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RADIO NIGERIA ENUGU NATIONAL STATION

Christiana Akpunonu, Baze University
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RADIO NIGERIA ENUGU NATIONAL STATION

CASE OVERVIEW

This case invites students to play the role of Ms. Christiana Akpunonu, a Nigerian who worked for more than 30 years at Radio Nigeria and, at the time of this case, had the role of deputy director in charge of news, marketing, and programs for Radio Nigeria's Enugu National Station. At one time, Radio Nigeria had a monopoly on broadcast industry in Nigeria; however, in August 1992, private sector individuals and corporate bodies were allowed to establish radio stations in Nigeria. Almost immediately, competition emerged not only in Lagos but also in all major markets in Nigeria, including Enugu, the former administrative capital of the eastern region of Nigeria. In response to the newly emerging competition, Radio Nigeria stations all across the country (including Enugu) found themselves having to compete, for the first time, for audience and market share. At this time, the executive director in charge of Radio Nigeria's Enugu National Station called Akpunonu to his office and charged her with developing a strategy to be executed within the next four months, so as to protect the audience and market share of Radio Nigeria's Enugu National Station. The challenge to Radio Nigeria stations all across the country (including the Enugu National Station) was made more severe by the fact that some of the newly emerging private radio stations were far better equipped than the Radio Nigeria National Stations and that it appeared that all of the radio stations (including the new ones) were competing for exactly the same radio audience.

CASE SYNOPSIS

Ms. Christiana Akpunonu, Deputy Director in charge of news, marketing and programs at Radio Nigeria's Enugu National Station, has been charged by her Executive Director to develop a strategy to ensure that the Enugu National Station manages to compete successfully for audience and market share against new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria.

Additional data and information in the case include:

- 1) For Nigeria, the Nigerian environment, and the Nigerian economy: Historical background plus selected statistics.
- 2) For the broadcast industry in Nigeria: Historical background plus selected data and statistics.
- 3) For the Enugu National Station of Radio Nigeria: Historical background plus selected data and statistics.

4) *For Eastern Nigeria (that is, the markets served by the Enugu National Station of Radio Nigeria): Background information on the region, the inhabitants, and some of the characteristic attitudes and behaviors of those inhabitants.*

THE SITUATION

Sensing that her meeting with the Executive Director of Radio Nigeria's Enugu National Station was ending, Ms. Christiana Akpunonu, Deputy Director in charge of news, marketing, and programs at the Enugu National Station of Radio Nigeria, gathered up her notes. Although she might, later on, need specific information from those notes, Akpunonu knew she would have no trouble remembering the challenge the Executive Director had given her, that is, to identify (within the next 120 days) a strategy to retain and grow Enugu National Station's audience and market share, against the new private-sector broadcasters who have popped up in response to the August 1992 deregulation of the broadcast industry in Nigeria. Because she knew that some of the new private radio stations were better funded and better equipped, Akpunonu believed that developing a winning strategy would be a serious challenge.

ADDITIONAL INFORMATION (1): THE COUNTRY

The Federal Republic of Nigeria is a large (one tenth the landmass of the United States) country in West Africa. Administratively, Nigeria is composed of 36 states plus the Federal Capital Territory (FCT). These states differ in many ways, one of which is that the terrain ranges from beaches and swamps in the south to desert conditions in the north. Levels of education and income tend to be higher in the south than in the north. The dominant religion in the north is Islam while the south is predominantly Christian. Hausa is the dominant ethnic group in the north; in the east, the dominant group is the Igbo, while the west is predominantly Yoruba. A small set of statistics on Nigeria, together with comparative data for the United States, are as indicated below:

| | NIGERIA | USA |
|-------------------------------|--|--|
| Size (square kilometers): | 923,768 | 9,826,675 |
| Population: | 170 million | 314 million |
| Major Ethnic Groups: | Hausa/Fulani 29% Yoruba 21% Igbo 18% | White 80% Hispanic 15% includes white+black |
| Number of Different Languages | officially, 250; unofficially, up to 500 | major languages include English, Spanish, and French |
| Religions: | Muslim 50% Christians 40% All Others 10% | Christian 78% Jewish 2% All Others 20% |
| Median Age: | 19.2 | 36.9 |
| Life Expectancy at Birth: | 52 years | 78.5 years |

| | | |
|--|----------------|--------------------|
| Fertility Rate (births per woman): | 5.38 | 2.06 |
| Infant Mortality Rate: | 74/1000 | 6/1000 |
| School Life Expectancy: | nine years | 16 year |
| % Of Population Who Are Literate: | 68% | 99% |
| GDP (purchasing power parity, or PPP): | \$414 billion | \$15.04 trillion |
| GDP per capita (PPP): | \$2600 | \$48,100 |
| % of Population Below Poverty Line: | 70% | 15% |
| Unemployment Rate: | 21% | 9% |
| Electricity Consumption: | 18 billion KWH | 3.741 trillion KWH |
| % Of Population In Urban Areas: | 50% | 82% |
| % of Population Internet users | 26% | 78% |
| Kilometers of Roads | 193,000 | 6,506,204 |
| % Of Roads Paved: | 15% | 67% |

Source: CIA World Factbook 2013

ADDITIONAL INFORMATION (2): HISTORICAL OVERVIEW OF THE ECONOMY

Historically, Nigeria produced large amounts of agricultural products including (in the North) groundnuts and (in the south) palm oil. In the early 1950s, however, oil was discovered in Nigeria and slowly but steadily, Nigeria became an oil monoculture. By the late 1970s, oil selling at \$40 per barrel was generating large amounts of money for Nigeria. At this time, the Federal Government of Nigeria (FGN) made huge investments in roads, bridges, and buildings for the public sector (administrative buildings, housing estates, apartments, etc.). The FGN also invested huge amounts of money in a large number of “showcase projects,” including steel mills, paper plants, expensive hotels, and a new federal capital city called Abuja. Many people moved to the oil areas, the project areas, and/or the large cities, hoping to find jobs in the oil sector, work on the private/public projects financed by petrodollars, and so on.

As a consequence of the large inflows of cash and the changing opportunities available in Nigeria, agriculture and agricultural production were badly neglected. By the early 1980s, agricultural exports had nearly disappeared, and Nigeria no longer produced enough food to feed itself. The shortfall in food production was made up by importing large amounts of food, including both traditional staples and alternative foodstuffs such as wheat.

In the early 1980s, the price of oil collapsed; over the next 10 years, the price was in the range of \$10-\$20 per barrel. The annual impact of this price collapse depended on the level of production; however, it is probably correct to say that during this period, each decrease of one dollar in the price of a barrel of oil reduced Nigeria's export earnings by at least \$700 million per

year. Over the decade of the 1980s, the total revenue loss for Nigeria from oil price decreases undoubtedly exceeded \$70 billion.

It took years for the impact on the Nigerian economy of the drying up of the oil revenues to fully manifest itself. The first economic consequences, caused by the shortage of foreign exchange, were the scaling back of the importation of big-ticket consumer items (for example, new cars). Subsequently, manufacturing activity relying exclusively on imported equipment, raw materials, and/or supplies began to suffer. For companies in these industries, the cost of imported equipment, spare parts, raw materials, and supplies increased sharply, as large amounts of local currency chased an ever shrinking pool of hard currencies including dollars. The increased cost of overseas materials led many industries to substitute local materials for imported ones (for example, brewers of beer substituted locally-grown sorghum for imported malt). Companies not able to find local substitutes increased prices, downsized their operations, or dropped out of business entirely.

The drying up of oil revenues had additional negative effects on the quality of life and economic activity in Nigeria. Over time, basic services like roads, electricity, water supply, and telecommunications began to deteriorate. By the late 1980s, neither industrial nor residential customers relied exclusively on public service providers for electricity or water. Instead, both groups had invested vast amounts of money in back-up generators (electricity) and private boreholes (water). In addition, because Nigeria's hardwire phone equipment barely functioned due to severe overloads and lack of maintenance, numerous business persons invested large amounts of money first in dedicated radio/microwave links and later, cellular telephone equipment. The need to make such investments increased the cost of doing business in Nigeria, and dramatically reduced the international competitiveness of Nigerian products and industry.

Another effect of the tremendous decrease in oil revenues was a very substantial increase in corruption. Due to the revenue decreases, federal, state, and local governments in Nigeria were unable to pay public sector employees. As prices of goods and services containing imported materials increased (most products sold in Nigeria are either manufactured overseas or include overseas components and/or materials), and as public-sector salaries fell or went unpaid, civil service and public sector employees searched for alternative sources of funds to maintain their standards of living. Ultimately, many public-sector employees started demanding bribes before they would act on requests for service by individual and/or corporate customers. By the late 1980s, Nigeria (and especially its international airport in Lagos, Murtala Muhammed Airport) had acquired the reputation of being both lawless and corrupt.

For most of the decade of the 1980s and much of the decade of the 1990s as well, Nigeria was a military dictatorship. While military dictatorships tend to be harsh, it must be said that from 1993 until the middle of 1998 the military dictatorship led by General Sani Abacha was particularly harsh and oppressive. During these years, the country of Nigeria became quite isolated internationally, as more and more countries backed away from Abacha and his regime.

In June 1998, General Abacha died of a heart attack. In an extraordinary chain of events, Nigeria moved quite rapidly from being an outcast country under a military dictatorship to a democracy. In the first presidential elections, held in 1999, former general (and, under Abacha,

prisoner) Olusegun Obasanjo, running on a platform which promised to tackle corruption and other major problems faced by Nigeria, was elected president. While Obasanjo's efforts to address the country's problems and move Nigeria forward met with limited success, Obasanjo was reelected to a second term in 2003. In 2007, however, when Obasanjo attempted to change Nigeria's constitution so as to be allowed to contest for a third term, the Nigerian Senate refused to support that change. Subsequently, Obasanjo stepped down and was replaced, as president of Nigeria, by Yar' Adua, a former governor of the northern Nigerian state of Katsina.

For several years, Yar' Adua had been plagued by rumors of ill-health. The rumors were accurate: It turned out that he suffered from a kidney condition. Shortly before the presidential election (21 April 2007), Yar' Adua flew to Germany for medical treatment; on 23 November 2009, he flew to Saudi Arabia for additional medical treatment. Yar' Adua did not return to Nigeria from Saudi Arabia until 24 February 2010; at that time there was speculation that he was being kept alive using life support equipment. Yar' Adua died on 5 May 2010 and (according to Islamic rites) was buried on 6 May 2010; that same day, Vice President Goodluck Ebele Jonathan was appointed President of Nigeria. In 2011, President Jonathan campaigned for re-election and in April 2011 he was (with 59% of the votes) re-elected President of Nigeria.

As indicated above, since the last days of the decade of the 1990s, military dictatorship has been replaced by democratic governance. Along with the move to democracy, there was a move in Nigeria toward privatization and a more market-oriented approach to managing the economy. During the decade starting in 2000, there were some huge private sector success stories in Nigeria; one of these was the telecoms industry and especially the rise of MTN, a provider of cell phone services in much of sub-Saharan Africa including Nigeria. In January 2001, MTN purchased its first GSM license in Nigeria; at that time the company had a subscriber base of zero. By the end of 2008, however, MTN had a customer base in Nigeria of more than 20,000,000 subscribers; that base has now expanded to more than 100 million customers. Nigerians have been very eager to purchase cell phones and use cell phone service; companies such as Cadbury Nigeria, Nestlé Nigeria, and Unilever Nigeria (that is, companies which sell foods, beverages, and personal care items including soap and laundry detergent) have discovered that individuals with very low levels of disposable income (70% of all Nigerians are in this category) are very likely to reduce their purchases of foods, beverages, and personal care items, so as to be able to afford to purchase air time for their cell phones.

There is at least one additional economic development which must be mentioned. After Nigeria moved to democratic governance in 1999, and continuing until up through 2008, the average price of a barrel of oil increased most years, as indicated below:

| YEAR | AVERAGE PRICE OF A BARREL OF OIL |
|------|----------------------------------|
| 2000 | \$27.39 |
| 2001 | \$23.00 |
| 2002 | \$22.81 |
| 2003 | \$27.69 |
| 2004 | \$37.66 |

| | |
|------|---------|
| 2005 | \$50.04 |
| 2006 | \$58.30 |
| 2007 | \$64.20 |
| 2008 | \$91.48 |
| 2009 | \$53.48 |
| 2010 | \$71.21 |
| 2011 | \$87.04 |
| 2012 | \$86.46 |

Source: InflationData.com

Because Nigeria had been producing (prior to the worsening of an insurgency in the Niger Delta) somewhere in the range of 2 million barrels of oil per day, an increase in the price of a barrel of oil has had (and continues to have) a huge positive impact on the revenues of the Federal Government of Nigeria. The good news in the above figures is that for years Nigeria has benefited from a steady increase in the value of each barrel of oil produced. While the lower average oil prices starting in 2009 had massive negative implications not just for the Federal Government of Nigeria and its budgets but for the country and its people as well, the other good news for Nigeria in the data shown above is that the average price of a barrel of oil is now (that is, today) quite close to the all-time high annual average of \$91.48 in 2008.

ADDITIONAL INFORMATION (3): EASTERN NIGERIA AND ITS PEOPLES

In 1914, the British combined two protectorates (the Protectorate of Northern Nigeria and the Oil Rivers Protectorate) to create the colony (now country) called Nigeria. By the time of independence (01 October, 1960) Nigeria had been divided into three administrative regions: Eastern Nigeria, Western Nigeria, and Northern Nigeria.

Regarding the geography and topography of the area once known as “Eastern Nigeria”: While Eastern Nigeria makes up a relatively small portion of the total land area of Nigeria, the vegetation and topography is quite varied. The southernmost tip of Eastern Nigeria merges with the ocean; as one moves north, there is a 10-40 mile area of low-lying mangrove swamps and tidal waters. As one moves further north, the next 100 miles is dominated by tropical rain forest; after that, in the northern-most part of the region, there are grasslands. In the eastern part of Eastern Nigeria there is a range of hills that run to the foothills of Cameroon; in this area, elevations can be as high as 5000 feet.

Regarding the current political and administrative characteristics of Nigeria: The three administrative regions in place at independence (Northern Nigeria, Western Nigeria, and Eastern Nigeria) have now been divided up into 36 states plus a Federal Capital Territory. The area once known as “Eastern Nigeria” has been divided into the following ten states: Abia, Akwa Ibom, Anambra, Bayelsa, Benue, Cross River, Ebonyi, Enugu, Imo, and Rivers.

Regarding the peoples of the area once known as “Eastern Nigeria”: While there are a very large number of tribes in the ten states of Nigeria formed from what used to be known as “Eastern Nigeria,” the dominant ethnic group in this region is the Igbo. The Igbo dwell primarily in urban areas, especially the cities of Enugu (formerly, the capital of the Eastern Nigeria), Owerri, Onitsha (a political and commercial center), and Aba (also commercially vibrant). Other major tribes in the region include the Ibibios, Efiks, and the Ijaws. People in all of these tribes (the Igbo as well as the others listed above) have the reputation of being exceptionally enterprising, hard-working, and resourceful.

Regarding broadcast-related attitudes, behaviors, and preferences, Ms. Akpunonu had (at the time she was given the assignment by the Executive Director) very little information available to her. Items she did have available to her included the sort of information shown in Exhibit #1 and Exhibit #2, that is, (in Exhibit #1) information on some characteristic attitudes and behaviors of Nigerians in general and (in Exhibit #2) information on some characteristic attitudes and behaviors of Igbos in particular.

ADDITIONAL INFORMATION (4) THE BROADCAST INDUSTRY IN NIGERIA

Radio broadcasting in Nigeria dates back to December 1932 when the British Broadcasting Corporation (BBC) set up (under the Department of Posts & Telegraphs) an experimental radio transmission of the Empire service from Daventsy, in the UK. The main feature of this system (called the Radio Diffusion System, or RDS) was to receive (in Nigeria) the overseas service of the BBC and to rebroadcast that service to loudspeakers in Nigeria. By 1935, the RDS system had spread from Lagos Island to Ikoyi, Ebute-Metta and Apapa (that is, several surrounding areas) with a total of about 500 loudspeakers at various official residences and offices.

In 1939, the public relations office of the RDS (it later became the Federal Information Department) began providing RDS with small amounts of indigenous programming generated in Nigeria. After the second world war, the RDS saw a period of expansion; from the 1940s to the mid-1950s, rediffusion became the principal form of broadcasting in Nigeria. During that period, services were extended not only to Lagos but also to several other large cities and towns.

Recognizing the strong role radio communication would play in economic, political, and colonial development, Britain set up a commission “to determine broadcasting needs and report on methods of development and whether the existing facility should be incorporated in any proposed new scheme.” From the recommendation of this commission of inquiry, the colonial government decided to convert the RDS scheme into a full-fledged system of national and regional broadcasts. In response to a request from the colonial government, the BBC provided two experts to help train Nigerians: Mr. T.W. Chalmers (in charge of programming) and Mr. John W. Murray (in charge of technical services). The charge to these two expatriates was: “to integrate the existing and expanding network of wire broadcasting stations and build a broadcasting system which would enable people in any part of the country to hear news, entertainment, and talks.” Messrs. Chalmers and Murray began staff recruitment and training

immediately; the result was the formation (on April 1, 1951) of the Nigerian Broadcasting Service (NBS). At this time, the NBS embarked on development of a regional/national system; according to Mackay (1964) “the emphasis was on regional consciousness, development, responsibility and the . . . Nigerian broadcasting service would have to satisfy these aspirations without losing sight of the main purpose and vision in the basic idea of “One Nigeria.”

As the NBS evolved, it began to be perceived (in the eyes of the public) as a tool of the federal government which (in its operations) tended to disadvantage the regions. On August 23 1954, the late Alhaji DS Adegbienro introduced a motion in the Nigerian parliament “to set up a corporation to take over the activities of the NBS, in order to address criticism by the press that the NBS is an organ of the Nigerian government.” On April 1, 1957, under Act 39 of 1956, the NBS was reconstituted as the Nigerian Broadcasting Corporation (NBC). The same day, Mr. JAC Knott (OBE), Director General of the newly founded NBC, in a talk on Radio Nigeria, indicated that “one of the most important aspects of the NBC is that it has no politics of its own. This political impartiality stems directly from the nature of its Constitution which does not serve any private interest and is not directly controlled by the government of the day. The NBC is under an obligation to give its listeners news that is objective and without political bias and to ensure that over the whole range of its programs, political comment is fair and balanced. In addition, the ordinance lays specifies that the NBC must be free from commercial advertisement or interest . . .”

The division of the country into regions determined NBC's initial structure, in the sense that programs for the different regions reflected the particular culture, characteristics, and needs of the area served. By 1961 the broadcasting facilities up and running in the federal and regional capitals included a short and a medium wave station in Lagos, a short and a medium wave station in Enugu, a short and a medium wave station in Ibadan, and a medium wave station in Kano. As indicated earlier, Nigeria now consists of 36 states plus a Federal Capital Territory (FCT); as these states were created, NBC established stations in each of them. This brought about an increase in the number of Nigerian languages used on NBC's national programs.

On June 1, 1978, the NBC was abolished and replaced by an organization called the Federal Radio Corporation of Nigeria (FRCN). The decree establishing FRCN centralized radio broadcast and restructured the industry; part of the change involved NBC handing over all state-level radio services it controlled to the state governments. The idea underlying this change was that states should now run their local radio services in their own Nigerian languages but that FRCN headquarters would provide (in English) a national educational service plus (also in English) national bulletins covering newsworthy events in Nigeria. This structure, known as “grassroots broadcasting,” has (from a national perspective) three tiers:

- 1) The nationwide network station at Radio House Garki, Abuja.
- 2) Four zonal broadcasting centers (Enugu, Ibadan, Lagos, and Kaduna); these centers have operational autonomy for their linguistic groups.
- 3) State broadcasting centers which broadcast to their local areas and produce some programs to feed their zonal centers.

In 1992, government partially commercialized FRCN. At this time, Radio Nigeria (a huge monopoly) suddenly found itself facing fierce and ruthless competition from the new private stations. These new private stations aggressively moved to poach well-trained staff from Radio Nigeria, offering them more money and better prospects for the future. At the new private stations, aggressive and more competent salesmen trolled the market for advertising and the related revenues. FRCN radio stations around Nigeria lost millions of listeners as new radio stations with very conducive and highly motivating work environments used state of the art equipment to provide very clear FM signals. Furthermore, listeners continued to perceive Radio Nigeria as a clearly biased voice of the Federal Government. As a result of these factors, closure of FRCN stations, retrenchment of FRCN staff, and downsizing of FRCN operations became rampant. While Radio Nigeria's Enugu National Station had not yet been downsized and staff at the Enugu National Station had not yet been retrenched, the danger that such steps could soon be taken seemed very real.

ADDITIONAL INFORMATION (5): STRATEGY OF RADIO NIGERIA'S ENUGU NATIONAL STATION AT THE TIME THE EXECUTIVE DIRECTOR REQUESTED MS. AKPUNONU TO IDENTIFY (WITHIN THE NEXT 120 DAYS) A STRATEGY TO RETAIN AND GROW ENUGU NATIONAL STATION'S AUDIENCE AND MARKET SHARE

At the time the Executive Director made his request, the strategy of Radio Nigeria's Enugu National Station was as indicated below:

Target market

The primary groups targeted for programming by the Enugu National Station included: Men, women, children, young people, and farmers.

Products Delivered To The Targeted Audiences

Information regarding the products (that is, the programming) delivered by the Enugu National Station to the target markets listed above at the time the Executive Director made his request:

- 1) The day-to-day programme schedule of the Radio Nigeria National Station included educational, informational, and entertainment-based programs. Because the Radio Nigeria National Station did very little audience research, management did not know much about the needs, motives, and/or attitudes of any of the targeted audiences listed above. Given the dearth of knowledge about the attitudes, preferences, and/or behaviors of the targeted audiences, management's approach was to broadcast to each audience what management believed they needed. It was also true that management presumed that all the audiences uncritically consumed any and all broadcast information broadcast to them. Management did occasionally receive feedback from listeners; however, management made no attempts to systematically collect information on the attitudes, preferences, and/or behaviors of members of the audiences targeted by the Enugu National Station.

- 2) While audience participation programs could have provided the Enugu National Station with insights on the radio-related behaviors, attitudes, interests, and opinions of listeners, such programs were rare. Sports commentaries originating from an outside venue (for example, “live” commentaries on a football match and/or a cultural festival) did not take place often. When such programs did take place, they were sometimes simulated.
- 3) On programmes featuring music, indigenous local music tended to account for about 80% while imported music accounted for the remaining 20%. As in the case of the other programmes offered by the Enugu National Station, this allocation between (on the one hand) local music and (on the other hand) imported music was based not on research regarding the attitudes, preferences, and/or behaviors of the groups targeted by management but rather on assumptions by the management of the Enugu National Station plus their desire to encourage local artists.

Pricing of the products delivered by the enugu national station

At the time the Executive Director made his request, news broadcasts by the station were not paid for by anyone and adverts broadcast by the station were still very cheap. Advertisers (that is, not broadcasters) commissioned whatever listener research was done.

Promotion

At the time the Executive Director made his request, the Enugu National Station was doing very little promotion of itself and/or its programs. Readers will remember that for many years Radio Nigeria had had a monopoly on broadcasting in Nigeria; as a monopoly supplier, Radio Nigeria had never felt much need to promote itself and/or its products and services.

Distribution

As indicated earlier, at the time the Executive Director made his request, the Enugu National Station distributed (that is, rebroadcast) English language educational programmes and English language national news bulletins using state-owned stations throughout the area which had been known as Eastern Nigeria. Each state-owned station throughout Eastern Nigeria filled in the broadcast time available by preparing and broadcasting local language content to their local communities.

ADDITIONAL INFORMATION (6): NEW PRIVATE STATIONS IN ENUGU AND THE STRATEGIES OF THOSE STATIONS

Two new private stations which came up within the Enugu coverage area as soon as the private participation in broadcasting was allowed included: 1) Ray Power FM; and 2) Minaj FM at Obosi. These two new stations were of course in addition to the FM radio stations belonging to the states located in what had been known as Eastern Nigeria; those states (and FM radio station locations) included Abia, Akwa-Ibom, Anambra, Bayselsa, Cross River, Ebonyi,

Enugu, Imo, and Rivers. Regarding the marketing strategy used by Ray Power FM and Minaj FM:

Primary target market

Adults 18-50 years old.

Product

Because the new private stations not only poached staff but also copied Radio Nigeria's existing program schedules as well, the format and shape of messages on air did not deviate much from those of the Enugu National Station. The new private stations did allocate more time to music than Radio Nigeria; also, the new private stations built more audience participation into their programme schedules. One consequence of this approach was that the programming of the new private stations (whether sports-related, news-related, or entertainment-related) was very likely to be based on the needs, preferences, and attitudes of the audience. In music, for example, 80% of the programming featured foreign music, while only 20% of the programming featured indigenous music; as indicated earlier, this was the direct opposite of what Radio Nigeria was offering. As for news, while local news was done in Igbo, other local content was done using the dialects of Igbo specific to various locations targeted by that local content.

Pricing

While Radio Nigeria did not have a well-developed pricing strategy, the new private stations established a definite cost for every package of broadcast material, irrespective of whether that broadcast material was news, sports, or entertainment.

Promotion

As indicated earlier, as a former monopoly supplier, Radio Nigeria had never felt it necessary to spend much time or energy promoting itself and/or its programmes. The new private stations, however, promoted themselves and their broadcasts intensively, all day, every day.

Distribution

The FM broadcast technology used by the new private stations was more simple and more people-oriented than the medium-wave and short wave broadcast technology still being used by Radio Nigeria.

The challenge

Assume you are Ms. Akpunonu.. What strategy will you recommend to the Executive Director, so as to retain and grow Enugu national station's audience and market share in Enugu

against the new private-sector broadcasters who have popped up in response to the August 1992 deregulation of the broadcast industry in Nigeria?

EXHIBIT #1
CHARACTISTIC ATTITUDES AND BEHAVIORS OF NIGERIANS

- 1) Some tribes (including the Igbo and the Yoruba) have a marketplace attitude toward negotiation: they see it as a means of achieving limited objectives through compromise and bargaining.
- 2) A foreign executive once observed that Nigeria is a beautiful place for business because “everyone keeps talking. . . everything is in flux, everything is negotiable.”
- 3) For some tribes (including the Igbo and the Yoruba), disputes arising out of business tend to be settled at home, through arbitration by a mutually respected or authority figure. Recourse to courts is infrequent and signals the end of a business relationship
- 4) Mentor relationships and tribal ties can strongly influence whether or not an individual will be appointed to a government position.
- 5) Personal bearing and image are highly regarded.
- 6) Educational credentials are important. As with the British, individuals with a generalist, literary education are considered more capable than individuals knowledgeable only about a particular industry. A PhD carries great weight.
- 7) Relationships are likely to overshadow prices, quality of product, and other substantive issues. for a number of reasons: Nigerians can be put off by the pushiness and strong task orientation of Americans. A style that reflects respect, empathy, and sincerity is preferred, and friendships facilitate business dealings.
- 8) Nigerians generally feel proud about their country's role in Africa.
- 9) Elders are respected because age is equated with wisdom
- 10) Roles are very important. Titles, including one's degrees, are used widely. For example, one might identify an individual as Chief the Hon. Alhaji ABC, MA (Oxford), PhD(Harvard), etc. Titles generally reflect power.
- 11) Nigerians can be eloquent rhetoricians. In Nigeria however words may not mean much. Meanings can be subtle and internalized, and there is a high tolerance for ambiguity.
- 12) Emotion, experience, and intuition more than empirical reason are the persuasive basis of argument.
- 13) Tribal loyalty, the force of personality, and aggressiveness are very important.
- 14) There is a dearth of detailed, reliable information in the country. The margin of error for reported unemployment figures, for example, has ranged from 25-50%.
- 15) Many Nigerian businessman-perhaps the Igbo in particular-have been described as “get rich quick men.”

- 16) The ties of individuals to their tribe are strong. When government administrations change, the new leader often brings in members of his own tribe. Stealing within one's tribe may be condemned while stealing from outsiders may be condoned.
- 17) Nigerians generally attempt to get to know their counterparts before making business transactions. Once friendships develop, even a foreigner can be considered a member of the family and looked upon with favor during negotiations.
- 18) At least among the Igbo and the Yoruba, individuals do not seem risk-averse. Members of these groups have taken great risks for large short-term gains.
- 19) Time is generally treated casually; even the simplest transactions require a great deal of time. Foreigners who hurry through a negotiation—even after a very late start—may be suspected of cheating.
- 20) Decision-making is highly centralized. Powerful individuals make the decisions and they tend to do so without consulting others. In Nigerian organizations, it is common to postpone decisions because the incumbent official is on leave and no one else can act for him. Additionally, any business venture of significance must involve government officials.
- 21) Although Nigerians do prepare written agreements (a practice encouraged by the British), many agreements are spontaneous and verbal. The key to commitment is not legal enforceability but an understanding under which the obligations of each party are clearly defined and matched with respective rewards.

Source: Unpublished working paper

EXHIBIT #2 **CHARACTERISTIC ATTITUDES AND BEHAVIORS OF IGBOS**

- 1) Unlike the Hausa, the Igbo embraced Western education and Christian religion with great enthusiasm and determination.
- 2) The Igbos tend to be very energetic and tend to attach much importance to individualistic achievement. One implication of this is that personal efforts and the use of one's abilities can lead to a rise of status.
- 3) Igbo society may be characterized as an open society wherein high status may be attained on the basis of occupational skill, enterprise and initiative, with achievement being one of the highest values.
- 4) Igbos have a reputation for being willing to take any sort of job (no matter how menial) when they first enter a town and then working their way up, living frugally and accumulating resources until they become wealthy.
- 5) The Igbo are clearly a group of great entrepreneurial activity whose drive for achievement and self-improvement has made them seek opportunities wherever they were and take advantage of any new situation that presented itself. Although the Igbo

came in contact with Western education much later than the Yoruba, from the early 1920s upward, in what Coleman (1971) has called 'the Igbo awakening', the Igbo strove to catch up.

While up to 70% of Ibos live in rural areas, and as many as 70% of them may be illiterate, the above comments suggest that members of the Igbo tribe (that is, the major tribe in what used to be known as Eastern Nigeria) may be especially interested (both as regards work and leisure) in activities with the potential to increase their abilities, accomplishments and skills.

Source: Adigun, I.O. (1995), "Effects of Domestic Multiculturalism on Job Attitudes in Nigeria: A Research Note," *The International Journal of Human Resource Management*, Vol. 6, #4, pp. 910-929

ATTACHMENT 1 MAP OF NIGERIA



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INSTRUCTORS' NOTE

RADIO NIGERIA ENUGU NATIONAL STATION

CASE OVERVIEW

This case invites students to play the role of Ms. Christiana Akpunonu, a Nigerian who worked for more than 30 years at Radio Nigeria and, at the time of this case, had the role of deputy director in charge of news, marketing, and programs for Radio Nigeria's Enugu National Station. At one time, Radio Nigeria had a monopoly on broadcast industry in Nigeria; however, in August 1992, private sector individuals and corporate bodies were allowed to establish radio stations in Nigeria. Almost immediately, competition emerged not only in Lagos but also in all major markets in Nigeria, including Enugu, the former administrative capital of the eastern region of Nigeria. In response to the newly emerging competition, Radio Nigeria stations all across the country (including Enugu) found themselves having to compete, for the first time, for audience and market share. At this time, the executive director in charge of Radio Nigeria's Enugu National Station called Akpunonu to his office and charged her with developing a strategy to be executed within the next four months, so as to protect the audience and market share of Radio Nigeria's Enugu National Station. The challenge to Radio Nigeria stations all across the country (including the Enugu National Station) was made more severe by the fact that some of the newly emerging private radio stations were far better equipped than the Radio Nigeria National Stations and that it appeared that all of the radio stations (including the new ones) were competing for exactly the same radio audience.

CASE SYNOPSIS

Ms. Christiana Akpunonu, Deputy Director in charge of news, marketing and programs at Radio Nigeria's Enugu National Station, has been charged by her Executive Director to develop a strategy to ensure that the Enugu National Station manages to compete successfully for audience and market share against new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria.

Additional data and information in the case include:

- 5) For Nigeria, the Nigerian environment, and the Nigerian economy: Historical background plus selected statistics.
- 6) For the broadcast industry in Nigeria: Historical background plus selected data and statistics.

- 7) *For the Enugu National Station of Radio Nigeria: Historical background plus selected data and statistics.*
- 8) *For Eastern Nigeria (that is, the markets served by the Enugu National Station of Radio Nigeria): Background information on the region, the inhabitants, and some of the characteristic attitudes and behaviors of those inhabitants.*

INSTRUCTORS' NOTE

As indicated in the case, the challenge faced by Ms. Christiana Akpunonu, Deputy Director of News, Marketing, and Programs at Radio Nigeria's Enugu National Station, is to develop a strategy to ensure that Radio Nigeria's Enugu National Station manages to compete successfully for audience and market share against the new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria.

As regards lessons and/or information which students should learn from this case, at least the following four points can be made:

- 1) At the beginning of the case, students will need to consider the extent to which developed-world models and conceptual frameworks can be applied to challenges and opportunities in the developing world. By the end of the case discussion, they will have discovered that some conceptual frameworks (for example, the Sheth 1985 turnaround strategy model and/or the marketing strategy model) can be useful guides to managerial action not only in the developed world but in the developing world as well.
- 2) Students will be able to compare their solutions to the one chosen by the central figure in the case, Ms. Christiana Akpunonu.
- 3) Students will discover that managers' decisions are likely to be powerfully impacted by the conceptual framework they use; they will also discover that the recommendations flowing from alternative conceptual frameworks (for example, the Arken (2002) "deep knowledge of consumers" framework on the one hand or the Sheth 1985 turnaround strategy model on the other) could be quite different.
- 4) As they work through the case, students are exposed not only to some information and history on an important market in Africa (that is, Nigeria) but also some information and history on the broadcast industry in that country.

DISCUSSION QUESTIONS

We often select one student to lead the discussion. Another approach would be to solicit input from various students at various stages of the analysis. Either way, our usual approach to this case is threefold:

- 1) Solicit from many students the details of the case, including information about the country, information about the organization, information on the individuals involved in the case, and so on. Usually, we write much of this information on the board, so

that if questions regarding “facts of the case” come up, we will have much of that information on the board in front of us.

- 2) Ask an individual student or the class as a whole to address a very specific series of questions. These questions, and comments relating to possible answers to those questions, are as listed below:

Q &A (#1): WHAT IS THE MAIN PROBLEM? Students usually conclude that Ms. Akpunonu needs to develop (within the next 120 days) a strategy to ensure that Radio Nigeria’s Enugu National Station manages to compete successfully for audience and market share against the new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria. The authors reinforce the idea that this problem statement is very consistent with the information provided in the case.

Q &A (#2): WHAT KIND OF PROBLEM IS THIS? Instructors should not be surprised if there are as many answers to this question as there are students in the class. Clearly, there is no one right answer. However, three alternative approaches, each of which seems quite relevant to the situation, are as indicated below:

- i. “Turnaround strategy”
- ii. “Marketing strategy”
- iii. “deep knowledge of consumers”

Q &A(#3): FOR THE KIND OF PROBLEM IDENTIFIED ABOVE, WHAT ARE THE KEY VARIABLES AND WHICH EXPERT SAYS SO?

For students concluding that the generic problem is the need for a “turnaround strategy,” Sheth (1985) suggests there are nine strategies which can be considered: 1) Entrenchment (that is, fight for a larger share of existing uses of products in existing markets); 2) Consider selling through intermediaries; 3) Mandatory consumption (that is, ask government to pass a law requiring the purchase by consumers of a company’s product or service); 4) Go international; 5) Broaden product horizons (that is, don’t sell just the computer; rather, sell the computer plus a full set of ancillary products and services); 6) In existing markets, identify new applications for products; 7) In existing markets, identify new usage situations; 8) Repositioning (that is, in new markets, identify new uses for products by changing the image of the product); and 9) Redefining markets (that is, in new markets, identify new uses for products by making functional changes in those products. For students concluding that the generic problem is “marketing strategy,” Perreault and McCarthy (2002) suggest that the key marketing strategy variables are: 1) Target market; and 2) The “4Ps” of the marketing mix (that is, place, price, product, and promotion). For students concluding that the generic problem is the need for “deep knowledge of consumers,” Arken (2002) suggests that the key questions which consumers need to be asked are as indicated below:

- 1) st 1 thing that comes to mind when you think about the product/service?
- 2) “Day in your life” regarding the product/service?

- 3) Earliest memory regarding the product/service?
- 4) Best/worst experience with the product/service?
- 5) Pivotal experience with the product/service?
- 6) ideal experience with the product/service?
- 7) What prevents you from achieving the ideal experience with the product/service?
- 8) What concerns you most at this time of your life?
- 9) What are you happiest about at this time of your life?
- 10) Most important things you are trying to achieve?
- 11) If you had a magic wand, what one thing would you change about the Product/service?

Q &A (#4): WHAT DATA FROM THE CASE RELATE TO THE KEY VARIABLES?

As implied above (and this is one of the key learning points of the case), the data students present will depend on the generic problem they identify. Students believing the generic problem is “marketing strategy” will focus on the five key variables in that concept; Appendix 1 identifies data from the case which relate each of those key variables. Students believing the generic problem is “turnaround strategy” will focus on the nine key alternatives identified earlier; Appendix 2 identifies data from the case which relate to each of these key variables. Students believing the generic problem is “deep knowledge of consumers” will focus on the 11 key questions identified above; Appendix 3 identifies data from the case which relate to each of those key questions.

Q &A (#5): WHAT ALTERNATIVE SOLUTIONS CAN BE IDENTIFIED?

Because research suggests we make better decisions if we first identify alternative solutions and then choose one of those solutions, we require students to identify at least two alternative solutions. Of course, students having difficulties coming up with a second alternative can be reminded that one possible solution is to “do nothing.”

Q &A (#6): WHICH OF THE ALTERNATIVE SOLUTIONS SET FORTH ABOVE DOES THE CLASS/STUDENT RECOMMEND, AND WHY?

“Doing nothing” is unlikely to help Ms. Akpunonu resolve the challenge she faces, that is, to develop a strategy to ensure that Radio Nigeria’s Enugu National Station manages to compete successfully for audience and market share against the new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria. Thus, students believing the generic problem is “turnaround strategy” will likely recommend an approach which focuses on one or more of the nine alternatives in Sheth’s turnaround strategy model from 1985. Students believing the generic problem is “marketing strategy” are likely to recommend focusing on the five key variables of the marketing strategy concept. Students believing the generic problem is “deep knowledge of consumers” are likely to recommend

focusing on collecting from members of the target market the answers to the 11 questions in the Arken (2002) conceptual framework.

The decision reached by Ms. Akpunonu was to use the “deep knowledge of consumers” conceptual framework to guide her thinking and recommendations. For additional information on the recommendations associated with this decision, please see the epilogue.

Q&A #7) WHAT NEGATIVES ARE ASSOCIATED WITH THE ALTERNATIVE SELECTED BY THE CLASS LEADER AND/OR OTHER MEMBERS OF THE CLASS?

Very few solutions are risk and/or problem-free. Negatives associated with the solution proposed by the class leader and/or other members of the class could include the following: The chosen alternative, if it requires Radio Nigeria’s Enugu National Station to acquire specialized equipment and/or skills the organization doesn’t currently possess, could be expensive both in terms of time and money. Also, because the case probably doesn’t provide all the data a decision maker would need (in other words, it is likely that some important data is missing), it is possible that assumptions made by the class leader regarding the actual situation faced by Radio Nigeria’s Enugu National Station are incorrect. If so, the proposed solution might be inappropriate.

3. The third and final step in discussing a case with students is to share with them what actually happened and to discuss with them the implications of that outcome. As indicated above, as she thought about developing a strategy to ensure that Radio Nigeria’s Enugu National Station does manage to compete successfully for audience and market share against the new private radio stations which have emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria, Ms. Akpunonu’s thoughts turned to a “deep knowledge of consumers” conceptual framework very similar to the one developed by Arken (2002). Based on her belief that having the answers to the 11 questions posed by Arken (2002) would be very useful to her, and given the fact that she did not yet possess the answers to those 11 questions, Ms. Akpunonu suggested to the Executive Director that the first step toward developing a strategy to ensure that Radio Nigeria’s Enugu National Station does compete successfully for audience and market share against the new private radio stations should be to develop “deep knowledge of consumers,” that is, to collect answers to the 11 questions posed by Arken (2002). Regarding the best way to do this: After discussing this issue at length with members of her team, Ms. Akpunonu decided to recommend that Radio Nigeria’s Enugu National Station set up a raffle for which the grand prize would be a brand new Peugeot car, that is, the brand of car loved by the people of the region. Sale of tickets should be at Radio House in Enugu, that is, the home base of Radio Nigeria’s Enugu National Station. Attached to the stub of the ticket kept by the staff of Radio Nigeria’s Enugu National Station would be a listener request card (the purchaser of a raffle ticket would be required to fill out this card) indicating (among other things) the answers to the 11 questions posed by Arken (2002). The raffle campaign was scheduled to last for four months; during this period, the raffle would be promoted intensively by the Enugu National Station. The objectives of the raffle included:

- a. To ongoingly place Radio Nigeria on the minds and lips of the listeners; furthermore, the awarding (at the end of the exercise) of a car will heighten not only the visibility but also the credibility of the station.
- b. To develop “deep knowledge” regarding the radio listening-related attitudes, behaviors, and preferences of the audience targeted by Radio Nigeria’s Enugu National Station.

Epilogue #1

The Executive Director approved the “deep knowledge of consumers” approach suggested by Ms. Akpunonu. The raffle was held, and the data were collected and analyzed. The sorts of questions asked on the listener response cards, and a sample of the sorts of answers received, are as indicated below:

Question #1: The 1st thing that comes to mind when you think about the product/service?

Answer: The news which the station gives about the whole of Nigeria, the traditional music the station plays, the football matches with live commentaries, etc.

Question #2: Describe a “Day in your life” regarding the product/service?

Answer: The mobile broadcast unit visited my school compound and made recordings which they put on air. I took part in a children's program; my mother, brothers, sisters and I heard me make contributions to that program.

Question #3: Your earliest memory regarding the product/service?

Answer: At age 9, while I was at our community's primary school, I heard my mother take part in a program for women. Radio Nigeria had come to our town hall to record a show on the proper application (timing, amounts, etc.) of fertilizer.

Question #4: Your best/worst experience with the product/service?

Answer: My worst experience was when I endeavored to listen to sports commentaries but the sound quality was very poor because of bad weather. This was very frustrating

Question #5: A pivotal experience for you with the product/service?

Answer: I heard a storytelling program with morals which changed my attitude to elders. Also, my missing brother (allegedly living in Ghana) was linked back up to our family through Radio Nigeria in Enugu; this brother actually came back and rejoined our family.

Question #6: Your ideal experience with the product/service?

Answer: The highlife music that plays for one hour nonstop. Also, listeners' request programs where listeners can call out music to be played for their friends.

Question #7: What prevents you from achieving the ideal experience with the product/service?

Answer: Where I live, reception is poor.

Question #8: What concerns you most at this time of your life?

Answer: I am growing and selling farm produce; I need to make enough money from those sales to cover my costs and make a profit. To succeed, I also need to be able to find fertilizer for my farm.

Question #9: What are you happiest about at this time of your life?

Answer: At the end of the day I come home and tune in to a late-night music program from Radio Nigeria. Also, I enjoy hearing live football commentaries from the Radio Nigeria Enugu National Station.

Question #10: What are the most important things you are trying to achieve at this time of your life?

Answer: I need to be able to feed my family of five adequately. Also, I need to be able to pay school fees for my three children. Finally, I would like to be able to build a house for my family.

Question #11: If you had a magic wand, what one thing would you change about the Product/service?

Answer: Radio Nigeria could broadcast from my village, using our local dialect to provide entertainment, information, and news to my community.

Epilogue #2

After reviewing the information collected on the listener response cards, and based on the insights provided by that information, Ms. Akpunonu made the following recommendations to the Executive Director (ED) of Radio Nigeria's Enugu National Station:

- 1) In addition to the existing shortwave and medium wave facilities, the Enugu National Station should establish an FM station with state of the art infrastructure. The benefits associated with having an FM capability include: It is easy for people to access, and it makes it possible for the Enugu National Station to provide listeners with additional entertainment, news, education, and information. Also, a new FM capability is well-suited to the new commercial broadcast environment.
- 2) Every producer, presenter, anchor or any other Enugu National Station staff who has a reason to have time with listeners should install a feedback mechanism, so as to be able to receive feedback (that is, audience response) on his/her presentation. Only by ongoingly collecting feedback from listeners will the Enugu National Station begin to develop deep knowledge and insights on the needs, preferences, and attitudes of listeners.
- 3) Increase the number of programmes featuring "live phone in," so that the Enugu National Station is able to learn immediately the reactions and/or audience response to issues discussed in their broadcasts.
- 4) Begin doing live broadcasts of national sporting events and establish an "all venues network" so that commentators will be able to take listeners from one venue to the other and then back again.

- 5) Post an Enugu National Station correspondent to each of the local government headquarters of each of the states in the Enugu National Station listening area, with amplified telephone connections linked to Broadcast House in Enugu, so as to foster an interpersonal togetherness of the listeners from the geopolitical zone. Implementing this recommendation should encourage a better balance (during programme planning sessions) between the views of rural dwellers and city dwellers throughout Enugu National Station's listening area.
- 6) Divide the airtime of the Enugu National Station into segments and then sell those segments to local language presenters who are interested in being able to communicate with members of the various language segments.
- 7) Establish a corporate/public relations department whose duty (among others) is to liaise with the public on courtesy calls. Once organized, such visitations should be covered and reported in the news of the day; this will enhance the image of the station and should encourage corporate and/or governmental bodies to participate in these visitations.
- 8) The ED of the station should embark on tours of important public and/or private facilities and/or factories; also, the ED should organize courtesy calls on governors and/or other senior level officials. Engaging in such activities and then broadcasting information about these activities will endear the Enugu National Station to the people.
- 9) Programming: In designing music programmes for the Enugu National Station, adjust the mix of overseas/indigenous music from 80/20 to 60/40. The benefits of this policy will include: 1) We will continue to encourage the growth of local content; but also 2) We will move closer to the mix provided by the new private stations.
- 10) Use existing groups (for example, Radio Nigeria Choir, Radio Nigeria Drama Club, Radio Nigeria Listeners' Club, etc.) to increase awareness and build the brand image of the Enugu National Station throughout the station's listening area.
- 11) All programs (including news, entertainment, education, etc.) produced by Enugu National Station should now be for sale (that is, available for sponsors to purchase), so as to generate funds to support the purchase of the equipment needed to maintain and/or upgrade the capabilities of the Enugu National Station.
- 12) Quality Control on Enugu National Station programmes: From now on, there should be monitoring and evaluation on a daily basis of all programs (news, education, entertainment, etc.) produced by the Enugu National Station.

Epilogue #3

The Executive Director of Radio Nigeria's Enugu National Station implemented each of the recommendations made by Ms. Akpunonu. The results of these initiatives are as indicated below:

- 1) Regarding the FM station suggestion: Enugu National Station established "Coal City FM" 92.8 MHz; it shared the same status as any other private enterprise.

- 2) Regarding feedback mechanisms and collection: As recommended, each programme, whether live or prerecorded, began collecting audience reaction data. Over time, and in response to the implementation of at least some of the suggestions, many programs became more popular and registered more participation
- 3) Regarding the need to implement programs featuring live phone in: The Chief Executive of the Enugu National Station used “Ka Oha Malu” (a radio personality) to launch a live two-hour period of discussion of current issues. The format used resulted in immediate reactions from participants throughout the Enugu National Station listening area, using amplified telephone services
- 4) Regarding the broadcasting of sports commentaries: These activities were increased. As an example: The Chief Executive sent commentators to the 10th FIFA world youth championship, known at the time as Nigeria 99 game. The commentators (including those from the Enugu National Station) were able to link up to all five of the football match venues at the same time. In other words, the commentators were able to take listeners from Lagos to Ibadan or to Kaduna or to Bauchi or to Calabar or to Port Harcourt and then back to the place from which they had started; sports listeners were delighted by these commentaries.
- 5) Regarding posting Enugu National Station correspondents to all local government headquarters areas: While the Executive Director of the Enugu National Station did not post correspondents to each local government area headquarters, he did post correspondents to each of the nine states in the Enugu National Station listening area; the role of that correspondent included making input into programming and providing the Enugu National Station with information on the needs, preferences, and attitudes of listeners in his or her portion of the Enugu National Station’s listening area.
- 6) Regarding the division of airtime into segments and the selling of those segments: The Executive Director offered to sell hour-long language segments to any willing community, so as to be able to serve the needs of people who speak a specific Igbo dialect. As a result of this initiative, there was a scramble from indigenes wishing to reach out to their community members; as for the Enugu National Station, it smiled all the way to the bank
- 7) Regarding courtesy calls and/or tours by the CEO and/or the public relations department (that is, recommendations #7 and #8): A very successful courtesy call program was implemented. Furthermore, as these visits were announced on the news, the popularity of the station increased substantially.
- 8) Regarding the mix (on music programmes) between overseas and indigenous music: The Executive Director changed from 80/20% to 70/30%; he based this decision on his desire not only to encourage the growth of local music but also his desire to offer approximately the same mix as the new private stations.
- 9) Regarding the use of established groups to promote and build the brand equity of the Enugu National Station:

- a. Choir: the ED supported the group and encouraged it to feature at public events. Although this group (that is, the Radio Nigeria Choir) became moribund in other locations (Lagos, Ibadan, etc.) the Enugu National Station Choir continues not only to function but also to perform at a national level.
- b. Radio Nigeria Drama Club: The ED supported the group and it continued to produce radio dramas. Ultimately, many of the actors found themselves becoming part of the hugely successful Nigerian film industry known as Nollywood.
- c. Radio Nigeria Listeners Club: While the ED did support the group, only a program called “Day Don Break O” (an early-morning chit chat program in pigeon English) had a strong listeners’ club. Ultimately, this club died a natural death.

10) Regarding the sale (to sponsors) of Enugu National Station Programs (for example, news programs, sports programs, music programs, etc.): This policy was successfully implemented.

11) Regarding quality control: The Executive Director supported this suggestion. As a result, a new and more vigorous quality control effort (it involved daily meetings of news, marketing, and programs departments, to discuss program quality, news output, and general performance) was initiated; this effort not only improved the quality of programs broadcast by the Enugu National Station but also assisted the station as it worked to get advertisers to agree to sponsor programs.

CONCLUDING COMMENTS

The above comments describe the initiatives identified by (and recommended by) Ms. Akpunonu to achieve the objectives set by her Executive Director (ED). Readers may be interested in the answers to the following questions:

QUESTION #1: Of the suggestions made by Ms. Akpunonu, which ones did the ED find especially interesting and/or useful?

ANSWER: Although the ED accepted and executed almost all of the recommendations made to him by Ms. Akpunonu, he confessed that recommendations number 5, 6, 7, 8, and 10 especially interested him. Specifically:

Recommendation #5 (posting correspondents to each of the nine states within the Enugu National Station listening area): According to the ED, doing this made it much easier not only to capture the attention and interest of ordinary listeners but also to capture the attention and interest of governors and/or public officers as well.

Recommendation #6 (language-segmented broadcasting): The first of these (Udi Ndee) was fully paid for by individuals representing the Udi speaking people of Enugu State. When

other communities heard this programme on air, delegations from other linguistic groups flooded in and a number of unsolicited language segments came on board. When the sale of time segments began in earnest, the popularity of the station increased dramatically; revenues generated by programs also increased dramatically as marketers desiring to reach members of various linguistic groups increased their purchases of air time from the Enugu National Station.

Recommendations #7/8 (courtesy calls and visitations): The ED was interested in these because they provided him an opportunity to meet the people he serves not only in his office but also at their place of work. The courtesy calls and visitations positively impacted the awareness for and image of the Enugu National Station; as a result, both the number of advertisers and the amount of airtime sold increased substantially.

Recommendation #10 (monitoring and evaluating): The National Broadcast Commission (NBC) monitors the programming and performance of all radio stations, including the Enugu National Station; furthermore, companies placing adverts hire research companies to assess the impact of the adverts they have purchased. Once he began ongoingly receiving in-house monitoring of programs and performance, the ED was far less likely to be caught unawares by complaints from either the NBC, the advertisers, and/or the general public.

QUESTION #2: Which of the alternatives suggested by Ms. Akpunonu were implemented and what results were achieved?

ANSWER: All of the alternatives recommended by Ms. Akpunonu were implemented. As for results, they include:

- 1) Based on the fact that the entertainment, information, and news provided by the Enugu National Station was now based on the needs and interests of local listeners, the station came to be perceived (within the Enugu National Station market area) as more trusted, dependable, and responsible.
- 2) The Enugu National Station was able to retain its leading position in the face of stiff competition from the new private sector competitors.
- 3) The Enugu National Station increased its stature and influence at Radio Nigeria headquarters in Abuja.
- 4) The live participatory program “Ka Oha Malu” had extremely high levels of participation; these high levels of listenership accrued then (and continue to accrue) to the network programs which precede and follow it.
- 5) On Radio Nigeria’s nationwide “media link” every Saturday morning 8-10AM, the first 3 to 4 voices would invariably come from listeners of the Enugu National Station.
- 6) The Enugu National Station expanded its business, thus avoiding staff retrenchment. In fact, staff were retained, welfare and promotions were increased, and additional jobs were created. Some staff members earlier poached by the new private radio stations attempted to come back to the Enugu National Station.

QUESTION #3: Are there other alternatives (that is, alternatives other than those suggested by Ms. Akpunonu which were put into play? If so, what were those additional alternatives and what results were achieved?

ANSWER: FM stations were opened in all the nine states within the Enugu National Station listening area. Also, the programming by the Enugu National Station changed from an approach dominated by the dissemination of national and/or international news from Abuja to an approach characterized by the presentation of entertainment, information, and news created and disseminated locally.

QUESTION #4: Did Radio Nigeria's Enugu National Station achieve its objectives, that is, to develop a strategy which ensured that Radio Nigeria's Enugu National Station did compete successfully for audience and market share against the new private radio stations which had emerged as a result of the August 1992 deregulation of the broadcast industry in Nigeria?

ANSWER. The Executive Director indicates that Radio Nigeria's Enugu National Station did achieve the objectives of competing successfully for audience and market share against the new private stations.

QUESTION #5: Are there any other comments and/or observations which the Executive Director would like to make, regarding either the initiatives which were launched or the short and/or long-term outcomes of those initiatives?

ANSWER: The Executive Director observed that because advertisers want to know how many listeners are exposed to their message, it was (at the time of the case) producers of products and services who had initiated broadcast audience research. Having said this, however, it became very clear (once the research organized by the Enugu National Station had been conducted) that audience research (and deep knowledge of customers) can be of great use not only to advertisers but also to broadcasters and their managers as well.

APPENDIX 1

CASE DATA RELATING TO MARKETING STRATEGY MODEL

FOR ENUGU NATIONAL STATION

TARGET MARKETS

The primary groups targeted for programming by the Enugu National Station included: Men, women, children, young people, and farmers.

Products delivered to the targeted audiences

Information regarding the products (that is, the programming) delivered by the Enugu National Station to the target markets listed above at the time the Executive Director made his request included:

- 4) The day-to-day programme schedule of the Radio Nigeria National Station included educational, informational, and entertainment-based programs. Because the Radio Nigeria National Station did very little audience research, management did not know much about the needs, motives, and/or attitudes of any of the targeted audiences listed above. Given the dearth of knowledge about the attitudes, preferences, and/or behaviors of the targeted audiences, management's approach was to broadcast to each audience what management believed they needed. It was also true that management presumed that all the audiences uncritically consumed any and all broadcast information broadcast to them. Management did occasionally receive feedback from listeners; however, management made no attempts to systematically collect information on the attitudes, preferences, and/or behaviors of members of the audiences targeted by the Enugu National Station.
- 5) Audience participation programs were rare. Such programs as sports commentaries originating from an outside venue (for example, "live" commentaries on a football match and/or a cultural festival) did not take place often. When such programs did take place, they were sometimes simulated.
- 6) On programmes featuring music, indigenous local music tended to account for about 80% while imported music accounted for the remaining 20%. As in the case of the other programmes offered by the Enugu National Station, this allocation between (on the one hand) local music and (on the other hand) imported music was based not on research regarding the attitudes, preferences, and/or behaviors of the groups targeted by management but rather on assumptions by the management of the Enugu National Station.

Pricing of the products delivered by the enugu national station

At the time the Executive Director made his request, news broadcast by the station was not paid for by anyone and adverts broadcast by the station were still very cheap. As already indicated, advertisers (that is, not broadcasters) commissioned whatever listener research which was done

Promotion

At the time the Executive Director made his request, the Enugu National Station was doing very little promotion of itself and/or its programs. Readers will remember that for many years Radio Nigeria had had a monopoly on broadcasting in Nigeria; as a monopoly supplier, Radio Nigeria had never felt much need to promote itself and/or its products and services.

Distribution

As indicated earlier, at the time the Executive Director made his request, the Enugu National Station distributed (that is, rebroadcast) English language educational programmes and English language national news bulletins using state-owned FM stations throughout the area which had been known as Eastern Nigeria. Each state-owned FM station throughout Eastern Nigeria filled in the broadcast time available by preparing and broadcasting local language content to their local communities. .

FOR NEW PRIVATE SECTOR RADIO STATIONS

Primary target market

Adults 18-50 years old.

Product

Because the new private stations not only poached staff but also copied Radio Nigeria's existing program schedules as well, the format and shape of messages on air did not deviate much from those of the Enugu National Station. The new private stations did allocate more time to music than Radio Nigeria; also, the new private stations built more audience participation into their programme schedules. One consequence of this approach was that the programming of the new private stations (whether sports-related, news-related, or entertainment-related) was very likely to be based on the needs, preferences, and attitudes of the audience. In music, for example, 80% of the programming featured foreign music, while only 20% of the programming featured indigenous music; as indicated earlier, this was the direct opposite of what Radio Nigeria was offering. As for news, while local news was done in Igbo, other local content was done using the dialects of Igbo specific to various locations targeted that local content.

Pricing

While Radio Nigeria did not have a well-developed pricing strategy, the new private stations established a definite cost for every package of broadcast material, irrespective of whether that broadcast material was news, sports, or entertainment.

Promotion

As indicated earlier, as a former monopoly supplier, Radio Nigeria had never felt it necessary to spend much time or energy promoting itself and/or its programmes. The new private stations, however, promoted themselves and their broadcasts over and over, every day.

Distribution

The FM broadcast technology used by the new private stations was more simple and more people-oriented than the medium-wave and short-wave broadcast technology still being used by Radio Nigeria.

APPENDIX 2 CASE DATA RELATING TO THE “TURNAROUND STRATEGIES” MODEL

entrenchment

According to Sheth (1985), this approach involves taking market share away from competitors. He suggests four alternatives which firms may be able to use; those alternatives and data from the case relating to those alternatives include:

- a. Segment the market (and introduce different products and/or services for each segment). The case indicates that the Enugu National Station had identified several segments (adults, children, farmers, etc.); however, the case also indicates that the Enugu National Station had not developed deep knowledge or understanding of the needs, preferences, and/or attitudes of the members of any of these groups.
- b. Identify specialty markets: Again, the case indicates that the Enugu National Station has very little information on any of its groups of listeners.
- c. Go after heavy users of the product: Again, the case indicates that the Enugu National Station has very little information on any of its groups of listeners.
- d. Seek multiple channels of distribution: The case indicates that while the new private stations are using FM (in other words, there is at least one alternative channel of distribution available), Enugu National Station is still using the existing channels of distribution it has used for many years, that is, the medium-wave and short-wave technologies.

switch to intermediaries

In this industry (that is, the broadcast industry), it is not clear that switching to intermediaries is an option.

mandatory consumption

It seems unlikely that government will pass a law requiring individuals to listen to the Enugu National Station.

Go international

It seems unlikely that the Enugu National Station will (at a time it is already under stress) launch an initiative to go international.

Broaden the product horizon

The case suggests there are a number of ways the Enugu National Station could broaden its product horizon, including: 1) Launch an FM station; 2) Do more “live call in” shows; 3) Provide live commentaries on sports and/or cultural events, etc.

New applications

Increasing the frequency of audience “call in” opportunities is one possibility.

New situations

Live commentaries on sporting and/or cultural events is one possibility.

Repositioning

The case indicates that the Enugu National Station has been a monopoly supplier of broadcast services in Nigeria, but that broadcasting has now been opened up to private individuals and/or corporate bodies. It is not clear whether the Enugu National Station might be able to reposition itself to become the broadcasting service of choice to members of its target markets.

Redefine markets

Sheth identifies four alternative approaches to using this strategy. Those four approaches, and data from the case relating to them, are as indicated below:

- a. Generic to specialty products: The financial products and services offered by Radio Nigeria’s Enugu National Station are not a generic product; this option does not seem relevant to this situation.
- b. Primary to secondary products: The case makes no mention of secondary products.

c. Industrial to consumer products: The retail banking products and services offered by Radio Nigeria's Enugu National Station are already consumer products; this option does not seem relevant to this situation.

d. Consumer to industrial products: While broadcasts to individuals are a consumer product, the case indicates that the Enugu National Station is eager to "sell" its programs to private sector (that is, individual and/or corporate bodies) sponsors.

APPENDIX #3

CASE DATA RELATING TO THE "DEEP KNOWLEDGE OF CONSUMERS" MODEL

Question #1: 1st thing that comes to mind when you think about the product/service?

Data from the case: No data on this point provided in the case.

Question #2: A "Day in your life" regarding the product/service?

Data from the case: No data on this point provided in the case.

Question #3: Your earliest memory regarding the product/service?

Data from the case: No data on this point provided in the case.

Question #4: Your best/worst experience with the product/service?

Data from the case: No data on this point provided in the case.

Question #5: A pivotal experience for you, with the product/service?

Data from the case: No data on this point provided in the case.

Question #6: For you, an ideal experience with the product/service?

Data from the case: No data on this point provided in the case.

Question #7: What prevents you from achieving the ideal experience with the product/service?

Data from the case: No data on this point provided in the case.

Question #8: What concerns you most at this time of your life?

Data from the case: No data on this point provided in the case.

Question #9: What are you happiest about at this time of your life?

Data from the case: No data on this point provided in the case.

Question #10: The most important things you are trying to achieve, at this time of your life?

Data from the case: No data on this point provided in the case.

Question #11: If you had a magic wand, what one thing would you change about the product/service?

Data from the case: No data on this point provided in the case.

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WHAT HAPPENED TO THE TAX EXEMPTION? THE CASE OF THE RICE TABERNACLE CHURCH

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CASE DESCRIPTION

The primary subject matter of this case is the importance of understanding the tax consequences of business decisions in nonprofit organizations. The case is appropriate for a senior or graduate level government and nonprofit accounting course. It could be used in the nonprofit portion of the advanced accounting class. The case is designed to be taught in one class hour and is expected to require approximately one hour of outside preparation by students. The events described in this case are based on real world experiences, but all names have been disguised.

CASE SYNOPSIS

The case concerns the challenges faced by religious organizations when they add activities that might negatively impact their tax exempt status. Rice Tabernacle Church (the Church) is a 2,000-member “mega-church” located in Brandon Hill, Kentucky. The church has experienced a 75 % growth in the past years and is literally ‘bursting at the seams. In order to handle this growth, church leadership decided to expand the current sanctuary by adding a 120,000-square structure which included a fitness center, a bookstore, and a café. The church’s property tax exemption only applied to the original structure; therefore it applied to the taxing authority for expansion of the exemption to include the additional structure. The exemption was denied since the income from the new businesses was considered unrelated to its mission. The church appealed the ruling and needs to develop a strategy in case its appeal is denied.

INTRODUCTION

Reverend Polk rose from prayer, turned to his wife and partner in the ministry, and shared with her the challenges he hoped his prayer would answer. He had spoken with the church leadership about the property tax decision, and they could not imagine how the church could pay the current property tax bill of \$325,000. This figure was expected to increase in future years. The choices were limited – retrench from its goals, reduce services to the community, or ask for a special offering from the congregation. Clearly, careful planning would be required in order to see them through these challenging times. A look at the establishment and growth of the ministry might help to illustrate how things progressed to this point.

BACKGROUND

The Rice Tabernacle Church (“the church) was started in 1989 when a young couple, Anthony and Mary Polk, felt they were called by God to establish a Pentecostal church in their Brandon Hill, Kentucky neighborhood. After much prayer they found and acquired a large foreclosed single-level brick building, a few blocks from their home. Although the building was foreclosed, it was located on two acres of land making it an ideal and attractive investment. The Polks used the proceeds from a home equity line of credit to acquire the building and to purchase basic furniture such as folding chairs. They estimated that as the church grew they could repay the loan and expand the facility to accommodate as many as 400 congregants. As a religious organization, the church applied for and received property tax exemption from its State Board of Equalization for the church property.

The Polks advertised the church in the local newspaper and soon opened the doors, and prepared to welcome people from the neighborhood and surrounding areas, to come and worship together in their church. On the first Sunday, the Polks stood at the front of the church at approximately 930am and nervously waited for the first people to arrive for the 10am service. They were overjoyed when an entire family of eight walked through the doors to worship. They were followed by 25 other newcomers for a first day attendance of approximately 40 people, including the Polks’ family members. This was a sign to them that they made the right decision in starting the ministry and in selecting a building within their lower middle class community.

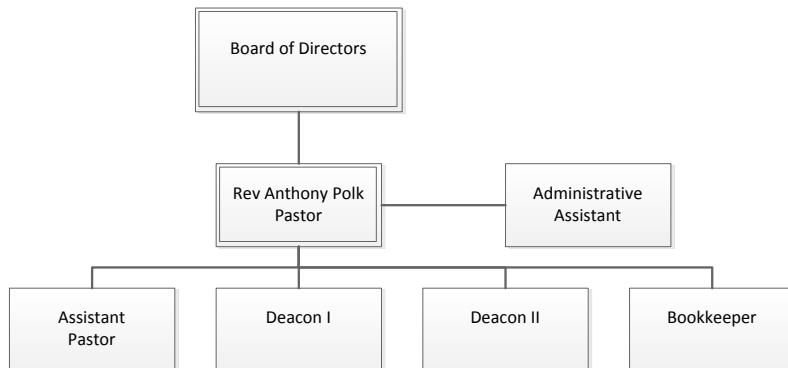
Each subsequent Sunday seemed to bring more and more visitors. Reverend Polk was particularly pleased with the diversity in terms of age of his new ‘flock’ which ranged from babies in arms to senior citizens. The location was particularly attractive to the senior citizens from the neighborhood who walked over to the church, not only to worship but to inquire about the “new church” they heard had started. Pastor Polk was so appreciative and elated by their dedication that he used his personal funds to purchase a used vehicle to transport any senior that needed a ride, especially on rainy and snowy days.

The church continued growing as the younger members started to marry and have their own families so that by 1999 it had over 500 members. With such membership growth, Reverend Polk felt that the church should provide services other than spiritual that were not available in the area. He also realized that to successfully accomplish this vision he would need some consistent administrative assistance. To assist in the administration and oversight of church activity, Pastor Polk appointed one assistant minister and two deacons. An administrative assistant and a bookkeeper were also hired to perform daily administrative and accounting duties. The Reverend Polk reported to a five-member board of directors (or elders), who are elected at the annual membership meeting for two-year staggered terms.

The church's organization structure appears below:

Rice Tabernacle Church

Organization Chart



By the year 2000, the church had experienced over a 75% increase, as membership reached over 2,000. While some of the growth was organic, the major increase was from individuals outside the community who were drawn to the message and ministry of the now "mega church". The blessings of rapid increase in membership however, presented accommodation issues. Members had to arrive earlier than usual to secure seats as the deacons were kept busy setting up chairs against the already overflowing pews. In the weekly pastoral meetings with the pastors and deacons where church business was conducted, the issue of inadequate accommodation was always a priority agenda item. However, this issue was discussed for numerous months without any meaningful solution. In addition, the pastor's vision of providing additional services to the community was also not being realized.

Finally, after consulting with the board of elders, the Church leaders decided that expansion was necessary to accommodate the rapid growth and growing community. The church leaders then discussed the expansion idea with the church membership during one of the annual membership meetings, and received their unanimous approval. All agreed that they had a responsibility to minister to the needs of the community.

THE EXPANSION

The church acquired an available five acre lot that was next to its current location which provided adequate space for expansion. The church members were excited about the acquisition and held several benefits to raise money for the building fund. The plan was to remodel the current structure and to add approximately 120,000 additional square feet. The new space would provide classrooms for bible study and other religious activities for diverse membership groups. The west end of the new space would house a fitness center, a bookstore, and a café, all to provide comfort and services for the congregants and community members. The construction

was completed in 2007 through the building fund proceeds and a small bank loan which was used to equip the fitness center and provide initial inventory for the bookstore.

Three offices were added, one for the Pastor, another for the assistant pastors, and the third for use by the bookkeeper. The bookkeeper's role was also expanded to include the accounting for the new businesses. Five classrooms were constructed for the various Sunday school classes. The smallest of which was converted into a nursery, staffed by volunteers, for use by the youngest members (i.e. the babies), during the worship service.

The fitness center was spacious and was promoted to the church members and community as a place to work on their physical health while providing the opportunity to fellowship with members from the congregation. It was opened seven days a week from 6am – 9pm for members and the general public's use. The fitness center's membership fees were reasonable, reflecting the community's income level, and were transferrable to a family member or friend if not being fully utilized. In fact, by providing such as space to the community, several non-members had formally joined the congregation as members.

The bookstore was expansive and included space for a café. The bookstore was well stocked with religious books and other items such as bibles, and special bible covers, ornaments, mugs, banners, bracelets, stuff animals, just to name a few. The church anticipated that this would generate additional revenue and so two cash registers were purchased to be utilized by the bookstore. The café offered various hot and cold drinks, sandwiches, and snacks, and served as a place for the community to meet and fellowship. These auxiliary services were welcomed by the membership since they provided additional income for the church (approximately 15% of total income).

THE CHURCH AT A CROSSROAD

In the fall of 2007, the church applied to the State Board of Equalization (The board) pursuant to the State's code for property tax exemption for relief on the additional structure. An initial site visit by a board inspector determined that most of the new building appeared to meet the tax exempt status.

By the summer of 2009, the church received an official response from the board denying tax exemption for the portion of the building that contained the bookstore and café, and the fitness center. The board considered them to be retail/commercial in nature and not used for religious purposes. Since the board's ruling was denying the tax-exempt status, it assessed that seven percent of the total facility should be subject to local property taxes. The board decided that the bookstore/café was totally commercial operations and the fitness center was 50% commercial. The church was assessed a property tax bill of \$325,000.

Rice Tabernacle appealed the board's decision and filed a motion for extraordinary relief. The church presented that it is entitled to a tax exemption since it believed that its facilities are used for carrying out the purpose of the church.

The Polks realized that the ministry was now at a crossroad and they needed divine intervention to resolve the tax issue. Since the church had always operated on a tight budget, it did not have the reserve funds to pay the current and any future tax assessments. Reverend Polk recognized the need to schedule another meeting with the leadership team, including the board of directors within the next week, to plan for an unfavorable outcome from the appeals process. In the meantime, the Polks agreed to continue praying for guidance to help the leadership team

develop an appropriate action plan that they could present to the congregation at the next membership meeting which was three weeks away.

CREDIT CARD FRAUD: WHEN EMPLOYEES MOVE FROM BEING AN EMPLOYER'S BIGGEST ASSET TO THEIR BIGGEST LIABILITY

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CASE DESCRIPTION

The primary subject matter of this case concerns a manager's discovery of fraud. Specifically, this case discusses credit card fraud committed by trusted supervisors and cashiers from within the organization. The case has a difficulty level of three and higher, appropriate for junior level and beyond. The case is designed to be taught in two to three class hours in a management, auditing, or ethics course, and is expected to require three hours of outside preparation by the students. This includes reading the case, understanding the concept of purchases and financial transactions in a retail environment, recognizing the importance of internal controls, observing ethical practices in the business environment, as well as making decisions for recourse once transgressions have been discovered by management.

ABSTRACT

According to the Association of Certified Fraud Examiners (ACFE), fraud is defined as, "a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment" (2013). In general terms, fraud is perceived as a crime for gain, Fruad includes any intentional or deliberate act to deprive another of property or money through deception or unfair means.

Different types of fraud exist. . Fraud within an organization can be committed either internally or externally.

Association of Certified Fraud Examiners' (ACFE) 2012 Report to the Nations, impact of occupational fraud, losses of five percent in revenues. This equates to \$3.5 trillion global loss after being applied to the 2011 Gross World Product (2012). In particular, United States merchants lose approximately \$190 billion a year to credit card fraud (Shaughnessy, 2011).

This paper opens with a case of fraud in the retail industry. It then follows with a background of credit card use history and how financial transactions are processed when using credit cards. Specifically, this case illustrates the discovery by a manager of rampant credit card fraud committed by an organization's trusted supervisors and their employees. Instructor's notes are provided for background on this topic. The reader is invited to put himself or herself in the place of the manager, make decisions on how to resolve the current

situation, as well as identify what could have been in place or could be implemented in the future to preclude credit card fraud in this retail organization.

CASE STUDY

Mr. Williams, General Manager of GTS Department store was performing one of his favorite tasks rituals in the morning; walking through his retail store right before opening all of by name. He prided himself on being a “people person” and now considered his long-time employees as family. He’d been in retail since starting as a part-time cashier in high school and now, only five years away from retirement, he had been put in charge of one of the largest department stores in the chain, located in the Western Pacific. Originally from Pennsylvania, this promotion, however, required him to move to a small island in the Pacific with his family. They immediately adapted to the island lifestyle and developed many friendships with the local population island professionals. Many of the island’s residents were related to each other, and there were strong family ties and bonds. The island lifestyle was hard to ignore and had a significant impact on the organizational culture of the company. He felt right at home though as the relationship oriented work culture fit his personal style.

His store was one of two department stores on the island and at 80,000 square feet required a staff of 120 full and part-time employees. The store consisted of 22 departments including a variety of products: from housewares and furniture to clothing, as well as jewelry and shoes. There were 24 individual cash register stations throughout the store all monitored by an in-house security force using cameras and an undercover roving patrol.

GTS Department Store made 70% of their annual sales between the months of November and December due to strong sales from Black Friday, Christmas and Christmas merchandise. The holiday shopping season was one of Mr. Williams’ favorite times of the year, despite the extra work and hours required to handle the additional seasonal shoppers. This was when he and really appreciated all the hard work and effort of his supervisors and the cashiers on the sales floors sales floor’s in his opinion, played a role in the store’s success

One morning after his daily rounds on the store sales floor, he received a visit from a friend’s wife, Alice, who was in the same civic organization as his wife, Sarah. She apologized for bothering him during the busy holiday season rush, but was curious about a charge on her credit card. Mr. Williams welcomed the opportunity to review it with her, as she was one of his store’s best customers. Alice had saved her store receipt from the week before and had circled the total amount as well as the one item on the receipt in question. The store receipt showed that Alice had purchased one couch with a credit card transaction. She then showed him a copy of her most recent credit card statement. The credit card statement showed not one purchase, but two separate, identical transactions on the same day. It had appeared as if she had purchased two couches in two different transactions on the same day. He apologized for the error and told her he would have her credit card credited back for the additional transaction.

The next day, Mr. Williams went to his accounting manager with a copy of the store receipt and the credit card statement and asked her to credit back the credit card for one of the transactions. His accounting manager, Doris, credited the credit card and pulled up the

inventory sheet to check and verify the stock level. She was surprised to find that the inventory listing showed no couches in stock. credit card charge This was odd as there had originally been two of the same couch items in stock. When she looked at the store's copy of all the receipts for that day, she saw that there was another transaction and receipt for the second couch only hours after the first couch was purchased. Alarmed, she walked downstairs to Mr. Williams' office to let him know about the situation.

Mr. Williams met with his security manager, Dave, and his assistant store manager, Jeff, to discuss the situation in confidence, as the security staff was responsible for ensuring that all merchandise released were properly documented. Dave made the point that his staff or the warehouse staff would not have caught the merchandise removal, as there were two receipts showing that two couches had been bought and paid for. Upon investigation and tracking of the sales receipts and merchandise pick up slips, it was discovered that two couches had been physically removed from the warehouse and loaded onto a delivery truck. The delivery slip happened to be tracked to one of the employees.

After further investigation and interrogation of the warehouse employee, Joe, who had signed the delivery slip, it was discovered that he had instructed the delivery truck driver, Alvin, to deliver one couch to Alice, and the other couch to another employees' house; despite the fact that the delivery slip, with the two receipts attached, had Alice's name and address on it, indicating that both couches should have been delivered to her house.

As it turned out, the second couch was not delivered to Alice's house; it was delivered to Stephanie Jackson's house. Stephanie was the supervisor for the furniture department at GTS Department Store. The security investigation now shifted focused to Marcy, the cashier who had initiated both the sale transactions. As Marcy was confronted she was made aware that Joe from the warehouse already admitted to instructing the driver to take a second couch to another employee's house based on the receipts that had been generated under Marcy's employee number. This evidence was highly suspicious. The policy clearly dictated that the employee number was supposedly only to be used or known by the employee to which it had been issued. Marcy adamantly claimed that she did not remember ringing up two transactions for this merchandise and that she would have remembered the purchase of two couches. She claimed maybe someone else must have used her number.

Dave spent that evening reviewing the security tapes and came across a transaction at 69:10 p.m. on the camera that clearly showed Marcy ringing up a purchase by Alice, with Marcy processing her credit card through the register. The security tape also showed Marcy ringing up a transaction two hours later, but with no customer present.

When Dave and Mr. Williams confronted Marcy the next day she realized that management had enough information to prove that she had been a part of the credit card fraud ring. She immediately began telling "her" side of the story and blamed most of the problem on her supervisor, Stephanie. Marcy said that Stephanie put pressure on her to participate in this scheme, even though she did not want to. She also defended her actions saying that other employees, in other departments, were doing the same thing. Marcy claimed that it was, in fact, another employee who had shown her how to save the credit card information and then use that information to later transact a "purchase" so that when merchandise was taken out of the store or warehouse through security, there was a paid

receipt attached. According to Marcy, “several other employees including supervisors knew this was happening and was involved or was ‘looking the other way’”.

Mr. Williams was devastated and felt horribly betrayed. and those who were involved were some of his most trusted and longest tenured employees. He had fostered their professional development and career growthtreated , offing tuition assistance for his managers as well as advancement opportunities for all of the employees who had been a part of this ring. How many other customers had been a victim of these employees and others not yet identified or namedand ? How many customers in the past few months had been victims and had not even known that their credit card had been compromised because they did not compare their receipts to their credit card statements?

All Mr. Williams could think of was, “How can I stop this from ever happening again?”

INSTRUCTOR’S NOTES

Discussion Questions

1. You are the store manager, now that you have discovered the fraud and the extent of the fraud, what are your options?
2. What remedies does the manager have with regards to actions taken against the employees? What actions would you take?
3. How could this have been prevented or detected sooner? What are some options for security that can be deployed to prevent theft or detect theft?
4. Now that this has occurred, what measures or systems should be put into place to ensure that does notit does not re-occur?

PREVENTION VS. DETECTION VS. INVESTIGATION

Prevention

From a credit card consumer’s perspective, there are numerous ways to prevent credit card fraud. These methods will reduce the risks, and cut time that will cost the investigation. First and foremost, consumers should keep their credit card number confidential. Upon receiving a new card, the consumer is encouraged to cut up their old card as they expire. Consumers are also advised to keep statements in a safe place, shred all statements, inform the card issuer when traveling, notify the card issuer of any change of address, and inform the card issuer immediately if their card was stolen or lost (Sicilliano, 2013).

Before shopping online, consumers should verify their privacy policy regarding

personal information. Upon a successful online transaction, consumers should document their order confirmation. When shopping at a store, consumers should carefully observe employees as they hand over their credit card. The employee may scan the consumer's credit card to obtain their number (Sicilliano, 2013).

The consumer should always keep their receipts so they can check them against their statement. In addition, it is good practice for consumers to review and verify transactions online (Sicilliano, 2013). Consumers can also sign up for receiving automatic text messages or emails for every transaction receipt (Mellinger, 2013). They should immediately contact the respective financial institution regarding suspicious transactions. If the consumer thinks that their identity is stolen, then they should contact Equifax, Experian, and TransUnion to issue a fraud alert and to initiate an immediate credit freeze (Sicilliano, 2013).

