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## Myrtle Beach, South Carolina April 13-16, 1998

# International Academy for Case Studies

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# Proceedings of the International Academy for Case Studies

## April 13-16, 1998
## Myrtle Beach, South Carolina

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# Proceedings of the International Academy for Case Studies

## Table of Contents

# LONE STAR EXPLORATION AND REFINING COMPANY

**Jerry Kinard, Western Carolina University**
**Beverly Little, Western Carolina University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns human resource selection of an Executive Vice President for an oil company. The case examines the decision-making processes of the CEO as he considers and weights the information available to him about the candidates. This case has a difficulty of three, and is suited to undergraduate or graduate human resource management. It can be taught in an hour and a half, with students preparing an hour before class.*

## CASE SYNOPSIS

*Lone Star Exploration and Refining Company is searching for an Executive Vice President to serve in its Houston, TX office. Each of the three finalists meets the minimun requirements, each has distinctive advantages to bring to the company, but each also has his own drawbacks.*

## THE SITUATION
Part 1

In December,1997, Lone Star Exploration and Refining Company lost one of its senior-level executives due to an untimely death. Harvey Hillburn, Executive Vice President in charge of international operations, two company geologists, and a pilot were killed in a helicopter crash ten miles east of Houston, Texas, in the Gulf of Mexico.

Hillburn, a native Texan, had joined Lone Star in 1984, after a somewhat turbulent 15-year career with one of the nation's leading oil companies. He brought to Lone Star a wealth of valuable experience in off-shore drilling, outstanding leadership skills, and an uncanny ability to judge people accurately. Hillburn was promoted to the position of Executive Vice President in 190. Thereafter, it was rumored that he was being groomed for the position of President and CEO. Without question, his death left a considerable void in Lone Star's operations.

In an effort to fill the vacancy created by Hillburn's death, Lone Star initiated a nation-wide search. On February 1, 1998, the following announcement was placed in trade journals and in the Wall Street Journal; personal contacts were made with individuals who worked for competing firms; and persons who were employed by Lone Star were encouraged to apply.

Executive Vice President for International Operations
Lone Star Exploration and Refining Company

Lone Star Exploration and Refining Co., a major oil and natural gas exploration and refining company headquartered in Houston, Texas, is seeking a dynamic, experienced individual capable of managing day-to-day global activities of a growth-oriented, billion dollar company with operations in the U.S., the North Sea, Central America, and Saudi Arabia, including joint partnerships with some of the world's largest oil and gas corporations.

The ideal applicant will have extensive experience in oil and gas exploration, refining, and transmission, and will have progressed through positions of increasing responsibility with companies that have global interests. Outstanding leadership qualities, including excellent communications skills, are essential. Fluency in foreign languages and a willingness to be active in community affairs are desirable. Extensive travel, often under adverse conditions, is required.

The total compensation package is attractive and competitive. Applications will be received through March 31, 1998. To be considered, please forward a letter of application, resume, the names and addresses of five references, and other supporting evidence of qualifications to: Mr. James Farsmith, CEO; Lone Star Exploration and Refining Company; P. O. Box 1122; Houston, Texas 77012

Lone Star Exploration and Refining Company is an EOE. Women and minorities are encouraged to apply.

In the two-month period following the announcement, Lone Star received 45 applications. Ten of the applicants appeared to meet the qualifications specified in the advertisement. Screening activities included phone calls to references, contacts with previous employers to verify each applicant's employment history, and a careful review of each finalist's data sheet. After carefully reviewing the credentials of all applicants, the President/CEO, James Farsmith, reduced the pool of applicants to three finalists -- T. R. "Tommy" Dunford, an external financial executive who had worked for six different oil and gas exploration companies; Jeffrey Coats, Plant Manager of Lone Star's West Texas refinery in Lubbock; and Carmen Sanchez, a native of Mexico who had emigrated to the U.S. in the mid-1980s and became a U.S. citizen in 1993.

Dunford possessed excellent credentials. He was highly recommended by previous employers and others who had worked with and for him. Contacts with references and previous employers characterized Dunford as "a great guy to work for." He was judged to be highly intelligent, demanding but fair, and impeccably honest. His academic background included a bachelor's degree in geology, with honors, from the University of Oklahoma and a master's degree in financial management from the University of Texas.

Coats, too, had an unblemished record. He had joined Lone Star in 1981, after receiving a degree in petroleum engineering from Texas A&M University. His knowledge, hard work, and loyalty to Lone Star were rewarded when he was named plant manager in 1990. Everyone who knew Coats felt that it was just a matter of time until he was promoted to the corporate office in Houston.

Sanchez possessed a unique combination of abilities that intrigued President Farsmith. First, he spoke fluent Spanish, English, and Portuguese. In Farsmith's opinion, Sanchez's ability to communicate effectively with a growing Hispanic population in the greater Houston area would serve the company well. Neither Dunford nor Coats was fluent in a foreign language, although Coats had learned enough Spanish to communicate in a very rudimentary manner. Moreover, Sanchez's references painted him as being "a polished diplomat and a seasoned negotiator, someone who commanded the respect of his associates." Sanchez had earned his bachelor's degree from San Diego State University, with a major in petroleum engineering, and a master's degree in accounting. His work experiences included two stints with oil refining companies in the U.S. and several increasingly responsible government positions in his native Mexico, some of which provided him with opportunities to impact the operations of the oil cartel to which Mexico belonged. After becoming a citizen of the United States in 1993, Sanchez formed an import-export business headquartered in Galveston with branch operations in fourteen Central and South American countries. As owner-manager of the company, Sanchez controlled all aspects of its operations. He had never married.

Each of the finalists was invited to Houston for a formal interview. The spouses of Coats and Dunford were also invited. Because the Executive Vice President and his spouse would be expected to entertain other corporate officials occasionally, Farsmith felt that the spouse of the Executive VP should be bright and charming, qualities that would enable her to be a gracious and entertaining hostess.

Tommy and Beth Dunford arrived in Houston on April 15. Their two-day visit included in-depth discussions with President Farsmith and other senior-level executives, a tour of the greater Houston area, and nightly entertainment. While Tommy was at corporate headquarters discussing job responsibilities, Beth concentrated on housing developments and educational institutions available to their two teenage children. Jeff and Mary Coats were extended similar courtesies one week later. Carmen Sanchez, who is unmarried, arrived early on April 29 and departed the next evening. Each of the candidates performed superbly during the interview process; each was knowledgeable, insightful, and pleasant; and each appeared to possess outstanding leadership qualities.

Questions for Discussion

1. Discuss the pros and cons of inviting the spouses of the two finalists. Should Sanchez's marital status place him at a disadvantage?
2. What questions should and should not be asked in the pre-employment interview?
3. Based on this limited information, which candidate would you select?

