitable Customers First", The Washington Post, June 1997).

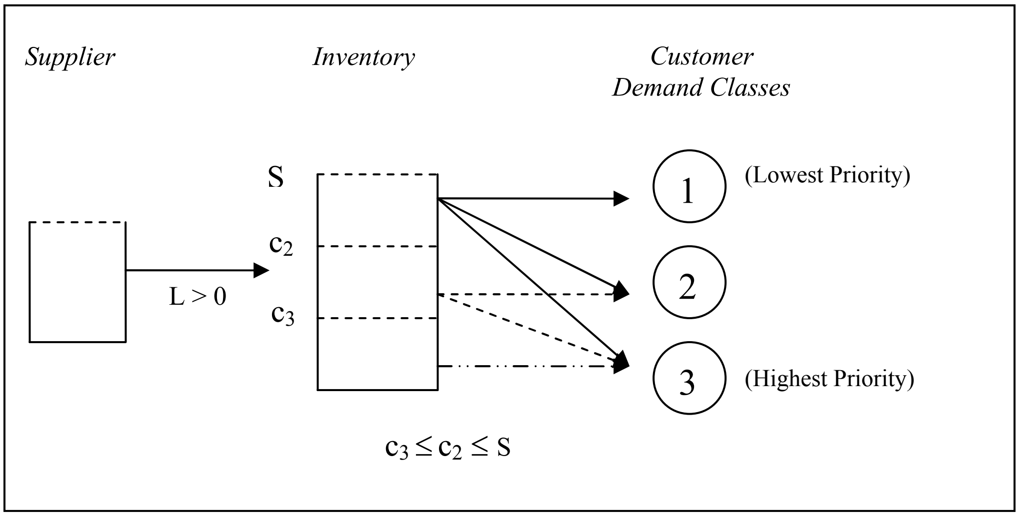



Figure IN1: Diagram for Three Demand Classes

Where, ci is the critical level, L is the replenishment lead time, and S is the order up to level in the (s, S) policy.

## SUMMARY

Since this case holds many inventory, sales, financial, and information system issues, we thought it best to summarize some of the questions/issues/recommendations that the professor could mention to Kioshi Mattsaka.

Mattsaka Koi and Fish Farm Company needs to collect the following data and make the following decisions and perhaps in this order:

Collect information on the past sales by

1. fish type
2. customer
3. season of the year
4. aggregate sales by season by type of fish

This is to determine the sales records of which companies are purchasing which fish, how many, when, and total sales by season. This should help to begin to balance total and priority market demand with supply.

*Based on past data (if it exists) determine the amount of each fish type (by type and size) at the start/end of each month. Even better would be a graph showing the inventories of fish (by type and size) on a continuous basis. This is not as laborious as it may seem; inventories will not change daily, but only need to be adjusted on a transaction basis – after some are sold, discarded, or are moved to another fish category (and perhaps another tank).

*Determine the amount and type of past lost sales and to which customers. Determine how much revenue and profit were lost.

This will help to determine the cost of lost sales, to which customers, and from this determine which customers' lost sales cost the most.

*Establish information systems to determine this information on a continuing basis and assign one (or more) person(s) the responsibility for this operation.

*Establish who are their best customers, next best, etc. – perhaps by A, B, C analysis – and determine which fish types and sizes are most important to them and when. Use the revenue, profit, and cost of lost sales information collected from the company.

*Based on the above analyses either:

- dedicate one or more pond(s) by fish type to the "best" customers (those whose cost of lost sales exceeds the cost of dedicating one or more ponds to them
- establish critical levels (c2, c3, etc.) for each customer priority level. (This will be difficult, but will be aided by the information from the databases established that provide the revenue, profit, and the cost of lost sales per customer.

The students will not be able to actually determine the critical levels (c2, c3, etc.) since the pertinent sales, profit, and cost of lost sales data are not provided.

One may wish to discuss how to establish a critical level by:

1. Maximizing (Total Sales to Highest Priority Customers – Total Lost Sales to Highest Priority Customers + Total Sales to Other Customers – Total Lost Sales to Other Customers)

Or

2. Maximizing (Total Profit from Highest Priority Customers + Total Profit to Other Customers)

This can be analyzed through "what if" simulation analysis or through sophisticated heuristics.

Neither of the above objectives is the same as...maximizing the number of ponds sold per year.., which the company is currently using.

Thus, the purpose of the case – to get the students to holistically consider the multi-functional, but interrelated sales, financial, and inventory information needs and resulting decisions necessary for Mattsaka to attack this multiple customer class, stock-out dilemma will have been served.

## REFERENCES

Arslan, H., S. C. Graves, & T. A. Roemer (2007). A single product inventory model for multiple demand classes. Management Science 53 (9), 1486 – 1500.

Deshpande, M. A. Cohen, & K. Donohue (2003). A threshold inventory rationing policy for service–differentiated demand classes. Management Science 49 (6), 683-703.

Ha, A. Y. (1997). Inventory rationing in a make-to-stock production system with several demand classes. Management Science 43 (8), 1093-1103.

Silver, E. A., Pyke, D.F. & R. Peterson. (1998). Inventory management and production planning and scheduling (Third Edition). New York, NY: John Wiley & Sons.

# STRATEGIC MANAGEMENT: THIS TIME ITS PERSONAL

**John Leaptrott, Georgia Southern University**
**J. Michael McDonald, Georgia Southern University**
**Jerry W. Wilson, Georgia Southern University**

## 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 to 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.*

## INSTRUCTORS' NOTES
## RECOMMENDATIONS FOR TEACHING APPROACHES

Obviously, the case has direct application in any course where strategic planning is covered, including strategic management, strategic marketing, etc. In strategic management, the case is an excellent tool to reinforce the learning of the process for organizational level management and to use in introducing students to how the strategic planning process can personally benefit them. The case will also fit well in professional selling classes, sales management and any other course involving aspects of career planning. A course in career counseling would also be ideal for implementing the case. Further, the level of research detail and analysis can be easily varied to fit different course platforms. In strategic management, the case should require the same effort as a company or industry case. In professional selling, it could used to compare different industry selling opportunities and career paths. In a career counseling course, students might be asked to strategically analyze several possible career choices – but with less detail than expected in an application in strategic management.

## CASE QUESTIONS

1. **Are Kitty and Teresa right to criticize Nancy's approach to managing her job/career?**

Of course the case is written to highlight the value of applying the principles of the strategic planning process to personal career planning. In this sense, Kitty and Teresa are managing their careers better, to this point, than Nancy. However, from the conversation, it is apparent that Nancy is perhaps not as focused on career, or her job, as her friends. During the discussion, Kitty is talking about a concert the three attended a while back and says to Nancy, "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." Later in the restaurant conversation, Nancy says, "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." Nancy is apparently not ready for a long-term commitment to a job/company/career like her friends Kitty and Teresa. This is an excellent point to make to class of undergraduates. When she is ready for the commitment, the lessons she has learned from her friends in applying strategic planning to their career development will still be valuable.

2. **How objective was Nancy in the process of looking for a new job?**

The strategic management process is almost totally absent from her decision making process. She applied for three jobs online – and took the first offer she received before either of the other firms had responded. The company that hired her is only six months old, and apparently intends to sell auto parts manufactured in Asia to U.S. auto manufacturing firms. She is not really sure if this is correct. Her information on the company is limited to a phone conversation and personal interview with the sales manager of the company. When asked by Kitty and Teresa what she had found out about the company before accepting the job, her response was, "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." In addition, when she was asked what the job would entail, she replied, "That is the best part. I get to keep traveling to Detroit and calling on the same auto industry customers."

Clearly, Nancy is basing her employment decision almost entirely on her personal preferences and not the strategic position of prospective employers. She chose the industry that she is already familiar with and that can continue to provide her with opportunities to visit family while on the job and at company expense.

The probability is low that the job will last long. In fact, given that the firm has only been in existence six months, it is also highly likely that the company will not last long!

3. **What can Nancy do to salvage the situation?**

She needs to employ the strategic management process. She can start by doing research on the company and its intended market/customers as quickly as possible. In other words, she needs to conduct a strategic analysis on the firm now. Given that she has already accepted the job and is going to place her house on the market, she needs to enlist the help of her friends in gathering and analyzing data. She may be better off reneging on the job offer, especially if her analysis reveals that her potential new employer may not be able to stay in business.

This would make an excellent classroom exercise. Split the students into groups (if they are not already grouped) and have them brainstorm on both the information Nancy needs to make her decision, and on what sources she should use to obtain the information.

4. **Critically analyze Nancy's management of her career at her first job.**

There is little positive to say here other than – if she is pleased with the outcome – then no harm has been done. However, it is patently obvious that, has she remained in closer contact with her friends, a different outcome would have been probable. Students should remark on at least two things in this discussion. First, Nancy really did not follow a logic-based process for career management, and certainly did not attempt application of the strategic management process to her job. Second, she ignored Kitty and Teresa when, in earlier conversations, they told her what steps they were taking to manage their positions with the company.

Nancy definitely shows signs of immaturity and/or lack of commitment to her job and employer. Ask the students to discuss how serious, in their opinions, these infractions are. This is an excellent opportunity to point out how poor decisions in the work environment can follow you from one job to another. If Nancy's new job does not work out, what would a reference call to either company reveal?

## CLASSROOM EXERCISES

Divide the class into two groups – one that is critical of Nancy's behavior to this point in her career, and one that feels she is more a victim of circumstances than a victim of bad decisions.

Give the groups time to develop arguments in support of their positions and to select a spokesperson for their views. Have the selected spokespersons debate their positions and then allow open discussion.

Divide the class into four or five groups. Assign different industries/companies to the groups that are disparate in terms of salary, duties, career possibilities, etc. In each case, assume that Nancy worked for the company in the job described. Within groups, have the students discuss how their company/job description would alter their opinions concerning Nancy's behavior. The point of the exercise is to get students to consider whether the job would alter their view of Nancy's behavior. For example, if Nancy's first job was as a management trainee with a big box retailer, would her lack of "strategic planning" for the job matter as much as for her position described in the case.

# M&D SUPPLY CASE A "STUFF HAPPENS"

**Jeff Dyson, Lamar University**
**Vivek S. Natarajan, Lamar University**
**Kabir. C Sen, Lamar University**

## 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.*

## INSTRUCTORS' NOTES
## RECOMMENDATIONS FOR TEACHING APPROACHES

This case is the first in a series that explores entrepreneurial strategies for survival in response to challenges, and growth despite market changes and intense competitive pressure. In this first module, students get a view of entrepreneurial behavior, business strategy, contingency planning, and succession planning. Students develop insight of an entrepreneur's decision making framework and unique definition of success.

The case can be used in courses that cover entrepreneurship, strategy, leadership, marketing, or operations management. Students should be able to extract several lessons from a well crafted case discussion.

## CASE OVERVIEW

M&D Supply Case "A" can be an engaging case because of the adversity faced by the protagonist. Practical thinkers will take the case in one direction, where those who think emotionally will likely recommend a different course of action. Initial assumptions may prove to be off the mark as the case unfolds.

## LEARNING OBJECTIVES

1. To understand the challenges of moving from a business to business to business to consumer situation.
2. To understand the role of key events in shaping the growth path of a company.
3. To illustrate the importance of responding to changes in the business environment.

## DISCUSSION QUESTIONS

**1. What do you think of the decision by Jack's partners to exit the business?**

Students may be surprised that despite 15 years of partnership and Jack's personal struggle, both his investor partners would exit. A discussion of what might have influenced the partners to exit will alert students to some of the reasons partnerships terminate. The point should be made that longevity and friendship do not prevent these occurrences. The instructor should cite other examples if he or she has knowledge of such situations. Remember that students do not have the experience in business to realize all the things that can happen between business associates. This question presents an opportunity to discuss all the things that can be done before the business is started to prepare for such events:

- Legal form of the business (governing law, by-laws, governance)
- Buy – Sell agreements
- Protection of intellectual property
- Non – Compete agreements

**2. What are the most likely consequences of the exit:**

**a. To Jack?**
**b. To M&D Supply?**

This question is a catalyst for discussion about partnership risk. Partnerships mitigate financial risk but create relationship risk. Students should recognize that the partners' exit weakens the business in the short term, but over time, may be for the best since they are not sold on the Jack's new concept. The instructor might consider having the students conduct a force field analysis to evaluate the strengths and weaknesses of partnership.

**3. Circumstances suggest the fire that destroyed M&D Supply was a form of creative destruction. Do you agree or disagree? Why?**

Students should recognize that even in the midst of tragedy, there is opportunity. Entrepreneurship is a process of self-discovery. This question sets the stage for discussion about Jack's options about M&D's possibilities going forward.

**4. What is the biggest challenge taking place in the environment?**

Students should recognize that the change in demographics of the town support Jack's new business concept. The concept calls for a new target customer and a change in the company's value proposition. They should realize that the change from a volume driven business-to-business model to a value driven business-to-consumer model will require a change in M&D's marketing plan.

**5. Jack's decision to move M&D from a business-to-business concept to a business-to-consumer model will require a change in marketing strategy. What are your suggestions?**

One of the major challenges when companies migrate from a business to business context to a business to consumer – centric context is a major shift in the marketing philosophy. The company needs to embrace a customer-centric culture. In M&D Supply's case, they are moving from a technically literate customer base (the professional farmer) to a less literate customer base (the consumer). This creates a knowledge gap. To be successful the company will need to fill the knowledge gap by employing consultative selling.

At the product level, the company would need to expand its product breadth and depth in order to reach diverse consumer segments. M&D's pricing philosophy needs to change, from a volume-driven strategy to a value-driven strategy. Distribution will change, requiring the company to manage inventory differently. Product variety will entail a more sophisticated level of inventory management to avoid stock outs. There will be a greater emphasis on advertising and promotions as opposed to mere personal selling.

**6. What are the strengths and weaknesses of M&D Supply? What are some of the opportunities and threats for M&D Supply?**

M&D's Resource Strengths and Competitive Assets:

- A favorable location – M&D is located on a high traffic thoroughfare
- The business and management experience of Jack Dyson and Harry Christian
- An established local brand that management is continuing to strengthen
    - The benefits of Ace Hardware membership:
    - A well recognized national brand
    - Breadth of products offered
    - Advertising programs
    - Buying power (low prices to M&D)
    - Dealer ownership
- Jack:
    - Community contacts
    - Knowledge of the local market
    - Knowledge of the existing customer base
    - Entrepreneurial spirit and determination

M&D's Resource Weaknesses and Competitive Liabilities

- A less known consumer brand than some rivals
- Continued decline in the regions agricultural sector
- Smaller than some national competitors
- Inexperience in business to consumer marketing and operations
- Jack:
    - Trauma of initial cancer diagnosis
    - Trauma of going through the fire and liquidation of M&D
    - Trauma of having his partners walk away
    - Trauma of being told he was cured and making the decision to re-open M&D, then later learning was terminally ill

M&D's Market Opportunities

- Capitalize on the region's rapidly growing high-paying consumer jobs (mostly blue collar) due to the expanding energy industry
- Capitalize on the region's rapidly growing industrial, commercial, and institutional businesses

External Threats to M&D's Future Well-Being and Profitability

- Competitive encroachment from other independents or national chains

Students should form teams and perform a SWOT analysis then define and prioritize Jack's options. Impress upon students that the most important part of a SWOT analysis is drawing conclusions from the SWOT listings about the overall situation.

**7. What should Jack do?**

Given the analysis, what do the student teams want Jack to do? What items from the SWOT analysis should be on Jack's worry list? Before students recommend an action, plan they should spend some time compiling a list of the challenges that Jack has no control or influence over versus a list of concerns he can influence.

Students should justify their recommendations and expose the assumptions and thinking they are employing.

## EPILOGUE

Dyson passed away in November of 1972, six months after M&D's grand re-opening, leaving the business to his young widow, Bernice. A woman with little business experience in a male-dominated industry, she was a reluctant entrepreneur. But grief and fear were soon replaced by drive and determination. She would make her mark in the business world and make her company a success.

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

**Patricia Lapoint, McMurry University**
**Carrol R. Haggard, Fort Hays State University**

## 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.*

## INSTRUCTORS' NOTES
## CASE OVERVIEW

The case focuses attention on public policy decision making by examining a highly contentious community project which pits tangible economic issues versus intangible quality of life issues. Tangible issues include the potential economic contribution of a wind farm: jobs created, construction expenditures, property tax revenue, economic stimulation due to royalties paid to land owners; as well as the potential economic costs: loss of tax revenue due to devaluation of property, loss of tourism, and loss of military payroll. The intangible issues include: diminished community relationships, diminished aesthetic value to the environment, environmental losses to wildlife habitat, vegetation, and flood-prone areas, potential medical conditions arising from a condition known as "wind turbine syndrome" and the perceptions of the business climate of other businesses considering locating in the community.

The strength of the case lies in its ability to get students to engage in an analysis of the kinds of issues that government entities at the city, state and federal levels face on a daily basis. Students are asked to put aside their personal feelings and base their decision on their analysis of the data. However, they must recognize that because intangible aspects are involved, it is never possible to truly make an "objective" decision.

## RECOMMENDATIONS FOR TEACHING APPROACHES

This case provides students with an opportunity to explore the complex issues related to economic development projects for local communities by evaluating the costs as well as the benefits to the local community. These instructor notes include information that will be useful to the discussion leader in guiding students through the intricacies of community politics, the pressures of public policy as mandates, and economic development costs/benefits.

The preferred teaching strategy for this case includes student assignments and class discussion. After assigning the case for reading ask the students to prepare written responses to the questions listed below in the "discussion questions" section. Since the case involves developing a costs/benefits study, the difficulty level of the case and the amount of out of class time needed to complete it can vary by the depth of the intangible issues the instructor wishes to consider. Sufficient cost data, both tangible and intangible, has been provided to enable students to develop the costs/benefits analysis for the proposed project, to assist the county commissioner board to make a good decision, and to address the complexities of the issues raised at the public hearing in balancing stakeholder concerns.

Instructors who wish to delve more deeply into the intangible issues may wish to have the students engage in a debate over these elements. Students can be assigned to either support the wind farm or to oppose it. In larger classes, the debate can be a demonstration which would set up the issues and the positions for general class discussion. In smaller classes, the instructor may wish to assign students to a "side" on a single issue (the merits of diversifying the county's economic base; property devaluation; reduction in the scenic beauty of the areas for the proposed wind farms; noise pollution, new flood prone areas; reduction in wildlife habitat, disruption of endangered species habitat, reduced vegetation; or encroachment of airspace for the local military base). Use of debate is an effective way to engage students in a discussion of the issues and to encourage students to see that there are many valid issues to be considered in making a decision.

In order to provide further background on the issues involved, the instructor may wish to assign students to review some, or all, of the following websites as part of the out of class preparation:

- American Wind Energy Association (http://www.awea.org)
- Climate Change organization (http://www.climate.org/resources/energy-links.html.)
- Department of Energy http://www.doe.gov)
- Energy Information Agency—DOE (http://www.eia.gov)
- The National Wind Watch Group (http://www.wind-watch.org)
- Pew Center for Global Climate Change (http://www.pewclimate.org)

Other useful resources include:

- Easton, T. A. (2008). Taking sides: Clashing Views on Environmental Issues, Dubuque, IA: McGraw Hill, 2008.

Discusses the various points of view on the environmental impacts of large scale wind turbines.

- National Research Council, Committee on Environmental Impacts of Wind-Energy Projects. (2007). Environmental Impacts of Wind Energy Projects. Washington, D. C.: National Academies Press. http://www.nap.edu/books/0309108349/html/index.html

Provides context for analysis of effects of wind-powered electricity generation in the United States. Discusses the ecological effects of wind-energy development. Provides the impacts of wind-energy development on humans. Discusses planning for and regulating wind-energy development.

- Pierpont, N., MD. (2006, March). Testimony before the New York State Legislature Energy Committee, www.savewesternny.org/docs/pierpont-testimony.html.

Identifies the harmful medical effects called “wind turbine syndrome.”

The decision point in this case is readily apparent —"Should the county commissioners vote for the reinvestment zone and offer property tax abatements and provide for an exemption to the ordinances regarding building moratorium and height restrictions in order to allow for wind farm development in the county." The complexity of the case can also be enhanced with a discussion of the community political relationships between the Air Force Base, the Economic Development Council, the Tourism Bureau, the Historical Conservation Society and the respective landowners who lease their property to wind farms and their neighbors who do not.

This case will allow the instructor to meet the following objectives:

- To explore the complexities of multifaceted decision making with respect to various stakeholders
- To justify the decision through the development of a costs/benefits study
- To provide qualitative analysis of the intangible aspects of the decision.
- To examine the role of national public policy (energy policy) and its mandates
- To explore long-term community relationships

## DISCUSSION QUESTIONS

1. **What are the issues which need to be addressed in the cost-benefit analysis study? What are some of the other issues that might not have been raised in the case, but are relevant to the commissioner's making a good decision?**

Students should be able to identify most, if not all, of the issues raised by the various speakers in the public hearing—1)diversifying the county's economic base; 2) additional property tax revenues; 3) property devaluation; 4) reduction in the scenic beauty of the areas for the proposed wind farms; 5) loss of tourism revenues; 6) noise pollution, new flood prone areas; 7) reduction in wildlife habitat, disruption of endangered species habitat, reduced vegetation; 8) encroachment of airspace for the local military base. Additional issues might come from the assigned readings, including such issues as ethical dilemmas that are confronted.