Detection

Fraud detection is the "identification of actual or potential fraud within an organization" (Fraud Advisory Panel, 2011). Employers are mindful that employees and other insiders know how to take advantage of the organization. Insiders committing fraud are stealing confidential customer information. Employees who commit fraud by taking over accounts and ID theft are abusing their positions. This can happen anywhere. Employees may feel the pressure, and opportunities may exist. When employers suspect an employee has committed fraud, it is time to go into detection mode (Mellinger, 2013).

There are multiple methods of detecting employee and insider fraud. One of the first efforts starts with the initial employment screening. Here, effective screening can be useful in identifying individuals that exert specific and peculiar behaviors; thereby identifying the potential for internal theft and fraud. Training can also detect and deter fraud. Fraud prevention and detection training can improve loss prevention efforts by identifying dishonest activities. Furthermore, such training puts employees on notice and serves as a benefit to the organization by informing employees that they are being monitored for such activities.

Every year, employees should have continual training to ensure that policies and expectations are being met. Regardless, of the aptitude and proficiency of an employee's knowledge or skill, each employee should, even as a refresher, go through such training. Again, employee behavior is a strong indicator of fraud. It is always a good idea to keep an eye on employees that are acting out of character including a sudden change of wealth or expressing content (Mellinger, 2013).

Another effective method of detecting fraud is through the use of surveillance cameras in the organization's building. Most companies will install cameras on the ceilings or near cash registers. This will enable the security department a better view to monitor how transactions are being conducted. There may be blind spots in certain locations, but by having surveillance cameras closer to the registers, it will help the security department catch the thieves. On a daily basis, the security department should have different staff monitor the surveillance cameras. They should also check the cameras on a daily basis to ensure it is in a working condition (Mellinger, 2013).

Investigation

Fraud activities can include misappropriation of cash or inventory, fraudulent financial reporting, and money laundering. Investigating credit card fraud can be done with various methods. This may include reviewing and inspecting emails, documents and files, databases of all user input and activity, recently opened or accessed or deleted files, and online activities. The company also has the ability to monitor closely compromised or stolen credit cards.

The merchant should immediately report fraud by contacting the local police department, and contact the financial institution to find out the maximum liability for the fraudulent charges. The affected consumer should also act and contact the financial institution to cancel the card, and file a fraud alert with the three credit bureaus – Equifax, Experian, and TransUnion. Both the consumer and merchant are mutually affected by fraud. They should work together with the police and financial institution to track down the people committing the fraud (Deloitte, n.d.).

HISTORY OF CREDIT CARD USE

Early 1900s

Credit cards have been in existence since the early 1900s beginning with oil companies and department stores. Since then, the use of credit cards and its popularity have evolved significantly over time. Today, the use of credit cards have become a lifestyle necessity; even replacing cash as the preferred means of purchase. Who carries cash anymore?

Dating back to the 1900s, certain companies issued their own proprietary cards for use only at their business. This was used as a method of creating customer loyalty and improving customer service (Gerson & Woolsey, 2009). In 1946, a banker in Brooklyn introduced the first bank card known as the “Charge-It” program. When a customer used the bank card for purchases, the bill was forwarded to the bank. The Brooklyn bank reimbursed the merchant and later obtained payment from the customer. This system required that cardholders had an account with the Brooklyn bank (Gerson & Woolsey, 2009).

Diners Club

Subsequently, the Diners Club Card made its debut. Frank McNamara had forgotten his wallet while eating dinner one night. Determined to solve his wallet problem he was compelled to find cash alternatives. McNamara paid his bill with a cardboard card, coining it as the Diners Club Card. This was mainly for travel and entertainment purposes, but was

20,000 Diner Club cardholders (Gerson & Woolsey, 2009).

American Express

Another key rival to the Diners Club Card was American Express. Although American Express was formed in 1850, and specialized in deliveries, they invented money orders (1882) and traveler's checks (1891), which served as cash alternatives. American Express later brainstormed the idea of creating travel charg cards in 1946, but it wasn't until the Diners Club card that American Express jump-started the innovation trend of cash alternatives. By 1958, American Express entered the credit card industry with its own product in full force. In 1959, American Express introduced the first plastic made credit cards (Gerson & Woolsey, 2009). Subsequently, American Express introduced local currency credit cards in other countries. By then, about 1 million credit cards were being used at about 85,000 merchant establishments within the first five years, internationally. In the 1990s, American Express transitioned from being a charge card to an all-purpose card. American Express, now commonly referred to Amex, is about to celebrate its 50th credit card anniversary (Gerson & Woolsey, 2009).

Both the Diners Club and American Express cards were part of a "closed-loop" system; which consisted of the consumer, the merchant, and the card issuer. In this system, the issuer authorizes and handles all aspects of the transaction and settles directly with both the consumer and merchant. At the same time, the idea of revolving balances was introduced. This allowed cardholders more flexibility in managing their money by incurring finance charges rather than paying off their entire bill at the end of each cycle (Gerson & Woolsey, 2009).

Visa and MasterCard

In 1966, Bank of America established a corporation franchising the "BankAmericard" brand (later to be known as Visa) to banks nationwide. Another national credit card system was formed when a group of credit-issuing banks joined and created the InterBank Card Association (later to be known as MasterCard). Both Visa and MasterCard became direct rivals and reshaped the industry by creating the general-purpose credit card in an "open-loop" system. Amex, Diners Club, and Discover Card remained "closed-loop." The open-loop system required interbank cooperation and funds transfers. Visa and MasterCard's organizations were managed by board members, high-level executives from their banking organization. Visa and MasterCard issued credit cards through member banks and set the processing rules. The credit card industry grew exponentially and more banks became members of either the Visa or MasterCard association (Gerson & Woolsey, 2009).

Total Amount of Credit Cards Issued

As of March 31, 2013, Visa issued 278 million cards in the United States and 522 million cards to the rest of the world. MasterCard, as of June 30, 2013, issued 180 million

cards in the United States and 551 million cards globally. Lastly, as of June 30, 2013, American Express issued 52.5 million cards in the United States and 51.8 million worldwide (Ghahremani & Ray, 2013).

HOW CREDIT CARD TRANSACTIONS ARE PROCESSED

Other than the credit card number, the most important aspect of processing the credit card transaction is the Card Verification Value (CVV) number; also known as Card Verification Value, Card Verification Code, Card Identification Number, or Card Identification Value. CVV numbers are also Card Security Code (CSC) numbers, as well as CVV2 numbers. It consists of a three or four digit number on the back of the credit card that is printed by the magnetic strip (CVV Number, 2013). The three digit number can be found on Discover cards, MasterCard and Visa cards. A four digit number can be found on American Express cards. The purpose of the CVV is to ensure that the cardholder is in possession of the actual card, since the number cannot be copied from receipts or the magnetic strip. Only the cardholder and the financial institution know the unique code. CVVs may provide some protection for the merchant, but not transactions from a stolen credit card. Fraudsters who have the credit cards can still read and copy the CVV number.

Under privacy laws, retailers are required to keep customers information secure in order to deter fraud. Currently, many receipts show only the last four or five digits of the credit card and must not show the expiration date. This procedure was implemented in 2006, under the Fair and Accurate Credit Transactions Act, to improve financial security. The law applies only to electronic receipts, not to hand printed receipts, and only applies to customer's receipts and not the business copy. This law is applicable to all businesses that accept credit or debit cards. Merchants who fail to comply with the law will pay a \$2,500 per violation (FTC, 2007). The information on receipts may not prevent the stealing of information; however, it is deterrent. The credit card company will never ask for the whole credit card number over the phone. Receipts will show other information from merchant ID number, an approval code, reference sequencing number, and sometimes the terminal number. It is always best for customers to keep their receipts until they have cleared. Once they have cleared, it is best to destroy it.

In addition, there are times when credit card transactions must be manually processed. In such instances the cashier will take the customer's credit card and requests an authorization from the merchant bank. There are legitimate reasons why credit card transactions need manual authorization. For example, either the credit card strip is unable to track or the amount of the credit card is too high.

Figure 1 in the following page demonstrates an authorization process of manually inputting a credit card transaction:

1. The cardholder presents credit card to cashier to pay for purchases.
2. The cashier contacts the merchant bank by providing the transaction and credit card information, and requesting an authorization from the merchant bank.
3. The merchant bank submits the authorization request to the cashier if it is approved or declined.

4. If approved, the cashier will input the authorization code on the cash register to proceed with the transaction.
5. The cashier returns the credit card to cardholder.



Figure 1
Manual Transaction Process

EMPLOYEE THEFT THROUGH CREDIT CARD FRAUD

According to the Association of Certified Fraud Examiners (ACFE), fraud is defined as, “a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment” (2013). In general terms, fraud is perceived as a crime for gain, which includes any intentional or deliberate act to deprive another of property or money through deception or unfair means.

Different types of fraud exist. Victims primarily include organizations or individuals. Fraud within an organization can be committed either internally or externally. Perpetrators can range from employees, managers, officers, customers, vendors, or other parties.

In the Association of Certified Fraud Examiners’ (ACFE) 2012 Report to the Nations, the impact of occupational fraud, otherwise known as fraud internal to the organization, were losses of five percent in revenues, which equates to \$3.5 trillion global loss after being applied to the 2011 Gross World Product (2012). In particular, United States merchants lose approximately \$190 billion a year due to credit card fraud (Shaughnessy, 2011).

The risk of theft increases in correlation to the increase in credit card use. Specifically, retailers may experience theft from fraudsters that are inside their organization. Employee theft of retail customer information has become a major challenge for businesses. As the world transitioned to a technological era, advances in technology also allowed employees to easily steal customer credit card information seamlessly. In addition, lenient security and protocol procedures allow loopholes for easy data misuse and pilfering

(Merchant Connect, 2009).

Employees that commit credit card fraud have previously done so in multiple ways. One way is the employee processing a credit transaction to their personal account using the Merchant Point of Sale (POS) device using funds meant for the merchant's direct deposit account. A second method is the employee noting down the cardholders' card number information to be used at a later time by the employee. Another method is the employee stealing information from the customer's credit card through the use of a "card skimmer." This handheld device reads a card's magnetic stripe and records the cardholder data for later download to a computer. Following this, the information can be used to make unauthorized purchases or create counterfeit cards. This is also a form of identity theft (Merchant Connect, 2009).

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SPRINKLES CUPCAKES: A CASE STUDY OF CREATING A SUCCESSFUL INTERNATIONALIZATION STRATEGY

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CASE DESCRIPTION

The primary subject matter of this case concerns developing an internationalization strategy for a growing business, Sprinkles Cupcakes. The business owners, Candace and Charles Nelson have grown their business from one store in 2005 to 17 stores in the US and 1 in the Middle East under a licensing agreement. Their innovations include using the highest quality ingredients (e.g. sweet cream butter, bittersweet Belgian chocolate, pure Madagascar vanilla, fresh bananas, carrots, real strawberries, and natural citrus zests) baked fresh daily in small batches, and the creation of a 24-hour cupcake ATM machine. Questions that students should consider include how should Sprinkles continue to grow their business? What types of internationalization strategy could they consider? Should they focus on domestic growth first? Which countries could they target for growth? What changes if any could/should they make to their business/product when they expand internationally? What considerations should they take into account if licensing or entering wholly owned operations when expanding internationally? The case has a difficulty level appropriate for a junior or senior level course, although it may be used at a first-year graduate level, depending on the amount and complexity of the background information that is assigned. The case requires one hour (if the goal is class discussion only) to three hours (if the instructor's goals involve presentations by individuals or teams of students). This is relevant topic to students studying international business and how to successfully create and implement an internationalization strategy.

CASE SYNOPSIS

Everyone loves a good cupcake. Sprinkles Cupcake owners, Candace and Charles Nelson, have created over 20 delicious cupcake recipes. They have grown their business from one store in 2005 to 17 stores in the US and 1 in the Middle East under a franchising agreement. Now they need to consider an internationalization strategy to continue to grow their business. This case raises several internationalization strategy questions. How do they develop an internationalization strategy? How does an internationalization strategy differ from their corporate strategy? Should they continue to expand internationally or instead focus on growth domestically? If they do decide to continue international expansion, what countries should they target first and why? Finally, how should they expand internationally, by franchising or by wholly owned subsidiaries?

The Birth and Growth of the Sprinkles' Cupcake

During a visit in 2002 to New York City, Candace Nelson, and her husband Charles Nelson, tried the cupcakes at a well-known bakery. As Candace explained, “I get the cupcake thing – cupcakes are awesome, but the cupcakes aren’t that great.” Candace believed that it was “time for cupcakes to stop being the backup dancer to cakes,” and that cupcakes “could taste so much better.” Candace and Charles took it upon themselves to create a better cupcake, and over the next two years, the couple developed over 20 cupcake recipes. (Cava, 2007)

The decision to start a cupcake bakery was a high-risk venture; especially since the bakery business was in a four-year decline in the U.S. Despite the odds, the Nelsons pursued their dream. In April 2005, the Nelsons opened the first Sprinkles store on Little Santa Monica Boulevard, in Beverly Hills, California. On their first day of operation, the cupcakes sold out in just one hour, and in the first week, the Nelsons sold over 2,000 cupcakes. Based on this success, the Nelsons quickly decided to open more stores. (Davidow, 2007)

The Nelsons wanted their stores to reflect a sophisticated image, so they sought out an architect from Vienna to design Sprinkles’ “sleek, minimalistic” storefronts. The company’s modern theme is carried through to its logo and packaging, which were created by a former Martha Stewart employee (see Exhibit A). In fact, the company’s cupcakes are most recognizable by their traditional “modern dot” topping. Candace Nelson hand-crafted her cupcake recipes by using the highest quality ingredients including sweet cream butter, bittersweet Belgian chocolate, pure Madagascar vanilla, fresh bananas, carrots, real strawberries and natural citrus zests. All of the cupcakes are baked fresh daily, in small batches, and contain no preservatives, trans fats or artificial flavors. Sprinkles has a “sophisticated” take on the classic cupcake and even sells specialty offerings like vegan and gluten-free cupcakes and dog-food cupcakes.

Sprinkles is credited with being the world’s first exclusive cupcake bakery by *The Food Network* and as “the progenitor of the haute cupcake craze” by the *Los Angeles Times*. Sprinkles’ business concept is often where many cupcake entrepreneurs take their inspiration.

Since 2005, the Nelsons have expanded their cupcake business into twelve U.S. locations. In 2011, the company entered into a franchise agreement with M.H. Alshaya Co. - the same company that has helped brands like Cheesecake Factory and Starbucks expand internationally – to help them expand into the Middle East. Sprinkles' first international store opened in Kuwait City in December 2012. In the coming years, the company plans to open stores in 15 more cities, including London and Tokyo. (Craig, 2013)

More than One Way to Eat a Cupcake: Current Products

As of 2013, there are four options for customers to purchase these high-end cupcakes: the traditional retail storefront in 12 locations, a mobile cupcake truck, a cupcake vending machine, and cupcake mix sold online and in stores. In the retail cupcake stores, flavors are rotated throughout different days of the week, along with seasonal offerings. Sprinkles cupcakes are a premium product, with single cupcakes priced at \$3.75 and a dozen priced at \$42.

Stores are located mainly on the West coast: Beverly Hills, Los Angeles (2), Newport Beach, Palo Alto, and La Jolla. Other branches are in Chicago, Dallas, Houston, Scottsdale, New York City, and Washington, D.C. The interior of the store has been fashioned as a “bar” setting. The store is set up to “[evoke] the memory of European bakeries flooded with the smell of baked goods and awash in natural light.” (www.sprinkles.com/about/design) Patrons are encouraged to sit and stay in the store to enjoy their cupcakes. About 1,500 cupcakes are sold in every retail store every day.

Sprinkles has a mobile cupcake truck in California, known as the Sprinklesmobile. The company uses social media, such as Twitter, to let customers know where the truck is located for the day. It is set up in high traffic areas and at public events and festivals around Los Angeles. The truck only stays in each location for four or five hours at a time. The Sprinklesmobile can be rented for private events. L.A. is currently the only city with the cupcake food truck.

In keeping with the trend of bringing the product to the customer, the newest inception is the “cupcake ATM.” It is basically a vending machine for “cupcakes on the go.” The first one was located outside of the original retail store in Beverly Hills. A second cupcake ATM opened up in downtown Chicago in 2012. Each vending machine is restocked nightly with a variety of flavors to keep the offerings fresh and is open 24 hours. This new idea sells around 800 to 1,000 cupcakes a day (per locale) and has received very positive fanfare from customers.

Finally, consumers can enjoy Sprinkles at any time by purchasing the cupcake mix, sold on shelves and online. The mix is presently distributed exclusively through Williams-Sonoma. It is packaged in sixteen ounce containers priced at \$14.95. A set of two is sold at \$19.95. Each container will make 12 cupcakes. The mixes are made up of the same high quality ingredients used to bake the cupcakes in retail cupcake stores and are offered in

limited flavors of dark chocolate, red velvet, vanilla, and lemon. These different means of product distribution allows Sprinkles to conveniently reach a wide range of customers.

International Growth: Dealing with Obstacles

After finding great success with their first store in the heart of Hollywood, Sprinkles Cupcakes was approached by leading franchise operator M.H. Alshaya. M.H. Alshaya had helped franchise household names such as Starbucks, American Eagle Outfitters, Victoria's Secret, Cheesecake Factory, and Pinkberry. With the help of their new partner, Sprinkles began to look overseas for potential growth opportunities.

Charles Nelson saw the potential in the Middle East as a growth economy. He also noted an emergent affinity in the Middle East for goods from the Americas, particularly among the younger generation. As a result, Sprinkles and M.H. Alshaya decided to open their first international cupcake store in Kuwait. When the store opened its doors in December of 2012, it would only be the first in a plan to open an additional 34 stores in the Middle East. Although areas of the Middle East may seem risky for new business ventures, Sprinkles took into account a solid market analysis and cultural norms before moving forward with the expansion into the Middle East. According to the International Monetary Fund (IMF), the Middle East economy was expected to grow at 3.6% during 2013, a good deal higher than the 2.6% forecasted growth for the United States.

Sprinkles international market expansion has not been without obstacles and modifications to its products and services. Many of the early issues stemmed from cultural differences between the United States and the Middle East. For instance, alcohol is forbidden by Islam and is illegal in several Middle Eastern countries. Therefore a substitute for vanilla extract (which contains alcohol) had to be found. Sprinkles also faced difficulties when trying to import ingredients such as butter for its Kuwait operation. Countries in the Middle East can often take up to three weeks to approve such imports because of various administrative barriers and red tape or simply wanting to ensure the integrity of the supply chain. Sprinkles also altered their cupcake offerings to include custom items that symbolized local holidays and monuments.

With an additional investment from KarpReilly LLC, a private investment firm, in January 2013, Sprinkles will forge towards additional product offerings and growth. This in addition to the product offerings of the Sprinkles "automated" cupcake ATM, Sprinkles Ice Cream and the mobile Sprinkles food truck. Sprinkles Cupcakes has immense opportunities ahead of them but they will need to balance globalization with maintaining their small cupcake store roots.

The Future: Goals for Growth

Sprinkles Cupcakes has several goals on the horizon as they look for different ways to expand their business. With the success of their franchise agreement with M.H. Alshaya Co., Sprinkles Cupcakes has plans to have thirty-four new locations spread across Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, the Kingdom of Saudi Arabia, and the United Arab

Emirates (Urban). However, one major question is whether they should capitalize on their Middle East growth and seek more franchise agreements in the area or in other parts of the world.

Another potential avenue is to expand on the success of the Sprinkles Cupcakes baking mix and pursue a larger distribution network in conjunction with or beyond William Sonoma. Williams Sonoma, also partnering with M.H. Alshaya Co., began their international expansion in 2010 with locations in Dubai and Kuwait and currently ships to over 75 countries. There are obvious synergies that these companies could exploit. Sprinkles could also pursue distribution agreements with other specialty food stores or larger food chains such as Whole Foods. Sprinkles could also pursue other opportunities to deploy their Sprinklesmobile and/or their vending machine domestically or internationally. Remaining innovative is critical to continued growth in a more and more saturated cupcake market.

Lastly, Sprinkles could begin to diversify their product offering internationally. For example, instead of just selling cupcakes, they have begun to sell ice cream domestically. This broadens their customer base and is an easy item to sell within their current store format as well as to grocery stores. Their first ice cream store opened in Beverly Hills, California, next door to their existing cupcake store. Sprinkles Cupcakes plans to open more ice cream stores in Newport Beach, California and Dallas, Texas. Not only is this another way to grow their sales, but the additional products will also help to increase brand recognition and drive more sales for their existing cupcake business. Success with the ice cream product does not necessarily translate to a successful product internationally, so Sprinkles will need to determine what will work in their international target markets.

The Nelsons have a lot to consider. Should they pursue an internationalization strategy, and if so, how do they develop such a strategy? How would an internationalization strategy differ from their corporate strategy? Should they continue to expand internationally or instead focus on growth domestically? If they do decide to continue international expansion, what countries should they target first and why? Finally, how should they expand internationally, by licensing and franchising or by wholly owned subsidiaries?

Exhibit A | **Sprinkles Photos**

Beverly Hills, California Storefront



Source: www.metainteriors.com

Kuwait City, Kuwait Storefront



Source: FOXBusiness

Trademark Modern Dot Cupcake



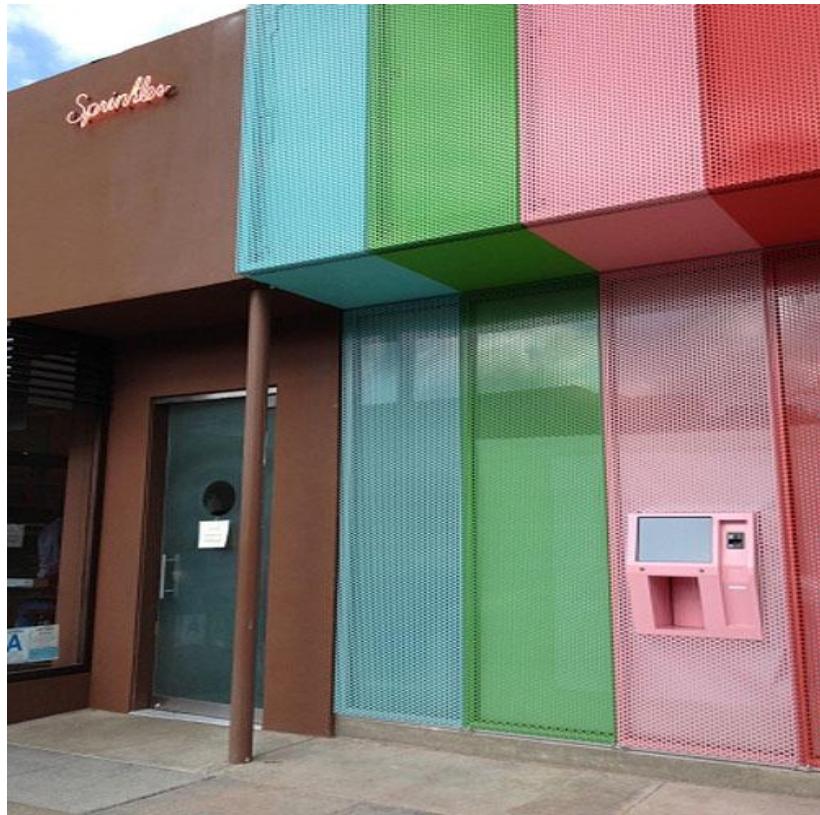
Source: anyluckypeny.wordpress.com

Cupcake Truck



Source: bestfamilytraditions.com

Sprinkles ATM



Source: www.huffingtonpost.com

Exhibit B | Sprinkles' Locations

- Arizona
 - Scottsdale
- California
 - Americana at Brand
 - Beverly Hills
 - The Grove
 - La Jolla
 - Los Angeles
 - Newport Beach
 - Palo Alto
 - Westlake Village
- Georgia
 - Atlanta
- Illinois
 - Chicago
- Nevada
 - Las Vegas
- New York
 - New York City, Downtown
 - New York City, Upper East Side
- Texas
 - Dallas
 - Houston
- Washington (Georgetown), D.C.
- Kuwait
 - Kuwait City

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INSTRUCTOR'S NOTES

SPRINKLES CUPCAKES: A CASE STUDY OF CREATING A SUCCESSFUL INTERNATIONALIZATION STRATEGY

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CASE DESCRIPTION

The primary subject matter of this case concerns developing an internationalization strategy for a growing business, Sprinkles Cupcakes. The business owners, Candace and Charles Nelson have grown their business from one store in 2005 to 17 stores in the US and 1 in the Middle East under a licensing agreement. Their innovations include using the highest quality ingredients (e.g. sweet cream butter, bittersweet Belgian chocolate, pure Madagascar vanilla, fresh bananas, carrots, real strawberries, and natural citrus zests) baked fresh daily in small batches, and the creation of a 24-hour cupcake ATM machine. Questions that students should consider include how should Sprinkles continue to grow their business? What types of internationalization strategy could they consider? Should they focus on domestic growth first? Which countries could they target for growth? What changes if any could/should they make to their business/product when they expand internationally? What considerations should they take into account if licensing or entering wholly owned operations when expanding internationally? The case has a difficulty level appropriate for a junior or senior level course, although it may be used at a first-year graduate level, depending on the amount and complexity of the background information that is assigned. The case requires one hour (if the goal is class discussion only) to three hours (if the instructor's goals involve presentations by individuals or teams of students). This is relevant topic to students studying international business and how to successfully create and implement an internationalization strategy.

CASE SYNOPSIS

Everyone loves a good cupcake. Sprinkles Cupcake owners, Candace and Charles Nelson, have created over 20 delicious cupcake recipes. They have grown their business from one store in 2005 to 17 stores in the US and 1 in the Middle East under a franchising agreement. Now they need to consider an internationalization strategy to continue to grow their business. This case raises several internationalization strategy questions. How do they develop an internationalization strategy? How does an internationalization strategy differ from their corporate strategy? Should they continue to expand internationally or instead focus on growth domestically? If they do decide to continue international expansion, what countries should they target first and why? Finally, how should they expand internationally, by franchising or by wholly owned subsidiaries?

Importance of an Internationalization Strategy

Business professors and instructors are very often interested in providing their students valuable and useful tools to help fill their business toolbox - tools which can assist these future business managers and executives in creating value for their businesses. In the field of international business, one such tool is the ability to create an effective internationalization strategy.

Developing an effective internationalization strategy can help guide businesses to successful growth outside of their domestic markets. An effective internationalization strategy can help organizations focus their limited resources into the markets and countries where they can create the most value. An effective internationalization strategy can also help guide internal functions and departments to work effectively together to meet the business' vision, mission, and goals.

Figure 1 depicts a model of internationalization strategy that some of the authors have employed in the instruction of MBA students. Figure one is a combination of strategies collected from previous research (Bartlett and Ghoshal, 2002; Yip, 1989) and leads the decision maker through the various steps that are required in developing an internationalization strategy.

The need for such a framework is evident as many multinational firms have failed to effectively manage their international expansions, due in part to the lack of a well-developed internationalization strategy (Phan, 2005; Chandrasekhar and Dawar, 2009). Such failures may have been in any one or more of the areas discussed within the internationalization framework, **FROM NOT** having a clear corporate mission/vision, from conducting incomplete country analyses and from poor execution of operational decisions.

FIGURE 1. INTERNATIONALIZATION STRATEGY

Source: Overby and Chen, enhanced from Bartlett and Ghoshal (2002) and Yip (1989).

An Effective Internationalization Strategy

The internationalization strategy illustrated in Figure 1 consists of eight distinct areas, each of which will be discussed in further detail: 1. Corporate Mission/Vision, 2. Internationalization Motivation and Objectives, 3. Business Analysis, 4. Country Analysis, 5. Industry Globalization Drivers, 6. Internationalization Strategy, 7. Entry Strategy, and 8. Operational Decisions. Each of these sections is an important part to an effective internationalization strategy, and no one part should take priority over another, nor should any one part be eliminated.

Corporate Mission/Vision

All effective strategies start with the corporate mission and vision. An effective internationalization strategy should be structured to support the corporate mission and vision. Any lack of clarity in the corporate mission and vision will only amplify itself throughout the internationalization strategy process.

Resources are available on how to develop a corporate mission/vision, and therefore this activity will not be covered in detail within this note. However, effective internationalization strategy must start with a clear and effective corporate mission/vision.

Researchers consistently assert that management commitment is critical to successful internationalization. Without commitment from the top, middle and lower-level managers are not likely to have the resource support to carry through with international projects, and senior managers are likely to pull out of such projects at the first sign of trouble (i.e., limited market share, recurring financial losses, foreign government interference, etc.).

Strategy exists at both the corporate and business unit level. Corporate strategy generally involves the choice of what businesses the organization competes in and how the various businesses units contribute value to the overall corporate profile. Although there are certainly international considerations at the corporate strategy level, the focus of this note and generally of graduate-level international business classes is at the business unit level. Therefore, our model is structured around internationalization at the strategic business unit level.

Helpful questions to help stimulate conversation may include:

What is Sprinkles' corporate mission and vision?

What should Sprinkles consider adding or removing from its corporate mission and vision?

Internationalization Motivation and Objectives

The second area of an effective internationalization strategy involves the internationalization motivation and objectives. What is often helpful in this stage is simply thinking through a series of questions. This can be done with a cross-functional executive team or be assigned to a lower level team and later reviewed by a cross-functional executive team.

Helpful questions to help stimulate conversation may include:

Why does Sprinkles want to expand at this particular time?

Why does Sprinkles want to expand internationally?

What benefits do they expect from international expansion?

Where does Sprinkles see their international presence five years from now?

What are Sprinkles' competitors doing internationally and why?

What has been Sprinkles' successes and challenges?

The answers to these questions are likely to be many and varied. However, there are several important motives that often emerge. The most cited motive is access to new markets. This motive can be driven simply by a proactive desire for new customers or reactively to changing market conditions in the home market, such as market saturation, falling profitability, increasing domestic regulation, or a poor domestic economy.

A second motive often involves the need to achieve lower costs and economies of scale. The more markets a company enters, the more it is able to spread fixed costs and improve overall operating efficiencies.

Another motive involves access to foreign resources. Those resources can include everything from foreign capital, affordable labor, advanced technologies, and natural endowments, such as organic and nonorganic materials, renewables and non-renewables.

A more strategic motive sometimes entails a company attempting to spread operating risk across a wider sphere. For example, an automobile manufacturer might actually reduce risk by maintaining engine plants in several diverse locations around the globe. Similarly, constructing an efficient value chain requires that each element (whether internally owned or externally contracted) be placed in the most efficient and effective location possible.

Another strategic motive might be the desire to exploit one's core competencies. Once a firm has built a core competency, it often makes sense to capitalize on that competency in as many places as possible and as quickly as possible, particularly if the competency is likely to be quickly replicated by competitors.

In the case of Sprinkles, they were approached by leading franchise operator M.H. Alshaya to license their business in the Middle East. Now, they should consider being more pro-active in developing their internationalization motivation and objectives.

Business Analysis

Conducting a formal business analysis takes the motivation and objectives a step further. Specifically, what are the organization's core competencies? Core (distinctive) competencies are the product of firm resources and capabilities (Prahalad and Hamel, 1990). Firm resources represent internal assets such as patents, brand equity, reputation, and knowledge. Capabilities are internal skills and practices that a firm possesses such as manufacturing processes, research and development, sales, distribution, and financial control. Distinctive competencies arise when an organization is able to use certain capabilities with certain resources so well that a rival is not able to duplicate the result. A good test of distinctiveness is when this competency enables the organization to deliver superior customer value.

According to Prahalad and Hamel (1990), three tests should be applied to determine an organization's core competencies: 1) it should provide potential access to a wide variety of markets, 2) it should be perceived as a significant contributor to customer benefit(s), and 3) it should be difficult for competitors to imitate.

Possible sources of global competitive advantage that have been identified in the literature include:

- transferring core competencies
- production economies of scale
- global experience
- logistical economies of scale
- marketing economies of scale
- product differentiation
- local responsiveness
- proprietary product technology

In terms of internationalization, an important question that must be addressed is whether an organization's core competencies are transferrable. If it will be difficult to transfer a core competency (e.g., brand loyalty, technological superiority) into international markets, then internationalization may not be easily or successfully achieved.

Given that strategy is ultimately about finding ways to deliver superior value, another important concept is the value chain. According to Porter (1985), the value chain represents each major stage where value is added, from conception to end use. The chain includes core processes, including research and development, suppliers, production, marketing, distribution, and ultimately final customers. Along the way, corporate services support the core processes. A well-designed value chain in itself can actually be considered a core competency. Therefore, it is important for a firm to analyze its value chain in order to identify weak points where greater value could be added and opportunities for improving the process.

There are obvious international implications for value chain analysis and design. For example, automobile manufacturers often require their suppliers to be located within a specified geographic radius in order to minimize the costs of transportation and maximize the speed of input deliveries. By exploiting both upstream and downstream information, firms are able to optimize their value chains and sometimes even create new business models, especially when they are able to bypass intermediaries and/or create innovative solutions.

Helpful questions to help stimulate conversation may include:

What are Sprinkles' competitive advantages?

What are some of Sprinkles' core competencies and capabilities?

How transferrable are Sprinkle's core competencies to other countries and foreign markets?

What are the key considerations in designing Sprinkles' value chain as they expand internationally? Which materials should be sourced locally and which from abroad?

Students may suggest that Sprinkles' competitive advantages include being the world's first cupcake bakery, its commitment to the freshest of ingredients, innovation with the cupcake ATM, and innovation with combining cupcakes with ice cream at their bakery locations.

The core competencies and capabilities of Sprinkles may include the ability to innovate - developing new and tasty cupcakes, ice creams and other food recipes. The competencies may also include the ability to innovate new retail channels such as the cupcake ATM.

The question around transferability of Sprinkles' core competencies should lead to debate among the students. Some students may argue that Sprinkles' ability to innovate product and service offerings will be easily transferrable. Others may argue that Sprinkles has no competitive advantage that cannot be easily copied internationally and is therefore doomed to fail if they continue to expand internationally.

Finally, Sprinkles' value chain analysis could lead the discussion in multiple directions. How should Sprinkles' decide what to purchase locally and what to source globally; from raw material ingredients for the cupcakes and ice cream, to equipment for the kitchen and displays, decorations, tables, and chairs, for the bakery? What process might the students propose for making these decisions? Separating the class into groups to draft a process flow chart may be useful in discussing potential value chain analysis decision processes.

Country Analysis

Conducting a country analysis of potential countries for Sprinkles Cupcakes to consider is an important exercise. A common and useful tool is the CAGE analysis framework (Ghemawat, 2001), which is shown as Table 1. Students could use the framework to identify and evaluate a list of countries along each of the CAGE dimensions (Cultural, Administrative, Geographical, and Economic distance). This exercise would then help students identify a subset of countries which Sprinkles might consider.

Detailed country analyses are critical to an internationalization strategy and should be conducted on all potential countries of interest. A funnel type of approach should be used, beginning with a large number of countries that are considered and analyzed with broad tools (i.e., criteria that are viewed as important to the firm). The CAGE framework could be used to help screen and filter countries from a large population to a much smaller subset. Once a handful of countries have been identified, then more detailed country analyses should be completed, possibly including several introductory visits to the countries to obtain first-hand knowledge.

Helpful questions to help stimulate conversation may include:

Using the CAGE framework, what countries should Sprinkles consider expanding?

Using the CAGE framework, what countries should Sprinkles avoid?

Which of the CAGE dimensions is most relevant to Sprinkles? Why?

Figure 2. CAGE Framework (Ghemawat, 2001)

| Cultural distance | Administrative distance | Geography distance | Economic distance |
|--|---|---|--|
| Attributes creating distance | | | |
| Different languages | Absence of colonial ties | Physical remoteness | Differences in consumer incomes |
| Different ethnicities; lack of connective ethnic or social networks | Absence of shared monetary or political association | Lack of a common border | Differences in costs and quality of |
| Different religions | Political hostility | Lack of sea or river access | <ul style="list-style-type: none"> • Natural resources • Financial resources • Human resources • Infrastructure • Intermediate inputs |
| Different social norms | Government policies | Size of country | |
| | Institutional weakness | Weak transportation or communication links | |
| | | Differences in climates | |
| Industries or products affected by distance | | | |
| Products have high linguistic content (TV) | Government involvement is high in industries that are | Products have a low value-of-weight or bulk ratio (cement) | Nature of demand varies with income level (cars) |
| Products affect cultural or national identity of consumers (foods) | <ul style="list-style-type: none"> • Producers of staple goods (electricity) • Producers of other "entitlements" (drugs) • Large employers (framing) • Large suppliers to government (mass transit) • Nat'l champions (aerospace) • Vital to nat'l security (telecom) • Exploiters of natural resources (oil, mining) • Subject to high sunk costs (infrastructure) | Products are fragile or perishable (glass, fruit) | Economies of standardization or scale are important (mobile phones) |
| Product features vary in terms of size (cars), standards (electrical appliances), or packaging | | Communications and connectivity are important (financial services) | Labor and other factor cost differences are salient (garments) |
| Products carry country-specific quality associations (wines) | | Local supervision and operational requirements are high (many services) | Distribution or business systems are different (insurance) |
| | | | Companies need to be responsive and agile (home appliances) |

Source: Recreated from Ghemawat, Pankaj. 2001. Distance Still Matters, *Harvard Business Review*, 140.

Industry Globalization Drivers

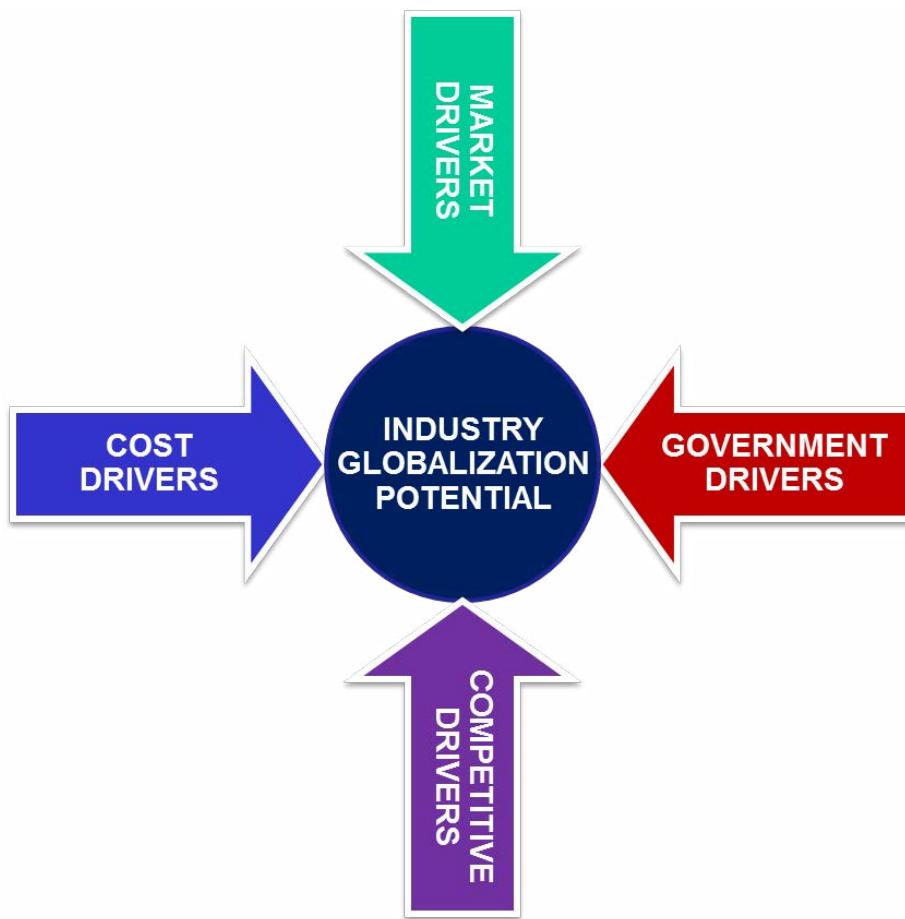
Aside from internal issues, the external industry environment can have a significant effect on internationalization potential. Yip (1989) discusses four key globalization drivers for industries: market, cost, competitive, and government (see Figure 3). These drivers can either increase (or decrease) the potential motivation of an industry or particular business to pursue globalization of markets or globalization of production.

For example, market drivers include common customer needs and tastes, global customers and channels, transferable marketing, and leading countries. These market drivers may cause companies to seek globalization. Similarly, cost drivers include global scale economies, steep experience curve, favorable transportation costs, differences in country costs (including foreign exchange), high product development costs, and fast-changing technology. These cost drivers could either positively support a company or industry to move towards globalization or negatively support a company or industry to move away from globalization.

Competitive drivers may include high exports and imports, interdependence of countries, competitors from different countries, globalized competitors, transferable competitive advantage, and equally application in service businesses.

Using this industry globalization framework, the key work to be completed in developing an internationalization strategy is to analyze a particular industry and business and determine which industry drivers are present for that industry or business. This detailed analysis can be utilized in conjunction with a similar business and country analysis and collectively be used as inputs into selecting the proper internationalization strategy. The flow of this analysis is illustrated in Figure 1.

Figure 3. Industry Globalization Drivers (Yip, 1989)



Helpful questions to help stimulate conversation may include:

Which of Yip's (1989) four industry globalization drivers might impact Sprinkles and the global baked goods market?

What are some Market drivers for the global cupcake and baked goods industry?

What are some Cost drivers for the global cupcake and baked goods industry?

What are some Competitive drivers for the global cupcake and baked goods industry?

What are some Government drivers for the global cupcake and baked goods industry?

Internationalization Strategy

After analyzing both firm-specific advantages, industry globalization drivers, and other external factors, a firm is able to assess the importance and appropriateness of internationalization to the goals of the firm. Assuming a firm has determined that internationalization is important and appropriate, a strategy for internationalization must be developed. Such a strategy involves answering several questions:

Which value chain elements are involved?

Where to compete?

How to compete?

The model shown in Figure 4 characterizes appropriate internationalization strategies along with the relevant elements involved. The model is not intended to be prescriptive but rather descriptive. However, it does identify the key decisions that must be made in order to formulate an appropriate internationalization strategy.

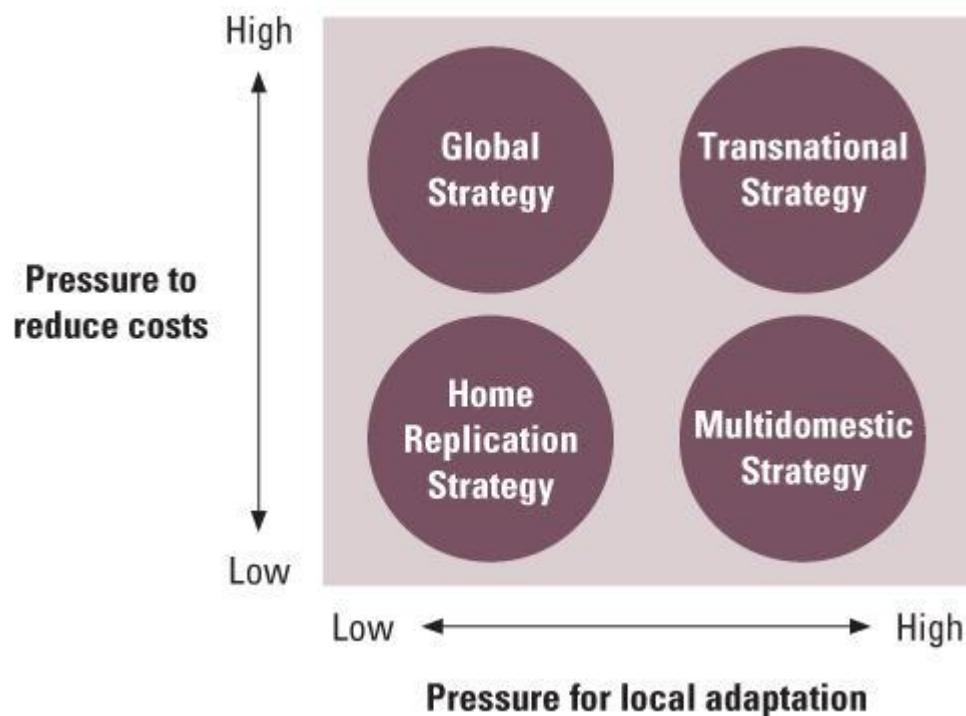
A firm's internationalization strategy can be defined as the actions that managers take to attain the goals of the firm. Profitability can be defined as the rate of return the firm makes on its invested capital. Profit growth is the percentage increase in net profits over time. The more value customers place on the firm's products, the higher the price the firm can charge for those products. The value created by a firm is measured by the difference between V (the price that the firm can charge for that product given competitive pressures) and C (the costs of producing that product). Firms can increase their profits by adding value to a product so that customers are willing to pay more for it or by lowering the costs. There are two basic strategies for improving a firm's profitability: a differentiation strategy or a low cost strategy.

Strategic Positioning. A central tenet of the basic strategy paradigm is that in order to maximize its long run return on invested capital, a firm must: 1) pick a position on the efficiency frontier that is viable in the sense that there is enough demand to support that choice; 2) configure its internal operations so that they support that position; and 3) make sure that the firm

has the right organization structure in place to execute its strategy. The value chain is one model for helping to design a strategic position. (Hill, 2014)

A common tool for selecting a broad international strategy is the Bartlett and Ghoshal (2002) international strategy 2x2 matrix. In this matrix, firms should identify the pressure for local adaptation that exists in a particular industry and the pressure to reduce costs that the firm experiences in that industry as well. Based upon these two dimensions, the firm can effectively select which international strategy may best be suited for the product or product category.

Figure 4. Bartlett and Ghoshal (2002)



Helpful questions to stimulate conversation may include:

Which internationalization strategy (Home Replication, Multi Domestic, Global, or

Transnational) might be the most appropriate for Sprinkles? Why?

What details should be included in their internationalization strategy stated above?

Entry Strategy

The entry strategy centers around two decisions: location and mode. Location has been discussed on a broad scale under country analysis, but can be focused more narrowly to cities and specific locations in a city for a given country. A sample framework is provided that could be useful in location analysis. It is often referred to as a factor rating tool, but allows for managers/executives to place quantitative analysis on more typical qualitative questions. Figure 4 shows a location Analysis Factor Rating tool that could be used in developing an entry strategy for Sprinkles.

Mode of entry involves the various forms of market entry which are available to organizations, including: exporting, licensing, franchising, joint ventures, and wholly owned subsidiaries. Discussion of which of these modes of entry is available and preferable to Sprinkles Cupcakes should lead to an interesting class discussion. Students should realize immediately that exporting cupcakes from the US would not be a preferable solution. However, discussion around whether franchising, joint ventures, and wholly owned subsidiaries is a more preferred method becomes less clear.

Helpful questions to help stimulate conversation may include:

Which location(s) should Sprinkles prioritize? Why?

Which mode of entry should Sprinkles pursue for each country? Why?

How can the location analysis factor rating be used to help make qualitative decisions more quantitative?

Figure 4. Location Analysis Factor Rating (example), Scale: 1 to 5, with 5 the highest

| Location Factors | Weight | Location | | | | |
|-------------------------|---------------|-----------------|----------|----------|----------|----------|
| | | A | B | C | D | E |
| Market Size | 30 | 3 | 2 | 2 | 3 | 2 |
| Labor Availability | 20 | 3 | 2 | 2 | 3 | 2 |
| Competition | 21 | 4 | 4 | 5 | 5 | 4 |
| Country Regulations | 14 | 2 | 2 | 2 | 3 | 2 |
| Infrastructure | 6 | 2 | 1 | 1 | 2 | 2 |
| Supply of Raw Materials | 9 | 2 | 1 | 1 | 2 | 1 |
| Total Ranking | 100% | 2.92 | 2.27 | 2.48 | 3.27 | 2.33 |

Operational Decisions

Operational decisions include (but are not exclusive to) areas of organizational structure, human resources, marketing, and production. Each of these areas requires attention and could be used to spark discussion among the students. Questions that could be used to stimulate discussion include but are not limited to the following.

Organizational Structure

- *What organizational structure would be appropriate for the Sprinkle's international ventures?*
- *What decisions are foreign stores allowed to make? Local original recipes? Modification of recipes? Substitution of ingredients? Decoration of the stores? Prices that can be charged? How much centralization/decentralization of decisions will be allowed?*

Human Resources

- *Does opening an international location require foreign owners/operators to spend time at a US location?*
- *Should Sprinkles assign US owner/operators at a foreign location for a period of time to train the local employees and staff?*
- *What similarities and differences should there be in regards to pay and benefits of local employees as compared to US employees?*

Marketing

- *How should Sprinkles market the products for each particular country? Are the target customers the same for each foreign country and are they the same demographic as in the US?*
- *Should Sprinkles include foreign locations on their US website and in their marketing in the US? Why or why not?*
- *How similar or different should the appearance of the stores be than in the US?*

Production

- *What changes in recipes or new products, if any, should Sprinkles consider for each foreign country?*
- *Which raw materials should be sourced locally and which should be sourced from the US?*
- *What equipment requirements will there be for each foreign location?*
- *How will the foreign locations ensure quality control?*
- *How will the foreign location employees and staff be trained?*

Summary

The Sprinkles Cupcake case is a case that allows business students to improve their skills in creating an internationalization strategy for a growing business. While the solutions may not be black and white for the company, the value of discussing a framework for creating an internationalization strategy and for utilizing tools to help create a strategy should prove useful in training future business leaders to meet the growing demands of a global economy.

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THE GOLDEN GUP: IDENTIFYING THE INVENTORY CHANGE VARIANCE

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CASE DESCRIPTION

Why don't the numbers add up? When you purchase a different quantity of inventory than you use in production, the cost variance does not equal the price and efficiency variance. The difference can be attributed to the inventory change variance, a new concept in variance analysis. In the Golden Gup Case this change in inventory variance is introduced, explained and calculated. The case, which has been used in both upper division cost accounting and MBA managerial accounting courses, addresses the functional, personal and broad business perspective core competencies as identified by the American Institute of Certified Public Accountants (AICPA).

CASE SYNOPSIS

In the Golden Gup case, the traditional direct materials price variance plus the direct materials quantity variance does not equal the total cost or flexible budget variance. This occurs because the price variance uses actual quantity of materials purchased and the quantity variance uses actual quantity of materials used. Traditional managerial/cost textbooks note that different quantities are used in these calculations but are silent on the actual calculation under such circumstances. Therefore, students cannot reconcile the total cost or flexible budget variance for direct materials and they are not prepared for real world applications where inventories do in fact change. Students find this frustrating both because the numbers don't add up and because they realize that this is a common phenomenon in the real world and they are not ready to deal with such a situation.

In this case we do the calculations and name the variance as an inventory change variance. Once we do that, the price variance plus the inventory change variance plus the quantity variance actually reconciles the flexible budget variance.

Gupper Gascoigne (aka the Golden Gup) is the Cadillac of Oldies Mobile DJs. He has a weekly radio program, restores and sells jukeboxes and classic cars, and has a Jukebox Rental business. He runs his many and varied businesses out of the 20 car garage at his home in Boonton, NJ. You can get additional information about his various business lines at <http://www.goldengup.com>.

Over the years Gup has been collecting small Jukeboxes that had been in diners at individual tables. He has been shining them up, inside and out, and selling them. Gupper's success has come from artistry and passion, rather than planning. His love of the R&B music that he plays, and his passion and energy, have made him a success without much need of careful planning.

Recently the Golden Gup married the Lovely Lulu. Lulu had a business background and took a look at Gup's varied businesses and thought she could make improvements. "Let's take a closer look at some of your product lines to see if we can make them better" she said. She was sure that with planning and budgeting as well as some performance evaluations at the end of a cycle, they would be able to identify Gup's strengths and weaknesses.

Recently at an antique car show Gup ran into a manager of a large diner chain (the Dashing Diners). The manager was interested in Gup's various businesses, particularly his interest in jukeboxes and how they gelled with his diner theme. He had plans to open a new diner in New Jersey and asked Gup for a bid on 120 custom mini jukeboxes and music for booths in the diner.

Lulu saw this as an opportunity to start a new business line, and turn it in to a profitable venture. She did the footwork in pricing out the components and figuring out the assembly process. She identified the following costs associated with the new product.

| | |
|----------|-----------------------------------|
| Shell: | \$18 |
| Innards: | \$15 |
| 45s: | \$20 (50 45s at about \$0.40each) |

From experience in putting together earlier jukes Gup estimated that it would take about an hour to put together each jukebox. Gup wanted to do it himself, but Lulu insisted his time was better spent on other business endeavors and that they should hire somebody. They figured they could hire somebody at \$12 an hour. Using this data, Lulu put together a budget so that they would have a cost figure to use for their bid.

After preparing the budget, Gup and Lulu sat down to think of what an appropriate pricing strategy would be. Lulu thought they should mark up costs 100% so they would be certain to cover any hidden costs they had not accounted for. Gup thought they should have a profit margin of 50%, because he heard somewhere that was an acceptable profit margin.

Gup and Lulu gave their bid to Dashing Diners who immediately accepted it and they went to work ordering parts and looking for someone to hire. Their neighbor had asked Gup if he had anything his son Ryan could do for him this summer. Ryan was just completing his junior year at State U. He was majoring in accounting and even though he had a 3.85 GPA he did not get one of the coveted summer accounting internships. Ryan's dad told Gup that although Ryan seemed a bit disappointed he said he'd just as soon hang out with Gup for the summer anyway. Gup and Lulu thought this would be a win win situation for everyone so they arranged to hire Ryan to assemble the parts.

Part way into production Dashing Diners called to say they had increased the size of the Diner and would like to increase their order from 120 units to 150 paying the same unit price. Lulu quickly put together a flexible budget for selling 150 units and Gup and Lulu agreed to supply the additional jukeboxes.

Additional information that Gup and Lulu found as they ordered parts and continued production is given below.

Shell: The shells were ordered from Ali Express. The price of an order (including shipping) was very subject to the lot size. If you ordered 1 unit, the cost was \$25. If you ordered 100 units, the cost went down to \$18 per unit, and if you ordered 500 units, the cost went down to \$16 per unit. Gup was certain the endeavor would be a success and more orders would come in. Therefore he ordered 500 units for a total cost of \$8000. When the order arrived from Singapore, 5 of the units had been damaged in transit and were thrown out. At the end of the job there were 345 units on hand.

Innards: The innards were contracted through a nearby electronics firm. Gup had been using this firm for years while restoring his old jukeboxes. He likes the firm because they have very high quality and if something doesn't work right, they replace it immediately. He originally contracted for 120 units at \$15 per piece, for a total of \$1800. When the added order for an additional 30 units came in, he went back to the electronics company and they said they would have to charge \$18 each to get the units in time since they would have to pay overtime. Gup agreed.

45s: Gup had a large stock of 45s (2000 45s at an average cost of \$.40 each) on hand, as he collected them and bought them at estate sales. However, to take care of the entire batch of 150 units, he needed a total of 7500 45s. On eBay Gup was able to purchase 6000 45s in good condition at a cost of \$2,520 (\$.42 each). A number of 45s needed to be thrown out due to scratches. A physical count of 45s after the project was complete showed 300 45s on hand.

Labor: They hired Ryan to assemble the units. They offered Ryan \$12 an hour, but Ryan's mother wouldn't let them pay him more than \$10. Even though Ryan was about to complete his accounting degree he was one "cool cat" and had admired Gup for years, hanging out around the garage whenever there was any activity. This was Ryan's dream job. He arrived early every morning and stayed late every afternoon. Whenever Gup showed up Ryan would follow him

around asking questions about the business. Gup enjoyed Ryan and liked having these “mentoring” chats with him. Ryan ended up working 200 hours at \$10 an hour.

Profits: When all was said and done, Gup and Lulu earned cash profit of \$4,640 on the Dashing Diner job. They are trying to understand why their profit was \$4,640 when they thought it would be \$9,750. That was what they had budgeted. They knew the revenue came in at budget and that some of their costs were even less than planned. For example, they paid Ryan \$10 per hour and had budgeted \$12 per hour. They were perplexed. Knowing Ryan was a great accounting student they asked Ryan if he could explain it to them. Additionally, they wondered if they should continue with this venture. Their time was very valuable and they expected to make at least a 40% profit margin on their projects.

THE GOLDEN GUP: IDENTIFYING THE INVENTORY CHANGE VARIANCE

TEACHING NOTES

CASE DESCRIPTION

Why don't the numbers add up? When you purchase a different quantity of inventory than you use in production, the cost variance does not equal the price and efficiency variance. The difference can be attributed to the inventory change variance, a new concept in variance analysis. In the Golden Gup Case this change in inventory variance is introduced, explained and calculated. The case, which has been used in both upper division cost accounting and MBA managerial accounting courses, addresses the functional, personal and broad business perspective core competencies as identified by the American Institute of Certified Public Accountants (AICPA).

CASE SYNOPSIS

In the Golden Gup case, the traditional direct materials price variance plus the direct materials quantity variance does not equal the total cost or flexible budget variance. This occurs because the price variance uses actual quantity of materials purchased and the quantity variance uses actual quantity of materials used. Traditional managerial/cost textbooks note that different quantities are used in these calculations but are silent on the actual calculation under such circumstances. Therefore, students cannot reconcile the total cost or flexible budget variance for direct materials and they are not prepared for real world applications where inventories do in fact change. Students find this frustrating both because the numbers don't add up and because they realize that this is a common phenomenon in the real world and they are not ready to deal with such a situation.

In this case we do the calculations and name the variance as an inventory change variance. Once we do that, the price variance plus the inventory change variance plus the quantity variance actually reconciles the flexible budget variance.

RECOMMENDATIONS FOR TEACHING APPROACHES

This case is appropriate on an individual basis for an upper division cost course or an MBA managerial accounting course. In the lower division managerial accounting course the students would benefit by working in groups.

In these courses most textbooks generally teach cost variances or flexible budget variances as the difference between actual and the flexible budget. The variances are defined as:

$$\text{Price or rate variance} = (AP-SP)AQ$$

$$\text{Quantity or efficiency variance} = (AQ - SQ)SP$$

$$\text{While the total cost or flexible budget variance} = (AP \times AQ) - (SP \times SQ)$$

Textbooks then note that for inventory the price variance uses actual quantity purchased while the quantity variance uses actual quantity used. The calculations are shown below:

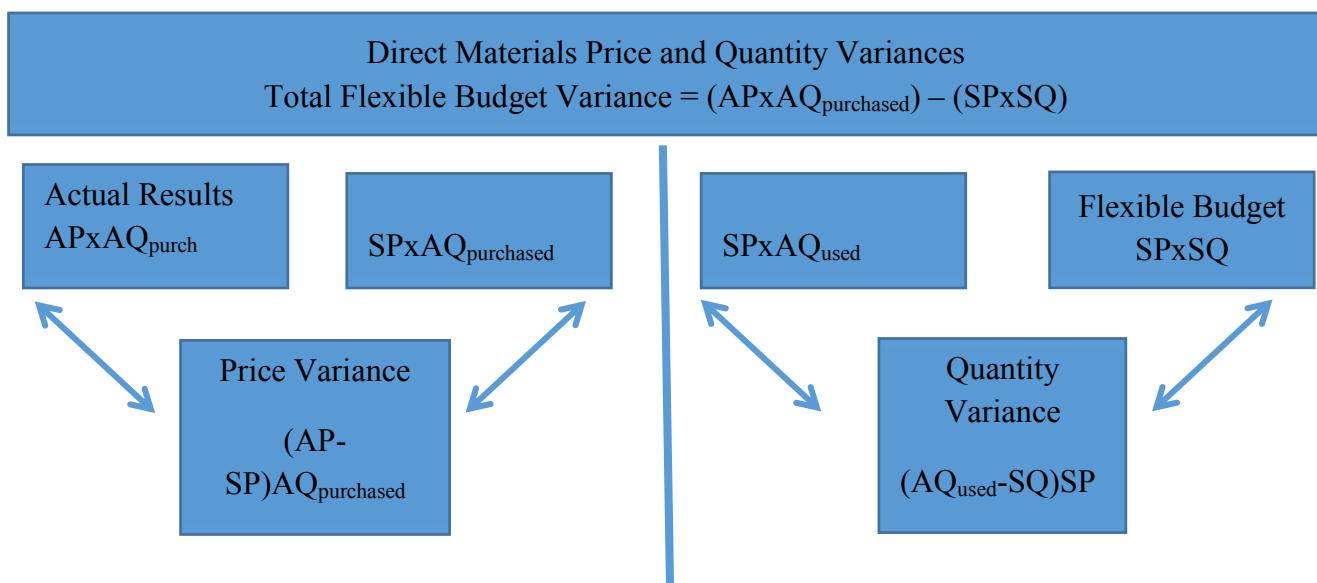
$$\text{Materials price variance} = (AP-SP)AQ_{\text{purchased}}$$

$$\text{Materials quantity variance} = (AQ_{\text{used}}-SQ)SP$$

$$\text{While the total cost or flexible budget variance} = (AP \times AQ_{\text{purchased}}) - (SP \times SQ)$$

Looking at the tree diagram in Figure 1 we can see why the price variance and quantity variance do not add up to the total flexible budget variance.

Figure 1



Having a disconnect of this nature is extremely frustrating to all students but particularly to accounting students who are used to numbers adding up to a totals that balance. We find that traditionally students have a very difficult time with the topic, even when you point out the difference is due to changes in inventory.

Learning Objective 3: Prepare a budgeted income statement

Learning Objective 4: Prepare a flexible budget

Learning Objective 5: Prepare a cash based income statement

Learning Objective 6: Calculate activity variances

Learning Objective 7: Calculate price/flexible budget variances

Learning objective 8: Calculate cost price and quantity variances

Learning objective 9: Calculate the inventory change variance

Learning objective 10: Reconcile the price/quantity/inventory change variance with the flexible budget variance

Learning Objective 11: Prepare an accrual based income statement.

Learning objective 12: Reconcile cash based and an accrual based income statement.

Perhaps most importantly, this case challenges students to think critically: to look beyond the textbook numbers to determine what provides valuable information in the real world.

AICPA CORE COMPETENCIES ADDRESSED

1. Functional Competencies
 - a. Decision Modeling: Students have to understand variances and determine which numbers are relevant and when and where to use those numbers for the evaluation being done.
 - b. Measurement: Both a master budget and a flexible budget are prepared. Then price, quantity and inventory change variances are calculated. Finally, both a cash basis and an accrual income statement are prepared and the two statements are reconciled.
 - c. Reporting: Findings must be reported to the owners of the Company in a professional manner that is clear and concise. All supporting documentation must be attached.
2. Broad Business Perspective Competencies
 - a. Strategic/Critical Thinking: Because textbooks do not cover an inventory change variance, students are left wondering what happens if different amounts of

inventory are purchased and used. The text tells them that in such a case the actual quantity of materials is different for the calculation of the price and quantity variances. However, textbooks fail to delve into the analysis when there is a change in inventory. This case provides students the opportunity to think about and determine the impact of a change in inventory on the spending variances and how it might be reported. Then they can evaluate the impact of the change in inventory variance along with the price and quantity variances.

- b. Leverage Technology: Students use Excel to calculate the variances. The memo and attachments are a word document with imbedded Excel tables.

3. Personal Competencies

- a. Professional Demeanor: The AICPA specifies that this competency includes a commitment to life-long learning, continually acquiring new skills and knowledge. This case drives the need for this competency home.
- b. Problem Solving and Decision Making: Students have to solve the problem of reconciling a flexible budget report when the company experiences a change in inventory. This is not taught in the current textbooks. Students see that, not only should this be taught in their course work, but that it has the ability to add valuable information to the business owner.
- c. Communication: Students must write a professional memo to the owners of the business. The memo must be professional, accurate, easy to read, clear and concise.

REQUIREMENTS

Do the nine calculations given below. Then, as Ryan, write a one-page memo to Gup and Lulu explaining what happened, and making a recommendation about whether they should continue this business line. Attach all required supporting documentation as appendices to your memo.

Note: The calculations are necessary for you to fully communicate the problem to Gup and Lulu.

1. What is the budgeted total cost of the 120 units?
2. Prepare a budgeted income statement for both scenarios (a 100% markup on costs and a profit margin of 50%) Which scenario provides the highest net income? Discuss.
3. Put together a flexible budget for selling 150 rather than 120 jukeboxes and show the activity variance (the difference between the flexible budget and static budget).
4. Put together the actual income statement (using the cash basis of accounting) for the job.
5. Compare actual cash basis results to the flexible budget. Think about where the major spending variances come from and if we have cause for concern.
6. Break the spending/flexible budget variances into price and quantity variances.

7. Do you find anything missing from the analysis in calculation 6? Do the price and quantity variances add up to the flexible budget variance? What accounts for any differences?

8. Just for fun prepare an accrual basis income statement using FIFO for inventory valuation.

9. More fun, reconcile your accrual basis and cash basis statements.

Below is our rubric for scoring the memo and solutions for each of the required calculations.

| Student Name: | | | | | | Score |
|---|---|--|---|------------------------|----|-------|
| Budgeting (questions 1-4) | | | | | | |
| Incorrect and incomplete | | | Either correct but incomplete or complete but incorrect | Correct, and complete | | |
| 0 | 6 | 12 | 16 | 18 | 20 | |
| Variance Analysis (questions 5-8) | | | | | | |
| Incorrect and incomplete | | | Either correct but incomplete or complete but incorrect | Correct, and complete | | |
| 0 | 6 | 12 | 18 | 24 | 30 | |
| Content of memo | | | | | | |
| Misses the point | | Uses some but not all of the relevant analysis | Relevant information is identified and correctly analyzed | | | |
| 0 | 8 | 14 | 18 | 20 | 25 | |
| Grammar and Punctuation | | | | | | |
| Numerous grammatical and punctuation errors | | | | Grammatically correct. | | |
| 0 | 3 | 6 | 9 | 12 | 15 | |

| Clarity of Presentation | | | | | |
|-------------------------|----------|---|----------------|----|---------------------------------|
| Uninterpretable | Rambling | | Somewhat clear | | Clear/direct and easy to follow |
| 0 | 3 | 6 | 9 | 12 | 10 |

Total Pts (100 max) **Assessment Rubric****Solution Set****1. What is the budgeted total cost of the 120 units?**

| | Per Unit | Total |
|---------|----------|----------------|
| Shells | \$18 | \$2,160 |
| Innards | \$15 | 1,800 |
| 45s | \$20 | 2,400 |
| Labor | \$12 | <u>1,440</u> |
| | | <u>\$7,800</u> |

2. Prepare a budgeted income statement for both scenarios (a markup on costs so that profit equals costs and a profit margin of 50%)

Lulu put together the following budgeted income statement based on a 100% markup on cost.

Revenues = Total cost + Profit, where profit = 100% total cost

Revenues = Total cost + total cost

Revenues = \$7,800 + \$7,800 = \$15600

Income Statement

| | |
|------------------|----------------|
| Revenues | \$15,600 |
| Total Cost | <u>7,800</u> |
| Operating Profit | <u>\$7,800</u> |

Gup put together the following budgeted income statement based on a 50% profit margin.

Revenues = Total cost + Profit, where Profit = .5 Revenues

Revenues = Total cost + .5 revenues

.5 revenues = total cost

Revenues = total cost/.5

Revenues = 7,800/.5 = 15,600

(continued)

Income Statement

| | |
|------------------|---------------|
| Revenues | \$15,600 |
| Total Cost | <u>7,800</u> |
| Operating Profit | <u>\$7800</u> |

(The income statements are the same, no matter which way you calculate the selling price since $\text{Revenues} = \text{cost} + 100\% \text{ cost}$ when $\text{Profit} = .5 \text{ Revenues}$. It just goes to show how married people think alike!!)

Master Budget (120 units)

| | Per unit | Total |
|---------------|----------|-----------------|
| Revenue | \$130 | <u>\$15,600</u> |
| Less expenses | | |
| Shells | \$18 | 2,160 |
| Innards | \$15 | 1,800 |
| 45s | \$20 | 2,400 |
| Labor | \$12 | <u>1,440</u> |
| Profit | | <u>\$7,800</u> |

2. Put together a flexible budget for selling 150 rather than 120 jukeboxes and show the activity variance.

Flexible Budget and Activity Variance

| | Master Budget | | Flexible Budget | | |
|---------------|---------------|-----------------|-----------------|---|-----------------|
| | 120 units | | 150 units | | |
| | Per unit | | Activity | | |
| Revenue | \$130 | <u>\$15,600</u> | <u>\$3,900</u> | F | <u>\$19,500</u> |
| Less expenses | | | | | |
| Shells | \$18 | 2,160 | 540 | U | 2,700 |
| Innards | \$15 | 1,800 | 450 | U | 2,250 |
| 45s | \$20 | 2,400 | 600 | U | 3,000 |
| Labor | \$12 | <u>1,440</u> | <u>360</u> | U | <u>1,800</u> |
| Profit | | <u>\$7,800</u> | <u>\$1,950</u> | F | <u>\$9,750</u> |

Recall, the activity variance is the difference between the master budget of 120 units and the flexible budget at the actual level of output of 150 units. It is the difference we expect due to

favorable revenue activity variance, and expense would also be higher, causing the unfavorable cost activity variances. We would expect net income to be higher (\$1,950 F) at sales of 150 units rather than sales of 120 units.

3. Put together the actual income statement (using the cash basis of accounting) for the job.

Cash Basis Income Statement

| | Per Unit | Units | Cash flows | |
|-------------------|----------|-------|------------|-----------------|
| Revenues | \$130 | 150 | | <u>\$19,500</u> |
| Direct Materials | | | | |
| Shell | \$16 | 500 | | 8,000 |
| Innards | \$15 | 120 | \$1,800 | |
| | \$18 | 30 | <u>540</u> | 2,340 |
| 45s | \$0.42 | 6,000 | | 2,520 |
| Labor | \$10 | 200 | | <u>2,000</u> |
| Total Cost | | | | <u>14,860</u> |
| Cash Basis Profit | | | | <u>\$4,640</u> |

5. Compare actual cash basis results to the flexible budget. Think about where the major spending variances come from and if we have cause for concern.

Cash Basis Income Statement vs. Flexible Budget

| | Actual | Budget | Flexible |
|-------------------|-----------------|----------------|------------------|
| | | Variance | Budget |
| Revenues | <u>\$19,500</u> | \$0 | <u>\$19,500</u> |
| Direct Materials | | | |
| Shell | 8,000 | 5,300 | U 2,700 |
| Innards | 2,340 | 90 | U 2,250 |
| 45s | 2,520 | 480 | F 3,000 |
| Labor | <u>2,000</u> | <u>200</u> | U <u>1,800</u> |
| Total Cost | <u>14,860</u> | <u>5,110</u> | U <u>9,750</u> |
| Cash Basis Profit | <u>\$4,640</u> | <u>\$5,110</u> | U <u>\$9,750</u> |

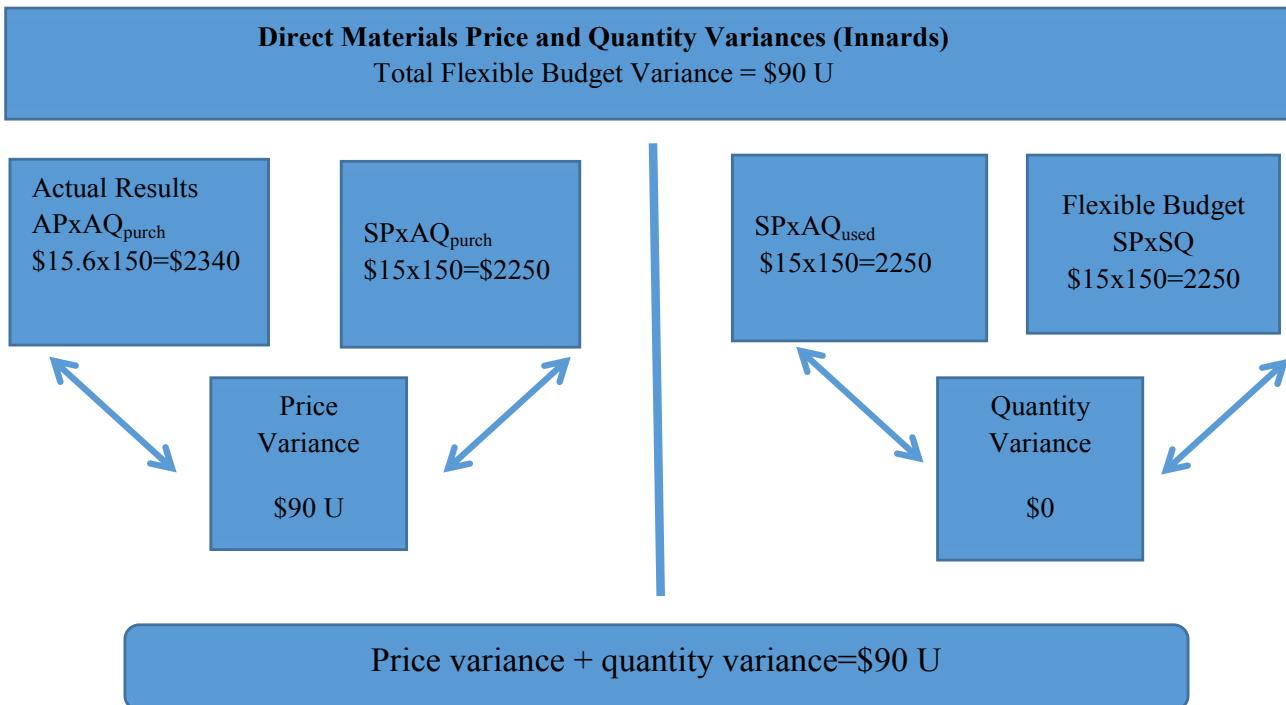
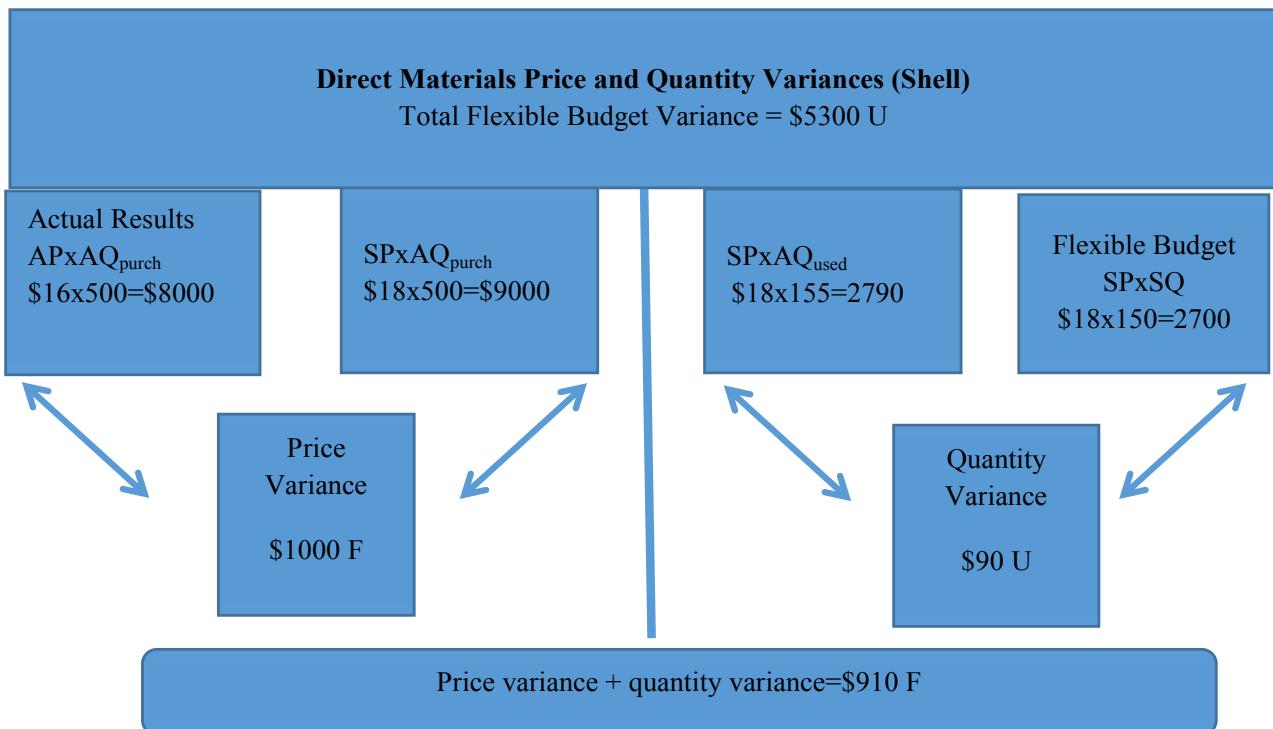
At first glance it appears most of the results come from a difference in standard and actual prices and standard and actual quantities. But wait. The 45s' variance is 480 favorable, which seems odd since the price was higher than expected. Definitely more detail is needed.

6. Break the spending/flexible budget variances into price and quantity variances.

Price and Quantity Variances

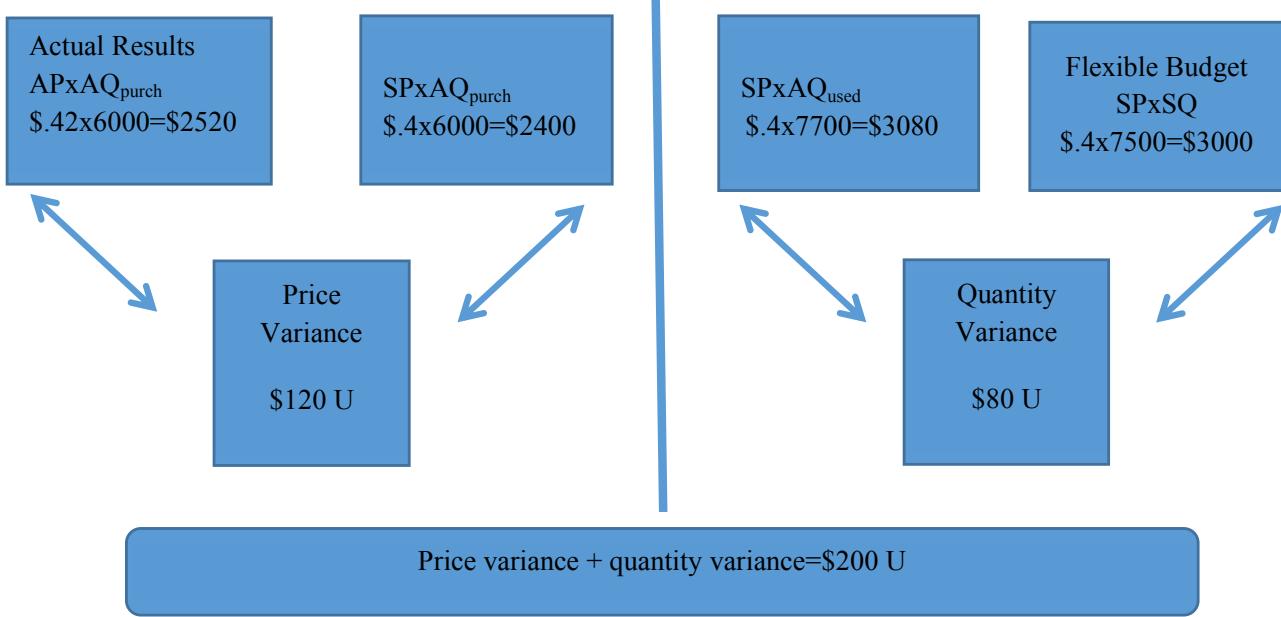
| | Price Variance AQ purchased (AP - SP) | Quantity Variance SP(AQ used - SQ) | Total Price and Quantity Variance | Total Flexible Budget Variance | | |
|--------------|--|---------------------------------------|---|---|----------------|------------------|
| Shell | 500(16 - 18) | \$1,000 F | 18(155 - 150) | \$90 U | \$910 F | \$5,300 U |
| Innards | 150(15.60 - 15) | \$90 U | 15(150 - 150) | 0 | \$90 U | \$90 U |
| 45s | 6,000(.42 - .40) | \$120 U | .40(7,700 - 7,500) | \$80 U | \$200 U | \$480 F |
| Labor | 200(10 - 12) | \$400 F | 12(150 - 200) | \$600 U | \$200 U | \$200 U |
| Total | | \$1,190 F | | \$770 U | \$420 F | \$5,110 U |

Now let's diagram the variances.