## Part 2

On one hand, Farsmith wanted to promote Jeff Coats as a way of recognizing his excellent performance as plant manager and because Coats was familiar with the corporate culture. His main reservation in extending Coats the offer was attributed to Jeff's wife, Mary. Throughout the visit to Houston, Mary seemed nervous and somewhat "out of control." Farsmith did not believe her odd behavior was caused by the stress of the interview. Moreover, if Jeff Coats were promoted, this would create another vacancy, that of plant manager in Lubbock. Corporate officers who were intimately familiar with the west Texas refinery advised Farsmith that there was no one presently at the refinery who was capable of taking charge. During the interview, Farsmith considered discussing Mary's behavior with Jeff, but decided against it at the time, opting instead to broach the subject prior to extending an offer.

Tommy Dunford was the most experienced of the three finalists. Farsmith considered Dunford's background to be both a blessing and a curse. Dunford's extensive experience provided him with a grasp of every aspect of the oil and gas business, but his employment record suggested a tendency to change jobs too often. Farsmith needed stability in the position of Executive Vice President, and he feared that longevity was not Dunford's long suit. At the same time, however, Farsmith recognized the value of experience and the excellent reputation that Dunford enjoyed throughout the industry.

Carmen Sanchez's greatest attribute was charisma. Throughout the interview, Sanchez "won over" those individuals who questioned his employment background and his ability to get things done in a tough, competitive industry. Not only did he demonstrate a command of complicated financial arrangements, but he also exhibited the ability to communicate effectively with people of diverse backgrounds and interests. Without a doubt, Sanchez was a master of deal making. And, he was bright and perceptive. Following the interview, the opinion of most executives who comprised the senior- management group was that Sanchez possessed excellent technical and human skills. In short, he was perceived as the "executive type," exhibiting poise, empathy, knowledge, and humor. His appearance and communication skills reinforced the notion that he was a professional manager, not simply a bureaucrat. President Farsmith was truly impressed with Sanchez, but he wondered if Sanchez's "alternative life style" would cause problems within the company.

Questions for Discussion

1. List the personal and professional characteristics that you deem most important and least important.
2. Compare each candidate with the lists that you have developed. Rank order the candidates and give supporting arguments.

## Part 3

After several sleepless nights in which he weighed the advantages and risks associated with each of the finalists, President Farsmith opted to extend the offer to Jeffrey Coats, provided that Jeff could offer assurances that his wife, Mary, enjoyed good emotional health. On May 15, Farsmith contacted Jeff by phone, explained his concern in a polite and professional manner, and then formally extended the offer. Three days later, Farsmith received the following response.

Mr. James Farsmith
President and Chief Executive Officer
Lone Star Exploration and Refining Company
Houston, Texas 77012

Dear Mr. Farsmith:

Please accept my resignation from Lone Star Exploration and Refining Company, effective immediately.

Sincerely,

Jeffrey Coats
Plant Manager

Questions for Discussion

1. Was Farsmith justified in raising the spousal considerations? Is Mary's emotional health job related?
2. Did Jeff Coats over-react to the discussion with President Farsmith? Why or why not?
3. Identify the alternatives that Farsmith now faces. What action would you recommend? Why?

# GOALS OF FACULTY CONTROL ARE ACHIEVED BEFORE GOALS OF TEACHING AND LEARNING ARE CONSIDERED

**Frederic M. Muse, East Tennessee State University**

## CASE DESCRIPTION

*Senior and graduate level courses on leadership approaches and their resulting consequences may find this a case against authoritarian management and in favor of a more democratic management of an organization's human resources. Senior and graduate level ethics courses will find fertile ground for questions regarding the act of and appearance of impropriety.*

## CASE SYNOPSIS

*Mr. Smith's students had greater gains as measured by post-test achievement scores than students from other classes in his school and any other schools in his school system. He produced two-thirds of the GED graduates of the five school system. He rarely missed work. He was generally the first to arrive at work and the last to leave each day. Fellow faculty respected and listened to him. Students returned to visit him more than they did any other faculty member. Through the principal's fabrication of events and the school system's questionable arrangement with a business organization, Mr. Smith was forced from a teaching position he loved and was very effective and situated in such a way that his career as a teacher may be ended.*

## INTRODUCTION

This is no ordinary school setting. The school system described herein is a correctional education setting. Mr. Smith taught for 24 years in this reform school for juvenile delinquents. Students were assigned to him as they were committed by the courts and released from him on an almost daily basis as they finished their time and completed their treatment and program goals. Students in any class represented ages 12-17 and grade placements 6-11. The superintendent of this school system is the head of a governmental agency, a political appointment. The school board is the head of a governmental department, a political appointment. Neither position requires any working knowledge of the complexities of the field of education. The normal "checks and balances" of power found in the public school setting do not exist in this school system.

## TROUBLE WITH THE PRINCIPAL

The struggle between Mr. Smith and Mr. Jones is based on Mr. Jones's perception that Mr. Smith represented a threat to his authority. Mr. Smith had favored the student version of a sexual harassment accusation against a fellow teacher that Mr. Jones defended. Mr. Smith had successfully fought to delete an objectionable requirement from the policy manual which ended with direct conflict with Mr. Jones. The principal attempted twice to reinstitute the requirement as a local policy only to be stymied by Mr. Smith. With each new episode of this ongoing story, Mr. Jones's wrath toward Mr. Smith grew. None of the warning issued to Mr. Smith were ever removed from his file even when the accusations proved untrue..

Mr. Jones submitted an oral warning to Mr. Smith's personnel file regarding one of the few sick days Mr. Smith had taken, but he never administered the warning. After accidently finding the warning, Mr. Smith submitted to Mr. Jones's immediate superior the receipt from the doctor and an empty prescription bottle. Mr. Smith received signed statements from these coworkers that the words and ideas attributed to them on the warning by Mr. Jones were never spoken by them.

Mr. Smith received favorable publicity. In the spring of 1990, the local public library newsletter published an article complete with a picture of Mr. Smith regarding his long use of the system to check out books for students who were placed in isolation due to their misbehavior. Mr. Smith had also received positive remarks in the local newspaper for several years regarding the performance of his teams in a local political simulation competition against area high schools. Evidence of Mr. Smith's effectiveness failed to make Mr. Jones happy though such successes reflected positively on his school. Mr. Jones never wrote any letters of recognition.