2. **How does national and state public policy influence the decision outcome?**

You may want to have students read about the national energy policy and the Renewable Portfolio Standards (RPS). The Department of Energy has established national targets for reducing the CO2 or carbon emissions levels by 2020 or 2030. Wind Power is the most widely supported renewable for the production of electricity, supported by the global warming advocates, the AWEA (American Wind Energy Association), and congressional sources. To facilitate wind power as a replacement for coal and other fossil fuel sources, the government subsidizes the production through the Production Tax Credit and state renewable energy credits. In addition, the RPS standards mandate that each state meet its state's target for renewable power by a certain percentage. This requires the utility providers must purchase this mandated percentage regardless of its competitive price on the open market. Currently, the DOE is considering a national RPS to replace the individual states' RPS.

3. **Develop an economic cost/benefit analysis based upon information provided in the case and your outside readings.**

There are several ways to approach the costs/benefits analysis. One approach is to ask the students to conduct a financial analysis comparing the potential financial losses to the county versus the additional revenues that might come from the wind farms over the 10-year period. This financial analysis might be calculated as the following:

| **Table 4<br>Potential gains due to wind farm development** | |
|---|---|
| Job creation | $ 1.5 million |
| Economic multiplier effect (8x) for jobs creation | $ 12 million |
| Additional property tax revenue | $ 15 million |
| Total Gains | $ 28.5 million |

| **Table 5<br>Potential losses due to wind farm development** | |
|---|---|
| Tax revenue devaluations of affected properties | $ 38.25 million |
| Loss of tourism | $ 64.5 million |
| Loss of military payroll | $ 36.8 million |
| Property tax abatement Losses | $ 6.24 million |
| Total Losses | $144.8 million |

4. **What intangibles factors should the commission take into account in making their decision? How should those factors affect their decision?**

Although it is difficult, if not impossible, to quantify the intangibles, students might become engaged in an ethical debate on the environmental issues, the long-term interpersonal community relationships especially in a very strong Christian community, and the potential medical harms that might occur to individuals. Since "wind turbine syndrome" is a relatively new medical phenomenon, it may take several decades for this condition to be documented and accepted by the medical community. This discussion could draw upon the analogies of asbestos and tobacco which took several decades to prove; in the meantime, many people developed serious medical conditions as a result.

Students might wish to develop the arguments both for and against wind farm development weighing the intangible "costs" of loss of area beauty and rural aesthetics with the tangible benefits of wind farm development. Students who adopt the "against" arguments will have to draw upon value judgments of aesthetic beauty and rural wildlife in making their case. In other words, what value does one place on losses to the environment? Students could become engaged in a general debate over the environmental losses while at the same time making an argument about global warming or climate change.

Undoubtedly, the most challenging of the intangible issues will be the long-term relationships between neighbors and the moral and ethical dilemmas that result. Students may wish to explore the theoretical frameworks of ethics (Moral Rights Rule, Utilitarian Rule, Justice Rule, and/or the Practical Rule) to analyze the ethical dilemmas. Because of the small religious community, these relationships may manifest themselves in church member relationships and business relationships. Students may wish to explore the informal behavioral dynamics in which individuals and groups of individuals line up on different sides of an issue. For example, will someone's business be negatively affected if they take a strong stand against wind farm development in the community and have vocalized their opposition? Or, will a family be ostracized from their church relationships and have to seek another church for worship? Students may wish to engage in discussion related to differences of perspectives and how those differences may manifest themselves in working on community non-profit organizations for example. There are many avenues of rich discussion students can pursue with respect to the informal interpersonal relationships that might occur.

5. **Given the encroachment issue with the Air Force base, how does the economic development analysis affect public policy decision making?**

This question relates to the possible encroachment of land from all kinds of economic development—wind farm, residential and commercial land development. Based upon the sensitivity of communities where there are military installations to the loss of military jobs and equipment in recent years with the BRAC (Base Realignment and Closure) decisions, communities have taken extensive political measures to prevent the loss of military economic benefits to their communities. It is quite possible that given the political and economic issues at stake for a community, a community may take actions to limit the extent of encroachment of community development projects no matter if they are wind farm related or otherwise. Students may wish to explore this issue in furthering the analysis of economic development and public policy decision making.

6. **On the basis of your analysis of both the tangible and intangible aspects, what recommendations would you make with respect to the decision before the county commissioners? Justify your response.**

Students will make different recommendations based upon their analyses. From the instructor's perspective, the recommendations should be aligned to the analysis in a coherent manner.

7. **How can public policy best balance economic development with community concerns?**

This answer to this question deals with philosophical issues. Some students can be expected to argue that public policy should take "the side" of the wind farm to maximize economic development, while other students may oppose the wind farm and related development. Answers should be evaluated based on the strength of the reasoning provided, not that they have reached a "correct" response.

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

**Kurt Jesswein, Sam Houston State University**

## 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.*

## INSTRUCTORS' NOTES
## PEDAGOGY

The focus of the case is the interaction between managerial accounting techniques and financial reporting rules under generally accepted accounting principles. It is assumed that students often compartmentalize their studies and may not fully understand how assigning indirect operating costs such as depreciation of assets used in producing a company's inventory, a matter typically discussed in managerial accounting courses, can affect the reporting of a company's financial statements, a topic covered in financial accounting courses. Assessments of the significance of the financial results are then examined in financial management courses and ultimately analyzed in various capstone strategic management courses.

The case demonstrates one area, absorption cost accounting of depreciation expenses, in which these distinct topical areas are interrelated. Through an analysis of the calculation and interpretation of selected financial ratios, students can gain a better understanding of how cost accounting principles (e.g., absorption cost accounting) affect inventory valuation and the estimation of the cost of goods sold, and eventually various ratios that are dependent on those variables. Not understanding the linkages can lead to misunderstandings or misinterpretations of a company's financial condition and the results of its operations. The students are lead to modify their initial conclusions about a company's financial situation after gaining a better understanding of part of the process linking managerial and financial accounting.

## TEACHING PLAN

Class discussion could begin with a basic review of key accounts presented on a company's balance sheet, income statement, and cash flow statement. This would then flow into a review of many of the key financial ratios used in assessing the financial strengths and weaknesses of the reporting entity. Next, a discussion of the principles of absorption cost accounting can be used to highlight some of the areas of concern in which the relative importance of various financial statement accounts may be scrutinized. Instructors may wish to structure the case discussions as follows:

1. Review the purpose and construction of the balance sheet, income statement, and cash flow statement.

2. Define the financial ratios described in the case, with a review of how the results might be interpreted.

3. Review absorption cost accounting rules, with a particular focus on indirect costs such as depreciation, looking at how different approaches could negatively affect the process of analyzing financial statements through ratio analysis.

4. Examine potential differences in the interpretation of financial results, given different approaches to how inventory costs such as depreciation are accounted for and reported.

## TEACHING PLAN SOLUTIONS

1. **Review the purpose and construction of the balance sheet, income statement, and cash flow statement.**

Although one cannot completely review all of the basic accounting principles, a quick overview of the purpose and construction of the financial statements may be required to help level the playing field if there is great variance in student backgrounds coming into the course. Students should be directed to review their accounting textbooks or to review online sites such as principlesofaccounting.com or accountingcoach.com. Nonetheless, a concise review of the financial statements may still be necessary.

The balance sheet summarizes the financial condition of a company at a particular point in time and is comprised of assets, liabilities and equity. Assets represent the resources employed by the company and are usually divided into current and noncurrent assets. Current assets are those expected to be used within a year, and noncurrent assets are expected to have longer economic lives. Current assets can include the company's cash and cash equivalents, accounts receivable, which represent credit provided to customers purchasing the company's goods or services, inventory, which represents items the company has made or is making available for sale, and other miscellaneous items such as prepaid expense items. Noncurrent assets are mostly made up of fixed assets such as property, plant, and equipment that are used in producing the company's revenues. Such assets are shown on the balance sheet at their historical cost less the accumulated expenses or write-offs that have taken place in the form of depreciation. Companies may also have intangible assets such as patents and goodwill and any of a wide variety of other long-term assets that are used in their operations.

Liabilities are also usually divided between current and noncurrent liabilities. Current liabilities are obligations expected to be paid within a year and noncurrent liabilities are obligations that involve longer periods of time. Current liabilities are typically comprised of accounts payable, which represent amounts of credit the company has received from suppliers that is often associated with acquiring inventory, accrued expenses such as salaries payable, which are various operating expenses incurred but not yet paid for, and miscellaneous other short-term financial obligations, often in the form of short-term debt or dividends or interest payable. Noncurrent liabilities can include the company's long-term debt financing, usually in the form of bank loans or bonds, and other long-term obligations such as deferred taxes and pension obligations.

Equity represents the residual value of the company, that is, the difference between the assets and the liabilities. The equity accounts will include the amount of capital invested by the owners and the retained earnings of the company, which represents the total amount of earnings generated by the company throughout its history less any amounts paid out in the form of dividends.

The income statement summarizes the results of the company's activities occurring over a specific period of time. It begins with a summary of the revenues the company has recognized from the sale of its goods or services. This is followed by the cost of sales, which represents an estimate of the costs of acquiring or producing the goods or services that were sold. Next come various other operating expenses, such as selling, general, and administrative costs that are directly charged off against the revenues they helped produce or that are charged off on a periodic basis if there is no direct relationship to the revenues generated. There may be other items that document the financing expenses incurred from borrowing external sources of funds, interest revenue earned on investment assets, and miscellaneous gains and/or losses from selling fixed assets or other investments. A provision for income tax expenses is then reported, representing the amount of tax charged against the company's taxable earnings. The remaining value is the "bottom-line", reported as the net income or loss for the period.

The cash flow statement summarizes the amounts and types of cash inflows and outflows that occurred during the same time period covered by the income statement. The statement is divided into three sections: one that documents the cash flows generated from or used by its operating activities, one that shows the cash flows generated from or used by its investing activities, and one that summarizes the cash flows generated from or used by its financing activities.

The cash flows from operating activities section is arguably the most important of the three for most users of financial statements. It shows how the revenues are related to actual cash receipts and how expenses charged are related to actual cash disbursements. According to current U.S. generally accepted accounting principles, it can be presented in either a direct or indirect method.

The direct method highlights the actual inflows of cash received from customers and other operating activities and the direct outflows of cash paid for inventory items, for other operating expenses, for financing costs, and for income taxes. The indirect method, which is the method most often used, is designed to reconcile the profits reported on the income statement with the amount of operating cash flows generated. It involves making specified adjustments to the reported amount of net income to account for expenses such as depreciation and adjustments to deferred taxes, as well as gains and losses from the sale of investment assets that appear on the income statement, but do not directly involve cash inflows or outflows. It also includes adjustments to account for changes in various current asset and liability accounts such as inventory, accounts receivable, and accounts payable that are used to essentially convert the accrual-based income statement to one that is more cash-based. For example, the revenues from sales is adjusted to incorporate changes (increases or decreases) in accounts receivable and the cost of goods sold is adjusted to incorporate changes in accounts payable and inventory.

The cash flow from investing activities documents cash flows being made for new investments in property, plant, and equipment or other productive long-term assets of the company, less any amounts received from the disposal or sale of existing assets. The cash flow from financing activities highlights cash inflows from issuing new debt or equity securities and cash outflows for repaying existing debt and equity or for paying dividends. The three cash-generating or cash-utilizing components are then summed together and will equal the overall change in the cash account for the period.

2. **Define the financial ratios described in the case, with a review of how the results might be interpreted.**

Financial ratios are among the most widely used tools in the analysis of financial statements. They are used in investment analysis, in credit analysis, and in management's own analysis of a company's strengths and weaknesses.

There are a myriad of different types of ratios. In fact, the number of ratios used may only be limited by the number of analysts available to conduct assessments of financial statements. To be able to assess the significance of a particular ratio one must be certain of how it is defined and/or calculated and how the results of those calculations might be interpreted.

One potential problem is that there are few ratios that are precisely defined within GAAP. It may be argued that only two, earnings per share (FASB Codification 260-10-45, originally SFAS 128) and the ratio of earnings to fixed charges (SEC §229.503, Item 503d) are explicitly defined within the accounting literature. Nonetheless, there tends to be a general consensus on how most ratios are defined, although each may be adjusted to suit the purposes of the individual analyst. Within the case the following ratios are used and are being defined or calculated as described below:

1. The *current ratio* can be defined as the ratio of current assets to current liabilities. It is a measure of a company's liquidity, measuring its ability to meet its short-term obligations with readily available liquid assets. As such, larger numbers imply greater means to cover those obligations. The major exceptions would occur whenever the liquidity of individual current assets, most notably inventory or accounts receivable, would be of concern.
2. The *quick ratio* also measures the company's short-term liquidity position but refines the current ratio by excluding less liquid assets in the numerator. It can be defined as the ratio of cash and receivables to current liabilities, although some analysts simply subtract inventory from total current assets to arrive at the numerator. As with the current ratio, larger numbers imply greater liquidity, although the true liquidity of the accounts receivable should also be assessed.
3. The days' sales in receivables estimates the time (in days) expected for a company to collect on its outstanding accounts receivable. It can be defined as accounts receivable divided by daily sales, which is estimated as total sales divided by 365. The usefulness of the ratio is largely dependent on the percentage of sales that are indeed made on credit. In any case, a smaller number would typically be preferred as it would indicate less time that cash is expected to be tied up in receivables; however, too small of a figure relative to the company's peers may be indicative of overly tight credit policies. Strict credit policies could reduce potential sales, which in turn could reduce potential profits and cash flows.
4. The *days' sales in inventory* estimates the time (in days) expected for a company to sell its existing inventory. It can be defined as total inventory divided by the daily cost of sales, which is estimated as the cost of goods sold divided by 365. A smaller number would typically be preferred as it would indicate less time that cash is expected to be tied up in inventory; however, too small of a figure relative to the company's peers may be indicative of

overly tight inventory policies. Managing inventory too tightly could reduce potential sales due to stock outages, which in turn could reduce potential profits and cash flows.

5. The *days' sales in payables* estimates the time (in days) expected for a company to repay its outstanding accounts payable. It can be defined as accounts payable divided by the daily cost of sales, which is estimated as the cost of goods sold divided by 365, although some analysts prefer to measure it as daily purchases, adjusting the cost of goods sold figure to account for increases or decreases in the amount of inventory acquired during the period. The usefulness of the ratio is largely dependent on the percentage of inventory acquired on credit. In any case a larger number would typically be preferred as it would indicate longer periods of time during which cash is expected to be borrowed from suppliers. However, too large of a figure relative to the company's peers may be indicative of excess usage of this "free" trade credit, the availability of which could subsequently be reduced or eliminated should the company abuse its privileges.

6. The *cash conversion* cycle estimates the time (in days) in which cash is expected to be absorbed in the company's operations. It can be defined as the sum of days' sales in receivables and days' sales in inventory, less the days' sales in payables. A smaller number would typically be preferred as it would indicate less time that cash is expected to be tied up in operations; however, the ratio might be too low if it reflects poorly on any of the three components described above.

7. The *debt ratio* measures the percentage of the company's assets that is financed by external funds rather than funds provided by the owners. It can be defined as total liabilities divided by total assets, although some analysts prefer to only include total external debt financing (bank loans, bonds, etc.) in the numerator. A smaller number would typically be preferred, at least by creditors, as it would indicate less risk placed on the creditors relative to the owners of the company.

8. The *gross profit* margin essentially measures the price mark-up of goods sold over the cost of acquiring or producing those goods. It can be calculated as gross profits, defined as sales less the cost of goods sold, divided by sales. A larger number would typically be preferred, as it would be indicative of a company's ability to generate excessive revenues from its inventory over the costs needed to produce that inventory.

9. The *net profit* margin measures the "bottom-line", or how much profit the company actually earns from its sales after subtracting out all of its operating and financing costs as well as taxes paid on the profits. It can be defined as net after-tax income divided by sales with a larger number preferred over a smaller one.

10. The *total asset turnover* measures the effectiveness of the company in generating revenues from its overall investment in assets. It can be defined as total sales divided by average total assets over a given time period. A larger number would typically be preferred, as it would indicate greater efficiencies in generating revenues out of the particular set of assets invested in by the company.

11. The *return on assets* measures the effectiveness of the company to generate profits from its overall investment in assets. It can be defined as net after-tax income divided by average total assets over the time period. It can also be viewed as the product of the net profit margin and the total asset turnover.

12. The *operating profit* margin measures the company's ability to generate operating profits from its sales. It excludes the impact of financing (interest expense) and taxes, as well as other non-operating activities that may generate additional revenues or costs not directly related to the company's day-to-day activities. It can be defined as earnings before interest and taxes divided by sales. As with the other profit ratios, higher margins would be preferred over lower ones.

13. The *interest coverage ratio* is a measure of the company's ability to meet its financing obligations. It can be defined as earnings before interest and taxes divided by interest expense. Although the measure can be complicated by other financing activities not directly related to the payment of interest (e.g., lease payments), a larger number would typically be preferred, as it would indicate a greater ability to generate profits, and ultimately cash flows from those profits, to cover the fixed costs associated with the external financing.

14. The *cash flow* margin is a measure of how effectively or efficiently the company converts its sales into cash. It can be defined as cash flow generated divided by sales. Often the cash flow generated figure is assumed to equal the cash flow from operating activities taken from the cash flow statement, but the amount is often defined by proxy. For example, it is not uncommon (as it is found in the Compustat and other financial databases) to find cash flow simply defined as reported net income plus an add-back of the company's depreciation and amortization expenses. As with the other margin and coverage ratios, a larger number would be preferred.

15. The *Altman-Z score* has been a significant tool in credit analysis for more than 40 years. It is based on a weighted average of five other financial ratios with the final result evaluated against predetermined norms. It can be is calculated as a sum of the following five variables: the ratio of net working capital to total assets multiplied by 1.2, the ratio of retained earnings to total assets multiplied by 1.4, the ratio of earnings before interest and taxes to total assets multiplied by 3.3, the ratio of market value of equity [stock price times shares outstanding] to book value of total liabilities multiplied by 0.6, and the ratio of sales to total assets multiplied by 0.999. If the final sum is greater than 3.0, the company is assumed to be less prone to bankruptcy; if it is less than 1.8, it is assumed to be highly prone to bankruptcy. Variations of the Z-score model can be found to apply to a wider array of companies, such as those whose equity is not publicly traded.

3. **Review absorption cost accounting rules, with a particular focus on indirect costs such as depreciation, reviewing how different approaches could negatively affect the analysis of financial statements.**

Absorption cost accounting involves calculating a standard overhead rate that is included when determining manufacturing overhead costs. This cost rate is then applied to the total units of inventory produced. Through absorption cost accounting, as inventory is produced, the depreciation of operating assets used to manufacture inventory is transferred from a manufacturing overhead account into the work-in-process inventory. As the work-in-process inventory is completed and sold, a proportional amount of the depreciation expense is then transferred to the finished goods inventory and ultimately to the cost of goods sold. The main justification for using absorption costing is that it follows one of the basic tenets of accounting:

the matching principle. Fixed manufacturing costs like depreciation are incurred as part of the process of producing inventory. Therefore, all costs of producing inventory are matched against the revenues generated from the sale of that inventory.

Although absorption costing is an integral part of the managerial accounting processes, it can be abused. For example, by increasing inventory production disproportionately to expected sales, a company can increase its profitability by moving fixed costs like depreciation from the income statement to the balance sheet where it is situated in the unsold inventory. Evaluating profitability is made more difficult because changes in net income can be attributed to changes in units sold, changes in prices, and changes in the cost of goods sold that arise from absorbing costs like depreciation into the units of inventory.

Depreciation expenses can become an issue for financial analysis in a variety of ways. For example, there are potential problems with the construction of cash flow statements using the indirect method, in particularly the determination of cash flow from operating activities. In using the indirect method of presenting the cash flow statement, one is required to adjust reported net income for various non-cash expense and revenue items such as depreciation. What is not apparent is whether the amount added back is the amount of depreciation expensed or the amount incurred (Nurnberg, 1989). For many companies, such as merchandising firms, the two depreciation amounts are the same. However, for manufacturing companies, because some of the depreciation is capitalized in the current period within inventories and then expensed as cost of goods sold in later periods, the amount of depreciation expensed can differ from the amount incurred. The difference can be especially significant for companies in which depreciation is a large component of manufacturing costs and inventory comprises a large part of total assets.

Although depreciation by itself does not represent a cash flow, how the figure is used within the analysis of financial statements can still give misleading results, particularly for analysts unaware of the potential problems. For example, financial databases such as Compustat routinely shift depreciation expenses from a company's reported cost of goods sold to other operating expenses. This can cause misunderstandings because the cost of goods sold figure that is used to construct various financial ratios will be understated and gross profits overstated. Likewise, in constructing cash flow ratios such as the cash flow margin, there can be considerable differences between cash flow estimates when using depreciation expensed or depreciation incurred.

Furthermore, there can be issues when reporting companies do not fully understand (or worse yet, attempt to circumvent) absorption accounting guidelines and treat depreciation expenses as regular operating expenses rather than as part of the cost of goods sold. The SEC has become very active in pursuing companies that may be reporting misleading results in their financial statements in this way (Deloitte, 2009).