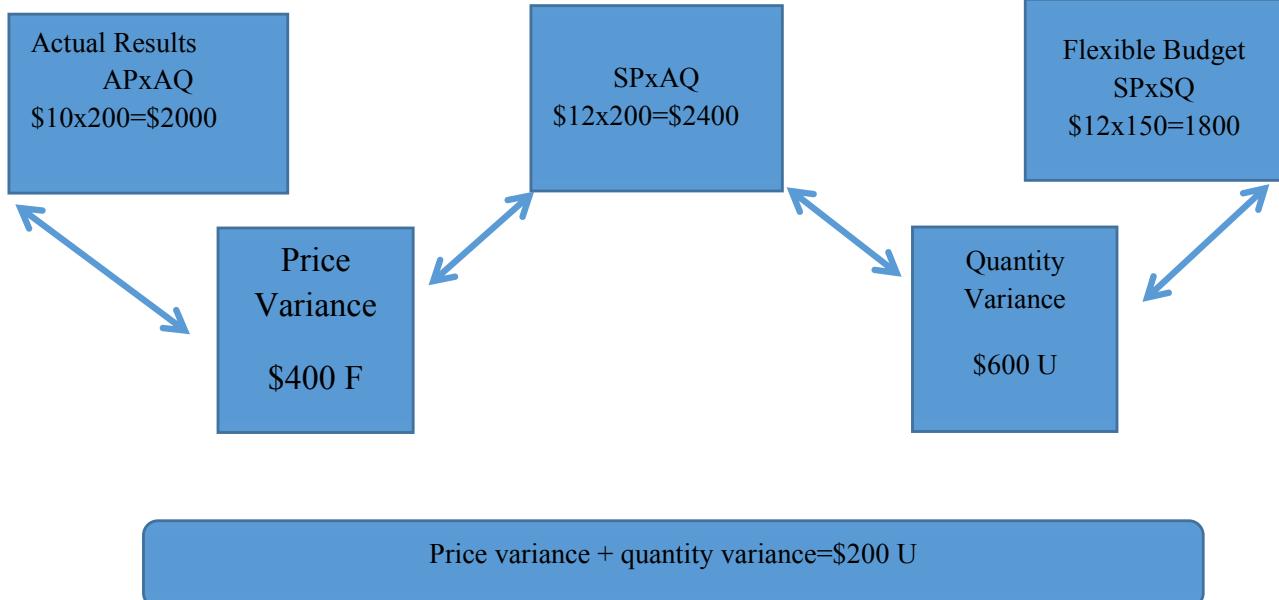
Direct Materials Price and Quantity Variances (45's)

Total Flexible Budget Variance = \$480 F



Direct Labor Price and Quantity Variances

Total Flexible Budget Variance = \$200 U



7. Do you find anything missing from the analysis in calculation 6? The price and quantity variances do not add up to the flexible budget variance. What accounts for any differences?

An issue exists with both shells and 45s....the price and quantity variances do not add up to the flexible budget variance. And what about the rest of the flexible budget variance? If the total flexible budget is \$5,110 U and the total price and quantity variance is \$420 variable there is a \$5,530 U discrepancy. What is this? This is a result of an unfavorable inventory change variance.

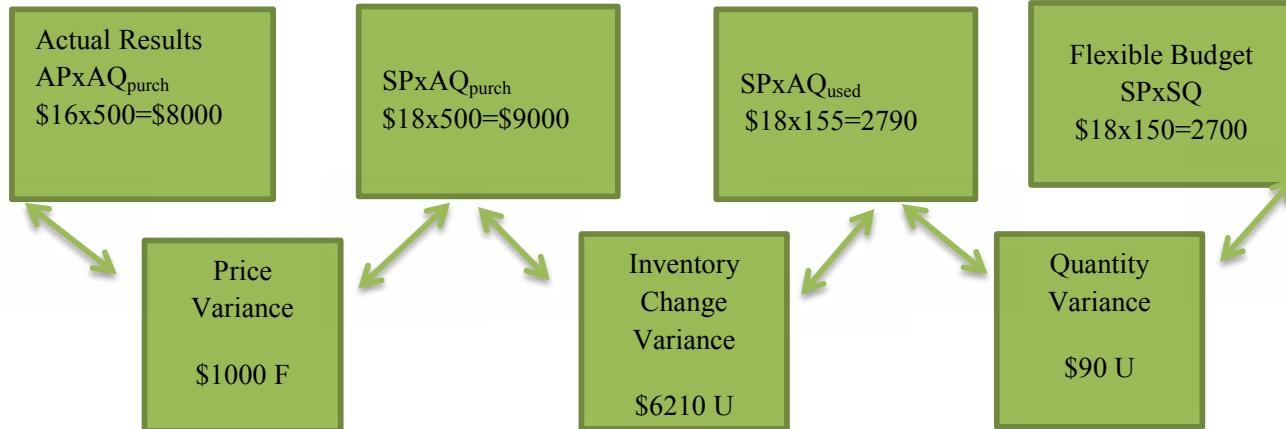
Price variance + Quantity variance + Inventory change variance = Total flexible budget spending variance

| Price, Quantity and Inventory Change Variances | | | | | | | |
|--|-------------------------|-----------|----------------------------|---------|--|----------|--------------------------------|
| | Price Variance | | Quantity Change Variance | | Inventory Change Variance | | Total Flexible Budget Variance |
| | AQ _{purchased} | (AP-SP) | SP(AQ _{used} -SQ) | | SP(AQ _{purch} -AQ _{used}) | | |
| Shell | 500(16-8) | \$1000 F | 18(155-150) | \$90 U | 18(500-155) | \$6210 U | \$5,300 |
| Innards | 150(15.6-15) | \$90 U | 15(150-150) | \$0 | 15(150-150) | \$0 | \$90 |
| 45s | 6000(.4-.42) | \$120 F | .40(7700-7500) | \$80 U | .40(6000-7700) | \$680 F | \$480 |
| Labor | 200(10-12) | \$400 F | 12(150-200) | \$600 U | 12(200-200) | \$0 | \$200 |
| Total | | \$1,190 F | | \$770 U | | \$5530 U | \$5,110 |

Now when you add in the inventory change variance the numbers add up.

Direct Materials Price, Quantity and Inventory Change Variances (Shell)

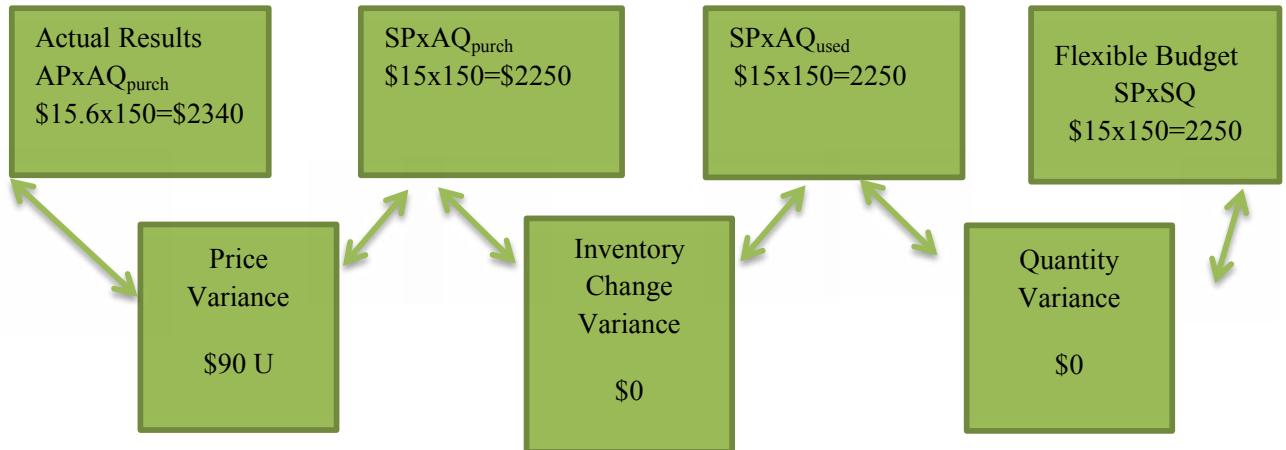
Total Flexible Budget Variance = \$5300 U



Price variance + inventory change variance + quantity variance = \$5300 U

Direct Materials Price, Quantity and Inventory Change Variances (Innards)

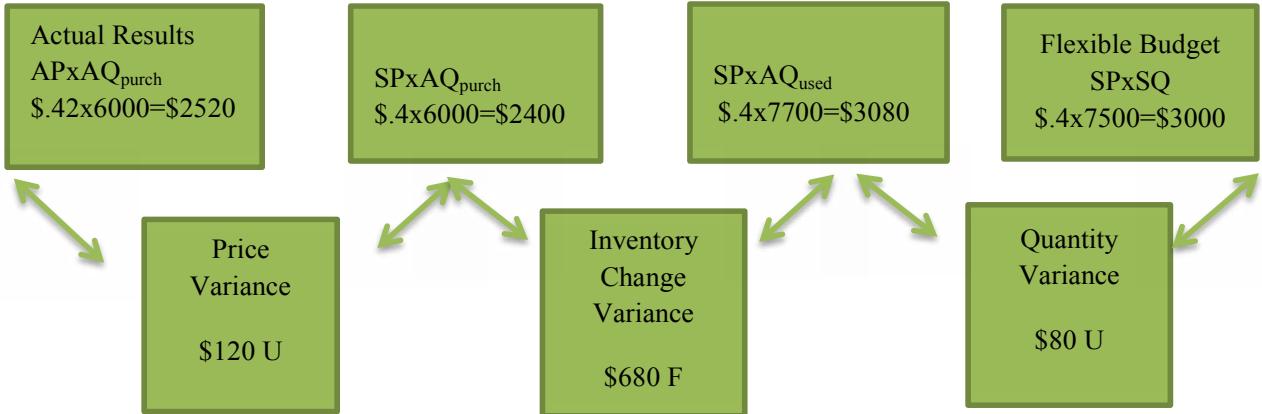
Total Flexible Budget Variance = \$90 U



Price variance + inventory change variance + quantity variance = \$90 U

Direct Materials Price, Quantity and Inventory Change Variances (45's)

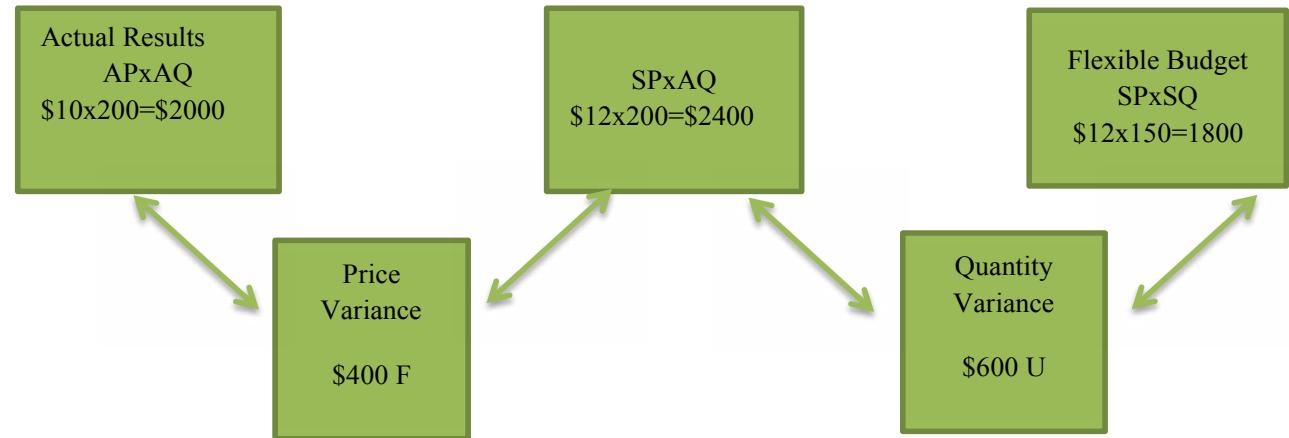
Total Flexible Budget Variance = \$480 F



Price variance + inventory change variance + quantity variance=\$480 F

Direct Labor Price, Quantity and Inventory Change Variances

Total Flexible Budget Variance = \$200 U



Price variance + quantity variance=\$200 U

8. Just for fun prepare an accrual basis income statement using FIFO for inventory valuation.

Accrual basis income statement

| | Actual | |
|------------------|-----------------------|--------------------------------------|
| Revenues | <u>\$19,500</u> | |
| Direct Materials | | |
| Shell | 2,480 | $\$16*155 = 2480$ |
| Innards | 2,340 | $(\$15*120) + (\$18*30) = 2340$ |
| 45s | 3,194 | $(.40 * 2000) + (.42 * 5700) = 3194$ |
| Labor | <u>2,000</u> | $\$10*200 = 2000$ |
| Total Cost | <u>10,014</u> | |
| Profit | <u>\$9,486</u> | |

9. More fun, reconcile your accrual basis and cash basis statements.

| | | | |
|--------------------------|-----------------------|--------------------------|--|
| Accrual income | \$9,486 | | |
| Increase in Shells | -5,520 | $\$16*345 = 5520$ | |
| Decrease in 45s | <u>674</u> | $(.40*2000) - (.42*300)$ | |
| Cash Basis Profit | <u>\$4,640</u> | | |

Memo

To: Gup and Lulu
From: Ryan (aka student name)
Date: date
Re: Reconciliation of budget and actual income for Dashing Diners

I analyzed your income versus budget discrepancies from the Dashing Diner job. For all the materials and labor there is the possibility of both a price and quantity variance: meaning you either paid or used a different amount than you budgeted or both. For the materials there can also be an inventory change variance, meaning you purchased and used different amounts of inventory. Let me show you where you had variances:

Price: Yes, you did have a favorable price variance on my labor. You also had a favorable price variance on the shells because you bought in bulk. However, you had an unfavorable price variance on the innards and the 45s. Recall we purchased the original innards for \$15 but had to pay \$18 for the additional innards. We also had to pay \$.42 for the 45s when we hoped to get them at \$.40. Your total price variance for the materials and labor was \$1190 favorable, meaning overall the prices you paid were less than you budgeted.

Quantity: We received five unusable shells and 200 unusable 45s. Also, you budgeted that I would work 150 hours but I worked 200 hours. Thus all of your quantities used were greater than quantities budgeted to produce 150 jukeboxes. Thus total quantity variance was \$770 unfavorable, or more than you had budgeted.

Inventory Change: You currently have in inventory 345 shells at a cost of \$6210. You also decreased your 45s inventory by 300 (from 2,000 to 1,700) at a cost of \$680. The increase in shells and the decrease in 45s for a net of (\$5,530) were not in your budgeted cash income statement.

Here is a summary of the variances. I have attached several Appendices showing my calculations.

| | | | Inventory | Total |
|--------------|-------------------------|-----------------------|-------------------------|-------------------------|
| | Price | Quantity | Change | Difference |
| Shell | \$1000 F | \$90 U | \$6,210 U | \$5,300 U |
| Innards | \$90 U | - | - | \$90 U |
| 45s | \$120 U | \$80 U | \$680 F | \$480 F |
| Labor | <u>\$400 F</u> | <u>\$600 U</u> | - | <u>\$200 U</u> |
| Total | <u>\$1,190 F</u> | <u>\$770 U</u> | <u>\$5,530 U</u> | <u>\$5,110 U</u> |

I believe you should continue this product line. Not only do you have a positive cash flow, but the accrual based profit margin is 50% exceeding your desired profit margin.

RE-ENERGIZING THE BRAND: SMITH & WESSON HOLDING CORPORATION

Paul J. Costanzo, Western New England University
Harlan Spotts, Western New England University

CASE DESCRIPTION

The primary subject matter of this case concerns marketing. Secondary issues examined include marketing management, promotional strategy, and marketing career preparation. The case has a difficulty level of three, appropriate for senior and first year graduate level. The case is designed to be taught in three class hours and is expected to require five hours of outside preparation by students.

CASE SYNOPSIS

Students who learn how to apply their marketing skill-set to a wide-range of markets will likely be a valued asset to most business organizations upon graduation. This case provides the reader with a behind-the-scenes perspective on how a newly appointed President/CEO was able to transfer his marketing skill-set to a completely different and seemingly unfamiliar industry. The reader will learn about the processes by which the President/CEO along with his newly appointed marketing manager and his team empowered themselves, and became successful applying their requisite knowledge of marketing.

Plagued by uncertainty in the marketplace spawned by strong controversial public opinion and legal regulation of their products, the case chronicles senior management's use of their marketing skills in the transformation of a one hundred and fifty year old company. They begin their task by engaging in brainstorming sessions to change their consumers and suppliers' images of their brand. The challenges for the marketing team soon become evident. How will they formalize business and marketing processes to help a company that was once an industry leader, regain market share and re-establish their brand.

This paper addresses the need for Marketing Educators to have access to a teaching case assignment where students learn how to apply their skill-sets to unfamiliar and politically charged market. Students will learn how to recognize, understand, and appreciate the marketability of their skill-sets and personal branding and how their ability relates to future employment opportunities.

INTRODUCTION

It is December 2004, Mr. Michael F. Golden, the newly appointed President and Chief Executive Officer, and Director of Smith & Wesson Holding Corporation has been on the job for two weeks. Mr. Golden is new to the firearms and security industry having served in executive positions for Kohler Company, Stanley Works Company, and Black & Decker Corporation. A

closer look at Mr. Golden's resume reveals that he has a strong marketing background with little knowledge about the firearms industry. He holds an MBA from Emory University in Atlanta, Georgia, and a Bachelor of Science degree in Marketing from Pennsylvania State University (Bloomsburg BusinessWeek, 2014). Upon his arrival at Smith & Wesson, one of the initial tasks facing Mr. Golden is to re-energize the Smith & Wesson brand using his requisite knowledge of marketing and sales management.

As he pulled into the parking lot of Smith & Wesson, his thoughts turned to the morning meetings with Mr. Tom Taylor, Vice President of Marketing, and their marketing team. After spending the last several days reviewing research reports and company data, it was time to discuss market opportunities. Mr. Golden is grappling with the future of the company, which had remained relatively stagnant over the past decade. As stated in the 2004 Annual Report, Smith and Wesson is "...the largest manufacturer of handguns, which includes revolvers and pistols, in the United States and the largest U.S. exporter of handguns. We manufacture handguns and related products and accessories for sale primarily through our distribution network and to public safety and military agencies in the United States and throughout the World." In line with this statement, prior management had viewed Smith and Wesson's strategy as one of being a "big fish" in a small pond, suffering from classic signs of myopic market vision (Leavitt, 1960). Shortly after joining the company, Mr. Golden is quoted in a local Springfield newspaper "When I joined the company we did not have a dime of business with the federal government, which was amazing to me. But it is a huge opportunity for our company" (Bloomberg, 2004). The company was under increasing pressure for a growth strategy given the low growth nature of the handgun market and an increasing number of international competitors.

COMPANY OVERVIEW

Smith & Wesson Corporation is located in Springfield, Massachusetts, a city having a long history with the firearms industry. The company was founded in 1852 by Horace Smith and Daniel B. Wesson and has experienced several changes in ownership over the years. After 21 years, Daniel B. Wesson purchased Horace Smith's share of the company. The Wesson family later sold Smith & Wesson Corp. to Bangor Punta Corporation in 1965. Bangor Punta Corporation purchased Forjas Taurus in 1971, another firearms manufacturer and at the time, the two companies shared proprietary firearm design and manufacturing information. The relationship between these two companies ended in 1977 when Bangor Punta sold Forjas Taurus. The ownership of these two companies is relevant today because Taurus International Manufacturing Incorporated (known as Taurus USA), is a competitor of Smith & Wesson and has ties to Beretta a long-standing competitor and Rossi firearms. In 1984 Lear Siegler Corporation located in Greenwich Connecticut purchased Bangor Punta and assumed ownership of Smith & Wesson. Smith & Wesson Corporation changed ownership two more times before it was finally purchased and renamed Smith & Wesson Holding Corporation in February 2002 (Annual Report on Form 10-K For the Fiscal Year Ended April 30, 2004).

Smith & Wesson Corporation competes in international and domestic markets, with net sales revenue of \$117 million (see Table 1), a 19.7 percent increase over 2003; operating income was \$5.2 million (Smith & Wesson Form 10-K Annual Report, 2004). They are one of the

world's largest manufacturers of handguns. Firearms account for approximately 87 percent of sales in 2004, with revolver sales about 47 percent of firearms revenue. The remaining company sales revenue was generated from non-firearms products and services (handcuffs, apparel, accessories and collectibles).

Table 1
SMITH & WESSON OPERATING PERFORMANCE

| | 2004 | 2003 | \$ Change | % Change | 2002 |
|--------------------|-------------------|------------------|------------------|-----------------|------------------|
| Revolvers | \$ 47,642,409 | \$38,230,676 | \$ 9,411,733 | 24.6% | \$33,928,233 |
| Pistols | 26,939,756 | 21,286,356 | 5,653,400 | 26.6% | 17,672,968 |
| Walther | 17,179,183 | 12,747,436 | 4,431,747 | 34.8% | 3,632,532 |
| Performance Center | 7,385,554 | 6,113,334 | 1,272,220 | 20.8% | 5,911,780 |
| Other | 3,135,058 | 2,039,649 | 1,095,409 | 53.7% | 2,650,151 |
| Total firearms | 102,281,960 | 80,417,451 | 21,864,509 | 27.2% | 63,795,664 |
| Handcuffs | 5,536,641 | 5,437,976 | 98,665 | 1.8% | 4,368,280 |
| Specialty services | 5,027,217 | 7,894,918 | (2,867,701) | (36.3%) | 6,379,604 |
| Other | 5,046,689 | 4,718,421 | 328,268 | 7.0% | 4,741,161 |
| Non-firearms | 15,610,547 | 18,051,315 | (2,440,768) | (13.5%) | 15,489,045 |
| Total | \$117,892,507 | \$98,468,766 | \$19,423,741 | 19.7% | \$79,284,709 |

Smith & Wesson Holding Corporation, Form 10-K Annual Report for fiscal year ended April 30, 2004, United States Securities Exchange Commission.

Smith & Wesson was a dominant player in the handgun market. This focus was clearly stated in their 2004 annual report: "We manufacture high-quality, center-fire revolvers and pistols with forged components. We have never manufactured or sold inexpensive concealable firearms, sometimes known as 'Saturday Night Specials,' and we do not produce 'assault weapons as defined in the Violent Crime Control and Law Enforcement Act of 1994. We offer a complete line of handguns to meet the needs of discriminating shooters. We currently offer more handgun models, in more calibers, for more applications than any other handgun manufacturer. We currently offer 73 different standard models of handguns with a wide variety of calibers, finishes, sizes, compositions, ammunition capacities, barrel lengths, grips, sights, actions, and other features. In order to enhance our competitive position we continually introduce new handgun models. We introduced five new revolver and four new pistol models in each of fiscal 2004 and 2003" (2004 Smith & Wesson Annual Report, pg. 1-2). Smith & Wesson maintains an overall 18 percent unit share in the Pistol and Revolver segments (see Table 2). As of 2003, they had a 35 percent share of revolvers and an 11 percent share in pistols.

Table 2
DOMESTIC SUPPLIERS

| Pistols | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-------------------------|----------------|----------------|---------------|---------------|---------------|---------------|
| Sturm.Ruger&Co. | 57,032 | 210,357 | 231,551 | 111,177 | 113,561 | 97,165 |
| Smith&Wesson | 130,471 | 124,358 | 80,290 | 53,428 | 60,544 | 72,598 |
| BerettaUSA Corp. | 110,719 | 116,614 | 89,416 | 56,399 | 69,282 | 91,048 |
| LorcinEng.Co. | 75,250 | — | — | — | — | — |
| Bryco Arms | 66,167 | 68,254 | 116,664 | 66,874 | 70,524 | 59,841 |
| Colt'sManufacturing | 58,789 | 35,965 | 24,825 | 24,868 | 14,344 | 13,020 |
| Sig Arms Inc. | 52,137 | 71,964 | — | — | 67,883 | 53,075 |
| PhoenixArms | 43,563 | 21,487 | 20,888 | 5,050 | 11,149 | 9,15 |
| DavisIndustries | 33,308 | 33,344 | 27,313 | — | — | — |
| KimberMfg. | 31,688 | 37,170 | 48,926 | 32,533 | 45,970 | 47,966 |
| SouthwestMetalFinishing | — | 31,268 | 61,957 | — | — | — |
| KelTecCNCIndustries | 19,239 | 30,919 | 42,447 | 45,658 | 44,839 | 47,020 |
| BeemillerInc. | 23,343 | 30,840 | 49,670 | 50,878 | 66,994 | 81,150 |
| Spring fieldInc. | 10,125 | 17,333 | 22,598 | 27,170 | 47,814 | 77,363 |
| Arms TechnologyInc. | 20,198 | 16,917 | 18,996 | 38,053 | 22,399 | 24,536 |
| Revolvers | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| Smith&Wesson | 139,583 | 114,867 | 90,173 | 65,948 | 92,237 | 98,340 |
| Sturm.Ruger&Co. | 113,230 | 92,505 | 107,228 | 147,104 | 143,807 | 108,853 |
| NorthAmericanArms Inc. | 28,545 | 25,770 | 25,797 | 20,718 | 22,605 | 24,716 |
| Colt'sManufacturing | 20,139 | 14,864 | 8,329 | 5,548 | 4,150 | 3,256 |
| H&R1871Inc. | 3,850 | 2,572 | — | — | — | — |
| HeritageMfg. Inc. | — | 29,687 | 23,830 | 34,100 | 33,776 | 34,270 |
| Charco 2000 | — | 3,860 | 7,970 | 9,144 | 11,491 | 8,720 |
| Misc.1 firearms | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| OFMossberg & Sons Inc. | 20,223 | 14,385 | 8,000 | 14,600 | 11,267 | — |
| MaverickArms Inc. | — | 9,71 | 4,336 | 1,514 | 3,960 | 1,665 |
| H&R1871Inc. | — | 4,972 | — | — | — | — |
| DefenseProcurementMFG. | — | — | — | — | — | 9,679 |
| Rifles | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| Sturm.Ruger&Co. | 321,158 | 414,832 | 296,149 | 234,096 | 289,301 | 219,591 |
| MartinFirearms Co. | 290,280 | 289,340 | 277,270 | 247,772 | 244,427 | 223,479 |
| RemingtonArms | 254,140 | 235,945 | 236,786 | 269,816 | 276,291 | 268,960 |
| USRepeatingArms | 107,069 | 152,703 | 111,641 | 109,377 | 120,914 | 120,176 |
| SavageArms Inc. | 80,621 | 78,343 | 157,178 | 69,001 | 101,492 | 88,153 |
| ArgusPublications | 33,917 | 40,905 | 60,987 | 63,037 | 88,099 | 80,947 |
| Colt'sManufacturing | 29,564 | 25,533 | 27,271 | 7,866 | 13,606 | 17,364 |
| H&R1871Inc. | 28,897 | 33,536 | 57,532 | 51,597 | 64,733 | 86,896 |
| BeemillerInc. | 28,642 | 33,100 | 12,390 | 13,450 | 19,990 | 7,310 |
| Bushmasterfirearms | 25,098 | 64,374 | 39,926 | 31,179 | 44,795 | 44,617 |
| WrightProducts | — | 28,614 | 127,922 | — | — | — |
| ThompsonCenterArms | 14,660 | 10,167 | 16,764 | 28,447 | 37,607 | 47,251 |
| CenturyArms Inc. | — | 13,875 | 19,468 | 21,893 | 17,789 | 18,019 |
| Shotguns | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| RemingtonArms | 319,251 | 353,233 | 346,231 | 263,651 | 285,835 | 288,130 |
| OFMossberg & Sons Inc. | 308,538 | 315,741 | 244,163 | 155,781 | 187,767 | 171,329 |
| H&R1871Inc. | 179,857 | 173,849 | 155,554 | 135,280 | 119,206 | 112,714 |
| USRepeatingArms | 67,215 | 134,013 | 72,735 | 45,527 | 49,615 | 41,710 |
| MaverickArms Inc. | 35,461 | 27,988 | 15,154 | 17,026 | 50,072 | 54,481 |
| Sturm.Ruger&Co. | 17,31 | 18,354 | 17,754 | 7,631 | 5,437 | 4,491 |

Source: Small Arms Survey: A Guide to US Small Arms (2004): A TF(1999–2003)

INDUSTRY OVERVIEW

The small firearms industry has seen moderate, at times stagnant growth since the mid 1990s. Market size in 2004 was \$4 billion in revenue and 5.4 million units (SBI, 2007). It had experience double digit growth from 2002 to 2003, but only 4 percent from 2003 to 2004.

The emergence of the firearms industry in the United States dates back to the industrialized revolution. At that time, many U.S. businesses either started a new venture business producing firearms or converted existing businesses to firearms manufacturing facilities. The majority of the original businesses were in the Northeastern United States where they were in close proximity to numerous mill towns with iron-ore and skilled-labor resources. Many of the original firearm businesses that started at that time still exist today. The most notable companies in the New England states in alphabetical order include Colt Manufacturing Company, Remington Arms Company, LLC, Ithaca Gun Company, Sturm, Ruger & Company, Marlin Firearms, Savage Arms Company, Dan Wesson Firearms, Massachusetts Arms Company (founded by Arthur Savage, Horace Smith and Daniel Wesson), O.F. Mossberg & Sons, Smith & Wesson, Springfield Armory, Stevens Arms, and Winchester Repeating Arms Company.

A number of factors make competing in this industry very challenging. For many consumers firearms purchases come from discretionary spending, thus when the economy is good unit sales increase, when bad they decrease. A second factor is consumer feelings about security. If consumers generally feel safe, there is a reduced likelihood of purchasing firearms than when they are concerned for their safety. Finally, government actions directly affect industry performance. Military actions around the world such as in the Middle East deplete the domestic supply of firearms and firearms related products such as ammunition. Calls for increased laws and regulatory actions affect the availability of firearms and ease of purchase. Of interest at this time is the call for taxing firearms purchases to pay for social spending policies of the federal government. Politics plays an important role when consumers adjust their firearms purchases based on which party wins national elections, usually due to the fear of repeal of the 2nd Amendment.

There are three, broad user segments that include Civilian, Law Enforcement and Military/Government markets. Product segments include handguns (pistols and revolvers), long guns (rifles), shotguns and muzzle loading (black powder) guns. Handguns accounted for about one million of the 5.4 million units sold in 2004, which is about one-third of the domestic production of small firearms. It is estimated that the Civilian/consumer segment owns approximately 230 million firearms, with an additional 5 million guns purchased every year (Small Arms Survey, 2004). This segment consists of hunting, shooting and sports enthusiast, and personal protection markets. The incidence of gun ownership has declined over the years, with approximately 34 percent of people report having a gun in the home. The greatest demand is for pistols, rifles and shotguns. Hunters account for about 60 percent of firearms sales, target shooters another 25 percent and 15 percent goes to the personal protection segment. As noted above, Smith & Wesson has a dominant position in handguns, but does not compete in other segments such as rifles and shotguns (see Table 3).

Smith & Wesson has virtually no presence in the Military/Government sector. Their position in the Law Enforcement segment has precipitously declined from a dominant 95 percent share, to less than 10 percent. The foreign competitor, Glock has a dominant 65 percent share, mainly due to the acquiescence of Smith & Wesson. Glock is known for their lighter, high capacity pistol made from plastic materials, creating a lighter pistol with more fire power. When first introduced Smith & Wesson ignored the competitor thinking that police departments would not trade their trusted metal S&W revolvers for plastic Glocks. They were wrong, police preferred the lighter firearm when having to carry them around on a daily basis.

Table 3
SMALL FIREARMS COMPETITOR SEGMENTS, 2004

| Manufacturer | Revolvers | Pistols | Rifles | Shotguns | Black Powder |
|---------------------------|-----------|---------|--------|----------|--------------|
| Beretta | | X | | X | |
| Browning | | | X | X | |
| Bushmaster | | X | X | | |
| Colt | X | X | | | |
| CVA | | | | | X |
| Dakota Arms | | | X | X | |
| DPMS | | | | | |
| Glock | | X | | | |
| Knight Rifles | | | | | X |
| Marlin Firearms | | | X | | |
| New England Firearms | | | | X | |
| O.F. Mossberg | | | | X | |
| Remington | | | X | X | |
| Rock River | | | | | |
| Sturm, Ruger | X | X | X | | |
| Savage | | | X | | |
| Sig Sauer | | | | | |
| Smith & Wesson | X | X | | | |
| Springfield Armory | | X | | | |
| Stag | | | | | |
| Taurus | X | | | | |
| Traditions | | | | | X |
| Weatherby | | | X | | |
| Walther | | | | | |
| Winchester Guns (Herstal) | | | X | X | |

Adapted from Source: Small Firearms & Ammunition Market in the U.S., December 2007, SBI.

Smith & Wesson competes against other manufacturers of firearms, including domestic companies such as Colt, Sturm, Ruger and Springfield Armory. Foreign competitors included Beretta, Glock and Taurus. Foreign competitors had recently become a significant force in the small firearms sector, accounting for approximately 40 percent of handgun sales.

Sales of firearms to the Military and Law Enforcement segments are direct, B2B purchase relationships. The Civilian/Consumer segment must purchase firearms from licensed retailers, who are supplied by authorized and licensed wholesalers. Gun purchases are regulated

and affected by governmental regulations related to waiting periods and background checks. While there are some large dealers, the firearms channels tend to be dominated by smaller retailers with less sophisticated marketing and merchandising capabilities. The number of firearms dealers has been declining over the last ten years.

While it is difficult to predict the future, the market is expected to lag due to slow economic growth and a number of high profile lawsuits filed against gun manufacturers.

SCENARIO

The market data indicated that the Smith and Wesson Company was not taking full advantage of its strong brand equity built over 152 years of handgun manufacturing. Given the lackluster market growth and continued attack by forces outside of the handgun and firearms industry, the management team had to develop a turn-around strategy to not just grow revenues, but also revitalize the company.

Smith & Wesson decided to hire Mr. Golden because of his extensive brand management and marketing experience at Stanley Works and Kohler. Likewise, Tom Taylor joined the company in July 2004 after having held marketing positions at Coca-Cola and Frito Lay. Both were newcomers to the firearms industry. The two individuals found themselves in a very similar situation. Both were newly hired, both had extensive marketing experience from other industries, neither had extensive marketing experience in the industry where they now held senior-level marketing positions.

One of Tom's first decisions was to recount a fundamental marketing rule – informative decisions start with sound marketing data. Tom decided to collect market data he could use to analyze potential viable markets. What he found would be useful to help re-energize the brand. Is the challenge before Golden simply applying his knowledge of marketing gained from vastly different industries to an industry unlike any he has seen? How can he use the marketing skills that he has learned in other industries? What basic marketing knowledge does he rely on to re-energize this brand? It was an exhilarating challenge that would require major changes to the corporate ideology and new marketing practices were about to be introduced to Smith and Wesson.

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RUNNING WITH THE BIG DOGS (PART A): A COMPETITIVE FORCES AND STRATEGIC ANALYSIS OF THE RUNNING SPECIALTY STORE INDUSTRY

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CASE DESCRIPTION

The primary subject matter of this case is a competitive forces analysis of a specialty retail company. Secondary issues examined include choosing an appropriate competitive strategy and leveraging technology and social media to build customer relationships and deliver a unique value proposition to customer. Students should develop a more in-depth understanding of the impact of external factors and the underlying drivers that affect competitive control and profitability. The case has a difficulty level of three and up, making it appropriate for junior level courses in management information systems, marketing strategy or business strategy. The case is designed to be taught in one or two class sessions and should require approximately 2-3 hours of outside preparation for students, primarily reviewing the case and reading articles related to the competitive forces framework.

CASE SYNOPSIS

The Big Dog Running Company is a running specialty store operating in the highly competitive and growing running shoe and apparel retail industry. The company started in late 2010 in the middle of an economic recession and against formidable odds in an industry dominated by large retailers and price competitive Internet-based companies. In this case, students analyze the specialty running store industry using Porter's Competitive Forces framework and assess trends in the industry that affect profitability. Examining the structure of an industry and the competitive forces that influence profitability will help students develop an understanding of the impact of external factors and the underlying drivers that affect competitive control and profitability.

THE "BIG DOG RUNNING COMPANY" STORY

It was 2009 and in the middle of the great recession. John Teeple and Reggie Luther were discussing the possibility of opening a new retail store in Columbus, Georgia specializing in the running sport. Not only were they running enthusiasts who had participated in multiple "ultramarathons" (i.e., marathons that are more than 26.2 miles) and "ultraruns" (i.e., unusually difficult running events such as those involving many hills and/or mountains), they were also

experienced entrepreneurs who had successful businesses in the Columbus, Georgia market. John Teebles was a local building contractor and Reggie Luther owned a website design business located in downtown Columbus. Consistent with national trends, they noted that running participation was increasing significantly in the Columbus area. Both John and Reggie noticed that other cities had new specialty stores dedicated to the sport of running, but not Columbus. This led them to the conclusion that there was a gap in the local market for a full service retailer catering specifically to the running sport. Also, John and Reggie felt that the recession may actually help to increase participation in the running sport since, compared to other sports like golf, it was a relatively inexpensive one. And they knew that the increase in health consciousness in the U.S. meant that the number of people choosing an active lifestyle was trending up -- in a recession they would be more inclined to choose a sport that was less expensive like running.

John and Reggie felt that there was a window of opportunity for a location in the city's newly revitalized downtown area. Like many cities across America, Columbus' downtown area was going through a renaissance. Many of the city's young professionals had started moving back downtown, and more and more retailers and restaurants were relocating to the downtown area to cater to them. More importantly, the Columbus Riverwalk brought tourists and sports enthusiasts downtown. Built in 1992, the Riverwalk is a paved trail that stretches 22 miles alongside the Chattahoochee River which runs straight through the heart of the downtown area. It provides a scenic public trail for the locals to use to walk, run, and bike. To add to the already growing downtown traffic, in 2009 the city announced plans for a \$42 million whitewater rafting course through downtown to be completed by 2012. It was being touted as "the world's largest urban whitewater course." It was expected to significantly increase tourism in the Columbus area and, more specifically, the retail customer traffic in the downtown area (in 2013, USA Today named this whitewater rafting course one of the "top 12 greatest man-made adventures on the planet"). Additionally, Columbus is located right next door to Fort Benning, Georgia, home of one of the army's largest training installations in the country with about 35,000 soldiers on active or reserve duty. This would provide the retail store with a constant influx of young soldiers in need of proper equipment for their PT training. On the weekends, many of the Fort Benning soldiers go to the downtown area for shopping, entertainment, and socializing, making it an attractive location to target military personnel. In anticipation of the new sports-minded traffic in the downtown area, other sporting goods stores had recently opened along the Columbus Riverwalk catering to fishing, biking, and water sports, but none catered specifically to runners.

After an initial assessment of the potential market for a running specialty store in Columbus, John and Reggie needed to decide on the appropriate strategy. With the revitalization of the downtown ("Uptown") area, and the proximity of downtown to the Riverwalk and Fort Benning, John and Reggie believed the downtown area would be the most desirable location for their target market. They found a suitable downtown location and then debated a name for the store. John Teebles' wife, Melissa, was a local veterinarian who loved animals, especially dogs

(his family included five rescue dogs!). It can also be assumed that many (if not most) Americans also love their dogs since Americans spend upwards of \$61 billion annually on their pets (Kurtzleben, 2013). This gave John an idea for the store name. After doing some focus group research and conducting a trademark search, John and Reggie decided that "Big Dog Running Company" would be the name of their new retail store. It was personal, memorable, unique, and appropriate. It would also give their target market the "warm fuzzy" feeling that may help them relate to the store on a personal level. Their next step was to decide on the store's competitive strategy.

SPECIALTY RUNNING STORE RETAIL INDUSTRY TRENDS

John and Reggie knew that their main competition in the local market area would include online stores such as Zappos and Amazon, and brick-and-mortar chain stores such as Dick's and Academy Sports, all of which carried apparel for many outdoor sports including running. However, in 2009 there were no retailers in the local area who specialized exclusively in running apparel. In fact, nationwide, privately-owned specialty running stores made up a relatively small percentage of suppliers of running shoes and apparel, numbering approximately 800 stores in the U.S. (Metzer, 2014).

Providing expertise, custom shoe fitting, and a sense of community have long defined the niche supplier who caters primarily to a core group of dedicated sports enthusiasts. Competition in the sporting apparel industry, however, was undergoing significant change driven by a growing and more diverse market, industry consolidation, and challenges from catalog and online merchandisers who are able to provide popular brand shoes at competitive prices with added conveniences such as free shipping and return guarantees (Metzer, 2014). The top sports apparel manufacturers had begun to put more restrictions on small retailers regarding pricing and online sales. By 2009, new specialty retailers were no longer allowed to sell products online anymore (current online retailers were "grandfathered in" and allowed to continue to sell online, however). Additionally, suppliers of the top selling brands such as Nike had also begun to put more limits on retailers' ability to reduce the price of their products. This is because the top manufacturers wanted to have more control over the marketing and image of their products.

A key variable in the volume of sales of running shoes and apparel is the number of participants in the sport. Over the past decade there has been a "second running boom" that has continued robustly with more non-traditional running events and record numbers of finishers (Running USA, 2014). Over the last five years (2004 to 2009), total running participation (defined as the number of people who participated in at least one running event over the year) increased from about 25 million participants in 2004 to about 32 million participants in 2009 -- a 28% increase. Analysts attribute the record growth in participation to a number of factors including the rise in the number of running destination vacations that offer participants the opportunity to combine running with leisure activities, frequent charitable and socially-oriented running events, and an interest in new wearable technology and apps that provide running enthusiasts new ways to measure their progress and share their training and results with others.

Although growth in the industry is expected to continue as the economy improves, future sales are predicted to increase primarily in the higher quality performance-gear shoes and apparel that are the focus of the specialty running store industry (Shaftoe, 2013). Leisure Trends Group, an industry research provider, however, estimates total specialty running store industry sales at less than \$1 billion annually (SportsInsight, 2013). Despite the estimates, manufacturers and large sporting goods stores are increasingly entering the market with their own version of brand-specific specialty running store. Asics recently opened a running-focused retail store in New York City offering their running shoe and apparel line complimented by state-of-the-art "Foot ID" technology to help runners select the best fit (Sports Insight, 2013). Dick's, a large sporting goods retailer, also recently opened its second specialty running store, "True Runner" in St. Louis, MO with plans to expand to other markets.

DEVELOPING COMPETITIVE STRATEGY THROUGH THE USE OF PORTER'S COMPETITIVE FORCES ANALYSIS

Michael Porter, one of the nation's leading strategy experts, developed an analysis tool to measure the impact of the basic competitive forces driving competitor control and industry profits. Companies use this tool to carefully scan the environment in order to determine the amount of competitive intensity (or rivalry), control, and potential profitability of a new business opportunity. According to Porter (2008), the important competitive forces that drive control and profitability are: (1) the potential threat of new entrants, (2) the rivalry among existing firms, (3) the threat of substitute products or services, (4) the bargaining power of suppliers, (5) the bargaining power of buyers, and (6) the power of other stakeholders such as the government and the local community. Using his model, a high force would be regarded as a threat because it is likely to reduce the amount of control and, thus, reduce profit potential. In the short run, these forces may act as constraints on a company's activities, but in the long run it may be possible for a company to adjust its strategy in order to change or dilute the strength of one or more forces (Wheelen and Hunger, 2010).

Based on the analysis of these six important competitive forces, a company can choose a competitive strategy that allows it to most effectively compete by diluting the effects of certain forces or creating barriers to market entry that buffer it from potential new market entrants. Before choosing a competitive strategy, companies need to assess their strengths versus competition and then ask two questions: (1) should (can) we compete long-term on the basis of lower cost, or should we differentiate based on something else such as our products or services?, and (2) should we aim at a broad target market or focus on a more narrow market niche? Answering these two questions points the company in the direction of one of the following five generic competitive strategies: (1) Cost Leadership (example: Walmart); (2) Broad Differentiation (example: Saks Fifth Avenue); (3) Cost Focus (example: The Dollar Store); (4) Differentiation Focus (example: specialty retailers); or (5) Best Value or Best Cost (example: Target). The "cost leadership" strategy targets a broad mass market and requires "aggressive construction of efficient-scale facilities, vigorous pursuit of cost reductions from experience,

tight cost and overhead control, avoidance of marginal customer accounts, and cost minimization in areas like R&D and marketing" (Porter, 1980, p. 35). Differentiation strategies (broad and focused) involve the creation of a valuable uniqueness in the product or service. This uniqueness costs the company more money to develop, but it allows the company to charge a higher premium for its product that can lead to higher profitability and customer loyalty (think Apple!). The "Best Value" strategy, or sometimes referred to as "Best Cost," can be focused or broad and is a blend of both the differentiation and low cost strategies. In a best value strategy, the company makes a product or delivers a service that is more upscale, or more valuable, when compared to the low cost competitor. Therefore, competitors using a best value strategy charge higher prices overall than low cost competitors, but customers feel they are getting more overall value for their money spent. If Walmart is an example of a broad low cost strategy, then Target would be an example of a best value strategy. Target's merchandising and service are a little more upscale and their overall prices are a little higher. However, Target customers keep coming back because they value this difference and are willing to pay more for it.

DEVELOPING BIG DOG'S COMPETITIVE STRATEGY THROUGH THE USE OF PORTER'S COMPETITIVE FORCES ANALYSIS

The choice of competitive strategy is determined through an analysis of the company's strengths and the six competitive forces. Firms should choose a competitive strategy that matches their strengths and allows them to dilute high forces and gives them the potential to create barriers to market entry. Based on an analysis of the current local market, John and Reggie needed to develop an appropriate business strategy that capitalizes on their own strengths and reduces their competitive weaknesses. Since they were going to be a small retailer with limited resources, they needed to decide where to focus their resources and efforts. John and Reggie were faced with the challenge of figuring out how to allocate their limited resources in a way that would allow them to carve out a niche and effectively compete with the large sporting goods chains, like Dick's, and established online retailers, like Zappos or Amazon. And since they couldn't sell their products online due to supplier agreements, they were also trying to determine exactly what role technology should play in the company's business strategy. They felt that even on a limited budget they would somehow be able to effectively differentiate their store to bring in new customers and develop customer loyalty in the local market. But, they knew it was not going to be an easy task. John and Reggie began to wonder if it was possible.

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TATA STARBUCKS: HOW TO BREW A SUSTAINABLE BLEND FOR INDIA

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CASE DESCRIPTION

This case is primarily intended for use in the corporate strategy section of a business policy or competitive strategy course. It can be used as an overview of the many decisions and actions that an organization has to undertake to sustain a competitive advantage. This case can also be used to augment discussions of strategic analysis, specifically both internal and external environmental analysis and strategic formulation.

The case is rich enough for advanced and graduate students, and has been developed in a manner that will allow students to diagnose the root(s) of the company's issue(s) as detailed in the case, and then form opinions and suggestions for any strategy that the company should pursue. In doing this, students should consider the activities, history, and goals of the company as presented.

It would be effective at the business strategy level, especially, to discuss the implications of industry life cycles, and at the corporate strategy level to discuss implications of diversification. The case also lends itself to discussions of strategic implementation and the effect of leadership on innovation, especially when trying to maintain a mature brand.

CASE SYNOPSIS

Starbucks entered the Indian market in October 2012 by forming a 50:50 joint venture with the Tata Group. The Indian Café market offered a lot of potential for the new Tata Starbucks alliance. While India was a nation known for its tea drinkers, sipping coffee and socializing at coffee shops was becoming increasingly popular. Domestic consumption of coffee had risen up 80% in the past decade.

The joint venture appeared to be at the crossroads of an important strategic decision. It could either revert to a plan to grow its store count aggressively much like it did in the US. It is possible that this was the original intent. After all, the initial launch pricing had been set to be competitive with Café Coffee Day's (CCD) pricing (coffee drinks available for as low as Rs 100^a). Alternately, it could choose to embrace a premium-priced, niche approach similar to the one it had used successfully in other Asian countries like Japan and China. The premium offering would then cater to an older, business elite with higher spending power. This would result in less rapid growth with a cherry-picked list of high profile, business-friendly locations that could also allow it to build a premium brand with premium pricing.

^a Assumed 50 Rs = 1 US Dollar

Would Starbucks and Tata under Davda's leadership finally be able to crack the code for sustained success in the competitive and complex Indian market? While Davda appeared proud of what the alliance had achieved at the 2014 Starbucks annual shareholders meeting, some critical strategic choices would need to be made to ensure the long term success of Starbucks in India.

HOW TO ACHIEVE LONG TERM SUCCESS: THE MILLION RUPEE QUESTION

Starbucks had had its eye on the large Indian market for a while. An attempt to enter the market in 2007 had failed due to complications with the Indian government and foreign direct investment (FDI) restrictions^b. The company had withdrawn its application then and was an eager responder when India's esteemed Tata Group knocked on its door with a partnership opportunity. A 50:50 joint venture was formed and Starbucks coffee was introduced to the Indian market in October 2012 with a generous initial investment of \$80 million.(Bahree, 2012) In the 2012 annual report for Tata Global Beverages^c, the Board of Directors expressed a lot of excitement about the potential of the newly formed joint venture between the company and Starbucks. *"Through Tata Starbucks, your company offers the legendary Starbucks coffee experience, backed by the trust of the Tata name, to the Indian consumer,"* announced Cyrus P. Mistry, Chairman, Tata Global Beverages.(Tata, 2012)

The Indian café market offered a lot of potential for the new Tata Starbucks alliance. While India was a nation known for its tea drinkers, sipping coffee and socializing at coffee shops was becoming increasingly popular. Domestic consumption of coffee had risen up 80% in the past decade. Given these encouraging trends, Starbucks CEO, Howard Schultz, believed that India could one day rival the company's successful venture in China.

With its store count exceeding 40, the Tata Starbucks joint venture had clearly come a long way since it was kicked off in January 2012, but it was too early to celebrate. Continuing to succeed in the Indian café market would not be an easy task due to two key challenges – competition and profitability.

The market was intensely competitive with multiple domestic and foreign players. The most formidable competitor was domestic giant, Café Coffee Day (CCD), which had already adopted a strategy of flooding the market with its cafes, closely mimicking what Starbucks had done in the US.

Another critical challenge before companies was the ability to break even. High real estate costs and rental rates, along with competitive pricing pressures and India-specific cultural preferences, made it extremely difficult for coffee companies to recover their initial investments.

Tata Starbucks CEO Davda admitted the initial consumer experiences had been a humbling experience. Tata Starbucks had opened its first store with a lot of fanfare in the trendy

^b The Government of India at the time permitted foreign retailers a maximum ownership stake of only 51%.

^c Tata Global Beverages is the Tata Group subsidiary that manages coffee and tea sales.

Horniman Circle area of Mumbai in October 2012. Despite having a high profile local partner, Starbucks was unable to use its name to secure any discounted rates in renting real estate. The first store was eventually opened in a Tata Group owned 4000 square foot site that had been lying vacant for a while.

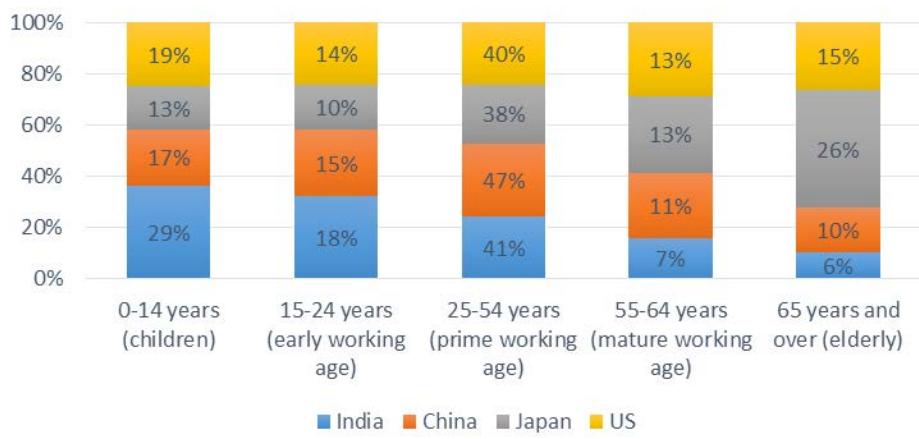
By Q3 2014, it appeared to have expanded to nearly 50 locations across the country in Mumbai, Delhi, Pune and Bengaluru (PTI, 2014). Yet, this was well short of the initial expectations - the target at launch had been set at 50 stores by end of the 2012 launch year. Clearly, something had changed in management expectations of the size or pace of growth from the venture. Quarterly earnings presentations since had boasted of robust store profitability with no numbers provided, possibly pointing to a slower and more selective approach to expansion (Tata, 2014).

The joint venture appeared to be at the crossroads of an important strategic decision. It could either revert to a plan to grow its store count aggressively much like it did in the US. It is possible that this was the original intent. After all, the initial launch pricing had been set to be competitive with CCD's pricing (coffee drinks available for as low as Rs 100^d). This approach was putting it in direct price competition with CCD, the domestic café market leader.

However, gaining market share among the youth of the country would allow it to tap into a large demographic segment. India's population showed a pronounced skew to younger age brackets (see Exhibit 1) and lower incomes when compared to other countries like Japan and the US. Building a presence within these segments as CCD had done, could be critical to succeed in the long term.

Exhibit 1: 2014 Age Distribution by Country

Source: CIA World Factbook



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SCHULTZ & STARBUCKS | CULTIVATING A COMPANY FROM AN IDEA

Starbucks started out in 1971 with a single coffee roaster and retailer store in the Pike Place Market in Seattle. Since then the company had expanded its global footprint considerably with over 17,000 coffee stores in more than 50 countries (Starbucks, 2014). The visionary behind this international success story was CEO, Howard Schultz.

Schultz had joined the company in 1981 and quickly assessed its growth potential after visiting coffee houses in Italy. He envisioned his coffee houses offering much more than just a cup of coffee. They were to become a third place for people to meet and socialize, in addition to home and work. In addition to serving coffee, the coffee houses would help people connect with other people and their local communities. Employees would be recruited and trained on coffee, company products and customer service to deliver a positive "Starbucks Experience" to each and every customer.

The company also quickly acquired a reputation for being an employer of choice and a socially responsible player.

- When the company went public in 1992, all employees were made "partners" in the company and given a share of company equity (aka bean stock). Comprehensive healthcare coverage was also provided to both full time and part time employees.
- Further, efforts were made to ethically source products and establish strong relationships with coffee producing farmers all over the world. In later years, the company began to utilize reusable and recyclable cups in its stores. Last but not least, its employee partners contributed several hours of volunteer work to help with community causes.
- After the 2008/2009 recession and the introduction of the Affordable Care Act, several companies began to cut employee benefits to manage costs. Schultz refused to reduce benefits for his partners arguing that this was a short term reaction and not in the interests of a company in the long term.

The company's mission was to inspire and nurture the human spirit one person, one cup, and one neighborhood at a time. The company had plans of doing this not just in the US but across the globe. The Starbucks name had been taken from a character in Herman Melville's classic adventure novel, Moby Dick. It was felt that the history of the coffee trade and Seattle had a strong association with the sea. In keeping with the sea theme, the image of a Norse twin tailed siren was also adopted as the company logo.(Starbucks, 2014)

The company under Schultz's leadership had performed remarkably well financially over time. Performance in 2013 showed total revenues up 12% to \$14.9B, same store sales up 7%, and \$2.9 billion in cash flow. Operating income, however, was hit due to a one-time litigation charge with Kraft Foods Global, which resulted in a pretax charge to fiscal 2013 operating results of \$2.8 billion. When excluding this one-time charge, operating income would have grown 23% to \$2.5 billion (Starbucks, 2013).

INITIAL EXPANSION INTO ASIA | TARGETING THE WESTERNIZED AND THE WEALTHY

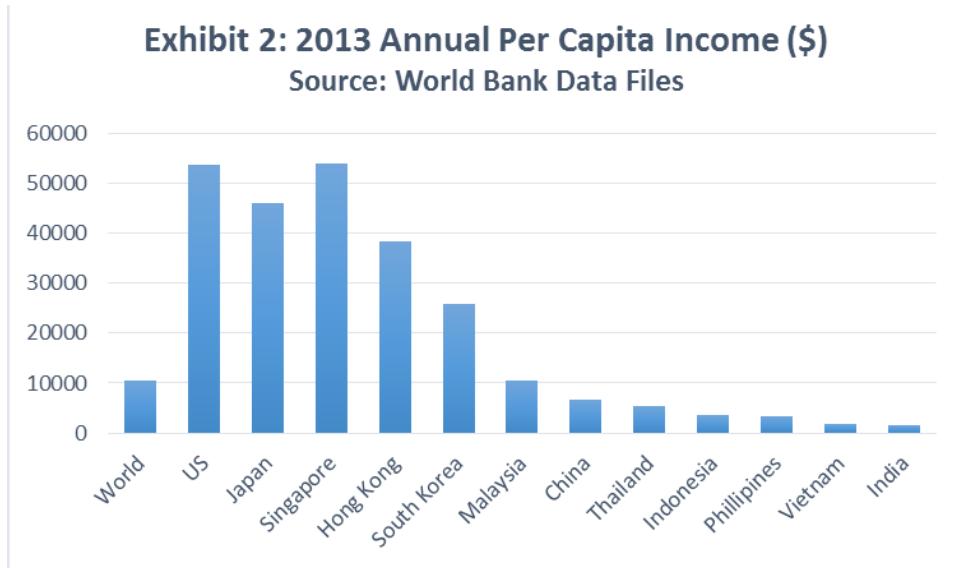
The first store outside North America opened in the fashionable Ginza district in Japan in 1996. Within the next few years, Starbucks had become a well-known brand name in Japan. Like Starbucks shops in the United States, those in Japan featured comfy sofas with American music playing in the background. Unlike most Japanese *kisaten*, or local coffee shops, Starbucks did not allow smoking. The policy proved popular with women who didn't smoke as much as men in Japan. Men eventually followed the women to Starbucks locations and business started humming. Given the strong performance, the stock of Starbucks Coffee Japan Ltd. made its debut on the NASDAQ Japan exchange and has performed strongly ever since. *"Any way you measure it, we've exceeded our wildest expectations,"* CEO Howard Schultz announced jubilantly, at the initial public offering in Tokyo, October 2001.

Tea-drinking Japan was not a total stranger to coffee. Dutch traders first brought coffee to Japan in the 17th century, but the shogun prohibited them from traveling freely in Japan, so very few Japanese were exposed to coffee mainly in port cities like Nagasaki. Coffee penetrated Japan further in the 1850s with the arrival of American ships. Soon after, Japanese started to travel overseas and brought back elements of the European coffee culture.

The first coffee shop opened in 1880s in Tokyo's Ueno district, and drinking the brew became associated with the wealthy classes. Over the next few decades, coffee increased in popularity within Japan and a number of coffee chains entered the market. As business flourished between the US and Japan, many Japanese traveled to the United States. West Coast cities like Seattle were popular destinations. So when Starbucks finally entered Japan in 1996, many Japanese were already familiar with the brand. Starbucks soon cultivated a loyal clientele of wealthy Japanese who considered it to be the original gourmet coffee shop and aspired to emulate the Western lifestyle.

Starbucks Coffee Japan turned its first profit in 2000, nearly four years after its initial launch. Clearly Starbucks entered markets with a commitment to win them over the long haul. Starbucks now has over 1000 stores in the country. For a while, sales volume per store was twice as high as in the United States. (Belson, 2001)

Between 1996 and 1999, Starbucks expanded to additional markets that had a high number of international travelers and a growing segment of Westernized and wealthy locals. These were countries with high or growing per capita incomes (see Exhibit 2).



- Starbucks Singapore opened its first store in December 1996 at Liat Towers, strategically located along the nation's renowned Orchard Road shopping belt.
- It then entered the Philippines (1997), Taiwan, Thailand and Malaysia (1998), and South Korea (1999), once again selecting premium locations frequented by the country's growing Westernized, affluent classes and international travelers.(Starbucks, 2014)

Happy with its initial successes, Starbucks began planning expansions into countries with more entrenched cultures and large, diverse populations.

NEXT EXPANSION WAVE | CRACKING THE CULTURAL CODES

Unlike Japan, tea-drinking China had little prior experience with coffee. In addition, the emerging superpower had deeply entrenched cultural traditions with regards to food and drink. Succeeding in China would be a critical challenge and opportunity for Starbucks. Cracking the cultural code here, could provide for conquering other emerging markets like India.

Starbucks had opened its first store in Beijing in 1999. The company figured out there was a universal need for being respected for our differences and feeling connected with others. Starbucks was catering to this need with its culture and values in a way that was conducive to local values and tastes.

Within China, instant coffee accounted for upwards of 80 percent of all coffee consumption. Given the average Chinese consumer's limited prior exposure to coffee, this proved to be a highly effective and affordable way of expanding consumption. Starbucks has taken a different approach and targets the affluent Chinese consumers with beverages priced up to 50 percent higher than the prices at its US stores. Most Starbucks beverages in China will cost upwards of 30RMB (or about US\$5). In contrast, Nestlé's Nescafé instant coffee can cost as little as RMB1.5 (US\$0.10) per packet.

Fueled by Starbucks, the wealthy commercial capital Shanghai, quickly became the coffee culture capital of China. The owner of Shanghai-based Café del Volcán, one of Shanghai's popular coffee retail outlets, noticed an interesting phenomenon in the initial days after opening his cafe. The prices had not yet been displayed, and most customers just ordered their beverages with only a few inquiring about prices. Clearly the Shanghai elite were not price sensitive. Much like Starbucks, the café then began to focus primarily on achieving the highest level of quality and service.

In 2011, a Starbucks outlet in China averaged US\$600,000 in annual revenues. The strategy proved to be successful with Starbucks' Chinese outlets becoming more profitable than those in the US market. China/Asia Pacific operating margins in the last quarter of 2012 were 33.7 percent in comparison to 20.8 percent in the United States. *"It's no doubt that one day China will become our second largest market after the United States, and it's possible that, over many years, potentially the largest one,"* mused Starbucks CEO Howard Schultz in an interview with China Daily.

While Nestlé and Starbucks had radically different methods for getting the Chinese to drink coffee, both succeeded. This success in part can be attributed to segmenting the market and recognizing the Chinese as unique consumers with different tastes and habits than those of American consumers. For instance, Chinese consumers did not like the bitter taste associated with black coffee or espresso, so both players have tailored their beverages accordingly. Nestlé's Nescafé packets include sugar and powdered milk, while Starbucks emphasizes milk-based drinks like frappuccinos, lattes and mochas in their stores. Starbucks' Chinese menus also added some local flavor, with customized choices like green tea tiramisu and Chinese moon cakes.

In addition, Starbucks localized its outlets by offering large seating areas since Chinese tend to not like to take their drinks to go. Local Chinese customers began to enjoy the "Starbucks experience" while sitting with friends and having something to munch on along with their coffee. Further, "family forums" were introduced to explain to parents the merits of having their children working at Starbucks. Large lounges with couches were provided at stores to accommodate the need for working customers to relax for a bit during afternoons. Menus were modified to include foods that were tailored to local tastes e.g. a Hainan Chicken sandwich and a Thai-style Prawn wrap(Burkitt, 2012).

By the end of 2013, it had opened its 1000th store in the country. It was this success in China that made Schultz particularly eager to venture into India. Like China, India was another large market with culturally entrenched tastes(Barlow, 2013).

"Our stores domestically and around the world, have become the third place for customers between home and work. The environment, the store design, the free Wi-Fi — everything we've been able to do has created this primary destination. That is the same in Honshu, (China), in Beijing, in Shanghai, in Spain, in Tokyo or in New York City. We've cracked the code on universal relevance," CEO Howard Schultz later reminisced in an interview in 2013(Bartromo, 2013).

CONQUERING UNFAMILIAR MARKETS | SEEKING THE MAGIC FORMULA

With Starbucks' stellar performance in its initial expansion into Asia, numerous industry analysts speculated on the best practices that could be used by the company to penetrate other markets or emulated by other companies(Wang, 2012). Three key themes emerged ...

1. Be Tactful in Marketing the Brand:

- Once Starbucks decided to enter China, it implemented a smart market entry strategy. It did not use any advertising and promotions that could be perceived by the Chinese as an American intrusion into the local tea-drinking culture. It just quietly focused on carefully selecting premium locations to build its brand image.
- Further, Starbucks capitalized on the tea-drinking culture of Chinese consumers by introducing beverages using popular local ingredients such as green tea. It also added more milk based beverages, e.g., frappuccinos, since the Chinese did not like the taste of bitter coffee.

2. Find a Good Local Partner:

- Working with right partners can be an effective way to reach local customers and expand quickly without going through a significant learning curve.
- China was not one homogeneous market. There are many Chinas. The culture from northern China is very different from that of the east. Consumer spending power inland is not on par with that in coastal cities. To address this complexity of the Chinese market, Starbucks partnered with three regional partners as part of its expansion plans.
- In the north, Starbucks entered a joint-venture with Beijing Mei Da coffee company. In the east, Starbucks partnered with the Taiwan-based Uni-President. In the south, Starbucks worked with Hong Kong-based Maxim's Caterers. Each partner brings different strengths and local expertise that helped Starbucks gain insights into the tastes and preferences of local Chinese consumers.

3. Make a Long Term Commitment:

- Long term commitment means patience. It took Starbucks time to educate the market and gain customer loyalty. Starbucks also did an excellent job in recruiting and training its employees. This turned out to be a win-win strategy because employees were after all the face of the Starbucks brand and at the heart of delivering the "Starbucks Experience" to customers.

These learnings armed Starbucks as it prepared to penetrate an even more complex and competitive market - India.

PASSAGE TO INDIA | TATA GROUP A WORTHY PARTNER

Founded by Jamsetji Tata in 1868, Tata's early years were inspired by the spirit of nationalism. It pioneered several industries of national importance in India: steel, power, hospitality and airlines. In more recent times, its pioneering spirit had been showcased by companies such as TCS, India's first software company, and Tata Motors, which made India's first indigenously developed car, the Tata Indica, and the world's most affordable car, the Tata Nano.

The Tata Group comprised over 100 operating companies in seven business sectors: communications and information technology, engineering, materials, services, energy, consumer products and chemicals. The group had operations in more than 100 countries across six continents, and its companies exported products and services to 150 countries.

Along with an increasing global footprint of Tata companies, the Tata brand was also gaining international recognition. In 2010, *BusinessWeek* magazine ranked had Tata 17th among the '50 Most Innovative Companies' list. Brand Finance, a UK-based consultancy firm, valued the Tata brand at \$18 billion and ranked it 39th among the top 500 most valuable global brands in their *BrandFinance® Global 500* 2013 report.

Like Starbucks, Tata had a strong belief in social responsibility. The company had created national institutions for science and technology, medical research, social studies, and the performing arts. The trusts had also provided aid and assistance to non-government organizations (NGOs) working in the areas of education, healthcare, and livelihoods. Individual Tata companies had also been known to extend social welfare activities to communities around their industrial units. The Tata name had been respected in India for more than 140 years for its adherence to strong values and business ethics.

The total revenue of Tata companies was \$97 billion in 2012-13, with nearly two thirds coming from business outside India. Tata companies employed over half a million people worldwide. Every Tata company or enterprise operated independently. Each of these companies has its own board of directors and shareholders. The major Tata companies were Tata Steel, Tata Motors, Tata Consultancy Services (TCS), Tata Power, Tata Chemicals, Tata Teleservices, Titan Watches, Tata Communications, Indian Hotels, and Tata Global Beverages.

Much like Starbucks, the Tata Global Beverages unit was looking for a retail partner to sell its coffee products. Its broad product portfolio also included tea and bottled water. Much like its Tata Group parents and Starbucks, Tata Global Beverages also prided itself with having strong values and purpose as a company. Thus a promising partnership was formed, and Starbucks was ready to make a grand entry into the market.(Tata, 2014)

COFFEE IN INDIA | AN EXISTING BUT LESSER KNOWN TRADITION

Unlike China, tea-drinking parts of South India did have some historical experience with coffee. The crop was first cultivated in Ethiopia, and by the 1600s was hugely popular

throughout the Ottoman Empire. The Turks boiled or roasted coffee beans before they left the Yemeni port of Mocha to keep them from being grown elsewhere, according to coffee historian and author Mark Pendergrast. That is why, according to legend, a 17th-century Muslim pilgrim named Baba Budan taped seven coffee beans to his stomach and smuggled them to India. The hills where he planted those beans are now known as the Bababudan Giris.

When the British arrived in the 1600s, looking at first to break a Dutch monopoly on the spice trade, tea and coffee were "backyard crops" in India. Over the centuries, the British installed plantations and established more organized production processes. Tea, which was a much larger crop, was grown mostly in the north, while coffee was grown mostly in the south.

For decades, the Coorg (aka Kodavu) region in South India had been home to coffee plantations. The British began planting coffee here in the 19th century. When India gained independence in 1947, the original British planters sold their estates to the locals (aka Kodavas) and other South Indians. Since the Indian government changed its policies and allowed farmers to take control of their own sales in the mid-'90s, India's coffee industry had seen a boost in quality and profits, and had taken a seat in gourmet coffee circles.(Allison, 2010)

With the alliance, Starbucks gained access to locally produced premium quality beans from Tata owned plantations in the Coorg region. Tata Coffee, a unit of Tata Global Beverages, produced more than 10,000 metric tons of shade grown Arabica and Robusta coffees at its 19 estates in South India(Badrinath, 2012). A strategic asset for Starbucks as it prepared to do battle with the domestic giant, CCD.

INDIAN CAFÉ MARKET | DOMINATED BY CAFÉ COFFEE DAY

By 2014, the Indian coffee house market was \$300M strong and growing at a robust 20% rate from year to year. While the market was crowded with international and domestic players, Starbucks' true competition came from a domestic giant, Café Coffee Day (aka CCD). The presence of international coffee chains was significant but the cumulative number of these outlets put together was only about a third of the 1,500 outlets operated by home-grown CCD.(Madonna, 2013)

CCD had been the market leader since its beginnings as a "cyber café" in 1996. As the retailing arm of the nearly 150 year old Amalgamated Bean Coffee Trading Company Limited (ABCTCL), it had the benefit of sourcing its coffee locally from a network of ABCTCL owned coffee plantations and using ABCTCL manufactured coffee roasting machines. These allowed CCD to insulate itself from global price fluctuations and serve coffee at lower prices than the competition. Most of the foreign competitors relied on imported coffee and foreign roasting machines.(CCD, 2014)

ABCTCL's charismatic CEO, V. G. Siddhartha, rapidly expanded CCD stores across the country. The mission of the company was to provide a world class coffee house experience at affordable prices. This had made the stores ubiquitous, much like Starbucks stores in the US. It also made CCD the destination of choice for the youth in the country who had limited money to

spend and were looking for socially acceptable places to socialize. The majority of India still disapproved of socializing at bars, and cafes offered a respectable alternative. A 2014 industry study showed the CCD brand was synonymous with coffee for most coffee drinkers in India.(Kaushik, 2011)

After CCD, the next biggest player was the Barista's chain which started in 2000. Tata Global Beverages had briefly explored the option of partnering with Barista (2001-2004) to sell its coffees, but eventually sold its stake. In keeping with its premium positioning, most of Barista's products were imports and its coffee roasted in Venice, Italy. In 2007, it was acquired by Italian coffee company, Lavazza. However, profits had proven elusive despite several years on the market and heavy investments. In 2013, Lavazza announced it would sell the Barista's business.

Industry watchers say that the business is becoming difficult to turn profitable even after years of operations. High rental expenses and intense competition had made most foreign players struggle to achieve profitability despite years of trying. According to industry estimates, rentals could account for 15-25% of the cost of running a cafe chain. Typical monthly rental market rates were Rs 200-300 per square foot of real estate(Srivastava, 2012). Then, there was the investment in making a store appealing to customers with its interiors, finding people to run them and building a food and beverage menu that was hip enough to keep 18-24 year-olds — the target market for many coffee chains — coming back for more. CCD had found a way around this problem by entering into a revenue-sharing deal, paying 10-20% of a unit's proceeds as a fee.^{Error! Bookmark not defined.} Coffee through bars was a sit-in concept in India where consumers generally hung around such outlets for hours compared to the global phenomenon of grabbing coffee on the go from generally tiny outlets and kiosks(Sachitanand, 2014).

Industry experts argued that coffee chains in India must maintain elaborate and plush outlets - and not kiosks - to give Indian consumers what they are looking from a coffee chain even if the proposition turned out to be very expensive, which is making it difficult for many companies to stay in the business and hard to scale up. Unlike countries like the US where purchasing coffee was often a quick transaction at a counter or kiosk for customers on the go, the culture in India was to sit down and socialize for hours over coffee or tea(Bailay, 2014). Some frustrated customers stopped frequenting stores because it was so hard to find a free table(Kaushik, 2011). This made it much harder for coffee retailers to churn a profit. According to Manmeet Vohra, the Tata Starbucks marketing and category chief, peak hours in India were 2 pm to 6 pm (compared to 5 am to 11 am in the US) and takeout orders accounted for barely a fifth of their business in India (compared to 80% in the US)(Sachitanand, 2014).

Other international entrants like the UK's Costa Coffee, the US based Coffee Bean and Tea Leaf Company, and Australia's Gloria Jean's Coffee experienced similar profitability challenges(Bailay, 2014). Costa Coffee had entered the market in 2005 and soon found its stores were too small to handle the peak time crowds. The Coffee Bean and Tea Leaf Company had started out in 2007 and tried to entice customers by offering new menu items each month. Gloria Jean's Coffee had entered the market in 2008 hoping it could crack the profitability code

by serving coffee in more kiosks, which required a lower capital investment. However, achieving profitability continued to remain elusive for most international players.

Starbucks appeared to be doing well in its initial stores. In quarterly investor presentations, Tata Global Beverages reported robust profitability in its stores. While no numbers were shared by the company, the information was corroborated by industry experts. The 4000 square foot Horniman Circle store was estimated to be generating Rs 8.5 lakhs in daily sales, which compared to Rs 1 lakh generated by the 400 square foot CCD store at the Mumbai airport. Top Indian store revenues in US dollars were comparable to those generated out of the stores in China (~\$600,000 per year since the real estate was obtained from the Tata Group, it is clear that at least the first store was percolating a healthy profit.

QUICK SERVICE RESTAURANT CHAINS | A LOOMING THREAT

In addition to traditional coffee chains, the Indian café market was being encroached upon by other quick service restaurant (QSR) options like McDonald's and Dunkin Donuts. These players threatened to steal market share with lower priced options to drink coffee at existing quick service establishments.

One of the major advantages for these over Starbucks and other competitors was the already existing network of locations in the country that allowed ready access and an ability to bring down establishment costs. Further, this ubiquity and lower pricing would allow these players to tap into the larger demographic segments that made up a large section of the Indian population.

“McDonald's has the advantage as their ability to expand is better, considering that they have a larger footprint now,” Amit Jatia, Vice-Chairman and CEO, Hardcastle Restaurants which is the McDonald's franchise for South Indian operations.

Price is another factor where McCafe is expected to hold an edge over Starbucks and other giants. Getting a cappuccino for Rs. 90 at a global brand like McCafe sounds more appealing than spending in excess of Rs. 110 for the same drink at Starbucks. Much like Starbucks, McCafe will source its coffee from Chikmagalur in Karnataka(Unknown, 2013).

TATA STARBUCKS | CHALLENGING DECISION AHEAD

“We have studied and evaluated the market carefully to ensure we are entering India the most respectful way. We believe the size of the economy, the rising spending power and the growth of café culture hold strong potential for our growth and we are thrilled to be here and extend our high-quality coffee, handcrafted beverages, locally relevant food, legendary service and the unique Starbucks Experience to customers here,” said John Culver, president, Starbucks Coffee China and Asia Pacific(Bhattacharya, 2013).

The business looked simple - have a standardized decor, choose a suitable location and offer good coffee and food - but ensuring that a customer's cappuccino tasted the same as it did yesterday and a service that did justice to the iconic Starbucks brand name every single day, was far more complex. What it required were carefully selected partners (store managers and stewards who went through intensive training) and an incredibly complex planning effort. That's why Starbucks had decided to avoid the franchisee route that could have seemed like the obvious choice for rapid expansion.

Also, Starbucks had to make sure to meet the expectations of its world-travelled customers, who were aware of the Starbucks experience. Many of these customers would check whether the coffee tasted the same as it did abroad, and whether the store ambience was equally comfortable. If the experiences matched up, they would become regulars.

But for sustained success, Starbucks needed to penetrate the domestic young and middle income markets. Starbucks laid out plans for different formats, such as "abbreviated stores" that would be smaller in size and stores at college and school campuses. The stores in India also began experimenting with their food menu. While Starbucks globally offered blueberry and chocolate muffins, it wanted to serve local innovations at its Indian locations. Coinciding with its first anniversary, the company launched a new local India Estates blend. This blend was Tata Starbucks' special country-specific coffee, developed thoughtfully with Tata for the Indian market and reflected the high quality Arabica coffee available in India. Additionally, the company launched the Indian Espresso Roast which was sourced locally through a coffee sourcing and roasting agreement between Starbucks and Tata. It was felt that the coffees captured the essence and rich heritage of the Indian coffee history.

The challenge ahead of Davda and Tata Starbucks was a difficult one. How could it maximize the long term success of the venture in India? This would mean going beyond the "westernized and the wealthy" targeting that had worked so well in relatively older and more affluent Asian markets. While the partnership with Tata was occasionally helping in negotiating for good real estate, it also would still need to figure out how to leverage the partnership to win over the larger young and middle income demographic segments. Store financials would need to be figured out to maintain profitability. These questions would need to be answered quickly as the company prepared to expand into the next tier of Indian cities.

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UTILIZING CURRENCY SWAPS TO HEDGE RISK AT SLC

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CASE DESCRIPTION

The primary subject matter of this case is the utilization of currency swaps to reduce long-term currency exposure. Secondary issues examined include counter-party risk and exploiting a comparative advantage. The case requires students to have an introductory knowledge of accounting, statistics, finance and international business thus the case has a difficulty level of four (senior level) or higher. The case is designed to be taught in one class session of approximately 3 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

St. Louis Chemical (SLC) is a regional chemical distributor, headquartered in St. Louis. Don Williams, the President and primary owner, began SLC ten years ago after a successful career in chemical sales and marketing. The company has gradually expanded its product line and network of manufacturers. Five years ago, SLC completed a joint venture with a German chemical distributor that included the option purchase the remaining 49% interest in the foreign subsidiary at a predetermined price. SLC is currently considering whether to exercise the option and more specifically, how to finance the debt needed to complete the purchase and reduce the additional currency risk that would accompany the conversion of the joint venture to a wholly owned subsidiary.

BACKGROUND

St. Louis Chemical (SLC) is a regional chemical distributor, headquartered in St. Louis. Don Williams, the President and primary owner, began SLC ten years ago after a successful career in chemical sales and marketing. The company reported small losses during its first two years of operation but has since reported eight consecutive years of increasing sales and profits. The growth has required the acquisition of additional land, equipment, expansion of storage capacity and more than tripling the size of the work force. SLC has become the leading distributor in the St. Louis area. Since beginning his career in the chemical distribution industry Williams has developed solid customer contacts in the St. Louis metropolitan area, as well as with major customers in Missouri, Illinois, Iowa, Indiana and Tennessee. He has also developed valuable contacts with key chemical manufacturers.

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of

manufacturers. They store bulk chemicals in "tank farms", a number of tanks surrounded by dikes to prevent pollution in the event of a tank failure. Tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. *RMA Annual Statement Studies* (2012-2013) indicates "profit before taxes as a percentage of sales" for Wholesalers - Chemicals and Allied Products, (SIC number 5169) ranges from 1.6 to 3.2% with an average of 2.7%. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts which will ensure a complete product line is available at competitive prices.

THE SITUATION

In January, 2014, Don Williams returned from a week-long vacation in Mexico knowing he had a big decision to make. Back in 2009, Williams had received a phone call from Ruth Odar, the president of RMO International, a division of a much larger conglomerate Heidelberg GmbH. RMO International is a regional chemical distributor located in Frankfurt, Germany. Williams had first met Odar at the Association of Chemical Distributors annual trade show a few years earlier. Odar and Williams had spoken on numerous occasions regarding current industry conditions, since both were in similar businesses. However, this phone call was a solicitation for a joint venture to buy a 51% stake in RMO International. The recent economic recession in Europe had left RMO International's conglomerate parent with liquidity issues and this particular offer also included the right to buy the remaining 49% in 5 years at a predetermined price.