Mr. Jones became an office recluse while doing graduate school work. He arrived at work, closed his office door, and completed his writing and reading assignments. Teachers interrupting him with concerns found themselves chastised for having problems and were seldom granted relief. Gradually, Mr. Smith became the relief valve by offering advice, finding a way to handle many discipline problems, and arranging class changes for students who needed them. Mr. Smith also initiated grade placement changes that placed many students in grade/age appropriate settings using the student's work completed at the institution and standardized test scores as justifications. Mr. Smith began to receive transcript requests from public schools. Students returning home after release did not know he was not the principal. Court counselors sought transfer of students from other schools specifically to enter Mr. Smith's classes. Through these activities, Mr. Jones became even more convinced that Mr. Smith represented a threat to his authority. Mr. Jones never realized that his own abdication from responsibility produced the perceived effect.

Mr. Jones made vague accusations against Mr. Smith alleging that he did not get along with his coworkers, engaged in unspecified unprofessional activities, spread dissent among the faculty, and failed to follow several of the orders issued to him. The Director of the institution was instructed to investigate the charges. The superintendent Mrs. Green, along with her second-in-command Mrs. Gordon, said after a meeting held specifically to address the charges that they did not like wasting time on unsubstantiated witch hunts.

Mr. Jones continued his harassment by assigning Mr. Smith 34 students in one class, knowing that only 20 student seats with room for no more occupied his small classroom. Mr. Jones came in person to view the chaos and chuckled at the obvious student and teacher discomfort. Mr. Jones declined the schedule change requests citing the need to first gain permission of another teacher, who had only six students, to accept more and declared that he would make no changes until the following Monday, the regular day for class changes.

Mr. Jones rescinded many of the reprimands issued to students by Mr. Smith for contorted reasons such as a student did not need to follow Mr. Smith's instructions if previously given instructions by someone else, students weren't required to attempt their schoolwork, and official interpretations of policy did not have to be viewed as policy. Students' excuses were routinely accepted as fact. Mr. Smith was seldom asked for his version of the story and just as seldom informed that his reprimands had been overturned. News of such actions more often came from students or other faculty. However, this tactic failed miserably as students themselves chastised those who evaded the consequences of their actions. Mr. Smith gained the respect being lost by Mr. Jones for even the students recognized the treachery of the events.

Mrs. Green and Mrs. Gordon had become upset at the persistent complaining coming from the particular school at which Mr. Smith worked. They mandated a new schedule that required all teachers to have a full complement of students from 7:55 am until 4:05 pm. To accommodate student coverage after the normal school day ended, teachers were divided into groups of three. Each group acquired responsibility for one wing of a residential hall, each hall having three wings and each wing having 16 beds. Mr. Smith and two of his professional friends were assigned an entire residential hall because they were able to handle that number.

Mr. Smith faced more serious tactics. He received a written reprimand for taking students off campus who never left their residential building. Mr. Smith proved the charges false, but administrators refused to reconsider or pull the reprimand from his file. He received a reprimand for not attending a hearing of a student who had escaped and been returned by the police. Attending the hearing would have left the school with two-thirds of the student population present and without any male supervision. It would also have left his female coworker alone with an entire residential hall of males. Dangers created by attending outweighed those created by staying. All allegations made by Mr. Jones against Mr. Smith concerning the incident except not attending the meeting were proven false, but the reprimand remained on file.

In 1992 the school administrators opted for a curriculum integration program. A workshop was held with facilitators from a public high school describing exactly how they had designed and implemented the program. Then Mr. Smith and his fellow teachers were told to copy this model program design. First, and last, came planning to implement the school-wide curriculum integration program. Academic and vocational teachers had to meet together to plan topics and strategies. Two problems were evident. First, students from all vocational teachers were dispersed to all teachers so planning could not be held with a particular vocational teacher and academic teacher as had been the case with the model school program. Mr. Jones would not change schedules of students to accomodate the model he insisted be implemented.

Second, to free the academic teachers to meet, vocational teachers were assigned all the students to supervise. When no planning took place, Mr. Jones asked why. When told the vocational teachers were not free to meet because they supervised large groups of students, Mr. Jones called for another planning session and assigned supervision of students to the academic teachers. Again, no meeting. Mr. Smith tried to explain to Mr. Jones that teachers cannot meet and plan and simultaneously supervise large groups of students who are, by definition accompanying incarceration, not always the most well-mannered individuals. Mrs. Green and Mrs. Gordon became frustrated that this school had made no progress toward implementing the model. Mr. Smith was fingered with the rationale was that he had pointed out the shortcomings of the program, thus poisoning everyone else against it and had himself refused to plan with anyone.

Mr. Smith was assigned the responsibility of producing the Christmas play. Mr. Smith already had the responsibility of getting several GED students ready to pass the examination in order to be released during the Christmas school holidays. He also had to complete the editing and publishing of the Christmas edition of the school newspaper. And, he still had the large class in the afternoon, the time designated for play practice. Mr. Smith asked for volunteers for the play and sought coverage for his class while he practiced. No one would cover his class for it was "too large." Mr. Smith declined to initiate play practices.

Mr. Jones demanded that Mr. Smith take his class and the volunteers to the practice site and supervise all the students while directing the play practice. The responsibility was too great and the risks too many for Mr. Smith to attempt alone. When Mr. Jones finally acknowledged that no play would take place, he assigned the play to another teacher with four students. These four students were reassigned and this teacher, along with an assistant also assigned to aide him, took the volunteers for the play and finished a creation that met the Christmas deadline. Mr. Jones reported to his superiors that Mr. Smith had attempted to sabotage the Christmas festivities.

## THE COMMERCIAL ASPECT

On July 1, 1990, the code governing the delivery of education services to the students of this school system was revised to explicitly state that individualized instruction be used by all teachers. State law had required this teaching practice since the juvenile justice code updates of the mid-1970s. The requirement reflected the reality of the classroom environment faced by all teachers within the school system. All levels of written procedure now contained the same directives. A general statute of the State now read: "When the judge commits a juvenile to the [the school system], the Director shall prepare a plan for the care and treatment within 30 days after assuming custody of the juvenile." The revised version of bureaucratic law that guides the implementation of the law now reads: "Individualized instruction provided by the teacher shall be based on the individualized plan of action." Departmental policy, which was revised at the same time, similarly reads: "During each school period, students shall be provided with individualized learning activities in accordance with their IEPs."

This legal requirement did not advance the goals of the assistant superintendent of the system, Mrs. Gordon. She not only worked full time in this next-to-the-top position but also moonlighted for a corporation advancing an educational product. Mrs. Gordon provided training in the use of this product. Mrs. Green, the superintendent and friend of Mrs. Gordon, purchased with state funds products from this business and required teachers to use them. The stated goal was improved teaching and improved learning. Mr. Smith became concerned. Mrs. Gordon's product required group instruction identical to that provided in the public schools, thus negating the legal requirement for individualized instruction. Mr. Smith did not believe the moral or legal arrangement between Mrs. Gordon, the school system, and the corporation were appropriate. He declined to take part in the "voluntary" training sessions. Mr. Smith became a threat to their authority. In January 1991, Mr. Jones announced that the principals and chief of education had decided that teachers were to have daily lesson plans based upon design of this product. A three year struggle began between Mr. Smith and his superiors.