4. **Examine potential differences in the interpretation of Penguin's financial results, given different approaches to how inventory costs are accounted for and reported.**

To demonstrate the potential implications in the Penguin Manufacturing case, we find that Penguin reported depreciation of $840,000 in 2009. If we were to assume that 90 percent of the depreciation was related to manufacturing operations and 10 percent to other activities, $756,000 of the expense should be associated with the production of inventory and $84,000 expensed as part of general and administrative expenses. If we further assume that Penguin sold 75 percent of the goods produced during the year, then $567,000 (75% of the applicable $756,000) should be charged against 2009 earnings as part of the cost of goods sold while the remaining $189,000 would remain within the finished goods and work-in-process inventories. To summarize, a total of only $651,000 ($567,000 for inventory and $84,000 for administrative expenses) of the total depreciation expense for the year should actually be charged against 2009 income with $189,000 of the cost remaining in inventory, where it would remain until the inventory is sold, at which time it would then become part of the cost of goods sold.

However, Penguin has mistakenly been excluding depreciation expenses from its cost of goods sold figure reported on its income statement. This unfortunately can cause significant differences when calculating ratios based on the reported results, ratios based on the assumption that all depreciation was included in the cost of goods sold, and ratios based on including only the amount of depreciation "incurred." The most glaring example of the problem can be seen when one examines Penguin's gross profit margin. Using the reported financial statement figures, one would calculate the gross profit margin as $3,484,000 ÷ $8,806,000, or 39.56 percent. However, including all of the depreciation expenses ($840,000) in the cost of goods sold would result in a much lower figure of 30.02 percent ($2,644,000 ÷ $8,806,000), which is nearly identical to the industry average of 30.27 percent. And if only the amount of depreciation "incurred" ($567,000) were included in the cost of goods sold, the value would instead be $2,917,000 ÷ $8,806,000, or 33.13 percent.

These different assumptions affect ratio calculations (and interpretations) in a variety of ways. What follows is a listing of some of the key ratios mentioned in the case, showing first the ratio calculated "as-is", and then with adjustments made to account for the depreciation issues, all of which are compared with the peer averages for the specified ratio.

- *Days' sales in inventory* = Inventory ÷ Cost of Goods Sold/365
  
  As-reported data: $1,798,000 ÷ $5,322,000/365 = 123.3 days
  Using depreciation expensed: $1,798,000 ÷ ($5,322,000 + $840,000)/365 = 106.5 days
  Using depreciation incurred: $1,798,000 ÷ ($5,322,000 + $567,000)/365 = 111.4 days
  Peer average: 105.2 days

- *Days' sales in payables* = Accounts payable ÷ Cost of Goods Sold/365
  
  As-reported data: $551,000 ÷ $5,322,000/365 = 37.8 days
  Using depreciation expensed: $551,000 ÷ ($5,322,000 + $840,000)/365 = 32.6 days
  Using depreciation incurred: $551,000 ÷ ($5,322,000 + $567,000)/365 = 34.2 days
  Peer average: 34.8 days

- *Cash conversion cycle* = Days' sales in receivables + days' sales in inventory – days' sales in payables
  
  Although the days' sales in receivables* is not affected, the cash conversion cycle will be because of changes to the other two components
  
  *Accounts receivable divided by daily sales = $845,000 ÷ $8,806,000/365 = 35.0 days
  
  As-reported data: 35.0 days + 123.3 days – 37.8 days = 120.5 days
  Using depreciation expensed: 35.0 days + 106.5 days – 32.6 days = 108.9 days
  Using depreciation incurred: 35.0 days + 111.4 days – 34.2 days = 112.3 days
  Peer average: 106.4 days

- *Cash flow margin* = Cash flow* ÷ Sales

  *If using cash flow from operating (CFO) activities, there should not generally be any differences from the reported results because of the issues with depreciation. However, they can be a difference if the proxy method is used in which the cash flow is estimated as net income plus the add-back for depreciation, and the different definitions (expensed or incurred) of depreciation are used.

  Using depreciation expensed**: ($504,000 + $840,000) ÷ $8,806,000 = 15.26%

  **figure used by Penguin management: net income and total depreciation in the numerator

  Using only depreciation "incurred": ($504,000 + $651,000) ÷ $8,806,000 = 13.12%

  Using cash flow from operations figure in numerator: $910,000 ÷ $8,806,000 = 10.33%

  Peer average: 11.20%

The remaining ratios would not be specifically affected by whether or not depreciation was included in the cost of goods sold. For example, the current ratio, quick ratio, and debt ratio only involve balance sheet accounts. The days' sales in receivables and total asset turnover ratios involve sales revenue, not the cost of goods sold. The net profit margin, return on assets, and interest coverage ratios only involve line items within the income statement that appear after depreciation expenses have been charged, whether included in cost of goods sold or within other operating expenses. And the Altman Z-score involves balance sheet accounts and only one income statement account (earnings before interest and taxes) that first appears after any depreciation expenses. For the sake of completeness, a summary of the calculations for each of these measures is found below:

- *Current ratio* = Current assets ÷ current liabilities

  As-reported data: $4,350,000 ÷ $2,063,000 = 2.11

  Peer average: 1.96

- *Quick ratio* = (Cash + accounts receivable) ÷ current liabilities

  As-reported data: ($1,420,000 + $845,000) ÷ $2,063,000 = 1.10

  Peer average: 1.18

- *Debt ratio* = Total liabilities ÷ total assets

  As-reported data: $5,942,000 ÷ $8,466,000 = 70.2%

  Peer average: 57.2%

- *Net profit margin* = Net income ÷ sales

  As-reported data: $504,000 ÷ $8,806,000 = 5.72%

  Peer average: 6.07%

- *Total asset turnover* = Sales ÷ average total assets

  As-reported data: $8,806,000 ÷ ($8,466,000 + $7,972,000) = 1.07

  Peer average: 1.11

- *Return on assets* = Net income ÷ average total assets

  As-reported data: $504,000 ÷ ($8,466,000 + $7,972,000) = 6.13%

  Peer average: 6.74%

- *Operating profit margin* = Operating income (earnings before interest and taxes) ÷ sales

  As-reported data: \$876,000 ÷ \$8,806,000 = 9.95%

  Peer average: 10.34%

- *Interest coverage ratio* = Operating income (earnings before interest and taxes) ÷ interest expense

  As-reported data: \$876,000 ÷ \$207,000 = 4.2

  Peer average: 4.5

- *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 to total assets.

  As-reported data: 1.2 × (\$4,350,000 – \$2,063,000)/\$8,466,000 + 1.4 × \$1,593,000 / \$8,466,000 + 3.3 × \$876,000/\$8,466,000 + 0.6 × (326,000 × \$31)/\$5,942,000 + 0.999 × \$8,806,000/\$8,466,000 = 2.82

  Peer average: 3.15

Therein rests the crux of the problem. By incorrectly including depreciation expenses among the other operating expenses rather than in the cost of goods sold, the company has actually penalized itself in terms of how external analysts, such as those from the bank, might view the company's results. Although the company had rested its laurels on its current ratio, its gross profit margin, and its cash flow margin, the true significance of these variables is probably at best questionable. The current ratio of 2.11 is minimally higher than the peer average of 1.96, but analysts will likely be concerned about what appears to be slow-moving inventory, a factor that may be keeping the current ratio artificially high. If the analysts use the financial statement data as presented, Penguin's days' sales in inventory of 123.3 days is some 18 days longer than the peer average. Yet when depreciation is shifted back to the cost of goods sold, the liquidity of the inventory appears to be much better at 106.5 days, much closer to the industry standard of 105.2. This is tempered somewhat by the days' sales in payables figure that also shrinks (which indicates less use of trade credit) by approximately 5 days. But looking at the combined effect as captured by the cash conversion cycle, the company, which initially appeared to have cash tied up for 14 more days than the industry average (120.5 versus 106.4 days) is actually much more in line with the industry norm at 108.9 days.

Similarly, using the reported data, the gross profit margin is severely overstated at 39.6 percent rather than the 30.0 percent figure when depreciation is included in the cost of goods sold. But since none of the subsequent profit numbers (operating profit, net profit, etc.) are affected by the incorrect placement of the depreciation, the banker's would likely focus more on examining those profit figures, both of which are very near albeit slightly below industry averages.

Rather than profitability, the bankers will likely be more concerned with the cash flows generated by the company, as these would be the primary source of repayment for any external financing. Therefore, the cash flow margin would likely come under greater scrutiny. The company touted its results (15.3 percent) as being considerably higher than the industry average of 11.2 percent. However, Penguin had based its calculation on the proxy for cash flow (net income plus depreciation) rather than the more standard, and arguably more correct, cash flow from operating activities as a percentage of sales. If the cash flow from operating activities figure of $910,000 is used as the numerator instead of the proxy amount of $1,344,000, the cash flow margin would be 10.3 percent, slightly less than the industry average. Thus, the one variable with which the company feels most proud is likely one of the areas of greatest concern for the bankers.

Other aspects of the company's operations can and likely would be examined as part of the loan review process. In terms of credit analysis, besides the variables discussed above, the Altman Z-score would be a key area of concern. The company's value of 2.82 is just below the 3.0 cut-off that is typically deemed a safe value. The score had improved greatly from the previous year's results but remains below the average of 3.15 for the industry. It would likely be closely examined in conjunction with other elements of the analysis, particularly the inventory management issues described earlier.

In summary, careful analysis of financial statements is crucial to many business decisions. It is therefore critically important that those statements be presented in a manner that truly reflects a company's situation, particularly in cases where the company's results are measured against others. When a company overlooks or disregards a basic rule of GAAP, in this case not incorporating depreciation expenses within the reported cost of goods sold, the analysis of that company can be fraught with errors. Penguin might or might not end up receiving the financing it had expected, but it does itself any great favors by misstating its financial reports, misstatements that paint a less flattering picture of its financial health.

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# 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.*

## INSTRUCTORS' NOTES

The case presents a situation where poor corporate governance enabled executives to enrich themselves at the expense of shareholders by backdating stock options. Students learn the accounting, tax, legal, and ethical aspects of option backdating. They also realize the vital role played by the board compensation and audit committees in monitoring management. Because of the richness of issues raised in the case, it can be used in a variety of ways. In the financial accounting course, the case can be used as part of stock option accounting to explain accounting and tax related differences between QSO and NQSO. In an auditing or fraud related course, the case can be used to highlight internal control deficiencies that enabled the management to commit backdating fraud and the responsibilities of external auditors in this regard. If the case is used in a business ethics or corporate governance related course, the instructor can emphasize the importance of good corporate governance and the fiduciary role of directors to prevent illegal and unethical practices such as backdating.

This case can be assigned individually or to groups of three or four students. However, all students should be asked to prepare and participate in the class discussion. The interaction of ethical and corporate governance issues with financial reporting and tax consequences of backdating requires that instructors lay necessary groundwork prior to assigning the case to students. An overview of these issues is provided below. We also provide an annotated reading list for this purpose (see Appendix). These articles should be assigned to students as part of preparation to minimize the time spent by students on research.

We start the case discussion by explaining different types of compensation (salary, bonus, and stock options) and then explain the reasons for the popularity of stock options. Companies give stock options to employees to motivate them to work harder. The theory is that by giving employees the opportunity to purchase company's stock at the current price, they are more likely to focus on creating value to shareholders because they participate in the resulting gains. Options also help retain key employees because they must remain in the employ of the firm for the vesting period and the firm benefits from their productive services during this period.

Weakness in corporate governance and internal controls provide an opportunity for executives to appropriate shareholder wealth by backdating stock options. In many cases of backdating, the executives had the decision-making authority to choose the number of options and grant dates. The grants were made numerous times during the year without any preset schedule making it easy to cherry pick the date. Option backdating violates Generally Accepted Accounting Principles (GAAP), SEC's financial reporting and disclosure requirements, and the Internal Revenue Service Code. If backdated options are in-the-money (exercise price lower than the market price) on the grant date, then the compensation expense is understated. Hiding this causes financial statements and compensation-related disclosures in proxy statements to be misleading. Backdating disqualifies options as QSOs and makes them subject to the one million dollar limit under section 162 (m) of the tax code. If options are in-the-money as a result of backdating, they become subject to income tax and FICA and company is liable for past due taxes, penalties, and interest. Subsequent probes in an implicated company's operations, shareholder lawsuits, departures of top level executives, remedying internal control deficiencies, and correcting and restating financial statements can be costly and cause significant disruption of operations (Rezaee, Langstraat, and Malloy, 2008).

The passage of SOX and the subsequent reforms pushed by the SEC have made backdating difficult. Under the SOX provisions, management is responsible for internal controls and has to certify the accuracy of financial statements. The SEC approved rules for exchange listing require the majority of board and all members of the audit, compensation, and nominating/governance committees to be independent. However, these reforms have not succeeded in stamping out backdating. Narayanan and Seyhun (2006) find that during the post-SOX period about 10% of stock option grants were reported late by over a month. In case of large stock option grants usually made to top executives, the stock price had increased by about 25% during this period indicating strong possibility of backdating.

In the ultimate analysis, backdating needs to be assessed from an ethical perspective. Adam and Schwartz (2009) raise the question as to what are the underlying values which enable directors to protect the interests of shareholders. It is the directors' core values that enable them to best serve their duties when a conflict of interest arises and preempt unethical practices like backdating.

The case has been used at the undergraduate level in the Intermediate Accounting II class and has been revised based on student feedback. After implementing the case, students were given a questionnaire. The responses were based on a seven-point scale, ranging from 1 ("not familiar" or "strongly disagree") to 7 ("very familiar" or "strongly agree"). Their responses indicate that the case increased their knowledge of stock option grants, accounting rules, backdating scheme, and the importance of corporate governance. They found the case interesting and recommended it for use in other courses (table1).

**Table 1**
**STUDENT FEEDBACK**

| | Questions | Pre-test (N=42) | Post-test (N=42) |
|---|---|---|---|
| 1 | How familiar are you with the concept of stock option grants? | 2.30 | 5.80 |
| 2 | How familiar are you with the accounting rules of APB No.25 and FASB 123 on stock option grants? | 2.35 | 6.05 |
| 3 | How familiar are you with the stock option backdating scheme? | 2.35 | 5.95 |
| 4 | How familiar are you with the concept of corporate governance under the Sarbanes-Oxley Act? | 3.14 | 6.27 |
| 5 | How familiar are you with the roles of board and compensation committee in the process of stock option grants? | 2.50 | 5.50 |
| 6 | Do you think that corporate governance is important in monitoring stock option grants? | 4.64 | 6.91 |
| 7 | Do you think that company's compliance with the disclosure requirements under the SEC and SOX rules is important to the capital markets? | 4.50 | 6.27 |
| 8 | Do you think that management's honest disclosure of company's information to the company's board and shareholders is important? | 5.36 | 6.38 |
| | Questions | | Post-test (N=42) |
| 1 | The case represents 'real world' scenario. | | 6.62 |
| 2 | The case encourages me to think critically on the issues related to stock option backdating scheme from the ethical and legal aspects. | | 5.55 |
| 3 | I find the case interesting. | | 6.00 |
| 4 | I would like to recommend this case to be used in other courses. | | 6.58 |

## DISCUSSION QUESTIONS

1. **What are CTI's advantages of using stock options as part of compensation?**

Stock options give employees the right to purchase company's stock at a fixed price (exercise price) in future after the passage of certain period of time (vesting period). Startup companies and cash starved companies like CTI use options to lure talented employees that they otherwise cannot afford to hire. Stock options also help with retention because if an employee leaves before the expiry of vesting period, all options are forfeited.

CTI used stock options as an incentive device to motivate employees to work harder and create shareholder value. As a result CTI experienced substantial growth in revenues and size during 1990s and 2000s. Another advantage of stock options is that this form of compensation does not result in any cash outlay to CTI. On the other hand, CTI experienced positive cash infusion when employees exercised options and in certain cases also received a tax deduction for the spread between the stock price and exercise price.

2. **Is CTI's stock option backdating practice illegal? If so, what accounting rules and tax laws does it violate?**

Managers have the discretion to choose grant date even if it is retrospective. In this sense, backdating is perfectly legal. However, it should be permissible under shareholder approved stock option plans and the consent of the compensation committee must be obtained for any backdating. If the stock price on the actual grant date is lower than the exercise price (in-the-money options), the difference should be recorded as compensation expense. The details of backdating must be disclosed in the proxy statements, financial statement footnotes, and 10-Q/K filings with the SEC.

Under section 10(b) (5) of the Securities Exchange Act of 1934, it is unlawful to omit material facts or to make untrue statements in connection with sale or purchase of securities. CTI intentionally omitted any mention of backdating and made a false statement that the exercise price of stock options was equal to market price on the grant date. These misrepresentations made financial statements and proxy statements potentially misleading. These are the kind of documents investors rely upon when making investment decisions.

Stealth backdating overstated earnings under APB No. 25, the accounting rule applicable to stock options during the period. Under this rule, stock option expense is equal to the intrinsic value of options; defined as the difference between the exercise price and market price on the date of grant. If the exercise price of options granted is equal to the market price on the grant date (at-the-money grants), no compensation expense need to be recognized. In case of backdated options, since the exercise price was lower than the market price, difference should have been recorded as compensation expense. (Although in another stock option related standard (SFAS 123), Financial Accounting Standards Board had expressed its preference for fair-valued method which measured stock option expense as the fair value of options, most companies including CTI did not adopt it because it was voluntary.) The overstatement was material and resulted in substantial decreases in income when financial statements were restated to correct this error.

Backdating also resulted in tax evasion by CTI and the recipients of stock option grants. The Internal Revenue Code (IRC) defines two types of stock options: qualified stock options (QSO) and non-qualified stock options (NQSO). QSO are not taxed at the hands of employee at the time of grant or exercise of options. When the employee sells the acquired options the difference between the sale price and exercise price is taxed as capital gain if holding period requirements are satisfied. NQSO are taxed as ordinary income when the employee exercises stock options and the corporation deducts an equal amount as expense. Options granted in-the-money do not qualify as QSO. By concealing backdating, CTI categorized them as QSO. Therefore employees owe income tax on backdated exercised options. Another implication is that NQSO do not qualify as incentive compensation for the purposes of computing one million dollar cap under 162 (m) of the tax code. Therefore, CTI cannot deduct any gains to employees from exercise of these options that exceed the million dollar cap.

3. **Do you consider CTI's stock option backdating unethical? Why or why not?**

The directors and officers of a corporation have a fiduciary duty of care and loyalty to shareholders. Loyalty demands that they act in the best interests of the corporation; not in self-interest. Backdating is unethical in several ways. When directors communicate with shareholders about corporate matters honesty is of paramount importance. Since CTI directors manipulated option dates to obtain additional undisclosed compensation at the expense of the company they failed in their fiduciary duties. They also misled shareholders who believed that stock option grants aligned employee's interests with theirs. In fact, the awardees of backdated option grants received compensation without any rise in stock price. When backdating came to light, CTI had to restate financial statements and stock price dropped significantly. As a result, shareholders suffered substantial losses. In addition, it also caused irreparable damage to the reputation of the firm (Raiborn, Massoud, Morris, and Pier, 2007).

4. **What internal control/corporate governance weaknesses of CTI did the trio exploit to operate their backdating scheme?**

Sound corporate governance is the cornerstone of protecting shareholder interests against managerial malfeasance. Effective governance requires separation of decision and control rights; with board retaining the top-level control rights for setting corporate strategy and to hire, evaluate, compensate, and fire top managers (Jensen and Fuller, 2002). Of all the corporate governance functions, executive compensation and especially stock options grants to managers is most susceptible to conflicts of interest (Adam and Schwartz, 2009). CTI's stock option grant process was flawed in several ways:

- In the US, it is not uncommon for the CEO to also serve as chairman of the board. This duality increases agency costs and weakens corporate governance because it allows the CEO to exert considerable influence over board members. Collins, Gong, and Li (2009) find that firms with weaker governance structures that allow CEOs to exercise greater power over the board are more likely to engage in backdating. The CEO of CTI, Alexander, was also the chairman of the board. As a result, the board and compensation committee were not in a position to effectively oversee the stock option grant process which was controlled by Alexander.
- Independence of directors is vital if board is to perform its fiduciary duty meaningfully. The composition of CTI's board left much to be desired. Alexander's father, brother-in-law, and sister were all members of the board. His brother-in-law and sister also served on the compensation committee which approved all stock option grants. Ironically, Alexander, who was deeply involved in the backdating scheme, also sat on CTI's audit committee. The committee supervised the financial reporting process and was also responsible for hiring Deloitte and Touche as the external auditor. Prior to joining CTI, Kreinberg, the CFO, had worked for Deloitte and Touche as the external auditor of the company. This may have caused the auditors to look the other way when backdating was going on. Although Kreinberg and Sorin were not directors of CTI, they were directors of Ulticom and Verint, two subsidiaries of CTI. Alexander also served as the chairman and CEO of these two subsidiaries. Sorin provided legal services to CTI that created another conflict of interest. Family ties among directors, interlocking directorships between CTI and its subsidiaries, and lack of independence of some of the compensation and audit committee members provided the trio with ample opportunities to manipulate the option granting process and falsify internal records and external disclosures to cover it up.
- CTI's bylaws permitted the compensation committee to approve stock option grants in the form of "unanimous written consent" (UWC) without convening a meeting in person. The committee approved all but one option grants without a formal meeting during the entire period

from 1991 to 2001. Almost exclusive reliance on UWC weakened the oversight function of the compensation committee. Since majority of the members of the compensation committee were independent, if the committee had met in person the outside directors would have received minutes of the meeting. More importantly, this would have created a dated record of approval of stock option grants making backdating very difficult. It is clear that the compensation committee abdicated its responsibilities and merely rubber stamped all stock option grants proposed by Alexander.