After a series of negotiations, SLC had closed on a joint venture with Heidelberg on July 1, 2009 and as a result of the transaction, SLC will now have to make a decision whether to exercise the option to purchase the remaining 49% stake in RMO International or keep the existing joint venture agreement in place. Williams was reviewing the financial report prepared by the corporate finance division concerning the conversion of RMO International from a joint venture to a wholly owned subsidiary.

On the surface, the financial analysis favored the conversion of RMO International into a wholly owned subsidiary. However, one of the most prominent uncertainties in the analysis is the significant foreign currency exchange rate exposure that would be transferred to SLC. Future euro cash flows generated by RMO would be remitted back to SLC and converted into US dollars at exchange rates that are not known today. If the euro strengthens in value from its current level, SLC will benefit from the higher conversion value and the return on investment increases. If the euro weakens in value from its current level, SLC will receive fewer dollars per euro and the return on investment decreases.

The report contained a scenario analysis related to exchange rate risk. Under a moderately neutral exchange rate fluctuation simulation, the conversion of euros to US dollars would result in a positive net present value with an 85% confidence level (holding all other operational risk factors constant). However, under a moderately weak euro exchange rate simulation, the positive net present value confidence level drops to under 65%. The persistently weak euro exchange rate scenario, while not highly probable, indicated a successful outcome will only occur about 35% of the time. There was a note at the end of the scenario analysis suggesting a currency swap agreement as a possible way to mitigate the exchange rate risk but no formal analysis had been completed to date.

In the capital requirements section of the report, it was suggested that SLC would need to borrow the equivalent of about \$135 million in order to raise the 100 million euros necessary for the deal at the current exchange rate of \$1.35/EUR. SLC's US investment bank had estimated SLC could conservatively raise \$135 million by issuing 5.9% annual coupon bonds at face value with a 5 year maturity. Zeutsche Bank (which had handled the joint venture between SLC and Heidelberg five years ago) had proposed a 5-year 100 million Eurobond denominated in euros that would need to carry a 6.1% annual coupon in order to sell at face value. The report did note that although the coupon rate was higher, future euro cash flows from RMO would likely be sufficient to cover the Eurobond coupon payments. In addition, this would significantly reduce the amount the euro cash flows remitted back to SLC and thus significantly reduce the exchange rate risk embedded in the deal.

After reading the entire report, Williams knew there were other important factors in the analysis to discuss with the corporate finance division such as demand forecasts, pricing pressure and margin variations, but it was the exchange rate risk that was particularly troubling to Williams. Williams had a firm grasp of the operational risks of the chemical distribution business, but his understanding of the foreign exchange rate market was limited. While the foreign exchange rate risk was significant, Williams wasn't sure he wanted to pay 20 basis points on a loan equivalent to \$135 million for five years to reduce the exchange rate risk. What he really wanted was the lower borrowing costs in the US dollar market and a reduction in the future exchange rate exposure.

Williams decided to explore the earlier suggestion of a currency swap a little further. Williams did a quick search on currency swaps and according to Wikipedia, the currency swap has three main uses: 1) to secure cheaper debt, 2) to hedge against exchange rate fluctuations, and 3) to defend against financial turmoil by allowing a country beset by a liquidity crisis to borrow money from others with its own currency. Williams also read that currency swaps were originally conceived in the 1970s to circumvent foreign exchange controls in the United Kingdom. They had also been used extensively by the Federal Reserve during the financial crisis of 2008 and a more recent currency swap agreements worth about \$10 billion had been established by South Korea and Indonesia. According to the Bank of International Settlements, the notion amount of currency swaps has risen from \$14 trillion in 2007 to \$26 trillion by 2013. Williams had not been familiar with the concept of a currency swap before, but was interested in learning more about them.

Williams went in to the office of his CFO, James Black, to discuss the possible advantages and disadvantages of borrowing euros to finance the acquisition. Black had commented that while Williams was on vacation, Zeutsche Bank had contacted him regarding a possible currency swap transaction with one of Zeutsche Bank's European customers, Eagle Aero. Eagle Aero, an aerospace firm with production and assembly plants in both France and the United States, is interested in making a substantial upgrade to its largest US subsidiary division located in Dallas, TX. Eagle Aero would prefer to borrow US dollars but has found it is relatively expensive to issue debt denominated in US dollars. Eagle Aero plans to use the US dollars generated by its US subsidiary to repay the US denominated debt. Eagle Aero could issue a 5-year 100 million Eurobond denominated in euros with a 6.3% annual coupon if sold at par value. If the bonds were denominated in US dollars, Eagle Aero bonds would need to carry a 6.7% annual coupon payment for a \$135 million face value issue. Zeutsche Bank had proposed that SLC issue the \$135 million bond issue at 5.9% and swap it for a 5-year 100 million euro interest only loan at 5.8% with annual interest payments. Eagle Aero would issue a 100 million euro denominated bond at 6.3% and swap it for a loan of \$135 million at 6.5%, with Zeutsche Bank acting as the broker-dealer. Black had sketched out a few details of the swap agreement in order for Williams to gain a better understanding of the deal.

| Company Name | Cost of US \$ denominated debt | Cost of € denominated debt |
|---------------------|---------------------------------------|-----------------------------------|
| SLC Inc. | 5.90% | 6.10% |
| Eagle Aero | 6.70% | 6.30% |

Black began his overview of the currency swap proposal by laying out the costs of borrowing for SLC and Eagle Aero based on the denomination of the currency. Black conveyed to Williams that the cost of borrowing for Eagle Aero was higher than SLC's cost of borrowing regardless of the currency denominating the debt, but it was substantially higher for Eagle Aero to borrow US dollars.

The swap agreement called for SLC to borrow \$135 million by issuing a 5.9% annual coupon bond in the US. The \$135 million would be exchanged for 100 million euros setting the initial exchange rate at \$1.35/1 euro. Using RLO International's euro cash flows, SLC would pay 5.8 million euros each year to Zeutsche Bank, while Zeutsche Bank would pay \$7.965 million to SLC so that the US dollar bond payments can be met. In short, the currency swap would mean that SLC would borrow \$135 million today, exchange it for 100 million euros and repay 5.8 million euros each year. From SLC's point of view the cost of borrowing in euros would now be 5.8%. At the end of five years, SLC would repay the 100 million euro principal and receive \$135 million from Zeutsche Bank, thus being able to repay the principal on the bond offering. Black noted that since Zeutsche Bank was acting as the broker-dealer in this transaction, there was no counterparty risk associated with Eagle Aero. In essence, as long as Zeutsche Bank remained solvent, the currency swap would allow SLC to lower their cost of borrowing relative to borrowing directly in euros and eliminate the exchange rate risk associated with the conversion of RMO from a joint venture to a wholly-owned subsidiary.

| Swap Proposal | | |
|--|---|---|
| SLC Inc. | Zeutsche Bank (Swap Broker/Dealer) | Eagle Aero |
| Borrow \$135 mil at 5.9% in US\$ market | Receive \$135 mil from SLC at 5.9% Receive €100 mil from Eagle at 6.3% | Borrow €100 mil at 6.3% in euro market |
| Receive €100 mil loan from Zeutsche Bank at 5.8% | Loan €100 mil at 5.8% to SLC Loan \$135 mil at 6.5% to Eagle Aero | Receive \$135 mil loan from Zeutsche Bank at 6.5% |

Williams was still skeptical and wanted to know how a currency swap could be so magical that it reduces SLC's borrowing costs and mitigates the exchange rate risk associated with the conversion of RMO International into a wholly owned subsidiary. What is the role of Zeutsche Bank in the swap transaction and how are they compensated? How is Eagle Aero going to benefit from this swap? Why would they want to participate in this currency swap? Are there any additional risks associated with the currency swap that Williams should be considering? Williams asked Black to lay out the details of the currency swap in laymen terms so that he would be prepared to answer questions from the board if SLC decided to exercise the option to purchase the remaining 49% interest in RMO and utilize the currency swap as part of the financing option. Williams left with a series of tasks for Black to complete by the end of the week.

THE TASK

The most important consideration for Williams is to be able to explain to the board how the currency swap might help SLC reduce their borrowing costs and reduce their exchange rate exposure if they decide to convert RMO International from a joint venture into a wholly owned subsidiary.

- 1) What is the anomaly in current market conditions that makes the currency swap a viable alternative?
- 2) Assume SLC borrows locally by issuing a \$135 million face value 5.9% annual coupon bond with a maturity of five years at par and engages in a currency swap with Zeutsche Bank for a five-year 100 million euro interest only loan at 5.8%. Simultaneously, Eagle Aero borrows locally by issuing a 100 million euro denominated bond with a 6.3% annual coupon and engages in a currency swap with Zeutsche Bank for a five year \$135 million interest only loan at 6.5%. Describe the initial exchange of cash flows related to SLC, Zeutsche Bank, and Eagle Aero.

- 3) Describe the annual interest cash flows that occur each year over the next five years related to SLC, Zeutsche Bank, and Eagle Aero and discuss any additional risks that SLC may occur over the five year period.
- 4) Describe the principal repayment cash flows that occur at the end of five years related to SLC, Zeutsche Bank, and Eagle Aero and discuss any additional risks that SLC may occur when the principal repayment is due in five years.
- 5) How does the currency swap reduce the cost of borrowing for both SLC and Eagle Aero?
- 6) How does Zeutsche Bank profit from the currency swap if it has no exposure to the initial exchange of cash flows nor does it have exposure when the principal repayment of cash flows are made at year five?
- 7) Calculate Zeutsche Bank's profit (both as a dollar amount and as a percentage of the \$135 million notional amount) per year assuming it is able to hedge its exposure to the currency swap agreement by taking a long position in a series of one- to five-year forward contracts each with a forward rate of \$1.35/euro.
 - 1 year forward rate = \$1.35/euro
 - 2 year forward rate = \$1.35/euro
 - 3 year forward rate = \$1.35/euro
 - 4 year forward rate = \$1.35/euro
 - 5 year forward rate = \$1.35/euro
- 8) Calculate Zeutsche Bank's profit (as a dollar amount) per year assuming it is able to hedge its exposure to the currency swap agreement using a series of one- to five-year forward contracts where the forward rate is determined from interest rate parity. The current exchange rate is \$1.35/1 euro and the applicable yield curve available to Zeutsche Bank is flat with US dollar interest rates at 3% per year and euro interest rates at 2% per year.

Exhibit 1: Historical Foreign Exchange Data (# of US dollars / 1 Euro)

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TIMBERLINE ENERGY INC.: VALUE CREATION VS. CORPORATE WELFARE

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CASE DESCRIPTION

The case of Timberline Energy is designed to encourage students to think about an investment decision in the context of value creation. Is the proposed wind-energy project a value-creating investment? Under what circumstances will it be a good investment? Who benefits? Who bears the costs? And what are the implications for public policy?

The case is aimed at MBA or advanced undergraduate students of finance who are well-versed in the process of making capital investment decisions. It is designed to be taught in a single 75-minute class period, after 3-4 hours of student preparation. The firms, individuals, and projects described are fictitious, though they are based upon a composite of real-world entities.

CASE SYNOPSIS

Over the past few years, an increase in public awareness and concern over sustainability, combined with a sharp runup in energy prices, has made the development of renewable energy sources a top priority for many private- and public-sector entities. Energy companies are tempted by the prospect of profitable new markets, and policymakers are thrilled by the promise of creating "green" jobs for their constituents. Indeed, the potential economic and environmental benefits of such development are undeniable. However, when politics are injected into the financial decision-making process, less-than-desirable outcomes can occur.

Timothy Albright is the founder and strong-willed CEO of Timberline Energy, a Midwestern developer of wind energy installations ("wind farms"). In early 2014, Albright is faced with a potential project that carries with it both new obstacles and new opportunities. With more than a decade of successful wind farm development to his credit, Albright is confident of his ability to navigate this new environment. However, a chance encounter with an elected official and an economics professor casts his investment decision in a new light.

INTRODUCTION

Timberline Energy, Inc. was founded in Rochester, Minnesota in 2002 by Timothy Albright, a professional electrical engineer with more than 10 years of consulting experience in the energy sector. Although oil prices were relatively low at the time, Albright was convinced that renewable sources of energy would become increasingly important in the future, and sought to gain a foothold in this emerging line of business. Early on, Timberline's specialty was small-scale wind turbine installations, which provided power for homes, farms, and other facilities in remote locations. Over the next few years, Timberline's business expanded and evolved into designing and building larger and larger "wind farm" installations for various customers (electric utilities) throughout the upper midwestern United States.

In 2008, Albright was approached by the Brazilian energy firm Energia do Brasil ("EDB") regarding a possible acquisition. By the end of that year, EDB had acquired a controlling interest in Timberline, with Albright remaining in the position of Chief Executive Officer. The infusion of capital enabled Timberline to shift its focus from by-contract construction to direct wind farm development. Timberline's first company-owned wind farm, a 50-megawatt installation in northern Illinois, went online in late 2009, generating electricity to be sold into the national grid at prevailing market rates. The project was considered a success by Albright and his partners at EDB, and they continued to seek out opportunities for additional wind energy developments. Consolidated financial statements for EDB are provided as Exhibits 1 and 2.

One of the factors driving Timberline's success during this time was the existence of the Production Tax Credit (PTC). The PTC was enacted by congress in 1992 with the goal of fostering the development of new, sustainable sources of energy. In particular, the PTC provided a tax credit of \$0.022 per kilowatt-hour generated for operators of commercial wind farms. Although the cost of producing electricity with wind turbines was still relatively high (considering the capital costs and maintenance costs), the PTC had made wind farm installations attractive investments for many operators.

The Production Tax Credit had originally been slated to expire in 1999; however, over the subsequent 14 years, the PTC was repeatedly renewed and extended by congress in 1- and 2-year increments. At the end of 2013, though, the PTC was allowed to expire, and in the present political climate, prospects for its reinstatement were uncertain at best. In any case, there would be no such tax break for projects started in 2014.

THE SAGINAW PROJECT

The opportunity that is the focus of Albright's attention is a proposed 240 megawatt wind farm to be constructed in a rural area west of Saginaw, Michigan. The area is known to have fairly steady winds from the northwest, and Timberline is in the process of negotiating a lease agreement with a landowner. Albright has developed a plan for the site that involves the installation of 133 wind turbines, each nearly 400 feet tall, and with a nameplate capacity of 1.8 megawatts. This is a fairly ambitious project for the young firm, over four times the size of its largest project to date. The installation would eventually generate enough electricity to power almost 50,000 homes. The size of the project meant that it would require a far greater investment of capital than his own budget authority allowed, so Albright knew he would have to make a strong case for it to EDB's board of directors.

The details of the lease agreement for the land have yet to be finalized, but Timberline's usual practice is to seek a 30-year lease, in exchange for an annual royalty payment of \$0.45 per megawatt-hour (1000 kilowatt-hours) produced, in addition to an initial payment. The amount of the up-front payment is still under negotiation, but Albright is expecting a figure of about \$25 million.

The cost of construction would be considerable; Timberline's engineers have estimated the initial cost to be approximately \$1.3 million per turbine, and it would take almost 12 months

for the construction to be completed. Production of electricity would begin about one year after breaking ground on the project.

Once operational, the costs of running a wind farm are fairly modest. Timberline would expect to keep a staff of about 15 individuals on-site to monitor the operation, at a total labor expense of about \$1,200,000 per year. Regular maintenance of the facility should cost about \$40,000 per turbine per year. Other overhead expenses for the facility should total no more than \$100,000 per year. The only working capital involved in this project would be a small inventory of maintenance supplies and hardware, a negligible investment.

As for project revenue, the local electric utility has agreed to a 20-year power purchase agreement (PPA) at a fixed price of \$0.035 per kilowatt hour. Although this is a competitive price at the current time, future market prices for electricity are somewhat unpredictable, and no assurance can be given as to the prevailing price after the PPA expires. The PPA provides stability for both Timberline and the local power company, reducing the risk of the project considerably.

As mentioned previously, the turbines used for this project would have a nameplate capacity of 1.8 megawatts; however, this is the maximum possible output of the units. In practice, wind turbines rarely generate electricity at the limit of their capacity (the wind doesn't always blow that fast). Average power output is measured by the capacity factor, which measures the actual realized output of a facility as a percentage of the theoretical maximum. For wind farms, capacity factors range from 20% to 50%; based on his experience with wind installations in the upper Midwest, Albright believes that an assumed capacity factor of 37.5% is appropriate.

Wind turbines are typically designed to have a 20-year life expectancy, and this is the customary assumption for the lifespan of an installation. Individual units may last longer, but beyond 20 years, it is expected that major components will begin to fail, and complete (expensive) overhauls would be needed in order to remain in service. At the end of their service life, the turbine components could be sold for recycling; in today's market a large wind turbine would have a scrap value of about \$100,000 after tax.

As a wholly-owned subsidiary of Energia do Brasil, Timberline's practice is to evaluate potential investment projects against EDB's cost of capital. The Saginaw project is fairly typical of the wind energy projects in EDB's portfolio, so based on recent experience, Albright expects that it will be deemed an average-risk project for cost-of-capital purposes. Selected capital market information pertaining to EDB is provided as Exhibit 3.

Timberline currently assumes a combined marginal income tax rate of 33% for U.S.-based projects. Because EDB and Timberline file a consolidated tax return, any project losses can be used to offset EDB's current income from other sources. The current tax law provides one benefit for wind energy development; despite their 20 year life expectancy, wind turbines qualify for a 5-year MACRS depreciation schedule. Because this system enables the cost of the project to be expensed over a relatively short time, the tax savings from depreciation are realized sooner, thereby benefitting the developer. MACRS depreciation percentages are provided as Exhibit 4.

THE PUBLIC-SECTOR INCENTIVE

With Timberline's legal department still in the midst of negotiating the lease for the Saginaw project, Albright took time to attend a fundraising dinner for the benefit of his alma mater, Michigan State University. At the dinner, he found himself seated next to Marcia Gutfeld, Michigan's recently elected Lieutenant Governor, and a former classmate from MSU. Albright was aware that the process of obtaining the necessary building permits for a project of this scale was going to be a challenge, so he seized upon the opportunity to "talk shop" with the elected official.

"It's great to see you again, Marcia. Congratulations on your new job! Even though I don't live in Michigan anymore, it was exciting to watch the results come in for you on election night."

"Thanks, Tim. It's been a wild ride, but I think I'm finally starting to get the hang of it. As you know, Governor Quincy has set some pretty lofty goals for his first term, so we have our work cut out for us."

"I can believe it. Michigan took quite a beating during the financial crisis. Have you made much progress on the unemployment rate yet?" Albright asked, cleverly steering the conversation in his direction.

"Some, but we're not where we'd like to be. It's still about two percentage points above the national average."

"Maybe that's something I can help you out with. Have you heard of my company, Timberline Energy?"

Gutfeld listened intently as Albright spent the next half hour telling her about the company, the renewable energy business in general, and the Saginaw project in particular, making certain to mention the staff that Timberline expected to hire locally. He knew that Governor Quincy had positioned himself as the "environmentally conscious" candidate, so he was hopeful that a little support from the administration might speed things along at the Public Service Commission.

"Wow, Tim, that's great news! Renewable energy was a big part of our campaign platform, and this is just the kind of development we want to support. In fact, I've been working on a new program that your firm might qualify for. Want to hear about it?"

"Sure, I'm all ears."

"I'm sure you know that the expiration of the Production Tax Credit has made life a lot harder for renewable energy producers, all over the country. Around the beginning of next month, the Governor is going to announce a plan that's intended to help offset the loss of the PTC for companies doing business in Michigan. We're going to offer interest-free financing for wind and solar energy projects for up to five years, with guaranteed renewal at market rates after that!"

Before Albright could respond, a voice from across the table groaned: "Oh no, not another corporate welfare boondoggle!" It was Professor Arrington, the longtime chair of MSU's department of Economics. "Weren't you in my Public Policy course, Gutfeld? Don't you know better?"

"Nice seeing you too, Dr. Arrington" she replied. "Quite a memory you have. That was twenty-plus years ago! But yes, I was in your class. In fact it helped inspire me to get into politics!"

"Serves me right for being so darned inspirational, I guess. How much taxpayer money are you planning to throw away on this lunacy?" Arrington was highly esteemed in economics circles, but he was not known for his agreeable personality.

"Well, we don't think it's being 'thrown away', because it's going to help with reducing greenhouse gas emissions, and create good-paying jobs for the people of Michigan. Furthermore, it's not really taxpayer money. The state will issue up to \$600 million worth of bonds, with the proceeds being used to fund the loans. We're just leveraging the state's tax-free borrowing capacity in a way that helps grow the economy, and preserves the environment to boot."

"Those bonds might be free of federal income tax, but they're not going to be free of interest, are they? Who's going to pay the interest on them? The windmill fairies?"

"Now you're being silly. Of course the state will have to service the debt, but we feel that the economic benefits will outweigh the cost. We'll have new wind farms and solar arrays generating electricity, making money, paying taxes, and hiring workers. We're confident that the expense is justified."

"We'll see about that. Have you projected the tax revenue that you're going to get from these outfits? That's assuming, of course, that they'll make any money to owe tax on."

"Not yet, but—"

"And who's going to be on the hook if your borrowers default? The taxpayers, that's who!" Arrington bellowed. "If it's such a great business, why can't this guy get his own financing in the public markets, like everyone else? Who are you, anyway?" Arrington asked, pointing at Albright.

"Tim Albright, sir, with Timberline Energy. Class of '90. Nice to meet you" he said, shaking Arrington's hand. He had been quietly watching the battle between the professor and the politician, more than a little annoyed by the interruption.

"Look, Albright, I'm not opposed to windmills or solar panels, or even subsidies, for that matter, as long as it's a viable business that can sustain itself. Can your operation do that?"

"We have a five-year track record of success in operating wind farms, so I think so. We're still working out the details for the Saginaw project, though."

"Well, you need to figure it out. It's simple, really. I assume you've taken at least an introductory finance course?" Albright nodded. "It's all about creating economic value. An investment project either creates value, or destroys it. If the benefits outweigh the costs, it's a good investment, and you don't need any subsidies to convince you to take it. If the costs outweigh the benefits, value is being destroyed, and we taxpayers don't want to help you pay for your mistakes."

"That's why we're going to offer this incentive program," Gutfeld interjected. "To make sure that these new, 'green' businesses can flourish. If the state can give a new business a boost to help it get off the ground, what's the harm?"

"There are situations where I might agree with you," the professor replied. "But here, there's no evidence that this is a value-creating business, absent some kind of government handout, like a tax credit. Even your hero, Warren Buffett, just recently made a public comment to the effect that 'wind farms don't make sense without a tax credit'.

"The bottom line is this," he continued. "A bad investment is a bad investment, regardless of who's paying for it. If the state tries to subsidize a bad investment into a good one, all that happens is that the cost is shifted onto the public sector. The only ones who benefit are the owners of the business!"

Albright bristled at this. "I don't think it's fair to call the Saginaw project a 'bad investment' just yet. We haven't even finalized the cost figures!"

"Maybe, maybe not" Arrington replied. "You need to work out the net present value of this operation for yourself. In any case, I'm opposed, on principle, to using taxpayer funds to prop up private businesses."

Albright leaned back in his chair, thinking quietly to himself while Gutfeld and Arrington continued sparring. They seemed to be having fun. At the end of the evening, he exchanged business cards with Marcia, each promising to keep the other updated via email. But he left the dinner feeling somewhat conflicted.

Would the Saginaw project be "viable," as Arrington put it? If not, would the interest-free loan make it viable? Although the interest subsidy would expire after five years, the promise of free capital during the critical construction and startup phase of the project was extremely enticing. But what if the project turned out to have a negative NPV? Would it even be right to accept taxpayer support in that case? These were some of the questions Albright wrestled with as he headed back to his hotel for the evening.

EXHIBIT 1
ENERGIA DO BRASIL - ANNUAL BALANCE SHEET (USD)

| Report Date | 12/31/2013 | 12/31/2012 | 12/31/2011 |
|---|---------------|---------------|--------------|
| Scale | USD Millions | USD Millions | USD Millions |
| Cash & cash equivalents | 184 | 110 | 169 |
| Accounts receivable & accrued revenue | 832 | 806 | 791 |
| Notes receivable | 57 | 37 | 44 |
| Inventories | 793 | 976 | 1,068 |
| Deferred Taxes | 295 | 171 | 190 |
| Prepayments & other current assets | 113 | 79 | 46 |
| Total current assets | 2,273 | 2,179 | 2,309 |
| Property, plant & equipment, gross | 14,566 | 14,033 | 13,276 |
| Less accumulated depreciation, depletion & amortization | 4,578 | 4,609 | 4,411 |
| Property, plant & equipment before construction work in progress | 9,987 | 9,424 | 8,865 |
| Construction work in progress | 1,034 | 972 | 705 |
| Property, plant & equipment, net | 11,021 | 10,396 | 9,570 |

| | | | |
|--|---------------|---------------|---------------|
| Regulatory assets | 1,377 | 2,058 | 2,219 |
| Notes receivable | 581 | 469 | 416 |
| Investments | 53 | 51 | 45 |
| Other non-current assets | 368 | 264 | 248 |
| Total non-current assets | 13,401 | 13,238 | 12,498 |
| Total assets | 15,674 | 15,417 | 14,807 |
| | | | |
| Current portion of long-term debt, capital & finance lease obligations | 506 | 487 | 951 |
| Notes payable | 153 | 99 | 0 |
| Accounts payable | 536 | 469 | 526 |
| Accrued liabilities | 365 | 342 | 372 |
| Deferred income taxes | 0 | 61 | 0 |
| Other current liabilities | 192 | 159 | 256 |
| Total current liabilities | 1,751 | 1,617 | 2,104 |
| Total LT Debt outstanding | 6,889 | 6,521 | 6,384 |
| Less current portion LT debt | -498 | -482 | -948 |
| Long-term debt, net | 6,391 | 6,039 | 5,436 |
| Non-current portion of capital & finance lease obligations | 124 | 138 | 150 |
| Regulatory liabilities | 1,994 | 1,891 | 1,688 |
| Postretirements benefits | 215 | 1,306 | 1,160 |
| Asset retirement obligations | 293 | 281 | 229 |
| Deferred investment tax credit | 36 | 39 | 41 |
| Deferred income taxes | 1,454 | 914 | 932 |
| Other non-current liabilities | 275 | 280 | 302 |
| Total non-current liabilities | 10,782 | 10,886 | 9,938 |
| Common stock & Add'l paid-in capital | 4,260 | 4,194 | 4,163 |
| Retained earnings (accumulated deficit) | -1,118 | -1,281 | -1,398 |
| Total equity | 3,142 | 2,913 | 2,765 |

EXHIBIT 2
ENERGIA DO BRASIL - ANNUAL INCOME STATEMENT

| Report Date | 12/31/2013 | 12/31/2012 | 12/31/2011 |
|--|--------------|--------------|--------------|
| Scale | USD Millions | USD Millions | USD Millions |
| Total operating revenues | 5,909 | 5,628 | 5,853 |
| Cost of sales | 2,993 | 2,879 | 3,161 |
| Maintenance & other operating expenses | 1,112 | 1,103 | 1,113 |
| Depreciation & amortization | 565 | 538 | 491 |
| General taxes | 211 | 205 | 185 |
| Total operating expenses | 4,882 | 4,725 | 4,950 |
| Operating income (loss) | 1,028 | 903 | 903 |
| | | | |
| Total other income (expense) | 11 | 14 | 18 |
| Total interest charges | 358 | 350 | 374 |
| Income (loss) before income taxes | 680 | 566 | 547 |

| | | | |
|--|---------------------|---------------------|---------------------|
| Income tax expense (benefit) | 272 | 221 | 172 |
| Net income (loss) | 409 | 346 | 375 |
| As Reported Annual Retained Earnings | | | |
| Report Date | 12/31/2013 | 12/31/2012 | 12/31/2011 |
| Scale | USD Millions | USD Millions | USD Millions |
| Previous retained earnings (accumulated deficit) | -1,281 | -1,398 | -1,588 |
| Net Income | 409 | 346 | 375 |
| Common stock dividends declared | 246 | 229 | 185 |
| Retained earnings (accumulated deficit) | -1,118 | -1,281 | -1,398 |

EXHIBIT 3
SELECTED CAPITAL MARKET DATA

| | |
|--|--------------|
| Risk-free interest rate | 4.50% |
| Market Risk Premium | 5.00% |
| EDB Beta | 0.95 |
| EDB Share price | 61.27 |
| EDB Bonds' weighted average maturity (years) | 13.5 |
| EDB Bond coupon rate | 7.50% |
| Recent EDB Bond price quote (% of par value) | 94.75 |

EXHIBIT 4
MACRS DEPRECIATION RATES

| Year | Depreciation rate for recovery period | | | | | |
|------|---------------------------------------|--------|--------|---------|---------|---------|
| | 3-year | 5-year | 7-year | 10-year | 15-year | 20-year |
| 1 | 33.33% | 20.00% | 14.29% | 10.00% | 5.00% | 3.750% |
| 2 | 44.45 | 32.00 | 24.49 | 18.00 | 9.50 | 7.219 |
| 3 | 14.81 | 19.20 | 17.49 | 14.40 | 8.55 | 6.677 |
| 4 | 7.41 | 11.52 | 12.49 | 11.52 | 7.70 | 6.177 |
| 5 | | 11.52 | 8.93 | 9.22 | 6.93 | 5.713 |
| 6 | | 5.76 | 8.92 | 7.37 | 6.23 | 5.285 |
| 7 | | | 8.93 | 6.55 | 5.90 | 4.888 |
| 8 | | | 4.46 | 6.55 | 5.90 | 4.522 |
| 9 | | | | 6.56 | 5.91 | 4.462 |
| 10 | | | | 6.55 | 5.90 | 4.461 |
| 11 | | | | 3.28 | 5.91 | 4.462 |
| 12 | | | | | 5.90 | 4.461 |
| 13 | | | | | 5.91 | 4.462 |
| 14 | | | | | 5.90 | 4.461 |
| 15 | | | | | 5.91 | 4.462 |
| 16 | | | | | 2.95 | 4.461 |
| 17 | | | | | | 4.462 |
| 18 | | | | | | 4.461 |
| 19 | | | | | | 4.462 |
| 20 | | | | | | 4.461 |
| 21 | | | | | | 2.231 |

Source: "How to depreciate property", Internal Revenue Service Publication 946, 2013. Retrieved from http://www.irs.gov/file_source/pub/irs-pdf/p946.pdf

ACCOUNTING ISSUES RELATED TO ACCEPTING BITCOINS

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Brad Reed, Southern Illinois University Edwardsville**

CASE DESCRIPTION

This case explores the accounting and tax issues related to a company accepting Bitcoin as payment from its customers. The case involves Overstock.com's decision in January 2014 to start accepting Bitcoin as payment for goods. Students are required to examine the accounting implications from accepting Bitcoins. Students are asked to research the relevant accounting pronouncements and make recommendations. Due to the new and unique nature of Bitcoins, students must employ critical thinking as they apply accounting principles to a new and evolving financial situation. Students are required to produce a short memo that addresses the accounting issues. Alternatively, this case works well for class presentations. The instructor could assign groups/individuals one of the questions and have the group present the issue, possible accounting treatments and a recommendation to the class. The case is appropriate for a senior level or graduate level accounting course. The difficulty of the case is 3/5.

CASE SYNOPSIS

Bitcoin is a new and unique type of asset. It is possible to view it as a currency, a commodity, an investment or an intangible asset. Each of these possible classifications present their own unique accounting issues. When Overstock receives a Bitcoin, a key issue is if the earnings process has been completed to the extent that it would be appropriate to recognize profit at the time of the sale.

If Overstock then holds the Bitcoin, accounting issues are presented regarding how to present Bitcoins on the Balance Sheet, as well as how to account for the change in value of the Bitcoins over time.

The student is in the position of a junior accountant working at Overstock performing research for the CFO. The junior accountant is asked to perform research related to some financial accounting issues that will arise if Overstock.com decides to hold Bitcoins. The junior accountant is asked to present relevant passages from the Accounting Codification and make recommendations for how Overstock should account for Bitcoins.

COMPANY HISTORY

On January 9, 2014 Overstock.com started accepting Bitcoin as payment (Metz, 2014). The initial day indicated that accepting Bitcoins could lead to significant new

business for Overstock. The success of the rollout can be seen from the following tweet from the CEO of Overstock.com, Partick M. Byrne:

“#Bitcoin’s first full day on @overstock.com was a huge success: 840 orders, \$130,000 in sales. Almost all new customers. #stunned.”

More than \$5,000 in sales occurred within the first thirty minutes of Overstock.com’s acceptance of Bitcoins. The first full month brought continued success with over \$870,000 in sales stemming from 4,000 orders. (Hill, 2014) “For Byrne, a rather opinionated libertarian who’s unafraid to take his company places others fear to tread, embracing the cryptocurrency is as much a political statement as a business decision. Like so many others, he believes Bitcoin can break the world from the control of big banks and big government. It helps us fight the machine he said” (Wired). According to Forbes.com, to further demonstrate his optimism for Bitcoins Byrne recently, “cashed in several million dollars worth of gold” for the digital currency. In addition, Byrne has publicly stated an interest in paying his vendors as well as his employees in Bitcoins in the future if they so choose.

Byrne started Overstock.com in 1999 and the company went public with an IPO in 2002. The company is an online retailer, based out of Salt Lake City, Utah that specializes in selling excess inventory discount prices. With diverse product offerings ranging from clothing, furniture, and fine jewelry to automobiles, the Consumer Usage Report rated Overstock.com as one of the five most visited mass merchandiser websites. Overstock prides itself on its high level of customer service, with the NRF/Foundation/American Express Customer Choice Awards ranking Overstock.com in the Top 10 in customer service among all U.S. retailers. The company currently has nearly 1,300 employees and offers nearly one million products at prices that have saved Overstock customers millions of dollars. In the most recent year, Overstock reported more than \$1 billion in revenue, up from \$1.1 million at the company’s inception. Byrne feels that the decision of Overstock.com to accept Bitcoin could help Overstock.com compete against other online retailers such as Amazon, in the \$60 billion market. (Murphy, 2014)

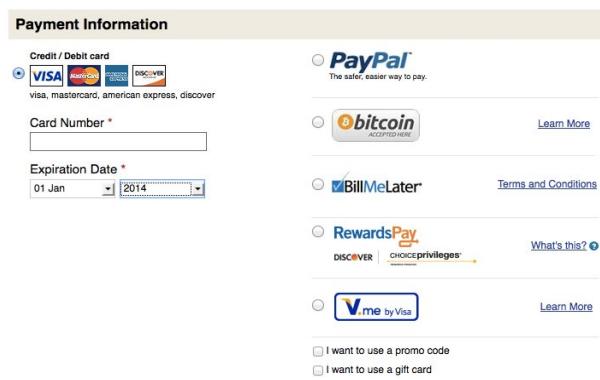
“Yes, I actually think that this forces the hand of Amazon and some other big players. They have to follow suit. You will see them follow suit. I’ll be stunned if you don’t, because they can’t just cede that part of the market to us, if we’re the only main, large retail site taking Bitcoin. Either they have to start taking it, or they’re just giving away a piece of the market.” Forbes (Phillips, 2014).

In addition, the strategic decision appears to be attracting a different clientele to Overstock.com, which could ultimately increase market share. A recent list of the top 25 products customers have bought with Bitcoins differs greatly from the top 25 products purchased by all Overstock.com customers during the same time period. For example, sheets were the most prevalent purchase for customers paying with Bitcoins, while area rugs were the most common purchase for all Overstock.com customers. Only a few

products made both lists. The most common products purchased with Bitcoins includes: cell phone accessories, A/V accessories, appliances, computer accessories, computers, men's shoes, hard drives, bedroom furniture, keyboards & mice, and men's watches.

Byrne describes his rationale for Overstock.com's acceptance of Bitcoins. He states, "We are on a crazy strategy with our central bank. It's good to have alternative ecosystems. It's not that the dollar will go away, but we need other options if it crashes or wildly inflates." Former U.S. Congressman and Presidential Candidate, Ron Paul has a stronger opinion, telling CNNMoney, "There will alternatives to the dollar, and this might be one of them. If people start using Bitcoins *en masse*, it'll go down in history as the destroyer of the dollar."

Overstock entered into an agreement with a San Francisco Company called Coinbase. When a customer purchases an item from Overstock and indicates that they will be paying with Bitcoin, Overstock's system will communicate with Coinbase. Coinbase sets an exchange rate, and that exchange rate is used to immediately convert the buyer's Bitcoin into dollars, and transfers the dollars to Overstock. Currently, Overstock never holds Bitcoins, but customers are encouraged to pay with Bitcoins and are even offered 1% back on purchases made with Bitcoins in the form of "Club O bucks". In addition, paying with Bitcoins is as convenient and easy as paying by more traditional methods. See the Bitcoin checkout option (shown above) available to purchase products at Overstock.com.



BITCOIN HISTORY

Bitcoins were developed by an anonymous programmer and are an emerging digital currency with no government backing. Bitcoins utilize cryptography (a form of mathematics used in computer science for the purpose of data integrity, confidentiality and security for passwords, electronic commerce and on-line banking) to prevent or at least mitigate double-spending, which is a common problem for digital currencies. BTC is the unit of measure for Bitcoins, similar to a U.S. dollar, but only in digital form. Bitcoins exist only as a numerical and alphabetical sequence and are not a physical currency. Bitcoins are stored in digital Bitcoin wallet, which is a Bitcoin application on the owners personal computer or cellular phone in which a unique Bitcoin address is created. Bitcoin wallets



have a public address that can be given to send Bitcoins to an individual. Bitcoin wallets also have a private address, also known as the private key, that is necessary for an individual to send his or her Bitcoins.

Bitcoins are transferred by the scanning of QR codes (a type of barcode), similar to other monetary exchanges. The Bitcoin wallet has a balance of all the Bitcoins and allows Bitcoins can be broken up in any denomination for easy spending. Unlike credit cards, there are little to no transaction fees (usually 1% or less) associated with the use of Bitcoins. Bitcoins have fluctuated in value from less than 1 U.S.D. to over 1,000 U.S.D. The above shows daily closing values of Bitcoins in U.S.D. from inception.

Bitcoins can be acquired in several ways. An individual receives Bitcoins through the scanning of QR codes as described above as payment for a good or service, by purchasing them from exchanges, visiting sites that provide free samples or offers, or trading cash for Bitcoins. In addition, individuals can participate in mining pools, which is how Bitcoins are initially created. Mining, allows individuals to receive new Bitcoins when they complete complex mathematical problems, which verifies Bitcoin transactions of others. Individuals who successful solve an equation can currently receive 25 Bitcoins, with the creation of Bitcoins halving every four years until the market cap is reached.

ACCOUNTING ISSUES

The CFO of Overstock has learned overtime that CEO Byrne often likes to be on the cutting edge of business practices. The CFO is concerned that CEO Byrne will decide that Overstock should start holding Bitcoins. The CFO would like to be prepared to discuss the relevant accounting issues related to holding Bitcoins, if the CEO should decide to hold Bitcoins. The CFO has assigned you as a junior accountant at Overstock to research and report on the financial accounting issues related to holding Bitcoin.

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MERGER TALKS GONE AWRY: MARTIN MARIETTA MATERIALS HOSTILE BID FOR VULCAN MATERIALS

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ABSTRACT

Lynne Davis, an extremely small investor in Vulcan Materials, was faced with a proxy vote on a hostile takeover offer from Martin Marietta Materials. Vulcan and Martin Marietta were number one and two respectively in the U.S. aggregates industry. They had entered into friendly merger negotiations, but the talks were discontinued. Subsequently, Martin made an exchange offer of its stock for each share of Vulcan's stock, and litigation from both companies soon ensued. As the June 2012 meeting approached, Lynne tried to sort through the myriad claims to reach her decision.

CASE DESCRIPTION

The primary subject matter of this concerns the legal use and interpretation of Non-Disclosure Agreements (NDA) and Joint Defense and Confidentiality Agreement (JDA) executed by the companies when they were on good terms. Secondary issues examined include proxy fights, hostile takeovers, and the aggregates industry dynamics. The case has a difficulty level appropriate to senior-level undergraduates or first year MBA students. The case designed for the business law courses is designed to be taught in a single 75-minute class period and requires no more than 2 hours of outside preparation by students.

CASE SYNOPSIS

In May 2012, Lynne Davis, an extremely small investor in Vulcan Materials, was faced with a proxy vote on a hostile takeover offer from Martin Marietta Materials. Vulcan and Martin Marietta were number one and two respectively in the U.S. aggregates (sand, rock, gravel) industry. They had entered into friendly merger negotiations, but the talks broke down in June of 2011. In December 2011, Martin made an unsolicited exchange offer of 0.50 shares of its stock for each share of Vulcan's stock, and litigation from both companies soon ensued. By February 2012, both companies initiated lawsuits, with some shareholders doing the same. Lynne had followed the litigation and reviewed the exchange offer but was undecided whether to vote her proxy for 4 new directors proposed by Martin Marietta or with Vulcan's nominees. As the June 2012 meeting approached, Lynne tried to sort through the myriad claims to reach her decision.

CASE BODY

As she walked down her driveway on a windy spring day, Lynne Davis cringed at the sight of the large envelope protruding from her mailbox. She took a quick glance at the return address titled Vulcan Materials Company which confirmed this was more proxy material related to Martin Marietta Materials hostile takeover of Vulcan. She had acquired 8 shares over 20 years earlier as a young employee at Vulcan's Birmingham, Alabama headquarters. Since that time she never gave much thought to the shares except each year when she received the notice of the annual shareholders' meeting. However, since the beginning of 2012 both companies had waged a proxy fight for the votes of Vulcan shareholders.

In early 2010, the companies had entered talks to discuss the merger of the two largest firms in the aggregates industry. After the talks broke down late in 2011 Martin Marietta made an unsolicited exchange offer for all outstanding shares of Vulcan's common stock at a fixed exchange ratio of 0.50 shares of Martin Marietta common stock. Vulcan's board immediately rejected the offer, and the proxy fight began with both companies filing lawsuits prior to the 2012 shareholders' meeting. Lynne opened the packet as she walked back up her driveway. A white proxy card was on top of the proxy material. She knew that the contents of the packet would include Vulcan's request to vote this white card just as Martin Marietta's material asked her to vote the blue card included with its proxy. She decided to review the events leading up to the June 1st vote before deciding how to vote her proxy.

AGGREGATES INDUSTRY

Aggregates were used in a variety of industries, but primarily in construction projects. Aggregates included crushed stone, sand and gravel. Demand for the industry's products was derived from different construction projects including airports, highways, water and sewer systems, manufacturing facilities, railroad track ballast, residential and commercial buildings. The industry consisted of over 5,000 companies in the U.S. In recent years, growth was typically accomplished through acquisition of existing facilities. The regulatory environment of aggregate producers often required dozens of permits to operate a single facility. Producers needed to navigate state and Federal regulations related to air quality, water quality, noise, zoning and safety. The ten largest producers accounted for 30-35% of the total U.S. aggregates production.

The industry revenue changes from 2006-2011 are shown in Table 1:

| Table 1 AGGREGATES INDUSTRY REVENUE | | |
|--|---------------------------|-----------------|
| <u>Year</u> | <u>Revenue \$ billion</u> | <u>Growth %</u> |
| 2006 | 16.645 | 11.4 |
| 2007 | 16.766 | 0.7 |
| 2008 | 14.833 | -11.5 |
| 2009 | 12.444 | -16.1 |
| 2010 | 12.362 | -0.7 |
| 2011 | 13.266 | 7.3 |

Source: Crompton, 2013.

Annual consumption reached 10.4 Mt per person in 2006 before falling to 6.3 Mt in 2009. Housing construction fell in excess of 70% from 2005 which accounted for much of the decline industry revenue. The remainder of the decline could be attributed to the 42% decline in Commercial and nonresidential building and the reduction in bank lending for construction projects.

VULCAN MATERIALS COMPANY

In 2011, Vulcan Materials Company was the largest U.S. producer of construction aggregates (i.e. crushed stone, sand, gravel) employing over 7,000 people Vulcan Materials Company. Vulcan controlled less than 10% of the market. The company also produced asphalt mix and ready-mixed concrete. As an aggregate producer the company sales fluctuated with the demand for highways, commercial and residential construction. The company's stock was listed on the New York Stock Exchange under the symbol VMC.

Vulcan Materials traced its beginning to the Birmingham Slag company, a family-owned construction company, founded in 1909. The company grew steadily under the leadership of Charles Ireland and his sons. The passage of the National Highway act under the Eisenhower administration catapulted its growth as the company supplied aggregates for interstate highway construction. In 1956 the company merged with the publicly-traded Vulcan Detinning Company of New Jersey. The company continued to grow through mergers and acquisitions reaching \$783 million in sales and number 367 on the Fortune 500 list by 1981. Vulcan divested its Chemical Division founded in 1957 to Occidental Chemical in 2005. The company celebrated its 50th year as a publicly-traded company in 2007. That same year the company completed its largest ever acquisition by acquiring Florida Rock Industries, Inc. in a \$4.6 billion deal consisting of cash and stock. Vulcan paid a 45% premium for the stock of Florida Rock.

Since 2008 the company's sales and earnings had languished. Selected financials are shown in Appendix 1a. As of 2011 Vulcan generated net sales of \$2.4 billion producing a loss of \$70.8 million. Prior to the merger talks with Martin Marietta, the stock price reached a high of just over \$128 per share in 2007. The stock price and dividend (see Table 2 below) had declined since 2007.

Table 2
VULCAN MATERIALS STOCK

| Year | High | Low | Dividend |
|------|----------|---------|----------|
| 2007 | \$128.62 | \$77.04 | \$1.84 |
| 2008 | \$100.25 | \$39.52 | \$1.96 |
| 2009 | \$ 71.26 | \$34.30 | \$1.48 |
| 2010 | \$ 59.90 | \$35.40 | \$1.00 |
| 2011 | \$ 47.18 | \$25.06 | \$0.76 |

Vulcan operated over 300 aggregates facilities across the U.S. In 2011, its top ten revenue-producing states were: Alabama, California, Florida, Georgia, Illinois, North Carolina,

South Carolina, Tennessee, Texas, and Virginia. It estimated its proven and probable reserves at 15 billion tons.

MARTIN MARIETTA MATERIALS COMPANY

In 2011 Martin Marietta Materials Company was the second largest U.S. producer of construction aggregates. The company employed nearly 5,000 employees in 28 states, Canada, the Bahamas, and the Caribbean. Its net sales in 2011 were \$1.5 billion with net income of \$82.4 million. The company was listed on the New York Stock Exchange using the symbol MLM.

The company traced its roots to Superior Stone founded in 1939. Superior merged with American-Marietta Corporation in 1959 and in 1961 with Glenn L. Martin Company to form the Martin Marietta Corporation. The company completed its initial public offering in 1994. The next year Martin Marietta Corporation merged with Lockheed Corporation to form Lockheed Martin Corporation. Lockheed Martin disposed of its interest in Martin Marietta Materials in 1996. The company continued to grow primarily through acquisitions reaching \$1 billion in sales by 1998. Selected financials are shown in Appendix 1b.

EVENTS UNFOLD

Lynne sifted through the stacks of proxy material and news clippings she had collected recently and constructed the following timeline of events leading to the current proxy vote (see Table 3). From what she had read the talks initially stemmed from the ever-growing consolidation within the aggregates industry. The market development through acquisition was a natural given the fragmented nature and the environmental concerns associated with quarries.

Table 3
Timeline of Events

| Date | Event |
|---------------|--|
| April 2010 | Informal Merger Talks Begin |
| May 2010 | Non-Disclosure Agreement (NDA) signed by VMC & MLM on 5/3/10; subsequent Joint Defense and Confidentiality Agreement (JDA) signed by VMC & MLM on 5/18/10 |
| June 2011 | Merger Talks Break down |
| Dec. 12, 2011 | Tender Offer Delivered by MLM to VMC |
| Dec. 12, 2011 | MLM files action in Delaware Court of Chancery seeking declaratory and injunctive relief (concerning reach of the 5/3/10 NDA); MLM files action in Superior Court of New Jersey against VMC seeking declaratory and injunctive relief (concerning its Tender Offer). |
| Dec. 19, 2011 | VMC files breach of contract (of the 5/18/10 JDA) lawsuit in U.S. District Court for the Northern District of Alabama |
| Dec. 20, 2011 | VMC files counterclaims in Delaware Court of Chancery and seeks declaratory judgment that MLM breached the NDA and an injunction preventing MLM from further disclosures. |
| Jan. 6, 2012 | VMC files answer in Superior Court of New Jersey denying MLM claims. VMC files motion to dismiss MLM claims which seek to prohibit VMC from becoming involved in MLM's attempt to propose new director nominees. Court denies VMC's motions on January 23, 2012. |
| Jan. 11, 2012 | MLM moves to dismiss VMC's complaint in U.S. District Court (Ala.). |
| Jan. 18, 2012 | Parties stipulate to dismiss JDA claims in U.S. District Court (Ala.) and have these claims |

| | |
|--------------------------|---|
| | heard along with NDA claims in Delaware. |
| Dec. 2011- Feb., 2012 | Four VMC shareholders filed derivative class action suits against the Vulcan Board. Each claim that Vulcan directors breached fiduciary duties owed to VMC in their handling of MLM's Exchange Offer. |
| Feb. 28, 2012 | Trial in the Delaware Court of Chancery between MLM and VMC concerning JDA and NDA dispute. |
| April 26, 2012 | MLM Proxy materials sent |
| April 30, 2012 | VMC proxy materials sent |
| June, 1 2012 | VMC Annual Shareholder Meeting to be held |

HOSTILITIES BEGIN

On December 12, 2011, Martin Marietta offered to exchange 0.50 share of Martin stock for each share of Vulcan common stock. According to Martin Marietta this offer represented a 15% premium over the closing price as of December 9, 2011. The \$4.7 billion stock for stock deal valued Vulcan at \$36.69 a share. In a letter to Vulcan shareholders, Martin Marietta asserted that the merger would create a company with a strong balance sheet and reduce the risk with the current Vulcan balance sheet. The deal promised a quarterly dividend of \$0.20 a share, twenty times the penny a share being paid by Vulcan. Martin Marietta believed it could achieve \$200 to \$250 million of annual cost savings as a result of the merger.

Vulcan countered that the offer was “opportunistic, inadequate and uncertain.” As evidence, Vulcan asserted that on 62.5 percent of the trading days over the last three years, the historical exchange ratio exceeded Martin Marietta’s offer. Vulcan asserted that Martin Marietta’s claims of synergies in the range of \$200-250 million were unsubstantiated and self-serving. Vulcan highlighted quotes from various Wall Street analysts who agreed with Vulcan’s position. As an example they quoted Craig Hodges of Hodges Capital Management Inc. who said, “If you’re a long-term shareholder, you definitely believe [the Martin Marietta offer] is low. There’s a lot of value in Vulcan. Martin Marietta is being smart and they’re kind of buying at the trough of the industry.”

However, some prominent shareholders disagreed with the Wall Street analysts. Glenn Ireland II, whose family owned Birmingham Slag for many years, wrote a letter to Vulcan’s board stating the offer from Martin made “excellent business sense.”

LEGAL MANEUVERS

The critical legal issues between the parties involved the use of confidentiality agreements in Martin Marietta’s unsolicited exchange offer and proxy contest for Vulcan. The referenced agreements were comprised of a non-disclosure agreement (NDA) and joint defense and confidentiality agreement (JDA) effective between the parties as of May 3, 2010 and May 18, 2010, respectively. These agreements were executed in contemplation of exploring a “business combination transaction” between the parties. *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072, 1077; 2012 Del. Ch. LEXIS 93, 2012 WL 1605146 (Del. Ch. May 4, 2012). There was no standstill agreement. Subsequently, for reasons stated above, Vulcan became disinterested in combining resources with Martin Marietta and accused Martin

Marietta of relying on confidential material contained in the NDA and JDA to launch its unsolicited exchange offer and proxy contest.

The content of the agreements included material subject to protection. This material was described in the agreements as either evaluation material (NDA, Preamble, p. 1) or confidential material (JDA, Common Interest, joint Defense and Confidentiality Agreement). Martin disclosed the content of the evaluation and confidential material to further its exchange offer and proxy contest. Vulcan alleged that this use violated the non-disclosure agreements.

To that end, Martin Marietta filed suit to obtain a declaratory judgment that the confidentiality agreements did not bar its exchange offer or proxy contest. Related lawsuits were filed from December 11, 2011 through February 28, 2013 to determine the legality of Martin's use and disclosure of information contained in the non-disclosure agreements. (See Table 1 above for more detailed dates.)

Vulcan asserted that the only lawful use of the confidentiality agreements was to further friendly negotiations "between" the parties; or, if an "external demand" compelled disclosure then disclosure would be authorized. Vulcan relied on the NDA's use of words "transaction" and "between" as evidencing mutual negotiation and not an unsolicited exchange offer or proxy contest. Vulcan took issue with Martin Marietta's use of the confidentiality agreements to further its unilateral pressure strategy against Vulcan. Further, Vulcan claimed that Martin Marietta had not received an external demand requiring disclosure of the material. Hence, Vulcan claimed that Martin Marietta's disclosures "flagrantly breached" the confidentiality agreements (*Martin*, p. 1079).

Vulcan noted that it was Martin Marietta's legal counsel who drafted the relevant language in the agreement, and that it was Martin Marietta who expressly coveted confidentiality during the 2010-2011 merger discussions. In fact, Martin Marietta appeared more concerned about the confidentiality of the 2010 merger discussions than was expressed by Vulcan. Martin Marietta's counsel edited the NDA to make it stronger in the "sense of broadening the information subject to restrictions and limiting permissible uses and disclosures of the covered information". (*Martin*, 56 A.3d 1072, 1082; 2012 Del. Ch. LEXIS 93, 2012 WL 1605146 (Del. Ch. May 4, 2012). The evidence indicated that Martin Marietta sought to design heightened protection from disclosures when the confidentiality agreements were drafted in 2010. At one point, a Martin Marietta counsel locked up the confidential material in a "sealed box" in her office, and she told Martin's advisors not to use "any Evaluation Material" (*Martin*, p. 1119). Vulcan asserted that the JDA and NDA were harmonious documents, both drafted to protect material from public disclosure, and that Martin Marietta's conscientious behavior during the 2010-2011 merger discussions was at odds with the position that they assumed in their lawsuit seeking a declaration that their use of the material to further their unsolicited exchange offer was legal.

Martin Marietta argued that Vulcan was trying to insert a non-existent "standstill" provision into the agreements. A standstill provision would explicitly prevent the parties from launching an unsolicited tender or exchange offer during a specific time. Martin argued that the agreements did not include such a provision and therefore, Vulcan should not be permitted to rely on a non-existent standstill provision (*Martin*, p. 1078). Martin further argued that it initially

only disclosed that which it was “legally required” to disclose to the SEC when it launched the exchange offer. Vulcan countered that Martin Marietta subsequently made generous disclosures of protected material that was not “legally required” to be disclosed (*Martin*, p. 1079). Vulcan maintained that the protected information necessitated disclosure to the SEC only because of Martin Marietta’s unilateral decision to launch a hostile bid. Vulcan asserted that a unilateral decision to launch a proxy contest and unsolicited exchange offer was not consistent with the language in the agreements which limited the protected material to discussions concerning transactions “between” the parties. Vulcan further contended that even if some of the information was “legally required” to be provided to the SEC, that Martin Marietta went too far by disclosing additional protected material to investors and to the press (*Martin*, p. 1078).

Some of the information that Martin Marietta disclosed included core confidential material such as “Vulcan’s nonpublic information shared at a March 8, 2011 meeting between Lloyd [Martin Marietta’s CFO] and Sansone [Vulcan’s CFO], as well as James’ [Vulcan CEO] synergy estimates” (*Martin*, p. 1136).

BLUE OR WHITE?

Martin Marietta’s blue proxy stated,

Despite the clear and compelling business logic our proposal and the urging of major shareholders, the Vulcan Board rejected our offer and refuses to even discuss it with us. But you now have an opportunity to communicate your wishes directly to the Vulcan Board. We believe the quickest path for Vulcan shareholders to realize the benefits of a combination is to elect independent directors to the Vulcan Board. To this end, we have commenced a proxy solicitation to elect four new, highly qualified and independent directors who we believe are neither beholden to Vulcan Chairman & CEO Don James nor entrenched in opposing a business combination with Martin Marietta. These four directors, who would constitute a minority of the Vulcan Board if elected, also are independent of Martin Marietta and would owe a fiduciary obligation only to Vulcan and you, the Vulcan shareholders.

Vulcan’s proxy material dated April 30, 2012 was titled “URGENT: PROTECT YOUR INVESTMENT IN VULCAN.” In part, Vulcan’s letter to shareholders stated,

Martin Marietta Materials, Inc., one of our competitors, is attempting to install four members on the Vulcan Board in support of its grossly inadequate offer to acquire Vulcan. Vulcan’s Board has always been open to serious conversations about maximizing value for Vulcan shareholders. In fact, Vulcan held extensive discussions with Martin Marietta in the past but was unable to come to an agreement on terms that would enhance value for Vulcan shareholders. Now Martin Marietta has launched a hostile, opportunistic offer in an attempt to acquire your company at a price substantially below its long-term value.

The board nominees from both companies are shown in Table 4. Lynne felt that the vote on Martin Marietta’s nominees to the board of Vulcan was really a vote on the attractiveness of

the exchange offer. She was unsure of how attractive the offer was, but somehow Martin's offer just didn't sit well with her. She remembered the heady days not so long ago when Vulcan's stock traded at over \$100 per share, and she felt that the industry was "rock solid" if unglamorous. However, Vulcan had struggled since the downturn in the economy in 2007. Lynne was also concerned about Vulcan's legal allegations concerning breaches of confidentiality by Martin Marietta, but she was unsure about the impact that such a breach would have on the value of the company. Besides, Martin Marietta was trying to obtain a legal declaration that it legally used the confidentiality agreements to further the exchange offer. She laid the Blue and White Proxy cards on her desk and decided to sleep on it before deciding.

Table 4
Board Nominees

| Vulcan Nominees | Martin Marietta Nominees |
|---|---|
| Phillip W. Farmer Former Chairman, CEO and President of Harris Corporation, an international communications and IT company. Chairman of the audit committee, executive and governance committees. | Philip R. Lochner, Jr. Former Senior Vice President and Chief Administrative Officer of Time Warner, Inc. Currently on the boards of Adelphia, Apria Healthcare, Monster Worldwide, Inc. and Solutia, Inc. |
| H. Allen Franklin Former Chairman, CEO and President of Southern Company, a leading US energy producer. Chair of the safety, health and environmental affairs committees and serves on compensation and executives committees. | Edward W. Moneybenny Former Senior Vice President of Finance and CFO of 7-Eleven, Inc. Currently on the boards of New York & Company, Inc. and until September 2011 was a director of Timberland Company. |
| Richard T. O'Brien President and CEO of Newmont Mining Corp., an international gold production company. Member of audit and safety, health and environmental affairs committees. | Karen R. Osar Former Executive Vice President and CFO of Chemtura Corporation, a specialty chemicals company. Currently on the boards of Webster Financial Corp., Innophos Holdings, Inc. and Sappi Ltd. |
| Donald. B. Rice Founder and former President and CEO of Agensys, Inc, a biotechnology company. Former Secretary of the Air Force and President and CEO of Rand Corp. and Teledyne, Inc. Chair of the compensation committee and member of Vulcan's executive and governance committees. | V. James Sardo Chairman of the Board of Capstone Infrastructure Corporation, and a director of New Flyer Industries Inc. Formerly a director and trustee of Consolidated Thompson Iron Mines Limited from 2010 to 2011. |

REFERENCES

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Hubbard, R. "Vulcan Materials shareholder and founding family member supports Martin Marietta deal," *The Birmingham News*, December 20, 2011.

Martin Marietta Materials, 10-K for fiscal year ended December 31, 2011.

Martin Marietta Materials, Inc. v. Vulcan Materials Co., No. 7102; 56 A.3d 1072, 2012 Del. Ch. LEXIS 93, 2012 WL 1605146 (Del. Ch. May 4, 2012).

Vulcan Materials Company, 10-K for fiscal year ended December 31, 2011.

Appendix 1a
Vulcan Materials Company Selected Financials
(In millions, except per share data)

| | 2011 | 2010 | 2009 | 2008 | 2007 |
|---|-----------------|-----------------|---------------|---------------|----------------|
| Net Sales | \$2,406.9 | \$2,405.9 | \$2,543.7 | \$3,453.1 | \$3,090.1 |
| Delivery revenues | 157.7 | 153.0 | 146.8 | 198.3 | 237.7 |
| Total Revenues | 2,564.6 | 2,558.9 | 2,690.5 | 3,651.4 | 3,327.8 |
| Cost of Goods Sold | 2,123.0 | 2,105.2 | 2097.7 | 2,703.4 | 2,139.2 |
| Delivery costs | 157.7 | 153.0 | 146.8 | 198.3 | 237.7 |
| Cost of Revenues | 2,280.7 | 2,258.2 | 2,244.5 | 2,901.7 | 2,376.9 |
| Gross profit | 283.9 | 300.7 | 446.0 | 749.7 | 950.9 |
| Selling, administrative & general expenses | 290.0 | 327.5 | 321.6 | 342.6 | 289.6 |
| Other operating income (expense), net | 69.6 | 12.3 | 24.1 | (158.0) | 53.1 |
| Operating earnings | 63.5 | (14.5) | 148.5 | 249.1 | 714.4 |
| Other income (expense), net | 0.0 | 3.0 | 5.3 | (4.4) | (5.3) |
| Interest income | 3.4 | 0.9 | 2.3 | 3.1 | 6.6 |
| Interest expense | 220.6 | 181.6 | 175.3 | 172.8 | 48.2 |
| Earnings (loss) from continuing operations before income taxes | (153.7) | (192.2) | (19.2) | 75.0 | 667.5 |
| Provision (benefit) for income taxes | (78.4) | (89.7) | (37.8) | 71.7 | 204.4 |
| Earnings (loss) from continuing operations before cumulative effect of accounting changes | (75.3) | (102.5) | 18.6 | 3.3 | 463.1 |
| Earnings (loss) on discontinued operations, net of tax | 4.5 | 6.0 | 11.7 | (2.4) | (12.2) |
| Cumulative effect of accounting changes | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net earnings (loss) | (\$70.8) | (\$96.5) | \$30.3 | \$0.9 | \$450.9 |
| Diluted earnings (loss) per share | | | | | |
| Continuing operations | (\$0.58) | (\$0.80) | \$0.16 | \$0.03 | \$4.66 |
| Discontinued operations | 0.03 | 0.05 | 0.09 | (0.02) | (0.12) |
| Cumulative effect of accounting changes | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Diluted net earnings (loss) per share | (\$0.55) | (\$0.75) | \$0.25 | \$0.01 | \$4.54 |
| Gross profit as a percentage of net sales | 11.8% | 12.5% | 17.5% | 21.7% | 30.8% |
| Net earnings | | | | | |
| As a percentage of net sales | -2.9% | -4.0% | 1.2% | 0.0% | 14.6% |
| As a percentage of average equity | -1.8% | -2.4% | 0.8% | 0.0% | 18.4% |
| Effective tax rate | 51.0% | 46.6% | 197.0% | 95.5% | 30.6% |

Source: Vulcan Materials Company 10-K report.

| Appendix 1b Martin Marietta Materials Selected Financials (In millions, except per share data) | | | |
|--|---------------|---------------|---------------|
| | 2011 | 2010 | 2009 |
| Net Sales | \$1,519.9 | \$1,475.7 | \$1,419.7 |
| Delivery revenues | 193.8 | 177.2 | 153.6 |
| Total Revenues | 1,713.8 | 1,652.9 | 1,573.3 |
| Cost of Goods Sold | 1,217.9 | 1,153.9 | 1,088.1 |
| Delivery costs | 193.8 | 177.2 | 153.6 |
| Cost of Revenues | 1,411.8 | 1,331.2 | 1,241.7 |
| Gross profit | 302.0 | 321.7 | 331.6 |
| Selling, administrative & general expenses | 124.1 | 130.4 | 135.9 |
| Business development costs | 18.6 | 1.2 | 2.2 |
| Other operating income (expense), net | (1.7) | (8.3) | 10.6 |
| Operating earnings | 161.0 | 198.4 | 189.9 |
| Interest expense | 58.6 | 68.4 | 73.5 |
| Other nonoperating expenses (income), net | 1.8 | 0.2 | (1.2) |
| Earnings (loss) from continuing operations before income taxes | 100.6 | 129.7 | 110.6 |
| Taxes on Income | 20.9 | 30.9 | 25.9 |
| Earnings (loss) from continuing operations | 79.6 | 98.8 | 84.6 |
| Gain (loss) on discontinued operations, net of tax expense (benefit) of \$2.2, (\$1.6) & \$1.6, respectively | 3.9 | (0.2) | 3.5 |
| Consolidated net earnings | 83.6 | 98.7 | 88.2 |
| Less: Net earnings attributable to noncontrolling interest | 1.2 | 1.7 | 2.7 |
| Net Earnings | \$82.4 | \$97.0 | \$85.5 |
| Net earnings (loss) per common share | | | |
| Basic from Continuing operations | \$1.70 | \$2.11 | \$1.84 |
| Discontinued operations | 0.09 | — | 0.08 |
| Cumulative effect of accounting changes | \$1.79 | \$2.11 | \$1.92 |
| Diluted net earnings (loss) per share | \$1.78 | \$2.10 | \$1.91 |
| Gross profit as a percentage of net sales | 19.8% | 21.8% | 23.4% |
| Source: Martin Marietta Materials 10-K report. | | | |

Instructors' Notes

MERGER TALKS GONE AWRY: MARTIN MARIETTA MATERIALS HOSTILE BID FOR VULCAN MATERIALS

Author 1, University of ***

Author 2, University of ***

Author 3, University of ***

CASE DESCRIPTION

The primary subject matter of this concerns the legal use and interpretation of Non-Disclosure Agreements (NDA) and Joint Defense and Confidentiality Agreement (JDA) executed by the companies when they were on good terms. Secondary issues examined include proxy fights, hostile takeovers, and the aggregates industry dynamics. The case has a difficulty level appropriate to senior-level undergraduates or first year MBA students. The case designed for the business law courses is designed to be taught in a single 75-minute class period and requires no more than 2 hours of outside preparation by students.

CASE SYNOPSIS

In May 2012, Lynne Davis, an extremely small investor in Vulcan Materials, was faced with a proxy vote on a hostile takeover offer from Martin Marietta Materials. Vulcan and Martin Marietta were number one and two respectively in the U.S. aggregates (sand, rock, gravel) industry. They had entered into friendly merger negotiations, but the talks broke down in June of 2011. In December 2011, Martin made an unsolicited exchange offer of 0.50 shares of its stock for each share of Vulcan's stock, and litigation from both companies soon ensued. By February 2012, both companies initiated lawsuits, with some shareholders doing the same. Lynne had followed the litigation and reviewed the exchange offer but was undecided whether to vote her proxy for 4 new directors proposed by Martin Marietta or with Vulcan's nominees. As the June 2012 meeting approached, Lynne tried to sort through the myriad claims to reach her decision.

The case describes the argument of each party in interpreting these confidentiality agreements. As shareholders, students must decide whether Martin Marietta's use, disclosure and interpretation of the agreements were legally valid. Information is provided to permit students to assess the perspectives and motives of the respective arguments asserted by the parties. Students can apply law to the dispute to determine a likely outcome of the litigation. The instructor, armed with knowledge of the actual court holding, can use the Socratic Method to lead the students to what the court held. Conversely, students can discuss ways that the companies could have proceeded to avoid litigation. Students can reflect on the perspective of each stakeholder to assess whether the role of

business ethics is relevant to the dispute. Students can also explore the role of corporate counsel in shaping business agreements.

RECOMMENDATIONS FOR TEACHING APPROACHES

This case was designed to be used as part of a unit in the legal environment of business course, in an upper level commercial law, or business course where corporate transactions are analyzed. While valuation is an important question, our experience shows that a separate treatment of the legal issues surrounding the hostile bid is helpful. Attempting to cover both the legal and valuation aspects proves unwieldy especially for undergraduates, but having said that we have included one question on valuation for instructors wishing to touch on the subject.

In the undergraduate courses the case provides a good example of how a seemingly desirable business transaction between corporations can result in an unexpected legal dispute, and how the court may resolve a dispute in a way that disappoints at least one party or company. Students should be aware that litigation is a risk in business which can be mitigated with some understanding of the law. The case should be presented near the end of the semester, or when the issue of corporate mergers is relevant in the syllabus and textbook assignments. In an MBA course, it could serve as an illustration of the complexities of legal agreements in the area of merger and acquisition matters. The interplay of business ethics and the law can be analyzed in this case at the undergraduate and graduate level as ethics is always a relevant consideration in business transactions. If used in conjunction with text coverage of these topics, then no outside preparation would be needed. However, it may be instructive to have students review the following articles to reinforce the concepts illustrated in the case: James Cole, Jr., Richard J. Grossman & Keith Pagnani, *Doing Deals 2010: the Art of M&A Transactional Practice: It's a Hostile World: Responding to Unsolicited Take-Over Proposals*, 1797 PLI/Corp 169, 175 (March 2010); Trevor S. Norwitz & Erica Mitnick Klein, *Blackberry Case Sends Long-Distance Message: Use Restrictions in NDAs Can Limit a Bidder's Freedom to Roam*, the M&A Lawyer, Thomson Reuters, Apr. 2009, at 7, 9.

The actual holding in the case does not need to be revealed to the students until the close of the classroom discussion. Of course, the instructor should read the court case in advance of the class discussion: *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072; 2012 Del. Ch. LEXIS 93 (Del. Ch. May 4, 2012); and, *Martin Marietta Materials, Inc. v. Vulcan Materials Company* 68 A.3d 1208 (July 10, 2012). The aforementioned Court of Chancery and the Supreme Court of Delaware cases should both be reviewed by the instructor to get the full flavor of the facts, dispute, law and holding.

For the undergraduate commercial law or legal environment of business course the case can be introduced during the unit on corporations, which generally comes later in the semester. Students should prepare for the discussion by reading the case, suggested articles above and the proposed discussion questions prior to class as a homework assignment. Instructors should also ask students to refresh their recollection of the earlier units on ethics and contracts prior to the day that the case is discussed in class.

One approach is to assign the students into 4 groups:

1. Martin Marietta executives;
2. Vulcan executives;
3. Shareholders of Vulcan
4. Shareholders of Martin Marietta;

Following presentation by the above groups, all students can then be divided into two groups:

1. Ethical jury; and 2. Court of law.

Ask each group to prepare answers to the questions in the light most favorable to the group that they represent. The instructor can begin by asking each group to thoughtfully explain their position regarding the merger and subsequent legal dispute. This may take about 30 minutes. Next, the instructor can divide students into “the ethical jury” and “the court of law”. The “ethical” jury will try to identify ethical issues, not necessarily related to the law, which may impact the desires of each stakeholder. The “court of law” group will try to identify legal issues involved in the dispute.

The instructor will act as a mediator and moderator of the discussion. The remainder of the class will be discussing how to prevent expensive litigation by trying to predict potential legal issues in advance of the dispute. The instructor can discuss how to assess legal pitfalls in advance of entering friendly merger talks.

In the MBA course, students can similarly divide into groups. Each group will present its viewpoint of the case. The MBA students may be tasked with trying to argue for, or against, a standstill agreement, or try to determine if the case would have turned out differently had the NDA and JDA been worded differently? The MBA students can spend a few minutes in class trying to draft a confidentiality agreement or a standstill provision.

The instructor may ask students to visit either <http://editiondigital.net/publication/?i=198174> or <http://rock.epubxp.com/i/271087> prior to class. Ask students to flip through one of these digital additions to familiarize themselves with the aggregate industry. This will make the discussion of the nature of the industry (primary products, suppliers, regulatory issues, etc.) go much smoother leaving more time for you to cover the legal and financial aspects. It also gives the instructor the opportunity to discuss trade journals as a source of industry information.

Finally, the case describes the argument of each party in interpreting these confidentiality agreements. As shareholders, students must decide whether Martin Marietta’s use, disclosure and interpretation of the agreements were legally valid. Information is provided to permit students to assess the perspectives and motives of the respective arguments asserted by the parties. Students can apply law to the dispute to determine a likely outcome of the litigation. The instructor, armed with knowledge of the actual court holding, can use the Socratic Method to lead the students to what the court held. Conversely, students can discuss ways that the companies could have proceeded to avoid litigation. Students can reflect on the perspective of each stakeholder to

assess whether the role of business ethics is relevant to the dispute. Students can also explore the role of corporate counsel in shaping business agreements.

RESEARCH METHODS

This case was developed from the actual proxy materials sent to Lynne Davis as a shareholder of record. Additional information was gathered from each company's annual 10-K reports and court records. Neither company provided direct contact with the authors. The authors have a release from Lynne Davis.

QUESTIONS FOR CLASS DISCUSSION

1. From a strategic view, why did Vulcan and Martin Marietta engage in the initial merger talks?
2. What was Martin Marietta asking Vulcan shareholders to vote for at the upcoming shareholders' meeting? Was Martin's stock offer stock attractive to Vulcan stockholders?
3. Evaluate Vulcan and Martin Marietta's arguments concerning the use and disclosure of material contained in the collective confidentiality agreements, the NDA and JDA. Does your analysis support Vulcan or Martin Marietta's position concerning the use of the agreements by Martin Marietta to launch an unsolicited exchange offer and hostile proxy context? (This requires students to research definitions and find some examples of confidentiality agreements used between corporations.)
4. What role would a standstill agreement have played in this negotiation? (Graduate students may be assigned this question. Students should be tasked with researching the definition and perhaps locate a sample standstill agreement prior to class.)
5. From an ethical view, should Martin Marietta ignore the confidential information of its competitor now that it has access to it?
6. How would you vote your proxy if you were Lynne Davis?

ANSWERS TO CLASS DISCUSSION QUESTIONS AND THEORY

1. From a strategic view, why did Vulcan and Martin Marietta engage in the initial merger talks?

Students usually have no problem in seeing that organic growth in the aggregates industry is not a strategic option. They have a slightly harder time understanding that this business is primarily transportation and logistics dependent. Rock, sand, and gravel are needed in all manner of construction. However, its weight, geological and geographical limitations make the proximity to customers a priority. The geographical coverage of the two largest players in this industry, coupled with the merged company's debt carrying capacity to engage in further industry consolidation through acquisitions of the remaining smaller quarries, made the merger talks appealing.

Better students will note that the devil was likely in the details of how to operationalize the merger itself. These students will raise many questions such as: How much synergy (i.e., cost savings) might be realized? Which executives would run the various parts of the new company? What elements of the business might need to be spun-off to satisfy anti-trust requirements? What would be a “fair” exchange for each company’s shareholders as the new company was formed?

2. What was Martin Marietta asking Vulcan shareholders to vote for at the upcoming shareholders’ meeting? Was Martin’s stock offer stock attractive to Vulcan stockholders?

Students often overlook the fact that the proxy vote was for the slate of directors and not directly on the exchange offer itself. Despite Martin’s claims that its slate of directors were not predisposed to accept the exchange offer once elected the vote on the board nominees was tantamount to voting on the offer itself.

In order to address the attractiveness of the offer, students must evaluate the Martin Marietta exchange offer from a shareholder’s perspective (Lynne Davis in this case). To conduct the evaluation, a student needs to figure out how to make the companies comparable. Martin Marietta promised to pay dividends of \$1.60 per share after the takeover, but what does that mean to Vulcan stockholders, who had received dividends of \$0.76 per share recently? On the surface, it seemed that a Vulcan shareholder would increase her dividends by more than 110% $((\$1.60 - \$0.76) / \$0.76)$, which would make the choice very easy. Stating the amount of dividends paid by each company in raw terms is very misleading. Martin Marietta is offering $\frac{1}{2}$ of a share of Martin Marietta for every share of Vulcan. Current shares of Vulcan outstanding, which can be found on its balance sheet, were 129,245,000. If the takeover happened, Martin Marietta would increase the stock it had outstanding by 64,622,500 shares $(129,245,000 / 2)$. The schedule below shows the increase in dividends that Vulcan stockholders would see, if Martin Marietta kept its promise to pay dividends of \$1.60.

| | | | | |
|---|---------------|-----------------------------------|---|---|
| Vulcan Shares Outstanding Before the Takeover | | Vulcan Dividend Payout Rate | | Total Dividends Paid by Vulcan |
| 129,245,000 | multiplied by | \$0.76 | = | \$98,226,200 |
| <hr/> | | | | |
| #Vulcan Shares after Conversion to MLM | | MLM’s Promised Dividend Payout | | Dividends Paid by MLM to Vulcan Shareholders |
| 64,622,500 | multiplied by | \$1.60 | = | \$103,396,000 |
| <hr/> | | | | |
| Additional Dividends paid to Vulcan stockholders as a result of the MLM takeover | | \$ 5,169,000 | | |
| <hr/> | | | | |
| Additional Dividends paid to Vulcan stockholders stated as a percentage | | <u>\$5,169,000</u> | = | 5.26% |
| | | \$98,226,200 | | |

Martin Marietta’s cash outflows for dividend payments is increased only by \$5 million as a result of the takeover, but the question is whether Martin Marietta will be able to hold up its promised dividends of \$1.60 per share into the foreseeable future. The increased cash payout would remove about 20% of Martin Marietta’s ending cash balance (\$5 million /\$26 million). Is it reasonable to assume that, when the companies are consolidated, the operating cash will continue to

be as strong (or stronger) than it is with the two companies operating individually? One can assume that there will be consolidation savings, but the trends for income, debt, and cash flows may create doubt that efficiencies will be sufficient for Martin to keep its promise. Better students will point out the “synergy-savings” was a contentious point between the two CEOs when the merger talks were occurring. Income for Martin Marietta had remained relatively stable from 2009-2011, but Vulcan operated at a loss in 2010 and 2011. Cash flows for both companies decreased significantly over the past three years. Martin Marietta increased its long-term borrowing however, and payback of the debt was not even. Martin Marietta had an unusually large payment due in 2015 (\$370 million), but the amount of debt MLM was paying back was very small compared to Vulcan even after taking into consideration proportionality. Of course, debt can be, and often is, refinanced using more long term debt, but events could occur that could make refinancing improbable (such as new environmental laws on quarries, making the underlying assets less valuable). The debt ratios for the firms mirror each other, long term debt as a percentage of total liabilities is almost the same (62% MLM, 60% Vulcan), and long term debt divided by total assets is the same for both companies (60%).

The corporation’s long-term debt maturities for the five years following December 31, 2011, and thereafter were:

| Martin Marietta's Schedule of Long Term Debt in 1,000s | |
|---|-------------|
| Year | Debt |
| 2012 | \$ 7,182 |
| 2013 | \$ 6,181 |
| 2014 | \$ 5,229 |
| 2015 | \$ 370,207 |
| 2016 | \$ 109 |
| Thereafter | \$ 671,176 |
| Total | \$1,060,084 |

The total (principal and interest) debt payments, excluding any draws, if any, on Vulcan's bank line of credit, for the five years subsequent to December 31, 2011 were as follows:

| Vulcan Debt Payments In 1,000s | | | |
|---|--------------|------------------|-----------------|
| Year | Total | Principal | Interest |
| 2012 | \$335,050 | \$134,762 | \$200,228 |
| 2013 | \$337,546 | \$150,610 | \$186,936 |
| 2014 | \$186,956 | \$177 | \$186,779 |
| 2015 | \$336,913 | \$150,145 | \$186,768 |
| 2016 | \$671,707 | \$500,134 | \$171,573 |

3. Evaluate Vulcan and Martin Marietta's arguments concerning the use and disclosure of material contained in the collective confidentiality agreements, the NDA and JDA. Does your analysis support Vulcan or Martin Marietta's position concerning the use of the agreements by Martin Marietta to launch an unsolicited exchange offer and hostile proxy context? (This requires students to research definitions and maybe some examples of a JDA and NDA.)