In February of 1993, several significant events occurred. Mr. Jones began more intensely to demand lesson plans from Mr. Smith in the design of the corporate product sold by Mrs. Gordon. On February 23, Mr. Smith received a written reprimand for not planning his students' education programs. Mr. Smith unsuccessfully contested the reprimand for not having lesson plans using the argument that individualized educational planning for instruction is education planning by definition. Next, Mrs. Gordon resigned from the school system to work full time for the corporation she had been representing for at least five years.

Mr. Jordan, the chief of education, spoke in a teachers' meeting and declared that the personalized education plans (PEPs, a new name for IEPs) for students should be more individualized. When the question arose about the inability to simultaneously provide individualized instruction as he had just described and group instruction as required by the product sold by Mrs. Gordon, Mr. Jones said that the teachers would just list PEP objectives as special goals and teach to the common group goals. Neither man would ever explained what a "common group goal" was, information the faculty asked for as this represented the first time the term had ever been heard, or how it fit into the policies teachers were supposed to follow.

Another noteworthy event was that Mr. Smith received a written notification that group lesson plans were required. It was the first statement in writing received by anyone in the entire school system on the subject, and <u>only</u> Mr. Smith received it. This supposedly official statement had been typed that day on a blank sheet of paper, not letterhead, and signed by Mr. Jordan.

Mr. Smith had a first period class of GED students whose schedule sent them directly to the GED teacher supplied from the local community college. Mr. Jones wished this form of group instruction similar to the design of Mrs. Gordon's product, used in this unique class of only GED students working on only English grammar, to be implemented in all of Mr. Smith's classes. Mr. Jones began assigning students to the class not of GED ability, not of GED age, and as young as 12, creating a class of students with diverse abilities, ages, and treatment and educational goals. Mr. Smith was chastised by Mr. Jones, who vehemently denied assigning to the class students unable to complete GED level work, for discontinuing the single subject group instruction. Mr. Jones declared that students of any ability, age, and maturity level were capable of GED level work and declared Mr. Smith to be unprofessional to think otherwise.

September 14, 1993 while departing for mandatory workshop at which Mrs. Gordon was the lead presenter, all teachers received a policy written by Mrs. Green demanding that they use the product of her still friend and former second-in-command. This represented the first written policy issued by the school system regarding this thre-year push for teachers to use the lesson plan design of the corporation. The policy provided a deadline for implementation of the lesson plan design and stated that training would be provided in the use of the product. Of course, only one group could provide training, the group that had a trademark and copyright protection over the product, the one in which the Mrs. Gordon now worked. During the workshop all vendors had tables outside the workshop area, a customary practice. Literature and order forms listing all available products from this corporation were handed out inside the meeting hall by school system administrators. Mr. Smith perceived the activity as illegal and unprofessional. Upon returning home he wrote the Governor's office and stated as much. A week later Mr. Smith had his second final written warning for refusing to do lesson plans.

## THE ORDEAL'S CONCLUSION

During February of 1994, the ordeal ended. Almost on the same day, Mr. Smith was named the Teacher of the Year for the state in correctional education and was dismissed as a teacher. The final insult came with the banning of Mr. Smith from campus. The letter announcing the ban accused him of taking materials purchased for the school with grants obtained by him to purchase school materials. Mr. Jones demanded that Mr. Smith produce receipts for the materials. Any administrator knows that a teacher cannot acquire personal grants without the signatures of a series of other responsible parties and that approved financial agents receive the items acquired by the grant and collect the receipts for those items. Teachers do not receive and administer grant money by themselves. Mr. Smith had no recourse against the charge of theft except through costly legal channels he was financially unable to pursue.

## EPILOGUE

Mr. Smith did proceed through the legal channels with his case. Stage One ruled only on the case of insubordination without taking any evidence. Stage Two accepted school system policy but did not accept any higher legal authority and ruled on the same question as Stage One. Stage Three did not accept any new evidence and ruled on the same question as Stage One.

Stage Four represents the first stage of the appeals process accepting any evidence of stronger authority than policy. The Court ruled that the statutes did not mean what they said, though the Court never said what they do mean. The Court accepted the changed wording of the law advanced by the administrators ["individualized" became "individual" and the presence of the individual programs such as a drug counseling program, a sex-offender program, and vocational counseling program was defined as having an individualized education program] and its subsequent interpretation by the administrators. The Court also accepted the administrators' application of the rules involving the case to a public school classroom rather than to the correctional setting for which they were written. The Court further ruled the bureaucratic law that interprets statutory law and represents guidelines for state government operation to be "vernacular" without any further comment.

Mr. Smith has had several job interviews based upon his résumé but no offers of employment. Prospective employers, as a part of their administrative procedures, call the former principal, Mr. Jones, for a recommendation. One may surmise that the recommendation alludes to Mr. Smith's being insubordinate and dishonest. The assumption from outside the system is that the boss is right, an assumption that generally stands without question.

# EXPLOITING BUSINESS OPPORTUNITIES

**Newell D. Wright, James Madison University**
**Reginald F. Foucar-Szocki, James Madison University**
**Paula Daly, James Madison University**
**Tom Wood, James Madison University**
**Robert Jerome, James Madison University**

## CASE DESCRIPTION

*This is a general business case. Specifically, it is designed for an "“introduction to business” course. As such, it briefly focuses on many of the issues across the entire business spectrum, from entrepreneurship to marketing. The case has a difficulty level of one. The case is designed to be taught in eleven fifteen minute segments across the course of a semester and is expected to require fifteen to thirty minutes of preparation for each segment. In essence, it is designed to be used at the beginning of the class period to introduce many of the topics to be discussed that day.*

## CASE SYNOPSIS

*This case follows Terry, a high school entrepreneur who starts a lawn mowing business that grows first into a landscaping business and finally into a retail nursery business. The case treats the following subjects. 1) Terry has a job bagging groceries, but stumbles into a lawn-mowing job when his ailing grandmother asks him to cut her lawn. 2) Terry discovers there is money to be made in cutting lawns. His grandmother gives him several referrals. 3) Terry learns about both the opportunities and costs of cutting lawns, and he realizes he needs to buy his own lawn mower. 4) Terry quits his grocery bagging job and concentrates on mowing lawns full time. He bids on a commercial contract—and wins the contract. 5) Terry discovers he needs more equipment and licenses to run his business. He also discovers he must pay taxes. 6) Terry develops a marketing plan and sets up lawn mowing contracts for the coming summer. He realizes he cannot cut all the lawns himself, and he discovers he has a storage problem. 7) Terry hires his best friend Chad to help him, but he quickly learns that Chad is not up to the task, and he must either fire or retrain his best friend. 8) Terry has now been in business for two years. He has three full-time workers cutting lawns for him. He starts some simple landscaping, and discovers there is money to be made in the landscaping business. 9) Terry gets a business partner who knows more about landscaping than he does. His partner bids on jobs and supervises the accepted bids. Terry is managing the business now and not spending as much time cutting lawns. 10) Two years later, Terry has a thriving lawn mowing and landscaping business. He discovers that he can buy a local nursery that is going out of business. 11) Terry realizes that he bought a family-run business with no operating procedures, no technology, and “full-time” family members who work less than 10 hours per week.*

Note: This case examines one of the eleven scenarios, scenario 4.