- Lack of internal controls aggravated the backdating problem. Although the case does not provide details of the internal control system of CTI, lack of proper record keeping is apparent. After the compensation committee approved stock option grants, the trio was able to change the number of options awarded and the awardees at will. Awards were granted to fictitious employees and later transferred to a phantom account. These were later given to other employees without the knowledge of compensation committee. The audit software of Equity Edge software was disabled so the daily history of changes was not available.

5. **How did backdating impact CTI's earnings?**

Under APB No. 25, the accounting rule applicable to stock option accounting, the intrinsic value of options, calculated as the difference between exercise price and market price of the stock on the grant date, is the amount of compensation expense. This expense should be recognized over the vesting period.(Vesting period is the time period after which the grant recipient can exercise stock options.) To illustrate the impact of backdating, table 2 shows total compensation expense (before taxes) for the eight backdated option grants that CTI should have recorded. This amount is lower than $265 million, the actual amount recorded by CTI because the details of all backdated grants are not available.

**Table 2**
**IMPACT OF BACKDATED GRANTS ON CTI'S EARNINGS**

| "As of" Grant Date | Actual Grant Date | Stock Price on "As of" Date | Stock Price on Actual Grant Date | Price Difference | Total Options Granted | Estimated Earnings Under-statement |
|---|---|---|---|---|---|---|
| 07/15/1996 | 09/10/1996 | $23.75 | $36.5 | $12.75 | 459,027 | $5,852,594 |
| 05/28/1997 | 06/16/1997 | 44.25 | 45.75 | 1.50 | 711,000 | 1,066,500 |
| 01/27/1998 | 02/19/1998 | 31.25 | 45.31 | 14.06 | 3,109,473 | 43,719,190 |
| 10/09/1998 | 10/15/1998 | 30.00 | 36.50 | 6.50 | 744,000 | 4,836,000 |
| 10/18/1999 | 11/23/1999 | 93.00 | 127.06 | 34.06 | 3,834,333 | 130,597,380 |
| 11/30/2000 | 12/13/2000<br>03/02/2001 | 85.00 | 112.12<br>76.06† | | 8,769,360† | 0 |
| 10/22/2001 | 12/18/2001 | 16.05 | 20.77 | 4.72 | 9,446,407 | 44,587,041 |
| Total | | | | | 27,074,600 | $230,658,705 |

†This grant became out-of-money by $8.94 per share on March 2, 2001. It was repriced in April, 2002.

6. **What provisions of SOX are relevant for backdating? How effective are they in preventing backdating?**

Before SOX, companies had up to 45 days after the end of the fiscal year to report option grants. This provided ample opportunity for companies to backdate option grants. After the passage of SOX, the SEC reduced this time period to two business days from the date of grant, thereby limiting the scope of backdating. As a result, the frequency of stock option backdating has been mitigated (Heron and Lie, 2007). The rule also forced Alexander to close the slush option fund account.

SOX requires management to establish adequate internal controls over financial reporting and assess their effectiveness. Auditors are required to issue an opinion on the effectiveness of internal controls. It also requires that the CEO and CFO certify that company's financial statements are accurate and complete in all respects. Under SOX, the CTI's management would have to disclose backdating as an internal control weakness and would not have been able to assert the accuracy of financial statements.

The stock exchange listing requirements approved by the SEC have strengthened corporate governance in several ways making backdating difficult:

- Company must have an audit committee composed of only independent directors responsible for hiring external auditors and overseeing the internal audit function. Any questionable accounting or auditing matters can be brought to the attention of the committee anonymously by employees or even outsiders. It is possible that an employee could have alerted the committee of backdating.
- Company must have a compensation committee composed of only independent directors. This would have disqualified Alexander's relatives from sitting on the compensation committee.
- Company must have a nominating/corporate governance committee composed of only independent directors. This would have acted as a check on the power of Alexander.
- Company must adopt and disclose a code of business conduct and ethics for directors, officers, and employees. This would have exerted moral pressure against the egregious practice of backdating.

As a result of the above reforms, the incidence of backdating has lessened. However, it has not completely gone away.

## EPILOGUE

Jacob Alexander, the former CEO of CTI, continues to live in Namibia. He is considered a fugitive and the government is trying to extradite him to US. David Kreinberg, the former CFO of CTI, is cooperating with the government and has not been sentenced yet.

The SEC asked CTI to file the restated audited financial statements from 1991 to 2005. The company has not yet been able to do so. As a result, it has been de-listed from NASDAQ. It has also been barred from issuing stock-based compensation prior to regaining compliance with the SEC reporting.

The CTI settled the case with SEC on June 18, 2009.( Securities and Exchange Commission Litigation Release No. 21090/Accounting and Auditing Release No. 2994 – June 18, 2009 available on http://www.sec.gov/litigation/litreleases/2009/lr21090.htm.) Without admitting or denying the allegations in the SEC's complaint, the company consented to the entry of a final judgment under which it will be subject to a permanent injunction against any future violations of the federal securities laws. CTI was also ordered to be in compliance with its obligations with respect to the filing of periodic reports with the SEC. No monetary penalties were assessed against the company. In accepting the settlement offer, the Commission considered, among other things, the company's extensive cooperation in the Commission's investigations.

## APPENDIX
## ANNOTATED READING LIST

Duffy (1999)- gives a nontechnical overview of employee stock options and discusses the primary reasons why stock options are used by companies.

Rezaee, Langstraat, and Malloy (2008)- present an excellent discussion of corporate governance issues related to option backdating. The authors point out the numerous negative effects of backdating that can have potentially significant impact. They also suggest the issues that need to be addressed by management to prevent future backdating scandals, namely poor corporate governance, ineffective internal controls, and aggressive accounting policies and practices.

Adam and Schwartz (2009)- offer a moral perspective on backdating and discuss the values that directors need to possess to prevent it.

Moyer and Weihrich (2000)- discuss the technical aspects of QSO and NQSO. It is a good primer on financial statement and tax effects of these two types of options.

NYSE (2003)- provides a summary of corporate governance rules for exchange listed firms.

Craddock (2002)- provides a summary of the Sarbanes-Oxley Act.

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# 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.*

## INSTRUCTOR'S NOTES

### General Discussion

In developing policy considerations, consistency is key to avoiding difficulties later on. Once the policy has been established, deviations for select organizations may provoke legal or public relations issues. For example, allowing the International Red Cross to collect donations may prove to be problematic if other organizations then ask to distribute literature and/or solicit contributions.

In using the case in a classroom setting, drawing on the students own experiences with shopping malls (some only as patrons and others with retail experience) will yield a good amount of discussion. Transitioning from those perspectives to what property managers need to consider with different types of events and organizations likely will flesh out at least some of the areas and specific points contained in the policies actually developed for the property. A number of exhibits are included in the instructor's notes for potential use in class discussions.

None of the information contained in the case study or this teaching note is disguised. All information was obtained through a face-to-face interview with Mr. Kristinn Jóhannsson, Operations Manager for Smáralind Shopping Centre in Iceland. The photographs used as figures were taken by the author in the public areas of the centre. Drawings used in the case study and teaching note were provided by Mr. Jóhannsson for use in the development of this project and for educational use.

## TASK QUESTIONS AND ANSWERS

**1. You should first compile a list of policy areas your document should address.**

The areas listed below represent major sections of the policy / rental agreement developed by Mr. Kristinn Jóhannsson and his staff.

- Price and payment terms of rental fees
- Maintenance and security
- Leasing period
- Sub-leasing or contracting
- Design and layout
- Tenants' activities
- Resolution of disagreements
- Staff parking
- Smáralind equipment
- Electricity, telephone and computer lines
- Posters and boards
- Announcements on the internal audio system of Smáralind
- Cars
- Fire precautions

**2. For each policy area, draft appropriate language that addresses who has what responsibilities (the organization vs. centre management)**

Figure TN-3 is the current agreement language used for Winter Garden rentals. Additionally, the appendices to that agreement cover the passage areas in the centre.

**3. Include in your draft language a mechanism for long-term tenants to have input for the ongoing implementation of your policy.**

This is addressed in the section titled "resolution of disagreements" albeit somewhat unsatisfyingly. In the U.S. agreements such as this tend toward resolution through arbitration rather than going to a legal body for adjudication. It does, however, offer insight to one of the differences between the U.S. system and that used in at least one European country.

**Table TN-1 Icelandic and European to American Conversions (6/18/2010)**

| | |
|---|---|
| One meter = | 3.28 feet |
| One Square meter = | 10.76 square feet |
| One Centimeter = | 0.39 inch |
| One U.S. Dollar = | 126.630 Icelandic Krona = 0.8082 Euro |

**Figure TN-1 Lower Ground Floor**


**Figure TN-2 Upper Ground Floor**


**Figure TN-3 A short-term leasing agreement for Winter Garden**

The parties of the contract:

| | Name | Security # | Address | City |
|---|---|---|---|---|
| Name of the property owner: | Smáralind ehf | 550496-2329 | Hagasmara 1 | 201 Kopavogur |

Name of tenant

**The leased property**

With this contract the property owner and the tenant agree to the leasing of the following part of Smáralind Mall, under the conditions stated in this contract.

The leased space is an area on the second floor, the Winter Garden. The area of the leased property is 1750 sq. meters. The net exhibition area is approximately 800 sq. meters. In addition, dressing rooms on the second and third floor are part of the leased property. Refer to the attached plan nr 09-952 which is part of this contract.

The property owner lets the space without lighting except regular daylight lighting of the Winter Garden, without any audio equipment or other equipment that the tenant might need, unless it is explicitly stated in this contract. The tenant is responsible for all assembly of equipment and is responsible for any cost incurred for equipment assembly as well as other costs incurred by the usage of the leased space.

Equipment such as audio systems, grids for lamps, podiums, tables, chairs, sofas etc. are not included in the leasing of the property. If the tenant wishes it is possible to make a separate agreement for equipment of this kind. Refer to Appendix A and price list.

The tenant and his subcontractors are not allowed to use the common areas (hallways, entrances etc) of the mall that are not part of the leased area, without the consent of the property owner. The tenant should make sure that his activities will not interrupt other activities of the mall, i.e. due to noise or passing through the leased area.

**Price and payment terms of rental fees**

The renting fee for the leased area is _________kr (Icelandic Krona) plus 24.5% value added tax (VAT).

**Maintenance and security**

The tenants should return the leased areas with clean floors and should make sure that the area is generally clean. Maintenance and cleaning are not included in the rental fees. Security watch is not included in the rental fees. The tenant must make sure that adequate security guards will be provided in the leased area during the leased period. When planning for security guards the tenant should take note of the mall's opening hours.

Should the tenant wish the owner to provide maintenance and security that are part of the tenant's responsibility a special agreement should be made. See the attached Appendix A and price list.

**Leasing period, beginning and termination of period**

The leasing period begins on ________________at_____________ o'clock
The leasing period ends on ___________________at_____________ o'clock
The area will be submitted to the tenant on _______at_________ o'clock (submission date)
Opening day of exhibition _______________at______________ o'clock

Closing day of exhibition _____________at_______________ o'clock
Final day _____________________at______________ o'clock

The submission date is the date when the owner submits the property for the usage of the tenant. Opening day is the day when the official activity of the tenant starts. Closing day is the day when the official activity terminates. Final day is the day when the tenant returns the property to the owner. The leasing period begins on the submission day and ends on the final day.

At the end of the leasing period the tenant must return the leased property in a similar condition to the one he received it in. The owner should approve of the state of the property upon return of the leased area. If the tenant fails to meet these requirements the owner will mend what is not in order, remove waste and equipment that has been left behind, all at the expense of the tenant. If the leased property is not returned on time, daily rates for each additional day will be collected from the tenant.

**Sub-leasing or contracting**

The tenant is not allowed to sub-lease the property without the written consent of the owner. He is not allowed to contract the leasing agreement to a third party.

**Design and layout**

The assembly of exhibition systems, floors, chairs, banners and billboards must be approved by the owner. Plans of the layout setup should be submitted for approval no later than four working days prior to the submission date.

**Tenants' activities**

The main activities of the tenant in the leased period are: _____________________

The tenant is not allowed to bring any other activities without the consent of the owner. The tenant should strictly follow Smáralind guidelines for fire precautions and security. See Appendix C.

The tenant should have the appropriate insurance that covers any damages done to the property or to third parties, by him and his subcontractors. The tenant is responsible for all the activities that go on in the leased area during the leasing period.

The tenant should emphasize doing business with those who have their operations in Smáralind and seek ways to connect their business with the activities of the tenant, for instance by promoting their products or in other ways that will be beneficial to both parities

The tenant must submit to the owner a plan for marketing activities regarding layout and scope of the activities that will be conducted in the leased area, no later than four days prior to the submission date.

**Other issues**

Other issues that are not acknowledged in this contract i.e. rights for termination of the contract and the condition of the property at the end of the period are conditions to the act of property leasing nr. 36/1994.

**Resolution of disagreements**

Should a dispute arise about the interpretation and procedures of this contracts the parties involved should by all means seek to reach a settlement. If a settlement cannot be reached a case should be made before the County Courts of Reykjavik.

This contract is made in two unanimous copies, one for each party.

**Kopavogi**

On behalf of tenant ________________________________ On behalf of owner __________________________

Witnesses to the correct date and signature of parties

___________________
Name, security number

___________________
Name, security number

**Appendix A: Security and Maintenance**

The tenant wishes for security guard and maintenance according to the following plan:

| | Maintenance | no. of hours | Security guard | no. of hours |
|---|---|---|---|---|
| Friday | from____to____ | ______ | from____to____ | ______ |
| Saturday | from____to____ | ______ | from____to____ | ______ |
| Sunday | from____to____ | ______ | from____to____ | ______ |

Total number of hours ______ ______
Price list

| | |
|---|---|
| Rate for maintenance 2 | 800 kr. pr hour plus 24.5% value added tax |
| Rate for security | 2800 kr. pr hour plus 24.5% value added tax |
| Rate for an audio assistant | 5400 kr. pr hour plus 24.5% value added tax |

## Appendix B: Resources and Services

### Staff parking

The tenant should make sure that his staff members do not park their cars in the customer parking area next to the Winter Garden. Staff parking is in the furthest most area of the Smáralind parking lot. See plan.

### Smáralind equipment

The tenant will notify parties on his behalf that Smáralind does not supply light equipment such as electricity plugs, computer cables, chairs, tables, garbage cans etc. The staff of the exhibition is not allowed to take these items from the common areas of Smáralind.

### Electricity, telephone and computer lines

The tenant should note to the owner the number of computer connections that will be in the area with at least a day's notice. In the Winter Garden there are boxes in the floor at six meter intervals. The boxes contain electricity, one phone plug, and one computer plug. It should be noted that tenants can contact Icelandic Telecom for a wireless connection. The first four connections are included in the rental fee; each additional connection costs 1000 kr + VAT.

### Posters and boards

With the consent of the owner the tenant is allowed to put up three posters (50x150cm) in the revolving doors, three banners hanging from the ceiling and six flags outside the mall. The posters, banners, and flags should be submitted to the service desk where Smáralind's staff will take care of setting those up.

Tenants are prohibited from gluing or pasting anything to floors and walls, such as cables, unless approved by Smáralind staff.

### Announcements on the internal audio system of Smáralind

Tenants should submit short, concise notifications on their event to the service desk. Only announcements from the tenant will be performed, not announcements from individual exhibitors. The service desk staff decides on the frequency of announcements.

### Cars

Any cars brought into the exhibition area should have an empty gas tank and batteries should be removed. It is not allowed to bring cars on nailed winter tires, and oil leakage should be prevented.

## Appendix C: Fire Precautions

**Procedures for displays and sale booths in mall's corridors:**

The following is put together due to shop owner's request of putting sales items on display in the mall's corridors.

**Conditions in corridors and walking passages**

The walking passages of Smáralind are intended to be accessible and safe pathways. Putting merchandize and store displays out in the passages is not according to this aim and can create hazardous conditions.

It should be noted— fire that starts in a passage and has conditions to increase is a more dangerous threat to public safety than a fire that starts within a closed shop. The design of the building does not account for the condition of fire augmentation in the passages and common areas. The managers of Smáralind are responsible to make sure that these conditions are met.

It is, however, considered to be of low risk to put a limited amount of merchandise into the corridors on surveillance and if precaution is taken

When a certain setup is assessed in terms of hazardousness the following should be kept in mind:

1 Main passages and escape routes must be kept clear.
2. The amount of flammable material (if any) should be kept under 0.5 liters
3. Merchandize and displays should be set up in restricted areas and separated in such a way that it decreases the likelihood of the spread of the fire.

All operation that involves a substantial amount of flammable material or can be classified as a public gathering should be held in the Winter Garden rather than in the passages.

**Rules for usage of the Smáralind passages**

1. A written permission for all usage of the passages, other than traffic and escape of the public should be sought from the operation manager of Smáralind. The application should be accompanied by a layout plan that shows how the area is to be used. In case of doubt, the operation manager should seek the advice of the Fire precaution institution.
2. Objects or merchandise must not be placed in such a way that pathways and escape routes are narrowed more than according to the following:
    a. Where there are shops on both sides of a passage the total unblocked width should be at least six meters
    b. On the second floor where there is a shop on one side and a railing on the other side the total unblocked passage should be at least three meters
    c. The unblocked areas should be in alignment with emergency exits and span the whole way through the passage

3 Flammable material should not be situated closer than three meters from the store front
4 Flammable material should not be located closer than three meters to the firewalls that close between smoke departments
5 Connected displays should not cover more than six meters. Clear areas around such displays should be at least three meters.
6 Displays and booth setups should be made from materials that are not flammable and fulfill at least Class 1 according to BS 476 part 7. “Surface Spread of Flame Test for Materials”.
7 Display- and sale booths should not have a closed roof.
8 Activities that contain the following are prohibited:
    a. Open fire
    b. Production of steam or sprinkles
    c. Handling of flammable liquid of more than 0.5 liters
    d. Usage of gas (propane / butane)
9 The following rules apply to cars
    a. Cars must not be placed in such a way that they block escape routes, according to the previous section.
    b. All gas should be removed from tanks and ducts.
    c. The tank should be ventilated to remove fumes.
    d. Batteries should be removed.

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# 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."*

## TEACHING NOTES

The approach for teaching this class can be as detailed or as broad as the instructor desires. If the instructor has covered all the relevant issues mentioned in the "Case Description"—competitive advantage, driving forces, key success factors, Porters Generic Strategies, SWOT, etc., the instructor can ask the students to read the case and be prepared to discuss all the questions discussed below. If the instructor wants to use this case to reinforce just some of these points, then the instructor may only assign those questions that relate to the points that the instructor wants to emphasize with this case.

**1. What are the driving forces in the walk-in clinic industry?**

a. The consumer's desire for quicker service at a lower price.
b. The insurer's desire to lower health care costs. Insurers even provide financial incentives to those who use walk-in clinics.
c. The employer's desire to reduce insurance premiums and work hours lost.
d. Employers are working directly with walk-in clinics to provide urgent cares services to employees rather than going through an insurance company.
e. Governments (Federal, State, and Local) desire and strategies to lower health care cost make walk-in clinics an excellent source of medical services.
f. The rapid expansion in the retail clinic market and the strategic alliances being formed by the retail clinics and other providers of medical services, such as drug store chains.

**2. What are the Key Success Factors in the walk-in clinic industry?**

a. Cost must be closely monitored to insure that the business can compete in this very price sensitive market.
b. Volume is critical. This is a very high fixed cost business. As volume increases, average fixed cost decreases resulting in greater profitability.
c. Availability--Patients do not just get sick from 9-5 on M-F. Nights and weekends can be very busy and therefore profitable times for a walk-in clinic.
d. Speed--In our fast paced world, patients are not willing to spend much time waiting, and when they do have to wait they need to have something to do to pass the time.
e. Quality is defined by affective values--how the patient is treated at the clinic (friendliness of staff, amenities, and amount and quality of times spent with physician). The patient does not have the expertise to actually judge the quality of care. Therefore, the patient uses these affective values to judge quality.
f. Building relationships is very important. Research indicates that consumers rely on a relative, friend, or neighbor when choosing a physician. Once they have gone to a doctor and had a good experience, they tend to become loyal to that physician.

**3. What is Physicians Quality Care's competitive advantage? Is it sustainable?**

Physicians Quality Care's competitive advantage is the experience that the patient has when they come to their clinic. Historically, doctors' offices are known for their long wait times and the impersonal treatment of patients. Many of the symptoms these patients experience are uncomfortable and often times cause the patient to be very impatient. It is impossible for a walk-in clinic to be able to control wait time because it cannot predict number or arrival times of patients. By being friendly to patients and giving them something to do while they wait, Physicians Quality care is doing something that other walk-in-clinics do not do.

**Is it sustainable?**

Their competitive advantage goes against the tradition business model for walk-in clinics. Instead of focusing completely on cost and being a low cost provider, they have chosen to focus on service. While others might try to duplicate this business model, many will choose not to do so because of the high cost involved in following this strategy. In addition it requires people with different skill sets than those customarily found in the medical field.

**4. When you look at Porter's generic strategies, which strategy is Physicians Quality Care pursuing?**

This case is an excellent example of a differentiation strategy. They have found a way to separate themselves from the pack. They offer the customer an "experience" they cannot get anywhere else. They use customer service to differentiate themselves from the competition. They have invested over $3,000,000 in "WOW" factors to make the customers' wait time as pleasant as possible. They have hired and trained employees to be friendly and courteous to patients and to go out of their way to help patients. If an employee does not contribute to this atmosphere the employee is given an opportunity to seek employment elsewhere.