Students should research unfamiliar terms that are relevant to the case. The non-disclosure agreement (NDA) and joint defense and confidentiality agreement (JDA) were effective between the parties as of May 3, 2010 and May 18, 2010, respectively. These agreements are essentially confidentiality agreements and they were executed in contemplation of exploring a "business combination transaction" between the parties (Del. Ch. May 4, 2012, p. 5). The court in *Vulcan* relied on the following law volumes to define such agreements: "Lou R. Kling and Eileen T. Nugent, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions*, Volume 1, § 9.02 (2011 ed.) (stating that NDAs "usually provide that [confidential information] . . . will be held as confidential and will be used only in connection with an evaluation of the transaction in question"); ABA Mergers and Acquisitions Committee, *Model Confidentiality Agreement* 342-43 (2011) (listing, among others, confidentiality and use restrictions "normally" provided for in non-disclosure agreements)." See, *Martin*, 68 A. 3d 1208, 1219, n. 45 (July, 2012). The court also noted "A confidentiality agreement is intended to protect a contracting party's non-public information, not its corporate ownership and control." *Martin*, at 1219, referencing Kirman, Igor, *M&A and Private Equity Confidentiality Agreements Line by Line* 59 (2008). Confidentiality agreements are intended

to protect information that is to be disclosed for a specific purpose. The extent of the confidentiality should be dictated by the agreement itself.

Student opinions will differ depending on their knowledge of contracts and their individual assessment of whether the facts presented in the case suggest that Martin Marietta breached the confidentiality agreements. Some students will argue that Martin Marietta's interpretation of "transaction" in the confidentiality agreements is reasonable and that it encompasses an unsolicited exchange offer and hostile proxy contest. To effectively launch its exchange offer, the SEC required Martin Marietta to disclose some information contained in the confidentiality agreements. Conversely, some students may argue that Martin Marietta can't have it both ways. The factual findings in the court records indicate that Martin Marietta appeared to support the strict confidentiality of the material contained in the agreements when it best suited its needs, such as when the documents were drafted and during the 2010 and early 2011 possible merger discussions with Vulcan. Yet, when Vulcan evidenced no further interest in negotiating a merger, Martin Marietta changed its position and generously disclosed protected material to the SEC, press, and investors to further its unsolicited exchange offer. Martin Marietta was dismissive of the importance of protecting the confidentiality of the material in the agreements after it launched its unsolicited exchange offer. This attitude was inconsistent with their previous conscientiousness toward protecting the confidentiality of the evaluation material.

Courts have held that the term "transaction" in a NDA excludes a hostile bid that is launched by the breaching party. For example, the Ontario Superior Court of Justice heard a case similar to the Vulcan and Martin Marietta dispute. In that suit, the target, Certicom, sued bidder Research in Motion (RIM) following friendly discussions which turned sour. See, *Certicom Corp. v. Research In Motion Ltd. And Research In Motion Acquisition Corp.*, 2009 CanLII 1651 (ON S.C.). In the *Certicom* opinion "the Ontario court held that in using confidential information covered by the 2007 and 2008 NDAs to evaluate its unsolicited bid, RIM breached both agreements." (Norwitz and Klein, 2009) Like *Certicom*, Martin Marietta used confidential information covered by a NDA to evaluate its unsolicited bid. The *Certicom* case was widely discussed in the U.S. and was even cited by Chancellor Strine in the *Vulcan* case (*Martin Marietta Materials, Inc., Vulcan Materials. Company*, Civil Action 7102-CS (May 4, 2012). The Wall Street Journal also discussed the *Certicom* case: Weinberg, Stuart, *Research In Motion Drops Certicom Bid*, Wall St. J., Jan 29, 2009;

The Court of Chancery in the case found that Martin used Vulcan's nonpublic information in the Proxy Contest to oust some of Vulcan's board members and that these disclosures were not properly part of the authorized "transaction" as that word was used in the confidentiality agreements. The only authorized transaction where protected information could be disclosed was in the friendly merger talks, not in the proxy contest. Martin appealed, but the Supreme Court of Delaware generally upheld the lower court's findings. See, *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072; 2012 Del. Ch. LEXIS 93 (Del. Ch. May 4, 2012); and, *Martin Marietta Materials, Inc. v. Vulcan Materials Company*, 68 A.3d 1208 (July 10, 2012).

4. What role would a standstill agreement have played in this negotiation? (Graduate students may be assigned this question. Students should be tasked with researching the definition and perhaps locate a sample standstill agreement prior to class.)

Generally, a standstill provision prevents a company from engaging in a hostile takeover of another company. Whereas a confidentiality agreement does not prevent a hostile takeover, but rather protects the confidentiality of information shared between parties to the agreement or contract. Hence, so long as a breach of confidential information does not occur, a hostile tender offer to acquire stock of the other corporation and a proxy contest to effect the replacement of directors is acceptable. But, a standstill provision would prevent one of the contracting parties from trying to acquire control of the other via a hostile bid. Standstill provisions and confidentiality prohibitions may appear in the same agreement, and the standstill clause may contain a prohibition against purchasing stock, engaging in a proxy contest, or prohibiting a hostile bid.

The Supreme Court of Delaware drew its descriptions of a standstill provision or agreement from several sources such as: Meryl S. Rosenblatt, *Letters of Intent and Exclusivity, Confidentiality and Standstill Agreements*, 1459 PLI/Corp 215, 237 (2004); and, *ABA Mergers and Acquisitions Committee, Model Confidentiality Agreement* 343 (2011). (*Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 68 A.3d 1208, 1219, n. 43-44 (2012)).

In this case, the parties did not draft a standstill provision, yet some might argue that essentially the Chancery court's decision was tantamount to having a standstill agreement in place as the court in fact did enjoin Martin from pursuing its proxy bid. The Supreme Court of Delaware generally held that the Chancery court had carefully distinguished a standstill provision from confidentiality agreements. Further, the remedy to enjoin the proxy bid was warranted by the circumstances and nature of Martin's breach of the confidentiality agreements.

In hindsight, Vulcan would have had an easier argument against Martin's attempt to oust Vulcan board members had a standstill provision been negotiated prior to merger talks. The outcome of the case, however, favored Vulcan even without a standstill provision due to the injunction.

5. From an ethical view, should Martin Marietta ignore the confidential information of its competitor now that it has access to it?

Students may reference their textbook chapters in business ethics to wrestle with this question. One way to approach this question is to distinguish the law from ethics. For example, legally the court can enjoin a company from disclosing information or using it if it was subject to a confidentiality agreement. But, Martin was still exposed to Vulcan's confidential information. This information may be hard to ignore when making future decisions in the marketplace. After all, Vulcan is a significant competitor of Martin. Ethically, should Martin not even consider the confidential information when it makes future decisions that may directly, or even indirectly, relate to Vulcan? Can it ignore the information?

The best place to start is with the company's own code of conduct. Martin's ethical code indicates that it would guard against disclosing the confidential information of a business partner. http://files.shareholder.com/downloads/MLM/3155520501x0x69988/c719de51-4cd0-4682-9d2b-f39c4075ca08/Code_of_Ethics_Card.pdf

Students can also consider the ethical conduct of other fierce competitors to resolve the ethical question presented. For example, in 2006, executives at Pepsi were contacted by someone who claimed to have ties with Coke. The secretive offer of confidential information was concerning a new Coke product. Instead of acting on temptation to gain access to their competitor's confidential information, Pepsi contacted Coke to let them know about the plot. The FBI stepped in and justice was served. Pepsi acted ethically instead of exploiting the opportunity. The Leader-Post (Regina, Saskatchewan), *Honour Among Soft Drink Makers*, July 7, 2006 Friday Final Edition. Martin Marietta Materials and Vulcan Materials cannot be any more competitive than Pepsi and Coke. Students may decide that if Pepsi could ignore an opportunity to exploit Coke by ignoring Coke's confidential information, then Martin can also ignore the confidential information that it acquired from Vulcan.

6. How would you vote your proxy if you were Lynne Davis? Why?

Students tend to side with Vulcan and oppose the takeover. The rationale for their choice typically falls into two areas. First, many students are "put-off" by MLM's hostile bid after the failure of the friendly merger talks. They cite the violation of the NDA as the primary reason not to proceed. In other words, "why would you want to do business with a firm that broke an important contract?" They sometimes cite Lynne's uneasiness with the offer as stated at the end of the case. They reason she only holds 8 shares so it isn't about the money regardless of any valuation calculations. A smaller group usually adheres to the idea that MLM is taking advantage of Vulcan's lackluster performance and is not paying fair value for the #1 player in the aggregate industry. However, when pressed students in this camp have a hard time using any recent financial data to support the undervalued rationale.

A small minority of students usually agree with the takeover. They use the initial friendly merger talks as evidence that joining the companies made sense, and the two company's differences in how the joining should be operationalized is no reason to abandon the merger. They also argue that firms in the aggregates industry could only grow through merger or acquisition as avenues for organic growth were not available due to environmental regulations and NIMBY attitudes in most communities.

Epilogue

The Court of Chancery of the State of Delaware decided the legal issues in a 138-page opinion on May 4, 2012. Chancellor Strine found that Martin Marietta breached the NDA and the JDA by considering and disclosing material pertinent to these nondisclosure agreements "in forming its hostile bid." 56 A.3d 1072, 1118 (Del. Ch. May 4, 2012). The court interpreted the language in the NDA concerning the confidentiality and disclosure of the material to be restricted to a possible

“transaction between” the parties which, according to the court, excluded a hostile bid transaction. The court further noted that it was Martin Marietta’s counsel who drafted the language. 56 A.3d 1072, 1118 (Del. Ch. May 4, 2012). Chancellor Strine stated that Martin Marietta’s counsel should have known about legal precedent, albeit a Canadian case (*Certicom*), where the word “between” in a confidentiality agreement may exclude unsolicited, or hostile, take-overs. 56 A.3d 1072, 1118 (Del. Ch. May 4, 2012). The court enjoined Martin Marietta from “prosecuting a proxy contest, making an exchange or tender offer, or otherwise taking steps to acquire control of Vulcan shares or assets” for a four-month period. 56 A.3d 1072, 1147 (Del. Ch. May 4, 2012). The case was affirmed on appeal.

The timing of the injunction prevented Martin Marietta from pursuing its proxy contest relevant to its selection of Vulcan board director nominees to be presented for election at the June 2012 annual meeting. Consequently, the slate of directors proposed by Vulcan was elected easily.

Martin Marietta Materials earned \$84 million on \$1.839 billion in sales for the year ended Dec 31, 2012. Its stock hit a high for the year of \$95.93 in the fourth quarter of 2012. Martin paid a quarterly dividend of 40 cents per share for each quarter of 2012. Meanwhile Vulcan suffered a loss of \$59 million on sales of \$2.411 billion for the same period. Its stock reached a high of \$53.85 in the fourth quarter of 2012. Vulcan shareholders received a quarterly dividend of 1 cent per share throughout 2012. For 2013 Martin registered sales of \$2.155 billion with a net income of \$121 million. Vulcan’s 2013 Sales were \$2.771 billion and net income of \$24.3 million. The market closed on March 4, 2014 at \$69.01 for Vulcan and \$121.95 for Martin. Vulcan’s stock price growth over this period was 72.9% while Martin’s rise in share price over the same period was 64%. As of July 2014, Martin Marietta had not renewed its pursuit of Vulcan Materials.

Lynne Davis still owns 8 shares of Vulcan Material Stock – inertia is a powerful force!

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DESIGN PROTOTYPES INC. PROJECT MANAGEMENT (C): WHEN MANAGEMENT DECIDES TO SHORTEN A PROJECT SCHEDULE

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

CASE DESCRIPTION

The primary subject matter of this case concerns project management. A secondary issue examined is team politics. This case can be used in Project Management, Operations Management, or Quality Management courses. The case has a difficulty level of four. The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

After 10 years at Design Prototypes, Inc., Raef Conley is leading his first major project team. Raef has assembled a highly qualified, diverse yet cohesive team and has the full support of his boss on the project, the regional Electrical Engineering (EE) Director, Jonathon Wright. It has been almost 6 months since the Alpha C306 project was green lighted by top management. Raef and other members of the project team have met several times during those 6 months to track the progress of the project activities and from Raef's perspective the team works well together and is still highly motivated.

Initially, the project was envisioned as taking a year and a half (548 days) to complete. However, Raef and his team had developed a Work Breakdown Schedule (WBS) that projected completion in 515 days, giving the team 33 days of slack time. Developing a 515 day plan was a very fortunate decision, as at this point the project is in the concluding stage of activity K (product testing) and due to unforeseen delays the 33 days of slack time have been expended. Thus the team is using the 515 day WBS for the just under one year remaining to complete the project. Top management is requesting that the project be shorted by a month (480 day schedule) or preferably two months (450 day schedule). In addition, the VP of Engineering's son, Simon, has been added as a team member. Simon, who has been with the company only 2 years and lacks technical qualifications, is attempting to use the project as a way to demonstrate his value to upper management. Therefore, Simon's agenda is very different from that of the other team members, creating a source of conflict. The case revolves around the questions of: Can the team develop workable shortened time schedules for completing the project in 480 and 450 days? Are the added costs of reducing the schedule economically sound? How do Raef and the other team members cope with the late addition of a divisive, politically connected team member?

DESIGN PROTOTYPES INC. PROJECT MANAGEMENT (C): WHEN MANAGEMENT DECIDES TO SHORTEN A PROJECT SCHEDULE

Raef Conley's tenth year at Design Prototypes, Inc., has been challenging, but largely enjoyable. Raef is leading his first major project team. He has assembled a highly qualified, diverse yet cohesive team and has the full support of his boss on the project, the regional Electrical Engineering (EE) Director, Jonathon Wright. It has been almost 6 months since the Alpha C306 project was 'green lighted' by top management. Raef and other members of the project team have met several times during those 6 months to track the progress of the project activities and from Raef's perspective, the team works well together and is still highly motivated.

Initially the project was envisioned as taking a year and a half (548 days) to complete. However, Raef and his team had developed a Work Breakdown Schedule (WBS) that projected completion in 515 days, giving the team 33 days of slack time to complete the schedule. Developing a 515 day plan was a very fortunate decision, since at this point the project is in the concluding stage of activity K (product testing) and due to unforeseen delays the 33 days of slack have been expended. Thus the team is using the 515 day WBS for the just under one year remaining to complete the project.

Raef's boss, Jonathon Wright, asked Raef to stop by his office before work on Friday for a brief conversation about the project. Raef knew that nothing good could come from a meeting with his boss on Friday, the thirteenth. He would not be disappointed.

Jonathon: "Thanks for dropping by before work. I only have a few minutes as I have an 8:00 meeting with top brass, so I will get right to the point. Can you expedite the Alpha C306 project completion date by a month, preferably two?"

Raef: "Is there a reason for the reduction?"

Jonathon: "There are a couple of reasons. First, one of our major clients is requesting as much lead time as possible so that they can market the product for the upcoming lucrative Christmas season. Second, there are rumors that Expert Electronics Design Solutions (EEDS) our chief competitor is working on a similar product. You obviously recognize the importance of our beating them to the market."

Raef nodding in agreement asked: "Can you confirm the accuracy of the rumors?"

Jonathon: "The information comes from Simon Wright who had overheard two EEDS executives talking after a round of golf at the country club."

Following a long pause, Jonathon added "I have some additional information for you. It seems that since over hearing this information, Simon had been talking to his dad (VP of Engineering Thomas Wright) about the project. As you will remember, Simon was one of your finalists in selecting the original team. It seems that Simon, who was very upset at not being selected for the project, has been closely following the project and has convinced his dad that not only would being a part of the project advance his career, but that due to his connections and background, he could make valuable contributions to the project. Thomas agrees and while he is not demanding that Simon be placed on the team, he is suggesting that you give it strong consideration."

Raef: "What do you think that I should do?"

Jonathon: "I know my big brother, and once he makes up his mind, he is pretty inflexible. 'Strong consideration' means that, if it were me and I had any hopes of remaining in charge of this project not to mention having any future with this company, I would add Simon to the team. But, ultimately, it is your choice."

Raef: "OK, Thanks for your candor. I will add Simon ... "

Jonathon interrupting: "I think that is a wise decision. Quite frankly, Thomas has some concerns about your ability to lead this project."

Raef: "Oh, really."

Jonathon: "Yes. He has been following the team's progress very closely, more closely than any of the other projects in development. While he would never 'interfere' with a project, he has demonstrated in the past when a project wasn't going as well as he thought that it should, heads would roll – meaning that he would demand that the project leader be replaced. Not having worked with you as closely as I have, Thomas doesn't have as much faith as I do in your ability to successfully complete this project on time. He feels that you and your team 'squandered' the 33 days of slack, you had built into your WBS. That, and he was disappointed in your initial decision to not include Simon as a member of your team."

Raef: "But, but, Simon has no technical qualifications."

Jonathon: "I think that Thomas recognizes that, and that is why he didn't insist that you put Simon on the team from the get go. However in retrospect, and this is just my guessing, as you know Thomas is almost 20 years my senior and with retirement looming in the not too distant future, I think that he views this project as one of the last, if not the last, opportunity he will have to help Simon get himself firmly established as a valued member of the management team. So, ...

At this point, Jonathon's assistant reminded Jonathon that his meeting starts in 5 minutes.

Raef: "Thanks for the information. I will get back to you on the shortened schedule options."

Jonathon: "I need those options within a week, and they need to be good. To be blunt, you will recall that when I was manager of the EE division, I was the one who hired you. After I was promoted to Regional EE Director, I have kept a close eye on your development. I was the one who selected you to lead this project, so my neck is on the line as well. If you go down, then I am right there with you. Don't let me down."

Raef: "I appreciate your continued confidence in me, and I will check with my team to develop a couple of options for you. We will get them to you within a week. I won't let you down. Have a good weekend."

As he left Jonathon's office, Raef reflected back on Simon's comment when he told Simon that he would not be part of the Alpha C306 team: "You are making a HUGE mistake by not including me on the team. We will see how the budget and timeline work out for you." Simon's words kept echoing in Raef's mind. Is it possible that Simon was orchestrating the shortened schedule so that he could be a part of the team?

Once back at his office, Raef arranged an emergency meeting of his team. Raef expected some resistance from his team to this aggressive action and was not looking forward to broaching the subject with them. Since it was on such short notice and on a Friday afternoon,

availability of his team members was limited, but Raef knew that it was important to give them the news as soon as possible. As luck would have it, everyone was available at 3:00, but only for 30 minutes.

Friday meeting to discuss shortening the schedule timeline

Raef: "Good afternoon everyone! Happy Friday the thirteen! I know that this meeting was not on our regular schedule and I appreciate everyone rearranging their schedules to come today. Let's get down to it. I had a meeting with Jonathon Wright before work this morning in which he asked that the project team develop 2 options to shorten the project schedule. He is requesting that we accelerate project completion by at least a month, preferably two months. In round numbers that means a 480-day and a 450-day schedule. Remember that activities A – K (see Table 1) took longer than we had originally estimated, so we no longer have an extra 33 days. So any revisions to the WBS must be based on our 515-day schedule."

Billy: "How can management ask us to shorten this schedule? We have spent the past 6 months putting together a realistic and feasible schedule for this project. This is unbelievable!"

Pierce: "Raef, did you explain to Wright how difficult it was to develop the 515-day schedule, and that we have already cut it to the bone? We cut our original WBS of 578 days to 515 days, and we can't reasonably be expected to reduce it anymore. The fact that we have already used up the 33 days of slack should be an indication that additional cuts aren't realistic. Did you also remind him that management approved the 515-day schedule? What has changed?"

Raef: "Jonathon indicated that some preliminary marketing results from several large potential customers suggested that they needed the product sooner. And, Simon Wright has obtained some information that Expert Electronics Design Solutions is working on a similar product. I can't stress enough how important it is that we beat EEDS to the marketplace."

Billy: "What does Simon Wright have to do with our project?"

Daniel: "Perhaps I might be able to shed some light on this issue. Developing new products is not an exact science; there is a lot of uncertainty especially for those projects with a long timeline. It has been my experience that many timelines have some 'fudge' built into them. Perhaps the excess we built into our timeline is not sufficient to meet the 480 and 450 day requests, but perhaps there is some compromise we could make. In any event, we may need to recalculate the shortened time frames and ultimately the subsequent related costs from our original estimates. Many times the additional costs are sufficiently high that they are prohibitive to the company's rate of return."

Raef: "Thank you for your comments, Daniel. I know that this request by management is not popular and both are aggressive, but we do not have a choice but to develop the proposals. As Daniel points out, it will be their choice based on the additional costs. Projects never go in a smooth straight line. I would like to reassemble the team for a Monday meeting to develop these 2 shortened schedules. Does Monday at 1:30 work for everyone?"

All members of the team agreed that Monday works.

As the team is getting up to leave, Raef adds: "Oh, one last thing, because of Simon's uncanny access to information and his unique skill set, I have decided to add Simon Wright to

the team. He will be joining us on Monday. Have a GREAT weekend, and see you Monday with your ideas regarding the shortened schedules.”

As they are walking down the hall, Billy and Pierce discuss the bombshell that Raef just dropped on them.

Billy: “I can see where Friday the thirteen gets its bad name. Can you believe what is happening to this project?”

Pierce: “What a mess. I knew that things had been going too well.”

Billy: “It is bad enough that management wants to shorten the schedule, but I can’t believe that upstart Daniel lecturing us on how project planning works. ‘In my experience’ hogwash! He has been here, what 4 years, and that makes him an ‘expert.’ I guess my 32 years here don’t count for anything, and what about you and all of your experience. His ‘I know it all’ attitude really bugs me.”

Pierce: “I agree, but I think that he can be handled, and actually, Raef is doing a pretty good job in holding him in check. Other than the shortened schedule what has me very concerned is the addition of Simon Wright. I knew that that little worm would find his way on to the project.”

Billy: “Why is that?”

Pierce: “To be blunt, Simon is an incompetent playboy. The only reason he has a job here is because his dad is VP of Engineering, and I am sure that daddy is the real reason that Simon is being added to the team. All Simon does is play golf and hang out at the country club; that is why they put him in Public Relations, so that he could ‘relate.’ His ‘information’ was probably something he overheard at the bar. In fact, it wouldn’t surprise me at all if he were bragging about the Alpha C306 to someone who then stole our idea. I just don’t trust the guy.”

Billy: “Good to know. I will keep an eye on him.”

Rae Beth who had been walking only a few steps behind the pair said “Maybe we should give Simon the benefit of the doubt and allow him to prove himself.”

Billy: “That’s right. I would expect you to take his side. You are always talking about how ‘wonderful’ his mom Mary Beth is. You and Simon got something going on?”

Rae Beth: “Only an impoverished demented mind could say something like that, or have you been smoking something, Billy?”

At that point, they had reached the end of the hall, where the three parted in their separate directions.

Monday meeting to finalize proposals

Raef: “Good afternoon everyone. Thanks for again rearranging your schedules so that we can meet. As you will recall, I mentioned on Friday that Simon Wright would be joining our team, so I would like to introduce Simon to those of you who don’t know him.”

Simon: “I am delighted to FINALLY be a part of this project. I think that you will see that I have much to add as we go along.”

Raef: “Thanks, Simon. Well, let’s deal with the aftermath of Friday the thirteen.”

Alison: "I hope no one minds, but I took the liberty of organizing some of our data. Based on where we are currently in our timeline, Activities A-K are completed (see Table 1). The remaining activities are L-T; all of these activities are on the critical path (see Figure 1) and are sequentially linked. This will make shortening the time frames much easier since the critical path will not change for either of the shortened options."

| Table 1 Normal Table for the 515 Day Completion Time | | |
|---|-------------|--------------|
| TASK / ACTIVITY | NORMAL TIME | NORMAL COSTS |
| A Develop Prototype: Specifications* | 0 | NA |
| B End-User Requirements | 60 | \$ 25,000 |
| C Application Requirements | 80 | \$ 78,500 |
| D Go/No Go Decision | 6 | \$ 2,500 |
| E Prototype Review | 14 | \$ 25,200 |
| F Financial Review | 20 | \$ 12,500 |
| G Schedule Review | 46 | \$ 63,750 |
| H Technical Capabilities Review | 52 | \$130,000 |
| I Financial Commitment Review | 10 | \$ 12,500 |
| J Go/No Go Decision | 6 | \$ 1,250 |
| K Testing | 82 | \$ 91,500 |
| L Results/Analysis | 30 | \$ 18,750 |
| M Corrective Actions | 10 | \$ 4,000 |
| N Re-tests | 95 | \$106,000 |
| O Re-tests Results/Analysis | 25 | \$ 16,600 |
| P Trial-Test Market | 40 | \$162,500 |
| Q Results-Test Market/Analysis | 50 | \$ 83,500 |
| R Integrate Test Market Results into Product Design | 85 | \$125,000 |
| S Final Product Specifications Review | 20 | \$ 37,500 |
| T Go/No Go Decision | 6 | \$ 2,500 |
| TOTAL PROJECT COSTS | | \$999,050 |

*These activities have already been accomplished; not part of the team's timeline

Raef: "Thanks, Alison. You are correct; according to our WBS we are currently in the final stages of Activity K, which means that starting with Activity L we have 361 days remaining. Let's deal with the 480-day schedule first. The 480-day schedule requires a reduction of 35 days. Let's see which of the time frames for activities L-T can be crashed?"

Rae Beth: "I suggest we consider crashing those activities which have longer task times; for example, I recall from our earlier discussions that Activity N (Retests) had some excess time built into it. We said earlier that the 'N' activity would take 75 days, but could we shorten it by 25 days? Perhaps, do we even need to do the retests at all at this stage?"

Pierce: "Are you kidding? If there is not enough time to test and retest the prototype, chances are we will wind up with an inferior product. Then what will management say about that!"

Robert: "Do you think it is possible to consolidate some of these tests. Activity 'O' (retests results/analysis) might also be able to contribute to the 35-day reduction."

Philip: "How about a compromise here. Let's reduce Activity 'N' by 20 days and Activity 'O' by 5 days. Looking ahead to the 450-day schedule, we might even be able to reduce the 'N' Activity by a total of 25 days. Does this seem reasonable?"

Pierce: "How 'reasonable' it is depends on how much extra management is willing to spend to shave time off of the project. Remember 'time is money' and in this case we are talking about pulling engineers off of their current project to work on the Alpha C306, so not only is there expense for their time, but there is staff time, support operations, etc. Therefore, to simplify matters I suggest we add in a flat \$7,500 per day for the added expenses."

Philip: "That seems a little high to me, how about we go with \$ 5,000 per day."

Simon: "I agree with Philip, the lower the cost, the more likely the brass will approve this. But, \$5,000 per day still seems steep, what about \$1,500 per day."

Billy: "Simon, that is laughable; you are showing your total lack of knowledge of the testing process."

Simon: "I resent that, my background in economics tells me that ..."

Pierce, interrupting: "While you are right, Philip, my estimates might be a bit on the high side; we don't want to put ourselves in hole here. Remember it is management who wants a shorter time frame and don't forget that our overly optimistic estimates in the early stages, A-K, put us in a hole time wise, as we have already used up all of the 'spare' days we had built into the schedule."

Raef, wanting to ease the tension, but also acutely aware of VP Wright's concerns suggests "how about we compromise, rather than applying a flat daily rate, what if we make reasonable estimates for each of the targeted activities? That way we can have reasonable cost estimates that won't put us in a bind in meeting the time commitments."

Philip: "That seems like a reasonable suggestion. Now all we have to do is determine what is a 'reasonable estimate' for each of the activities."

Alison: "Activity N involves retesting, so while that will obviously involve some engineering time, it will probably also take staff time in the preparing reports and documentation. How about \$2,900 per day for Activity N?"

Pierce: "Let's see, engineers, plus replacement costs, plus support staff, given that initial testing has already occurred, \$3,000 per day should do it."

Philip: "How about we split the difference and go with \$2950?"

Alison: "Ok, now on Activity O, Re-tests Results/Analysis, should take much less engineering time and more time from the statistics guys in product research, so this activity shouldn't be as expensive."

Rae Beth: "I agree. Since I work closely with those guys I think that \$1600/day seems reasonable."

Philip: "I think that we should defer to your expertise Rae Beth and go with that."

Raef: "I would like to gain a consensus from the group on Philip's proposal. If we agree to this proposal, this will give us 25 days towards the 35 days required, and add a total of \$4550 for each day reduced. If we agree, then finding the other 10 days should result in less impact to the other remaining activities. What do you think?"

Somewhat reluctantly, Pierce agreed to go along with the others, indicating that it was not a “deal breaker.”

Raef: “OK. Now let’s find the other 10 days. Any thoughts?”

Daniel: “I suggest that we capture the 10 days from the ‘R’ Activity (Integrate test market results into Product Design). We had originally allocated 85 days in the 515-day timeline. By the time we get to this point, many of the integration efforts from the test market data will have already been considered. The test market data is for the most part a confirmation. Therefore, I believe we could realistically cut Activity ‘R’ by a total of 10 days for the 480-day schedule. I am not sure, however, if we can cut more days from the ‘R’ Activity for the 450-day schedule.”

Raef: “Does anyone else have anything they would like to add?”

Billy: “I also concur with Pierce’s concerns. In my 32 years with the company, I have seen management flip/flop on decisions and set some unrealistic expectations and deadlines. We are at risk, as Pierce said, of developing an inferior product that we cannot manufacture and distribute to the marketplace. We run the risk of making promises to the large customers and find out that we cannot deliver on those promises. We must be careful here to not set expectations unrealistically. Raef, I think it is your job to make sure management understands how strongly we feel about producing a quality product, one that reflects well on the company.”

Pierce: “To that end, time reductions at this stage in the process will be very expensive as this step involves primarily engineering expertise, very skilled engineering expertise. Daniel is correct that much of the integration efforts will have already been accomplished. However, changes at this point will involve highly technical fine tuning, thus requiring focused attention by engineers who have both skills and experience with this process, and those efforts are expensive. That is why I was suggesting the \$7,500/day.”

Simon: “Are you back to that unrealistic position again? I still think that \$1,500/ day is adequate.”

Billy: “Simon, Simon, Simon... you really don’t have a clue, do you?”

Rae Beth: “There is no need to get personal here. Pierce is right, reductions at this stage will be expensive, but \$7,500/day does seem a bit high. How about \$4,500/day?”

Philip: “That seems like a reasonable estimate.”

Pierce: “OK, I can see the writing on the wall; however, I can’t support anything less than \$5,000/day.”

Philip: “That seems like a reasonable compromise, one that I can support.”

As Raef looks around the room, he sees everyone but Simon nodding in agreement.

Raef: “Other than Simon, there seems to be general agreement on a reduction of activity R by 10 days at an added cost of \$5,000/day. Is that correct?” Everyone nods in agreement.

Simon: “While I am obviously outnumbered, I want to go on record as being opposed to an excessive, extravagant and totally unrealistic cost estimate.”

Raef: “Thank you Simon, your position is noted, however, since there seems to be general agreement, let’s use those numbers for finalizing the 480 day schedule and move on to the 450 day schedule.”

Simon: “Do what you want; I guess we will see how ‘reasonable’ this estimate is as we go along.”

Rae Beth: "Perhaps, we could include a probability analysis for each option. Management needs to know what the risks are. What better way than to provide them with a Decision Table for the risk."

Alison: "That's a very good suggestion Rae Beth."

Raef: "Ok, then, for the 480 day schedule, we will shorten Activity 'N' by 20 days, Activity 'O' by 5 days, and Activity 'R' by 10 days, at an added total cost of \$9,500/day. Let's turn our attention to the 450-day schedule. We need to find another 30 days reduction from the 480-day schedule. What..."

Billy: "With all due respect Raef, you are asking the impossible. Even Daniel stated that he was doubtful that the "R" activity could be reduced further. Philip indicated that we could 'squeak' another 5 days from Activity 'N'."

Robert: "Perhaps, we could find smaller cuts in some of the other activities. For example, we might cut 5 days from Activities 'P' and 'S' respectively (see Table 1)." The combination of cuts from Activities 'N', 'P', and "S" would total 15 days. That gets us half way to the 450-day schedule."

Daniel: "There seems to be few activities we can shorten to reach a 450-day schedule. However, it has been my experience with test markets results/analysis, we could possibly gain an extra 10 days by crashing the 'Q' activity (see Table 1). I do not see the product development department personnel analyzing the test market data any quicker than 40 days; as you recall in our original 515-day schedule, we said it would take 50 days to complete the 'Q' activity. I think we can get 10 more days, but that means the schedule would be a 455-day schedule, not a 450-day schedule."

Raef looks around the room at the team and asks for additional thoughts on the proposed 455-day schedule. No one responds. Everyone's body language tells the mood of the team.

Raef: "OK, let's propose a 455-day schedule rather than a 450-day schedule. We still need to come up with cost estimates for those cuts."

Alison: "Since we are proposing cutting 5 additional days from Activity N, "Retests," we need to recognize that the additional time will be more expensive than the initial reductions. An additional \$250/day above the initial reduction costs should cover it."

Simon: "Since this will probably mean adding one junior staffer, how about \$200/day additional?"

Philip: "That seems a little low, even for a 'junior staffer.' I think it would be safer to go with an additional \$230/day."

Simon: "While you folks seem to want to price this project out of existence, an additional \$230/day seems more reasonable than anything else you have proposed."

Raef: "Ok, we are making progress, Activity N reduced an additional 5 days by an additional \$230/day. Other suggestions?"

Rae Beth: "The 5 day reduction for Activity P, Trial-Test Market, will involve a number of different departments – engineering, statistics, marketing, and various support staff, thus making this one of the more expensive areas for reduction. This may be another of those \$5,000/day reductions."

Daniel: "While you are correct that the step will involve a number of different departments, the primary ones will be statistics and marketing. While marketing activities, with their related costs with graphics, design, etc., take time, they can be items that can be 'fast tracked.' Therefore, I would propose that \$4,400/day should be adequate."

Philip: "Since Daniel is from marketing, I think that we should defer to his expertise."

Raef: "Alright, we are really making some progress. We can propose another 5 day reduction at \$4,400/day. That gives us estimated costs for a total of 10 days. Any other suggestions?"

Daniel: "The 10 days from Activity Q Results-Test Market/Analysis, while including other departments are also heavily related to marketing activities and statistical analysis. This should be able to be accomplished with an additional \$ 1,890/day."

Philip: "Again, I think we have to defer to Daniel."

Raef: "That leaves us with estimates for Activity S, Final Product Specifications Review. Any thoughts here?"

Philip: "This is another activity that involves multiple departments, but primarily engineering. Since precision is extremely important at this stage, any time reductions which can be achieved will require multiple double checking by 'fresh eyes.' Therefore, an additional \$3,000/day seems reasonable here."

Simon: "There you go again, trying to jack up the costs. Why wouldn't \$1,500/day work here?"

Pierce: "Philip explained the reasoning, the step requires precision. This is a place we don't want to 'cut corners.' However, in an effort to respond to your cost concerns, what's say we compromise at \$2,200/day?"

Philip: "I am not sure that will be enough."

Simon: "I agree, I am not sure that will be enough of a cut."

Alison: "Pierce seems to have offered a reasonable compromise, I would vote to go along with him."

The others nod in agreement.

Philip: "While I am not sure that this funding level will be adequate, for the sake of winding this up, I am willing to go along with the majority."

Simon: "This is another case where I think that the group is being extravagant."

Raef: "OK, Simon, your objection is again noted. So, in summary, we are proposing a 455-day schedule, with an additional 5 days cut from Activities N, P and S and a 10-day reduction in Activity Q at an additional cost per day of \$8,720 over the 480-day schedule. Is that correct?"

All nod in agreement.

Raef: "There is no doubt that a risk/probability analysis will have to be conducted for both the 480-day and the 455-day schedules. The risk analysis and the additional costs will most likely dissuade management from seriously considering the 455-day schedule. Who knows, perhaps they will be happy with a compromise schedule somewhere between 480 and 455 days. My report to management with our analysis and recommendation will be strongly suggestive that the 455-day option is not realistic, but the 480-day may be feasible. This of course assumes that

the results from the risk analysis confirm my opinion. Facing management's deadline for our analysis gives us very little time to be as thorough as we might like. I also have to work up the cost tables based on these changes to include in the report."

As a result of the discussion, Raef knew that the team was reluctant to make reductions to achieve a 480-day schedule and were openly hostile to a 450-day schedule. However, they seemed to be willing to at least offer up a proposal. Raef knew that he was in a difficult position as he was trying to balance the desires of his bosses while at the same time maintain the confidence of his team so that they could complete the project. His negative comments about the 455-day schedule were, in part, an attempt to placate the team as he suspected that his bosses would prefer to complete the project as quickly as possible, assuming it was economically feasible to do so. Therefore, Raef moved toward ending the meeting by saying:

"Listen folks—I know that this is not ideal. Our job is to provide the best analysis to management that we can and that includes our concerns and reservations. Are we in agreement?"

The group reluctantly agrees with Raef.

Raef: "Thanks everyone for your assistance on developing the two shortened schedules. I will work up the report for management and send you all a copy. If you see anything in the report that needs revision, let me know by Wednesday."

Over the next couple of days, Raef developed the report for management. Included in the report are three tables: 1) Normal Table 515-Day Schedule, 2) Crash Table—480-Day Schedule, 3) Crash Table—455-Day Schedule; and 2 Figures are included: 1) Activity Network and 2) Decision Tree. Given the analysis, management would have to decide if shortening the schedule, and by how much, made economic sense.

Figure 1
Activity Network

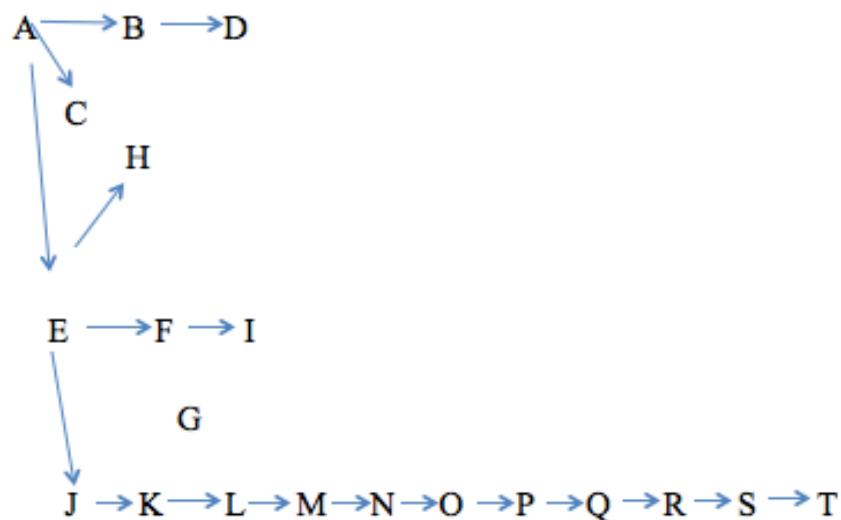


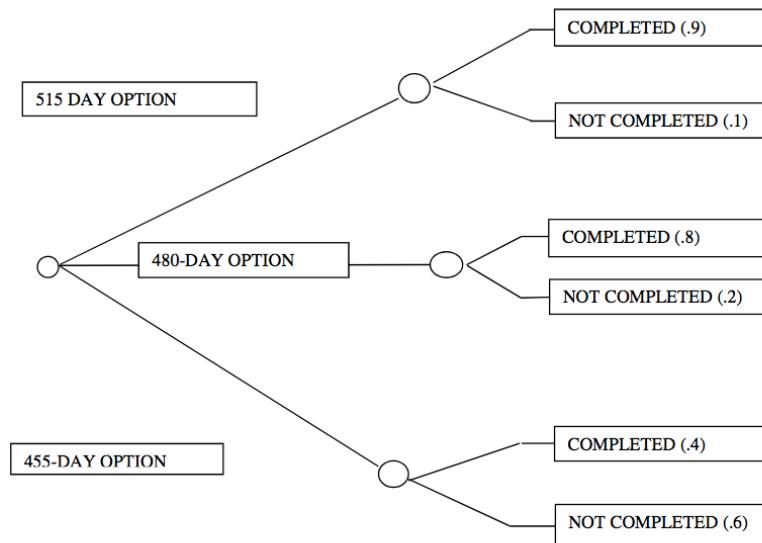
Table 2
Crash Table for the 480 Day Completion Time

| TASK/ACTIVITY | NORMAL TIME | NORMAL COSTS | CRASH TIME | CRASH COSTS | COST / DAY |
|----------------------------|-------------|------------------|------------|--------------------|------------|
| A | 0 | NA | NA | NA | NA |
| B | 60 | \$ 25,000 | NA | NA | NA |
| C | 80 | \$ 78,500 | NA | NA | NA |
| D | 6 | \$ 2,500 | NA | NA | NA |
| E | 14 | \$ 25,200 | NA | NA | NA |
| F | 20 | \$ 12,500 | NA | NA | NA |
| G | 46 | \$ 63,750 | NA | NA | NA |
| H | 52 | \$130,000 | NA | NA | NA |
| I | 10 | \$ 12,500 | NA | NA | NA |
| J | 6 | \$ 1,250 | NA | NA | NA |
| K | 82 | \$ 91,500 | NA | NA | NA |
| L | 30 | \$ 18,750 | 30 | \$ 18,750 | |
| M | 10 | \$ 4,000 | 10 | \$ 4,000 | |
| N | 95 | \$106,000 | 75 | \$ 165,000 | |
| O | 25 | \$ 16,600 | 20 | \$ 24,600 | |
| P | 40 | \$162,500 | 40 | \$ 162,500 | |
| Q | 50 | \$ 83,500 | 50 | \$ 83,500 | |
| R | 85 | \$125,000 | 75 | \$ 175,000 | |
| S | 20 | \$ 37,500 | 20 | \$ 37,500 | |
| T | 6 | \$ 2,500 | 6 | \$ 2,500 | |
| TOTAL PROJECT COSTS | | \$999,050 | | \$1,116,050 | |

Table 3
Crash Table for the 455 Day Completion Time

| TASK / ACTIVITY | NORMAL TIME | NORMAL COSTS | CRASH TIME | CRASH COSTS | COST/ DAY |
|----------------------------|-------------|------------------|------------|--------------------|-----------|
| A | 0 | NA | NA | NA | NA |
| B | 60 | \$ 25,000 | NA | NA | NA |
| C | 80 | \$ 78,500 | NA | NA | NA |
| D | 6 | \$ 2,500 | NA | NA | NA |
| E | 14 | \$ 25,200 | NA | NA | NA |
| F | 20 | \$ 12,500 | NA | NA | NA |
| G | 46 | \$ 63,750 | NA | NA | NA |
| H | 52 | \$130,000 | NA | NA | NA |
| I | 10 | \$ 12,500 | NA | NA | NA |
| J | 6 | \$ 1,250 | NA | NA | NA |
| K | 82 | \$ 91,500 | NA | NA | NA |
| L | 30 | \$ 18,750 | 30 | \$ 18,750 | |
| M | 10 | \$ 4,000 | 10 | \$ 4,000 | |
| N | 95 | \$106,000 | 70 | \$ 185,500 | |
| O | 25 | \$ 16,600 | 20 | \$ 16,600 | |
| P | 40 | \$162,500 | 35 | \$ 184,500 | |
| Q | 50 | \$ 83,500 | 40 | \$ 102,400 | |
| R | 85 | \$125,000 | 75 | \$ 125,000 | |
| S | 20 | \$ 37,500 | 15 | \$ 48,500 | |
| T | 6 | \$ 2,500 | 6 | \$ 2,500 | |
| TOTAL PROJECT COSTS | | \$999,050 | | \$1,247,450 | |

Figure 2
DECISION TREE: RISK ANALYSIS



CENTER FOR THE ARTS: START UP PROBLEMS OF AN INTERGOVERNMENTAL BUSINESS VENTURE

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ABSTRACT

This case concerns issues related to an inter-governmental joint venture comprised of a regional state university, a county government, and two city governments, in overseeing a jointly funded operation. The case describes the resulting ambiguous chain of command, failure to provide top management support, and power conflict. Secondary issues involve the failure to implement secure information processing procedures. After months of conflict, a compromise that smoothed over the organizational structure problem without resolving it was reached.

The case is suitable for graduate and advanced undergraduate business management and management information systems courses. The case has a difficulty level of four. Students should spend from eight to ten hours outside of class analyzing the case, depending on the breadth and depth of the analysis the instructor desires.

CASE SYNOPSIS

The Mid South University (MSU) Center for the Arts had its grand opening in September 2011. The \$32 million facility was a long-time dream come true for MSU and its surrounding communities that could enhance their national and international image and brand.

The Center for the Arts is a 2,016-seat facility with a Broadway-quality theater, a grand lobby suitable for multiple events, and a configurable “black box theater,” with a capacity of 250 for small events. It is the largest performing arts center in the state. An experienced and regionally well-known arts administrator, was hired to be the Center’s Executive Operations Director six months before the grand opening.

There were twenty-one performances the first season, and revenues exceeded expectations despite internal accusations that the Center was seriously mismanaged. After a six month long internal investigation, the MSU president publicly announced his intent to fire the executive director for:

“...fiscal misconduct and falsification of university records and documents. Violation of human-resources policies (e.g., improprieties such as submitting inappropriate meals and items on expense reports, and directing students to falsify time cards, creating a discourteous and unfriendly work environment,

inappropriate behavior toward students (e.g., student workers, such as stagehands, ushers, and parking valets), improper handling of customers' credit card information, and the misleading of university officials ...” (Copley, 2013c).

The Center's executive director denied the accusations claiming she misunderstood, or was unaware of, the university policies. To avoid being fired, she submitted a letter of resignation to the Center's Community Operations Board which had recruited and hired her. Surprisingly, the Board rejected her resignation, and rejected the university president's claim of authority to fire the executive director without the Board's approval. Thus, the stage was set for a battle between the university and the Board over who has authority over the Center's executive director.

BACKGROUND

MSU is the fourth largest public university in Kentucky and located in the state's fastest growing county. In 2003, MSU adopted a strategy to reposition itself from a regional brand to a national and international brand, and a first-class performing arts center was seen as a way to enhance the status of MSU and its surrounding communities. In September 2011, Center for the Arts opened on the MSU campus. It is a 2,100-seat Broadway-capable, Broadway-quality theater with a “fly system” and a 60-foot by 24-foot stage proscenium, as well as a configurable “black-box” theater with seating up to 250.

The nearest performing arts center is the Flagship University Center for the Fine Arts, 25 miles away, which was built in 1979 and has a seating capacity of 1200. The next closest is the Martin Center at Central College, 45 miles away, which is an internationally acclaimed performing arts center with a seating capacity of 1470. The Martin Center hosts outstanding guest artists, touring productions, symphony orchestras, and hosted Vice Presidential Candidates debates in 2000 and 2012.

POOLING RESOURCES

From the beginning, MSU included local government officials in developing plans for the Center for the Performing Arts. MSU's share of the construction cost had to be appropriated through specific authorization by the state legislature. Since, the financial situation of the state was in poor shape at the time, with no likelihood for improvement in the foreseeable future, a strategy was developed to pool funding from two city governments (Richland and Bergen), one county government (Macon), and the state government via MSU. The state legislation authorized the creation of a 13-member Community Oversight Board for the Center with representatives of MSU, the cities of Richland and Bergen, and Macon County to oversee the design, construction

and operations of the Center. The joint organization of the Center was the subject of a presentation at the fifth annual Best Practices in Building University/City Relations Conference, hosted by the International Town & Gown Association and Iowa State University. (“Center for the Performing Arts ...,” 2010)

MSU had two powerful allies in the state legislature, Harry Matherly and Ed Wardly. Matherly was the MSU Vice President for Finance & Administration and Chairman of the House Appropriations Committee, and Wardly, a Richland native and MSU alumnus, was the minority leader in the state senate. Matherly and Wardly, ushered the bill through the legislature. During the drafting of the bill, Matherly inserted a provision stating that oversight control of the Center would be jointly shared by a Community Operations Board comprised of representatives from Macon County, City of Richland, City of Bergen, and MSU, and that the Board would be responsible for hiring the Center’s Executive Director.

After the bill was signed into law by the governor in the spring of 2009, a 13-member Community Operations Board was created to oversee construction of the Center and to hire an executive director. Composition of the Board is as follows (“MSU...,” 2011):

- *Two members appointed by Mayor City of Richland*
- *One member by Mayor City of Bergen*
- *Four members appointed by Macon County Judge-Executive*
- *Six members appointed by MSU President*
- *One ex officio member representing MSU*

Construction of the Center began in the fall of 2009. Once construction was underway, a national search for the Executive Director was conducted which resulted in the hiring of Carolyn Engstrom. Engstrom assumed the duties of Executive Director on January 1, 2010. She had eleven years of experience as executive director of a Community College Performing Arts Center and four years of experience as director of community development for the state’s Arts Council (Mandell, 2009).

When the executive director position was created, the director was classified as a non-contract MSU employee for payroll purposes and depicted on the university’s organization chart as subordinate to the university president despite, by state law, being hired by and reporting to the Board, which is independent of the university. As an MSU employee, the university administration demanded that she clear her decisions and actions through them, and to follow its complex set of accounting policies for expenditure approvals, expense documentation, and personnel management policies. The Board, on the other hand, was concerned about “big picture” issues like construction costs and construction progress.

In October 2011, Engstrom resigned. Officially, the stated reason was to family health issues, but colleagues knew she was frustrated about with the university’s confusing accounting and budgeting procedures by herself. She had expected the Board would hire a business operations director to handle accounting and budgeting tasks, but the Board had yet to hire one.

With Engstrom's resignation, the Board acted quickly to hire a new executive director to make decisions about the Center's interior designs and furnishings, and to book acts for the first season that was scheduled to begin September 2012. After a month long search, the Board hired a new Executive Director. The new director started work on February 1, 2012 without a written contract. (Robinson, 2012)

The new director, Johnson, had eighteen years of experience as the assistant director for the Martin Center for the Arts at Central College. She had exceptional energy and initiative, and brought many extraordinary events to the Martin Center, but she had no experience in managing day-to-day business operations, such as payroll, processing ticket sales, budget management, etc. When the Martin Center executive director job became open in June 2011, she applied for the position but did not get it. After conducting a national search, Johnson was not offered the Martin Center executive director position. Shortly afterward, she submitted her resignation. (Copley, 2010).

In an interview, she said she resigned because "Things feel like they are going in a different direction, and it felt like it was time to move on...If you are going to make a career change, you need to do it when you are still young and smart enough to make the right moves." (Copley, 2010)

THE GOOD AND THE BAD

The Center's first season was considered successful due to the high quality of acts that performed. More than 50,500 tickets were sold which generated more than \$2 million in revenue. However, the first year operating loss was \$486,000.

From the very first performance, business process problems were apparent. At the grand opening, a long line for tickets at the will-call window delayed the performance by nearly an hour. The executive director explained that the Center's online ticketing system had not been set up yet, which meant all credit/debit card transactions had to be entered by authorized personnel. The executive director was only one at the Center authorized to access the university's credit/debit card transaction processing software.

Without an online order and payment system, patrons had to phone in their order, or buy their tickets in person at the Center. Those who purchased by phone had to provide their mailing address and credit/debit card numbers to a Center employee. The executive director often took these calls on a cell phone as she attended to various tasks around the building and recorded the ticket request and credit/debit card numbers on a notepad to be processed later. When other Center employees took phone calls, they wrote the card information on Post-it Notes for later entry by the executive director. Patrons, who did not want to give their card numbers over the phone, had to go to the Center in person to purchase tickets. Patrons had the option to have tickets mailed to them, or to pick them up at the Center in advance or at the will-call window.

As the first season progressed, the university administration received complaints about personnel and operational mismanagement of the ticket sales and other problems, which prompted the university president to authorize an investigation. The findings of the investigation were compiled in a 740-page report.

Report Findings

The report listed the following financial management problems. (Copley, 2013b)

- *The Center did not accurately pay production companies for 12 out of 26 performances. After these underpayments were discovered, payments in full were immediately issued. For the year, they overpaid performers by a total amount of \$46,622, which was not returned.*
- *Weak internal cash handling controls allowed errors or irregularities to occur that might make it impossible to pinpoint responsibility for the loss on one individual. For example, cashiers were not required to reconcile their cash drawer at the end of the shift, and sales reports were not routinely compared with bank deposits. Recorded ticket revenue for the season was nearly \$1.8 million, but the ticketing sales system showed nearly \$1.9 million in sales, a discrepancy of \$104,731.*
- *All box office desks were inundated with slips of paper containing patron names, ticket request information, and credit card numbers. It was impossible to determine any system for collecting, processing or managing this information for ticket sales and payment collection.*
- *Calculations on some invoices from some production companies were altered so the amount billed would match the amount actually paid.*
- *6,899 complimentary tickets, valued at \$389,039, were distributed free of charge. There was no record of who received 3,125 of those tickets.*
- *A "Save Your Seat" fundraising program placed 74 engraved plaques on the seats in the main auditorium, but records indicated that only 29 patrons made the designated \$500 donation.*
- *Irregularities in the director's university issued procurement card (ProCard). There were 98 transactions, totaling \$14,564, either by unauthorized individuals or for disallowed meal purchases.*
- *Violation of various HR policies and procedures, including but not limited to falsification of time cards by directing students to inaccurately report time worked, allowing individuals to "work" at the Center prior to being hired by the University pursuant to established HR procedures; and inappropriate conduct in violation of the Staff Handbook work rules for employees; and*
- *Inappropriate conduct by maintaining credit card information provided by ticket holders in an unsecured area, in direct violation of PDI Date Security Standard (PCI DSS) and 16 CFR Part 314 as well as intentionally misleading University officials as to the existence of this information.*

Director's Response

The director responded by saying manual ticket sales process was not an unusual method for taking orders, and that the late arrival of the Center's online ticketing and purchasing software and lack of computers for box-office workers forced her to create the manual processes.

The director also claimed to not know others should not use her university issued ProCard. "The university bureaucracy was overwhelming because I had never worked in state bureaucracy before. But, as I was told of these policies and procedures, they were implemented

... As I told the Board when I was hired, I'm no financial manager — that's not my strong suit." (Copley, 2013b) Johnson claimed that when she accepted the job, there was an understanding that the Board would hire an operations director to handle the financial, personnel, and details for the Center. Twice, the Board conducted unsuccessful searches for an operations manager. However, no one applied for the position presumably due to the low advertised salary. (Copley, 2013b)

After reading the report's findings, the university president sent a letter to the Center's director to notify her that her employment was being terminated and that she was to vacate her office immediately. In response, the director immediately submitted her letter of resignation to the Board. Surprisingly, the Board rejected her resignation and declared the university president did not have the authority to fire the Center director. Thus, the stage was set for a battle between the university president and the Board over the management control of the Center's director.

WHO'S IN CHARGE?

The Board based its claim for management control on the section in the state law that authorized the construction and partial funding of the Center. That section placed authority regarding personnel with the Board, not the university.

"... a majority of the center Board disagreed with the university's action, saying the Board had authority over personnel decisions at the center. Board member Harry Matherly cited state law regarding the center which states the Board "shall make all decisions regarding personnel." At the June 14 meeting, the Board voted 8-3 for a resolution to retain (the current Director). The resolution said the university did not have "authority to take unilateral personnel action" against employees at the center." (Copley, 2012)

Reluctantly, after several contentious days, the Board accepted the director's resignation and appointed an interim director. Then, the university president and the Board began grappling over the wording of a formal agreement to clarify who has authority over the Center's director. Meanwhile, job availability announcements for the full-time director position were posted in newspapers and relevant trade publications. Eight months passed without a resolution of the conflict between the Board and the university president. The committee in charge of conducting the search for director candidates received about 90 applications. However, the selection of candidates to interview was put on hold until the Board and the university resolved their conflict, because the committee wanted to know to whom the new director would report before interviewing applicants. (Copley, 2013a)

Eventually, the MSU President agreed that the Center's executive director would report to the Board and perform duties in compliance with university accountability standards, regulations, policies and procedures. "We cannot let this go on another six months. University guidelines and policies can be adhered to within the parameters of the Board, and (we) trust that everybody will act in good faith." (Copley, 2013a)

NEW DIRECTOR

The Center was managed by an interim director during its second season. Attendance and revenue were down. An online ticket sales processing software was installed for the Center's website. However, the software was not compatible with the university's transaction software. This incompatibility meant that credit/debit card data had to be manually transcribed from the Center's online processing software to the university's online processing software.

During the second season, the Board conducted a national search for a new executive director. Ninety candidates were considered for the director position before the Board hired Joel Aalberts. Aalberts was the Director of Bloomington (Illinois) Center for the Arts. His prior experience included assistant marketing director for the University of Iowa's Hancher Auditorium, arts marketing assistant at the University of Michigan and University of Arizona, and public affairs officer at Dartmouth College. (Copley, 2014)

Aalberts was well aware of the problems he faced, but they didn't bother the seasoned veteran. "From looking from the outside, (and) the areas that needed work, I felt like I knew how to fix those. I had gone through the same process at my last center, so I feel like it's something I could get right for here." One of the first changes he made was getting an online transaction software installed that is compatible with the university's software. Thus, eliminating the need to manually transcribe data from one system to another while substantially improving the card/debit card security for patrons.

"I've read the reports. I kind of know the stuff that's been out there. In some ways, the politics of it really doesn't matter to me that much. It's all done. I need to be aware of it so I can address those problems. I need to be aware of it so that if there is anyone who was pushed to the side, in all of the things that happened, if there are opportunities we missed, I need to go find those people and introduce myself and talk about what it is that we want to do... In some ways, it's like going back to square one. There's a bit of baggage that I need to clean up to get things going. There's a great group of people in the staff at the Center. We need to regain peoples' confidence and to be a stronger economic engine for the community."

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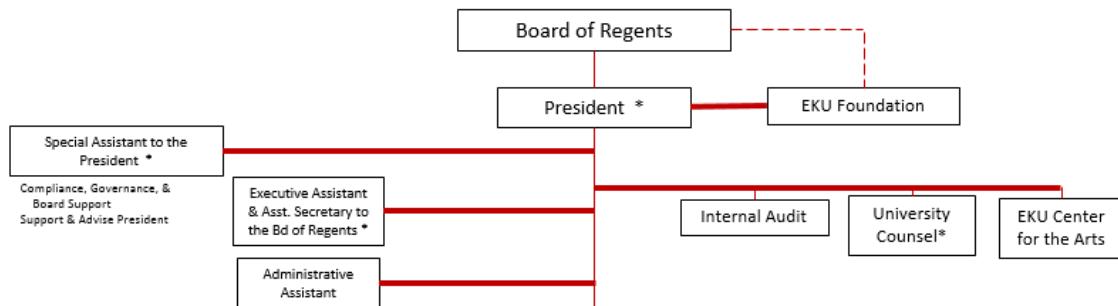
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EXHIBIT A



CENTER FOR THE ARTS: START UP PROBLEMS OF AN INTERGOVERNMENTAL BUSINESS VENTURE

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INSTRUCTOR'S NOTES

ABSTRACT

This case concerns issues related to an inter-governmental joint venture comprised of a regional state university, a county government, and two city governments, in overseeing a jointly funded operation. The case describes the resulting ambiguous chain of command, failure to provide top management support, and power conflict. Secondary issues involve the failure to implement secure information processing procedures. After months of conflict, a compromise that smoothed over the organizational structure problem without resolving it was reached.

The case is suitable for graduate and advanced undergraduate business management and management information systems courses. The case has a difficulty level of four. Students should spend from eight to ten hours outside of class analyzing the case, depending on the breadth and depth of the analysis the instructor desires.

CASE SYNOPSIS

The Mid South University (MSU) Center for the Arts had its grand opening in September 2011. The \$32 million facility was a long-time dream come true for MSU and its surrounding communities that could enhance their national and international image and brand.

The Center for the Arts is a 2,016-seat facility with a Broadway-quality theater, a grand lobby suitable for multiple events, and a configurable “black box theater,” with a capacity of 250 for small events. It is the largest performing arts center in the state. An experienced and regionally well-known arts administrator, was hired to be the Center’s Executive Operations Director six months before the grand opening.

There were twenty-one performances the first season, and revenues exceeded expectations despite internal accusations that the Center was seriously mismanaged. After a six month long internal investigation, the MSU president publicly announced his intent to fire the executive director for:

“...fiscal misconduct and falsification of university records and documents. Violation of human-resources policies (e.g., improprieties such as submitting inappropriate meals and items on expense reports, and directing students to falsify time cards, creating a discourteous and unfriendly work environment, inappropriate behavior toward students (e.g., student workers, such as stagehands, ushers, and parking valets), improper handling of customers' credit card information, and the misleading of university officials ...” (Copley, 2013c).

The Center's executive director denied the accusations claiming she misunderstood, or was unaware of, the university policies. To avoid being fired, she submitted a letter of resignation to the Center's Community Operations Board which had recruited and hired her. Surprisingly, the Board rejected her resignation, and rejected the university president's claim of authority to fire the executive director without the Board's approval. Thus, the stage was set for a battle between the university and the Board over who has authority over the Center's executive director.

INTRODUCTION

The root causes of the problems in this case are: (1) the failure of the Community Board to perform the management oversight role of establishing an appropriate organization structure and failure to monitor the progress of executive director in getting the Center ready for business; (2) the Board's failure to recognize that the second executive director had no experience in operations management and no experience in designing and implementing systems and business processes for sales, human resource management, and accounting system; (3) the failure of the university to provide timely training and assistance in setting up business processes that conformed to those of the university; and (4) the uncertainty about the chain of command between the Board and the university which left the director in limbo.

It is important to remember that this case is not about a devious or dishonest executive director. While the second director made serious mistakes, she did not do anything illegal. Most of the problems identified in the university's report resulted from well-intentioned acts by an overworked director, and from poorly designed business processes.

LEARNING OBJECTIVES

Students will learn about the need to have an experienced manager fully engaged in designing and implementing business processes for a new organization. The instructor could introduce the students to the critical success factors (CSF) method in which management focuses on specific activities, procedures or areas that the organization depends on for its survival.

(Boynlan and Zmud, 1984) For the Center, ticket sales and distribution, security of patron credit/debit card data, and the accounting system are three CSF areas **that** did not get adequate attention. Students will learn about problems arising from overburdening a manager with too much responsibility while providing too little support. Students will learn the need for executives to be knowledgeable users of information systems who follow good security practices. The case also reflects a failure of communication among the three parties—the executive director, the Board, and the university.

TEACHING METHODS

The instructor should act as the moderator for the case discussion. The case questions can be assigned **to** individuals or to small groups.

DISCUSSION QUESTIONS AND NOTES

The following questions can be used by the instructor to stimulate class discussion. This case is intended to be used as a basis for class discussion. It represents the authors' interpretation of events described in publicly available sources which might not be factually complete or accurate.

Question 1: What did the Community Board do wrong?

It might be fairly said that when important projects fail, all blame falls on top management. This case is an example of that. Since the Center was scheduled to open in less than a year when Engstrom resigned, the Board rushed to find a replacement who could takeover on short notice. So, the Board rushed to hire Johnson without conducting a national search or evaluating many candidates. They also failed to hire an operations director. Moreover, the Board failed to perform its management oversight role for the Center project and over the executive director.

Question 2: What did the university do wrong? What could the university have done to support the proper design and completion of the ticket sales processing system?

As a co-partner in the Center, the university had an obligation to provide more training, guidance, and support for designing and implementing business operations processes to ensure compliance with university accounting policies than it did. The university could have prevented many of the Center's problems by assigning one an accountant from its Accounting Services Office to work with the executive director. Instead of proactive, the university was reactive when it conducted the internal investigation and released a report that placed the entire blame on the executive director. In doing so, the university created unnecessary public relations problems for itself and the Center.

Question 3: What did the second executive director do wrong?

You might have the students engage in an exercise of empathetic thinking by putting themselves in Johnson shoes, to see things through her perspective. Students should see that Johnson was under a lot of stress from being responsible for managing too many things for which she lacked experience, training, and support. The inexperience is evident in the failure to select an online transaction software that was compatible with the university's software, the accounting control problems, and personnel problems. She could be faulted for not insisting the Board hire an operations manager, not insisting the university provide an accountant, and funding to hire someone to complete the development of the transactional website.

However, asking for help was not her style. She has a strong personality and was reluctant to delegate tasks. When she did delegate, she tended to "over supervise" her subordinates. It might be fair to say, she tried to do and control too much. The problems listed in the investigative reports, e.g., invoice changes and falsification of student time cards, were not intentional acts of theft or fraud. Rather, they seem to indicate someone who has panicked and is concocting various alibis to shift blame on to others, which is not unusual behavior for someone who is stressed from overwork. It takes courage to admit you are in over your head and you need help. Possibly, in a more supportive organization, she would have been comfortable in admitting she needed help.

Question 4: Should the executive director be blamed for not implementing the university's policies and procedures related to accounting controls, information processing, and information security?

Knowing your employer's policies and procedures is a fundamental responsibility for managers. Supervising and involvement in information systems development is the responsibility of management that cannot be delegated and forgotten. The director needed to work closely with an experienced business analyst to create proper accounting and information system processes that conformed to the university's policies and systems, and to provide proper security.

As a startup organization, the Center should have employed a project management approach for developing the business for its first season. Using this perspective, the critical success factors for project development is helpful in identifying sources of problems in the Center for the Art.

Defining critical success factors as "those few things that must go well to ensure success for a manager or an organization, and ... represent those managerial or enterprise areas that must be given special and continual attention to bring about high performance. CSFs include issues

vital to an organization's current operating activities and to its future success." (Boynlon and Zmud, 1984).

The Standish Group publishes the CHAOS reports which is a ranked list of IT project success/failure factors. The factors could be summarized as: "Good people who know what they are doing, have good involvement and communication with top management, and are well-supported by top management."

The following are the CHAOS 2013 ranked success factors. (Caroll, 2014)

1. Executive/Top management Support
2. User Involvement
3. Clear Business Objectives (Clear Vision and Objectives)
4. Emotional Maturity of the project leader
5. Proper Scope
6. Agile Process
7. Project Management Expertise
8. Skilled Resources (Competent staff)
9. Good Execution
10. Correct Tools & Infrastructure

Question 5: What are business processes and who should design them?

Business processes are what organizations do. Whether documented or not, whether designed or not, whether understood or not, nothing gets done until someone (or "the system") does it. They are a combination of business operating procedures, business rules, business data, and supporting technology.

The Center for the Arts was essentially a new business venture that replaced the responsibility for designing and building business processes on the executive director. Since the second director did not have that experience, and the Board did not hire an operations director, the Board or university should have provided or contracted an experienced business analysis to assist the executive director in the designing and implementing appropriate and secure business processes.

Question 6: Develop a logical design for an online ticket sales processing system.

If there are CIS/MIS majors in the class who are taking, or have taken, a course in systems analysis and design, they could develop a design and present it to the class, or assist other students in creating a process diagram. Small groups of students could sketch a basic business process flow chart, such as shown in Figure 1. Have student work in small groups to create and present to class. Have class discuss the process model to make corrections and

modifications. If there are MIS/CIS majors in the class, the instructor might have them create a flow chart using BPMN or UML.

Question 7: Was the conflict between the Board and the university inevitable? Can shared governance by a university, a county government, and two city governments work?

Because of the complex interdependencies, interactions, and ambiguities between individuals, groups, teams, and constituencies within organizations conflict is going to be inevitable. It is a question of whether conflict can be managed appropriately and constructively by means of creating a supportive environment for positive, productive conflict. The parties involved should believe they have benefited rather than lost as a result of the conflict (Tjosvold, 1986). In order to stimulate new ideas, innovation and change often it is useful to encourage constructive conflict.

In this particular instance the problem was exacerbated through violation of Fayol's principles of unity of command and clear power structure. Principle of unity of command requires that an individual should receive orders from one boss who will be responsible for them, while clear power structure enables communication problems to be solved faster.

Shared governance can work depending on the extent to which each party is willing to work in order to meet the other parties' needs (cooperativeness) but also the extent to which its own concerns need to be met (assertiveness). The two dimensions of cooperativeness and assertiveness define five basic conflict management approaches. These approaches are avoiding, accommodating, competing, compromising, and collaborating (Thomas, 1976).

Question 8: Which of the five approaches would have been most appropriate for addressing the conflict at the MSU Center for the Arts?

Avoiding and accommodating approaches are non-confrontational strategies while a competing approach is an example a control strategy. Collaborating and compromising approaches are solution-oriented strategies that would perhaps be more appropriate. Collaborating approaches in particular involve creatively engaging the problem and generating a solution for which every party is a winner, but such approaches are typically time consuming. Figure 2 provides a useful summary of when to use the Five Conflict Management Approaches (Thomas, 1977)

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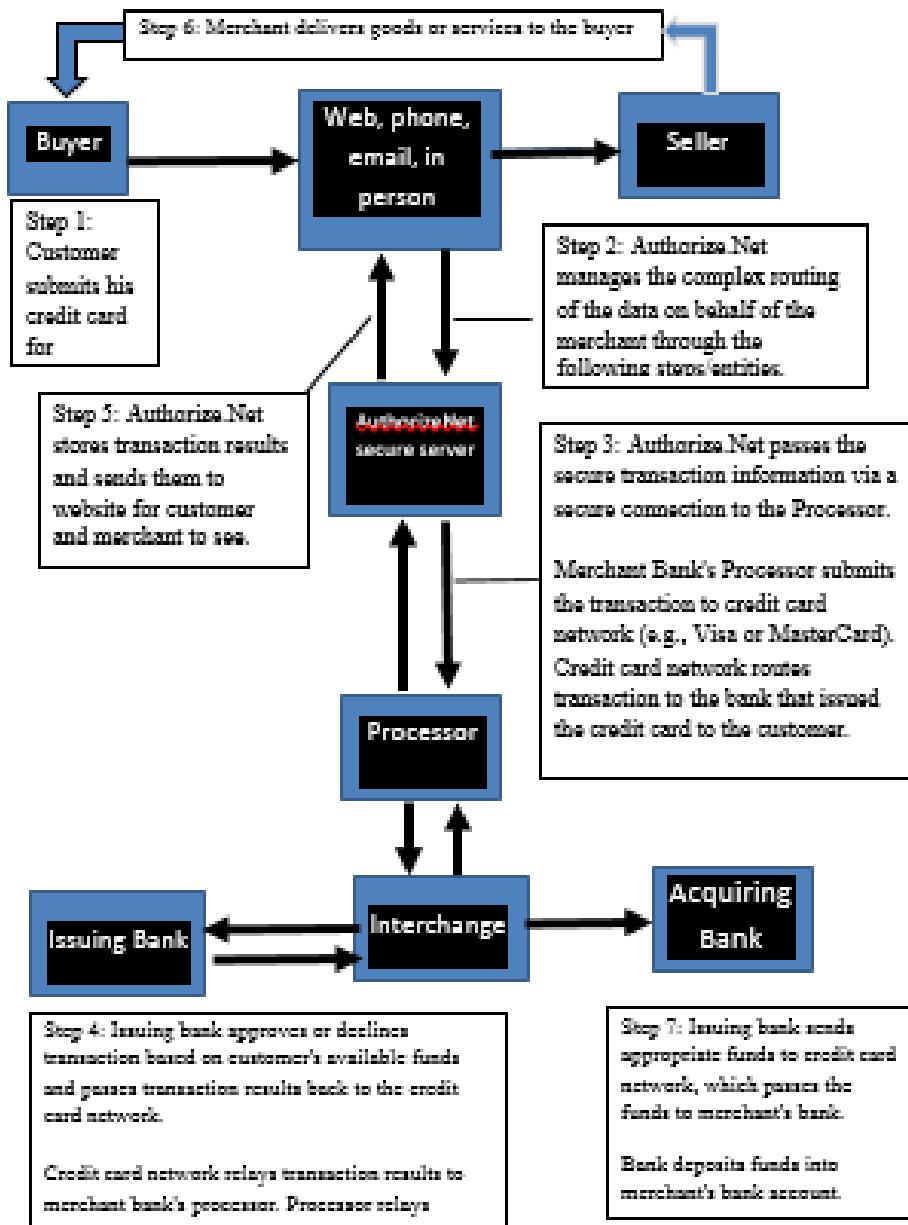


Figure 1: Online Credit/Debit Card Transaction Process
 Adapted from <http://www.authorize.net/resources/howitworksdiagram/>

When to Use the Five Conflict Management Approaches

| Approach | Appropriate Situations |
|---------------|---|
| Competing | <ol style="list-style-type: none"> 1. When quick, decisive action is vital. 2. On important issues where unpopular actions need implementing. 3. On issues vital to organization's welfare, and when you know you are right. 4. Against people who take advantage of noncompetitive behavior. |
| Collaborating | <ol style="list-style-type: none"> 1. To find an integrative solution when both sets of concerns are too important to be compromised. 2. When your objective is to learn. 3. To merge insights from people with different perspectives. 4. To gain commitment by incorporating concerns into a consensus. 5. To work through feelings which have interfered with a relationship. |
| Compromising | <ol style="list-style-type: none"> 1. When goals are important, but not worth the effort or potential disruption of more assertive modes. 2. When opponents with equal power are committed to mutually exclusive goals. 3. To achieve temporary settlements to complex issues. 4. To arrive at expedient solutions under time pressures. 5. As a backup when collaboration or competition is unsuccessful. |
| Avoiding | <ol style="list-style-type: none"> 1. When an issue is trivial, or more important issues are pressing. 2. When you perceive no chance of satisfying your concerns. 3. When potential disruption outweighs the benefits of resolution. 4. To let people cool down and regain perspective. 5. When gathering information supersedes immediate decision. 6. When others can resolve the conflict more effectively. 7. When issues seem tangential or symptomatic of other issues. |
| Accommodating | <ol style="list-style-type: none"> 1. When you find you are wrong—to allow a better position to be heard, to learn, and to show your reasonableness. 2. When issues are more important to others than to you—to satisfy others and maintain cooperation. 3. To build social credits for later issues. 4. To minimize loss when you are outmatched and losing. 5. When harmony and stability are especially important. 6. To allow subordinates to develop by learning from mistakes. |

Figure 2: When to Use the Five Conflict Management Approaches

Adapted from Thomas, K. W. (1977). "Toward Multi-Dimensional Value in Teaching: The Example of Conflict Behaviors" *Academy of Management Review*, 2, no. 3.

JUHEL NIGERIA LTD.

Basil Okoli, Baze University

CASE OVERVIEW

This case challenges students to develop alternatives for (within the next 12 months) very substantially increasing the revenues of a pharmaceutical company in Nigeria called Juhel Nigeria, Ltd. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Dr. Ifeanyi Okoye is the founder and promoter of Juhel Nigeria, Ltd., a pharmaceutical manufacturer and marketer in Nigeria. At its inception, the company focused on manufacturing and selling pharmaceuticals in Eastern Nigeria; now, however, the company sells its pharmaceutical products not only in Eastern Nigeria but all across Nigeria. While the company is already believed to be one of the top five pharmaceutical manufacturers in Nigeria, Dr. Okoye is eager to dramatically increase the pharmaceuticals-related sales and revenues of the company.

Additional data and information in the case include:

1. *Regarding Nigeria: Historical overview, a sample of recent demographic statistics from the World Bank, (and for benchmarking purposes, comparable statistics for the United States), plus information on the economy of Nigeria.*
2. *Regarding the company: Business model, current marketing strategy, current performance, and numerous factors impacting that performance.*
3. *Additional information: Information on the pharmaceutical-related activities and behaviors of members of the market the company has targeted, information about competing products and companies, and information about the pharmaceutical industry in Nigeria.*

THE SITUATION

Sensing that his meeting with Dr. Ifeanyi Okoye, founder and promoter of Juhel Nigeria Ltd. was ending, Professor Ben Odu gathered up his notes. Although he might, later on, need specific information from those notes, Odu knew he would have no trouble remembering the challenge Dr. Okoye had given him, that is, to identify (within the next 30 days) a set of alternatives for (over the next 12 months) dramatically increasing the revenues of JUHEL NIGERIA LIMITED, a pharmaceutical manufacturer headquartered in Enugu, Nigeria.

ADDITIONAL INFORMATION (1): THE COUNTRY

The Federal Republic of Nigeria is a large (one tenth the landmass of the United States) country in West Africa. Administratively, Nigeria is composed of 36 states plus the Federal Capital Territory (FCT). These states differ in many ways, one of which is that the terrain ranges from beaches and swamps in the south to desert conditions in the north. Levels of education and income tend to be higher in the south than in the north. The dominant religion in the north is Islam while the south is predominantly Christian. Hausa is the dominant ethnic group in the north; in the east, the dominant group is the Igbo, while the west is predominantly Yoruba. A small set of statistics on Nigeria, together with comparative data for the United States, are as indicated below:

| | NIGERIA | USA |
|--|--|--|
| Size (square kilometers): | 923,768 | 9,826,675 |
| Population: | 170 million | 314 million |
| Major Ethnic Groups: | Hausa/Fulani 29% Yoruba 21% Igbo 18% | White 80% Black 13% Hispanic 15% includes white+black |
| Religions: | Muslim 50% Christians 40% All Others 10% | Christian 78% Jewish 2% All Others 20% |
| Median Age: | 19.2 | 36.9 |
| Life Expectancy at Birth: | 52 years | 78.5 years |
| Fertility Rate (births per woman): | 5.38 | 2.06 |
| Infant Mortality Rate: | 74/1000 | 6/1000 |
| School Life Expectancy: | nine years | 16 years |
| % Of Population Who Are Literate: | 68% | 99% |
| GDP (purchasing power parity, or PPP): | \$509 billion | \$15.04 trillion |
| GDP per capita (PPP): | approximately \$3000 | \$48,100 |
| % of Population Below Poverty Line: | 70% | 15% |
| Unemployment Rate: | 21% | 9% |
| Electricity Consumption: | 18 billion KWH | 3.741 trillion KWH |
| % Of Population In Urban Areas: | 50% | 82% |
| % of Population Internet users | 26% | 78% |
| Kilometers of Roads | 193,000 | 6,506,204 |
| % Of Roads Paved: | 15% | 67% |

Source: CIA World Factbook 2013

The implications flowing from the information provided in the statistical comparison between Nigeria and the United States include the fact that Nigeria is characterized by high birth and death rates, a high percentage of population in rural areas/agriculture, low per capita income, and high illiteracy. According to Onah and Thomas (2004), additional characteristics of the population and/or the environment include: Poor sanitation and health practices, poor housing, weak feelings of national cohesion, tradition-directed behavior, low status for women, inadequate communications, power, transportation and water infrastructures, export of raw (rather than value added) materials, low savings and low net investments, very low agricultural yields, wealth in the hands of few landlords, poor credit facilities and high

interest rates, prevalence of non-monetized production, vast productive land in small holdings, wealth concentrated in one or two large cities (or exported to “safe” developed countries), and family (and/or tribal) centered concerns and orientations. Onah and Thomas (2004) indicate that “these prevailing conditions affect all facets of economic and social activities.”

ADDITIONAL INFORMATION (2): ECONOMIC OVERVIEW OF NIGERIA

Before the discovery of oil 1956, Nigeria’s economic growth and development depended primarily on export of primary agricultural commodities such as cocoa, palm oil and palm kernel, groundnut, cotton and so on. These agricultural commodities provided the major revenue base upon which the three regional governments (Eastern, Western and Northern Nigeria) then constituting the Federal Republic of Nigeria generated funds to pay for the development of the country. Oil revenue began to play significant role from 1970’s onward especially after the Arab- Israeli conflict (Yon-Kipur war) of 1973. As a consequence of the war, Middle East supply of world oil needs was disrupted and Nigeria benefited from the resultant hike in oil prices.

Historically, manufactured goods including medicines and allied products principally were imported from abroad and major trading firms in Nigeria were the sole importers and distributors of such goods; In those times, Nigerian businessmen then were involved more in the retail end of the value delivery chain. The Federal Government of Nigeria became concerned about the situation, and this prompted government deliberate policy thrust to effect a change through enactment by the military government then of the indigenization laws that were aimed at transferring 100 percent ownership of some of the hitherto less technical businesses held by foreigners to be controlled by Nigerians. But the 60-70 percent of the manufacturing sector businesses that were capital intensive could be controlled by foreign interests. The First and Second National Development Plans, 1971 through early 1980’s pursued import substitution policy which tried to set up industries in Nigeria with raw materials, and in some cases parts, being supplied from abroad. That was the period motor assembly plants such as Anambra Motor Manufacturing Co. (ANAMCO-Mercedes) for Mercedes trucks, National Motor Manufacturing Company Co. Ltd, Kano for (Fiat trucks) and Volkswagen Plant, Ibadan, (for Volkswagen vehicles), were set up. In the same manner other foreign firms involved in the manufacturing of other goods allowed some form of Nigerian participation in order to remain in business in Nigeria’s huge market. However, industrial production in Nigeria has not shown significant impact in the overall development of Nigeria. At 2.5% annual growth rate (2010 estimates) many industries are facing challenges arising from poor infrastructural facilities such as poor electricity power supply, bad roads, water supply, and in addition corruption and general insecurity and terrorism.