SEGMENT 4:
BAG THE BAGGING JOB

Terry took the plunge and decided to quit his job bagging groceries. Through word-of-mouth, he is now up to cutting 18 lawns per week, bringing in a weekly gross of $290. He quickly paid back the $172 he had withdrawn from his savings account. After paying about $8 a week for gas, his only other expense was transportation to and from job sites. This was taking up every spare moment of his two days off, and he was making more money cutting lawns than bagging groceries. The opportunity costs of keeping his bagging job were starting to mount, and he decided to quit his bagging job. The net effect of this decision was to increase his spare time. In effect, he went from working seven days a week to three days a week.

Just for the heck of it, Terry decided to bid for a contract cutting the lawn at one of the apartment complexes in town. He was somewhat concerned about this, as he did not have any of the tools that would be necessary to allow him to cut this much grass. For example, he would probably need a bigger lawn mower, as well as a weed whacker, roller, herbicide dispenser, etc., not to mention something to transport all of that equipment in. But he decided to submit a proposal anyway. He estimates that the lawns he is already mowing have the combined size of seven or eight football fields, generating an income of $1,200 per month. He figures that the apartment complex will take him three hours per week to mow, including all trim work. The actual lawn size at the apartment complex is about 1 1/2 acres.

1. When Terry was bagging groceries, he was paying taxes. Now his entire income is not taxed. What should he do about his tax responsibility?
2. What should Terry include in his bid?
3. How much should he bid for the job?
4. If he gets the job, what other opportunities and threats will he face?

INSTRUCTOR'S NOTES FOR
BAG THE BAGGIN JOB

1. When Terry was bagging groceries, he was paying taxes. Now his entire income is not taxed. What should he do about his tax responsibility?

Terry should at least estimate the income tax and social security obligations and set aside the money in an escrow account. If he is more cautious, he might hire an accountant to set up the accounts and ensure that the tax payments are made correctly and on time.

2. What should Terry include in his bid?

In his bid, Terry should include at least all of the relevant costs, including:

1. his labor (opportunity cost of working other lawns)

2. depreciation on the equipment (lost market value or legally allowed tax rate)
3. supplies (e.g., gasoline)
4. maintenance on the equipment
5. profit (return on risk)
6. additional taxes

3. How much should he bid for the job?

If information is available on what Terry's competition generally charges on jobs such as this, Terry might want to consider those amounts. If this is the case, Terry would want to underbid the competition, but to cover the estimated costs. If Terry cannot competitively cover the costs estimated in question #2, the bid should still cover the costs and Terry should expect to lose the job. The question of whether Terry should take the job at a loss in order to break into the market might arise, but Terry is not committed to this industry, and this type of pricing strategy is probably not appropriate. (Terry certainly does not have the capital to engage in a long price war with more established firms.)

4. If he gets the bid, what other opportunities and threats will he face?

If Terry gets the job, opportunities will include:

1. The ability to advertise using the side of the truck while on the job
2. The opportunity to expand the range of services offered to the residential customers

Threats (additional mandated considerations) will include:

1. Increased liability to employees (insurance expense)
2. Increased liability to customers (bonding expense)
3. License and permit requirements
4. Overextending his commitments (lowered standards for new and old customers)

# BMW OF NORTH AMERICA, INC. v. GORE: ETHICS GO FOR A RIDE

**Joseph S. Falchek, King's College**
**Christopher S. Alexander, King's College**

## CASE DESCRIPTION

*On the 20th day of May, 1996, the Supreme Court of the United States dealt a blow to the professors who teach ethics as an integral part of their Business Law courses. By a five (5) to four (4) vote, the Supreme Court curtailed jury awards aimed at punishing or deterring misconduct when it struck down as 'grossly excessive' a two million dollar punitive damage award to an Alabama oncologist. Dr. Gore's suit was based upon undisclosed pre-delivery damage and repair to his BMW sports sedan (BMW of North America, Inc. v. Gore, 1996). At first blush, what seems to be a punitive damage case can be used in the classroom as a case study for ethical considerations in business. The primary subject matter of this case concerns business ethics and business law. Secondary issues examined include marketing. The case has a difficulty level of three, appropriate for junior level courses; or four, appropriate for senior level courses. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.*

## CASE SYNOPSIS

*This paper will discuss the majority opinion of the Supreme Court as well as the individual concurring and dissenting opinions. Irrespective of the reported decision, there exist numerous facts and issues that were presented and went unanswered in the record, briefs and oral argument before the Court. By sensationalizing this case, the popular press reported the case with 'sound bite' headlines. These headlines may have been read/heard by today's college students, thus flavoring and/or desensitizing the ethical issues that should be addressed by all college students prior to entering the business world of tomorrow. The case of BMW of North America, Inc. v. Gore case may be used as a means to highlight the overlapping legal/ethical considerations in a framework that is understandable, realistic and relevant to the class. This case can promote an interactive exchange of ideas on many of the unreported facts and issues that are supported by legal and ethical considerations. These discussions will prompt the class to form its own opinion on the legal and ethical issues, and to decide whether or not they are in agreement with the decision of the Supreme Court.*

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BMW of North America, Inc. v. Gore, ____ U.S.____, 116 S. Ct. 1589, 134 L.Ed.2d 809, 64 U.S.L W.4335 (1996).