It is obvious they are not a low cost provider. The huge investment they have made in this business and their pricing strategies made it clear that they neither can be nor want to be a low-cost provider.

They are not pursuing a focus strategy, because they are always looking for ways to expand their product offering—examples of this are their Occupational Medicine program, Boomers, and Laser Room. They readily admit that they are willing to provide any service if the revenue generate warrants.

**5. Do a SWOT analysis of Physicians Quality Care?**

**Strengths:**

- The knowledge and the passion of the owners.
- One of the owners having a marketing background
- Unique approach—make the visit as pleasant as possible
- Owners have a lot of experience in this business

**Weaknesses:**

- Huge amount of debt almost $3 million. This is several times more than most walk-in clinics would have. Must have huge annual debt retirement business.
- Laser Room—big expense that is not paying off.
- Boomers—a lot of floor space and equipment. Not likely to pay off.

**Threats:**

- The medical group they worked for have a walk-in clinic that has been in business for years and the medical group has over 125 doctors as resource personnel for the walk-in clinic. There is a lot of loyalty to this clinic in the community. It is located next to the major hospital in this community.
- Retail Clinics have not really saturated their market yet, but they could be a major force. They offer lower prices and have lower overhead.

**Opportunities:**

- Large market opportunity—115 million medical visits a year could be handled by urgent care clinics.

- Forming strategic alliances with employers to meet both their occupational and urgent care needs.
- Franchising—if they can get their business model refined, they can have a business model that would be good to franchise.

**6. How has the owners' experiences and personal values influence the business strategy?**

Jimmy's fascination with Disney has caused him to go all out. He has probably put some things into the business that were not absolutely necessary, examples—laser room and "Boomers." Melanie's interest in the book Good to Great has impacted how they run the business. "Getting everyone on the bus, getting everyone in the right seat, want to be the Nordstrom's of urgent care clinics. Their becoming fed up with the customer service provided by their previous employer has caused them to invest a lot of money and resources to provide outstanding service.

**7. Given what you know from reading this case and the industry analysis, what would you do differently if you were opening up an urgent care clinic?**

- One obvious answer that comes to mind is the Laser Room. It was very expensive and has not generated enough business to warrant the investment.
- Second, Boomers is not very busy and is not generating the expected revenue. Competition in this area is likely to prevent it from being profitable.
- With the exception of the WOW Factor, the theatre is grossly underutilized.

# 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, this case provides an opportunity for the student to distinguish the tax law for contract laborer vs. employee, and understand the use of actual car and truck expenses (including the auto insurance and auto depreciation) vs. the standard mileage rate. Additionally, the student must determine what are deductible business supplies expense, the specific regulations for deductibility of travel expense, and the statutory limitation for 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. The case is particularly helpful to assess the students' ability to identify potential accounting issues in an accounting research class, where the typical research sequence is: gather facts, identify issues, locate relevant authority, evaluate authority, conclude and communicate (Everett, Hennig & Nichols, 2010). Sample assessment goals, including those for identifying issues for a tax research course are also included in table form, below. 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.*

## INSTRUCTORS' NOTES: LITERATURE REVIEW

Common sense has indicated that the use of real-life material in the teaching of accounting courses helps to generate strong validity of the teaching process. In accounting, Angelini, Maletta & Anderson (1999) find that students learn more from working out tax cases than from lectures alone. Accounting students desiring to become leaders in the accounting field must learn to use professional skepticism and critical thinking skills in evaluating information purported to be true by the person submitting that information. Albrecht (2002) actually assigns values to the performance of the different stages of accounting: Stage 1 (bookkeeping) worth up to $10 per hour, Stage 2 (summarizing transactions) worth up to $30 per hour, Stage 3 (manipulating data into useful information) worth up to $100 per hour, Stage 4 (converting information into knowledge helpful to decision making) worth up to $300 per hour, and Stage 5 (making value-added decisions using Stage 4 knowledge), worth up to $1,000 per hour.

Several studies have been made on the development of critical thinking. For example, Dewey (1933) finds that critical and reflective thinking is a multi-step process utilizing: problem recognition in an environment of uncertainty, search for possible solutions, evaluation of alternatives, assessing the best solution, and the reformulation of the decision as necessary. Piaget (1974) explains that critical thinking can be achieved in developmental stages. Bloom (1956) structures a taxonomy that describes the critical thinking process as six progressive steps. Fischer (1980) describes taxonomy where learning stages begin as concrete knowing (knowing of facts) and progress to systems of facts, abstracts of those systems of facts, and the relationship between multiple abstracted systems of facts. King & Kitchener's (1994) model of critical thinking has seven stages of increasing complexity. The first three stages show thinking where knowledge is certain and all problems have a correct solution, as justified first by an authority and progressing to justification by experts. The next two stages show quasi-reflective thinking, which is where the student evaluates conflicting evidence based on intuition and finds evidence to back up his or her present beliefs. In the final stage, the student interprets and weighs evidence based on the rules of his or her discipline to draw his or her own conclusion.

Wolcott and Lynch (2002) adapted critical thinking theory specifically to business situations, introducing an Issues-Theory-Analysis-Conclusions (ITAC) model. Building on a concrete foundation of knowledge, each of the four ITAC steps requires progressively complex cognitive ability. In the foundation of knowledge and skills, the student gathers information and establishes justification toward a single correct solution to the problem. The lowest stage of cognitive complexity, called "issues," includes identifying the problem and relevant information and uncertainties. The next stage, "theory," involves interpreting and organizing information. In "analysis," the information is evaluated and prioritized in to a plan for implementation. The highest level of complexity, "conclusions," results in the solution.

Specifically, tax returns are often used beyond filing and paying tax. For example, tax returns were used to substantiate the amount of lost income for reimbursement in the 2010 British Petroleum Oil Spill (Noguchi, 2010), Tax returns might also be used to verify income for alimony and child support. In determining child support in the state of Kentucky, "[i]ncome statements of the parents shall be verified by documentation of both current and past income. Suitable documentation shall include, but shall not be limited to, income tax returns, paystubs, employer statements, or receipts and expenses if self-employed" (Kentucky 2010, page 2).

## CASE BACKGROUND

This case, based on actual court testimony with the names and amounts changed, subjects a tax return and in particular, the income statement from a business, to student scrutiny. The case provides a hypothetical client, who is seeking child support from the father of her child. Child support, it is explained, is based upon a statutory state formula, which is based upon the most recent year's federal income tax return unless the validity of that income tax return is successfully challenged. Successful completion of this case is dependent in part upon the student having completed at least one full semester of federal taxation. The student's task is to identify suspicious items for further development. After the students make their recommendations, the underlying basis for the actual issues identified is discussed in class to confirm or refute the basis for the students' suspicions.

The rest of this case is presented as follows: the instructional audience is identified, learning objectives are outlined, and the case is presented with a sample instructor's key. Teaching notes, other business applications, limitations and conclusions complete the case study.

## INSTRUCTIONAL AUDIENCE

This case goes beyond foundational knowledge and delves into issues requiring the use of judgment as to whether or not the character of transactions and the amounts reported within an income tax return appear to be reasonable considering the context of the case excerpt shown below. This case also requires a justification, or theory consistent with Wolcott and Lynch (2002). Given that the case excerpt is extremely brief, students must try to piece together what is happening and do not have enough information to confirm their suspicions. This process leads the better students to do some ad hoc analysis on items such as car and truck expenses. Finally, for those not-so-better students whose foundational knowledge has atrophied, research skills are reinforced. This case is best presented to graduate level tax students, near the beginning or middle of the semester.

## LEARNING OBJECTIVES AND MAJOR ISSUES

This case, at its core, attempts to teach students to identify issues for further audit. Specifically, at the conclusion of this case the student should be able to:

- Determine whether the character of the income has been properly classified
- Determine the effect on expenses when income is improperly classified
- Provide a rational justification for suspecting most expense amounts provided
- Redraft the AGI and taxable income for the year based on their preliminary analysis of the correct amounts
- Communicate any concerns clearly and concisely in a tax file memorandum format, and/or
- Prepare an audit planning memorandum indicating what information would be needed to conduct a financial statement audit of the father's video court reporting business and listing issues to be addressed.

## CASE EXCERPT

The stem of the case reads as follows:

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?"

The case stem is then followed by a hypothetical W-2, Form 1099, Form 1040, Schedule C for Form 1040, and Schedule SE for Form 1040 printed in IRS format. (See student case for copies of these forms.)

## RECOMMENDATIONS FOR TEACHING APPROACHES

This case was administered as an individual case and overviewed in class but students solved the case using primarily out-of-class time. Generally, the students had one class period (2 calendar days) to generate an answer.

After analyzing the tax return provided by opposing counsel and reaching their preliminary conclusions about suspicious items, a CPA in a real life situation would usually ask the plaintiff's attorney to make additional requests for documentation to support questionable items. Students must identify suspicious issues, but will not yet have all the information to support a final opinion of the correct income. However, since this case is reality-based, the answers to those questions are known by the instructor. Once the case is turned in, it is discussed in class where students can voice their suspicions and the underlying basis for the income or deduction is revealed. Students can then confirm or adjust their preliminary conclusions until a class consensus of the correct treatment is found. Below (under the headings "what the students don't know") are the underlying bases for the income, deductions, and related interest and penalties that are revealed in the class discussion. In the "what the students should know" sections of the answer key, are the answers on which the written case is graded. The case grade was generally reduced by the percent that the student's AGI differed from the corrected AGI. Bonus points can be earned by the student for including a corrected contemporaneous schedule of business expenses, which should have been used for preparation of a corrected Employee Business Expense, Form 2106 including Page Two, Part II Vehicle Expenses, Sections A - Vehicle Information and Sections B- Standard Mileage Rate. The Bonus points are awarded since Form 2106 is not required to recalculate the corrected AGI, and the student would show a more complete understanding of the issues by being thorough in showing how the business expenses are reclassified and recalculated (with the unreasonable expenses being disallowed), once the income is reclassified as W-2 income and not as originally reported, as 1099 income. Furthermore, the student would need to recognize that the father would need in excess of $7,000 of other schedule A expenses in order for any of the Form 2106, unreimbursed employee business expenses to be deductible ($5,450 plus the approximate $1,518 2% miscellaneous itemized deduction limitation). While there are tax preparation fees, and standard mileage expenses, it is highly unlikely that the father would be able to exceed the approximate $7,000 threshold in order to itemize and be able to deduct any business expenses.

## ANSWER KEY

### What the Students Don't Know - General

In reality, the non-custodial father was an extremely skilled marksman. Most of the expenses associated with the business supported what the father-taxpayer later called "business development," which is where the taxpayer traveled the country to different marksmanship events and meeting other marksmen who might one day be "potential business contacts." As such, nearly all of the expenses are suspect and very likely disallowable as hobby expenses, not §162 expenses incurred in a trade or business. However, this conclusion is not readily apparent from the Schedule C alone. From a financial statement audit standpoint, the GAAP separate entity assumption would be violated because the father is not keeping personal hobby expenses separate from those of his video court reporting business.

### What the Students Should Know - General

What is evident from the case material presented to the student is that the classification of income from the business (Schedule C) is suspect. The Schedule C income should be reclassified as wage income. Revenue Regulation 31.3402(e) (1) explains that generally pay a worker receives from working two jobs for the same employer must be treated alike. To verify which treatment is appropriate, the student should review the rules of independent contractor vs. employee. The previous 20 common law tests can be summarized as essentially a test of the degree of control that the service provider (v. employer) has. Control falls into three categories: behavioral control, financial control, and the relationship between the parties. All the services are provided for the taxpayer's sister's company, indicating that the taxpayer's sister (employer) has the behavioral and de facto financial control. Since the taxpayer is an acknowledged employee of the company, an employee relationship is expressly acknowledged for nearly half the income, and therefore for the relationship test of contractor v. employee as well. Additionally, Ernest Halfhill, d/b/a/ Halfhill Trucking v. Commissioner (96-1 USTC 50,208) supports consistent employee v. contractor treatment for income coming from one company. (See also Kentfield Medical Hospital Corp. v. U.S.; 2002-2 USTC 50-542.) Revenue Ruling 58-505, 1958-2C.B., 728 states that an employee can also be an independent contractor of the same company only if the services provided to the company are not interrelated. In this case, the taxpayer works as a court reporter (per the case paragraph) and as a video court reporter (per the Schedule C). These activities are similar and the purpose of both activities is to provide detail of court testimony. In both situations, the reporter must provide and use the necessary equipment. Thus, the Schedule C income should be reclassified as W-2 income from either wages or as part of an unaccountable expense reimbursement plan. AGI therefore is increased from $38,619 to $75,926 (and unreimbursed employee business expenses in excess of 2% of this higher amount (=$1,518) are potentially deductible). Not all the expenses claimed should be accepted without further scrutiny, however.

**What the Students Don't Know – Car and Truck Expenses for Tax**

With further questioning of the taxpayer, it was discovered that car and truck expenses ($3,837), depreciation ($6,166), and insurance ($1,878) are all for the taxpayer's (sole) vehicle. The correct presentation would be to combine all actual amounts spent for these three categories in to one category for car and truck expenses, filling in Part IV of the Schedule C (which was left blank). Using an average standard mileage allotment for 2009 of 55¢ and the total car and truck expenses of $11,811, the taxpayer appears to have driven about 21,500 miles/year for this business. Further, if he drove an average of 30mph, for 50 weeks/yr, he drove over 14 hours/week for this job (in addition to performing his part-time job, his full-time job and commute), which appears an excessive amount to drive for a $1,764/yr ($33.92/week) profit. The automobile listed is an SUV (truck) rated at more than 6,000# gross (loaded) vehicle weight, and therefore exempt from luxury auto limitations in 2009, but would fall under the new SUV restrictions.

**What the Students Should Know - Car and Truck, Depreciation, Insurance Expenses for Tax**

Transportation expenses should include only those expenses to get from one business destination to another while not away from home overnight (Reg. §1.62-1(g)). Commuting to and from a first job is not deductible. The cost of going directly from one job to another may be deductible (Rev. Rul. 75-380, 1975-2 C.B.59). When going from a temporary assignment within the general area of the taxpayer's employment and he or she has a regular place of business, or if the temporary assignment is outside the general area of the taxpayer's employment, then commuting to the temporary assignment is generally deductible (Rev. Rul. 99-7, 1999-1 C.B. 361). The deductions would be taken on Form 2106 if the Schedule C income were reclassified to wage income.

Car expenses may be figured using either actual expenses or a standard mileage allotment. Actual expenses usually include the costs for gas, oil, repairs, maintenance, insurance, depreciation, taxes, licenses, garage rent, parking fees and tolls. If the taxpayer is deemed to be self-employed, then interest on a loan to purchase the car may also be deductible. Depreciation is normally figured using MACRS (as is shown on Form 4562), and should be shown as listed property. Where the car is used for less than 100% for business (as is the case here), these amounts must be pro-rated between business and personal use. Alternatively, the average standard mileage allotment of 55 ¢/mile for 2009) may be used if it was adopted in the first year the car is placed in service.

Auto expenses are further limited by the luxury auto restrictions (Code §280(f)) where any four-wheeled vehicle manufactured primarily for public road use has an unloaded gross vehicle weight of 6,000# or less (or in the case of a truck or van, a loaded gross vehicle weight of 6,000# or less). Correspondingly, the make and model of the vehicle should be verified.

**What the Students Don't Know – Supplies Expense for Tax**

The supplies are primarily for shotgun shells used in marksmanship practice and tournaments, which the taxpayer reasons is deductible because he will meet potential business contacts at the tournament events. No clients have as yet come from this activity. Code §162 generally allows a deduction for reasonable expenses incurred in the conduct of a trade or business, but the practice and marksmanship competition are the primary activity here, and any connection to a trade or business is incidental at best. While there are prizes associated with winning the marksmanship tournaments, this activity is not as yet self-supporting, and fits more closely with Code §183, which ordinarily disallows hobby costs except to the extent of hobby income.

**What the Students Should Know – Supplies Expense for Tax**

Supplies for a video court reporter would logically include the cost of video tapes, miscellaneous office supplies, memory (if digitally recorded) and perhaps postage. Video tapes typically cost between $1 - $3 each, depending upon the quality and quantity of tapes purchased. Assuming that the cost is $2 per tape, and about $4,875 of tapes was purchased, that would equate to about 2,438 video tapes, or 48 tapes per week. Since video tapes can play for up to 3 hours each, the cost for the video tapes appears to be unreasonable. Alternatively, if the taxpayer were actively engaged in video taping 5 nights per week @ $2/tape, 50 weeks/year, tape cost would be $500/year, or roughly 10% of the cost claimed. If the taxpayer is using digital recorders, no tapes would be required. A memory stick is substantially cheaper, running about $25 with sales tax.

**What the Students Don't Know – Travel Expense for Tax**

The travel is for trips across the country to participate in marksmanship tournaments. The taxpayer has de minimis winnings from this endeavor, which are included in the income figure of $40,310.

**What the Students Should Know – Travel Expense for Tax**

For travel to be deductible, it must be effectively connected with the operations of a trade or business while away from home overnight on business (Reg. §1.62-1(g)). Travel costs include the costs for transportation, 50% meals, lodging, cleaning & laundry, telephone, and other similar expenses (Reg. §1.162-2(a)). Where travel within the United States but away from home includes both business and pleasure, the taxpayer may deduct all the costs to and from the destination if the trip is primarily for business. If the trip is primarily for personal purposes, travel is not allowed even though some business is conducted. Factors included in determining business vs. personal travel include the amount of time devoted to business compared to personal activities, type of location where business occurs (e.g. shooting range vs. law office). It should be noted that the Cohan rule, which permits a deduction for unsupported but reasonable estimation of an expense does not apply to travel and entertainment per Reg. §1.274-5T(a)(4). It is industry practice to hire video court reporters locally, so travel of over 40% of income (and over $1,300/month) is questionable. If the rather substantial car and truck expenses account for the to-and-from travel expenses, and an average of the high and low per diem rate for lodging is applied, then travel costs of $16,479/$146/night = 113 days. To assert one spends roughly 1/3 of a year traveling overnight, away from home primarily for business pertaining to the taxpayer's second job is cause for suspicion. To the extent travel is by other than his car, travel becomes more reasonable, but car and truck expenses become less reasonable.

**What the Students Don't Know – Meals & Entertainment Expense for Tax**

The taxpayer habitually attended church on Sunday. Following Sunday church service, it was the custom of the Sunday school class to go to lunch together at a moderately-priced cafeteria, where each attendee paid his or her own bill. The taxpayer considered these meals business development, and deducted 50% of them accordingly. Additionally, there were several suspect entertainment expenses, including two tickets to an Ozzie Osbourne concert. The taxpayer fails all three tests listed in the "directly associated with" test below. The taxpayer had no records substantiating business discussions for meals or entertainment as is necessitated by the "associated with" test below, and prima facie, Sunday school (not business) was discussed before the weekly meals. Upon examining the underlying receipts, it is unlikely that any of the meals and entertainment would be accepted as deductible if scrutinized by the IRS.

**What the Students Should Know – Meals & Entertainment Expense for Tax**

The requirements for meals and entertainment to be deductible specify that the expense be either directly related to or associated with the taxpayer's business (Code §274). To be directly related to business, there must be more than a general expectation of deriving some income or specific benefit (other than goodwill) as a result of the expenditure, and business was actually discussed during the entertainment, and the combined business and entertainment was principally characterized by business (Reg. 1.274-2(c)(3)). Entertainment is "associated with" business if it is immediately before or after a substantial business discussion (Reg. 1.274-2(d)).

**What the Students Don't Know – Other Expenses for Tax**

The legal and professional fees are a pro-ration of the tax preparation fees. If income is reclassified, this item would be combined with any other tax preparation fees and itemized on Schedule A, but not be included on Form 2106 along with the unreimbursed employee business expenses. The $37 dues are for membership in a shooting club, which would likely be disallowed in full.

**What the Students Should Know – Other Expenses – for Tax**

With the number of questionable expenses examined so far, it is likely worth questioning these, although they will likely not have a material effect on the tax return. Additionally, the instructor might open the discussion of the penalties and interest to which the taxpayer is exposed. In particular, the taxpayer may be responsible for an accuracy-related penalty equal to 20% of the underpayment of tax under IRC §6662(b) and interest on underpayment under IRC 6601(a)-(e).

**What the Students Don't Know – Financial Statement Audit**

The non-custodial father was including hobby expenses as expenses of his business.

**What the Students Should Know – Financial Statement Audit**

To conduct a financial statement audit of the Schedule C business, the CPA will need to request substantial additional documentation. Since a balance sheet is not required for a Schedule C business, the CPA will need a trial balance for the video court reporting business. In addition, the CPA will need to request:

- Monthly bank statements (both personal and business) for 2007, 2008, and 2009
- Documents (invoices, receipts) supporting expenses on Schedule C
- Federal income tax returns for 2007 and 2008

**What the Students Don't Know – Related Party Transactions**

The Form 1099-MISC (Miscellaneous Income) provided to the father by his sister's company could understate nonemployee compensation.

**What the Students Should Know – Related Party Transactions**

SAS (Statement on Auditing Standards) 45, "Related Parties," provides related party definitions and suggested auditing procedures for a financial statement audit. Since the non-custodial father's Schedule C business income is entirely from services for his sister's company, the sister (a related party) could be significantly influenced by her brother to understate income reported to him. Furthermore, SAS 99, "Consideration of Fraud in a Financial Statement Audit," specifically lists significant related party transactions as an opportunity relating to fraudulent financial reporting.