Having said all this, it seems worth noting that according to African Development Bank (2014) in the wake of the recently announced figures of Nigeria’s rebased GDP of \$509.9, “the economy still fall short of being a knowledge economy given the domination of informal sector activities. The new data also show that the industrial sector contribution declined from 46.1% to 25.8%. While the oil and gas contribution has fallen to 15% Nigeria still remains highly dependent on crude oil as its main export. But there was a modest increase in manufacturing contribution to 7% from 4%”. Placed side by side with the high degree of poor infrastructural facilities and other issues that tend to make doing business in Nigeria costly, one can agree with those who commented on the release of the new GDP figure that the

country was “growing in the dark”. That is, growth was recorded despite poor electric power supply plus other deficits.

Regarding electric power: Nigerian’s quest to provide a robust electricity power to the economy commenced in April 1972 with the formation of a national power monopoly, the National Electric Power Authority (that is, NEPA). For many years, NEPA was responsible for generation, transmission, distribution, and sale of electricity to all parts of the nation. The idea was to propel the nation’s technological and industrial growth through robust energy supply. Over 40 years down the line this mandate has not been realized and the manufacturing sector has suffered from this failure to the extent that some firms that earlier established factories in Nigeria preferred to move to neighboring countries in Africa especially Ghana which have a relatively more stable electric power supply. Companies such as Michelin Nig. Plc, Dunlop Nig Plc, and others to name just a few have moved over to Ghana. The aftermath of this trend is the low contribution of the manufacturing sector to the country’s GDP, only about 6.83 percent and low employment for the youths of the country.

ADDITIONAL INFORMATION (3): HEALTH & HEALTHCARE-RELATED CHARACTERISTICS OF NIGERIA

As noted by UNIDO 2011, “the determining factor in the pharmaceutical business is the disease pattern and West Africa is no exception to this dictum. Malaria, HIV/AIDS, and tuberculosis, coupled with widespread malnutrition and poverty, represent a double burden of disease on the population. In addition, heart-related diseases are also on the increase. Consequently, over the counter medicines such as analgesics, antimalarials and multivitamins make up a large share of the market. Antiretroviral (ARV), artemisinin combination therapy (ACT), anti-TB and antimicrobial antidiarrheal agents are life saving for patients in Nigeria.”

Another approach to looking at the health & healthcare-related characteristics of Nigeria is to look at the statistics regarding diseases contributing to morbidity; the statistics are as indicated below:

Contribution to Morbidity Disease conditions Contribution

- 1 HIV/AIDS 16.0%
- 2 Respiratory diseases 14.0%
- 3 Malaria 11.0%
- 4 Cardiovascular diseases 10.0%
- 5 Childhood diseases 9.0%
- 6 Diarrheal diseases 7.0%
- 7 Injuries (Road accidents, drowning, violence) 7.0%
- 8 Perinatal conditions 4.0%
- 9 Others (cancer, urinary diseases, TB, etc.) 22.0%

Source: Federal Ministry of Health, Abuja, 2010, as shown in UNIDO 2011

Regarding the major disease conditions contributing to morbidity the following observations can be made:

Malaria. UNIDO (2011) indicates that “malaria is responsible for 60 per cent of all outpatient attendance, 30 per cent of all hospital admissions and 300,000 deaths annually

(FMoH, 2010). Artemisinin CombinationTherapy (ACT) is the first line treatment in accordance with the national malaria treatment guidelines. The cumulative prevalence rate for malaria infection in most parts of the country is 100 per cent in any 10 month period. It is estimated that at least 10 per cent of all childhood deaths are due directly to malaria and up to 25 per cent indirectly. As of 2003, the volume of economic output lost because of incapacity through malaria was estimated at 4 per cent of GDP per annum (Amos Petu, 2004). Undoubtedly, malaria is one of the principal causes of morbidity and mortality in Nigeria and imposes an enormous socio-economic burden on the country.”

Tuberculosis. UNIDO (2011) indicates that “TB is a major public health problem in Nigeria with the country ranking fourth among the 22 high TB burden countries which collectively account for about 80 per cent of the global burden of TB. According to the Federal Ministry of Health (FMoH), the number of TB cases notified in the country increased from 31,264 in 2002 to 90,307 in 2008. There are some 374,000 estimated new cases annually. In view of the magnitude of the burden of TB in Nigeria, the FMoH declared TB to be a national emergency in 2006. The public health burden posed by TB is becoming increasingly onerous as the country’s HIV/AIDS epidemic unfolds. WHO estimates that more than a quarter of new TB patients are HIV positive. Collaborative TB-HIV/AIDS services are being scaled up and the number of TB patients tested for HIV increased from about 7,500 in 2006 to 27,850 in 2007 (FMoH, 2010).”

HIV/AIDS. UNIDO (2011) indicates that “According to a UNAIDS Report published in 2009, the HIV prevalence in Nigeria has been steadily contracting from 5.8 per cent in 2001 to 3.1 per cent in 2007. This is a much lower figure than in other African countries, such as South Africa and Zambia, but the size of the population means that by the end of 2009 there were 3.3 million Nigerians living with HIV (AVERT). Nigeria is one of 15 focus countries, which collectively represent 50 per cent of HIV infections worldwide. . . . (there is a large gap) between those who need ART and those receiving ART. It also indicates the increasing trend in the number of HIV positive births, underlining the additional challenge of preventing mother-to-child HIV transmission.”

Regarding the health care system in Nigeria, UNIDO (2011) indicates that: "The country's health system was ranked 187th out of 191 member states by the World Health Organization (WHO) in 2000. The Government has acknowledged that the healthcare system is poorly organized and resourced and that this has contributed to an overall decline in health status indicators over the past decade. Government actions with respect to the pharmaceutical industry include:

1) A tariff structure designed to discourage the import of those essential medicines which are manufactured locally; the list of several medicines for which installed capacity of drug manufacturers in Nigeria is high is as indicated below:

Installed Capacity of Drug Manufacturers in Nigeria

- 1 Analgesics:** Tablets 40 billion, Syrup/suspension 70 million liters, Ointments/Balms 700 million tubes
- 2 Antimalarials:** Tablets 8 billion, Capsules 5 billion, Syrups 50 million liters
- 3 Antibiotics:** Tablets 20 billion, Capsules 20 billion, Syrups 40 million liters
- 4 Antiretrovirals:** Tablets 20 billion, Syrups 30 million liters
- 5 Vitamins:** Tablets 50 billion, Capsules 40 billion, Syrups 80 million liters

- 6 Antitussive syrups:** 45 million liters
- 7 Infusions:** 500 million liters
- 8 Antacids:** Tablets 30 billion, Syrups 50 million liters
- 9 Antiseptics / Disinfectants** 60 million liters
- 10 Injectables:** 400 million vials

Source: PMG-MAN, Lagos, 2010, as cited in UNIDO (2011)

- 2) Import prohibition of the 18 medicines listed below; for these medicines, local manufacturers are believed to possess adequate capacity to meet domestic demand .

List of Pharmaceuticals prohibited for Import into Nigeria, 2005

Number Products Formulations

- 1 Paracetamol Tablets and Syrups
- 2 Co-trimoxazole Tablets and Syrups
- 3 Metronidazole Tablets and Syrups
- 4 Chloroquine Tablets and Syrups
- 5 Haematinic Formulations Tablets and Syrups
- 6 Ferrous Sulphate and Ferrous Gluconate Tablets
- 7 Folic Acid Tablets
- 8 Clotrimazole Cream
- 9 Ampicillin/Cloxacillin Combination Capsules
- 10 Vitamin B Complex Tablets (except modified release formulations)
- 11 Multivitamin Tablets, Capsules and Syrups (except special formulations)
- 12 Aspirin Tablets (except modified release formulations and soluble aspirin)
- 13 Magnesium Trisilicate Tablets and Suspensions
- 14 Piperazine Tablets and Syrups
- 15 Levamisole Tablets and Syrups
- 16 Penicillin/Gentamycin Ointments
- 17 Pyrantel Pamoate Tablets and Syrups
- 18 Dextrose, Normal Saline Intravenous Fluids

Source: UNIDO 2011

ADDITIONAL INFORMATION (4): THE PHARMACEUTICAL INDUSTRY IN NIGERIA

Historically, manufactured drugs were being imported from England (Britain), Europe (principally Germany). During the colonial period, British pharmaceutical firms such as May and Baker, Glaxo SmithKline, and Pfizer (USA) and others were in charge of importing drugs for use in hospitals and sale to numerous drugs marketers in the country who are indigenous traders sometimes not really trained as pharmacists. Local manufacture of drugs, in the real sense of it, appeared in the Nigerian business environment from the 1970's when some indigenous entrepreneurs went into partnership with some foreigners to set up pharmaceutical companies producing various types of drugs for the Nigerian market and other African countries. But still, Nigeria produces less than 25 percent of the drugs needs of

the country; as indicated below, the market share of the various therapeutic classes of medicines locally produced in Nigeria varies considerably. It seems worth noting that the class of analgesics/antirheumatics/antipyretics has the largest share due to their affordability and availability in both urban and rural communities, as well as widespread use and misuse of these products for a wide range of symptoms.

Estimated Market Share of Local Manufacturers by Therapeutic Class

| <i>Name</i> | <i>Market share</i> |
|--|---------------------|
| 1. Analgesics/antirheumatic/antipyretics | 25% |
| 2. Antibiotics + antibacterials | 15% |
| 3. Multivitamins + haematinics | 15% |
| 4. Antimalarial medicines | 14% |
| 5. Antihypertensives | 8% |
| 6. Cough and cold preparations | 5% |
| 7. Antiretroviral medicines | 6% |
| 8. External/topical preparations | 5% |
| 9. AntiTB medicines | 4% |
| 10. Others | 3% |
| Total | 100% |

Source: UNIDO 2011

UNIDO 2011 also observes that “the active pharmaceutical ingredients (APIs) used in Nigeria are imported, mainly from India and China. Companies need to make careful forward planning for the import of APIs because of lengthy delays (three months or more) at the seaport due to clearance, customs and NAFDAC formalities. In most cases, both primary and secondary packaging materials are obtained locally. In addition, about 25 per cent of excipients are locally sourced. Most of the machinery and virtually all the quality control analytical equipment are imported, mainly from Asia and Europe respectively. Some of the drug manufacturers fabricate a few spare parts but most are imported. Some companies, which are using similar machines supplied by the same foreign companies in India and in Europe, also join together to contract expatriate engineers and to organize workshops on machine maintenance.

As indicated below, estimates regarding the current size of the pharmaceutical market in Nigeria vary significantly:

- 1) UNIDO (2011) indicates that “In 2009 the Pharmaceutical Manufacturing Group of the Manufacturers’ Association of Nigeria (PMGMAN) estimated the size of the total pharmaceuticals and healthcare products market to be in excess of US\$ 2 billion annually. The estimated market for prescription ethical pharmaceuticals is US\$ 500 million and that for over the counter (OTC) pharmaceuticals about US\$ 900 million. Furthermore, PMG-MAN estimates the Nigerian market for biological products (including vaccines, insulin, interferon, etc.) to be worth about US\$ 100 million. In addition, related healthcare and lifestyle products account for about US\$ 500 million.”
- 2) UNIDO (2011) indicates that “Business intelligence services estimate the pharmaceutical market in Nigeria at US\$ 600 million (Business Monitor International BMI 2010) for 2009. Out of this figure, BMI attributes the largest share of US\$ 418 million to generic medicines, US\$ 121 million to over the counter (OTC) products and US\$ 61 million to patented products. Frost & Sullivan estimated a pharmaceutical

market value of US\$ 740 million in 2009. Out of this figure, US\$266.4 million were attributed to generic medicines, US\$ 177.6 million to branded products and US\$ 296 million to OTC products (Frost & Sullivan 2010)."

Regarding industry constraints and issues, UNIDO (2011) indicates that " Drug manufacturers in Nigeria are up against several constraints, including low capacity utilization, under capitalization, a weak financial base, high production costs as a result of the high cost of inputs, poor infrastructure, difficulty in meeting WHO prequalification criteria, low level or obsolete technology, high interest rates and unstable demand. The fluctuations in demand are a reflection of prevailing low purchasing power within the population and the fact that drug distribution is still a challenge." Regarding distribution, UNIDO (2011) goes on to observe that "The reality regarding supplies of medicines in Nigeria is that those who are not trained and registered as pharmacists are actively involved in supplying pharmaceuticals, using unregistered premises. Rural and poor communities, which have no health facilities, receive medicines from patent stores and vendors in open market places."

According to UNIDO (2011), other characteristics of the pharmaceutical industry in Nigeria include:

- 1) UNIDO (2011) indicates that "According to the Pharmacists Council of Nigeria (PCN), there were 128 registered drug manufacturers, 1,534 retail pharmacies, 724 drug distributors and 292 drug importers in Nigeria in 2010. Nigeria has a total of 14,607 public and 9,034 private healthcare facilities (National Bureau of Statistics, 2006a). However, it has been estimated that there are over 10,000 unregistered patent and proprietary medicine stores, which are thought to sell Over The Counter (OTC) products only. Most such stores are located in villages and poor communities throughout the country, in areas where fully fledged pharmacies do not exist."
- 2) The average plant utilization rate for pharmaceutical manufacturers in Nigeria is 40%. UNIDO (2011) indicates that "The low capacity utilization in the pharmaceutical manufacturing sector is attributed mainly to the current lack of competitiveness with imported products and to unpredictable demand for the products. A major challenge faced by local producers is the cost of importing all their active pharmaceutical ingredients and virtually all their pharmaceutical excipients. The burden is then multiplied by the fact that local manufacturers must pay Value Added Tax (VAT) on the imported raw materials whereas there is no VAT on imported finished medicines. Furthermore, some foreign pharmaceutical manufacturers, such as those in India, produce both pharmaceutical raw materials and the finished products. Such companies have an added advantage when they export both the raw materials and medicines to Nigeria through pricing that will favor their finished products."
- 3) The number of workers employed in the manufacturing and distribution of pharmaceuticals in Nigeria is about 500,000; of these, most are semi-skilled (that is, they have received training for the skills they need so as to be able to perform their jobs.
- 4) 60% of the pharmaceuticals produced in the Economic Community of West Africa (ECOWAS) are produced in Nigeria. Given that the population of ECOWAS is about 600 million, the ECOWAS subregion represents a huge potential market. UNIDO (2011) indicates that the Nigerian companies exporting to ECOWAS include:

PZ Cussons Plc
May & Baker Nigeria Plc
Fidson Healthcare Plc

Evans Medical Plc
Neimeth International Pharmaceuticals
GlaxoSmithKline Nigeria
Mopson Pharmaceutical Industries Ltd
Emzor Pharmaceutical Industries Ltd
Drugfield Pharmaceuticals Ltd.

- 5) Most pharmaceutical manufacturing companies are not fully automated, although some are working toward that goal.
- 6) Additional strengths, weaknesses, opportunities and threats (SWOT) characterizing the pharmaceutical industry in Nigeria but not already mentioned include:
 - a. Strengths:
 - i. Some pharmaceutical manufacturers in Nigeria are working toward attaining World Health Organization (WHO) current Good Manufacturing Practice (cGMP) and prequalification status; once they have attained those qualifications, they will be able (for the first time) to participate in international tenders for supplies of antiretrovirals, antimalarials and anti-TB medicines.
 - ii. Technical skills, trained manpower and basic manufacturing infrastructure already exist; clearly Nigeria does have the potential to become a leading manufacturer and distributor of essential medicines in sub-Saharan Africa.
 - b. Weaknesses
 - i. As indicated earlier, Nigeria is characterized by poor infrastructure (power, water, transportation); the infrastructure problems increase manufacturing and distribution costs and impact negatively on growth.
 - ii. As indicated earlier, no Nigerian medicine manufacturer has yet attained WHO cGMP or WHO prequalification status; the result is that no local firm is able to participate in international tenders for pharmaceutical supplies.
 - iii. High bank lending rates (more than 20% per annum) mean that funds required for working capital and upgrading of facilities are limited.
 - c. Opportunities
 - i. In addition to increasing the percentage of treatments for malaria, tuberculosis, and HIV/AIDS produced locally, there is an opportunity to manufacture and market treatments for “neglected childhood diseases.”
 - ii. Increases in purchasing power should increase the percentage of individuals able to afford to purchase medical care including pharmaceuticals.
 - iii. There is an opportunity to increase exports within (or perhaps even outside) ECOWAS.
 - iv. The initiative by the Federal Government of Nigeria (FGN) to establish a National Health Insurance Scheme (that is, to provide universal healthcare) offers the prospect of a huge increase in funding for medical services and supplies.
 - d. Threats
 - i. The high level of poverty and the lack of purchasing power undermine the market for locally produced medicines.

- ii. Substandard and/or fake health products affects both international and domestic prospects for the marketing of medicines produced in Nigeria.
- iii. The uncontrolled/chaotic distribution system for pharmaceuticals and The presence of large amounts of low cost imports from Asia.
- iv. Corruption within the distribution and/or regulatory systems.

1) Regarding the efficacy of different treatments for malaria, UNIDO (2011) indicates that:

| Zones | Chloroquine* | Sulphadoxine Pyrimethamine* | Artemether/Lumefantrine** | Artesunate/Amodiaquine** |
|---------------|--------------|-----------------------------|---------------------------|--------------------------|
| South East | 3.70% | 14.90% | 100% | 100% |
| South South | 9.10% | 8.50% | 87% | 82.50% |
| North Central | 53.20% | 82.70% | 100% | 96% |
| North West | 77.30% | 94.20% | 100% | 100% |
| South West | 40.90% | 75.60% | 100% | 100% |
| North East | 50.80% | 64.80% | 100% | 100% |

* 2002 Drug Efficacy Study ** 2004 Drug Efficacy Study

Source: National Policy on Malaria Diagnosis and Treatment, Federal Ministry of Health, Abuja, 2010.

2) Regarding severe attacks of malaria, UNIDO (2011) indicates that “The most recent version of the National Policy on Malaria Diagnosis and Treatment indicates that injections of Quinine Dihydrochloride, Artemether and Artesunate are the medicines of choice for severe attacks of malaria.”

Malaria

Medicines Dosage form Strength

Quinine Dihydrochloride Injection 300mg/ml in 2ml ampoule

Artemether Injection 80mg/ml in 1ml ampoule

Artesunate Injection 60mg/1ml vial

Artesunate* Suppository 50mg suppository

* Suppositories if Artesunate is used only as pre-referral treatment

Regarding medicines for tuberculosis: UNIDO (2011) indicates that in Nigeria, it is the international aid partners who supply these pharmaceuticals.

Regarding the antiretroviral medicines (ARVs) for HIV/AIDS: UNIDO (2011) indicates that:

Companies Manufacturing Antiretrovirals (ARVs) in Nigeria are as indicated below:

Ranbaxy Nigeria Limited Avolam Liquid (Lamivudine 50Mg)

Azido Liquid (Zidovudine 50Mg)

Nevran Liquid (Nevirapine 50Mg)

Fidson Healthcare Plc Virex Lzn (Lamivudine+Zidovudine+Nevirapine Tablets)

Virex Lz (Lamivudine + Zidovudine Tablets)

Virex L (Lamivudine Syrup)

Virex Z (Zidovudine Syrup)

Virex N (Nevirapine Suspension)

Archy Pharmaceuticals Ltd Archivir (Lamivudine 50Mg + Stavudine + Nevirapine) Tablets
May & Baker Nigeria Plc Lamar (La mivudine) Tablets
Stavar (St avudine) Tablets
Nevipar (Nevirapine)Tablets
Gemini Pharmaceuticals Nigeria Limited Viramune (Ne virapine) Tablets
Emzor Pharmaceutical Industries Ltd Nevirapine Syrup
Zidovudine+Lamivudine Tablets
Drugfield Pharmaceuticals Limited Fluconazol (Flucamed Capsules 200Mg)
Antirovir Capsules (Lamivudine + Zidovudine)
Swipha Nigeria Ltd Virazid (Zidovudine 100Mg) Tablets
Evans Medical Plc Arved Tablets (Lamivudine + Zidovudine)
Arved – N Tablets (Lamivudine + Zidovudine + Nevirapine)
Lavudine – S 30/40 Tablets (Lamivudine + Stavudine)
Lavudine Snp – 30/40 Tablets (Lamivudine + Stavudine +
Nevirapine)
Vitabiotics (Nig) Ltd Efavirenz Tablets

1) Regarding HIV/AIDS treatments: UNIDO (2011) indicates that “The first line antiretroviral combination was Stavudine, Lamivudine and Nevirapine but this was subsequently changed to Zidovudine, Lamivudine and Nevirapine because of side effects from Stavudine”.

ADDITIONAL INFORMATION (5): THE COMPANY

Juhel Nigeria Ltd. is a 100 percent Nigerian indigenous company incorporated in 1987. As indicated earlier, the promoter and founder of the company is Dr. Ifeanyi Okoye, a pharmacist by training. The company was formed with the vision to “produce cost-effective generic products to fill the gap left by multinational companies operating in Nigeria”. It seems worth noting that various national and international organizations are highly supportive of the idea that generic pharmaceuticals can and should be produced locally in Less Developed Countries; UNIDO (2011) indicates that “Since 2006, UNIDO, with funding from the Government of Germany, has been conducting a project on strengthening the local production of essential generic drugs in developing and Least Developed Countries. The objective is to help the pharmaceutical sectors in developing countries realize their potential role of acting as a pillar of public health and contributing to economic and social development.” In any case, Juhel Nigeria Ltd. commissioned its factory in 1989 and started (at that time) producing tablets. At present the product range has grown; the current range includes “therapeutic classes such as antibiotics and anti-infective cardiovascular, anti-diabetics, anti-malarial, cough and cold, vitamins and minerals, anxiolytics, anti-histamine, etc.”

Juhel Nigeria Ltd. (hence, JNL) started as a company focused on serving a regional market, specifically, the eastern region of Nigeria. Now, however, JNL has grown to become a national brand in Nigeria. While JNL’s factory is located at Emene near Enugu, the capital of Enugu State and the former capital of Eastern Nigeria, the company has depots in Aba, Lagos, Abuja and other places to serve its customers nationwide.

Regarding JNL’s marketing strategy, the following comments can be made:

Target market

The company's primary market targets for drugs include direct and indirect customers throughout Nigeria. Direct customers (that is, customers to whom JHL sells directly) include: Wholesalers, large retailers, hospitals, clinics, pharmacists, doctors, and so on. Indirect customers (that is, the customers who purchase JNL products from the direct customers) include small retailers, market ladies, and individual consumers needing medication, including both adults and children. Naturally for a drug firm, some of the business is funded by federal, state, and/or local governments (that is, public money); in Nigeria, however, UNIDO (2011) indicates that "74.7% of expenditure on health is made by the private sector, underlining the low contribution of Government to the health sector."

Products

As indicated earlier, the major pharmaceutical products on offer by the company include: Antibiotics and anti-infective drugs; analgesics, steroids and antispasmodics; vitamins, minerals and hematics; antacids, cough cold and catarrh; cardiovascular, diuretics, antihistamine and anxiolytics; anti-malarias, anti-diabetics and anti-helminthics; and infusion products which include also infusion water, ear and eye drops, etc.

These pharmaceutical products are meant to deal with common diseases that plague not only Nigeria but also tropical Africa in general. In other words, they are meant to serve markets not only in Nigeria but also beyond the boundaries of Nigeria.

Price

Price of the products are usually determined by market forces of demand and supply. The health care situation in Nigeria is not good: Many people are poor, sanitation is problematic, sickness and disease are rampant, and pharmaceuticals can be expensive. Elaborations on the above points which can be made include:

- 1) While demand for manufactured drugs is high, prices are also high. UNIDO (2011) indicates that "A national survey on medicine prices was undertaken in 2006 by the Federal Ministry of Health in collaboration with the World Health Organization (WHO), the UK's Department for International Development (DFID), the European Union and Health Action International. The results of the survey (include):
 - Patients pay between 2-64 times the international reference prices for medicines at various health facilities in both the private and public sectors
 - Prices in the public sector were almost identical to those in the private pharmacies
 - Private health clinics charge about 184 per cent more than the public health facilities and about 193 per cent more than private retail pharmacies
 - Innovator brands cost between 2-7 times the lowest priced generic equivalentsThe 2006 survey concluded that 90 per cent of Nigerians who live below the income level of US\$ 2 per day, as well as Government workers who earn a minimum wage of US\$ 1.4 per day, cannot afford medicines."
- 2) Alternative methods of treating diseases by use of herbal medicine are still highly patronized, especially by lower income consumers and in rural areas.
- 3) Sometimes faith-based healing solutions to ailments prevail to an astonishing degree, particularly for low income earners. Faith preachers (both Christians and Muslims) abound in both urban and rural environments.

Promotion

Pharmaceutical companies in Nigeria tend to promote their products by adopting a combination of strategies that include: personal selling, media selection, advert copy and sales promotion. JNL uses combinations of the above strategies to create awareness of and influence demand for its products.

Place

(i.e. *Distribution*) Regarding private sector sales: Many pharmaceutical companies in Nigeria have adopted selective distribution strategies, that is, they appoint selected drug stores located in different cities of Nigeria to market their products to open market and other retailers. In such a system, the selected drug stores are the entities who sell the products of the manufacturer to end consumers. While JNL uses the same method, the company also sells directly to hospitals and clinics. To service its growing numbers of retailers, JNL currently maintains depots in cities such as Lagos, Onitsha, Aba, Port Harcourt, and Abuja. It seems worth noting that in the private sector, and as indicated above, manufacturers and importers have their own distribution channels and can sell to wholesalers, retailers and hospitals. One implication of this system is that medicines and medical supplies are often sold by unregistered and unlicensed premises and, in some cases, by non-pharmacists.

Regarding sales to government, the following observations can be made:

- 1) The Government (including Federal, State and Local Government Areas) supplies pharmaceutical products to its various health institutions. The Federal Government is responsible for policy formulation and technical guidance to all healthcare providers. In addition, the Federal Government supplies drugs and medical supplies to tertiary healthcare centers (University Teaching Hospitals) and Federal Medical Centers located in all 36 states. State governments are responsible for providing healthcare to state hospitals as well as offering technical support to the Local Government Areas (LGAs). The LGAs take care of healthcare services at primary healthcare level. As indicated earlier, the private sector, traditional health practitioners and non-governmental agencies provide healthcare services at all three levels of the healthcare system.
- 2) At one time, under a government initiative to deliver health care to Nigerian citizens, JNL was involved in the contract production of drugs for government.
- 3) Nigeria's HIV/AIDS supply chains – many of which include separate procurement, warehousing, and distribution systems – are owned and operated by various federal, state, nongovernmental and faith-based stakeholders with oversight from the Federal Ministry of Health (FMoH) and the National Agency for the Control of AIDS (NACA).

ADDITIONAL INFORMATION (6): PHARMACEUTICALS-RELATED ATTITUDES AND BEHAVIOURS OF CONSUMERS IN NIGERIA

Investigations and research carried out over the years on health-care in Nigeria to ascertain the attitudes and behaviours of majority of Nigerians regarding treatment of diseases and medicine consumption generally, the following information collected tended to support a general belief that every member of the Nigerian society irrespective of his or her socio-economic class is interested in finding the best way to treat or prevent an actual or perceived ailment confronting him or her.

- 1) Upper-class Nigerians, on being confronted with sickness of any kind (both of themselves or of any members of their families) will first consult a doctor (or qualified pharmacist) to investigate and prescribe drugs for the treatment of the sickness.
- 2) Middle class and lower class members of the society, upon becoming sick, will first on their own go to drugstores or the open market to buy drugs perceived to be adequate for the treatment of the suspected ailment, having learned from varied experiences (word-of mouth, television or newspaper advertisement, and/or shared interaction with someone who suffered something akin to what is happening to him or her). On failure to get alright through their own direct purchase of drug in an open market or drugstore, members of the middle socio-economic class may then approach a doctors' clinic or hospital for investigation and treatment.
- 3) Regarding members of the very lowest socio-economic class: UNIDO (2011) indicates that they "tend to approach traditional herb providers for further treatment. In other words traditional medicine still command huge patronage particularly for low income individuals and in rural communities." In this lowest socio-economic class (and for some members of the middle and/or lower class as well) there are people who rely on prayers provided by "acclaimed men and women" who are perceived to be able to "deliver" people from their troubles (including health-related issues) through prayers to God.

It seems worth noting that the National Bureau of Statistics (NBS) indicated in 2010 that 69% of the population of Nigeria are poor. This is reflected by the following observations on the ability of patients in Nigeria to pay for pharmaceuticals:

- a. Regarding malaria: UNIDO (2011) indicates that "about 15 per cent of the population can afford to purchase ACTs (that is, antimalarial drugs) on their own, 30 per cent can afford them with some assistance, and 55 per cent need to obtain them free of charge."
- b. Regarding tuberculosis: UNIDO (2011) indicates that "under the NTBLCP more than 450,000 TB cases have been successfully treated free of charge since 2005 in Nigeria. This is necessary because, according to the Ministry of Health, "only about 5 per cent of the population can afford anti-TB medicines on their own. Furthermore, about 35 per cent of TB patients can afford the medicines if supported, while 60 per cent cannot afford them at all."
- c. Regarding HIV/AIDS: UNIDO (2011) estimates that 5 per cent of the population can afford ARVs without financial assistance, 15 per cent can afford them with some assistance, and 80 per cent cannot afford them. UNIDO (2011) goes on to observe that at 2009 levels, HIV/AIDS would cost somewhere between US\$ 530 million to US\$ 650 million per year with prevention, care, and treatment constituting 35 per cent, 20 per cent and 45 per cent of the total cost respectively. Scaling up HIV/AIDS services over the next five years would cost an additional US\$ 113 million per year; by 2014 the total annual funding level would be US\$ 1.1 billion. According to NACA, "over US\$ 2.5 billion per year will be needed to achieve universal coverage throughout the country and the scaling up of services will require funding not only for direct provision of services but also for the development of infrastructure for training and retraining of health workers. The present level

of funding is only 11 per cent of what is needed for universal coverage of prevention, care and treatment and the possibility of innovative funds mobilization strategies, including cost-sharing mechanisms, grants, private contributions, and increasing national contributions need to be explored.”

One of the implications of the above behaviors is that for upper-class and many middle class consumers, affordable high quality drugs and efficient medical delivery are highly desired. As it happens, the challenges associated with the above statement include not only the issue of affordability (as pointed out earlier, in Nigeria pharmaceuticals can be very expensive) but also the issue of quality. Elaborations on this point include:

- 1) In an interview in the Guardian Newspaper (____ 2007), Akunyili indicates that “fake drugs were first noticed in Nigeria in 1968, The situation progressively got worse and even deepened during the import license saga (of 1980-1984) until about 2001 when Nigeria became rated as one of the countries with the highest incidence of fake drugs. We had about 41 percent of drugs in circulation then as fake. In 1990, Adeoye Lambo,(sic of WHO) reported 54 percent of drugs in Nigeria (as fake).”
- 2) The Nigerian government set up National Agency for Food and Drug Administration and Control (NAFDAC) by a Decree in 1993 to regulate and control the production, importation, exportation, advertisement and sales of all drugs, medical devices, foods, cosmetics, chemicals and all drinks including water.
- 3) The existence of the Agency was never felt until 2002 when the body was headed by Professor Dora Akunyili. Long before then the drugs and regulated products market in Nigeria was described as “dumping ground for fake and adulterated products.” Indeed, no regulation was going on. Drugs were being sold in open markets and shops by unqualified personnel that often get involved in faking and adulteration in order to make stupendous profits at the expense of the lives of their consumers.
- 4) The regulatory activities of NAFDAC commencing from 2002 helped to sanitize the food and drug sector in Nigeria. According to the Director of the Agency and collaborated by many manufacturers “...lives have been saved and genuine local industries are booming, investors are also encouraged to invest in Nigeria and the incidence of fake drugs have come down from 41 percent to 16.7 percent, unregistered drug from 58 percent to 19 percent;...local industries are revived and they are booming. They were 70 in number before but they are now 150 and all of them are producing at high capacity, multinationals that left Nigeria in frustration are coming back, our drugs that were banned in the West Africa countries are also back there” (Newswatch Magazine 2007)
- 5) The problem of fake pharmaceuticals is not completely solved; it appears that some 17 per cent of essential generic medicines as a whole are routinely faked and also as much as 30 per cent of anti-malarials in the Nigerian market (PMG-MAN). One way of tackling this problem would be through the introduction of Radio Frequency Identification Technology for Logistics and Tagging.

ADDITIONAL INFORMATION (7) INFORMATION ON COMPETITION AND COMPETITORS

The 20 leading Nigerian Pharmaceutical Manufacturers by Total Revenue (2008)

Rank **Company**

Estimated annual revenue (US\$ million)

| | | |
|----|---|-----|
| 1 | GlaxoSmithKline Nigeria | 80 |
| 2 | May & Baker Nigeria Plc | 40 |
| 3 | Fidson Healthcare Plc | 40 |
| 4 | Emzor Pharmaceutical Industries Ltd | 40 |
| 5 | Juhel Nigeria Ltd | 40 |
| 6 | Evans Medical Plc | 30 |
| 7 | Swiss Pharma Nigeria Limited (SWIPHA) | 25 |
| 8 | Nigerian-German Chemicals Plc (NGC Plc) | 25 |
| 9 | Ranbaxy Nigeria Limited | 25 |
| 10 | Vitabiotics (Nig) Ltd | 20 |
| 11 | Neimeth International Pharmaceuticals Plc | 15 |
| 12 | Afrab-Chem Limited | 15 |
| 13 | Tuyil Pharmaceutical | 15 |
| 14 | Pharma-Deko Plc | 15 |
| 15 | Bentos Pharmaceutical Products Ltd | 15 |
| 16 | Mopson Pharmaceutical Industries Ltd | 15 |
| 17 | Morison Industries Plc | 15 |
| 18 | Daily-Need Industries Ltd | 15 |
| 19 | SKG-Pharma Ltd | 10 |
| 20 | Drugfield Pharmaceuticals Ltd | 10 |
| | Total Revenue | 505 |

Source: PMG-MAN

THE CHALLENGE

Assume you are Mr. Odu. What alternatives for ensuring the growth of JHL will you recommend to the founder and promoter of the company, taking into account the information presented in this case study?

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INSTRUCTOR'S NOTE
JUHEL NIGERIA LIMITED

CASE OVERVIEW

This case challenges students to develop alternatives for (within the next 12 months) very substantially increasing the revenues of a pharmaceutical company in Nigeria called Juhel Nigeria, Ltd. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Dr. Ifeanyi Okoye is the founder and promoter of Juhel Nigeria, Ltd., a pharmaceutical manufacturer and marketer in Nigeria. At its inception, the company focused on manufacturing and selling pharmaceuticals in Eastern Nigeria; now, however, the company sells its pharmaceutical products not only in Eastern Nigeria but all across Nigeria. While the company is already believed to be one of the top five pharmaceutical manufacturers in Nigeria, Dr. Okoye is eager to dramatically increase the pharmaceuticals-related sales and revenues of the company.

Additional data and information in the case include:

1. *Regarding Nigeria: Historical overview, a sample of recent demographic statistics from the World Bank, (and for benchmarking purposes, comparable statistics for the United States), plus information on the economy of Nigeria.*
2. *Regarding the company: Business model, current marketing strategy, current performance, and numerous factors impacting that performance.*
3. *Additional information: Information on the pharmaceutical-related activities and behaviors of members of the market the company has targeted, information about competing products and companies, and information about the pharmaceutical industry in Nigeria.*

INSTRUCTOR'S NOTE

As indicated in the case, the challenge faced by Mr. Ben Odu is to provide the founder of Juhel Nigeria Ltd with suggestions on how to substantially grow (within the next 12 months) the business. As regards lessons and/or information students can learn from this case, at least the following 4 points can be made:

- 1) The extent to which models and concepts developed economies can apply in less-developed economies such as Nigeria.
- 2) Students will be in the position to compare suggestions offered by them during class discussions to that provided by the management consultant, Mr. Ben Odu.
- 3) Students will also be in a position to find out that managers' decisions are influenced by the conceptual framework they tend to apply and that conceptual frameworks can lead to varying recommendations.

- 4) Background information on Nigeria and Juhel Nigeria Limited will go a long way to enrich the students' knowledge of the biggest economy in Africa with a GDP of \$501.9 billion (that is, well above the figures for South Africa and Ghana, two major democracies on the African continent that are one way or the other in competition with Nigeria).

DISCUSSION QUESTIONS

In the class, usually a student could be selected to lead the discussion. Three methods or approaches may sufficiently be used to deal with this case namely:

- 1) The students can be called upon after reading the case to provide details they have gathered from the case regarding information that touched on the country, the organization, individuals that played some roles in the case, etc. It is instructive to note the information emanating from the students, on the board. Such provides a template of "facts of the case" that may be found useful as the discussion progresses.
- 2) Another approach is to elect a student or the entire class members to address certain specific questions regarding the case. For this particular case we hereunder present such series of questions and relative comments to those questions.

Q#01: What is the main problem?

Students are likely to decide that the main problem is that Mr. Odu must develop a set of alternative strategies which have the potential (within the next 12 months) to substantially increase the revenues of the company. We reinforce the idea that this definition of the main problem is very consistent with the facts of the case.

Q#02: What kind of problem is this?

The students' response to this problem may be many reflecting their different views about the issue raised in the case. Undoubtedly, there is no one right answer. In any case two alternative approaches can be used as each seems relevant to the situation. The approaches are indicated as follows:

- 1) "Grow the Business"
- 2) Turnaround strategy

Q#03: For the problem identified above, what are the key variables and which expert postulated them?

For students who conclude that "growing the business" is the main problem, Ansoff (1957) suggests that the following are the key alternative approaches to growing a business:

- 1) Market penetration
- 2) Market development
- 3) Product development
- 4) Diversification

For students concluding that the main problem is the need for a “turnaround strategy,” Sheth (1985) suggests there are nine strategies which can be considered:

- 1) Entrenchment (that is, fight for a larger share of existing uses of the product or service in existing markets);
- 2) Consider selling to intermediaries;
- 3) Mandatory consumption (that is, ask government to pass a law requiring the use of a product or service);
- 4) Go international;
- 5) Broaden product horizons (that is, don’t sell just the computer; rather, sell the computer plus a full set of ancillary products and services);
- 6) In existing markets, identify new applications for products;
- 7) In existing markets, identify new usage situations;
- 8) Repositioning (that is, in new markets, identify new uses for products by changing the image of the product); and
- 9) Redefining markets (that is, in new markets, identify new uses for products by making functional changes in those products).

Q#04: WHAT DATA FROM THE CASE RELATE TO THE KEY VARIABLES:

The data the students suggest will depend on the problem they have identified. Students believing that the main problem is to “Grow the Business” will pay attention to the four variables in that concept; Appendix 1 shows the data from the case relating to each of those key variables. Similarly, students believing that the main problem is the need for “turnaround strategy” will focus on data from the case relating to those nine alternatives; Appendix 2 shows the data from the case relating to each of those alternative strategies.

Q#05 : WHAT ALTERNATIVE SOLUTIONS CAN BE IDENTIFIED?

It is an acceptable assumption that better decisions can be made if alternative solutions are identified and then one of them can be chosen. The student will be required to provide at least two alternative solutions and should be advised that providing only one possible solution can be considered inappropriate.

Q#06: WHICH OF THE ALTERNATIVE SOLUTIONS PROVIDED ABOVE DOES THE STUDENT/CLASS RECOMMEND AND WHY?

“Changing nothing” is unlikely to help Mr. Odu achieve his objective of identifying a set of alternatives for achieving the objectives set by the CEO of JHL, that is, to substantially increase the revenues of JHL within the next 12 months. Thus, students believing the main problem is the need to “grow the business” will recommend an approach which focuses (or re-focuses) on the four options identified by Ansoff (1957), that is, penetration, market development, product development, and diversification. Students believing the main problem is the need for a “turnaround strategy” are likely to recommend consideration of one or more of the alternatives identified by Sheth.

It turns out that the approach recommended by Mr. Odu was a “turnaround strategy” approach remarkably similar to the approach suggested by Sheth (1985). For additional information on what happened, please see the epilogue.

Q#07: WHAT NEGATIVES ARE ASSOCIATED WITH THE ALTERNATIVE CHOSEN BY THE CLASS AND/OR OTHER STUDENTS:

There are usually some negatives associated with the solution proposed. If the chosen alternative requires Juhel Nig. Ltd to source more raw materials or open up new locations for its products and/or even acquire more skilled labor, these imply increases in the cost of inputs and/or increases in marketing costs. The details relating to these aspects of information required to make decisions are absent in the case, consequently, the decision maker could be inexact in his or her suggestions

The third and final step in discussing the case with the students is to share with them what really happened and to discuss with them the implications of that outcome. As indicated above, as he thought about identifying alternatives to increase the revenues of JHL within the next 12 months, Mr. Odu’s thoughts turned to the turnaround strategy conceptual framework suggested by Sheth (1985). Based on the nine turnaround strategy alternatives suggested by Sheth (1985), Mr. Odu identified (and suggested to the CEO) the following alternatives for substantially increasing the revenues of JNL over the next 12 months:

- 1) Entrenchment-related recommendations. Based on the four entrenchment-related options identified by Sheth (segmentation, specialty markets, heavy users of the product, and multiple channels of distribution), Mr. Odu identified the following alternatives for increasing JNL revenues within the next 12 months:
 - a. Segmentation: From the full set of all direct and indirect consumers in Nigeria, identify the subsets (or segments) able and willing to purchase quality generic pharmaceuticals and committed to the idea that ongoing access to high quality generic pharmaceuticals will enhance the quality of life for themselves and/or their customers. Once these subsets of all direct and indirect consumers in Nigeria have been identified, conduct (with each group) a study of the perceived “value for money” offered by each major category of JNL products (that is, antibiotics, anti-infective cardiovascular, anti-diabetics, anti-malarial, cough and cold, vitamins and minerals, anxiolytics, anti-histamines, etc.), compared to the perceived “value for money” offered by competing products; for a model of the process which can be used to measure perceived “value for money,” see Gale (1994).
Based on the results of these studies:
 - i. For JNL products perceived by the above subsets of direct and indirect customer (that is, those able and willing to buy, and committed to the idea that high quality pharmaceuticals will enhance their quality of life) as offering high “value for money,” focus intense promotional effort on those products to the relevant subsets. Regarding these promotional efforts: the message could stress the enhanced quality of life theme, for individuals and for families. As for getting this message to members of the targeted subsets of all direct and indirect consumers: In addition to the

usual approaches used by JNL and other marketers of pharmaceutical products (that is, personal selling, advertising, and sales promotions), perhaps JNL could offer non-governmental organizations (NGOs) and/or faith-based and/or other organizations financial support in return for efforts by these organizations to help promote JNL and its products already perceived by direct and/or indirect customers as providing high “value for money.”

ii. For JNL products not perceived by the relevant subsets of direct and/or indirect customers as offering high “value for money”: Before launching promotions for these products, JNL should use the results of its “value for money” analyses to increase the perceived “value for money” for those products; once the perceptions of direct and/or indirect customers have improved, intense promotional efforts can be launched for these products as well.

b. Specialty markets: As indicated in the case, nearly 70% of Nigerians are poor, and many are not able to afford medical treatment. If there are ways in which JNL can help make treatment affordable (by reducing costs, by partnering up with corporate entities and/or NGOs and/or social groups) to the large percentage of Nigerians who are currently unable to afford pharmaceuticals (the case indicates that 55% of Nigerians cannot afford to purchase anti-malarials, 60% cannot afford TB treatments, and 80% cannot afford HIV/AIDS treatments), this should massively increase the demand for JNL products.

c. Heavy users of the product: From the full set of all direct and indirect consumers in Nigeria, identify the subsets (or segments) who are heavy users of pharmaceutical products. Once members of these segments (that is, the heavy user segments of direct and indirect users of pharmaceuticals) have been identified, focus an intense promotional effort on persuading members of these heavy user segments that ongoing access to the pharmaceuticals manufactured and/or marketed by JNL will improve the quality of life for themselves and/or their customers. For these groups (that is, heavy users of pharmaceutical products), schemes to provide savings and generate additional income could be pursued. It seems worth asking the question whether the “product” offered by JNL should be access to a bundle of health care-related products and services which includes not only the pharmaceuticals manufactured and/or marketed by JNL but also wraps around those pharmaceuticals a package of health care-related services designed to maximize the benefits and the quality of life of the direct and indirect customers. While it is not clear exactly what features this package should include, it seems likely that physical exams and/or provision of inexpensive but effective diagnostic tests should maximize the attractiveness of JNL products and services to heavy user segments of direct and/or indirect customers. Under this alternative, pharmaceuticals manufactured and/or marketed by JNL become a secondary product; the primary products are the packages designed to maximize the quality of life-related benefits of purchasing “products” offered by JNL.

d. Multiple channels of distribution: The case indicates that approximately 75% of expenditures on health are made by the private sector. So in

addition to efforts JNL makes to pursue opportunities with federal, state, and/or local governments, the company needs to vigorously pursue all possible private sector opportunities. The case does not indicate whether JNL has attempted to partner up with faith-based and/or social organizations; if JNL has not, it should immediately launch an effort to partner up (before competitors do so) with these sorts of organizations. In other words, JNL should look for opportunities to partner up not only with for-profit organizations but with not-for-profit organizations as well.

- 2) Sell through intermediaries-related recommendations. Under this heading, Sheth (1985) recommends that companies re-organize their selling efforts and utilize third parties to make sales. In the case of anti-malarials, perhaps JNL would be able to partner up with corporate bodies eager to protect the health (and productivity) of their workers; the idea would be to sell anti-malarials to corporate bodies who would distribute these treatments to members of their workforce, in an attempt to avoid the situation described in the case (that is, that the cumulative prevalence rate for malaria infection in most parts of the country is 100% where because (during the course of a year) every worker is falling ill, corporate productivity and profitability are low.
- 3) Mandatory consumption-related recommendations. As indicated in the case, the Federal Government of Nigeria (FGN) has passed a law outlawing the importation of 18 pharmaceutical products. Assuming that JNL produces some of the products on this list, and assuming that these JNL products are perceived by the relevant subsets of direct and indirect customers (that is, those able and willing to purchase high quality pharmaceuticals and believing that the use of high quality pharmaceuticals has potential to improve their quality of life) as offering high “value for money,” JNL could launch an initiative to capture as much of this business as possible.
- 4) Go international-related recommendations. Sheth indicates that sometimes a company which is failing can rescue itself by pursuing overseas opportunities. The case study lists nine pharmaceutical companies exporting to ECOWAS; JNL is not one of those nine. If JNL is not currently involved in international sales, perhaps this could be an opportunity for JNL. .
- 5) Broaden the product horizon-related recommendations. Sheth (1985) indicates that sometimes a company can rescue itself by adding ancillary products and/or services to their basic product and/or services. Perhaps there are some ways this could be done: One alternative (if JNL is not already doing this): Perhaps the company could begin organizing and offering health care-related events and experiences for local community groups all across Nigeria. Assuming for example that JNL produces artemether/lumefantrine and/or artesunate/amodiaquine (the treatments of choice for malaria, everywhere in Nigeria): The company could organize malaria prevention and treatment sessions with social groups in villages all across Nigeria; the theme of such sessions could be “_____ (the name of a child from that village who died of malaria recently) didn’t have to die.” Another possibility here, if JNL is not already doing it, would be to provide (on each pack of pharmaceuticals) a phone number the buyer can call, to verify the fact that this particular pack of pharmaceuticals is the real thing, not a fake.

There are undoubtedly a number of other ways in which JNL could broaden the range of products/services it is offering to direct and/or indirect consumers, by wrapping one or more health care-related services (designed to maximize quality of life benefits) around the products offered by JNL.

- 6) New situations-related recommendations. Sheth (1985) suggests that sometimes a business can be turned around by putting an existing product or service into new usage situations. For the sorts of pharmaceutical products which JNL manufactures (i.e. treatments for various illnesses), it is not so clear that there might be new situations in which use of some products might be appropriate.
- 7) New applications-related recommendations. Sheth (1985) suggests that sometimes a business can be turned around by putting products and/or services to work in new and different applications. JNL already manufactures the sorts of small doses (81mg) of aspirin which individuals elsewhere in the world take once a day, just to enhance their health and/or quality of life; it seems possible that there may be other products JNL produces which could also be promoted to individuals as something which can be used not only to treat medical problems but also as something which could and/or should be taken daily, so as to enhance health and/or quality of life.
- 8) Repositioning-related recommendations. According to Sheth, this strategy involves redefining a product's image into new usage situations within the same general application context. For the sorts of pharmaceutical products which JNL manufactures (i.e. treatments for specific illnesses), it is not so clear that there might be new situations in which use of some products might be appropriate.
- 9) Redefine markets-related recommendations. Sheth identifies four alternative approaches to using this strategy. Those four approaches, and comments relating to them, are as indicated below:
 - a. Generic to specialty products: For JNL products perceived by direct and/or indirect customers as offering high "value for money": If JNL has not already created its own brand (that is, a manufacturer brand), the company could create its own brand and then promote that brand vigorously to direct and/or indirect customers.
 - b. Primary to secondary products: As mentioned earlier, it seems possible that pharmaceuticals produced by JNL could be re-positioned (and then promoted) to be part of a bundle of products and services designed to enhance health and/or improve the quality of life for individuals and their families.
 - c. Industrial to consumer products: Many of the pharmaceuticals JNL produces (for example, the OTC products) are already consumer products; however, depending on the rules and regulations, perhaps it would be possible to convert some prescription (that is, "industrial," in the sense that they are sold to hospitals and/or pharmacies and/or other corporate bodies) products to OTC products.
 - d. Consumer to industrial products: It seems possible that JNL could approach corporate bodies and offer to sell them bulk amounts of products such as anti-malarials. The unique selling proposition for such a move would be the idea that by providing their workers with anti-malarials, the companies would reduce the incidence of malaria (100% probability that a worker will come down with malaria at least once, during the course of a year) to some much lower level and, in the process, increase the productivity and profitability of that company. Another possibility would

be for JNL to pursue WHO pre-qualification status, with the idea that if JNL is successful, it would then be able to tender for international procurement opportunities

CONCLUDING COMMENTS

The above comments describe the alternatives identified by (and recommended by) Mr. Odu to achieve the objectives set by the CEO of JHL. Readers may be interested in the answers to the following questions:

Question #1: Of the alternatives suggested by Ben Odu which one did the CEO of Juhel Nigeria Limited find particularly interesting and/or useful?

ANSWER: The CEO of JNL indicates that both the suggestion regarding “going international” (that is, exploring the possibility of exporting pharmaceuticals into other ECOWAS markets) and the suggestion regarding going for WHO prequalification are especially interesting.

Question #2: Have any of the alternatives suggested by Mr. Ben Odu been implemented? If so, which alternatives were implemented and what results have been achieved so far?

ANSWER: JNL had (in the past) tried to sell into ECOWAS markets but had encountered regulatory problems and issues. The products there are sold through 3rd party exporters; there may be ways forward around this issue. JNL is still working with NGOs and similar organizations (including the Crown Agents) and the prospects for success are very encouraging.

Question #3: Are there other alternatives (that is, alternatives other than those suggested by Mr. Odu) which have been put into play? If so, what are these additional alternatives and what results have been achieved so far?

ANSWER: An additional alternative is to develop incentives for certain JNL products, so as to motivate the salespersons. For example, a certain percentage of the profit could be given when a salesperson sells a given quantity; historically incentives like this have generated increases in sales.

QUESTION #4: Overall, does it appear likely that Juhel Nigeria Limited will achieve its objectives, that is, to substantially increase its revenues within the next 12 months?

ANSWER: While it is still early days, a substantial increase in revenues within the next 12 months could still be possible.

QUESTION #5: Are there any other comments and/or observations which the CEO would like to make regarding either the current situation and/or prospects for the future?

ANSWER: Because of regulatory considerations governing the manufacturing and marketing of pharmaceuticals, some of the suggestions made by Mr. Odu may not be possible. Regarding the possibility of “new applications,” for example: Because getting approval to use a pharmaceutical in a new application is likely to require very costly (in terms of both time and money) specialized trials and/or research, medium-sized companies like JNL may not be able to afford to invest the time and/or money which pursuing these sorts of alternatives would entail.

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APPENDIX 1

CASE DATA RELATING TO THE KEY VARIABLES IN ANSOFF'S MARKET GROWTH MODEL (that is, the cross-classification of "products" and "markets")

Product-related data (existing products) from the case:

As indicated earlier, the major pharmaceutical products on offer by the company include: Antibiotics and anti-infective drugs; analgesics, steroids and antispasmodics; vitamins, minerals and hematics; antacids, cough cold and catarrh; cardiovascular, diuretics, antihistamine and anxiolytics; anti-malaria, anti-diabetics and anti-helminthics; and infusion products which include also infusion water, ear and eye drops, etc.

These pharmaceutical products are meant to deal with common diseases that plague not only Nigeria but also tropical Africa in general. In other words, they are meant to serve markets not only in Nigeria but also beyond the boundaries of Nigeria.

Product-related data (new product opportunities) from the case: In addition to increasing the percentage of treatments for malaria, tuberculosis, and HIV/AIDS produced locally, there is an opportunity to manufacture and market treatments for "neglected childhood diseases."

Market-related data (existing markets) from the case:

Regarding private sector sales: Many pharmaceutical companies in Nigeria have adopted selective distribution strategies, that is, they appoint selected drug stores located in different cities of Nigeria to market their products to open market and other retailers. In such a system, the selected drug stores are the entities who sell the products of the manufacturer to end consumers. While Juhel Nigeria Ltd uses the same method, the company also sells directly to hospitals and clinics. To service its growing numbers of retailers, JNL currently maintains depots in cities such as Lagos, Onitsha, Aba, Port Harcourt, and Abuja. It seems worth noting that in the private sector, and as indicated above, manufacturers and importers have their own distribution channels and can sell to wholesalers, retailers and hospitals. One implication of this system is that medicines and medical supplies are often sold by unregistered and unlicensed premises and, in some cases, by non-pharmacists.

Regarding sales to government, the following observations can be made:

1) The Government (including Federal, State and Local Government Areas) supplies pharmaceutical products to its various health institutions. The Federal Government is responsible for policy formulation and technical guidance to all healthcare providers. In addition, the Federal Government supplies drugs and medical supplies to tertiary healthcare centers (University Teaching Hospitals) and Federal Medical Centers located in all 36 states. State governments are responsible for providing healthcare to state hospitals as well as offering technical support to the Local Government Areas (LGAs). The LGAs take care of healthcare services at primary healthcare level. As indicated earlier, the private sector, traditional health practitioners and non-governmental agencies provide healthcare services at all three levels of the healthcare system.

2) At one time, under a government initiative to deliver health care to Nigerian citizens, JNL was involved in the contract production of drugs for government.

3) Nigeria's HIV/AIDS supply chains – many of which include separate

procurement, warehousing, and distribution systems – are owned and operated by various federal, state, nongovernmental and faith-based stakeholders with oversight from the Federal Ministry of Health (FMoH) and the National Agency for the Control of AIDS (NACA).

Market-related data (new market opportunities) from the case:

- 1) Increases in purchasing power should increase the percentage of individuals able to afford to purchase medical care including pharmaceuticals.
- 2) There is an opportunity to increase exports within (or perhaps even outside) ECOWAS.
- 3) The initiative by the Federal Government of Nigeria (FGN) to establish a National Health Insurance Scheme (that is, to provide universal healthcare) offers the prospect of a huge increase in funding for medical services and supplies.

APPENDIX 2

DATA FROM THE CASE RELATING TO KEY VARIABLES IN SHETH'S TURNAROUND STRATEGY MODEL

- 1) Entrenchment (that is, fight for a larger share of existing uses of the product or service in existing markets): The case indicates that the vision of JNL Nigeria Ltd. (hence, JNL) is to “product cost-effective generic products to fill the gap left by multinational companies operating in Nigeria.” In other words, the case indicates that the ways JNL fights to win market share away from competitors include: 1) Offering generic versions of various branded pharmaceuticals; and 2) Offering products which fill gaps not covered by multinational pharmaceutical companies operating in Nigeria.
- 2) Consider selling to intermediaries: The case indicates that JNL already sells both to direct customers (wholesalers, large retailers, hospitals, clinics, pharmacists, and doctors) but also (through the direct customers) to indirect customers (small retailers, market ladies, and individual customers). The case also indicates that JNL already sells through both private sector and government channels of distribution. Finally, the case indicates that at one time JNL was involved in the contract production of drugs for government.
- 3) Mandatory consumption (that is, ask government to pass a law requiring the use of a product or service): It seems unlikely that any governmental entity will pass a law requiring customers to purchase pharmaceuticals from JNL.
- 4) Go international: The case indicates that several pharmaceutical companies in Nigeria (not including JNL) are selling their products throughout the ECOWAS region.
- 5) Broaden product horizons (that is, don’t sell just the computer; rather, sell the computer plus a full set of ancillary products and services): The case does not indicate whether JNL is selling “products” which include both a pharmaceutical and services relating to that pharmaceutical.
- 6) In existing markets, identify new applications for products: The case does not address this issue; however, given the rules and regulations around the prescribing of pharmaceuticals, it seems likely that getting an approval for a new application for a particular pharmaceutical might be quite a lengthy and complicated process.
- 7) In existing markets, identify new usage situations: The case does not address this issue; however, given the rules and regulations around the prescribing of pharmaceuticals, it seems likely that getting an approval for a new use for a particular pharmaceutical might be quite a lengthy and complicated process.
- 8) Repositioning (that is, in new markets, identify new uses for products by changing the image of the product): Again, while the case does not address this issue, given the rules and regulations around the prescribing of pharmaceuticals, it seems likely that getting an approval for a new use for a particular pharmaceutical would be quite a lengthy and complicated process.
- 9) Redefining markets (that is, in new markets, identify new uses for products by making functional changes in those products): Again, while the case does not address this issue, given the rules and regulations around the prescribing of pharmaceuticals, it seems likely that getting an approval for a new use for a particular pharmaceutical could be quite a lengthy and complicated process.

BIG AL'S PUMPS: BIG AL NEEDS YOUR HELP

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CASE DESCRIPTION

The following is an accounting case designed to integrate financial accounting and internal control principles with a practical business environment so that the relationships can be analyzed by accounting students. The case is designed for junior and senior level accounting students. The minimum level of accounting knowledge should be the completion of Financial Principles and the first semester/quarter of Intermediate Accounting so that students have been exposed to financial accounting and internal control rules. The case was created to fill a need of a large number of students who, even at the senior level, had not worked with scenarios sufficient to provide experience with “big picture” accounting and business issues.

Small businesses, especially as they begin operations, may employ relatively few employees and may experience difficulty with internal controls, including segregation of duties among employees, providing an environment contributing to employee fraud. The case provides insights at both fundamental and deeper levels on how financial information can contain indicators, i.e. danger signs, of which accountants and other users of financial information should be aware. Students must be able to analyze financial data based on relationships contained in the financial data and comparisons with other financial and business data to ascertain the accuracy of the financial statements and their component parts.

The suggestion for the time required for solution by students is two hours for requirement one and another two hours for requirements two and three together for a total of four hours total for the three requirements. The three parts of the case can easily take another four hours for the instructor to discuss in class. Because of the time required to complete each part it is recommended the parts be assigned separately. It is also recommended part one be covered first as it is the most time consuming and requires the most comprehensive analysis of the three parts.

CASE SYNOPSIS

Al B. Seeinyou was employed for many years in the agricultural pump sales industry. Two years ago he started his own business, consisting of the sale of pumps to agricultural companies in the central valley of California. Big Al's Pumps just concluded its second year of operations and is experiencing real-world business and financial issues. The issues are broken down in three parts, consisting of requirements.

The first requirement of the case is the analysis of financial information, including two years of comparative financial information, in order to identify current year accounts that should be further analyzed because the account balance may not be accurate. The identification of accounts for further analysis is based on information provided in the case. The information includes inconsistencies between related accounts in the current year, the comparison of the current year account balances of certain accounts to the account balance of the same account in

the prior year, and the relationship of current year's accounts to other business and financial information provided in the case.

The second requirement of the case is the analysis of the case's financial and business related information to determine what fraudulent schemes may potentially have been taking place by the employees. Small businesses with relatively few employees have an inherent disadvantage with regard to the application of appropriate internal control because of the difficulty segregating duties properly. This case provides an opportunity for students to apply some basic concepts of internal control to a business that contains weaknesses that occur in real world situations.

The third requirement of the case provides additional facts detailing a theft of cash by one of the employees who covers the theft by lapping accounts receivable. Students must first determine the financial effects of the theft on specific elements of the financial statements. After determining the effects of the theft on the specific elements of the financial statements students must compare those financial effects of the theft of cash and lapping activity to the financial information provided in the case. The comparison provides evidence whether the actual financial information confirms or contradicts the solution to the first part of the requirement.

INTRODUCTION AND FACTS

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

Based on his knowledge of the local pump market, Big Al knew the local pump retailers maintained a full line of pumps and received multi pump orders from their best customers, the large, local agricultural companies. The retailers gave generous discounts and excellent customer service to these large volume customers. The pump retailers also received orders from small and medium sized customers but provided minimal customer service and either small or no discounts to them because they ordered relatively few pumps.

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

Big Al located and leased commercial space for Big Al's Pumps. He signed the lease agreement October 1, 2011 with the sixty month lease period beginning January 1, 2012 and

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

Employees of Big Al's Pumps

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

Little Al—Big Al hired his son, Al B. Seeinyou, Jr., known as Little Al. Little Al has had trouble getting and keeping a regular job. Big Al thought all Little Al needed was some direction so he hired Little Al and gave him the title of Store Manager and a weekly wage of \$800. Little Al was put in charge of sales at the store, both over-the-counter sales and taking telephone orders. Big Al's Pumps receives very good walk-in traffic because the area where the store is located contains other agricultural supply stores. At the end of every day Little Al gives the bookkeeper, Martha, the checks and cash from the sales to customers who have dropped in the store to buy pumps. Approximately one-half of the walk-in customers pay for the pump(s) with cash. Little Al fills out a sales invoice for each sale.

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

Martha—during the interview with Henry, Big Al mentioned that he was also looking for someone who could do the books, do all the banking, pay the bills, and all other office related duties. Big Al joked with Henry that he knew nothing about accounting, and had never even prepared a bank-reconciliation, that he wasn't even sure what a bank-reconciliation was. Henry told Big Al that his mother-in-law had been a bookkeeper for the last 25 years and he had heard her talk about doing everything Big Al wanted. Henry said Martha was available and would

send Martha by the next morning. When Big Al got to the store about ten minutes before 8 the next morning Martha was waiting outside the front door. Big Al immediately thought Martha looked very much like his deceased mother and was very impressed with her apparent promptness and motivation. During the interview Big Al didn't understand enough about accounting or what needed to be done in the office so he asked Martha what she had done on her previous jobs. Martha's answers assured him that she could take care of all the accounting and banking and whatever other office related functions were required. Martha opens all the mail, makes the bank deposit slips from the customer checks received in the mail and checks and cash received by Little Al from walk-in customers. Martha pays all the bills, with either her or Big Al signing the check. Martha performs all accounting functions, including preparing the financial statements, using QuickBooks software. Big Al hired Martha at \$600 per week.

Accounting Policies and Procedures

Martha performs all the accounting functions required for Big Al's Pumps. She also prepares all the financial statements for all purposes, including the bank. Martha told Big Al she applied the accrual method of accounting using QuickBooks and applied other accounting rules, as follows:

Cash—all cash received by Big Al's Pumps is deposited into the Cash-Operating account. Martha opens all the incoming mail, fills out a deposit slip, and takes the deposit to the bank. She told Big Al she is too busy to go to the bank every day so the deposit sometimes contains more than a single day's receipts. She told Big Al the deposit usually contains less than a week's receipts. Martha also writes the checks for the bills from Big Al's vendors and mails them out. She sometimes pays bills of small amounts with the cash receipts. She told Big Al paying bills with cash receipts doesn't make any difference because the revenue and expense just cancel each other out. Martha keeps track of the balances in all three cash accounts and makes transfers to and from the Cash-Operating account, the Cash-Payroll account, and the Cash-Money Market accounts as needed. Martha receives the bank statements in the mail monthly and prepares the bank reconciliations for the three cash accounts. After Martha prepares the bank reconciliations she puts them in her file cabinet.

Accounts Receivable/Bad Debts Expense—all Sales are recorded on a Sales Invoice form. The form was designed by Martha and includes the sales detail such as types of pump sold and price per pump along with the customer name and other detail. Each Sales Invoice has a box at the top right of the form so whoever is making the sale, whether an employee or Big Al, can initial it. Martha believes that it is more important to know who made the sale than keeping track of the sales invoices with any numbering system. Whoever makes the sale makes a copy of the sales invoice for the customer if they want one. The collection terms for sales on account are 1/10, net 30. Martha told Big Al most customers pay within ten days and take the discount. She added that the customers who don't get the cash discount pay within 30 days, with only a few customers who end up not paying their bill. The allowance method, using the percent of accounts receivable method, was applied for the estimation of bad debt expense. Martha told Big Al she wrote off uncollectible accounts totaling \$5,636 during 2012 and \$7,893 during 2013.

Inventory—the FIFO method was applied for the cost flow assumption. Big Al makes sure the order sizes are large enough to receive quantity discounts from the manufacturer. Big Al estimates the order size for each type of pump was enough to last for six to eight weeks. When Henry informs Big Al they are low on a particular pump Big Al calls in the order and when it's ready, usually in a day or two, Henry picks it up in the company van. Big Al talked to Henry about the two of them taking a physical inventory at December 31, 2012 and 2013 but Henry said he was too busy.

Property, Plant, and Equipment—during 2012 Big Al purchased two company vehicles, a van for the pick-up and delivery of pumps and a small truck for himself. Both vehicles will be used one hundred percent for business purposes. He also purchased a small fork lift for the warehouse and office equipment including three desks, two computer work stations, and filing cabinets. Big Al also installed some leasehold improvements such as storage shelves in the warehouse and a sales counter and two display cases in the sales room. Depreciation is computed using the straight line method over various years depending on the type of asset. Big Al neither purchased nor disposed of any long lived assets during 2013.

Accounts Payable—the large suppliers of pumps that Big Al's buys from offers payment terms of 1/10, net 30. Big Al instructed Martha to pay all the bills immediately as they are received and to take the cash discount when available. He thought it was a good idea that payments to vendors and employees be signed only by him or Martha. Martha reassured Big Al regularly that she was paying all the bills as they were received and was taking all the cash discounts.

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

Al B. Seeinyou, Capital—to start the business Big Al invested \$100,000. He didn't withdraw any cash from the business during 2012 or 2013, instead living off his savings. Neither has he made any additional capital contributions during 2012 or 2013.

Sales and Cash Collections—sales were approximately evenly split between cash sales and sales on account. Cash collections, whether from current sales or from accounts receivable, are deposited into the Cash-Operating account. Martha said sales increased only slightly from January through December 2012 and increased steadily during 2013.

Wages—all employees are paid for a five-day work week and paid weekly on Friday for the Monday through Friday work week just ended. As of December 28, 2012, a Friday, there were 52 full weeks paid during 2012. Employees were paid Friday, December 28, 2012 and again Friday, January 4, 2013, both checks for a full week. Employees were paid Friday, December 27, 2013 and again Friday, January 3, 2014, both checks for a full week.

Big Al's Pumps--Exhibit 1--Financial Information for 2013 and 2012

| Account | At 12/31/2013 | At 12/31/2012 |
|---|-------------------|-------------------|
| Cash-Operating | 28,000 | 29,365 |
| Cash-Payroll | 1,000 | 1,000 |
| Cash-Money Market | 62,899 | 105,734 |
| Accounts Receivable | 77,633 | 16,322 |
| Allowance for Doubtful Accounts | (18,439) | (1,098) |
| Inventory | 89,076 | 23,117 |
| Prepaid Insurance | 13,000 | 3,245 |
| Prepaid Rent | 4,000 | 4,000 |
| Current Assets | 257,169 | 181,685 |
| Equipment & Leasehold Improvements | 151,905 | 151,905 |
| Accumulated Depreciation | (49,307) | (18,397) |
| Total Assets | 359,767 | 315,193 |
| | | |
| Accounts Payable | 33,101 | 2,319 |
| Wages Payable | 840 | 420 |
| Rent Payable | 15,965 | 10,919 |
| Interest Payable | 15,324 | 6,998 |
| Current Liabilities | 65,230 | 20,656 |
| Long Term Debt | 200,000 | 200,000 |
| Al B. Seeinyou, Capital | 94,537 | 94,537 |
| Total Liabilities and Owner's Equity | 359,767 | 315,193 |
| | <u>Year Ended</u> | <u>Year Ended</u> |
| | <u>12/31/2013</u> | <u>12/31/2012</u> |
| Sales Revenue | 618,235 | 501,967 |
| Sales Returns and Allowances | (18,776) | (4,267) |
| Sales Discounts | (7,332) | (2,497) |
| Net Sales | 592,127 | 495,203 |
| Cost of Goods Sold | (323,856) | (254,693) |
| Gross Profit | 268,271 | 240,510 |
| Wages Expense | (108,200) | (109,620) |
| Rent Expense | (64,000) | (58,919) |
| Insurance Expense | (13,000) | (12,788) |
| Depreciation Expense | (21,482) | (18,397) |
| Utilities Expense | (23,000) | (25,214) |
| Payroll Tax Expense | (8,538) | (8,770) |
| Bad Debts Expense | (8,500) | (6,734) |
| Interest Expense | (6,000) | (6,998) |
| Miscellaneous Expense | (8,000) | (182) |
| Interest Income | 0 | 1,649 |
| Income Tax Expense | (6,000) | 0 |
| Net Income/(Loss) | 1,551 | (5,463) |

INSTRUCTORS' NOTES

CASE DESCRIPTION

All three requirements of the case can be used relatively early in a forensic accounting course, or any other accounting course, as exams, in class assignments, homework, or extra credit assignments. The three requirements can be used separately. All three requirements have been student tested in a senior level forensic accounting course.

When scheduled relatively early in a Forensic Accounting course, the case has improved student learning by providing an opportunity to review financial accounting and internal control rules. Even senior level accounting students benefit from applying the rules to a big picture scenario. The application of the rules to financial and internal control issues in a practical setting enables students to be better equipped to solve the advanced problems that are encountered later in the Forensic Accounting course. When combined with lecture, the case helps students get up-to-speed with their understanding of financial accounting, internal control, and the relationship between the two sets of rules.

The case can be used in any accounting course after basic financial accounting topics, including internal control, have been covered. It is beneficial for students to have a sufficient grasp of financial accounting and internal control rules. All three requirements of the case have been student tested in a Forensic Accounting course after the applicable topics were reviewed in class. The individual requirements, or the entire case, can be assigned either as an in-class assignment, group project, take home assignment, or exam.

In the Forensic Accounting course students were given two hours in class to solve requirement one and another two hours for requirements two and three together for a total of four hours total in class time for the three requirements. The student in-class time is divided in half, with the first half consisting of each student working independently and the second half working in an informal group of three or four students. The three requirements of the case can easily take another four hours for the instructor to discuss in class. Because of the time required to complete each requirement it is recommended the requirements be assigned separately. It is also recommended requirement one be covered first as it is the most time consuming and requires the most comprehensive analysis of the three requirements.

The case consists of factual information for a business entity and three requirements suitable for solution by students in accounting courses. Requirement one is the identification of current year accounts that should be further analyzed because the account balances may not be correct. Requirement Two asks students to analyze financial and related information to identify fraudulent schemes that could potentially be perpetrated by employees. Requirement Three asks students to identify the effects on specific accounts and elements of financial statements based on additional facts provided that detail a theft of cash perpetrated by an employee.

CASE OVERVIEW

Al B. Seeinyou was employed for many years in the agricultural pump sales business. Two years ago he started his own business, consisting of the sale of pumps to agricultural

companies in the central valley of California. Big Al's Pumps just concluded its second year of operations and is experiencing real-world business and financial issues. The issues are broken down in three parts, consisting of requirements.

The first requirement of the case is the analysis of financial information, including two years of comparative financial information, in order to identify current year accounts that should be further analyzed because the account balance may not be accurate. The identification of accounts for further analysis is based on information provided in the case. The information includes inconsistencies between related accounts in the current year, the comparison of the current year account balances of certain accounts to the account balance of the same account in the prior year, and the relationship of current year's accounts to other business and financial information provided in the case.

The second requirement of the case is the analysis of the case's financial and business related information to determine what fraudulent schemes may potentially have been taking place by the employees. Small businesses with relatively few employees have an inherent disadvantage with regard to the application of appropriate internal control because of the difficulty segregating duties properly. This case provides an opportunity for students to apply some basic concepts of internal control to a business that contains weaknesses that occur in real world situations.

The third requirement of the case provides additional facts detailing a theft of cash by one of the employees who covers the theft by lapping accounts receivable. Students must first determine the financial effects of the theft on specific elements of the financial statements. After determining the effects of the theft on the specific elements of the financial statements students must compare those financial effects of the theft of cash and lapping activity to the financial information provided in the case. The comparison provides evidence whether the actual financial information confirms or contradicts the solution to the first part of the requirement.

REQUIREMENTS AND ANSWERS

Big Al's Pumps—Requirement1

Big Al has come to you because of your extensive accounting experience and education. Read the 'Introduction and Facts' for Big Al's Pumps and 'Big Al's Pumps—Exhibit 1---Financial Information for 2013 and 2012'. Big Al is emphatic that Big Al's Pumps performed better during 2013 than the financial information indicated. Based on the information included in the Introduction and Facts and Exhibit 1---Financial Information for 2013 and 2012, provided by Martha to Big Al, identify specific 2013 accounts you want to analyze. Limit your answers to **2013 accounts only** (you may want to use 2012 information in your analysis of 2013 but limit your comments to 2013 accounts. For the purpose of this case assume the 2012 information is correct). Be specific about the factor(s) you identify that makes you want the additional information. Do not comment on internal control deficiencies and disregard information provided in other Big Al's Pumps cases. The Financial Information for 2013 and 2012 (See Exhibit 1) is post-closing. Assume the balance in the Equipment & Leasehold Improvements account of \$151,905 is fairly stated at 12/31/2013 and 12/31/2012. Assume the depreciation

expense account balances of \$21,482 for 2013 and \$18,397 for 2012 were computed correctly. Assume the bad debt expense account balances of \$6,734 for 2013 and \$8,500 for 2012 were computed correctly. Please organize your answers using the format, as follows:

Account-----Describe the Reason(s) you want the Additional Information-----

Big Al's Pumps--Solution for Requirement 1

Account-----Describe the Reason(s) you want the Additional Information-----

Cash (three accounts)—the balances of the three cash accounts have decreased from a total of \$136,099 at 12/31/2012 to \$91,899 at 12/31/2013. An analysis of bank reconciliations, along with copies of the appropriate bank statements, may provide more reasons for requesting additional information. Similarly, the analysis of a Statement of Cash Flows for the year ended 12/31/2013 may identify additional reasons to request information that would help explain the decrease in cash from 12/31/2012 to 12/31/2013.

Accounts Receivable—the 12/31/2013 Accounts Receivable balance of \$77,633 (See Exhibit 1, Financial Information for 2013 and 2012) appears to be relatively large. The \$77,633 balance is a substantial increase from the 12/31/2012 balance of \$16,322. The increase in the Sales Revenue account from 2012 to 2013 was not sufficiently large to explain the large increase in the accounts receivable account. The average monthly 2013 sales on account (one-half of total sales are sales on account) of approximately \$25,760 ($\$618,235/2 = \$309,118/12 = \$25,760$) represents an upper limit of estimated Accounts Receivable collectible at any one time during the year because collection terms are 1/10, n30 and Martha said most customers take the cash discount by paying within ten days and those that don't take the discount pay within thirty days. The recorded balance for Accounts Receivable of \$77,633 substantially exceeds the estimated balance of \$25,760, so should be analyzed.

Allowance for Doubtful Accounts--according to the Requirements of the case Martha computed the bad debts expense amount of \$6,734 for 2012 and \$8,500 for 2013 correctly. According to the Introduction and Facts of the case Martha wrote off specifically uncollectible accounts in the amounts of \$5,636 during 2012 and \$7,893 during 2013 so the Allowance for Doubtful Accounts balance at 12/31/2013 should be \$1,705 ($\$6,734 - \$5,636 + \$8,500 - \$7,893 = \$1,705$) as compared to the \$18,439 balance at 12/31/2013 that is on Exhibit 1, Financial Information for 2013 and 2012. Because of the discrepancy the account should be analyzed.

Inventory—the 12/31/2013 Inventory balance of \$89,076 (See Exhibit 1, Financial Information for 2013 and 2012) appears to be relatively large. The \$89,076 balance is a very substantial increase from the 12/31/2012 balance of \$23,117. The average monthly Cost of Goods Sold for 2013 is \$26,988 ($\$323,856/12 = \$26,988$). According to the Introduction and Facts of the case Big Al keeps enough of each type of pump to last no more than 8 weeks. So even if inventory is at the maximum quantity for each pump, so that there is 8 weeks of each pump on hand at 12/31/2013 the inventory would be estimated at \$53,976 (\$26,988 per month for two months). The \$89,076 Inventory balance reported is appreciably larger than the estimated balance of \$53,976 (a maximum estimate), suggesting further analysis.

Prepaid Insurance/Insurance Expense—the Prepaid Insurance balance of \$13,000 at 12/31/2013 is the same amount as Insurance Expense for 2013 compared to \$3,245 prepaid at

12/31/2012 and \$12,788 expense for 2012. Also, it is interesting that the \$13,000 amounts for both accounts are account balances with a multiple of a thousand dollars.

Accumulated Depreciation/Depreciation Expense—the balance of the Accumulated Depreciation account at 12/31/2013 should equal \$39,879 (2012 depreciation of \$18,397 and 2013 depreciation of \$21,482 = \$39,879). The Introduction and Facts and Requirement sections tell us Depreciation Expense for both years was computed correctly and there were no additions or dispositions of Equipment or Leasehold Improvements during 2013. The correct balance of the Accumulated Depreciation account should be \$39,879 but the recorded balance in Exhibit 1, Financial Information for 2013 and 2012 is \$49,307. Because there is a substantial discrepancy between the actual and recorded amounts the account should be analyzed.

Accounts Payable—according to the Introduction and Facts of the case Big Al has directed Martha to pay all the bills immediately as they are received so an Accounts Payable balance of \$33,101 at 12/31/2013 seems large enough to warrant further investigation. Also, the 12/31/2013 balance is substantially larger than the Accounts Payable balance of \$2,319 at 12/31/2012. The 12/31/2013 balance of \$33,101 should be analyzed.

Wages Payable/Wages Expense—according to the Introduction and Facts of the case the three employees were paid \$109,200 (a combined \$2,100 per week for 52 weeks is \$109,200). Wages Expense of \$108,200 for 2013 appears to be a lesser amount than it should be and should be analyzed. The Wages Payable account appears to be correctly stated at 12/31/2013 as it includes two day's pay, December 30 and 31.

Rent Payable/Rent Expense—according to the Introduction and Facts of this case rent is \$4,000 per month and 2 percent of gross Sales Revenue. The amount of 2013 Rent Expense is \$60,365 (12 months at \$4,000 per month = \$48,000 plus \$12,365 (\$618,235 at 2 percent = \$12,365) for a total of \$60,365). The Rent Expense account is \$64,000, a difference of \$3,635. An analysis should explain how the \$64,000 was arrived at. The balance in the Rent Payable account at 12/31/2013 of \$15,965 appears to be incorrect if the monthly rent has been timely paid during the year. The correct balance in the Rent Payable account at 12/31/2013 should be \$12,365 according to the above computation.

Interest Payable/Interest Expense—the interest rate is stated in the Introduction and Facts of the case at 6 percent per year. Six percent of \$200,000 (the balance in the Long Term Debt account for all of 2013) would provide an estimate, using a simple interest calculation, of interest expense for the year of \$12,000 as compared to \$6,000 of Interest Expense in Exhibit 1, Financial Information for 2013 and 2012. The \$15,324 balance in the Interest payable account should be analyzed to determine how it was computed, especially because of the loan agreement requires interest be paid annually.