# STEPHENS INC.

**Ramona Akin, Henderson State University**
**Shekar Shetty, Henderson State University**

## CASE DESCRIPTION

*Stephens Inc. is designed for use in a Managerial Finance, Banking, or Investments class at the junior level. The case has appropriate applications for a discussion of the legal and regulatory perspective as well as the ethical perspective. Major concentration should be on analyzing the current situation in which Stephens Inc. is operating, determining potential environmental threats, and planning future strategy.*

*This case is intended to be examined by students first on an individual basis. Those individual evaluations may then be incorporated into a group analysis, with approximately five students per group. At the end of these exercises, each group may report its respective analyses, conclusions, and recommendations. The case is designed to be taught in approximately two class hours with minimal outside preparation.*

## CASE SYNOPSIS

*This case describes a large investment banking firm, Stephens Inc., which is headquartered in Little Rock, Arkansas. Originally founded as W.R. Stephens Investment Company in 1933, the company has been quite successful. Stephens participates in corporate offerings, provides debt management and stock and bond brokerages, and handles mergers and acquisitions. It has offices in several states and is wholly owned by the Stephens family, who are worth about $1.2 billion. However, the firm has faced allegations of illegal activity over the years, some of which have resulted in fines and negative publicity.*

## INTRODUCTION

Stephens Inc. is a full-service investment banking firm headquartered in Little Rock, Arkansas. It is a business with an interesting history that includes political intrigue as well as legal and ethical questions.

The Stephens story began many years ago with two brothers, Witt and Jack, who were reared in poverty in a rural Arkansas town with population of about 250 people. Their father, A.J. Stephens, was a farmer, amateur geologist, politician, Bible scholar, legislator, and deacon in a Baptist Church. His philosophy about poverty was rather simple. It was nothing to be ashamed of and nothing to brag about. It was, on the other hand, something to get rid of, just as soon as one conveniently could.

Success, according to the elder Stephens, was not a destination to be reached. Rather, success was to be measured by the quality of one's journey there.

## WITT STEPHENS

Witt, the older Stephens brother, struck out on his journey first. He began by selling belt buckles on military posts at a handsome dollar profit per buckle in 1927. Interestingly enough, one purchaser of those belt buckles was a young Orval Faubus. Perhaps the Stephens' ties to politics began with this transaction between Witt and the man who was to become one of Arkansas' best known politicians.

The company which eventually became Stephens Inc. was founded as W.R. Stephens Investment Company in 1933 by Witt Stephens for the purpose of trading Arkansas Highway bonds. By the time the bonds paid off at par, Stephens had gained a reputation for municipal bond expertise and sound financial counseling.

In 1957, Witt left the company to run ArkLa Gas. Witt had bought Fort Smith Gas Co. in 1945, an investment he parlayed into ArkLa Gas, a major utility with reserves valued in excess of $1 billion.

## JACK STEPHENS

Jack Stephens graduated as a United States Naval Academy midshipman, but he never received a Navy commission because of eye problems. Jack never was accused of lacking vision, however, when it came to business.

He joined the firm in 1946. The 50-50 partnership between Witt and Jack Stephens began on a handshake, and the two Stephenses began patiently building their empire. Jack's 50-year journey has resulted in his becoming a billionaire investment banker and chairman of the family-owned investment firm.

The "Jack Years," as they are called by an Arkansas DemocratGazette writer, began in 1957 when Witt left the company to run ArkLa Gas. When Jack Stephens took control of the family business, the brothers' net worth was nearly $7.5 million. Within 30 years, that figure had grown to well beyond $1 billion. Stephens interests supplied the money to help Sam Walton go public with Wal-Mart Stores Inc. stock and financed Don Tyson's 'chicken wars' in a hostile takeover of rival Holly Farms.

By 1989, Jack's business acumen had allowed him to buy a $2.3 million home on exclusive property in Miami. He lost the home, however, in a divorce settlement in 1991, the same year that Witt Stephens died. By that time, the combined Stephens' net worth was $1.7 billion, 34th among U.S. fortunes and in Arkansas second only to the Walton family. Each brother's personal fortune was estimated at $380 million, or roughly equivalent, according to Time magazine, to that of Donald Trump.

## STEPHENS AND POLITICS

Jack Stephens' journey to success included an association with politics and politicians that began when he was a teenage statehouse page. Although a Republican, Jack aided his former Naval Academy classmate, Jimmy Carter, by raising funds for his presidential campaign in the 1970s. He was a major GOP contributor during the Bush administration, and he helped bankroll the Clinton-for-

President Democratic campaign in 1992. He was a leading stockholder in a bank that gave Clinton a $3.5 million credit line.

In fact, the Stephens brothers have a history in Arkansas as political kingmakers. Their clout has led some political observers, tongue in cheek, to label the combined influence of Jack and Witt Stephens by the acronym, JAWS.

Despite the observations of political pundits, however, Jack Stephens received the 1989 J. William Fulbright Award for international trade development in recognition of his efforts to attract foreign investment capital to the Mid-South. Along with Witt in 1991, he won the William F. Rector Memorial Award for Distinguished Civic Achievement from 50 for the Future, a business group.

Various honors notwithstanding, Jack prefers to keep a low profile and he abhors interviews. In 1991, he was named to head the Augusta National Golf Club and the Masters Golf Tournament. Golf Digest magazine, in seeking to feature him, asked a fellow golf club member about the financier's identity. The golfer replied simply, "He owns Arkansas."

## THE STEPHENS EMPIRE

The Stephens Group has included such diverse operations as a nursing home, a sunglasses distributor, a maker of needlework patterns, a Hong Kong brokerage, a Hilton Head plantation, and manufacturers of everything from water heaters to motor boats. In the early 90s, the Group acquired controlling interest in the Donrey Media Group, a major chain of businesses based in Las Vegas. This acquisition was viewed by some as being analogous to the collision of two financial worlds--each created from the grass roots up by entrepreneurs much in the spirit of Horatio Alger.

Stephens Inc., Arkansas' largest securities firm and one of the largest brokerages off Wall Street, shed $132.2 million in assets for the year in 1991, down from $529.2 million. At the same time, the company showed increased net worth, up $13.9 million, to $129 million. As of June 27, 1997, Stephens had total assets of $745.3 million and a net worth of $141.2 million respectively.

According to a company marketing brochure, the Stephens philosophy encompasses a belief that strong relationships based on mutual understanding and integrity are, without exception, more important than individual transactions. The integrity of the firm, however, has been called into question.

## PROBLEMS

Jack Stephens' political activism may have been instrumental in winning him some critics. For instance, a writer for the Wall Street Journal reported in 1991 that Jack played a central role in bringing the Pakistan-based Bank of Credit and Commerce International (BCCI) to the United States. Six individuals were indicted in 1992 and charged with criminal activity arising from the operation of BCCI, which the government called 'a criminal enterprise.'

Although Stephens denied any BCCI association, the Journal reported that he helped link BCCI-related individuals with an energy company associated with George W. Bush, the president's son.

Stephens branded the Journal article as reckless, irresponsible journalism which was riddled with numerous inaccuracies and misstatements. He said, "I am driven to the conclusion that the

Journal is engaged in a vendetta to discredit me and my family as part of some separate and hidden agenda which has nothing directly to do with us."