**What the Students Don't Know – Extended Procedures to Detect Fraud**

Again, the students don't know that the non-custodial father was including hobby expenses in his business expenses. They also don't know for a fact that his sister may be understating nonemployee compensation.

**What the Students Should Know – Extended Procedures to Detect Fraud**

SAS 99, "Consideration of Fraud in a Financial Statement Audit," addresses responses to risk factors for frauds. Extended procedures are additional auditing procedures that can be performed when financial statement fraud is suspected.

In this case, students should include analytical procedures (horizontal and vertical analyses) and expenditure analysis in their audit planning memorandum. Horizontal analysis will involve computing changes in financial statement numbers and ratios from year to year. In vertical analysis, students will calculate each expense category on the Schedule C as a percentage of sales. As discussed in the earlier sections on car and truck expenses and supplies expenses, the relationships between these expense categories and sales will not appear logical. This indicates a potential overstatement of expenses and fraud.

If the CPA can obtain monthly bank statements, he/she can perform an expenditure analysis. The non-custodial father's spending for all purposes can be compared with reported income. The amount by which spending exceeds reported income may be income not reported on the father's federal income tax return.

## STUDENT RESULTS

This case was administered to public university graduate students as one of nine required cases in five separate sections over five separate semesters. Student scores were generally based on the amount that their AGI differed from the correct AGI listed above. However, if misstatements of fact or case law were made, or if logic was specious or omitted, additional points were deducted. The most frequent error was the failure to reclassify income; those who reclassified income generally received a grade of A, although students who failed to reclassify income but disallowed most of the expenses could score well. Scores for this exercise were bell-shaped around a mid-B.

## THE COURT DECISION

In this particular case, the CPA was called as a witness to testify. The underlying documentation for return preparation was not supplied to the CPA (and is not required to be); only the gross amounts were provided. When confronted with the underlying documentation, the CPA that prepared the father's return testified that had he known the nature of the underlying documentation, he would have prepared the income tax return differently. On cross-examination, the father's CPA was questioned about different specific findings of the mother's expert witness, and concurred with the expert's findings. The child support awarded by the court (which had both preliminarily and in the final ruling deducted the same standard deduction and amount for one exemption) was nearly triple the preliminary amount based upon the income tax return as originally filed.

### SAMPLE EVALUATION RUBRIC FOR ACCOUNTING RESEARCH

| Task | Exceeds Expectations: Meet Expectations and… | Meets Expectations | Below Expectations |
|---|---|---|---|
| Gather Facts: | Evaluate the case for potential factual omissions or facts that may be indirectly related to t/p's case. Use judgment to arrive at estimates and weighted, relevant assumptions. | Identify all directly relevant facts provided in scenario and distinguish the (ir)relevance of information. | Miss a key relevant fact or misstate relevance of facts |
| Identify Issues: | Deduce potential issues for follow-up to determine possible future tax savings. | Recognize and describe all immediate, pertinent tax issues. | Miss one or more critical tax issues |
| Locate Relevant Authority: | Support primary sources with emerging tax trends, applications, pending tax legislation and/or tax cases. | List, summarize and explain relevant Code sections, regulations, rulings and case law. Classify findings by hierarchical importance. | Fail to identify one or more key authorities |
| Evaluate Authority: | Evaluate (defend and criticize) the strengths/weaknesses of the authorities as it applies to your application. | Interpret and correctly apply relevant authorities to your circumstance. Calculate effects of tax alternatives. | Mis-rank or misinterpret key authority |
| Conclude: | Anticipate limitations/circumstances that would necessitate revision of your plan/advice. | Choose and justify recommendations for your client (correctly) re: his/her situation. | Mis-advise and/or take an excessively risky tax position |
| Communicate: | List the citation and explain the application of law or mathematical solution and its limitations to a layman or colleague. Written/oral reports might include visual aids/hand outs and should be smooth and convincing. | Report conclusions in a form free of grammatical errors. The synthesis should be free of internal inconsistencies, and relate to the audience (be easy to follow). Provide references, and illustrations as appropriate. | Will have grammatical errors and/or contain internally inconsistent content. Advice not consistent with underlying documentation in conclusion, etc. above. |
| Notes: 1) This class requires the completion of case assignments (but no exams). The rubric is designed as a guideline to evaluating written/oral case assignments. 2) Not all rows may apply to a specific assignment. 3) Categories may not be equally weighted. | | | |

## OTHER BUSINESS APPLICATIONS

Copies of Federal income tax returns are often requested in a wide array of situations. Since a taxpayer signs the income tax return under penalties of perjury, students should begin to understand not only how to prepare a reasonably accurate timely and accurate income return, but also many of the possible implications to both the CPA and to the client of an improperly prepared return.

## LIMITATIONS AND CONCLUSIONS

Due generally to the ease of their availability, the use of income tax returns of self employed individuals to help determine the amount of child support obligations is rather commonplace. However, several limitations exist within the approach. For example, in the hands of an unskilled or an inexperienced income tax return preparer, it would be very easy to draw some erroneous, and costly, conclusions simply from accepting the income tax return as being valid on its face. A healthy level of professional skepticism should be injected into the process of reviewing the income tax return, along with a high degree of probing into all sections of the income tax return, including not only the amount and character of the gross income being reported, but also in regard to any and all expenses and deductions which appear to be unreasonable or in some other way misaligned with the underlying nature of the activities reported as being engaged in by the self employed individual. Given the correct set of circumstances, however, the use of such income tax returns can prove most beneficial to all parties. Not only can their use prove cost effective, additional benefits can be obtained through the process such as affirming or refuting the level of financial sophistication of the self employed individual , as well as even the credibility of the taxpayer.

## 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."*

*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.*

*The 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, 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.*

*This time both labor and management agreed to try a 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.*

## INSTRUCTOR'S NOTES

## CASE ISSUES AND SUBJECTS

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

## INTENDED COURSES AND LEVELS

This case study explores the subject of labor-management conflict and conflict resolution in a unionized organization. It is intended for class study application of concepts learned in the classroom. This case is intended for advanced undergraduate or graduate courses in Human Resources Management, Organizational Behavior, Industrial Organization, and Public Administration. It is designed to complement knowledge derived from concepts in labor-management conflict, collective bargaining, agreement negotiations, third-party intervention, and contract administration, with application to an actual setting. In other words, it seeks to provide an applied, hands-on format for students to increase their understanding of these topics. Answers to the questions in the case will derive from what students learned from theories and concepts.

## CASE OBJECTIVES

The core pedagogical objective of the case is to help provide an applied, hands-on format for students to increase their understanding of the topics of conflict and its resolution in unionized organizations. More specifically, at the completion of this case the student will be able to:

1. Understand the nature of conflicts in a unionized organization.
2. Understand and explain the collective bargaining process.

3. Compare/contrast how labor agreements are negotiated through traditional collective bargaining, interest based bargaining, and arbitration/mediation.
4. Identify the modes of conflict resolution.
5. Actively engage in conflict resolution through traditional methods, arbitration/mediation, and/or interest based bargaining.

## SUGGESTED CLASSROOM APPROACHES TO THE CASE

### 1. Introduction of the Case in the Class

It is recommended that the instructor introduce the script at least a week before the class discussions (duration from 30 minutes-one hour) and assign the questions derived from the case. Doing so ensures that the students have read and understood the issues of the case. While this case could be done on an individual basis, the authors found it most effective to create case study groups and request formal group answers to the case questions. If it is to be done in a group environment, please refer to groups' formation and report and presentation for more teaching instructions.

While there is no one single approach to addressing labor-management conflict and resolution, emphasizing student application of such constructs is extremely important to the learning process. Individually or as a five-member group, students will be asked to discuss and answer the case questions. A PowerPoint presentation and a written report of 2-3 pages should address the case questions.

Based on the authors' experience, requiring a formal response to the questions to help students enhance their written communication skills is a good approach. Please note that this formal write-up of the case requires the instructor to read and grade the students' work more critically. Because of the nature of this case study, it is suggested that the class be divided evenly into three groups of up to five students per group. The students will respond to the questions as a group. The final question (#5) will be answered by splitting the entire class into three groups representing: 1) Management, 2) Labor, and 3) Facilitators, Consultants, Mediators, or Arbitrators. Students will respond to the final question based on their respective position in the group role playing exercise.

Finally, instructors should have enough copies of the script with its instructions to distribute to students at least a week before the class discussions.

Answers to the questions in the case will derive from what students learned from the course concepts, text book and outside reading material. The case is expected to be completed and presented for class discussions.

### 2. Forming Groups

At least a week before the class discussions, students will be encouraged to network and get to know fellow students in order for them to decide with whom they want to team. Allow 10-15 minutes towards the end of the class meeting to submit group members' names. Initially, students need to form a group of up to five students to conduct this required study. Students will subsequently re-group and form three groups representing: 1) Management, 2) Labor, and 3) Facilitator, Consultant, Mediator, or Arbitrator.

**3. Process**

Each group will start working on this case after the instructor introduces the subjects of unions, the collective bargaining process, labor agreement negotiations, third-party intervention to conflict resolution, mediation, arbitration, interest based bargaining, the "Resolve" method, and contract administration. Students are expected to develop and build their responses (as a group) on their acquired knowledge. It is recommended that the instructor address and clarify case questions ahead of time with the class.

**4. Use of Power Point and Audiovisuals**

It is recommended that students be encouraged to create an effective group presentation. That could be achieved through the use of whatever audio-visual materials, including but not limited to power point. The case itself does not come with a video.

**5. Group Report and Presentation**

Each group is required to write at least a 2-3 page report (12 point font, double-spaced and using the APA writing style). One report is needed for each group. Each group is also required to prepare a 10-15 minute power point presentation explaining its answers. Students are required to use the chapters assigned for the course. To support their responses and enhance their report, students must include outside references such as books, journals, newspapers, internet information, or a direct interview as resources for the case answers (in case of an interview, they need to include the interview questions as an appendix of the report).

**6. Recommended Outline**

The structure of the written report is critical. In the first part of the case write-up, students should provide salient points of the case before proceeding to answering the case questions.
In the second part of the case write-up, students present their answers and recommendations. Instructors need to encourage them to be comprehensive in their answers, and make sure that answers are in line with the previous ones so that it fits together and moves logically from one to the next.

**7. Starting the Class Discussion**

Before engaging in a class case discussion and presentations, it is recommended to stress to the students that they might be disagreeing with the points that are being made by other students and that this disagreement is healthy and should not be taken personally. A reminder is helpful. This clarification and reminder ensures that the disagreements/discussions remain open and inviting and do not turn into personal matters.

**8. Analysis**

Since this case is an application of topics covered in the subjects of organizational unions, collective bargaining, contract negotiations, mediation, arbitration, interest based bargaining, the "Resolve" method, and related ethical considerations, students' understanding of these concepts will be essential.

**9. Content and Grading**

Students' answers and presentations should clearly and concisely demonstrate their knowledge and comprehension of the subject concepts learned in the class, as well as the individual or the group's ability to apply knowledge learned in class and through research (synthesize, analyze, and evaluate his/her/their work). Students will be graded based on the following criteria: (a) The use of innovative and creative ideas, (b) the application of concepts learned in the class, and (c) the use of outside research to support the case.

It is recommended that this case study constitute 5-10% of the student's participation grade.

## RESEARCH METHODOLOGY AND EXPERIENCE TEACHING WITH THE CASE

**1. Research Methodology**

This research is based on published secondary data and some interviews obtained by the authors from available sources related to the case.

**2. Experience Teaching with the Case**

One of the authors has used "The Metropolitan Transportation Authority: Interest Based Bargaining As an Alternative Approach to Collective Bargaining" case in a graduate course "Seminar in Organizations Theory and Behavior" and an undergraduate course "Organizational Behavior." The instructor applied the case after covering the course related subjects of organizational unions, collective bargaining, third party interventions, good faith bargaining, and ethics. It is important to point out that the case was very motivational and well received by the students.

## DISCUSSION QUESTIONS AND POSSIBLE ANSWERS

**NOTE:** The following answers provide only guidelines that are designed to assist in the case analysis process and engage students in critical thinking. These guidelines are not intended to be rigid. Therefore, each question is intended to raise issues that will be helpful in analyzing and resolving the case.

Students must be reminded that their answers to the case discussion questions should be well reasoned and supported with evidence/research when applicable. Although there is not one best answer to the discussion questions, some answers might be more appropriate than others. Accordingly, students should be told that simplistic answers to complex questions, situations, or problems such as in our case will never be "good" answers.

1. **What are the facts and major issues in the 2006 Los Angeles Metropolitan Transit Authority (MTA) case?**

The facts of the case are: In January 2006, the Metropolitan Transit Authority's (MTA's) Chairman of the Board, Mayor Antonio Villariagosa, was planning for a meeting with MTA's executive team regarding upcoming negotiations for the labor contract due to expire on June 30, 2006. Chairman Villariagosa was concerned about economic and social impacts to the region if labor and management at Metro could not come to an agreement short of a labor strike. He did not want to see a repeat of the 2003 strike and economic loss to MTA, its employees, Los Angeles County, and various levels of tax revenues. (See Exhibit 1)

| **EXHIBIT 1**<br>**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. | |

During the following weeks, MTA's Chief Negotiator John B. Catoe, Jr., worked with staff towards a goal of developing new and different approaches for the upcoming labor negotiations. Mr. Catoe and staff strived to develop an approach that would respond to the need to change the culture of past traditional labor negotiations at the agency. Based on the book, "Getting To Yes: Negotiating Agreement Without Giving In, by Roger Foster and William L. Ury, interest-based bargaining was recommended for the upcoming contract negotiations. " [1] Catoe and his team persuaded Villariagosa and MTA's CEO Roger Snoble to try this unique form of negotiation. MTA board members and union officials were very skeptical about this process, but agreed to give it a try. Gloria Molina, who served as MTA's first vice chair of the board said, "the goal of this approach is to reduce the level of hostility that typically pervades negotiations of this type". [2] ATU President Neil Silver stated, "I personally didn't think this would work". [3]

The negotiations process elicited issues and positions from each side of the bargaining table. The contract issues at stake in 2006 were as varied as the unions and management teams represented at MTA. Bus drivers and rail operators, who are members of the United Transportation Union (UTU), maintenance workers, who are members of the Amalgamated Transit Union, (ATU), and clerical workers, who are members of the Transportation Communications Union (TCU) delineated a number of issues that they wanted in the contract. These issues evolved around wages, break times, cost of living allowances, and health care. They were ultimately delineated in the form of "interests," rather than demands, which included: cost of living adjustments, maintenance of quality of life, and improved grievance procedures. MTA's issues pertained to less absenteeism from employees, profitability, and customer satisfaction. These positions were described as the following "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, and support an "interest-based" approach. [4]

**2. Using any of the unions involved in the MTA case as examples, discuss what you believe are the appropriate roles of unions in society today and why.**

The three unions involved in the MTA case were the United Transportation Union (UTU), representing 4,800 bus drivers and rail operators, the Amalgamated Transit Union (ATU), representing 2,000 maintenance workers, and the Transportation Communications Union representing 700 clerical workers. [5]

In the instant case, the members of the ATU, Local 1277, Los Angeles, representing mechanics and maintenance clerks, proposed a list of 27 changes to the labor contract, including a significant pay increase for all worker classifications. [6] This demand exemplifies the fact that one of the primary reasons for organized labor is to give employees more influence in workplace decisions. Wage increases are at the heart of every union member's agenda; and support for unions stems from their ability to promote issues such as pay raises and health and retirement benefits for workers. Employees in today's workforce feel that management is unwilling to work closely with them, and that unions benefit employees to close the gap between management and labor. In some cases in today's society, support for unions is usually a direct result of personal or family member experiences from working for unionized or nonunion employers. [7]

In considering the history of labor strikes at MTA and the adversarial relationship between the unions and management, the 2003 labor strike is a good example of the role of unions today. Union members believed that management did not want to work with the employees and union members regarding health care benefits and wage increases. This ultimately led to a 35 day strike, which was finally resolved through binding non-binding arbitration. [8]

During the 2006 negotiations, MTA management responded to labor's demands by presenting spreadsheets analyzing industry and MTA financial data. Through interest based negotiating, the union's bargaining team was able to understand the financial picture of MTA and management was able to consider labor's interests in view of the budget. [9] This negotiating process put labor and management in a position to negotiate the contract from a perspective of what was best for all entities involved, rather than from a traditional perspective of "us against them." This case exemplifies the need for unions in today's society, not only as employee representatives, but to help management understand the day to day needs of its workforce.

**3. Using the MTA facts and issues described in our case, give a brief history of the contract negotiation process used at MTA in the past and the contract negotiation status in January, 2006. Discuss the pros and cons of traditional collective bargaining negotiations and arbitration methods used at Metro.**

MTA had a history of difficult labor negotiations, resulting in labor strikes by one or more of its unions. The extended strike in 2003 cost the region nearly $175 million, not to mention the non-monetary "cost" to over 400,000 commuters dependent on public transportation to get to work, school, medical facilities, and other daily needs. Historically, MTA relied on traditional collective bargaining during its contract negotiations. In 2003, MTA and the unions reached out and tried a novel type of mediation known as binding non-binding arbitration, which ultimately ended the strike. [10]

Collective bargaining, used for years at MTA, is a mechanism for organized groups of workers and their employers to resolve conflicting interests and to pursue agreement over common interests. [11] It includes negotiation between organized workers and their employers to determine issues such as wages, hours, rules, and working conditions.[12] In the MTA case, the contract negotiation process implemented in prior years led to strikes on behalf of the organized workers. One of the issues at stake in 2003 pertained to health benefits for active and retired mechanics. The bargaining units and management could not come to a contractual agreement, resulting in a thirty-five day transit strike. [13] Ultimately the health care issues were determined via arbitration. The type of arbitration used in 2003 is defined as binding-nonbinding arbitration and requires that two parties submit their proposals to an arbitration process. A decision is rendered, but different from traditional binding arbitration, either side can reject it by a supermajority vote. This alternative type of arbitration proved to be a successful means to end the 2003 strike stalemate pertaining to health care benefits. [14]

All labor negotiations include what is referred to as bargaining units. A bargaining unit includes the workers or jobs covered by a collective bargaining agreement. [15] For example, in the MTA case, bargaining units included the ATU, representing maintenance workers, the UTU, representing drivers and rail operators, and the TCU, representing clerical workers. In 2003, the ATU's bargaining unit was concerned with the health benefits for mechanics. [16] The binding-nonbinding arbitration method involved the creation of a panel of arbitrators; one from ATU, one from MTA, and one neutral. The neutral party unsuccessfully attempted to mediate a settlement. Since this didn't work, formal hearings were held, with each side submitting briefs. The panel then issued a decision, and either party had the option of rejecting the decision by a 2/3 vote of their boards. Since neither party rejected the decision, the decision became part of the contract, extending to 2006. [17] Since this method of arbitration resulted in an end to the labor strike, it would seem to be a positive type of contract negotiation.

- In collective bargaining, the key participants (or parties) involved are:
-

1. Management. This term refers to individuals or groups responsible for promoting the goals of their organizations and their employers,
2. Labor. This term refers to both employees and their respective unions that represent them.
3. Government: This is the local, state, and the federal political processes. It also refers to governmental agencies responsible for passing and enforcing public policies relating to negotiations and the government as a representative of the public interests. [18]

Past contract negotiations, described above, gave the management team a window into the challenges faced in the traditional approach to labor relations. Management didn't want to go down this road again and wanted to avoid a costly strike. The management-labor relationship was considered to be adversarial, with only difficult negotiations ahead.