Al B. Seeinyou, Capital—the ending balance of \$94,537 at 12/31/2012 is a correct balance as Big Al initially invested \$100,000 in the business and according to the Financial Information for 2013 and 2012 the Net Loss for the year ended 12/31/2012 was \$5,463. It was stated in the Introduction and Facts that the balances were post-closing and Big Al neither made additional capital contributions nor made capital withdrawals during 2013. The Capital account balance at 12/31/2013 should be \$96,088 (\$94,537 + \$1,551). Even if the Net Income of \$1,551 for year ended 12/31/2013 is incorrect because of incorrect revenues and/or expenses it should be

added to the 12/31/2012 Capital account balance to determine the post-closing 12/31/2013 Capital account balance.

Sales Returns and Allowances—the \$18,776 amount for the year ended 2013, which is 3.03 percent of 2013 gross Sales Revenue, appears to be relatively large, especially in comparison to the 2012 amount of \$4,267, which is less than 1 percent of 2012 gross Sales Revenue. The reasons for the returns and allowances could be because of faulty ordering from the manufacturer, faulty receipt of phone orders from customers, delivering the wrong pumps, and/or faulty pumps. These “legitimate” reasons for returns and allowances are potentially correctible once the reasons are understood. However, an account balance that is affected by a debit entry could also result from an illegitimate reason, such as used to disguise the theft of cash. Because of the above, the account should be analyzed for both business, financial, and potential employee fraud reasons.

Sales Discounts—according to the Introduction and Facts of the case, sales on account for 2013 are approximately \$309,118 (one-half of gross Sales Revenue of \$618,235 = \$309,118). The payment terms are 1/10, net 30 so if a cash discount was received on all credit sales the cash discount would be \$3,091 (one percent of \$309,118). The recorded amount of \$7,332 exceeds the estimated amount of \$3,091 by more than \$4,000 and is double the estimated amount.

Cost of Goods Sold/Purchase Discounts—the 2013 Cost of Goods Sold amount of \$323,856 is 52.4 percent of gross Sales Revenue compared to the 2012 amount of \$254,693 and 50.7 percent. The 1.7 percent increase in Cost of Goods Sold from 2012 to 2013 is an increase suggesting the account should be analyzed. According to the Introduction and Facts Big Al’s Pumps is entitled to a one percent discount on its purchase price for the timely payment of pumps. There is not a separate Purchase Discounts account in Exhibit 1, Financial Information for 2013 and 2012, so there is insufficient information available to determine how much, if any, of the cash discounts have been taken. The cash discounts on purchases, if taken, would most likely be included in the Cost of Goods Sold account. The cash discounts should be analyzed no matter what account they are included in.

Payroll Tax Expense—the expense amount of \$8,538 is 7.89 percent of Wages Expense of \$108,200. Payroll taxes can be estimated to be approximately 8 percent of wages based on the employer’s payment of the social security and Medicare taxes and federal and state unemployment taxes. The Payroll Tax Expense appears to be reasonable and does not need further analysis. While the Payroll Tax Expense account does not need further analysis it may be beneficial to students to discuss it.

Miscellaneous Expense—the Miscellaneous Expense amount for 2013 of \$8,000 is relatively large, especially when compared to the 2012 Miscellaneous Expense amount of \$182. The Miscellaneous Expense account should be used as little as possible because all account titles should be descriptive of the contents of the account. The only way to determine what types of expenses are in this account is to analyze it.

Interest Income—included in the Financial Information with the cash accounts is Cash-Money Market. The money market cash account did earn interest of \$1,649 during 2012 and, without information to the contrary, should have earned interest during 2013. There was no interest income recorded for 2013 so the account should be further analyzed.

Income Tax Expense—the business form of Big Al's Pumps is a sole proprietorship so the entity should not incur income tax expense. The Income Tax Expense account of \$6,000 should be investigated.

Income Statement Expense Accounts--A large number of expenses (six of the eleven listed) have totals that are exactly \$1,000 or multiples of \$1,000.

Other—the list above contains the most obvious examples of concerns with the accounts contained in Exhibit 1, Financial Information for 2013 and 2012, and other information provided in the case. It is not intended to provide an all-inclusive list of answers.

Big Al's Pumps—Requirement 2

When you met with Big Al he seemed upset. He told you he didn't want to believe it but wondered if one or more of his employees were stealing from the business. He didn't want to confront any of them directly without substantial proof so asked you to gather as much evidence as possible of possible employee fraud. What fraudulent activities may have been taking place by the employees of Big Al's Pumps based on the information contained in the Introduction and Facts and Exhibit 1, Financial Information for 2013 and 2012? Please number your answers and confine each answer to one fraudulent activity. Your answer should include the name of the employee most likely to conduct the fraudulent activity and what is transpiring in the activity. Two or more employees may be separately conducting a fraudulent activity on the same account. For example, Martha and Little Al may both be stealing cash. Treat those two employee fraudulent activities separately, each with a different numbered answer. Assume there is no collusion between Little Al, Henry, and Martha.

Big Al's Pumps—Solution for Requirement 2

1. Martha may be stealing cash from customer receipts. Martha opens the mail (including payments received from customers), makes all bank deposits, receives the bank statements in the mail, prepares the bank reconciliations, and performs all accounting functions. Whenever an employee has access to assets and performs the accounting functions for assets there is risk the employee is stealing assets. Specifically, Martha could be involved in a lapping scheme where she receives customer payments in the mail and deposits the customer checks in her own bank account. She can cover her theft by not recording the stolen customer check(s) as cash received or a reduction in that customer's subsidiary accounts receivable account. Future customer's payments received can be recorded as cash received and a reduction of the customer's account the cash was initially stolen from.
2. Little Al may be stealing cash from customer receipts. Little Al runs the front-counter and is in charge of walk in customers. He may be able to make a sale without including the sale in the accounting system as a sale and keep the cash or customer check. He could deposit the customer check into a bank account he sets up for that purpose. The fraudulent scheme is called skimming. Little Al would be stealing money from the business before it is recorded. Little Al could make a sale, keep the cash or customer

check, either not complete a Sales Invoice or fill one out and later dispose of it. An unrecorded sale would not be apparent because Big Al's doesn't use pre-numbered sales invoices.

3. Henry may be stealing inventory either from the store location or when he is picking up purchased pumps or making deliveries to customers. Henry apparently has access to the inventory assets without there being an accounting of the pumps sold or purchased. According to the Introduction and Facts Big Al's Pumps does not keep a perpetual record of pumps purchased or sold. And an actual inventory has not been taken. Without knowledge of the accuracy of the number and types of pumps actually in inventory it can't be determined whether the account balance for inventory on the books is accurate. Henry is the employee who normally picks up the purchased pumps and delivers pumps to customers. It would be easy for him to drop off and sell pumps for his own profit as he is driving to and from the Big Al's store location.
4. Martha may be stealing cash by writing checks to fictitious vendors. Martha and Big Al can sign checks with a single signature. Martha is the bookkeeper and receives the bank statements and prepares the bank reconciliations without oversight by Big Al or anyone else. Martha can write checks to a fictitious vendor or vendors. She can set up a bank account for the fictitious company with herself as the only signature accepted by the bank, allowing her to endorse checks (she may also get an endorsement stamp for the fictitious company) and withdraw cash.
5. Martha may be stealing cash or other assets and covering it up by manipulating accounts to cover up the theft. Martha has access to all the assets of Big Al's Pumps and she is the only one involved in the accounting functions. She can steal cash received from Little Al for the sale of pumps to walk in customers. She can also write herself a check and debit any account. Even a cursory look at the balance sheet accounts in comparison with the prior year raises questions as to their accuracy.
6. There are more possibilities of employee theft. All three employees, according to the Introduction and Facts, have access to the physical assets such as inventory and equipment. Internal control is either weak or nonexistent and no security measures are in place. For example, any of the three employees could be stealing inventory or cash or computer equipment when that employee is alone in the store.

Big Al's Pumps—Requirement 3—Part 1

Assume your work comparing the receipt of customer checks (your work included calling some customers to get specific amounts and dates of their payments) with the recording of the customer receipts uncovered evidence that Martha started stealing cash during the early part of 2013 and increased the practice through the year. Martha covered her theft of cash, consisting of

the customer checks, by lapping accounts receivable. Martha stole a significant amount of cash during 2013. List all accounts and balance sheet and income statement components, post-closing for 2013, affected by the theft of cash by Martha by lapping accounts receivable. Use Exhibit 1, Financial Information for 2013 and 2012, as a guide for accounts and balance sheet and income statement components. As an example, if the Sales Revenue account was overstated the following accounts and balance sheet and income statement components would be affected and they would be affected by being overstated or understated, as follows:

- Sales Revenue—overstated
- Net Sales—overstated
- Gross Profit—overstated
- Net Income—overstated
- Capital—overstated

Big Al's Pumps—Solution for Requirement 3—Part 1

Martha's theft of cash by lapping accounts receivable would affect the accounts and balance sheet and income statement components by being overstated or understated, as follows:

- Cash—understated
- Current Assets—understated
- Total Assets—understated
- Accounts receivable—overstated
- Current Assets—overstated
- Total assets—overstated

Big Al's Pumps—Requirement 3—Part 2

When you initially met with Big Al he told you Martha reminded him of his deceased mother. You got the distinct impression from Big Al you better have substantial evidence that Martha was engaged in a fraudulent activity. Compare your solution for Requirement 3, Part 1 to the account balances at December 31, 2013 in Exhibit 1, Financial Information for 2013 and 2012. Additional facts in Requirement 3, Part 1 provided information that Martha stole a substantial amount of cash during 2013 and covered up her theft by lapping accounts receivable. Explain whether the account balances in Exhibit 1, Financial Information for 2013 and 2012, confirm or contradict your solution to Requirement 3, Part 1. Provide specific examples that provide evidence of your answer to this part.

Big Al's Pumps—Solution for Requirement 3—Part 2

Martha has been stealing cash and covering the theft up by lapping accounts receivable. Theft of cash using lapping is accomplished by an employee taking a customer's check received in the mail. The customer intended the check to be payment on that customer's account. There are two effects of lapping on the balance sheet accounts. One effect, as a result of the employee not depositing the check in the company bank account or recording the receipt of the customer's check as an increase in the company's cash account, is the cash account is understated. The balance in the three Cash accounts decreased by \$44,200 from December 31, 2012 to December

31, 2013, even though Sales Revenue increased by \$116,268 from 2012 to 2013. There could be legitimate reasons for the cash accounts to decrease even though sales increase. Without additional information it is difficult to try to explain the reason(s) for the decrease in cash. Besides the business reasons, such as the purchase of equipment for cash, another reason includes the employee theft of cash.

A second effect of the lapping is the effect on the Accounts Receivable account. In order to hide the theft of cash by taking a customer check, the employee does not reduce the accounts receivable account in the general ledger or the subsidiary ledger for that customer. As lapping continues and increases in volume the Accounts Receivable account is not decreased by the customer payments that are received by the employee who is stealing the cash and not recording either the receipt of cash or the reduction of Accounts Receivable. Because the Accounts Receivable account wasn't being reduced it was overstated. Accounts Receivable increased from \$16,322 at December 31, 2012 to \$77,633 at December 31, 2013, a substantial increase. While there may be legitimate business reasons for the increase, another possible reason could be employee theft using the lapping of accounts receivable.

RUNNING WITH THE BIG DOGS (PART B): GROWTH THROUGH STRATEGIC POSITIONING AT BIG DOG RUNNING COMPANY

**Jennifer P. Pitts, Columbus State University
Robin L. Snipes, Columbus State University**

CASE DESCRIPTION

The primary subject matters of this case are (1) choosing an appropriate growth strategy and (2) leveraging technology and social media to build customer relationships and deliver a unique value proposition to customers. Students should develop a more in-depth understanding of how to strategically position a company by developing market-specific strategies and effectively using technology to gain sustainable competitive advantage. The case has a difficulty level of three and up, making it appropriate for junior level courses in management information systems, marketing strategy or business strategy. The case is designed to be taught in one or two class sessions and should require approximately 2-3 hours of outside preparation for students, primarily reviewing the case and reading articles related to the competitive forces framework. This case can be used as a follow-up to the Part A case or as a stand-alone case focused on strategic positioning using technology-based initiatives.

CASE SYNOPSIS

The Big Dog Running Company is a running specialty store operating in the highly competitive and growing running shoe and apparel retail industry. The company started in late 2010 in the middle of an economic recession and against formidable odds in an industry dominated by large retailers and price competitive Internet-based companies. Based on an external market analysis, students evaluate and "tweak" a competitive strategy for a retail location that is not currently successful. Students will also recommend one of Ansoff's generic Product-Market Growth strategies to enable the company to continue to grow. Students assess the company's strategies and tactics to identify and understand how the company continues to deliver a unique value proposition to their customers in other distinct market locations.

THE "BIG DOG RUNNING COMPANY" STORY

It was September of 2014 and Big Dog Running Company owners, John Teebles and Reggie Luther, were contemplating their next competitive move. Overall, their running specialty store concept had been successful. In fact, Big Dog Running Company (BDRC) now had three locations: two in Columbus, Georgia and one in Auburn, Alabama (about 40 miles from Columbus). The business venture had been a success in two of the three locations, but the owners were having problems with the Auburn location. In fact, John and Reggie were seriously contemplating leaving the Auburn area. The strategy just didn't seem to work in Auburn. They currently have an eager buyer for their Auburn location, so they could sell the store and be out of the area quickly. However, the potential buyer seems so eager that it is causing them to question their hasty decision to leave. Was it possible that the Auburn location just didn't deliver on all of the key strategy areas that make the other two store locations successful? If that was the case, it

was not clear to John and Reggie whether the Auburn store strategy could be effectively "tweaked" to transform the store and make it as successful as the two Columbus locations.

The company's story begins in 2009 when John Teebles and Reggie Luther both came to the realization during a conversation that there was a gap in the local market for a full service retailer catering specifically to the running sport. John and Reggie were both entrepreneurs and running enthusiasts who had known each other for several years. During their discussion, they both agreed that there was a window of opportunity for a location in the city's newly revitalized downtown area. Columbus, Georgia is also located right next door to Fort Benning, Georgia, home of one of the army's largest training installations in the country with about 35,000 soldiers on active or reserve duty. Fort Benning provides BDRC with a constant influx of young soldiers in need of proper equipment for their PT training. In fact, Fort Benning soldiers now represent about 50% of BDRC revenues in their downtown Columbus location.

The company opened its first store in downtown Columbus in August of 2010. After some trial and error, the Columbus location became a success by all accounts. The owners realized from the beginning that the key to their success was to differentiate themselves from the "big box" and online retailers by focusing more on location, customer service, and merchandising. Through trial and error, the owners eventually discovered a successful formula for their store that included five "key success factors": (1) location, (2) store ambiance, (3) knowledgeable sales staff, (4) event tie-ins and programming with the local community (to build customer relationships), and (5) inventory management (i.e., having the right products at the right time). According to the store's website, Big Dog Running Company offers customers a "comfortable store and friendly, knowledgeable staff who will make you feel right at home as they assist you in selecting the best running gear to suit your needs." Their current mission is listed as follows on their website:

"At Big Dog Running Company, we pledge to consistently provide excellent customer service and quality products to our community in an environment that is welcoming, comfortable, and friendly. We realize that we have a responsibility to do more than just sell a product. We take very seriously our role in helping our community become healthier and happier through the ALFA (Active Lifestyle For All) principle."

After an evaluation of each of the five "success" factors in the Auburn location, they realized that it was lacking in at least three of them. The owners discovered that simply having a store located next to a large university and a young population is not enough to bring in the customers -- the store has to successfully deliver on each of the five success factors. For starters, unlike the two Columbus locations, the Auburn store is not in a prime location. It is more than a mile away from the downtown area and in an unattractive strip. On Auburn football weekends, the number of people in the downtown area more than triples. So, possibly relocating to the downtown area could significantly increase Auburn's store traffic, and the feel and ambience of the store. Secondly, Auburn's current employees are not as knowledge and enthusiastic about running. John and Reggie both make frequent visits to the Auburn store, but it is a 40-minute drive from downtown Columbus. So, they are not present in the Auburn store as often as they are in the other two Columbus locations. They need a full-time manager who is as enthusiastic as they are in the Auburn store. Lastly, they would need to come up with a more unique relationship-building strategy to spread the word among college students, who are the primary target market in the

Auburn location. The current social media and event strategy doesn't seem to be as effective in Auburn.

SPECIALTY RUNNING STORE RETAIL INDUSTRY TRENDS

BDRC's main competition in the local market area includes online stores such as Zappos and Amazon, and brick-and-mortar chain stores such as Dick's and Academy Sports, all of which carry apparel for many outdoor sports including running. The top running apparel manufacturers have begun to put more restrictions on retailers regarding pricing and online sales. New specialty retailers, like the BDRC, are not allowed to sell products online anymore. Additionally, suppliers of the top selling brands such as Nike have also put more limits on retailers' ability to reduce the price of their products. This is because the top manufacturers would like to have more control over the marketing and image of their products. This means that there is very little price variance between online retailers and brick-and-mortar stores, which is good and bad for small retailers like BDRC -- on the one hand they no longer have to compete on price, but on the other hand they also can't manage inventories by running special price promotions on their products when needed.

Recent trends have been positive for the running industry as a whole. According to the latest National Sporting Goods Association's data, total sales of running/jogging shoes climbed from \$2.3 billion in 2010 to over \$3 billion in 2013, an increase of over 33% (see Table 1). The number of running shoes sold in the U.S. grew from 37 million units to over 46 million in 2013, driven in part by customers' frequent replenishment cycle with consumers purchasing an average of three pair per year (Shaftoe, 2013). Likewise, growth in running apparel has also reached record heights over the last decade. With record numbers of new runners participating in the sport in the last decade, the running shoe and apparel industry has enjoyed steady growth in the sales of shoes, apparel, running accessories, and event attendance.

Table 1: Jogging & Running Footwear Sales in U.S.

| | 2010 | 2011 | 2012 | 2013 |
|----------------------|----------------|----------------|----------------|----------------|
| Running Shoe Units | 37.16 million | 38.02 million | 44.62 million | 46.25 million |
| Running Shoe Dollars | \$2.32 billion | \$2.46 billion | \$3.04 billion | \$3.09 billion |

SOURCE: National Sporting Goods Association (2014)

A key variable in the volume of sales of running shoes and apparel is the number of participants in the sport. Over the past decade there has been a "second running boom" that has continued robustly with more non-traditional running events and record numbers of finishers (Running USA, 2014). Continuing this trend, in 2013, the total number of running participants in all categories increased by 5% over the previous year to almost 40 million runners (see Table 2). Adventure racing, a relatively new category of the running sport, recorded the highest growth with a total increase in participation of almost 30%, and the highest concentration of runners is in the southeastern states. Analysts attribute the record growth in participation to a number of factors including the rise in the number of running destination vacations that offer participants the

opportunity to combine running with leisure activities, frequent charitable and socially-oriented running events, and an interest in new wearable technology and apps that provide running enthusiasts new ways to measure their progress and share their training and results with others.

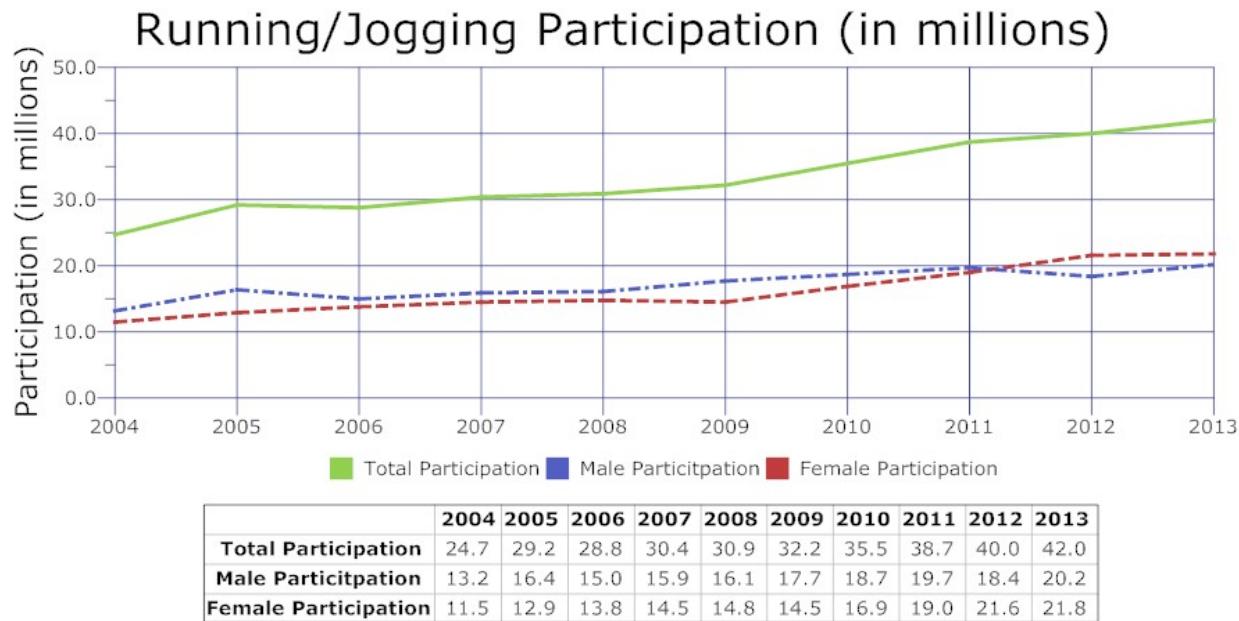
The general sporting goods retail industry is expected to continue to grow overall due to strong demand for sporting goods from more health-conscious individuals. According to the National Sporting Goods Association (NSGA), running/jogging continues to show strong and consistent growth annually as running total participation (defined as running at least six days out of the year) was up 2.5% overall in 2013 versus 2012. However, nationally the demand for running apparel is expected by many to flatten out as the economy continues to recover from the recession. Some have suggested that the sport of running may be counter-cyclical to the economy. Since it is an inexpensive sport, it is believed that running participation may increase during an economic recession to replace other, more expensive, sports. That means that running participation may decline as the economy improves. However, current running participation data shows a continued increase in participation and does not support this assertion at this point in time. Figures 1 and 2 illustrate the growth in participation overall and by gender over the past ten years. Interestingly, female participants continue to outnumber male participants primarily in the Age 25-34 age group category.

Table 2: U.S. Running Participation Numbers 2013

| Survey | Category | Total Participants ('12-'13 +/-) |
|------------------------------|------------------------------------|----------------------------------|
| SFIA Total Runners | <i>Run/Jog at least once</i> | 54,188,000 (+5.3%) |
| SFIA Core Participants | <i>Run/Jog 50+ days/yr</i> | 29,843,000 (+1.2%) |
| SFIA Total Trail Runners | <i>Run on Trails at least once</i> | 6,792,000 (+17.0%) |
| SFIA Total Adventure Racing | <i>Participated 1+ times</i> | 2,095,000 (+29.5%) |
| SFIA Casual Adventure Racing | <i>Participated 1 time</i> | 901,000 (+34.0%) |
| SFIA Core Adventure Racing | <i>Participated 2+ times</i> | 1,194,000 (+26.3%) |
| NSGA (1) All Runners | <i>Run/Jog 6+ days/yr</i> | 41,996,000 (+4.9%) |
| NSGA (1) Frequent Runners | <i>Run/Jog 110+ days/yr</i> | 9,944,000 (+7.8%) |
| NSGA (1) Occasional Runners | <i>Run/Jog 25-109 days/yr</i> | 19,514,000 (+5.1%) |
| NSGA (1) Infrequent Runners | <i>Run/Jog 6-24 days/yr</i> | 12,538,000 (+2.5%) |

SOURCE: National Sporting Goods Association. (1) = NSGA Sports Participation in the United States 2014 Edition, SFIA: Sports & Fitness Industry Association. 2014 SFIA Sports & Fitness Participation Topline Report

Figure 1: Running/Jogging Participation (2004-2013)



SOURCE: National Sporting Goods Association. (1) = NSGA Sports Participation in the United States 2014 Edition

Figure 2: Running Participation by Age and Gender



SOURCE: National Sporting Goods Association. (1) = NSGA Sports Participation in the United States 2014 Edition,

Table 3 shows the percent of unit sales by distribution channel. Disconcertingly, sales from specialty athletic footwear stores, or the "brick-and-mortar" stores, decreased slightly in 2013 from 18% in 2012 to 14.1% in 2013. Additionally, sales in general sporting goods and department

stores has remained flat for the past four years and is not predicted to grow significantly. However, not surprisingly, internet and web-based stores show the strongest gains in sales, capturing almost 18% of total sales in 2013 with predicted continued growth in the segment.

| Table 3: Sales Channels - % of Units | | | | |
|---|-------------|-------------|-------------|-------------|
| | 2010 | 2011 | 2012 | 2013 |
| General Sporting Goods | 22.5% | 23.3% | 22.4% | 22.6% |
| Discount Stores | 21.4% | 18.5% | 19.8% | 20.4% |
| Online/Internet | 12.2% | 12.5% | 17.5% | 18.1% |
| Specialty Athletic Footwear | 16.2% | 19.6% | 18.0% | 14.1% |
| Department Stores | 8.8% | 7.2% | 7.4% | 7.0% |
| Family Footwear | 6.3% | 6.4% | 4.1% | 6.7% |
| Factory Outlet | 7.7% | 5.7% | 4.9% | 4.9% |
| Specialty Sport Shops | 4.7% | 5.2% | 4.4% | 3.9% |
| Other Outlets | - | - | - | 1.1% |
| Mail Order | 1.4% | 0.4% | 1.1% | 0.8% |
| Pro Shop | - | - | 0.4% | 0.4% |

SOURCE: NSGA Sporting Goods Market 2014 Edition

STRATEGIC POSITIONING AT BIG DOG RUNNING COMPANY



Avid runners and entrepreneurs, John Teebles and Reggie Luther, filled an unmet need in 2010 when they opened their first specialty running store in Columbus, Georgia. Following national trends, local running participation was growing at a rapid pace and runners of all abilities were participating in droves in running events, group runs, and corporate sponsored wellness programs. Serving this growing and diverse market with an alternative to the big box sporting goods and department stores was a key goal of the owners who sought to create a place where the running community could not only get expert advice on purchasing running shoes but also engage with each other through sponsored events and activities. However, they have now reached a "strategic inflection point," which occurs when external events result in the need for a change in the strategy of a company. BDRC would like to continue to grow and increase its store presence in other cities, but the Auburn, AL store isn't working. The owners know that they want to keep moving forward. They have an eager buyer for their Auburn location, but they are hesitant to sell. As John Teebles points out, "we are always looking at our formula -- we know that what's working today won't necessarily work tomorrow."

BDRC's Value Proposition

BDRC's value proposition in its two Columbus locations can be seen in the various customer-oriented initiatives and events that provide on-going opportunities for runners, not only to meet to run but also to provide a venue for like-minded individuals to congregate. Unlike Internet-based companies and mass-market retailers, specialty stores are uniquely positioned to offer a more personalized experience for their customers. One way they achieve this is by providing a place where runners of all abilities can gain knowledge, support, and advice from other runners through a combination of programs and activities that complement the store's products. This is known as developing a "fourth place."

In 1999, Ray Oldenburg identified the need of human beings for social gatherings to have a feeling of belonging to a group. He proposed that most of us have three places in our lives that define us: our home (first place), our work (second place), and a "third place" which encompasses informal public social gatherings other than home or work where people can meet and just "hang out," such as local coffee shops, bars, or libraries on college campuses. In 2005, Fleener extended the concept by suggesting that retailers can create a "fourth place" that serves a similar function, but is centered on a shared common interest targeted to a specific consumer group. Successful independent specialty store retailers have embraced the concept of the "fourth place" with a strategy and mindset that focuses on developing and nurturing relationships with customers to whom they can sell products to as opposed to a focus on just selling products.

Creating a sense of community by providing a venue to congregate and activities that engage the running community has enabled specialty running stores like BDRC to thrive in a market where other small local retail stores have closed shop, victims of big discount chains and online retailers who can often undercut prices. Unlike early running specialty stores that catered primarily to a core group of dedicated runners, the new model of specialty running stores that opened during the second “running boom” in the United States were designed to cater to a more diverse group of fitness-minded individuals who enjoyed the sport of running and the benefits of a healthy lifestyle. Spandorfer (2013) describes the new model of specialty running stores as ones owned by business people who enjoy running but also understand how to grow their customer base by making the sport more accessible and inclusive to runners of all ages and abilities. From the beginning, BDRC has embraced this model through its mission statement and strategies that were customer-focused, inclusive, and designed to bring together a diverse community of experienced and new participants to the sport.

Creating the “Fourth Place”

In the BDRC Columbus locations, the owners constructed space in the store to create a venue where runners not only felt comfortable “hanging out” but could also obtain expert advice on running-related topics. Year-round, each store hosts a series of educational workshops and seminars on running related topics such as injury-prevention, nutrition, and proper running form. The events are open to the public and free to encourage new and experienced running enthusiasts to attend. This complementary service helps BDRC build relationships with existing and potential customers and helps ensure that runners not only have the right equipment but also learn how to stay injury-free and properly trained for the activities they engage in.

Unique to each store are also various events that bring runners together to train and socialize. For example, the company hosts a popular “Pancake Run” at their Columbus downtown (“Uptown”) location, which starts with a group run and end with a free pancake breakfast at the store. The 2nd Columbus location (“Columbus Park”) hosts group training runs and a “Couch to 5-K” program that provides training and support to new runners with the goal of running a 5-K race at the end of the program. On a larger scale, the store sponsors the “Jeff Galloway Training Program” designed for runners to train for a marathon or half-marathon in a structured group program with a focus on injury-prevention and training support. The goal is for runners to participate in one of Columbus’ biggest events, the highly successful “Solider Marathon” held annually at the National Infantry Museum in neighboring Fort Benning, Georgia and sponsored by BDRC. A growing segment of BDRC’s customer base in Columbus are the military stationed at nearby Fort Benning.

Social Media and Database Marketing Initiatives

Creating a sense of community and value for their customers extends beyond the store’s physical locations. Capitalizing on co-owner Reggie Luther’s expertise in social media marketing and professional web design, BDRC has developed an engaging and effective online strategy that supports and extends the company’s mission. The BDRC website is designed to provide information about the store and its products as well as promote the store’s numerous activities, events, and services. An event calendar by store location provides information on group runs and educational workshops, and a blog provides running and fitness related information and commentary. The website does not offer sales of products and is designed as an information only

forum. BDRC also does not advertise its stores or products through traditional outlets, relying instead on grass roots marketing from positive word-of-mouth, repeat customers, and viral marketing through its social media outlets. BDRC's point-of-sale system allows the company to capture and maintain customer information, manage inventory, and provides valuable sales data for analyzing sales trends. The system also facilitates notifications to customers to remind them they are due for new shoes based on their running mileage.

Figure 3: Big Dog Running Company on Facebook



The BDRC's Facebook page shown in Figure 3 is actively maintained with postings about upcoming events and photos of running activities, races, and customers engaged in store-sponsored events. The Auburn store maintains a separate Facebook page tailored to its own local market and events. A Twitter account is also part of the company's social media strategy and followed by over 1000 of the company's customers. All three sites (Facebook, Twitter, and BDRC's main website) encourage customers to sign up for the company's email newsletter, "Big Dog Bites," (Figure 4), sent weekly to customers with timely information about happenings in the running community as well as stories of interest.

Figure 4: Big Dog Bites (BDRC Newsletter)


 The image is a screenshot of the Big Dog Running Company website. At the top is the company's logo, "BIG DOG RUNNING CO." with a small dog silhouette above the text. Below the logo is the tagline "LIVE BIG." and the slogan "Big Dog Bites" followed by "Something to chew on." To the right of the slogan is the date "SEPTEMBER 10-16, 2014". The main visual is a photograph of two runners in motion in front of a store with large windows. Below this is a smaller image of various healthy snacks like nuts and fruit. To the right of the image is a section titled "INSPIRATION" with a quote by Confucius: "Our greatest glory is not in never falling, but in rising every time we fall." Below this is a section titled "THOUGHTS". On the left side of the main content area, there is a sidebar with the text "TUESDAY, SEPTEMBER 16th BDRC Uptown - 7:30pm MARATHON & HALF MARATHON NUTRITION CLINIC".

Social media is also used to grow BDRC's customer base by attracting new runners to its "Couch to 5-K" programs, running series, and themed events such as the popular "Color Runs" that are increasingly non-competitive and designed to promote participation and fun over achieving personal records. Information from local races managed by BDRC and affiliation with the local running club help BDRC gain new customers and promote participation in its activities and events. With only 5-7% of the total U.S. population currently participating in the sport, there is limited upside market potential, making the development of new participants in the sport important to the company's long-term growth.

BDRC'S STRATEGIC INFLECTION POINT

By paying close attention to the "Five Key Success Factors" identified by the owners, BDRC has been very successful in capturing the local market in the two locations in Columbus, Georgia. In these two locations, the company offers customers a compelling value proposition with the combination of a prime location, well-designed stores that facilitate a sense of community, knowledgeable employees, effective and accessible events and programs, and finally, having the right inventory on hand to meet the needs of each location's customer base. As the company enters

its fifth year of operations, the owners recognize that to stay competitive in the industry and continue to grow the company's customer base, it must continuously adapt to meet the changing needs of its market. However, John and Reggie are seriously contemplating leaving the Auburn area since it doesn't seem to be working. But, they are hesitant since they have already invested a lot of time and energy developing the Auburn market. Is it possible to turn the Auburn store around? John and Reggie know that the strategy for each separate retail location needs to be "tweaked" differently depending on the target market and the local competitive environment. They are looking for unique relationship-building strategies that might spread the word among college students and appeal more to that target market. For example, they would like to come up with a "fourth place" concept in the Auburn store location that appeals to the local target market (mainly college students).

Another concern of the owners is how to continue grow their current business in light of recent national forecasts for the specialty running shoe market. Although running shoe apparel sales continue on the upswing, sales from the "brick-and-mortar" store segment decreased slightly in the past year. Additionally, sales in general sporting goods and department stores has remained flat for the past four years and is not predicted to grow significantly. Furthermore, the national demand for running apparel is expected by many to flatten out as the economy continues to recover from the recession, since it is believed that the sport of running may be counter-cyclical to the economy. In light of this, John and Reggie are debating how to grow BDRC's business while protecting (buffering) the two Columbus locations from potential revenue declines in the future. They know there are many ways to attempt to grow the company, but would like to choose the most cost-efficient and least risky methods to expand their market presence and increase revenues.

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THE AMERICAN WHISKEY RENAISSANCE: THE REBIRTH OF AN AMERICAN SPIRIT

Charles A. Rarick, Purdue University Calumet
Claudia C. Mich, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case involves the rise of the American whiskey industry after decades of stagnation and the sustainability of the industry's popularity. Secondary issues examined include globalization and ethical concerns. The case has a difficulty level appropriate for junior 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

American made whiskey is once again a hot product, especially in the premium priced segment of the market. Fueled in part by the popularity of American movies and television shows, along with changing tastes and preference and good product promotion, the American whiskey industry is experiencing a boom in sales. American whiskey is not only popular among drinkers in the United States, but international sales are exceeding all expectations. The case looks at the rebirth of this American industry and its prospects for the future.

INTRODUCTION

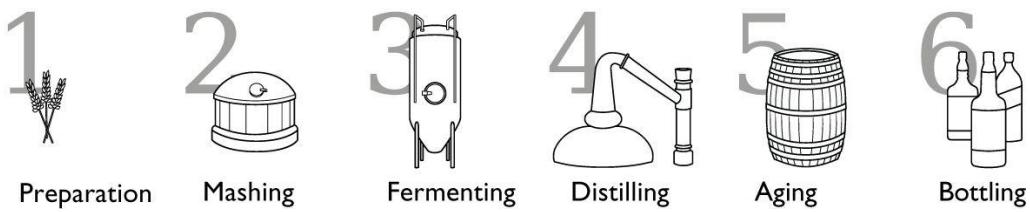
Whiskey making has a long history in the United States. Even President George Washington owned a whiskey distillery. In the early days of American whiskey making, many distillers were farmers who also produced and sold whiskey as a source of additional income. In 1791, the U.S. Secretary of the Treasury, Alexander Hamilton, placed a 25% tax on whiskey distillers in order to generate revenue for the young country. Most of these distillers were operating small production facilities and many were located in Pennsylvania. They greatly objected to a tax imposed by the federal government. By 1794 the hostility grew into a rebellion, called "The Whiskey Rebellion" which caused the federal government to send troops to enforce the tax ([video](#)). The result was the relocation of whiskey distillers to the West, most notably to Kentucky. Over time whiskey was being produced in a number of states, including Tennessee which produced the famous Jack Daniel's brand. The popularity of whiskey grew over the years and reached its heyday in the 1950s in the U.S., but soon the drink lost popularity and sales declined. During the past decade American whiskey has experienced a renaissance, both in the United States and internationally. Whiskey is once again a popular drink and that popularity is growing exponentially in foreign markets. Whiskey producers have expanded capacity and new entrants have entered the market. Whiskey distillers in the United States can now be found from Alaska to Florida, many producing popular small batch lines. The general feeling in the industry is that this popularity will continue, however, it is yet to be seen if this surge will be long-lasting or simply a fad.

WHISKEY, BOURBON, OR SCOTCH?

The word whiskey, or whisky, has a Gaelic origin meaning “water of life.” There is often some confusion about the differences among whiskey (or whisky), bourbon, and scotch. In the end they are all whiskey but their contents and location of production make them different products. They are all alcoholic drinks distilled with grain. While there are a number of nuances that make each different, the main differences can be briefly summarized. As far as the difference in spelling, the term “whiskey” is used for products produced in the United States and Ireland, and “whisky” is used for products produced in Canada and Scotland. Bourbon, by law, must be produced in the United States, and most of it is produced in the state of Kentucky. Since bourbon can only be made in the United States, the drink is sometimes referred to “America’s whiskey.” Bourbon must be produced from a mash of at least 51% corn, distilled at a level no higher than 160 proof, stored in new charred oak barrels, and aged for a minimum of two years (although most bourbon is aged longer). Tennessee Whiskey is not bourbon and has its own legal requirements. While similar to the requirements of bourbon, Tennessee Whiskey must be made in the state of Tennessee and be charcoaled filtered using sugar maple charcoal. Scotch is a whiskey produced in Scotland and malted barley as the main ingredient. All whiskey goes through a six-step process which includes preparation, mashing, fermenting, distilling, aging, and bottling (Figure 1).

Figure 1

The Basic Process of Whiskey Making



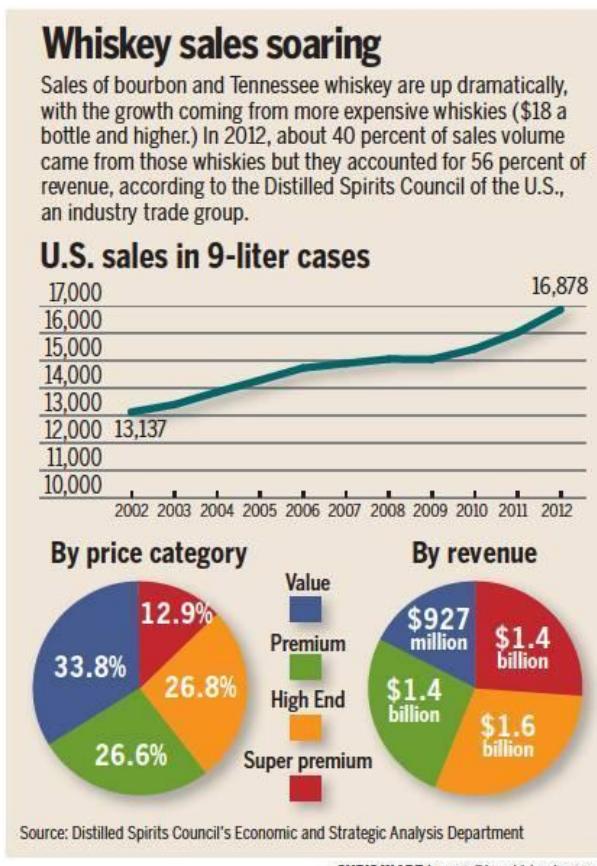
Source: www.whiskydram.co.za

The preparation phase involves crushing and then cooking grain. The mashing process adds water to the crushed grain. Fermentation involves adding yeast, which converts to alcohol and through distillation, the alcohol is turned into a vapor. Water is added to the vapor runoff and stored in barrels for aging. After the whiskey has aged to the desired number of years it is then bottled and is ready for sale. Unlike some spirits, whiskey requires aging and therefore has a long lead time between production and availability for sale. A ten-year bottle of whiskey requires ten years of aging. While some blending of younger and older whiskey is not an uncommon practice, ramping up production still requires years until the product is ready for sale ([video](#)). The increased demand for whiskey has generated a number of companies selling spirits which contain the “moonshine” name. The product is sometimes labelled whiskey or “natural spirits.” While some “moonshine” is sold in impressive cantors, many are sold in Mason jars to enhance the rebel image of the product.

INCREASING DEMAND

Whiskey was a popular spirited drink in the 1950s and 1960s in the United States. Over time demand dropped as consumers began to perceive the product as something old – an old drink for old men. Other spirits like vodka and tequila gained in popularity, along with American beer and wine. During the late 1990s whiskey started to once again become popular, especially a brand with a strong image of heritage like Jack Daniel's which advertised its unique history. Premium and super-premium branded whiskey was starting to grow even more in popularity. By the early 2000s whiskey sales were on a steep upward trend (Figure 2).

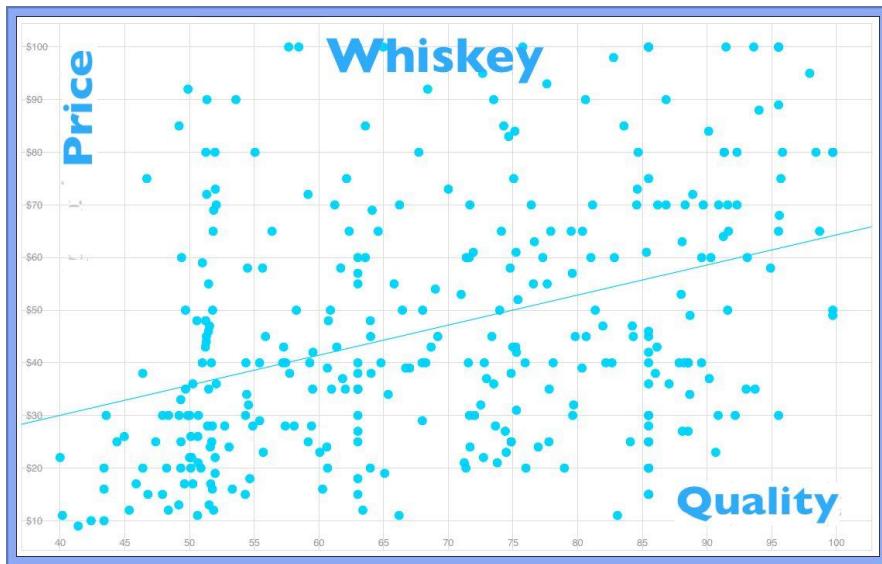
Figure 2



While sales of value-based whiskey (less expensive) account for the most volume, revenue from high-end whiskey far exceeds that of the value-based product. Image, uniqueness, and heritage appear to be very important in whiskey sales. Whiskey labelled reserve, single batch, or single barrel have a special appeal to modern consumers. The age of the whiskey and the story behind it also produce a premium price. What was once a shelf-sitter gathering dust can be almost impossible to buy now. For example, Papa Van Winkle 20-year-old bourbon can sell for over \$100 a shot in a bar or restaurant, if you can even find it.

It would be easy to conclude that higher priced whiskey commands a higher price due to its superior quality. In a sense, it does, but only moderately. Age influences the quality of whiskey to a point, but could marketing, image, and product placement be more important in driving sales? In a study of quality versus price for five spirits (vodka, gin, tequila, rum, and whiskey), liquor experts blind taste tested various brands and rated them on a 100-point scale for quality. It would be expected that those priced high would be rated high. However, this was mostly not the case. In fact, of the five liquors, only whiskey had even a “modest” correlation between quality and price (Figure 3). It appears that quality, even for whiskey, is not the entire story.

Figure 3



Source: B. Taylor, Business Insider 2013.

Not unlike the vodka industry, which uses premium packaging to sell its product, the image of quality portrayed through advertising and product placement appears to be driving price differentials in the whiskey industry. Product placement, also known as brand placement, is a specific form of marketing communication that embeds brands into entertainment media such as movies, T.V. shows, books, computer games, Broadway musicals, and even artwork. The advantage of product placement over advertising is its ability to interweave brands into compelling plots such that audiences do not feel “sold to.” Since customers learn about brands through associations (colors, jingles, characters, etc.), a brand strategically placed in a film could be perceived as cool, evil, or innovative depending on the way it is integrated into the plot (i.e.; evil if used by a villain). Whiskey has crept into American movies and television shows such as *Mad Men*, *Breaking Bad*, *The Internship*, and others, increasing the image of a drink that is desirable. The globalization of entertainment media helps promote American products internationally. The image of something American has strong appeal abroad ([video](#)).

Regardless of high prices, the demand for premium American whiskey continues to rise, especially in foreign countries. Approximately half of the production of Jack Daniel's is exported to over 130 countries. Rival brand Jim Beam likewise exports heavily to over 100 countries. Master distillers from these and other companies appearing at promotional events abroad draw huge crowds seeking pictures and autographs of these "celebrities". The Distilled Spirits Council of the United States, which conducts whiskey promotional events around the world, is sponsored in part by federal funds used to promote American products. The Council also brings foreign journalists to tour popular distilleries in the United States. These activities, coupled with creative advertising and packaging, create the special status that seems to be driving foreign demand for whiskey. American whiskey sales have exploded internationally, not only in traditional international markets like Japan, Germany, and the U.K., but also in markets previously not considered very important. For example, from 2002 to 2013, sales of American whiskey increased over 6,500% in Mexico, over 13,000% in Colombia, over 10,000% in Estonia, and over 4,600% in Nigeria. American whiskey is part of a growing globalization trend with increasing numbers of consumers seeking universal products. While whiskey is produced in many countries, the American brands seem to be commanding most of the attention and sales.

WHAT'S DRIVING DEMAND AND WILL IT LAST?

The rise in demand for American whiskey, both domestically and abroad, doesn't seem to have one clear cause. Things American sell well abroad and declining tariffs and a weaker dollar help sell the product overseas. As developing economies continue to grow, their purchasing power increases and allows for the consumption of more expensive foreign products, including American whiskey. Additionally, innovation in flavored whiskey products has attracted drinking populations previously not targeted, including women. A very popular whiskey in 2013 was a whiskey called Fireball. This cinnamon flavored whiskey, with a sweeter taste, attracted a female following in a liquor segment that traditionally has been dominated by male consumers.

The ability of the industry to create an image of "coolness" associated with the product may be enduring, particularly if associated with a concrete occasion such as Champaign with celebrating. Therefore, it can be difficult to ascertain how long whiskey's popularity will last. On the one hand, the industry wants to be careful not to label an enduring trend a fad, as Schwinn did with mountain biking in the 1980s, resulting in huge losses. On the other hand, it can mean financial disaster to label a passing fad a trend. Marketing strategy recommends three essential questions to distinguish between trends and fads:

- *What is driving the behavior?* Trends suggest underlying lifestyle, technology, or demographic shifts, while fads are based on what is currently popular or in fashion.
- *Is it accessible to the mainstream market?* If the behavior requires major changes in habits or a substantial investment of either time or money, it is not accessible by the mainstream market and might be a fad.

- *Is the base broad in scope?* Can the behavior be expressed across industries or product categories? If so, we could be looking at an enduring trend, as with Eastern influence in food, health, medicine, etc.

Promoting an image that sells the brand is critical to keeping whiskey a strongly demanded product. Companies in other industries have succeeded in building strong brand communities around their products. Harley Davidson and Jeep have provided loyal consumers a place to connect and interact with other loyal consumers, deepening customer involvement with and loyalty to the brand. Whiskey producers may be similarly effective. Currently, different producers use different messages and motives in their promotional material. American whiskey distillers have recurring themes of authenticity, tradition, and quality in their advertisements. Not always, but generally the product has a story and a history to tell. A sampling of video advertisements for American whiskey, along with a commercial from Fireball (Canadian whisky) and Jameson (Irish whiskey) can be seen using the hyperlinks below. *

Select Whiskey Television Commercials

[Jack Daniel's](#)

[Knob Creek](#)

[Jim Beam](#)

[Jim Beam in Japan](#)

[Wild Turkey](#)

[Maker's Mark](#)

[Fireball - Canadian](#)

[Jameson - Irish](#)

One problem with increasing demand of a product that takes years to make is the ability to supply that increased demand. With no way of speeding up the aging process, if demand continues to soar, prices will rise to allocate the scarce product. If the price rises too fast and too far, the mass appeal of the product will decline. While there are innovative ways of speeding up the aging process being considered, including placing barrels on moving ships in tropical climates to use temperature and the motion of the seas to age whiskey faster, no sure method has been accepted as practical. Besides, part of the appeal of a premium whiskey is the number of years it has been aged. A number of American distillers have begun huge expansion projects to meet future demand, however, this strategy assumes whiskey demand will continue to grow for years to come. If the popularity of American whiskey is a passing fad, these producers will once again be sitting on an asset they cannot sell.

Discussion Questions:

1. Do you think the demand for American-made whiskey will continue, or is it a fad that will soon be replaced by another spirited drink? Explain your answer.
2. What can be done to ensure that the American whiskey industry can sustain its growth pattern?

3. Viewing the whiskey commercials and researching other forms of American whiskey promotion, what changes, if any would you suggest in order to attract more consumers?
4. What accounts for the lack of correlation between quality and price in the study mentioned in the case?
5. Do you think it is ethical for American distillers to heavily promote a product abroad that is potentially unhealthy? Explain your answer.

- Hyperlinks - if unable to view the hyperlinks in the case, including the commercials by holding the control key and clicking, you cut and paste the addresses found below into your Web browser.

Whiskey Rebellion – <http://www.youtube.com/watch?v=mwenAlLvbFY>

Whiskey Making - <http://www.youtube.com/watch?v=JfsQEVDxuFI>

American Products - <http://abcnews.go.com/Video/playerIndex?id=14901168>

Jack Daniel's - <http://www.youtube.com/watch?v=hQokYC2-b2A>

Knob Creek - <http://www.youtube.com/watch?v=tUMqrfrEvHuU>

Jim Beam - <http://www.youtube.com/watch?v=yMnhAzxLrzw>

Jim Beam in Japan - <http://www.youtube.com/watch?v=qhxkg6ISn2E>

Wild Turkey - <http://www.youtube.com/watch?v=1R4ATnbrGr4>

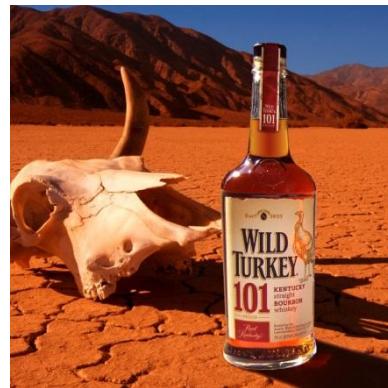
Marker's Mark - <http://www.youtube.com/watch?v=Gw02k6xym9Y>

Fireball - <http://vimeo.com/89348989>

Jameson - <http://www.youtube.com/watch?v=yqYOv3-nqUo>

APPENDIX

SELECT WHISKEY PRINT ADVERTISING



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UNUSED SERVICES AT GET FIT GYM

Dana Schwieger, Southeast Missouri State University
James Ricks, Southeast Missouri State University

CASE DESCRIPTION

The case describes the implementation and lack of member acceptance of virtually-led classes at a moderate sized fitness facility. The primary issue of the case is the lack of user acceptance and the steps that can be taken now to turn a struggling investment around and eventually into a competitive advantage. Students should have an introductory level understanding of business strategy, marketing, and general business issues. The case is primarily designed for junior or senior-level undergraduate students majoring in marketing or management and has a difficulty level of three or higher. The case is designed to be taught in less than 1 class hour and is expected to require approximately 2 hours of outside preparation by students.

CASE SYNOPSIS

The case tells the story of Get Fit Gym, a fitness facility in an area housing approximately 67,000 people. The facility implemented virtual fitness class programming to phase instructor led fitness classes out while continuing to provide similar services as their competition. The project was implemented under the direction of the facility manager in reaction to corporate budget cuts with no input from affected stakeholders nor plan for helping customers to embrace the classes. Now that the investment has been made, the manager needs to start crafting a plan to turn their virtual class programming into a competitive advantage and prevent similar situations from occurring in the future.

BACKGROUND

Bob Baxter has been the facilities manager at Get Fit Gym in Peach Grove, Illinois for the past five years. Peach Grove has a population of about 47,000 people with surrounding communities adding another 20,000. There are currently five gyms within Peach Grove's city limits with the majority of fitness members enrolled in Total Fitness Gym, Get Fit Gym, and the local university's gym in that order.

FACILITY DESCRIPTION

Get Fit Gym is a full service facility offering workout equipment, for fee trainers, swimming pools, saunas, whirlpools, and instructor led classes in cycling, weight lifting, aerobics, yoga, water aerobics, and for fee Cross fit training. Get Fit offers classes at various times throughout the day based upon member interest and instructor availability. The gym has one large exercise studio for aerobics and weight lifting classes, a smaller studio that is used for yoga, a room dedicated for cycling classes, and another room dedicated for Cross fit training classes. The gym is open during the week from 5:00 a.m. to 10:00 p.m. with shortened operating

hours during the weekends when fewer people work out (7:00 a.m. to 6:00 p.m.). Gym members receive a swipe card that they must swipe at the front desk in order to gain access to the gym. As members swipe their cards for entry, they are usually greeted by front desk staff.

Gym members pay an activation fee to join the gym and then a monthly fee of \$45 thereafter. A member must remain a member of the gym for one year and then can cancel his/her membership within a month's notice to avoid a deactivation fee. Get Fit caters to a variety of customers covering a number of age brackets and fitness levels. In general, Get Fit's customer base may lean a little more heavily toward young professionals in their late 20's to early 40's. Get Fit strives to provide state-of-the-art equipment in an attractive, comfortable setting. Their vision is to...

"... equip members with the tools they need to achieve their fitness goals." (Get Fit's Web site)

THE COMPETITION

Overall, Total Fitness Gym is very similar to Get Fit Gym. Total Fitness offers similar services for the same price as Get Fit. However, the facility is bigger; they have one more pool; and they offer more instructor led courses using an additional exercise studio. Total Fitness' hours of operation are the same and they cater to a very similar clientele as Get Fit Gym. However, a greater number of older customers seem to patronize Total Fitness as compared to Get Fit. Total Fitness' vision is to ...

"...provide fitness programs, equipment and guidance in a fun and caring environment to help members meet their health goals." (Total Fitness' Web site)

The university's gym caters to college students, university employees, alumni, and community members with a majority of the patrons being college age. The university gym offers a weight room, instructor led fitness classes, a swimming pool, and fee based personal training. The overall cost for membership is about half that of the other two gyms for community members and is automatically built into the fee structure for students.

CLASS OFFERINGS

Like every organization facing budgetary restrictions, Get Fit has been trying to provide more services with fewer resources. Since one of Bob's biggest expenditures has always been staffing, cuts in this area have been able to provide the greatest influence on the facility's budget. Bob has considered himself fortunate to have not had to fire any of his employees. Over the past five years, some of his staff members have moved on to better paying positions at other businesses and he has addressed his budgetary needs by not refilling their positions. (Class instructors get paid \$25 per class.) However, this has come at a cost as some of the classes taught by the former employees are no longer being offered. A noticeable difference in class offerings has become increasingly apparent between Get Fit and its biggest competitor, Total Fitness, causing customers to start to grumble.

VIRTUAL CLASSES

Bob had read about virtual classes offered by the professional exercise organization with which Get Fit was affiliated. Other fitness facilities were offering virtual classes during off-peak time slots and to extend their class offerings at a low cost. One of the testimonials that Bob read regarding the use of virtual classes indicated that a facility was using virtual classes to offer a little variety during a lunchtime time slot.

Bob thought that virtual classes would be a great solution for addressing the increasing difference in class offerings between Get Fit and its biggest competitor. After talking to representatives at a few of the facilities that were utilizing virtual classes, Bob enrolled Get Fit in virtual classes to supplement the instructor led courses. He purchased, and had installed, a presentation system for broadcasting the classes in Get Fit's exercise studio at a cost of approximately \$11,000. The projection system was expected to last 4 years and had an estimated monthly maintenance cost of \$300. He also purchased a subscription to a variety of canned, professionally generated virtual classes to be offered on a daily basis including aerobic dance, weight lifting, body core building and yoga. (The virtual classes are, in essence, exercise videos. You will see the exact same video no matter which day and time you attend. So, the banter between instructors that you hear during your class on Monday at noon will be the same banter that you hear on Tuesday at 5:00 p.m., and any other day, for the rest of the month until a new release is programmed into the schedule.) The subscription for the classes costs approximately \$300 per month but varies based upon the number of classes offered.

A schedule of virtual classes was created around the current instructor led courses (Table 1). The number of class offerings more than doubled with classes being offered throughout the day and late into the evening. Although more classes were being offered to gym members, few were taking advantage of them. Most classes were empty and when they did have participants, they usually would contain just one or two members. Bob overheard the following conversation between gym members who had been patrons of the gym for several years:

Sue: "Have you tried the new virtual classes yet?"

Lisa: "Yes, I have taken a couple of classes, but I was the only person in the classroom each time.

The classes are very good and I could get a good workout, but I come to the gym for the social aspect of talking and working out with others. I don't work out as hard when I am by myself. I think I would rather just work out on the machines."

Another comment Bob overheard was from a new member:

Abby: "I really like the virtual classes. I was the only person in class and I didn't feel intimidated by other people watching me."

Table 1
GET FIT GYM VIRTUAL CLASS SCHEDULE

| Monday/Wednesday | Tuesday/Thursday | Friday |
|--------------------------------------|----------------------------------|-------------------------------------|
| Open - 9:00 Virtual classes | Open - 9:30 Virtual classes | Open - 9:00 Virtual classes |
| 9:00 - 11:00 Instructor led classes | 9:30 - 11:00 Instructor led | 9:00 - 11:00 Instructor led classes |
| 11:00 - 12:00 Virtual class | 11:00 - 12:00 Virtual class | 11:00 - to 5:30 Virtual class |
| 12:00 - 1:00 Instructor led class | 12:00 - 1:00 p.m. Instructor led | 5:30 to 6:30 Instructor led class |
| 1:00 - 4:00 Virtual classes | 1:00 - 4:00 Virtual classes | 6:30 to Close Virtual classes |
| 4:00 - 7:30 Instructor led classes | 4:00 - 6:30 Instructor led | |
| 7:30 - Close Virtual classes | 6:30 - Close Virtual classes | |
| | | |
| Saturday/Sunday | | |
| Open to 11:00 Instructor led classes | | |
| 11:00 to close Virtual classes | | |

SECOND GUESSING

The virtual classes are still new and Bob is hoping that, with summer right around the corner, members will take advantage of the greater flexibility of course offerings. However, he is starting to wonder if the investment in the resources to offer the virtual classes and the monthly subscription fees are worth the costs. In regards to the goals of the gym, Bob questions whether or not he made the right decision in implementing virtual classes into the gym's programming? He also wonders if he followed the appropriate steps in making his decision.

However, it is too late to turn back and the investment has already been made. He needs to find ways to increase attendance in the virtual classes while not having the budget to create a big advertising campaign. He is wondering if there is something that he can do with Get Fit's current marketing channels and technology (occasional flyers, instructor announcements, a monthly newsletter, a web site, social media and a membership database) to better advertise its services to members that would respect customers' privacy, yet increase the number of members attending virtual classes. Bob would like to see this investment become a competitive advantage for his facility.

GLOBAL TRAVEL, INC.

D.K. (Skip) Smith, Baze University

CASE OVERVIEW

Ever wished you had a case on negotiation which young adults (i.e., the kinds of people you are probably teaching) should find very easy to relate to? This case describes a situation where a young adult attempting to purchase an airline ticket for a friend using her uncle's credit card has been rejected by an online travel agency (OTA) but then uses a framework she learned at university to persuade the OTA to reverse the earlier decision and approve the credit card purchase of the airline ticket for her friend. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Ms. Millicent Buhari and her good friend Ms. Ester Mgba are students at the University of Wurundi, in Africa. Last week Ms. Buhari's uncle in Houston, Texas invited the two young women to come and visit him in Houston, Texas; earlier this week, the uncle in Houston sent (by courier) a return ticket from Wurundi to Houston for Ms. Buhari. Regarding a Wurundi to Houston (return) ticket for Ms. Mgba: the uncle has given the details on his U.S. credit card to Ms. Buhari and urged her to use that credit card to purchase a ticket for Ms. Mgba from an online travel company called Global Travel Inc. (hence, GTI). When Ms. Buhari attempts to purchase a Wurundi to Houston (return) ticket for Ms. Mgba from GTI using her uncle's U.S. credit card, however, she encounters a series of problems and rejections. Ultimately, however, Ms. Buhari succeeds in getting GTI to accept her uncle's U.S. credit card and issue the Wurundi to Houston (return) ticket for Ms. Mgba. Additional data and information in the case include:

1. *Regarding the situation: Information on the series of problems and rejections which Ms. Buhari received from GTI is provided.*
2. *Regarding Online Travel Agencies (OTAs): Information is provided on the OTA industry.*
3. *Regarding the company: Information is provided on an online travel agency and its operations.*
4. *Regarding the online travel purchase-related behaviors of consumers: Information is provided.*

THE SITUATION

Ms. Millicent Buhari and her good friend Ms. Ester Mgba are students at the University of Wurundi, in Africa. Last week Ms. Buhari's uncle in Houston, Texas invited the two young women to come and visit him in Houston, Texas while he is recovering from a major surgery; earlier this week, the uncle in Houston sent (by courier) a return ticket from Wurundi to Houston for Ms. Buhari. Regarding a Wurundi to Houston (return) ticket for Ms. Mgba: Because his doctors have told him that for the time being he must do nothing more than rest, the uncle has given the details on his U.S. credit card to Ms. Buhari and urged her to use that credit card to purchase a ticket for Ms. Mgba from an Online Travel Agency (OTA) called Global Travel Inc. (hence, GTI). Acting on her uncle's suggestions, Ms. Buhari went to the GTI website and submitted the travel information for her friend Ms. Mgba, including the destinations, the days of travel, the name of the traveler, and the credit card details which her uncle had provided her. After submitting that information, Ms. Buhari received back the following email from GTI:

From: GTI Customer Service
To: Millicent Buhari
Date: 6 June
Subject: GTI order number XXX391

Dear Ms. Buhari:

Your reservation has been set up for ticketing. You should be receiving an E-ticket email for the flights you requested within 24hrs.

Passenger: Ms. Ester Mgba

Kind regards,

Global Travel Inc. Customer Service

THE SITUATION

Within 15 minutes of receiving the above email from the company, two developments took place:

- 1) Ms. Buhari noted (on her uncle's online credit card statement) that GTI had charged her uncle's credit card both for the tickets for Ms. Mgba and the commission which GTI would earn for issuing those tickets
- 2) Ms. Buhari also received a second email from GTI. The text of that second email to Ms. Buhari is as indicated below:

From: GTI Customer Service
To: Millicent Buhari
Date: 6 June
Subject: GTI order number XXX391

"Dear Ms. Buhari:

Thank you for booking your trip with Global Travel Inc. In order to process your payment we must be able to match the cardholder billing telephone you provided online with the telephone on record with the card issuing bank.

We are unable to match the provided credit card billing telephone at this time.

Please provide us with the telephone number registered with your card issuing bank and ensure that you are reachable at this number for the purpose of online payment authorization. If you are not available to answer calls at your billing telephone during normal business hours please let us know a good time to call. We must be able to verify your telephone with the bank and obtain verbal charge authorization at the same telephone number before processing your payment and reservation. PLEASE NOTE: **You must submit this information within the next 24 hours.**"

**Global Travel Inc.
Customer Service**

THE SITUATION

After thinking a bit about the above email and considering alternative ways to respond to it, Ms. Buhari sent GTI back an email explaining that;

- 1) She was attempting to purchase a Wurundi to Houston (return) ticket for her friend Ms. Mgba using a credit card belonging to her uncle in the United States.
- 2) Because she was located outside the United States, she would not be able to call GTI using the U.S. telephone number associated with her uncle's U.S. credit card.

THE SITUATION

Shortly after she sent her explanatory email to GTI, Ms. Buhari received the following response from GTI:

From: GTI Customer Service
To: Millicent Buhari
Date: 6 June
Subject: GTI order number XXX391
"Dear Ms. Buhari:

We understand that you are unable to call us from the billing phone number since you are outside the US. However, in order to process the payment, we must provide the credit card company with the correct information, including the billing phone number.

Thank you.

With best regards,

**Global Travel Inc.
Customer Service**

THE SITUATION

After thinking a bit about the above email and how best to respond to it, Ms. Buhari sent GTI an email which (as indicated below) included two telephone numbers which her uncle had assured her were associated with the U.S. credit card information he had provided her, so that she would be able to use his card purchase the Wurundi to Houston (return) air tickets for Ms.

Mgba. A few hours after she sent this information to GTI, Ms. Buhari received the following response from GTI:

From: GTI Customer Service
To: Millicent Buhari
Date: 6 June
Subject: GTI order number XXX391
Dear Ms. Buhari:

Thank you for booking your trip with Global Travel Inc. Your payment has been flagged for additional screening because you are either paying for travelers who do not bear your last name or because the reservation falls into our screening category. [CLICK HERE](#) to learn more about payment screening and cardholder authentication.

In an effort to fight widespread international Internet credit card fraud we kindly ask that you supply us with additional credit card payment authentication documents as follows:

- Fill out the attached credit card payment authorization form
- Attach a clearly legible copy of your credit card's front and back
- Attach a clearly legible copy of your government issued photo identification (driver license or passport)
- Attach a clearly legible copy of your most recent credit card billing statement's first page as received from your bank (if you do not have a paper document you may also submit your online banking credit card statement screenshot).

PLEASE NOTE: You must submit these documents within the next 24 hours.

We use the documents to authenticate you as the true cardholder. The documents are kept securely by us for up to one calendar year in order to assist us in resolving potential credit card fraud related disputes.

You must use the same credit card for payment authentication that you submitted during the online reservation process. Using another card might delay issuing your travel document(s) due to additional processing time required by our agents.

Please fax the documents to (012) 345-6789 or email us scanned copies to Reservations@GTI.com by the payment deadline. Your reservation will not be processed without the required copies.

IMPORTANT NOTE: Our customer service representatives cannot waive the additional payment authentication document requirement, because your payment or reservation falls into the screening category. You can avoid the screening only by cancelling this reservation and using a traveler's own credit card for payment.

WHY CREDIT CARD COPIES ARE REQUIRED

Your type of reservation fits into a high risk payment category according to our sales records. This could be due to the itinerary's origin or destination, travel date(s), your physical location, lack of billing address verification capability and lack of secure online payment authentication (e.g., Verified by Visa), because you are paying for other travelers than yourself, or for other reasons.

Global Travel Inc. Customer Service

THE SITUATION (7)

After considering the above (and most recent) email from GTI, and after collecting a bit of documentation from her uncle in the U.S., Ms. Buhari sent GTI the following response:

From: Ms. Millicent Buhari
To: GTI Customer Service
Date: 6 June
Subject: GTI order number XXX391

“Gentlemen:

As you requested in the most recent email you sent me, I have provided you with:

- a. the GTI form you requested that I complete.
- b. a clearly legible copy of the front and back of the U.S. credit card which my uncle provided me so that I would be able to purchase a plane ticket for Ms. Ester Mgba.
- c. a clearly legible copy of my passport
- c. a clearly legible copy of the first page of the latest credit card statement sent by Bank of the Mid/Southwest (that is, the U.S. bank which issued my uncle his U.S. credit card) to my uncle in the U.S.

Please note : As I mentioned to you in an earlier email, before placing my order for the ticket for Ms. Mgba, I called (using Skype) Bank of the Mid/Southwest to alert them to the fact that I would be using my uncle's U.S. credit card to purchase a plane ticket for my friend Ms. Mgba. The person at Bank of the Mid/Southwest with whom I spoke indicated that she had made a note of my upcoming purchase, and that the bank would be expecting (and would approve) my purchase of the plane ticket for Ms. Mgba using the U.S. credit card which the bank had issued to my uncle.

In conclusion: Given all the documentation and other information I have provided to GTI, and given that there is now not enough time for me to attempt to purchase the Wurundi to Houston (return) plane ticket for Ms. Mgba from any other travel agency, I do hope that GTI will now take the action which you indicated on the form which I have filled out for you, that is:

- a. GTI will IMMEDIATELY charge my uncle's U.S. credit card upon receipt by you of the documents you requested and which I have now sent to you.

b. GTI will IMMEDIATELY issue the Wurundi to Houston (return) plane tickets for my friend Ms. Ester Mgba.

Sincerely,
Ms. Millicent Buhari

THE SITUATION

In response to the above email, GTI sent Ms. Buhari the following email:

From: Global Travel Inc. Customer Service

Sent: 07 June 2014

To: Ms. Millicent Buhari

Subject: XXX391 GTI order number

Dear Ms. Buhari:

Until now, none of the phone numbers you have provided matched with the phone number your bank has on file. We have also not been able to contact you by phone.

Since we have not received your verbal authorization until the payment deadline that was presented to you at the time of your reservation, your reservation has therefore expired and is no longer valid.

Please allow up to 5 business days for any pending charges to be reimbursed to your credit card. . . Thank you for choosing Best Travel Store.

Kind regards,
Global Travel Inc.
Customer Service

ADDITIONAL INFORMATION: THE ONLINE TRAVEL AGENCY (OTA) INDUSTRY

Wikipedia indicates that Online Travel Agencies (OTAs) can be described and categorized as indicate below:

- 1) Online Travel Agencies (OTAs) specialize in offering (over the internet, to individuals and/or corporate bodies) travel-related services including planning, travel options, and/or booking services. Major (by revenue) OTAs include:
 - a. Voyages-sncf.com. Revenue of €2.23 billion (2008).
 - b. Expedia, Inc. (includes Expedia.com, Hotels.com, Hotwire.com, and others). Revenue of US\$2.937 billion (2008)
 - c. Sabre Holdings (includes Travelocity, lastminute.com, and others). Revenue of US\$2.9 of billion (2008)
 - d. Opodo. Revenue of €1.3 billion (2008)
 - e. Priceline.com. Revenue of US\$1.9 billion (2008)
 - f. Orbitz Worldwide, Inc. (Includes Orbitz.com, CheapTickets, ebookers, and others). Revenue of US\$870 million (2008).
 - g. Wotif.com. Revenue of A\$145 million (2012)
 - h. Webjet. Revenue of A\$59.3 million (2012).

- 2) "Metasearch Companies" are a subset of OTAs which conduct travel-related searches across multiple independent OTAs including those listed above. Metasearch companies often make use of "screen scraping" to get live availability of flights; "screen scraping" is a way of crawling through airline websites to get content from those sites by extracting data from human-readable HTML feeds.
- 3) "Fare aggregators" are another subset of OTAs; these companies redirect users to an airline, cruise, hotel, or car rental site or another Online Travel Agent for the final purchase of a ticket. Aggregators' business models include collecting information from major OTAs and then displaying to the user all of the results on one screen; from the options identified, the OTA selected by the user (for example, Expedia or Priceline or Travelocity) then fulfills the ticket. Aggregators generate revenues through advertising and charging other OTAs for referring clients. Examples of aggregate sites are Bravofly, Cheapflights, Dohop, Kayak.com, Mobissimo, Momondo, CheapOair, Ixigo.com, SideStep, Wego.com, Skyscanner, and Webjet.

Source: Based on material from Wikipedia

ADDITIONAL INFORMATION: TRAVEL-RELATED CUSTOMER BEHAVIORS

Wikipedia indicates that travel-related customer data and behaviors include those listed below:

- 1) The average consumer visits 3.6 sites when shopping for an airline ticket online, according to PhoCusWright, a Connecticut-based travel technology firm.
- 2) Yahoo claims 76% of all online travel purchases are preceded by some sort of search function, according to Mr. Malcolmson, director of product development for Yahoo Travel.
- 3) A 2004 Travel Consumer Survey published Jupiter Research noted that "nearly two in five online travel consumers say they believe that no one site has the lowest rates or fares." Thus a niche was created for aggregate travel search which seek to find the lowest rates from multiple travel sites, obviating the need for consumers to cross-shop from site to site.

Source: Based on material from Wikipedia

ADDITIONAL INFORMATION: THE COMPANY

On its website, Global Travel, Inc. (hence GTI) indicates that it is an Online Travel Agency (OTA) that is passionate about developing advanced airfare search technology, in order to provide customers with the lowest airfares available. Other comments and/or claims made by GTI on its website include:

- 1) When customers purchase from GTI, they buy the best deals on the market from a company that has served hundreds of thousands of domestic and international air travelers through its own extremely efficient search engine since 2012.

- 2) GTI operates a world-class travel reservation system that powers this website and all Customer Service operations, from automated ticketing, billing, and airline schedule change processing, to Customer Call Center Support. The power of GTI's technology and the dedication of the company's Software and Customer Service teams ensure that customers receive (from a single source) not only the best deals but also the best customer service.
- 3) The GTI travel agent call center is located in Atlanta and is staffed with seasoned professionals who care about the quality of customer trips. If a customer's plans change, GTI works with airlines to ensure that the customer's booking and travel experience is as hassle free as possible. Because GTI designs airfare search technology, GTI knows precisely how airfares work and how to ensure that customers get what they pay for.
- 4) To increase customers' peace of mind, GTI also offers travel insurance protection plans.
- 5) Since 2012, GTI has been a Georgia Better Business Bureau member with an "A" rating. The company is registered as a Georgia Seller of Travel with a good standing and active business license.
- 6) GTI hopes customers enjoy using their website and GTI looks forward to finding customers the best deals to their destinations. Life is a journey and customers deserve the best, so begin traveling with the best deal on airfare from GTI.

Source: Based on material from the GTI website

ADDITIONAL INFORMATION: THE COUNTRY OF WURUNDI

Wurundi is a country in Africa whose name must remain disguised. The country has about 5% of the landmass of the United States, and the terrain is diverse, ranging from beaches and swamps to desert conditions. Large deposits of both oil and natural gas have been discovered. Even though much of the gas was discovered by accident (in many cases, the gas was discovered by companies prospecting for oil), Wurundi's proven reserves of gas are worth (at any reasonable price per standard cubic foot) billions of dollars. In other words, Wurundi is richly endowed with energy resources.

Data collected by Wurundi's Bureau of Statistics indicates that 70% of Wurundi's population is classified as "poor." It is also true, however, that Wurundi's Gross National Product (GNP) exceeds \$100 billion. In a report titled "Lions on the Move" and published by the McKinsey Global Institute, Roxburgh et al. (2010) claim that "the continent (that is, Africa) is among the world's most rapidly growing economic regions" and that "the rate of return on foreign direct investment in Africa is higher than in other developing countries." As for the country called (in this case study) Wurundi, each of the last five years the economy has grown by more than 5%. In other words, the economy is not only quite large but is growing much more rapidly than most developed world economies. For several countries which export food products, Wurundi is one of their top 5 export markets in the world.

A final point about Wurundi involves the level of financial fraud and corruption in the country and the economy. In its annual rankings of the most and least corrupt countries in the world, Transparency International in Berlin (TI) has always ranked Wurundi in the bottom quartile (that

is, the most corrupt quartile) of all countries in the world. While it is viewed as less corrupt now than in the past, Wurundi is still ranked in that bottom (that is, most corrupt) quartile.

THE CHALLENGE

Assume you are Ms. Buhari. What will you now say to or do with GTI, so as to attempt to get them to reverse their decision and allow you to use your uncle's U.S. credit card to purchase the Wurundi-Houston (return) air ticket for your friend Ms. Mgba?

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Roxburgh, C. et al. (2010) Lions on the Move. Washington, D.C.: McKinsey Global Institute

GLOBAL TRAVEL INC.

CASE OVERVIEW

Ever wished you had a case on negotiation which young adults (i.e., the kinds of people you are probably teaching) should find very easy to relate to? This case describes a situation where a young adult attempting to purchase an airline ticket for a friend using her uncle's credit card has been rejected by an online travel agency (OTA) but then uses a framework she learned at university to persuade the OTA to reverse the earlier decision and approve the credit card purchase of the airline ticket for her friend. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Ms. Millicent Buhari and her good friend Ms. Ester Mgba are students at the University of Wurundi, in Africa. Last week Ms. Buhari's uncle in Houston, Texas invited the two young women to come and visit him in Houston, Texas; earlier this week, the uncle in Houston sent (by courier) a return ticket from Wurundi to Houston for Ms. Buhari. Regarding a Wurundi to Houston (return) ticket for Ms. Mgba: the uncle has given the details on his U.S. credit card to Ms. Buhari and urged her to use that credit card to purchase a ticket for Ms. Mgba from an online travel company called Global Travel Inc. (hence, GTI). When Ms. Buhari attempts to purchase a Wurundi to Houston (return) ticket for Ms. Mgba from GTI using her uncle's U.S. credit card, however, she encounters a series of problems and rejections. Ultimately, however, Ms. Buhari succeeds in getting GTI to accept her uncle's U.S. credit card and issue the Wurundi to Houston (return) ticket for Ms. Mgba. Additional data and information in the case include:

- 1) *Regarding the situation: Information on the series of problems and rejections which Ms. Buhari received from GTI is provided.*
- 2) *Regarding Online Travel Agencies (OTAs): Information is provided on the OTA industry.*
- 3) *Regarding the company: Information is provided on an online travel agency and its operations.*
- 4) *Regarding the online travel purchase-related behaviors of consumers: Information is provided.*

INSTRUCTORS' NOTE

As indicated in the case, the situation faced by Ms. Millicent Buhari is that she needs to persuade GTI to accept her uncle's U.S. credit card and issue the Wurundi to Houston (return) ticket for her friend Ms. Mgba. As regards lessons and/or information students should learn from this case, at least three points can be made:

- 1) At the beginning of the case, students will need to consider the extent to which developed-world models and conceptual frameworks can be applied to challenges and opportunities in the developing world. By the end of the case discussion, they will have discovered that some conceptual frameworks (for example, the steps in the negotiation process) can be useful guides to managerial action not only in the developed world but also in the developing world as well.
2. As they work through the case (and the solution to the case), students are exposed to a negotiation process developed by a member of the Global Negotiation Project at Harvard which has the potential to be very useful to them not only in their professional lives but in their personal lives as well.
3. As they work through the case, students are exposed to a bit of information on an industry sector (Online Travel Agencies) which may be of considerable interest and use to them.

DISCUSSION QUESTIONS

I often select one student to lead the discussion. Another approach would be to solicit input from various students at various stages of the analysis. Either way, my usual approach to this case is threefold:

1. Solicit from many students the details of the case, including:
 - a. Information on the chain of events experienced by Ms. Buhari as she attempted to use her uncle's U.S. credit card to purchase from Global Travel Inc. (an Online Travel Agency) a Wurundi to Houston (return) air ticket for her friend Ms. Ester Mgba.
 - b. Information on the Online Travel Agency industry.
 - c. Information on the Global Travel Inc. company, that is, the Online Travel Agency from whom she has attempted to purchase a plane ticket.
 - d. Information on the country in which Ms. Buhari is based, and from which she is attempting to purchase plane tickets for Ms. Mgba using the U.S. credit card details provided to her by her uncle.

Usually, I write much of this information on the board, so that if questions on "facts of the case" arise, we will have much of that information in front of us.

2. Ask an individual student or the class as a whole to address a very specific series of questions. Those questions, and comments relating to two alternative approaches to the case, are as listed below:

1) What is the main problem?

Students are likely to conclude that Ms. Buhari needs to persuade Global Travel Inc. (hence, GTI) that the company should go ahead and allow her to use her uncle's U.S. credit card to purchase a Wurundi to Houston (return) plane ticket for her friend Ms. Ester Mgba. I reinforce the idea that this is a reasonable statement of the challenge Ms. Buhari faces.

2) What kind of problem is this?