According to the Journal, however, Stephens ignored a 60-year-old doctrine that is supposed to keep banking and securities as separate as church and state. In response, Stephens suggested that someone call that doctrine to the attention of financial firms such as Citibank, Chase Manhattan, Bank of America, and dozens of others which Stephens said were engaged in the securities business--with the blessing of the Federal Reserve Board. In 1992, BCCI officials pleaded guilty to state and federal criminal charges and agreed to pay $550 million in restitution.

Also in 1992, a 7-year-old bankruptcy case of an industrial supply company that Stephens Inc. once owned was settled when the Stephens firm paid a $1.25 million settlement. The original suit alleged that Stephens was guilty of fraud in a 1984 leveraged buyout when the Little Rock investment firm sold Hollis & Co. The 1987 suit charged that Stephens, which owned Hollis & Co. at the time of the buyout, caused the company to go bankrupt because of the transaction.

Officials at Stephens denied the claim, saying instead that mismanagement of Hollis & Co. after the sale led to the bankruptcy filing. The settlement agreement noted that Stephens produced various audits that supported its claims that the buyout had nothing to do with the bankruptcy.

The Stephens business empire was reported in 1993 to be under investigation by the Federal Reserve with regard to the extent of the family's control and ownership of two banks, Worthen Banking Corp., Arkansas' largest bank company, and the First National Bank in Stuttgart, and whether the relationships violated laws limiting concentrations of financial power.

The New York Times focused on the First National Bank of Stuttgart, which showed considerable ownership by the Stephens family and stated that the Fed found the Stephens holdings violated The Glass-Steagall Act. This act prohibits people who control securities firms from owning more than 50% of a bank. Further, the Times alleged that the Fed went easy on the Stuttgart institution and, instead of levying a fine or bringing a formal enforcement action, suggested that it change to avoid future Fed scrutiny. The article quoted sources as saying that the late Witt Stephens had exerted considerable control in the operations of the bank.

According to documents and interviews, representatives of Stephens Inc. and the Stuttgart bank failed to disclose to the government the full extent of the family's ownership and control of the Stuttgart bank. These incomplete disclosures helped persuade regulators that the family’s holdings were permissible, and they allowed the family to exercise control over the Stuttgart bank for more than a decade. One of the incomplete disclosure documents was filed by associate White House counsel William H. Kennedy, III. Kennedy was formerly a Little Rock lawyer who headed the Rose Law Firm where Hillary Rodham Clinton worked.

A Stephens attorney said the family did not agree with the Fed's findings that it had more than 50% ownership in the Stuttgart bank, arguing that some of the family's trusts were independent and should not be counted. He stated that the omission of some of the Stephens bank holdings on the 1984 document stemmed from a legal 'misunderstanding' of disclosure requirements.

Differences were reported within the Fed on whether it was too quick to resolve one violation in the mildest way possible, as well as to how vigorously the questions that remained should be pursued. Instead of levying a fine or bringing a formal enforcement action, the Fed suggested that the bank become a state-chartered bank which would allow it to avoid future federal scrutiny. At a closed meeting three months prior, two members of the Fed's board of governors favored tougher enforcement, but Greenspan and four other members backed the milder course.

Worthen and Stephens took it on the chin in newspaper reports about their relationship. The New York Times published an article on the Federal Reserve Board's investigation of Worthen ownership, along with its approval of Worthen's merger with Union.

As a result of new stock issued in Worthen Banking Corp.'s merger with Union of Arkansas Corp., the Stephens family interest in Worthen decreased to the point that the McAdams family which owned Union replaced the Stephens as the company's major stockholder. Stephens ownership of Worthen dropped from 36.6% to 26.6% while the McAdams family, which took Worthen stock for their Union stock, became the major stockholder with 27.2%.

Along with the New York Times, the Wall Street Journal also lambasted the Stephenses, with both newspapers noting Stephens' close connections with President Clinton. It might be mentioned that while the Stephens business empire had close links to the Clinton White House, none of the Fed's top officials had been appointed by the Clinton administration.

In 1996, Stephens Inc. was fined $225,000 by the National Association of Securities Dealers regulatory arm because of a lack of supervisory control over some of its employees. The firm was also censured, and two Stephens brokers were sanctioned. The sanctions were related to the sale of the proprietary mutual funds of NationsSecurities Inc., a subsidiary of NationsBank Corp.

As part of its settlement, Stephens was required to hire an independent auditor to review the firm's supervisory policies and procedures and to implement changes recommended by the auditor. The consultant was also to conduct mandatory training for senior personnel and supervisors.

Stephens neither admitted nor denied the association's findings. General counsel for Stephens said he didn't think securities dealers' sanctions would hurt the firm's reputation or its business.

One of those sanctioned, a Stephens analyst, however, called the findings 'ludicrous' and filed an appeal. The analyst had been fired from Stephens in 1994 after poor annual reviews. He claims Stephens tried to blame him for losses incurred by Stephens customers who bought TPI stock. He said, "I refused to be the scapegoat for the ineptitude of nonrevenue-producing senior vice presidents at Stephens Inc."

In 1997, this former Stephens Inc. securities analyst was cleared by an appellate committee of the National Association of Securities Dealers of making misrepresentations to Stephens customers in 1993. This decision reversed an earlier district committee's finding that the analyst misled customers regarding the stock of TPI Enterprises Inc., which led to censure and a $40,000 fine.

The Stephens company had no comment on the reversal.

In the fall of 1997, it was reported that the Federal Securities and Exchange Commission had issued a cease-and-desist order against Stephens Inc., requiring the company to change its disclosure practices when selling stock owned by the company to its customers. In an order filed September 16, the federal agency said it had accepted Stephens' settlement offer, which the company made in anticipation of administrative proceedings by the SEC. As part of its settlement, Stephens consented to the order and its findings.

The company neither admitted nor denied any wrongdoing.

## PRESENT AND FUTURE FOR STEPHENS INC.

Stephens Inc. finished the year 1997 as the leading underwriter of new municipal bond issues in Arkansas, a market that was up 36% in volume over 1996. The company served as managing underwriter on 36 municipal bond issues that raised a total of $357.3 million, or 28.2 percent of the market in the state.

Stephens also finished the year as the state's top municipal financial adviser, with 10.7% of the market.

The question one might pose at this point in time is whether the problems Stephens has experienced over the years will have a negative impact on its reputation and, as a result, affect its credibility. Another point of interest might be an assessment of the adequacy of the penalties Stephens has received as compared to those of other large investment banking firms in the United States.