That being said, examples of the "cons" of traditional labor negotiations include a "win/lose" approach that is tedious, lengthy and exhibits a lot of posturing. [19] (Refer to Exhibit 2). Since its creation in 1993, MTA weathered labor strikes in 1994, 2000 and 2003, disrupting service to transit riders, after traditional bargaining came to a contract resolution standstill.[20]

Traditional bargaining usually involves labor seeking a bigger slice of the pie and management offering the same or smaller slice of the pie.[21]

However, in the instant case, both sides were well aware that traditional bargaining could result in the dreaded strike, and decided to try a more open communication method of negotiation. In January, 2006, in view of the historical adversarial management-labor relationship, the MTA management team and the union members did not want a repeat of the 2003 failed collective bargaining process that resulted in a 35 day strike. All parties were very much aware of the fact that the 2003 strike ended only after a mediation plan via arbitration was put into place regarding the key issue of health benefits for active and retired mechanics. [22] With this in mind, MTA began to assemble a team to lead interest-based negotiations and chose Chief Executive Officer for Operations, James B. Catoe, Jr. to lead the MTA negotiating team. [23]

**4. What is Interest-Based Bargaining? Distinguish between an "interest" and a "position" through analysis of one labor or management "interest" in the MTA case. Explain the RESOLVE method, if needed.**

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. [24] (Exhibit 2 provides a summary of traditional vs. interest-based bargaining). It is based on relationships and requires trust among the parties. Interest based bargaining is an approach to contract bargaining when both sides indicate at the outset what issues are most important to them in the new agreement. [25]

**EXHIBIT 2 Contrasts Between Traditional Labor Relations AND "RESOLVE" Labor Relations**

| Traditional Approach Tends to Result in: | "RESOLVE" Approach Tends to Result in: |
|---|---|
| Large numbers 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:<br>Loud/visible posturing between groups<br>Name calling<br>Energy spent on justifying positions<br>Upset employees, managers, customers and elected officials. | Collaborative relations lead to:<br>Recognition and focus on common goals<br>Sense of team among all participants<br>Feeling of good will and appreciation among employees and managers that carries over to customers/officials.<br>Mutual sense of accomplishment. |
| Source: The table was used with permission granted by Rhonda Hilyer of Agreement Dynamics, Inc. | |

In order to form a trustworthy management team, MTA formed a negotiation team comprised of respected operations managers who worked collaboratively throughout the entire process. This team did its homework and analyzed industry and economic data including inflation rates, consumer price index, local costs of living, and the actual cost of a strike. This team worked closely with the board of directors to develop the following agency 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. [26]

The team focused on the fact that interests are needs, concerns, and key priorities, and are not demands, unilateral positions, and forced outcomes. [27] It is noteworthy that the management team pledged to the unions to adhere to a lengthy set of behaviors no matter what happened, and kept this commitment. Some of the behaviors included: show respect at all times, communicate openly and publicly, use accurate information and data, listen, comprehend . . . then speak. [28]

In the instant case, management's interest #2 - improve employee and labor relations - would seem to be readily achievable based on its commitment to engage in respectful behaviors at all times during the negotiation process. If management showed genuine respect for the union representatives at all times, the logical result could only be "improved employee relations!" This act, in and of itself, would improve employee-labor relations, as positive interaction during the negotiations funneled back to the employees. During discussions of diverse interests, maintaining this type of commitment could be very challenging, yet rewarding, if upheld. The fact that management was 100% honest during the negotiation process led to formation of a trusting relationship between the MTA and union negotiators. [29]

In contrast, a "position" held by management in the past could have been, "freeze cost of living adjustments." This unilateral position would definitely put both parties in an adversarial posture before any negotiations even began. While management may have been looking at the bottom line budget concerns, employees would see management as the "enemy," not concerned with them as individuals. A "position" is also referred to as a "demand" in collective bargaining terminology. In the instant case, the ATU put forth a list of demands including "Increase Bereavement time to 5 days in State and 10 days out of State." [30] This position was addressed during the interest based negotiations by analyzing it from a cost perspective as well as considering the underlying interests of the employees. In summary, in interest based bargaining, the parties seek ways to improve the pie for all by addressing "interests." [31]

The RESOLVE approach is a highly successful approach to interest-based bargaining, developed by Rhonda Hilyer, founder of Agreement Dynamics. RESOLVE shifts the parties, labor and management, for example, from imposing their respective positions to interest-based or problem solving negotiations. Implementation of the RESOLVE method requires training of all parties involved in the process in order for true joint problem solving to exist. RESOLVE is explained as:

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 participant's interests to be.

5. Let them clarify any misunderstandings about their interests and you do the same about yours.
6. Vacuum 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. [32]

Early in 2006, MTA's newly formed management negotiation team enlisted labor, management, and board members to participate in RESOLVE training prior to initiation of contract negotiations. This training paved the way for the parties to incorporate their stated interests into the bargaining process, rather than initiate the process through the traditional position based bargaining negotiations.

**5. It is now April 2006, and labor and management are preparing to negotiate a new MTA contract. It is your responsibility to negotiate a new contract. The interests/positions of both labor and management are included in the case study materials. Be sure to explain the method or methods your group used. (traditional collective bargaining, arbitration/mediation, interest based negotiations/"Resolve"approach.) Answer the following question, based on your group assignment.**

**a) If you are a member of the labor group, what are your interests/positions? Discuss and analyze the negotiation process. Provide an example of terms of the proposed or final contract.**

Two of the labor unions at MTA involved in contract negotiations were the ATU and the UTU. These unions include bus drivers, service attendants, maintenance workers, and mechanics, who enjoy their work providing a necessary service to the citizens of Los Angeles and the surrounding areas. In early 2006, one of the concerns of the service attendants, represented by ATU, was the system of pay/promotion. There were two wage tiers of service attendants with no movement between the two tiers in place.[33] They wanted management to provide a means for service attendants to move to a higher tier.

A large percentage of the members of the unions were employees in 2003 during the MTA strike and were hoping for a contract resolution without having to go on strike. Based on the advice of ATU President Neil Silver, an agreement was reached to engage in interest based negotiations, with the hope of coming to a contract agreement all parties could live with.

In January 2006, prior to any formal contract negotiations, the ATU union members discussed a number of issues that should be included in the contract renewal terms. These issues/positions were discussed from the perspective that if labor didn't get what it was asking for; the only option would be to strike. This posturing was the only way labor knew how to "negotiate" via the collective bargaining process. [34] As in traditional collective bargaining, the proposals to the new contract were provided to MTA, and several are listed below:

- wage tiers of service attendants
- significant pay increase for all classifications
- increase the number of days for casual vacation days
- increase retirees' pension
- cost of living adjustments [35]

Based on the battled history between labor and management at MTA, the union leaders bravely imposed interest based bargaining as a workable alternative. The thinking seemed to be that the labor groups were ready for something new and different. Before any negotiations began, labor and management members of the bargaining teams received interest based bargaining training. This training helped the labor leaders to identify "interests" rather than "positions". [36] This training included learning and applying the RESOLVE method. [37] At first, this training was very uncomfortable since it requires an open and trusting environment between all parties. However, after several months of negotiation and placing 100% trust in management, the labor representatives put forward three interests that were included in the final contract. These interests were a result of discussing and negotiating each of 27 proposals submitted to management with a complete understanding of the cost analysis presented by MTA. The three interests were: Cost of living adjustments, maintenance of quality of life, and improved grievance procedures. [38]

As mentioned above, an example of one of the terms of the final contract pertains to the ATU service attendants' issue with two-wage tiers and no possible movement from the lower tier to the higher tier. This issue was converted to the following interest based solution, included in the 2006 contract: "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 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. They continue the progression after one year of no attendance policy violations." [39]

The interest based solution was achieved during the negotiations when management's interest in reducing the rate of absenteeism among service attendants was weighed against labor's desire to be able to promote to a higher wage tier. The interests of each side were considered and a workable resolution was reached.

**b) If you are a member of the management group, what are your interests/positions? Discuss and analyze the negotiation process. Provide an example of terms of the proposed or final contract.**

The members of the management team, an operations-focused management bargaining group, put together by John B. Catoe, Jr., Chief Negotiator, brought in a management consultant, Gayland Moffat, almost a year before the labor contracts expired.

These dynamic leaders formed a team of key operations managers from MTA, with little or no prior labor negotiations experience. The team met almost daily and worked collaboratively throughout the process. One of the hired consultants was very helpful in identifying stakeholders, interests, and positions. In preparation for the contract negotiations, the team collected and analyzed industry data which helped develop a comprehensive economic picture including inflation rates, consumer price index, local cost of living as well as actual cost of a strike. [40]

Prior to entering the negotiation process, the team received training in the RESOLVE method of interest based bargaining. This training helped all of the team members understand and develop interests rather than unilateral positions. [41] The management team went the extra step in the negotiations process to give the union officials advance notice on issues that were likely to be raised with the board or potential operations changes that might be considered.

Unheard of in traditional negotiation proceedings, the management team pointed out information that was advantageous to the union's arguments. Such openness built trust and both ATU and UTU accepted management's analysis of financial data. [42]

The positive results of the RESOLVE training are exemplified in a negotiation procedure involving rest/breaks for UTU operators. Wage Order #9, a legal requirement under California law mandated that operators receive 2 ten-minute rest periods and a 30-minute meal break. The UTU wanted to make sure that their members got these breaks and wanted to ensure that the Union was protected in any legal proceedings regarding the wage order. Management also wanted compliance with the wage order, but at the lowest possible cost. This issue was converted to the following interest based solution, included in the final contract:

"The EOL [end of line] and other schedule recovery times will now 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 will require adjusting running and recovery times in the runs." [43]

Obviously, interest based bargaining and the RESOLVE method allowed management to move forward and finalize a contract without encountering a labor strike. Management was able to develop and finalize the following interests through the negotiation process:

- 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 [44]

**c If you are a member of the consultant/arbitrator/facilitator group, explain your role in the 2006 contract negotiations. Discuss what transacted prior to and during the negotiations process. Describe what techniques contributed to the success, or in the alternative, the inability to finalize a contract. Provide examples of the terms of the final or proposed contract.**

The facilitator group looked at MTA's strike history and engaged in interest based bargaining to negotiate the 2006 contract between labor and management. Because interest based bargaining was a new concept to both labor and management at MTA, Rhonda Hilyer of Agreement Dynamics, Inc., was hired to provide training and act as facilitator at the ATU and UTU negotiation sessions. This training included the newest theories in collaboration, conflict resolution, and team building. One of the methods used to build trust between the unions and management was something as simple as eating lunch together, which helped formed a bond between the two groups. [45] The facilitator worked separately with the parties and helped them to utilize interests as opposed to positions or demands. For example, the ATU Service Attendants wanted to be able to move from a lower wage tier to a higher wage tier, and were frustrated with the inability to do so. Management did not have a system in place for this to occur. However, management had an interest in lowering the incidence of absenteeism of service attendants. The Union had an interest in providing a way for the service attendants to move to the higher wage tier. To facilitate a resolution of this issue, for example, the parties engaged in the "RESOLVE" method (explained in answer #4 above). The goal of RESOLVE is to obtain voluntary agreement between groups by dealing directly with their differences, which include values, interests, styles, and perceptions. Individuals know that differences lead to disagreement, which can be interpreted as threats, leading to conflict. RESOLVE goes beyond this conflict with the goal of attaining mutual trust, respect, and understanding. Once implemented, RESOLVE training allowed the parties to set a very positive tone at the negotiation table. [46] There were times, however, during the three month negotiation process, when discussions became very heated and argumentative. Ms. Hilyer was able to calm things down and keep negotiators on task by holding up cards with expressions such as, "Don't personalize this," and "No shouting."[47]

The RESOLVE method was successful in leading to the interest based solution in relation to the ATU Service Attendants wage tier issue. The 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. They continue the progression after one year of no attendance policy violation."[48]

The facilitator was able to show management and labor how to put the "interests" of each side on the table and engage in joint problem solving, rather than focusing on demands that lead to conflict. As evidenced in the ATU example, the service attendants were given an opportunity to advance to a higher wage tier, so long as they complied with attendance criteria. Management's interest in lowering absentee rates of service attendants became a viable possibility now that movement between the wage tiers was based on attendance records. This also helped morale of the service attendants, and saved the MTA money in the long run by preventing high turn-over and the associated training costs. [49] This is a win-win situation!

Through implementation of interest based negotiation, a labor agreement was successfully facilitated between MTA and the unions. This is a welcome change from the past history of strikes at the MTA. The terms of the contract include the "interests" articulated by labor and management in sections a and b, answered above.

## EPILOGUE

On June 26, 2006, The Mayor of the City of Los Angeles, Antonio Villaraigosa, announced that the Metropolitan Transportation Authority entered into a three-year tentative agreement with its bus drivers and mechanics, ensuring that mass transit in Los Angeles County would continue uninterrupted by labor strife. That was the first time in nearly a decade that MTA labor negotiations ended without a bus strike. [50]

Flanked by union officials at a news conference outside MTA headquarters in downtown Los Angeles, Villaraigosa said "the buses will continue to roll and the trains will keep on running without interruptions". [51] James A. Williams, general chairman of the United Transportation Union commented by saying "we reached a good agreement…my members are going to like it". [52]

According to Neil Silver, Amalgamated Transit Union President, "I figured it wouldn't work and I didn't really want to partake in a time-wasting event." Later, it did work and this is the result. I'm very happy." [53]

While the MTA relied on a team of inexperienced negotiators in 2006 negotiations, John B. Catoe Jr., put aside his regular duties as Metro's deputy chief executive officer to negotiate the contracts full time. [54] In his own words, "We listened. We didn't challenge them on issues that we didn't understand…It didn't mean we agreed, but we respected each other." [55]

## ENDNOTES

1. This information was provided based on an interview on July 30, 2010 with John Catoe, Jr., MTA's Chief Negotiator, 2006, currently President and CEO, The Catoe Group.
2. For more information, refer to "Statement by Los Angeles County Supervisor Gloria Molina on the Tentative Labor Negotiation Agreement Reached Between the MTA and the UTU/ATU/TCC" by Roxane Marquez, June 27, 2006. This article and its related information were retrieved on January 17, 2010 from: http://molina.lacounty.gov/pages/Press/2006%20Press/06%2026%202006%20Molina%20Approves%20LA%20County%20Budget.htm. Para. 5. Also refer to: Transit deal reached for L.A. Marathon by Susannah Rosenblatt, Los Angeles Times (February 16, 2007). This article and its related information were retrieved on January 17, 2010 from: http://articles.latimes.com/2007/feb/16/local/me-marathon16.
3. For more information, refer to "Mayor Villaraigosa and Union Leaders Announce Tentative Agreement on Transit Labor Contracts" by Marc Littman, Metro Media Relations, June 27, 2006. This article and its related information were retrieved on January 15, 2010 from: http://www.metro.net/news_info/2006/metro112.htm. Para. 10.
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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

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## 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.*

## KEYWORDS:

Finance: capital budgeting, net present value (NPV), internal rate of return (IRR), payback period, economic multiplier, downsizing, sustainability, risk.

Ethical: social responsibility, rights, justice, utility, values, labor relations, stakeholder.

## INSTRUCTOR'S NOTES

**Objective**: To have students address a capital budgeting decision that has ethical, social responsibility and sustainability issues. The case is intended to allow students to consider that a financial decision may have greater consequences to stakeholders other than common shareholders. Financial number crunching is an important part of business decision making, but not the only part.

**Materials**: provided: case document, spreadsheet, not provided: simulation software such as (@Risk™, Crystal Ball™ or EXCEL's simulation utility.

As the objectives suggest, there are both traditional capital budgeting (sometimes called capex for capital expenditure) issues and issues relating to what a firm may owe to the community that relies upon it.

The project has been constructed so that the NPV is modest but positive, as presented. A monte carlo simulation could produce a probability of a negative NPV under certain circumstance. Even without the simulation, students might argue or be lead to argue that expected cash flows in case3s are seldom considered really uncertain or that the calculated NPV should be questioned.

The discussion then may move on to "other considerations". Does a firm that has a large "foot print" in a community, have any social obligations? This sort of question has been raised before in finance cases, but appears to have fallen by the way over time. Emphasis on ethics and sustainability in the academic and business worlds suggests cases should revisit the discussions.

The authors suggest starting with the question, should the owners care about what happens in the town?

**Other suggested questions to begin discussion**:

1. What benefits would be derived from accepting the purchase of the new machine?
2. What is the IRR and NPV of the project as presented in the spreadsheet?
3. What risks are associated with accepting the purchase?
4. What costs does the standard analysis NOT consider?
5. Will the relationships at the company location change with the purchase?

## 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?**

Students may note the following points:

- The local manager may understand the risks and costs better.
- The local manager may have a better sense if there will be labor unrest.
- The local manager may have a sense if there will be training problems.

**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?**

- Stockholders:
  - Stockholders will have an increase in their stock price.
  - Stockholders may have an increase in their stock price.

- Dan, the manager:
  - Dan will have a more efficient operation to run.
  - Dan will have the prestige of having investment at his location.
  - Dan will have additional knowledge of leading technology in his field.
  - Dan may get a bonus if this project runs well.

- Joe and Sophie:
  - Joe will get a raise in pay.

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

- Stockholders:
  - Stockholders may have a decrease in their stock price if there is labor unrest and customers are bothered by the change.
  - Some stockholders may feel that the company is not being socially responsible (if they know about the situation.)

- Dan, the manager:
  - Dan will have to live in a location where he has laid off many people, which in turn, affected local businesses, etc.
  - Dan may have low morale issues with workers.

- Joe and Sophie:
  - They will lose Sophie's income.
  - Their children may have to change their plans for going to college, at least for now.
  - Hard feelings within the community may develop over competition for any other local jobs that Sophie might compete for, say working in the local grocery store.
  - There may be a breakdown in some of the local organizations, such as the band.

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

Students often note the value of the NPV is positive and that supports the financial manager's objective of increasing owner wealth.

Students may note that the NPV number is uncertain and so the outcome could easily be negative rather than the expected value. This may be supported by students' @Risk analysis if it is used.

Students may note that the single decision about NPV does not take into account the impact on all stakeholders and the company may be injuring the area with the decision.

Students may note that the calculations do not take into account the impact of unemployment costs (to which other students may note that the company paid insurance premiums to cover unemployment should it occur.)

Students may note that competition of the firm probably will take advantage of new technology or move to locations where labor costs are very low and so it is a case of "change or die" so Dan is actually saving those still employed.

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

Students may be given a handout or some instructions for this. The key points of an executive summary is to (1) begin by stating the recommendation, (2) note top variables that impact more on the decision, (3) note key risk sources that could have a major impact on the success of the project, and (4) state again the recommendation. All of this should be done in 1 to 2 pages.

Additional Considerations that could be brought into the case:

a) Unemployment insurance premiums (taxes) should rise for the firm if people are terminated. Typically this sort of cost is never considered in a capex project. While the federal tax rate level is 6.2% of the wage base ($7000 per employee), states may have different levels and the employer receives credit at the federal level for state taxes. An employer laying off or firing employees will likely accrue higher unemployment taxes in the future (experience rating adjustment). This increase in tax will obviously be less than the savings from the workers' wages and benefits but does present an offset. See Federal Unemployment Tax Act (FUTA) and state regulations.
b) IF there are multiple sections of the course, one section could be given just the spreadsheet, without any "people" considerations, while the other section is given the whole case. After each section has arrived at some decision, a comparison could be made and discussed to see if knowing the non-quantitative information impacts on decision making.
c) In the past, some employee groups have had a strike to try and change management's decision. In that case, surely the company will lose money. At what point the strike will wipe out the benefit of the change might be discussed.
d) Consider if the firm were employee-owned (ESOP) and if there is a different set of considerations. Should the remaining employees be hurt by having to retain other employees replaced by the new machine?
e) The setting is rural. Would we need to be as concerned in an urban setting with more potential employers? What factors come into that discussion (skill sets, benefits lost or gained, etc.)?
f) Labor relations are not directly mentioned but could be brought into the discussion. Since the case uses a manufacturing facility in the northeastern U.S. in a traditionally unionized industry, it is possible to have some measure of the impact of a strike or slowdown if the union decided to fight the layoffs, should they occur.

Related Suggested Activities:

a) Students can find ads, photos, etc. of individuals that they think look like the characters in the case and these photos can be posted during class discussion. This might provide more of a human face to the project.
b) Students may develop some role playing. For example, they can have interviews for a fictional local paper about the layoffs and interview various characters as to their position. A student could play a union leader or ask a student from a labor relations class to come in to act the part.
c) Students may be asked to discuss on-line the pros and cons or present "letters to the editor".
d) Cognitive dissonance predicts that a person who is required to produce support for a position that they do not believe in is much most likely to change their opinion to meet the stance they had to support. This can open discussion into whether some business culture subtly changes people to be other than they would be naturally. Students could be required to support a position in a speech or "interview".
e) Students could list the 2 most important values to themselves personally and evaluate the decision based on only those values. Examples of values would be: family stability, money, loyalty, love, not being bored, etc.

# 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

*The State of North Carolina joined 34 other States and outlawed smoking inside restaurants and bars. Jim Foster had owned and operated, the Selwyn Pub, for 17 years. He wondered if there was a proactive way that he could use the ban to his benefit. He had a large outdoor seating area and the ban did not restrict smoking in outdoor spaces. He had considered improving the outdoor area for several years; however, he was concerned that the return would not justify the investment. His plan for the patio included fireplaces, fire pits, auxiliary heaters, comfortable furniture, an aluminum awning, and several large flat screen televisions. From prior experience he knew that given the harsh treatment furniture received in a bar that he would need to replace the heaters, TVs and furniture within five years. Given the investment risk Jim wanted to have the costs returned within one year. Further, he was concerned that even if the investment made economic sense, was he being socially responsible by improving the smoking area and making it more comfortable for smokers. The law was intended to discourage smoking and protect patrons and workers from second hand smoke. By improving in the outside area would he be subverting the spirit of the law even if he is not violating the letter of the law?*

## INSTRUCTORS NOTES
## LEARNING OBJECTIVES AND INTENDED AUDIENCE

This case is designed for undergraduate marketing students studying new product decisions, social responsibility, and marketing ethics. The case works well in Principles of Marketing and Marketing Management.

The learning objectives for the case include:

1. The student will be able to develop a payback analysis in a situation of uncertain fixed costs and revenue to determine the viability of the investment.
2. The student will be able to determine a course of action based upon a financial risk analysis.
3. The student will be able to evaluate the ethical issues involved in potentially violating the spirit of a law while complying with the letter of the law.

## THEORY APPLICATION

Discussion Questions 1 and 2 require the student to develop a payback analysis for this investment. Many small businesses are managed from a cash flow sheet and payback is a typical decision criteria. However, as any small business owner will attest, determining investment cost is an inexact science, and cost overruns, unexpected delays, and unforeseen challenges typically occur. Further, the forecast of revenue is typically even more inexact. Therefore, it is often best to have students make several calculations using different assumptions. In question 1 the student is challenged to develop a matrix of outcomes and then through judgment determine a course of action.

Discussion Question 3 examines Foster's dilemma within the framework of Nash's 12 questions. There are other frameworks that the instructor may wish to use including Cooper's Active Process and The SAD Formula. Nash's is used here because it provides an excellent way to direct the students' attention to issues.