Instructors should not be surprised if there are as many answers to this question as there are students in the class. Clearly, there is no one “right” answer. However, two alternative approaches, each of which seems quite relevant to the situation, are as indicated below:

1. Persuasion problem
2. Negotiation problem

3) For the kind of problem selected, what are the key variables and which expert says so?

For students concluding that the main problem is a persuasion problem, Cialdini (2001) identifies the following six principles of social persuasion:

- 1) Reciprocal, defined as the idea that “we should try to repay in kind what another person has provided us.”
- 2) Consistency, defined as the idea that we “desire to be (and to appear) consistent with what we have already done.”
- 3) Social proof, defined as the idea that “we determine what is correct by finding out what other people think is correct.”
- 4) Liking, defined as the idea that “we most prefer to say yes to the requests of people we know and like.”
- 5) Authority, defined as the idea that we tend to be obedient to authority.
- 6) Scarcity, defined as the idea the “opportunities seem more valuable to us when they are less available.”

For students believing that the main problem is “negotiation,” the negotiation process model developed by Ury (1991) seems very relevant. According to Ury (ibid), the steps in the negotiation process include:

- 1) Go to the balcony (that is, instead of reacting to challenges and/or problems identified by the other party, step back, collect your thoughts, evaluate the situation objectively, etc.);
- 2) Step to their side (that is, listen to the other party, understand their concerns, and agree where you can);
- 3) Reframe the argument (that is, see if it is possible to identify a win-win solution);
- 4) Build them a golden bridge (that is, make it easy for the other party to say “yes”); and
- 5) Use power to educate (that is, make it hard for the other party to say “No.”)

4) What data from the case relate to the key variables?

As implied above (and this is one of the key learning points of the case), the data students present will depend on the main problem they identify. Students believing the main problem is persuasion-related will focus on the six key principles of social influence identified by Cialdini (2001), that is, recognition, consistency, social proof, liking, authority, and scarcity;

Appendix 1 overviews the data from the case associated with these variables. Students believing the main problem is “negotiation” will focus on the five key variables in the negotiation process set forth by Ury (1991), that is, 1) Go to the balcony; 2) Step to their side; 3) Reframe the argument; 4) Build them a golden bridge; and 5) Use power to educate; Appendix 2 overviews the data from the case associated with these variables.

5) What alternative solutions can be identified?

Because research suggests we make better decisions if we identify alternatives and then choose one, I require students to identify at least two alternatives. Of course, students having difficulties coming up with a second alternative can be reminded that one possible solution is to “do nothing.”

6) Which one alternative does the class/student recommend, and why? “

“Doing nothing” is unlikely to help Ms. Buhari achieve her objective, that is, to persuade GTI to allow her to use her uncle’s U.S. credit card to purchase a Wurundi to Houston (return) plane ticket for her friend Ms. Ester Mgba. Thus, students believing the main problem is persuasion could recommend an approach utilizing some or all of the suggestions made by Cialdini (2001). Students believing the main problem is “negotiation” could recommend an approach which focuses on the five key steps in the negotiation process identified by Ury (1991).

7) What negatives are associated with the alternative selected by the class leader and/or other members of the class?

Very few solutions are risk and/or problem-free. Negatives associated with the solution proposed by the class leader and/or other members of the class could include the following: The chosen alternative, if it requires Ms. Buhari to expend large amounts of time and/or energy, might not be practical. Also, because the case may not provide all the data a decision maker would need (in other words, it is possible that some important data is missing), it could be that some of the assumptions made by class members are incorrect. If so, the solution they propose might not be appropriate.

The third and final step in discussing a case with students is to share with them what actually happened and to discuss with them the implications of that outcome. As she considered how to tackle the challenge of persuading getting paid by GWL, Ms. Buhari’s thought process was very close to the approach to “negotiations” recommended by Ury (1991):

- 1) Go to the balcony: Ms. Buhari did not respond immediately to GTI’s cancellation of her purchase of plane tickets for her friend Ms. Mgba; rather, she gave herself some time to think about the situation.
- 2) Step to their side: In several of the emails GTI sent to Ms. Buhari, the company indicates that it is very concerned about credit card fraud; given Wurundi’s reputation for corruption and/or financial fraud, it seems very likely that Ms. Buhari is both aware of (and understands) GTI’s concerns on this point. Having said this, however, GTI’s website indicates that the company is also very eager to maintain its reputation as

delivering world-class service to its customers; it seems likely that Ms. Buhari is also aware of this aspiration of the company.

3) Reframe the argument: As indicated earlier, Ms. Buhari's primary objective is to ensure that she is able to use her uncle's U.S. credit card to purchase a Wurundi to Houston (return) plane ticket for her friend Ms. Mgba. It does not appear that Ms. Buhari is motivated by any desire to pick an unnecessary fight with GTI or by any desire to embarrass the company.

4) Build them a golden bridge and 5) Use Power to Educate: In response to the email from GTI cancelling the purchase of the plane tickets for her friend Ms. Mgba, Ms. Buhari sent GTI the following email:

From: Ms. Millicent Buhari
To: GTI Customer Service
Date: 6 June
Subject: GTI order number XXX391

“Gentlemen:

For a company that claims on its website to offer excellent customer service, the chain of events I have experienced as I have tried (over the last few days) to purchase a plane ticket for my friend Ms. Ester Mgba, using a U.S. credit card provided me by my uncle in the U.S., seems absolutely unbelievable. The “chain of events” to which I am referring includes:

- 1) I was told that I needed to call you using the number associated with my uncle's U.S. credit card after I had already told you twice that (because I am located in Wurundi) I would not be able to do that.
- 2) I was told that the U.S. phone numbers associated with my uncle's U.S. credit card are not the correct numbers, even though he has assured me that the numbers I provided you are in fact the correct phone numbers.
- 3) I was asked to email or fax you a huge amount of information (front and back of my uncle's credit card, copy of my passport, copy of the latest credit card statement received by my uncle from his bank, etc.), and I was told (on the form which you sent me) that as soon as I submitted that information, my uncle's credit card would be charged and the plane tickets I had requested for my friend Ms. Ester Mgba would be issued.
- 4) Now, instead of charging the plane tickets for my friend Ms. Ester Mgba to my uncle's U.S. credit card, you have sent me an email telling me that you have cancelled my purchase of plane tickets for my friend.

For a company which (supposedly) prides itself on the quality of service it provides to its customers, this chain of events is absolutely and totally unbelievable. I am sending you this note on the chance that you will be willing to change your position and issue the tickets which I had ordered for Ms. Mgba. If there is no change in your position, I look forward to sharing this sorry story not only with the Office of the Attorney General of the State of Georgia but also with

the Georgia Better Business Bureau which your website indicates has (to date) given your company an “A” rating.

Sincerely,
Ms. Millicent Buhari

EPILOGUE

Within 24 hours of the time Ms. Buhari sent her final email, GTI sent her back the following response:

From: GTI Customer Service
To: Millicent Buhari
Date: 6 June
Subject: GTI order number XXX391

Dear Ms. Buhari:

Your reservation has been set up for ticketing. You should be receiving an E-ticket email for the flights you requested within 24hrs.

Passenger: Ms. Ester Mgba

Kind regards,

Global Travel Inc.
Customer Service

CONCLUDING COMMENTS

At this point, it may be useful to review briefly the lessons which can be learned from this case. In the opinion of the author, those lessons include:

- 1) For young adults (that is, the sorts of students you are likely to be teaching), there is a small but very practical lesson this case can teach them: In some countries (especially those associated with high levels of financial fraud and/or corruption), purchasing plane tickets over the internet using a credit card can be very difficult. This is especially true if there is anything unusual about the transaction; “unusual” would include attempting to use a credit card belonging to someone else, buying a ticket when the person traveling is not the person whose name is on the credit card, etc. In such situations, anyone attempting to purchase a plane ticket over the internet using a credit card should start their attempts to purchase tickets long before they plan to travel.
- 2) While purchasing plane tickets over the internet using a credit card in situations such as the ones set forth above can be difficult, making such a purchase is not impossible. In such situations, knowledge of a negotiation model such as the one proposed by Ury (1991) can be very useful. Ultimately, Ms. Buhari succeeded in getting GTI to sell her the plane tickets she wanted by following the steps suggested by Ury (ibid), that is, she:
 - a. Went to the balcony: As indicated in the case, each time she received an email from GTI, Ms. Buhari gave herself time to think about the situation she was facing, rather than simply becoming angry and/or upset.

- b. Stepped to their Side: Ms. Buhari spent some time understanding how the situation looked to GTI (that is, she understood that the transaction she was attempting to make did raise red flags for GTI).
- c. Reframed the Argument: Ms. Buhari looked for a way to position the transaction she was requesting as a “win-win” situation both for her as a customer and for GTI as an Online Travel Agency.
- d. “Built Them a Golden Bridge”: In her final email to GTI, Ms. Buhari reminded GTI of the comments on the GTI website committing the company to delivering world-class service to its customers. Also, she reminded GTI that she had sent to them every document they had requested, and that the company had promised (in the document they asked her to fill out and which she submitted to them) her that once the company had received those documents, they would issue the plane tickets for Ms. Mgba immediately.
- e. Used power to educate: In her final email to GTI, Ms. Buhari also told the company that if they refused to issue the tickets which they had promised, she would file a complaint against GTI with the Attorney General of the State of Georgia. Furthermore, Ms. Buhari reminded GTI that a complaint from her regarding the treatment she had received from the company had the potential of putting at risk the “A” rating which GTI had been given by the Better Business Bureau of Georgia.

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Ury, W. (1991). *Getting Past No*. New York: Bantam Books

APPENDIX 1: DATA FROM THE CASE RELATING TO THE SIX PRINCIPLES OF SOCIAL INFLUENCE IDENTIFIED BY CIA LDINI (2001)

Regarding data in the case relating to the six principles of social influence identified by Cialdini (2001):

- 1) Reciprocation (that is, the idea that “we should try to repay in kind what another person has provided us”): The case indicates that Wurundi (that is, the place Ms. Buhari is based) has a reputation for financial fraud and corruption. Given that reputation, and assuming that individuals and/or organizations from Wurundi probably have attempted in the past (and will continue in the future) to attempt to defraud GTI, it seems unlikely that Ms. Buhari will be able to benefit from this principle of social influence.
- 2) Consistency (that is, the idea that we “desire to be (and to appear) consistent with what we have already done”): The case indicates that GTI has attempted to position itself in the minds of consumers as a world-class provider of internet travel services; it seems likely that the company is very keen to continue to be perceived in that light. The implication is that as Ms. Buhari deals with GTI, the communications she sends and/or the actions she considers should either reinforce the impact she could have on the image and/or positioning of the company. The bottom line here is that it seems likely that Ms. Buhari might be able to benefit from this principle of social influence.
- 3) Social proof (that is, the idea that “we determine what is correct by finding out what other people think is correct”): The case indicates that Ms. Buhari has provided not only every bit of information but also every document requested by GTI; furthermore, GTI indicates

on one of their own documents that once a customer submits the additional documents requested of them, GTI will issue the requested plane tickets immediately. The implication here is that if Ms. Buhari goes public (to the Office of the Attorney General of Georgia, to the Georgia Better Business Bureau, etc.) with her complaint, GTI is likely to discover that “other people” will perceive that Ms. Buhari has not been treated correctly and thus the reputation GTI has attempted to create for itself (i.e. a world-class provider of internet travel services and a company which deserves the “A” rating it has received from the Georgia Better Business Bureau) will be at risk. The bottom line here is that it seems likely that Ms. Buhari might be able to benefit from this principle of social influence.

- 4) Liking (that is, the idea that “we most prefer to say yes to the requests of people we know and like”): As indicated in the case, GTI is an Online Travel Agency (OTA); for that reason, it is unlikely that GTI knows Ms. Buhari and it is unlikely that Ms. Buhari knows anyone at GTI. In short, it seems unlikely that Ms. Buhari would be able to benefit from this principle of social influence.
- 5) Authority (that is, the idea that we tend to be obedient to authority): As indicated in the case, Ms. Buhari is a student at the University of Wurundi, in Africa. It seems unlikely that a university student in Africa unknown to GTI would be able to benefit from this principle of social influence.
- 6) Scarcity (that is, the idea that “opportunities seem more valuable to us when they are less available”): As indicated in the case, Wurundi (that is, the location in which Ms. Buhari is based) has the reputation of being a place characterized by financial fraud and corruption. Given that reputation and the fact that individuals and/or organizations from Wurundi probably attempt to defraud GTI regularly, it seems unlikely that Ms. Buhari would be able to benefit from this principle of social influence.

APPENDIX 2: DATA FROM THE CASE RELATING TO THE URY (1991) NEGOTIATION MODEL

Regarding data in the case relating to the five steps in the negotiation process recommended by Ury (1991):

- 1) Go to the balcony: The teaching note indicates that each time Ms. Buhari received an email from GTI, she took time to consider how best to respond to that email.
- 2) Step to their side: The case indicates that as Ms. Buhari considered how to respond to the cancellation of the plane tickets for her friend, she was very aware not only that GTI was fearful of fraudulent credit card use but also that GTI is keen to protect its image as a firm which provides its customers with world-class travel-related services. The case also indicates that GTI is proud of (and presumably interested in maintaining) the “A” rating which it has received from the Georgia Better Business Bureau.
- 3) Reframe the argument: No data. At the time that she received the email from GTI cancelling her purchase of the plane tickets for Ms. Mgba, Ms. Buhari had not yet attempted this stage of the negotiation process, that is, to reframe the argument.
- 4) Build them a golden bridge: At the time of the case, Ms. Buhari had not yet attempted to build a golden bridge to the company, that is, to make it easy for GTI to say “Yes” to her request that the company reverse its cancellation of her purchase of plane tickets for her friend Ms. Mgba. However (and as indicated earlier), the case does indicate that Ms. Buhari was very aware of several issues which are very important to GTI, including:

- a. GTI aspires to provide its customers with world-class travel services.
- b. GTI is proud of (and presumably desires to maintain) the “A” rating it has received from the Georgia Better Business Bureau.

5) Use power to educate: At the time of the case, Ms. Buhari had not yet attempted to use power to educate, that is, make it hard for GTI to say “No” to her request that the company reverse its cancellation of her purchase of plane tickets for her friend Ms. Mgba. However, the case does indicate that Ms. Buhari is aware of several customer-service related problems which GTI is likely to be keen to avoid, including:

- a. It seems likely that GTI would prefer not to have Ms. Buhari file a complaint to the Office of the Attorney General of Georgia; a well-documented (and publicized) complaint like that might irreparably damage the image of “world class provider of travel services over the internet” which GTI has worked to create.
- b. It seems likely that GTI would prefer not to have Ms. Buhari file a complaint to the Georgia Better Business Bureau; if she files a complaint, this could put at risk GTI’s “A” rating from the Better Business Bureau.

HEARTLAND PHARMACY: TOBACCO OR NOT TOBACCO

INSTRUCTORS' NOTE

David Kunz, Southeast Missouri State University

Rebecca Summary, Southeast Missouri State University

CASE DESCRIPTION

The subject matter of this case concerns the primary objective of the corporation: shareholder wealth maximization. Case examines a situation where profits and “the right thing to do” conflict. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 2-3 hours of preparation time from the students.

CASE SYNOPSIS

At the most recent board meeting, Dr. Allen Springer, a board member of Heartland Pharmacy, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company’s objective of improving customers’ health care. Springer had not discussed the recommendation with John Wiley, Heartland’s President and Chief Executive Officer (CEO), or Robert Davis, Heartland’s Chief Financial Officer (CFO) prior to the meeting. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley’s initial thought was the proposal had merit, but Davis pointed out sales and profitability would suffer and that the primary objective of Heartland management and board is to increase the wealth of the shareholders. Springer said he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate, the board of directors of Heartland Pharmacy agreed to table the recommendation until further information and analysis could be obtained.

The learning objectives of the case include: 1) A review of the primary objective of the a firm’s management: shareholder wealth maximization 2) Identification of the different stakeholder groups of a corporation and how their interests enter into the wealth maximization objective, 3) An examination of the ethical issue regarding the sale of tobacco products, which are a known carcinogen and 4) A review of alternative ethic perspectives.

CVS CAREMARK'S DECISION

In February of 2014, CVS Caremark, the nation's largest drugstore chain in terms of overall sales, announced that it would discontinue the sale of cigarettes, cigars and chewing tobacco at its more than 7,600 drugstores nationwide. According to CEO Larry Merlo, "We have about 26,000 pharmacists and nurse practitioners helping patients manage chronic problems like high cholesterol, high blood pressure and heart disease, all of which are linked to smoking. We came to the decision that cigarettes and providing health care just don't go together in the same setting." (Strom, 2014) It is estimated that this decision will cost the company about \$2 billion in annual sales, less than two percent of overall sales of \$123 billion in 2012.

In discussing the announcement, Dr. Troyen Brennan, a former professor of medicine at Harvard University, and current chief medical officer for CVS, noted that the decision to drop tobacco products will give his company a "competitive advantage" against other pharmacies because of the credibility it will give CVS when talking to physicians. This "credibility" may be related to participation in Accountable Care Organizations, in which health care providers are paid according to patient outcome, not procedures. Over the past few years, major drugstore chains have become more involved in the provision of health care, with walk-in clinics that treat common ailments and offer flu shots. According to Forbes, "if CVS can help save money or keep patients healthier, it might get a piece of the action." (Herper, 2014) This is one reason why CVS did not downgrade its earnings forecast for 2014. Some critics note that this attempt to appeal to physicians in order to increase CVS's business as a health care provider/partner is the real motive behind the decision.

CASE OVERVIEW

At the most recent board of directors meeting of Heartland Pharmacy, Dr. Allen Springer, a vocal board member, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company's objective of improving customers' health care. Springer had not discussed his recommendation with John Wiley, Heartland's President and Chief Executive Officer (CEO), or Bob Davis, Heartland's Chief Financial Officer (CFO) prior to the meeting. Springer had mentioned his proposal to a few of the other board members and received very limited support. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley's initial thought was the proposal had merit but was concerned with how lost revenues and profits from the sale of tobacco products would impact the firm. Davis pointed out that tobacco and related products are one of Heartland's higher margin categories and that their removal would most likely result in a reported loss. Davis asked Springer how he thought the company could compensate for the lost sales and profits. Springer said he did not have an answer and he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate the board of directors of Heartland Pharmacy, agreed to table the recommendation until further information and analysis could be obtained.

Heartland Pharmacy is a closely held corporation headquartered in Poplar Bluff, Missouri. Heartland serves a predominately rural, Midwestern market. It operates forty-three pharmacies in

southern Missouri, southern Illinois, northern Arkansas, western Tennessee and western Kentucky. All pharmacies are located in small towns. An additional six stores are scheduled to open over the next two years and expansion into northern Mississippi and eastern Oklahoma is also being studied.

Company growth has been financed with internally generated funds and private equity sales to friends of the Wiley family. The external investors were needed when growth financing requirements exceeded family resources. There are seven major external investors, mostly friends and business associates of James Wiley and all are members of the board. A number of Heartland's managers are also shareholders, but their holdings are relatively small. The Wiley family owns a controlling interest, but the non-family board members currently control close to forty percent of the outstanding shares.

After the board meeting John Wiley asked Davis to join him in his office to discuss how they were going to address the tobacco issue raised by Springer. Wiley did not think the board was likely to support a decision to remove tobacco products without adding a new revenue source and even then some members may be reluctant to sacrifice profits. Wiley valued Springer's long service and wanted to provide an objective analysis of his suggestion.

Davis stated that tobacco sales varied from store to store, but company-wide tobacco products contributed about ten percent of Heartland's annual revenue over the last four years. He also stated that the average gross profit margin on tobacco sales during that same period was close to twenty percent. Wiley instructed Davis to prepare a report that would quantify (dollars) the impact of removing tobacco products from their stores. Wiley suggested modifying the projected income statement for 2015 and to keep the analysis simple, he suggested they reduce revenues (by 10% to reflect the removal of tobacco products) and remove gross profits from tobacco sales (using a tobacco sales gross margin of 20%) but make no adjustments to selling or administrative expenses and examine the results. In addition, Wiley asked Davis to begin thinking about non-quantitative reasons for continuing the sale of tobacco products other than shareholder wealth maximization.

Davis discussed the task with the company controller, August Sawyer. Sawyer did not think preparing the revised 2015 statements would be difficult particularly with key assumptions provided, but he expressed reservations with non-quantitative analysis. Sawyer stated that a class in his graduate business program examined decision-making from a number of ethical perspectives and suggested this might be a basis for developing non-quantitative reasons to either support or oppose Springer's recommendation. Sawyer explained that teleological and deontological are the most common categories of ethical theories used to analyze the ethics of conduct. He also mentioned utilitarian and libertarian theory. Davis asked Sawyer to prepare a brief description of the various ethical theories and models and to explain where maximizing shareholder wealth fit into the decision-making process.

THE TASK

Students may take many approaches to the case, but their solution should address the following questions/issues raised by Wiley, Davis and Sawyer. A course of action should also be recommended, in particular, how will they deal with Springer's concerns?

- 1) Review the justification of shareholder wealth maximization as an accepted basis for decision-making.
- 2) Identify the different stakeholder groups and their interests that should be considered when deciding whether to discontinue the sale of tobacco and tobacco related products. Explain how a firm reconciles the interests of the different stakeholder groups with the shareholder wealth maximization.
- 3) Use the financial statements provided in Appendices One and Two, to prepare a report illustrating the impact of not selling tobacco products on the financial performance of Heartland. Use Wiley's suggestion regarding selling and administrative expenses.
- 4) Use ethical theories to develop non-financial reasons why the company should continue to sell or discontinue selling tobacco products.
- 5) Prepare a recommended course of action with supporting analysis.

Answers to the questions/issues.

- 1) Review the justification of shareholder wealth maximization as an accepted basis for decision-making.

Shareholder wealth or value is a function of the return shareholders receive on their investment. This return is in the form of cash dividends, an increased stock price or a combination of both. Shareholder value maximization is a long-term target that suggests that management's objective should be to make decisions that result in increased shareholder value. Stock price is used as a proxy for shareholder wealth. Stock price is a function of 1) the timing and amount of company returns, measured as cash flows and 2) the risk associated with the returns. Stock price is increased when cash flows are increased or received sooner rather than later and/or risk associated with receiving the cash flows is reduced. Shareholder wealth is maximized when stock price is maximized.

Shareholders are the providers of equity capital. Without equity capital, debt capital is not available. Debt capital providers require, desire, want equity investors to "put cash into the game" before investing. Without capital, assets cannot be acquired, people cannot be employed and products and services cannot be provided to its customers. If shareholders receive a return that is less than appropriate based on the risk level of the firm, they will cease being investors. Without sufficient capital the company will fail. If the company fails, all stakeholders suffer.

- 2) Identify the different stakeholder groups and their interests that should be considered when deciding whether to discontinue the sale of tobacco and tobacco related products. Explain how a firm reconciles the interests of the different stakeholder groups with the shareholder wealth maximization.

A typical listing of stakeholders group includes equity investors, creditors (suppliers of debt capital), employees, customers, suppliers, community and government.

| Stakeholder | Primary Interest |
|------------------|---|
| Equity investors | Appropriate return based on the risk level of the firm. |
| Creditors | Appropriate return (interest) based on the risk level associated with their investment (loans). |

| | |
|------------|--|
| Employees | Continued employment, appropriate compensation and opportunity for advancement. |
| Customers | Quality products or services at an acceptable price. |
| Suppliers | Timely payment for goods and services provided to the company. |
| Community | Increased quality of life in the community. A company provides residents employment, pays local taxes and contributes to charitable organizations. |
| Government | Increased receipt of tax dollars. |

To achieve the goal of maximizing long-term wealth of the shareholders, the interests of all stakeholder groups need to be considered. A company cannot achieve long-term success with a dissatisfied or disgruntled workforce. Employees must be adequately compensated and a productive workforce environment cultivated. Inferior products or services that fail to meet the needs and desires of the customer will result in financial failure. Customers must be satisfied that the products or services received are fairly priced and meet their needs better than a competitors. Creditors, suppliers and taxes must be paid in a timely manner. Shareholders are the providers of equity capital. None of the needs of the stakeholder groups can be met if the company is not profitable and meeting the needs of the equity investors. Shareholders receive top position on the stakeholder priority list.

| Heartland Stakeholder | Primary Interest |
|-----------------------|--|
| Equity investors | Maximize stock price. Removing tobacco products from the shelves of Heartland Pharmacy would result in lower profits and have a negative impact on stock price. |
| Creditors | Lower revenues will result in lower profits and expose creditors to higher default risk. |
| Employees | Revenue will decrease as the tobacco products are discontinued. Declining revenues may cause employee wages to stagnate or decline. Continued employment may be at risk as Heartland restructures to adjust for lower revenues. |
| Customers | Tobacco customers will be forced to shop elsewhere and may also shop elsewhere for their other product needs. It should be emphasized that tobacco products will be available elsewhere. The health of the tobacco user will most likely not change as a result of Heartland's decision to discontinue tobacco products. |
| Suppliers | Tobacco product suppliers will no longer have a major customer but their business may be transferred to other retail outlets. |
| Community | Heartland's lower revenues and profits will most likely have a negative impact on the quality of life in the community. If Heartland's work force is reduced, there will be less money to be spent in the communities. Income and other taxes will decrease. Heartland's contributions to community and charitable organizations may be reduced. |
| Government | Lower revenues and lower profits will result in less tax dollars paid by Heartland to all levels of government (local, state and federal). |

Satisfying the interests of the various stakeholder groups is not a mutually exclusive task. A productive and content work force will produce quality products or provide superior service. Heartland will be profitable and investors and creditors will receive a return commensurate with risk. A profitable Heartland will pay taxes and contribute to the communities' well-being. All of Heartland's stakeholders depend upon a healthy and

profitable company. All stakeholder groups would likely oppose removing tobacco products from Heartland Pharmacy.

- 3) Use the financial statements provided in Appendices One and Two, to prepare a report illustrating the impact of not selling tobacco products on the financial performance of Heartland. Use Wiley's suggestion regarding selling and administrative expenses.

Davis provided the following assumptions to modify the projections for 2015:

- tobacco sales contribute 10% of revenues
- tobacco products have an average gross profit margin of 20%
- make no adjustments to selling or administrative expenses

Applying the new assumptions to the original 2015 projection indicates net income would decrease substantially from \$3,621,760 with tobacco products to \$984,307 without the sales of tobacco and tobacco related products. The removal of tobacco products would also impact certain balance sheet accounts. Heartland's investment in accounts receivables and inventories would be reduced, thus reducing financing requirements by about \$4,000,000. Using the \$4,000,000 to reduce debt would result in reduced interest costs, but the overall impact of removing tobacco and tobacco related products would be negative. Unless a new product line could be added, selling and administrative expenses would also need to be reduced. A major restructuring would be required.

Of major interest to the board would be the reduction in dividends resulting from the lower earnings. Maintaining the same 50% dividend payout ratio would reduce dollar dividends from \$1,810,880 with tobacco sales to \$492,153 without tobacco sales, a reduction of more than 70%. It is very unlikely shareholders would be happy with the lower dividends.

Future expansion plans may also be at risk since Heartland is heavily dependent upon internally generated equity to finance growth.

Heartland Pharmacy

| Income Statement (\$000) For the Year Ended December 31 | With Tobacco Projected 2015 \$ | W/O Tobacco Projected 2015 \$ |
|--|--|--|
| Sales revenue | 204,100,000 | 183,690,000 |
| Cost of goods sold | 157,136,590 | 140,808,590 |
| Gross profits | 46,963,410 | 42,881,410 |
| Operating expenses | | |
| Selling expense | 27,859,650 | 27,859,650 |
| General & administrative expenses | 9,796,800 | 9,796,800 |
| Depreciation expense | 3,326,830 | 3,326,830 |
| Total operating expense | 40,983,280 | 40,983,280 |
| Operating profits | 5,980,130 | 1,898,130 |
| Interest expense | 806,187 | 491,977 |
| Net profits before taxes | 5,173,943 | 1,406,153 |
| Taxes (rate = 30%) | 1,552,183 | 421,846 |
| Net profits after taxes | 3,621,760 | 984,307 |
| Dividends | 1,810,880 | 492,153 |

Heartland Pharmacy

| Balance Sheet (\$000) As of December 31 | With Tobacco Projected 2015 \$ | W/O Tobacco Projected 2015 \$ |
|---|--|--|
| Assets | | |
| Current assets | | |
| Cash | 1,020,500 | 918,450 |
| Accounts receivable | 13,968,268 | 12,571,442 |
| Inventory | <u>19,162,999</u> | <u>17,171,779</u> |
| Total current assets | <u>34,151,767</u> | <u>30,661,671</u> |
| Gross fixed assets | 30,472,130 | 30,472,130 |
| Less: Accumulated depreciation | <u>13,896,830</u> | <u>13,896,830</u> |
| Net fixed assets | <u>16,575,300</u> | <u>13,528,087</u> |
| Total assets | <u><u>50,727,067</u></u> | <u><u>44,189,758</u></u> |
| Liabilities and Stockholders' Equity | | |
| Current liabilities | | |
| Accounts payable | 11,365,496 | 10,184,512 |
| Notes payable | 660,668 | 660,668 |
| Accruals | <u>415,828</u> | <u>415,828</u> |
| Total current liabilities | <u>12,441,992</u> | <u>11,261,008</u> |
| Long-term debts | <u>9,496,674</u> | <u>5,569,049</u> |
| Total liabilities | <u><u>21,938,666</u></u> | <u><u>16,830,057</u></u> |
| Stockholders' equity | | |
| Common stock (at par) | 10,500,000 | 10,500,000 |
| Retained earnings | <u>18,288,402</u> | <u>16,859,702</u> |
| Total stockholders' equity | <u>28,788,402</u> | <u>27,359,702</u> |
| Total liabilities & stockholders' equity | <u><u>50,727,067</u></u> | <u><u>44,189,758</u></u> |

4) Use ethical models to develop non-financial reasons why the company should continue to sell or discontinue selling tobacco products.

Discontinuing the sale of tobacco products is supported by Kantian ethical theory. According to Kant, respect for people is a necessity, and people should not be treated as a means to an end. Motives are important to a Kantian: people must make the right decisions for the right reasons. The motivation for any action should be a sense of duty and good will. By discontinuing the sale of tobacco products, Heartland Pharmacy is treating its customers with respect. The motive for the decision is to improve the health of its customers.

Utilitarians look at the consequences of an action; an action is ethical if it leads to the best possible net outcome of good over bad consequences. From the perspective of a utilitarian, discontinuing the sale of tobacco products does not lead to the greatest good; gains do not outweigh losses. Stockholders will lose as a result of lower profits.

Employees are also likely to lose as some of them may lose their jobs. Likewise, suppliers that provide tobacco products to Heartland will lose a customer, although this loss may be offset by higher sales to other retailers. Heartland's customers will be able to secure tobacco products at other retailers, and so there is no gain to their health as a result of this action. The communities in which Heartland Pharmacies operate will not experience any gain if jobs are lost, and community health is unlikely to improve since tobacco users can purchase products at other retailers. Governments may lose some tax revenue from lost jobs (see Stakeholder Analysis above). The negative consequence of a ban on the sale of tobacco products is further substantiated by industry conditions. With respect to growth potential, "diversification of product lines and general merchandise geared toward customer needs ...may hold the brightest future for the independent drug store." (Lindberg and Vaughn, 2004) Banning tobacco products does not follow this recommendation. Likewise, the growing degree of competition forecasted for independent drug stores suggests that Heartland Pharmacy continue to sell tobacco products in order to maintain the same product lines as its competitors.

A libertarian would not support a ban on the sale of tobacco products. Profit maximization is the primary goal for a libertarian; the social responsibility of a company is to maximize profits for its stockholders. Since discontinuing the sale of tobacco products leads to lower revenue and profits, a libertarian would clearly not support this action.

5) Prepare a recommended course of action with supporting analysis.

From a financial perspective, discontinuing tobacco sales would have a substantial negative impact on Heartland. Projected 2015 revenues would decrease from \$204,100,000 (with tobacco sales) to \$183,690,000 (without tobacco sales). Profits would suffer a similar decline from \$3,621,760 with tobacco products to \$984,307 without tobacco and tobacco related products. Maintaining a 50% dividend payout ratio would reduce dollar dividends from \$1,810,880 with tobacco sales to \$492,153 without tobacco sales, a reduction of more than 70%. It is very unlikely shareholders would be happy with lower revenues, profits and dividends. The decision is straightforward; continue sales of tobacco and tobacco related products.

Addressing Dr. Allen Springer's objections to the sale of tobacco products is more difficult. An argument can be made that tobacco products are legal and if Heartland discontinues their sale, tobacco users will still have access to tobacco products at other retail outlets. Tobacco users may cease to shop at Heartland for all their pharmacy needs, thus creating additional pressure on revenues and profits.

It can also be argued that tobacco products are not the only products sold by Heartland which have a negative impact on the health of its customers. Alcohol products, snack foods, dessert items, soft drinks, candies, etc. can be viewed as unhealthy. Following Springer's logic, should Heartland consider discontinuing these products as well?

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DINNER OR NO DINNER: A STUDENT LEADERSHIP DECISION

CASE DESCRIPTION

The primary subject matter of this case concerns leadership, governance and the roles of board members and individual and institutional reputation. Secondary issues examined include stakeholder analysis; conflict management; and decision analysis by the student leaders. The case has a difficulty level of two through five. The case is designed to be taught in 45-75 minutes and is expected to require 30-45 minutes of outside preparation by students.

CASE SYNOPSIS

This case portrays the mismatch between the requirements and expectations of a leadership position and the capabilities of the elected student leader to fulfill the role. The emotional tension that arises when peers don't measure up to expectations or organizational requirements leads to conflict and in this case the conflicts are acute requiring action to protect and enhance the reputations of individuals and a university school of management. The case dramatizes the challenges and choices of the organization's executive leadership board to intervene productively to change the situation, including removing the board president, and still achieve a positive outcome for a high profile event annually hosted by the organization for the entire university community. The stakes are high in this case because the student organization, a business fraternity, has undertaken an annually recurring, highly public event that carries reputation risk for the fraternity, the school of management that hosts the group and the alumni affairs function of the university. The case is a real-time drama of students evaluating a sensitive situation, seeking advice from their chapter faculty adviser, whose role is to facilitate and mentor the organization, developing options for action, and through Socratic questioning helped them select and implement a preferred option. The case offers students an opportunity to project themselves into situations common to student-led organizations that carry similarities to organizational leadership challenges in the professional world.

INTRODUCTION

Claire Burns and Spencer Heddins walked out of the room angry and frustrated. As seniors, both of them were established leaders on the University campus and in the School of Management and both were long-standing members of the School's business fraternity. They had just left the executive board meeting in which the fraternity president, Joseph Strawn, had criticized everyone collectively and individually for lack of action on a major, upcoming event, *Dinner with the Industry*, an annual signature event of the business fraternity. While both knew there were problems regarding the event, they were taken aback by the President lashing out at the other fraternity leaders. Not only was it not helpful but they thought Strawn was as much the

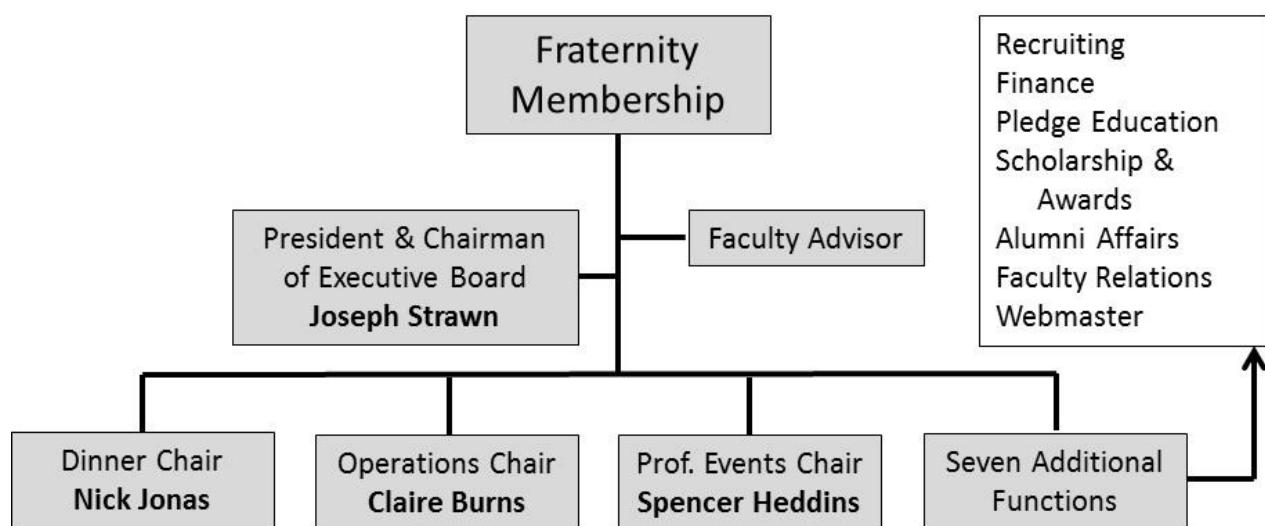
problem as anything else. But what should they do about it? It was the fall semester and the president had been elected in the prior semester. He had raised some concerns then about his interpersonal style and last-minute decision making pattern.

BACKGROUND

The co-educational, nationally affiliated business fraternity, chartered at the School of Management for ten years, had grown to an active membership of approximately 60 undergraduate students. As top students of the School, they represented all majors and concentrations in the business field. They engaged a wide range of professional events that they scheduled for the members' professional readiness and leadership experience. The focus on leadership aligned very well with the School of Management's overarching theme, "Learn, Lead and Serve." The fraternity frequently acted as the arms and legs of several of the School of Management's annual, signature programs such as Leadership and Ethics Day in the spring, an event that the Dean of the School of Management hosted on behalf of the University. The fraternity members acted as ambassadors, hosts and guides of the business leaders who came to campus to discuss current issues with students in the students' classes for the day.

The fraternity executive board of eleven annually elected members was the guidance system for the fraternity's activities during the year. The board developed a strategic plan, presented it to the chapter, and managed its execution throughout the school year. Rush, professional events, faculty relations, alumni affairs, the national chapter of excellence competition, and a dinner for industry professionals were among the major annual events of the organization. The structure of the executive board is depicted in Figure 1, with the principal student leaders identified in the boxes.

Figure 1. Business Fraternity Executive Board Structure



Strawn's leadership had created conflict in the past largely due to a combative style in which every detail had the potential to be an issue, regardless of its importance. In a number of encounters over the previous year, he had taken on members of the executive board over issues that resulted in bad feelings and little resolution of the issue on the table. He was well-spoken and had the image of being "in-charge" and assertive. At the same time, he maintained very close control over all of the information and expectations of the members, controlled communication left those responsible for the event in the dark. He had a noticeable habit of procrastination and last minute decision making that irritated many of his peers. In the fall, an important annual event that the fraternity organized and hosted was *Dinner with the Industry*.

DINNER WITH THE INDUSTRY

Dinner with the Industry had grown in its five-year life to a level of significant participation: an average of 50 community-based businesses and over 200 students from across the campus attended a dinner to meet and talk informally with principals in fields and businesses that the students felt they might be interested in pursuing professionally. The dinner had become a major event on campus that garnered significant allocation of funding support from the campus student activities board and had the support of influential alumni of the University. One alumnus, who was a well-known industry leader in the community and leader of a newly formed University alumni organization, wrote to the student organizer after the previous year's event, "Congratulations on a very successful event. Thanks for inviting me to participate." In addition to his leadership role in business, his role as president of the University Alumni Leadership Council made his note a particular compliment to the student organizers and the School and University leadership. "We should get the Leadership Council involved," he concluded. This impressed the vice president of advancement for the University and helped solidify the reputation of the student organization with the University and School of Management leadership.

The response of the leadership council president reflected the broad sentiment among the business community leadership. The response of the community's business leaders was the hope of the dinner organizers and the School of Management, whose leadership actively supported the students in promoting the event. The Dean commented, "The event is totally student driven from invitations, to arrangements, to program; it is an end-to-end student project." And, the Dean saw the event as a learning laboratory for leadership.

Under the supervision of a management professor, John White, the fraternity's faculty adviser, and with the assistance of the University's Career Services department and other resources that the students secured, the event carried the "brand" of the School of Management and provided an excellent real-time experiential learning and leadership environment. "This is quite real for the students. The leadership in planning, programming, the emotions, pressure, tension of performance and execution are all on display. This is real and it is a delicate, sensitive leadership learning experience," the Dean of the School of Management stated. The Dinner had grown in prestige and visibility campus-wide and a lot was riding on its execution.

EXECUTIVE MEETING POSTMORTEM

Following the meeting of the fraternity's executive board, Heddins and Burns walked toward the stairway leading to the foyer of the School of Management. "Can you believe Joe's attitude!" Burns said as they headed downstairs. "He just doesn't see the conflict and how frozen we all are. No one really knows who is doing what! Now, no one wants to act because nobody wants to step on anyone else's toes."

"You can't forget that Joe has got the broad support of the fraternity, but the executive board is losing patience. There's the willingness to help, but he is alienating everyone," Heddins said. "The most important immediate issue is the Dinner."

Heddins spoke bluntly about Strawn's approach, "He's got blinders on and is so bull headed. He just wants it his way. Nick [Jonas] has all of the capabilities to make the Dinner with the Industry work, but Joe just gets in the way. And, he is so abrupt with everyone." Heddins and Burns both acknowledged that Nick was not only well regarded in the fraternity but also in the School of Management and the whole campus.

"That's not the only thing either," Burns added. "There's that total train wreck that occurred at Harvesters when they didn't even know we were coming earlier this year. Joe was supposed to coordinate that. And, remember the pledge voting process? It was totally screwed up."

"And, we've got elections coming up and I'll bet that Joe wants to stand for re-election. It won't go so well for him, if the Dinner doesn't work," Burns added.

Burns asked Heddins if he had time to talk for a few minutes about the situation with Joe. "Do you think that there is anyone on the exec board who can stand up to Joe? He isn't that close to anyone on the board this year like it was last year when there were some close personal ties," Burns said. "We need a way to get Joe to back off and let Nick do his job, so Joe can concentrate on the other important stuff, like recruiting and professional events."

"There's also falling morale," Heddins added. "I don't want us to gang up on him, but we have to bring this out in the open. The Dinner is six weeks away and we need to get going on the plans while we're planning for spring rush and the professional events. Maybe we're doing too much?"

"We've basically got three things going on, don't we?" Burns said. "The dinner, the professional events on the calendar and planning for rush."

"And overall morale: I think confidence of the executive board and the fraternity is on the line, ultimately. It's our reputation," Heddins added.

What if we called Professor White and talked with him about the problem. I mean he might have some ideas," Burns speculated.

"He may have some ideas," Heddins said. "I agree, let's call him. Maybe he can meet with us now."

The phone rang in the office and Professor White answered to hear an urgent tone in Heddins voice with a request to talk. As the faculty adviser to the fraternity, he was aware of the tension around the dinner event. White said that he was free now and to come up. "What's the issue," White asked before he hung up?

“Kind of chaos in the leadership group,” Heddins said. “And, it is affecting meeting the deadline for Dinner with the Industry and a bunch of other stuff. I’d like for Claire Burns to come also.”

“That’s fine,” White said. “See you in a while.”

DR SOLAR

Joette Wisnieski, Indiana University of PA

CASE DESCRIPTION

This case focuses on a young entrepreneur pondering whether or not to start his own business. This case is useful in an entrepreneurship class as it contains most parts of a feasibility plan and allows students to work up the numbers and determine whether to proceed or not. In addition, this case could be used in a strategy class or a technology management class.

This case would be useful with junior level or senior level courses. The pertinent points can be easily covered in a one hour period and depending on how much emphasis the instructor wants to put on the numbers would require probably take 1-3 hours of outside class work preparation.

CASE SYNOPSIS

Students should find this case interesting. This case is set in spring 2013 as the US is faced with falling natural gas prices, gas fracking controversies and rising gasoline prices. A young man four years after college graduation with an engineering degree is faced with a dilemma. He has an excellent well-paying job, but part of him would like to return home. There are no jobs with his current company in Pennsylvania so the young entrepreneur begins to think about starting his own business. He has no real mentors, but can't shake the idea that this maybe his ticket home.

He has always been fascinated with the possibilities of alternative energy sources. He wonders if he has missed this opportunity or if the business model he has in mind is just different enough to allow him success. He decides to create a business plan and hopes that this will help him with his decision.

BACKGROUND OF ENTREPRENEUR

Dave Roberts is 26. He graduated from a prestigious engineering school and went to work for a large corporation in an energy related field. He really liked the company he worked for but always thought the idea of owning his own business would be something he would like to do. He also liked the idea of something related to renewable energy sources. Dave knew a lot about engineering, but not a lot about business, but he did know he needed a business plan.

The decision must be made soon. The company he is with has just offered him a transfer and promotion. If he takes it and then changes his mind, he will owe the company his moving expenses along with his \$5000 bonus to move. He must tell the company in the next few weeks whether or not he will take the transfer and promotion.

OVERVIEW OF ENERGY INDUSTRY

The electric power industry is a \$298-billion-plus industry that provides the nation with the most common energy form known—electricity. It is also a very fragmented industry includes any company producing, selling, or distributing electricity. These energy markets include the “traditional” electric utilities, such as shareholder-owned companies, electric cooperatives, and government-owned utilities.

Fossil fuels, uranium and water are the most common sources of energy that are converted into electricity. About 66 percent of generation in the United States came from fossil fuel in 2013. Coal and natural gas are currently the dominant fossil fuels used by the industry. Nuclear contributes approximately 20 percent, while the contribution from conventional hydroelectric fluctuates between 6 and 8 percent.

Electricity generation from renewable sources other than water is growing in importance. Electricity generation from wind, in particular, has been growing rapidly in recent years, with wind contributing about 4% in 2013.

Some other renewable sources of energy that are converted into electricity include:

- Geothermal energy,
- Solar thermal energy,
- Photovoltaic energy, and
- Biomass

While much work has been done to reduce emissions from burning fossil fuels to generate electricity, still some gases and particulates are not captured by the pollution control equipment and are released into the atmosphere. Among the gases emitted during the burning of fossil fuels are sulfur dioxide (SO₂), nitrogen oxides (NO_x), and carbon dioxide (CO₂) contributing to global warming. Electric power plants emit more than two billion tons of carbon dioxide each year, or roughly 40 percent of total emissions.

Renewable energy sources—such as solar power, wind, geothermal, and biomass—produce minimal environmental impact and generally have low or no fuel costs. But there are issues with these as well. Many renewable sources are not available at all times or not readily available when electricity is required immediately. Renewable sources of energy also face their own environmental and siting concerns.

OVERVIEW OF THE SOLAR PANEL INDUSTRY

History of Solar Energy

Solar energy is not as new as you may think. According to the US Department of Energy, solar energy has been around since 7th Century B.C. when man first used glass to magnify the sun's rays and make fire. Some sources say that in 212 BC, the Greek scientist, Archimedes, used soldier's bronze shields to focus sunlight and set fire to wooden ships from the Roman Empire which were besieging Syracuse. What is perhaps more interesting is the Greek

navy recreated the experiment in 1973 and did successfully set fire to a wooden boat at a distance of 50 meters.

Roman architecture as far back as early 1st century A.D. shows that Roman bathhouses had large south facing windows presumably to let in the sun's warmth.

The first patent was applied for in 1816 by Robert Stirling applied for his economizer at the Chancery in Edinburgh, Scotland. Robert Stirling was actually a minister in the Church of Scotland whose hobby was building heat engines in his home workshop.

Albert Einstein was also interested in solar energy and published a paper on it in 1905 and in 1921, wins the Nobel Prize for his theories on the photoelectric effect.

The first silicon solar cell, which as really the beginning of all solar-powered devices, was built by Bell Laboratories in 1954. Not surprising, the space industry was an early adopter of solar technology. It was solar technology that powered space crafts beginning in the 1960s. The Vanguard 1 -- the first artificial earth satellite powered by solar cells -- remains the oldest manmade satellite in orbit -- logging more than 6 billion miles, according to the Energy.gov site.

Solar Energy Industry Today

The current solar power market has three main types of solar related businesses. There is the hardware that goes into the solar power array and that comes from component manufacturers. Solar panel installers, who are responsible for the physical installation of the solar systems.. In addition, the last major solar related businesses are the solar utility companies who use massive arrays of solar power systems to produce electricity and sell it to the consumers.

Germany has historically been the leader in solar power. In 2013 China, who has over 50% of the world's manufacturing capacity, realized its own need for a clean power source and really increased its use of solar power. China has become the world leader in the use of photovoltaic solar and there is no reason to believe this will change anytime soon. In the last several years, both Japan and the United States have also come on strong with significant installations.

The solar industry is one that has performed very well in recent history in the US. Sales of solar panels have grown a minimum of 40% per year since 2000. The five year growth rate from 2007 to 2012 was approximately 55% per year! In the first quarter of 2012, developers installed 85 percent more solar panels compared to the first quarter of 2011. During 2012, over 80,000 households installed solar panels on their property. Total U.S. installations were projected to reach 3,300 megawatts in 2012 -- making the US the fourth largest solar market in the world.

Solar Panel Technology

There are two main types of solar technology currently in use. Photovoltaic (PV), uses the photovoltaic effect to generate electricity by capturing the sun's rays via solar panels.

According to Nasa Science News, photovoltaic works at the atomic level by directly converting light into electricity. The photoelectric effect causes certain materials to absorb photons of light and release electrons. When these free electrons are captured they create an electric current that can be used as electricity.

A polycrystalline solar panel module is made from a block of silicon that has multiple crystals. These panels are square in shape, and their surface resembles a mosaic due to all the different crystals that make up the module. Those made with silicon crystals may appear smooth and even and are called monocrystalline modules.

Monocrystalline panels made from a single crystal are more efficient than polycrystalline solar modules but, polycrystalline panels are much simpler to produce, and cost far less to manufacture. They are just as durable and have a similar life span as the monocrystalline systems therefore they are less expensive for consumers.

LOCATION

Dave wanted to return to his hometown of Pittsburgh, PA. So he began his research looking at that as an option. Weather would be a primary factor in the feasibility and profitability of DR Solar since the primary commodity that the company is dealing with is solar energy.

Pittsburgh was sunny during the day 45% of the year and had clear skies 59 days throughout the year with an average amount of sunlight of 2021 hours. It appeared that Pittsburgh also had 3 companies specializing in installing solar power. They were Honeycomb Solar, LLC - Pittsburgh , Vox Energy Solutions - Allison Park , and West Penn Energy Solutions - Pittsburgh.

The housing market would also be important. Pittsburgh has roughly 589,201 homes occupied by 58.65% of the population and a median household income of \$49,000.

CUSTOMER DEMOGRAPHICS

Energy costs have been rising. Between 2004 and 2007, the national average price of electricity increased almost 20% percent from 7.6 cents per kilowatt hour (kWh) in 2004 to 9.1 cents per kWh in 2007. As fuel costs continue to rise so did the cost to produce electricity. In doing his research, Dave found out some facts about who buys solar power. 84% of solar electric systems installed are for residential customers. While these systems are much smaller than commercial systems, they actually represent only 33% of grid-tied PV systems in megawatts.

Who Buys Solar Power?

The Solar Electric Power Association conducted a survey of about 600 households who made the decision to pursue solar systems and found some interesting facts:

Half of the respondents do not have children or no longer have children in the home.

Most had a household income over \$100K, however about 1/3 of respondents had an income between \$50K and \$100K.

A strong majority of households also said that they have joint financial decision makers so both parties had to agree to making this decision.

Educated. Most have an undergraduate degree and over half have a post-graduate or professional degree.

Why Did Consumers Decide to Purchase a Solar Panel System?

Environmental concerns were chosen as the top priority for most households, although respondents were also motivated to decrease the dependence on foreign oil, produce their own electricity, and reduce their current electricity rates.

A different survey of 200 solar home owners conducted by Pure Energies showed some different results though. This survey found men were initially most interested in solar power. While mean household average was about the same (76,000-100,000), these customers surveyed said they did it for the money. Without the economic benefit of going solar, nearly 3 or 4 homeowners say they wouldn't have done it. 70% of solar homeowners say they're "savvy spenders" or "budget conscious." 44% of solar homeowners say they're "tech crazy" or "gadget crazy."

COMPETITION

Dave discovered that large companies are continually entering/exiting the market on a daily basis because of the volatile nature that is associated with a new solar business. The primary reason for this is because many companies take on more customers and millions of dollars in debt.

Dave found 3 competitors. They were Honeycomb Solar, LLC - Pittsburgh , Vox Energy Solutions - Allison Park , and West Penn Energy Solutions - Pittsburgh. This did not seem like a large number of competitors given Pittsburgh's size.

BUSINESS MODELS

Selling vs. Leasing

There are two main business models available from the installers point of view. The installer has the option to sell the panels directly to the consumer or lease the panels and retain ownership. There are pluses and minuses to both options.

In the leasing option, DR Solar would own the panel and any electricity generated. The consumer would then pay a fixed fee to have the solar energy cut down on the consumer's electric bill. The main advantage of this aspect for the consumer is the ability to lock in a fixed rate on energy bills in deregulated states where energy bills are expected to greatly increase. The main advantage for DR Solar was the ability to maintain and control the solar panels throughout the process but will the solar panels last long enough to regain his investment. DR would earn cash by selling the extra electricity back to the grid. There are also many legal issues involved when a consumer sells their home and must transfer the lease to the new home owner.

In the selling option, DR Solar would sell the panels to the consumer. From DR's perspective, this shifts the burden of paying for the system to the consumer. The consumer then is in a position to receive tax benefits if any are available

Costs

As a business, DW Solar could have four different sizes of solar panels that would be distributed to the consumer. The solar panels have sizes from 3KWh, 5KWh, 7KWh, and 10KWh. The 3KWh solar panel system will cost DW Solar \$12,000 but he intended to add an additional \$3000 or a 25% markup, while it will only cost the consumer \$10,500 (after tax incentives) plus installation. The hourly output for the 3KWh solar panel will be 3KWh, depending on the location of the panel. The daily production of the 3KWh solar panel is around 10.5KWh, which would bring it to 315KWh monthly and 3,780KWh yearly. This would bring consumer monthly revenue to \$34.64 and yearly revenue to \$415.80. What split would he need to make a profit? Would the remaining be enough to make the sale? And how many sales would it take to make a profit?

Dave had many reasons to return home. Most of his family and friends were still in the Pittsburgh area and Dave loved the city. He had saved quite a bit of money already and he tended to live simply so money was not a huge motivator for him. But a decision had to be made soon. If he accepts the promotion, then it becomes very costly to leave the company. If he is going to leave, it should be now. "I just don't know whether this is the right move," Dave thought to himself but knew time was running out.

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STARTUP PRODUCTION PLANNING UNDER FUNDING CONSTRAINTS

Dennis Zocco, University of San Diego

CASE DESCRIPTION

The primary subject matter of this case concerns relationships between three critical decisions facing founders of startups in planning for initial production capacity: space leasing, subcontracting, and cash burn. A startup wind turbine manufacturing company faces these decisions under an initial funding cash constraint as they plan the company's first two years of production capacity. Secondary issues are to understand 1) the elements of a manufacturing facility lease, 2) the rationale and motivations for subcontracting all or a subset of the product's component parts, 3) the financial forecasts necessary to determine the cash burn associated with various levels of production capacity, and 4) the complexities of integrating these decisions and forecasts in developing the optimal initial production capacity for the startup. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in three or four class hours, depending on the student proficiency in finance and accounting, and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

WindPower is a wind turbine manufacturing company founded by an American executive from General Electric, an executive from a large German electric utility, and a young Norwegian scientist just graduated from MIT, with a Ph.D. in aeronautical engineering. The two executives bring to the startup a combined \$7 million in cash. The scientist brings with him a patent for a two-blade, flexible housing turbine that will generate an energy efficiency yield higher than any wind turbine on the market. The company has received interest in their wind turbine from wind farms in the U.S. and Europe. However, these farms are reluctant to place orders with the new company without being sure of their production capacity. Therefore, they ask the WindForce founders how many turbines they can produce and sell to them in the next two years. The WindForce founders are now faced with selecting the manufacturing site and size of facility as well as the components that will be produced in-house and will be subcontracted, which in a recursive fashion affect the size of the facility. These decisions need to be made under the constraint of the initial cash available for use in the company and the desire to not only maintain a minimum monthly cash balance but have sufficient cash at the end of the two years to accelerate production beginning in year three. A relational set of financial models are used in the case to facilitate the understanding of how these decisions are inter-related and of the implications of these decisions on cash burn.

THE NEW VENTURE

In 1915, the British scientist Frederick W. Lanchester provided scientific evidence that the maximum kinetic energy in wind that can be extracted in open flow, independent of the design of the turbine extracting the energy, is 59.3%. Published scientific papers indicate that the German physicist Albert Betz came to the exact same conclusion four years later in 1919. A year after Betz's publication, research published by Nikolay Yegorovich Zhukovsky, a Russian scientist and the founding father of modern aero- and hydro-dynamics, reported exactly the same results. The 59.3% turbine maximum kinetic wind energy extraction conclusion came to be known as Betz's Law, and the percent limit became known as the Betz coefficient.

In his capacity as an aeronautical engineer and Vice President of the Energy Management Division at a major U.S. wind turbine manufacturer, Sal Turner knew of and understood the implications of Betz's Law. The maximum wind power extraction efficiency of his company's turbines is around 35% which is at the high end of the efficiency scale for current commercially available wind turbines.

Sal's position provided him with a rewarding platform to learn about the renewable energy industry and with the opportunity to travel the world observing innovations in sustainable energy products and practices. In his travels he spoke with entrepreneurial scientists who were passionate about their innovations and who had built businesses to provide their products and services to the world. Over time, he discovered that he wanted to be one of those entrepreneurs.

THE OPPORTUNITY

Sal had just attended a conference on wind power held in Beijing and sponsored by Greenpeace International and the Global Wind Energy Council. At the conference he learned that economic experts in the industry are forecasting that wind power could supply up to 12% of global electricity by 2020, creating 1.4 million new jobs and reducing CO₂ emissions by more than 1.5 billion tons per year, more than five times today's level. By 2030, wind power could provide more than 20% of global electricity supply.

Based on those forecasts he concluded that the success of a new venture in the wind energy industry sector would be based on three key elements: (1) a compelling, innovative product idea, (2) a team with highly-skilled and diverse talents to build a business model around that idea, and (3) significant funding. He had neither of the first two. As for the third, he knew that venture capitalists are reluctant to invest in a venture at its inception, especially in the very speculative sustainable energy industry. So his venture could get off the ground only if a founding team could be organized and he funds the venture himself.

His professional career has been lucrative for him, with escalating salaries and generous bonuses. With his savings and an inheritance from his grandfather, also an entrepreneur, Sal had \$8 million in the bank and was willing to invest half of it in his new venture.

Further thinking had him realize that he would not be able to attract to his venture highly-talented people who had secure and lucrative positions elsewhere unless he demonstrated that he was willing to take the risk of forgoing his own position. He also did not want to struggle with the ethical issues of pursuing a new venture while still working at his current company, although many entrepreneurs have successfully and ethically navigated through those issues. So he gave his four-week notice. A month later, at the age of thirty-eight, he was unemployed...but he was also about to become an entrepreneur.

He wanted his new venture to be special, with a product that was able to harness the force of wind and capture its inherent energy. He began planning for his new venture. His first decision was to name it *WindForce*.

Sal's preliminary business idea for WindForce was to design, manufacture, and market a new and innovative wind turbine. He knew the design would have to come first. Since Betz's Law set the maximum efficiency of wind turbines at 59.3% and that the most efficient turbines on the market provide a maximum of around 35% efficiency, he thought if he could design a turbine that could move energy-capture efficiency a few percentage points closer to the Betz coefficient, and if he could manufacture it at a cost that would allow a very competitive price, he would not only have a profitable company but also forge forward in his primary passion—to expand the frontier of sustainable energy. So he drew upon all his knowledge of aeronautical engineering and his experiences in the sustainable energy industry to begin the process of designing a wind turbine that would meet his WindForce venture's success criteria.

A few weeks into his design effort, he had made no progress. He soon realized that he had been out of the product design area for too long, having devoted his efforts at his former company to managing the business of manufacturing and distributing wind turbines. So he started looking at past and current patents and patent applications related to wind technology.

THE INNOVATOR – JO SANDBERG

A recent patent grant caught Sal's attention for two reasons. First, elements of the technology described in the patent were very innovative in nature and addressed many of the turbine design problems currently constraining wind energy extraction efficiency. Second, one person owned the patent which would make discussions on that patent easier than dealing with multiple inventors or a company. The name on the patent was Jo Sandberg. Sal searched the Internet for Sandberg and found that he was pursuing the same degree that Sal had earned (a Ph.D. in Aeronautical Engineering) from the same university (MIT).

Sal called Sandberg and told him about the WindForce venture and that he wanted to talk to him about his patented technology. Sandberg agreed to meet Sal at a Starbucks on Harvard Street just a couple blocks from Sandberg's apartment.

In their meeting, Sandberg explained to Sal that his turbine technology is based on a 2-blade, horizontal axis design with the rotor orientation downwind of the tower. The reason for the downwind design is that the wind will drive the rotor blades away from the tower so that the rotors do not have to be as rigid as an upwind design which needs to be concerned about the rotors bending and hitting the tower. Therefore, the down-wind rotors and the turbine tower and housing can be lighter in weight and therefore less expensive to manufacture than 3-blade upwind turbines.

Sandberg explained to Sal that his innovation—one that no one had thought of before—is in the mechanism that attaches the turbine blades to the rotor shaft. Drawing from the design of the latest military stealth helicopter blade design, Sandberg's design for the turbine's flexible coil rotor shaft uses a new, environmentally friendly, extremely flexible, and super-strong material called nanocellulose.

A supplementary innovation is that the nanocellulose coil is not in the form of a spring, but in a series of latticed, multi-angled figure eights that allow the rotor blades to efficiently capture the kinetic energy from wind coming at the turbine from any angle within a 180 degree radius. Sandberg told Sal that this innovation will allow turbines using his design to have an energy extraction efficiency much closer to Betz's limit of 59.3% than any current commercial turbine. An additional benefit is that his design virtually eliminates the fatigue loading factor on the turbine tower and rotor housing that exists in the current rigid rotor blade design. This allows for lighter, less expensive materials to be used in the tower and housing manufacturing process

as well as the foundation and mooring devices. Sandberg told Sal he believes the production cost, including tower, could be twenty-five percent less than the average cost of current wind turbines of \$1.0 million.

Since the average cost of a wind turbine is \$1.0 million, Sal was sure Sandberg had not built one to test his design. So he asked Sandberg if he was able to verify his energy extraction efficiency claims. Sandberg said he used outside contractors to build a mini-version of the blade-rotor configuration assembly. The results were exactly as he stated.

Sal was convinced that Sandberg's technology was just what the wind energy industry was waiting for—a means to make the capture of wind energy more efficient and more cost-effective. Sal also was convinced that Sandberg's technology could be the foundation for the success of WindForce. He was pleased to see the Sandberg was excited about the WindForce venture being the means by which his innovation could make a difference in the generation of sustainable energy.

Sal's next step was to convince one other very important and influential person to join the WindForce venture's founding team.

THE EUROPEAN CONNECTION- CHRISTA HOFFMAN

Christa Hoffman was a thirty-nine year old Senior Manager for the Strategic Planning Unit at one of Germany's largest electric utility service provider. Christa is also a senior member of EREC, the European Renewable Energy Council. EREC is the umbrella organization of the major European renewable energy industry, trade and research associations active in the field of photovoltaics, small hydropower, solar thermal, bioenergy, geothermal, solar thermal electricity and ocean energy.

Sal had known Christa professionally for five years. As Europe generates almost twice as much wind power as all of the U.S. and is more receptive to the development of efficient wind energy, Sal saw it as a primary market for a WindForce product. With Christa part of the WindForce team, the venture would achieve instant credibility within Europe. She could open doors for the sale of WindForce turbines that otherwise would be very expensive, and maybe impossible, for a new, unknown company to open. Sal called her and asked if he could meet with her the next day to discuss an exciting professional opportunity for her.

At their meeting Sal asked her to join the WindForce venture founding team on a full-time basis. Without hesitation, Christa declined. Then Sal showed her Sandberg's patented turbine design.

Christa had never seen anything like it. Retro two blades instead of three; flexible and made from a material she had never heard of and attached by a coil design that looked like it came from a science fiction movie. She asked Sal if the design resulted in an improvement in wind energy extraction efficiency. Sal told her Sandberg had shown him the engineering design, the physics of the energy capture, and mathematical calculations on the turbine efficiency, all of which indicate that the design was feasible and that the efficiency of the turbine would be 48% rather than the current 35% achieved by the most efficient currently available turbines.

Christa was shocked by the number. Even an improvement of two or three percentage points would have been big news in the industry, but thirteen percentage points would be an industry game-changer, if it were possible. When Sal told her about the cost reduction made possible by the new design, Christa agreed to join the WindForce venture. Two weeks later, Sal, Christa, and Jo signed a founders' agreement and WindForce was launched. Sal brought \$4 million to the venture, Christa brought \$3 million, and Jo brought his patent.

PRODUCTION PLANNING

The next four months were busy for Sal, Christa, and Jo. They agreed to the terms of the founders' agreement (35%, 35%, 30% equity and \$175K, \$175K, \$120K annual compensation, respectively). During that time, Sal worked diligently on preparing for the launch of WindForce. He started the legal process of incorporating WindForce as a C-corporation with twenty million shares authorized and one million of those authorized shares issued to the founders as a group and allocated according to their percentage ownership. Each share will have a \$0.01 par value. The group also decided to value Jo's patent (now WindForce's patent since Jo gave ownership to the company in exchange for his WindForce equity ownership) at \$3.5 million, the mid-way point between the cash investments of Sal (\$4 million) and Jo (\$3 million). All admitted that the patent value was subjective, but they reasoned that if the company is successful, the patent could easily be the reason for \$3.5 million in cash flows to the company on a present value basis. Jo received his 20-year patent grant on October 1, 2012, so the first day of WindForce will mark the one year anniversary of the patent. The company was going to be debt free, at least for the first few years.

The initial efforts of the founding team were on two fronts: business development and production planning. Business development had progressed very well, with Christa gaining strong interest from European wind farms located in the United Kingdom, France, and Romania. Sal had concentrated on business development in the U.S. and had received interest from wind farms in Oregon, Washington, and Arizona. Sal and Christa believe that those wind farms will be placing orders for WindForce turbines. However, Sal and Christa know that the production capacity of WindForce will be limited by the cash available to start the company and fund operations (Esper, Ellinger, Stank, Flint, & Moon, 2010). They do not want to promise delivery of turbines the company is unable to produce due to the cash constraint. Therefore, to manage customer expectations, at least for the first two years of WindForce operations, Sal, Christa, and Jo decided to forecast their production capacity. In determining the production capacity for WindForce turbines for the first two years of production, the founders need to consider several different factors that impact that capacity (Alvarez & Barney, 2005; Umble, Haft, & Umble, 2003).

Available Cash

WindForce's initial production capacity is constrained by the initial cash balance of \$7 million (Sal's \$4 million and Christa's \$3 million). An additional constraint is that the founders have decided to maintain a minimum cash balance at all times of 5% of sales. Sal is also concerned with the dynamics of cash flow as embodied in net cash build or net cash burn. He understands that young companies usually burn through cash in their early years but the successful ones eventually turn that cash burn into cash build (Simić, Simić, & Svirčević, 2011).

Net Cash Build (Burn)

The calculation of net cash build or burn is in three parts. The first is the calculation of cash burn, the second is the calculation of cash build, and the third is the net of the first two calculations.

$$\text{Cash Build} = \text{Net Sales (Revenues)} + \Delta\text{Accrued Liabilities} + \Delta\text{Accounts Payables} \quad (1)$$

$$\text{Cash Burn} = \text{CGS (Variable/Direct Costs)} + \Delta\text{Accounts Receivable} + \Delta\text{Inventory} + \text{General \& Administrative Expenses} + \text{Lease Rent} + \text{R\&D Expenses} + \text{Interest} + \Delta\text{Prepaid Expenses} + \Delta\text{Lease Security Deposit} + \Delta\text{Gross Fixed Assets} + \text{Taxes} \quad (2)$$

$$\text{Net Cash Build (Burn)} = \text{Cash Build} - \text{Cash Burn} \quad (3)$$

If Cash Build is greater than Cash Burn, there is Net Cash Build. If Cash Burn is greater than Cash Build, there is Net Cash Burn. The Average Net Cash Build (Burn) can be found by dividing Net Cash Build (Burn) by 12.

Production Time

Sal and Jo plan to have production facilities and the labor force to be able to produce and deliver on all orders one month after an order is received. If an order is too large to be filled in one month, Sal will work with the customer to segment the order so that production and delivery can take place over several months.

Credit Terms

An additional cash constraint is the restrictive credit terms imposed upon WindForce by customers and vendors. Customers pay nothing up front (0% in Month 1) and 50% on the first day of Month 2 (when delivery is made on the turbine order) and 50% on the first day of Month 3. WindForce makes full payment to vendors on the first day of the month (100% in Month 1).

Price Markup

Sal and Christa decided that WindForce should price the WindForce turbines within the industry average range of 20%-25%.

Cost of Production and Capital Expenditures

Equipment purchases will be made in two areas: production and R&D. Each component has its own cost, including component cost and direct labor costs (\$45 per hour including benefits), space requirement, production manpower days, and capital expenditure requirement, as shown in Table 1 below. Research and development will have its own CapEx budget of \$100,000. Capital expenditures for both production and R&D are expected to increase in the second year at the same rate as cost of goods sold increases and have an average depreciable life of ten years.

Table 1
Production Costs, Capital Expenditures, and Space Reduction from Subcontracting

| Component [1] | Component Costs per WindForce Wind Turbine (\$000s) [3] | Direct Labor Allocation (Manpower Days) per Turbine [4] | Direct Labor Cost per Turbine [5] | Total In-House Cost per Turbine [6] | Capital (Equipment) Expenditure Required for In- House Production [11] | Reduction in Required Space if Component Production Subcontracted [13] |
|---|--|--|--|---|---|---|
| Rotor | | | | | | |
| Hub | \$30,000 | 10.00 | \$3,600 | \$33,600 | \$50,000 | 10.0% |
| Pitch Mechanism & Bearings | \$30,000 | 12.00 | \$4,320 | \$34,320 | \$45,000 | 5.0% |
| Spinner, Nose Cone | \$3,000 | 10.00 | \$3,600 | \$6,600 | \$75,000 | 10.0% |
| Drive train, nacelle housing | | | | | | |
| Shaft and Bearings | \$23,000 | 8.00 | \$2,880 | \$25,880 | \$75,000 | 5.0% |
| Gearbox | \$105,000 | 8.00 | \$2,880 | \$107,880 | \$30,000 | 5.0% |
| Mechanical Break | \$1,800 | 6.00 | \$2,160 | \$3,960 | \$33,000 | 5.0% |
| Generator | \$67,200 | 7.00 | \$2,520 | \$69,720 | \$5,000 | 5.0% |
| Variable speed electronics | \$82,000 | 8.00 | \$2,880 | \$84,880 | \$23,000 | 5.0% |
| Yaw drive & bearing | \$14,000 | 14.00 | \$5,040 | \$19,040 | \$45,000 | 10.0% |
| Main frame | \$64,000 | 8.00 | \$2,880 | \$66,880 | \$15,000 | 10.0% |
| Electrical connections | \$42,000 | 8.00 | \$2,880 | \$44,880 | \$5,000 | 5.0% |
| Hydraulics, Cooling system | \$12,000 | 6.00 | \$2,160 | \$14,160 | \$34,000 | 5.0% |
| Nacelle Cover | \$12,000 | 8.00 | \$2,880 | \$14,880 | \$30,000 | 10.0% |
| Control, Safety system, Condition Monitoring | \$25,000 | 8.00 | \$2,880 | \$27,880 | \$25,000 | 10.0% |
| Blades | \$105,000 | 16.00 | \$5,760 | \$110,760 | \$350,000 | |
| Tower | \$90,000 | 25.00 | \$9,000 | \$99,000 | \$160,000 | |
| Totals | \$706,000 | 162.00 | \$58,320 | \$764,320 | \$1,000,000 | 100.0% |

In-House Production vs. Subcontracting

The founders discussed the pros and cons of subcontracting. They decided the pros of subcontracting are 1) reduction by 10% the direct cost of manufacturing a component, 2) quick ramp-up of production, 3) reduction of equipment capital expenditure, 4) reduction of manufacturing space requirements and, therefore, lease-based cash outflow, and 5) subassembly done closer to the client which reduces shipping costs for both WindForce and the customer. The cons are 1) design and utility features are revealed to the subcontractor, 2) potential scheduling problems may occur, and 3) WindForce relinquishes some degree of quality control (Görg & Hanley, 2004; Oke & Onwuegbuzie, 2013)).

Sal and Christa like the idea of subcontracting. However, Sal is concerned on three counts. First, he wants WindForce to be known as a manufacturing company and not one that only licenses out the technology for contract manufacturers to completely build the turbine. He believes that WindForce will have more value as a manufacturer. Second, he is concerned about others becoming proficient in building Jo's design into the turbine manufacturing process. For that reason, he wants to keep in-house as much of the component manufacturing that relates to the proprietary design features that give the company a competitive advantage. Third, manufacturing those critical components in-house will provide a greater degree of quality control on the turbine product. Sal wants WindForce turbines to have the reputation of extremely high quality and reliability (Salimath, Cullen, & Umesh, 2008).

Sal asked Jo which components he believes are most critical to the functioning of his design. Jo replied that all the rotor components as well as the shaft and bearings, the gearbox, the mechanical break, and the yaw drive and bearing are unique to the design and an integral part of the patent. The blades and tower are unique to the WindForce turbine, but there is nothing proprietary or secret about them. They differ from other turbines only because of the reduced stress on the turbine frame and tower made possible by the flex rotor design. All other components are standard.

The team has decided that due to the extensive space required to manufacture the turbine blades and towers and the resultant significant cost of leasing that space, the best solution would be to subcontract the manufacture of those two components. They still need to decide on which of the other components will be manufacture in-house and which subcontracted.

Operating Expenses

Sal estimated that the operating expenses in the form of General & Administrative expenses will be \$516,000 in the first year of operation and then double in year two. Research and development expenses in year one are expected to be \$60,000 and then triple in year two.

Space Requirements

The WindForce founders will need to decide on the location of their manufacturing facility as well as the size of the facility. Sal plans to sign a four-year lease, but will base his estimates of the space requirements on the projected production in Year 2 (Beatty, Liao, & Weber, 2010). His estimates of space requirements as a function of annual production are shown in Table 2.

| Table 2 WindForce Production Space Requirements | |
|--|--------------------|
| Turbine Production per Year (excluding production of blades and tower) | Space Requirements |
| 1-60 | 10,000 |
| 61-150 | 17,000 |
| 151+ | 26,000 |

Location

The WindForce founders decided to have the company headquarters in Richmond, Virginia and found twenty-two possible Richmond manufacturing facilities with building grades ranging from A- to C. They decided that a B+ grade would be the lowest they would consider (Gibler & Lindholm, 2012; McDonagh & Nichols, 2009). Each potential location offers a small office that will serve the needs of WindForce for at least the first year. The available Richmond spaces and their terms are shown in Table 3.

Table 3
Potential Manufacturing Sites with Lease Terms

| Address | Building Grade | Minimum Lease Term (Months) | Maximum Lease Term (Months) | Monthly Lease Rent (\$/SF) | Annual Base Rent Increase (%) | Tenant Percent of Landlord's Tax and Operating Expense Annual Increases (%) | Estimate of Average Landlord's Annual Tax and Operating Expense Increases for Each Year during the Term of the Lease | One-Time Improvement Allowance (\$/SF) | Parking Space Allotment (#/000 SF) | Security Deposit |
|------------|----------------|-----------------------------|-----------------------------|----------------------------|-------------------------------|---|--|--|------------------------------------|-------------------------|
| Address 1 | B+ | 36 | 60 | \$1.37 | 3.10 | 2.40 | \$15,000 | \$5.00 | 1.4 | First and Last |
| Address 2 | A- | 36 | 60 | \$1.47 | 3.20 | 2.50 | \$18,000 | \$5.00 | 1.3 | First and Last |
| Address 3 | B+ | 36 | 60 | \$1.32 | 3.12 | 2.60 | \$15,000 | \$9.30 | 1.0 | First, Second, and Last |
| Address 4 | B | 24 | 48 | \$1.25 | 3.17 | 2.40 | \$20,000 | \$12.10 | 1.8 | First and Last |
| Address 5 | B+ | 48 | 72 | \$1.30 | 2.99 | 2.40 | \$17,000 | \$5.50 | 1.4 | First, Second, and Last |
| Address 6 | B- | 36 | 60 | \$1.20 | 3.16 | 2.00 | \$21,000 | \$13.10 | 1.2 | First and Last |
| Address 7 | B+ | 36 | 60 | \$1.32 | 2.86 | 2.00 | \$15,000 | \$12.60 | 0.9 | First and Last |
| Address 8 | B+ | 36 | 72 | \$1.36 | 3.07 | 2.50 | \$15,000 | \$14.90 | 1.5 | First and Last |
| Address 9 | A- | 60 | 120 | \$1.45 | 3.30 | 2.40 | \$17,000 | \$4.50 | 1.2 | First and Last |
| Address 10 | A- | 36 | 60 | \$1.44 | 2.83 | 2.30 | \$15,000 | \$10.00 | 1.6 | First and Last |
| Address 11 | B+ | 48 | 66 | \$1.30 | 2.85 | 2.30 | \$22,000 | \$11.60 | 1.2 | First, Second, and Last |
| Address 12 | A- | 36 | 60 | \$1.44 | 2.97 | 2.40 | \$18,000 | \$3.10 | 0.8 | First and Last |
| Address 13 | A- | 36 | 48 | \$1.42 | 2.84 | 2.40 | \$21,000 | \$11.30 | 1.4 | First and Last |
| Address 14 | B | 36 | 48 | \$1.35 | 2.91 | 2.80 | \$15,000 | \$9.30 | 1.0 | First and Last |
| Address 15 | A- | 36 | 60 | \$1.47 | 3.08 | 2.30 | \$15,000 | \$2.50 | 1.6 | First, Second, and Last |
| Address 16 | B | 36 | 60 | \$1.29 | 3.09 | 2.40 | \$15,000 | \$13.70 | 1.2 | First and Last |
| Address 17 | B+ | 24 | 48 | \$1.35 | 3.29 | 2.40 | \$15,000 | \$14.40 | 0.9 | First and Last |
| Address 18 | C | 24 | 36 | \$1.19 | 3.04 | 2.80 | \$26,000 | \$9.60 | 1.6 | First and Last |
| Address 19 | B- | 48 | 72 | \$1.30 | 3.03 | 2.70 | \$22,000 | \$8.40 | 1.2 | First, Second, and Last |
| Address 20 | C | 12 | 36 | \$1.20 | 3.05 | 2.40 | \$24,000 | \$6.10 | 1.1 | First and Last |
| Address 21 | B+ | 36 | 60 | \$1.39 | 2.96 | 2.10 | \$16,000 | \$5.10 | 0.8 | First and Last |
| Address 22 | B+ | 36 | 60 | \$1.38 | 3.22 | 2.20 | \$15,000 | \$7.50 | 1.0 | First and Last |

THE PRODUCTION PLANNING DECISIONS

Given the information they had gathered so far, the WindForce founders' group decided on the following goals for their production planning session:

- 1) Decide which turbine components will be manufactured in-house and which will be subcontracted (assume blades and turbines are subcontracted). Given these decisions, the founders will be able to determine the total per unit turbine cost (including direct labor), the capital expenditures required to support in-house production, and the space savings from subcontracting.
- 2) Determine the production capacity of the company for the first two years of operation by making the two-year forecast of monthly sales and production subject to the cash constraints of the company. Corollary to that decision is the inventory decision resulting from greater production than sales on a monthly basis (Protopappa-Sieke & Seifert, 2010).

- 3) Decide on the location of the manufacturing facility, given the parameters set by the founding group (four-year lease, B+ or better building grade). Given this decision, the founders will be able to determine the cash outflow for the first two years of operation.
- 4) Calculate the average net cash build (burn) of the company for the first two years of operation.
- 5) Determine the overall monthly and annual production capacity of WindForce over the next two years.

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