## RESEARCH METHODS

The data for this case was collected from interviews with Jim Foster the owner operator of the Selwyn Pub, observation at the pub, and the public record concerning the smoking ban in restaurants and bars in North Carolina. No information was disguised. Jim Foster is one of the authors of this case.

## QUESTIONS AND ANSWERS

**1. Using the data provided complete a one year payback analysis based upon the range of fixed costs and projected revenue. Make both an optimistic and pessimistic assumptions in your calculations. Would your answer change if you used a five year payback?**

The question requires that the student complete a matrix of outcomes. There is a range of possible investments (fixed costs) from $71,800 to $93,000. These can be looked at as best and worst case estimates. The revenue picture is more difficult. If we believe that Jim is correct with his estimate of increased profit of from 10%-25%, then Table 1 provides the range of outcomes and likelihood of payback in one year.

| Table 1<br>Investment/Revenue Matrix<br>One Year Payback | | |
|---|---|---|
| | **Revenue** | |
| Investment | 10% | 25% |
| $71,800 | $(15,850) | $68,075 |
| $93,000 | $(37,050) | $46,875 |

Given the above analysis, it can be seen that in the most optimistic scenario, Jim increases his profit by $68,075. However, in the most pessimistic assumption he would lose ($37,000). It is clear from the analysis that the results are most sensitive to the revenue projections. A slight change in the revenue outcome can have a significant effect on the profitability of the investment.

Some students may be tempted to suggest that since the one year pay back point occurs in only the most optimistic revenue assumptions, that this is not a good investment. However, since the expected life of the upgrades is five years, it is important for the student to ask whether Jim's objective is realistic. If the numbers are taken to the full five years, then the result would be significantly different. See Table 2.

| Table 2<br>Investment/Revenue Matrix<br>Five Year Payback | | |
|---|---|---|
| | **Revenue** | |
| **Investment** | 10% | 25% |
| $71,800 | $207,950 | $627,575 |
| $93,000 | $186,750 | $606,375 |

Using a five year time line, the projected life of the upgrades, even under the most pessimistic scenario, the investment is highly profitable. It is important to ask students if the risk profile changes on the five year time line and what Jim should be concerned with when using this longer time line.

**2. Choose a course of action based upon your analysis. What risks are you accepting and which are you eliminating and why?**

If only one year is considered in the analysis, then only under the best scenario will the revenue justify the investment. Students may then choose to reject the investment. However, if the five year return is considered, then the return under any scenario is sufficient to justify the expense. The decision depends upon the willingness of the student to accept risk. This should lead to a discussion of the risks of making or not making the investment. A few of the possible risks include:

- Risks if the investment is made:
  1. The project will not make money because the revenue is insufficient or inaccurate.
  2. Current outdoor business of non smokers will suffer because of the increasing number of smokers using the outdoor facility.
  3. Legislators will include outdoor areas in the no smoking ban in the future.
  4. The changes in the outdoor area will change the look and feel of the Pub and current customers will go elsewhere.

- Risks if the investment is not made:
  1. Opportunity costs from lost potential revenue.
  2. Smokers will drink elsewhere or at home where they can smoke and drink comfortably.
  3. Other pubs with outdoor areas will upgrade leaving the Pub as a second choice location.

**3. Complete Nash's 12 questions concerning the ethics of Jim's decision.**

There are many ethical constructs that an instructor may choose to use in class. Nash's 12 questions are used here to provide a foundation for discussion. There is no one right answer to these questions, but asking them provides the instructor with an opportunity to understand the thinking of the students and for the students to hear the thinking of their classmates.

1. **Have you defined the problem accurately?**
   - Is the issue payback on the investment or potential harm to the customers and employees? Is the issue the letter of the law, or the spirit of the law? Defining the problem is critical to framing a position.
2. **How would you define the problem if you stood on the other side of the fence?**
   - It is worth looking at the various stakeholders here; smoking customers, non smoking customers, employees, politicians, and members of anti-smoking groups. The decision might be very different from each stakeholder's position.
3. **How did this situation occur in the first place?**
   - Since Jim estimates that a significant number of his customers smoke, the situation arises because these customers want to be able to smoke when they drink. The legislature has decided that the threat of second hand smoke is high enough to warrant a ban on smoking in indoor bars and restaurants. Research supports the danger.
4. **To whom and what do you give your loyalties as a person and as a member of the corporation or as a member of society?**
   - This question has been expanded to include a member of society. The answer requires the student to look at the tradeoff between profit and public health. It asks, whose responsibility is it to look out for public health. A good argument

can be made that smoking is a choice and patronizing a business that permits smoking outdoors is also a choice.

5. **What is our intention in making the decision?**
    - Jim's intention is to make a profit. But he also feels a responsibility to provide an enjoyable environment to his long term customers who smoke.
6. **How does the intention compare with the likely results?**
    - The numbers appear to support the investment. It would also be in concert with serving the needs of his smoking patrons. However, it may not be in concert with his beliefs about smoking.
7. **Whom could your decision or action injure?**
    - Employees, non smoking customers, smoking customers who do not have a suitable place to eat and drink where they can smoke.
8. **Can you engage the affected parties in a discussion of the problem before you make your decision?**
    - Yes. Jim could poll employees and survey current customers.
9. **Are you confident that your position will be as valid over a long period of time as it seems now?**
    - It is not clear what the legislature might do in the future concerning outdoor eating and drinking spaces. Further, there is little or no research data on the effect of second hand smoke in outdoor places. Each of these could affect the decision long term.
10. **Could you disclose without qualm your decision or action to your boss, your CEO, the board of directors, your family, or society as a whole?**
    - An interesting question since Jim does not smoke and his mother died of a smoking related disease.
11. **What is the symbolic potential of your action if understood? If misunderstood?**
    - The decision to go ahead could suggest that Jim is in favor of smoking and actively supports it. Further, it could signal that he will ignore the spirit of a law while adhering to the letter of the law.
12. **Under what conditions would you allow exceptions to your stand?**
    - If it was shown that there is little or no hazard to second hand smoke outdoors. If the profitability was shown to be nonexistent even in a five year scenario. If it appeared that the NC legislature was planning on adding outdoor facilities to their ban.

**4. What decision should Jim make given the financial and the ethical issues?**

There is no right answer. The important issue here is that students must evaluate both the financial and ethical issues. Students choosing the one year financial decision will have an easier time deciding on the ethics since there appears to be a good chance that the investment will not be returned in the first year. However, when confronted with the possibility of gaining up to $627,000 if the five year optimistic outcome occurs, then the ethical decision may be more difficult. The instructor is urged to focus on the five year financial outcome since it is likely to create the highest level of discomfort for the student and the liveliest debate. Further, the instructor can end the discussion with the question, “Should ethics be profit dependent, or regardless of the possible rewards, should doing the right thing most important.”

## EPILOGUE

Jim decided to make the investment in the outdoor area. Results exceeded his expectations. Not only did he see a 25% increase in outdoor revenue, but the percentage of tips to total bill (an unobtrusive measure of customer satisfaction), increased by 1% from 18% to 19%.. As for his ethical dilemma, Jim did not receive any complaints from customers regarding second hand smoke, and in fact many customers were pleased that they could find a pleasant place where they could have a beer with a friend that smoked. Further, many non smoking patrons now went inside since they no longer had to contend with second hand smoke inside the pub.

## 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.

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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.*

## INSTRUCTOR'S NOTES
## RECOMMENDATIONS FOR TEACHING APPROACHES

This case is based on an actual company, Gaming Partners International Corporation, from information included in its 2007 10k report. However, facts regarding the company and its transactions have been altered in the case in order to hide the identity of the company and also to serve the educational purposes of the case. The learning objectives are to help the students learn to:

1. Identify current accounting-related problems faced by businesses, including those related to financial accounting, tax issues, and auditing issues.
2. Effectively utilize professional accounting literature, including online databases, to solve problems in all areas of accounting
3. Demonstrate an understanding of the interrelationships of accounting subjects (financial, tax, audit) in real world applications
4. Demonstrate competency in oral and written communications

This case is suitable for use in an Auditing course, an Intermediate Accounting course, a Corporate Income Tax course, or an accounting Capstone course. It has been used by the author for two semesters in an undergraduate Accounting capstone course. As such, the students worked in teams and each team was required to address all five issues presented in the case. The students turned in the written paper and also presented their results in class. In one of the classes, the student presentations were evaluated by a team of practicing accountants from both public accounting and the private sector. Feedback on the case from the practitioners was positive. Instructors wishing to reduce the required time for the course can assign one issue to each student team and have the teams present their conclusions to the class for discussion. Alternatively, the case could be used in a tax course with only the tax aspects of the issues addressed, or in an advanced financial accounting course with only the financial reporting aspect of the issues addressed.

This case forces the students to research professional literature and formulate recommendations on both financial reporting and tax treatment of various issues for an audit client. The approach to assigning the case will depend on how much prior experience the students have had in using tax and financial accounting databases. If students have not yet had experience researching tax issues or have not yet utilized the new FASB Accounting Standards Codification, then a minimum of 30 minutes of class time should be spent up front showing the students how to access the databases and giving them tips for how to research issues in the databases. Access to the codification for academic purposes is being provided to colleges and universities through the American Accounting Association. Any database or printed resources that include the United States tax code and regulations will be sufficient for the tax research. If students do not have access to tax references through the campus library, the tax code can be accessed free from various websites, including the Cornell University Law School at http://www4.law.cornell.edu/uscode/26/.

## SUGGESTED ISSUES FOR RESEARCH AND DISCUSSION

**Issue 1**: What is the proper financial reporting and tax treatment for the contract for exclusive rights to use chip security technology? A total of $150,000 was paid for the rights, which run through 2019.

**Issue 2**: What is the proper financial reporting and tax treatment for the prior year depreciation understatements?

**Issue 3**: What is the proper financial reporting treatment for the lease of the Mexican manufacturing facilities and the lease of the apartment? What disclosures are required?

**Issue 4**: What is the correct financial reporting treatment of the lawsuit? What are the rules regarding the tax deductibility of the legal expenses?

**Issue 5**: What is the proper accounting for the $45,000 gain from the forward currency contract? What is the tax treatment for the $45,000 gain?

## SUGGESTED SOLUTIONS FOR RESEARCH ISSUES

**Issue 1**: What is the proper financial reporting and tax treatment for the contract for exclusive rights to use chip security technology? A total of $150,000 was paid for the rights, which run through 2019.

**Financial Reporting Conclusion**: The contract would be recorded as an intangible asset and amortized over the life of the contract.

The exclusive rights contract would fit under the FASB Codification's definition of an intangible asset (ASC Section 350-10). Therefore, the $150,000 should be recorded as an asset on the balance sheet. Because the contract has a definite useful life, ASC 350-30-35-1 states that the cost should be amortized. Per ASC 350-30-35-2, amortization should be done over the period of time that the asset is expected to contribute to the company's cash flows, which in this case would be the contract's useful life. The straightline method is acceptable, unless there is a better way to identify a pattern of use of the benefits of the contract (ASC 350-30-35-6), which in this case there is not. Therefore, the cost of the contract should be amortized on a straight-line basis over the life of the lease. Because technology changes rapidly, GSI may need to write off the cost before the expiration of the agreement term if it feels the asset's value is impaired, which could occur if the technology becomes obsolete (ASC 350-30-35-1 and 360-10).

In the year of acquisition, the company must disclose the amount assigned to the asset, the residual value (which in this case is zero), and the amortization period (Section 350-30-50). In subsequent years, GSI must disclose the gross carrying amount of the asset and the accumulated amortization, the aggregate amortization expense for the period, and an estimate of the aggregate amortization expense for each of the following five years (Section 350-50-2). Per Section 210-10-S50-7 and Regulation S-X Rule 5-02.17 paragraph 210-10-S99-1, each class of intangible asset should be shown separately on the balance sheet or in the notes to the financial statements if it represents greater than five percent of the total asset balance.

**Tax Conclusion**: The contract is depreciated under IRC Section 167 over the life of the contract. It is not considered a Section 197 intangible asset for tax purposes.

IRC Section 197 identifies several types of assets that would be considered as Section 197 intangibles, including "any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item"(IRC Section 197(d)(1)(C)(iii) and supplier based intangibles (IRC

Section 197(d)(1)(C)( v)), either of which initially appears to fit the description of GSI's exclusivity contract. Per Reg. 1.197-2(b)(7), a supplier-based intangible is "the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer. This section specifically lists favorable supply contracts as an example. GSI's exclusivity contract fits this definition. According to Reg. 1.197-2(c)(6), "section 197 intangibles do not include any right to receive tangible property or services under a contract or from a governmental unit if the right is not acquired as part of a purchase of a trade or business." GSI purchased this asset separately, not in conjunction with the purchase of a trade or business, so if the contract is considered to be a supplier-based intangible, it would appear to not be a Section 197 asset. There is also an exception for contract rights under Section 197. Reg. 1.197-2(c)(13) describes an exception for rights under contracts when the right is acquired in the ordinary course of business, is not an asset described in IRC Section 197(2)(1)(A), (B), (E), or (F), is not a customer-based intangible, and has a fixed duration of less than 15 years. The GSI contract rights fall under this exception, so even if considered as "rights", the contract is not a section 197 intangible.

Per IRC 167(a), a depreciation deduction can be taken for assets used in a trade or business or held for the production of income. Reg §1.167(a)-3 indicates that GSI's contract can be depreciated over the life of the contract. IRC Section 167(f)(2) states that if a depreciation deduction is allowable under IRC section 167(a) with respect to any property described in IRC Section 197(2)(4) subparagraph (B), (C), or (D), the deduction can be computed in accordance with regulations. Both supplier-based intangibles and "rights" are described under subparagraph (C). Reg. 1.167(a)-3(a) states that "if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation." Since the GSI contract has a definite limited life, depreciation can be taken under IRC 167. The default useful life is 15 years, but the life of the contract can be used since it is a known useful life. Depreciation should be on a straight-line basis. (Reg. 1.167(a)-14(c))

**Issue 2**: What is the proper financial reporting and tax treatment for the prior year depreciation understatements?

**Financial Reporting Conclusion**: If the cumulative effect of the errors would be material to the 2009 financial statements, using the methodology described in Staff Accounting Bulletin 108, but the amounts were immaterial in prior years, as the case indicates, then the correction of the error has been properly reported by GSI as a prior period adjustment. Adjusting for the error in current year earnings or ignoring the previously immaterial amounts would materially misstate the current year's financial statements, so it must be corrected as a prior period adjustment. If it is immaterial to both the prior years and the current year, then no correction is necessary. Although a restatement of beginning balances is made, the actual prior period statements do not need to be re-issued because the amounts were immaterial in those years.

According to ASC 250-10-45-23, an error in prior period financial statements that is discovered after their issuance should be reported as a correction of an error. This is done by restating the affected financial statements from the prior periods. "Restatement requires all of the following:

a. The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error. (ASC 250-10-45-23)"

Error corrections should not flow through the current year's net income (ASC 250-10-45-1).

Per ASC 250-10-50-7, "When financial statements are restated to correct an error, the entity shall disclose that its previously issued financial statements have been restated, along with a description of the nature of the error. The entity also shall disclose both of the following:

a. The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented

b. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented."

The effect on the net income of prior years should be disclosed in the annual report for the current year as well as in the interim reports issued during the year (ASC 250-10-50-8).

Further guidance is found in Staff Accounting Bulletin 108 (see also ASC 250-10-S99). The statement (page 4) indicates that the impact of correcting misstatements must be quantified, taking into account the carryover and reversing effects of prior year misstatements and their effect on the current year statements. If the cumulative impact on the current year is material, taking into account both quantitative and qualitative factors, then the prior year financial statements should be corrected, even though the amounts were deemed immaterial in those years. When the error amounts were immaterial in prior years, as in GSI's case, the previously filed reports do not need to be reissued. SAB 108 states that the correction can be made with the next filing. The cumulative effect of the prior period adjustment should be reflected in the carrying amounts of affected assets and liabilities as of the beginning of that year, with a corresponding adjustment to retained earnings. The nature and amount of the errors should be disclosed. The company should also disclose when and how each error arose and the fact that the errors were previously considered immaterial.

**Tax Conclusion**: GSI cannot take a "catch up" depreciation deduction, but could potentially amend its returns for the prior years.

Per Reg § 1.167(a)-10, taxpayers should deduct the proper amount of depreciation allowable each year and cannot increase the depreciation deduction in later years if they fail to deduct the proper amount in prior years. Therefore, the only way for GSI to get a deduction for the depreciation would be to amend its returns within the timeline allowed under IRC section

6522(1), which is within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever is later.

**Issue 3**: What is the proper financial reporting treatment for the lease of the Mexican manufacturing facilities and the lease of the apartment? What disclosures are required?

**Financial Reporting Conclusion**: GSI should report the leases as operating leases and expense rent expense on a straightline basis, rather than on an as-paid basis. Related party disclosures must be made.

GSI's current treatment is not appropriate under GAAP. Per ASC 840-20-25-1 and 840-20-25-2, the rental payments on the leases should be expensed on a straight-line basis, incorporating the scheduled increases in the rent amount. Normally, rent is expensed as it is payable, but when there are scheduled increases in rent payments, the straight-line method should be used unless "another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used (ASC 840-20-25-1)." Since the rent increase is not based on increased usage of the property, the straight line method should be used. GSI should take the total cost of the five year contract, divide it by 60 months, and expense an equal amount each month. No rent expense should be recognized for the optional additional space that could be rented, until such time as GSI agrees to rent that additional space (ASC 840-20-25-4).

Additionally, certain disclosures need to be made. Per ASC 840-20-50-1, since the lease is for more than one year, GSI will need to disclose the following:

a. the total minimum future rental payments required to be paid for the five years following the balance sheet date.

b. any rentals to be received by GSI under sublease agreements (there are none at this time)

c. rental expense for each income statement period presented, with amounts disclosed separately for minimum required payments, contingent rental payments, and sublease payments.

d. a description of the lease arrangements, including a description of how any contingent rent payments are calculated, a description of any renewal or escalation clauses and any purchase options included in the contract, and identification of any covenants included in the contract that would restrict GSI's dividends or other financial arrangements.

Additionally, because the other party to the contract is a family member of a management employee, related party considerations apply. The ASC includes in its definition of related parties a company's principal owners and the company's' management, as well as members of the immediate families of the principal owners and management (ASC Section 850 and master glossary). Therefore, both of these leases would qualify as related party transactions. Per ASC 840-10-25-26, the accounting for related party leases should be the same as that for leases with unrelated parties, unless the terms of the contract are "significantly affected" by the relationship between the two parties. If the terms are "significantly affected", then the accounting treatment should be modified to present the economic substance of the transaction. There is no indication that GSI's lease terms are significantly affected by the fact that the lease is with a related party, although no information is available regarding the true market value rental of either property.

Per ASC 850-10-50-1, disclosures should include:

1. the nature of the relationship between the parties
2. A description of the transaction and any information necessary to enable financial statement users to understand the impact of the transaction on the financial statements
3 The amount of the transaction for each income statement period presented
4. Any amount due to the lessor as of the date of each balance sheet presented
5. All information required by Section 740-10-50-17, related to income taxes.

**Issue 4**: What is the correct financial reporting treatment of the lawsuit? What are the rules regarding the tax deductibility of the legal expenses?

**Financial Reporting Conclusion**: GSI must disclose the nature of the contingency and include a statement that an estimate of loss cannot be made at this time.

Per ASC 450-20-50-3, when an accrual for a loss contingency cannot be made because either it has not been determined to be probable or the amount cannot be reasonably estimated, then disclosure must be made if there is "at least a reasonable possibility" that a loss has been incurred. Since GSI's attorneys do not have enough information to allow for the contingency to be recorded, but do feel that a loss is reasonably possible, disclosure of the potential loss must be made. The disclosure must include a description of the nature of the contingency and either an estimate of the range of loss or a statement that an estimate cannot be made at this time (ASC 450-20-50-4).

**Tax Conclusion**: Internal Revenue Code § 162 allows deductions for any ordinary and necessary expense incurred in normal business operations. Expenses for legal counsel and defense satisfy both of these requirements, so the $100,000 of legal fees can be deducted by GSI.
Issue 5: What is the proper accounting for the $45,000 gain from the forward currency contract? What is the tax treatment for the $45,000 gain?

**Financial Reporting Conclusion**: GSI did not designate its contract as a hedging contract. Therefore, according to ASC 815-20-35-1a and 815-10-35-2, the gain should be recognized in current earnings. This treatment is specified for these types of contracts when they are not specifically designated as hedging instruments.

**Tax Conclusion**: The gain is treated as ordinary income for 2009.

For tax purposes, treatment of the gain is addressed in IRC Section 988. IRC Section 988 (c)(1)(B)(iii) identifies "entering into or acquiring any forward contract, futures contract, option, or similar financial instrument" as one of three transaction types that may qualify for a section 988 transaction. According to IRC Section 988 (c)(1)(A), to qualify as a section 988 transaction, the contract must be either stated in terms of a "nonfunctional" currency or the amount must be determined using a nonfunctional currency. For GSI, the contract amount will be determined based on the Euro, which for GSI is a nonfunctional currency. Per IRC Section 988(a)(1)(A), gain from a section 988 transaction should be treated as ordinary income. However, there is an exception allowable for forward contracts, which may have allowed GSI to elect capital gain treatment (IRC 988(a)(1)(B). However, the election would have had to be made by the end of the day that the transaction occurred. There is no indication that GSI made such an election and, therefore, the gain will be treated as ordinary income.

## REFERENCES

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