Although the reputation of Stephens Inc. appears to have survived unscathed thus far, one might wonder what would happen if competitors chose to exploit the negative publicity Stephens has received. If that should occur, how might Stephens counter such an attack?

What measures might the company take to prevent legal and ethical questions about its operation in the future?

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# ACME HEALTHSOURCE, INC.

**Stanley J. Clark, University Of Southern Mississippi**
**Charles E. Jordan, University Of Southern Mississippi**
**W. Robert Smith, University Of Southern Mississippi**

## CASE DESCRIPTION

*This case contains a revenue recognition problem that can be adapted to a number of accounting courses. The case has applications at the undergraduate level in intermediate accounting and at the graduate level in a theory or current financial problems or even a tax research course. Generally students can research the case in one or two weeks outside of class. At the undergraduate level, 15-20 minutes of class discussion typically suffices. At the graduate level, 45 minutes is usually a minimum.*

## CASE SYNOPSIS

*Acme HealthSource, Inc. has expanded its healthcare operations by opening two retirement centers. These retirement centers have created an accounting problem because patients are allowed (in some instances, required) to pay a deposit upon entering the retirement center. The deposit keeps the patients' monthly rental at the same level throughout their stay, even if the level of care increases dramatically. There are two types of deposits, and each contains a refundable and non-refundable portion. The case focuses on the proper revenue recognition of these deposits.*

## INTRODUCTION

Acme HealthSource, Inc.(AHS) is a holding company that operates, on a for-profit basis, several hospitals and clinics throughout the southern United States. AHS has been very successful in all of its healthcare ventures. As a result, AHS expanded its operations this period by opening two continuing care retirement centers (CCRCs). These CCRCs provide an upscale living environment along with first class medical care for retirees.

AHS plans to open CCRCs throughout the south. Their marketing plan is to open CCRCs only in communities that are successfully marketing themselves as retirement communities. AHS believes there is tremendous potential for growth in providing this type of service, and AHS feels that it is well positioned to take advantage of this opportunity.

The two CCRCs that are now open provide first-class living arrangements to the retirees. AHS provides different levels of living arrangements based on a retiree's (patient's) needs. The three levels of living arrangements currently offered are retirement housing, assisted living, and nursing home. AHS plans to add another level for Alzheimer's patients.

Retirement housing is appropriate for individuals who need little or no assistance with daily life. Such an individual's monthly rent is primarily based on apartment size and style. Assisted living exists for individuals who require some assistance (medical or other) with daily living. Monthly rent is still based in part on the size and style of the apartment but also includes an increased cost of care. Finally, nursing home care is provided for individuals that require extensive amounts of daily assistance. This level is very akin to a hospital environment with a nicer living area; it also has the highest monthly rent to offset the increased level of care required.

Individuals can enter the CCRC at any level. Those entering at the retirement housing or assisted living levels will typically progress through the upper levels over the remaining course of their lives. This progression results in the patient's monthly fees increasing as they move up to the next level of care. AHS provides a means by which patients can pay a deposit upon entering the CCRC to lock in a fairly stable monthly rent for their remaining life or stay at the facility. This deposit eliminates the increases in monthly rent due to the progression through the levels of the living arrangements. Individuals entering at the nursing home level would obviously pay no deposit since there is no higher level in which to progress. Rent at all levels may still be increased due to cost of living adjustments or changes in the cost of care.

## THE ACCOUNTING PROBLEM

AHS has set up two types of deposits that individuals may pay upon entering the CCRC. The basics of each of these deposits are as follows:

1) Option 1 - 15% of the deposit is non-refundable; 85% is refundable on a pro rata basis if the individual moves out of the CCRC in the first 60 months.
2) Option 2 - 10% of the deposit is non-refundable; 90% is refundable when the individual moves out or dies.

The amounts of each of these deposits are based on many factors, including level of living arrangement upon entrance to the CCRC, size and style of apartment, and age of person or persons. Option 2 deposits are significantly higher than Option 1 because of the large percentage that will eventually be refunded to the individual or his/her heirs. Option 1 deposits generally range between $150,000 and $250,000 while Option 2 deposits range between $350,000 and $500,000. Most individuals entering at the retirement housing level pay one of the deposits, and a significant percentage of those entering at the assisted living level also pay a deposit.

John Mashburn, Controller for AHS, and Deron Farmer, Controller for the CCRC subsidiary, have been discussing the proper revenue recognition procedure for these deposits. This is the first year of operations for the CCRCs, so neither has dealt with this issue before and they have not been able to find definitive guidance in any FASB statements. They have both agreed that the refundable portion of Option 2 deposits should be shown as a liability and never shown as revenue. Therefore, their two prime areas of concern are the non-refundable portions of each type of deposit and the refundable portion of the Option 1 deposits.

Deron believes that the non-refundable portions can be recognized as revenue since they are non-refundable. She further believes that the refundable portion of Option 1 should be amortized to revenue over 60 months. This amortization is consistent with the provisions of the deposit. John does not have a real problem with the amortization of the refundable portion but is concerned about the immediate revenue recognition of the non-refundable amounts.

# THE EFFECT OF TAXES ON CAPITAL BUDGETING DECISIONS IN THE COMPETITIVE ELECTRIC GENERATION MARKET

**James E. Williamson, San Diego State University**

## CASE DESCRIPTION

*The case was originally structured as a capital budgeting problem, suitable for an introductory management accounting class. In that role, the case has students look at the effects of current and prospective tax provisions on the capital budgeting project selection decision. However, because there are so many levels of analysis that the case can be expanded to, it also can be used in an upper division or graduate management accounting course. At the higher levels of analysis, because of its integrative nature, the case may best be used in an interdisciplinary manner. The case would work well in a senior seminar capstone type course, where it could be appropriately used to integrate environmental and financial markets issues into capital budgeting decisions. Other issues that could be brought into the case include the U.S. dependence on international sources of fossil fuel, the international balance of payments, and the effect on capital markets.*

## CASE SYNOPSIS

*This is a real world case. The Research and Development Office of the California Energy Commission is participating in a study of tax equity issues in the competitive electric generation market. Previous studies conducted by the Commission and confirmed independently show that projects generating electricity from renewable resources tend to incur higher lifetime discounted tax loads than their conventional gas turbine competitors of the same generation capability. The tax burdens can differ by as much as two to one for renewable generation and proportionately increase the electric generation sales revenue required to attract investors. Unlike other markets, the capital costs of the different approaches to electric generation can differ by as much as ten to one. At the same time, and equally important, the operating costs (including fuel) of different generation approaches can have an inverse relationship to capital costs. The case demonstrates that, under current local, state, and federal tax treatments, these structural differences give rise to widely different tax loads over project lifetimes. The case also notes, that while these differences had little competitive effect in the regulated utility market they may have a significant effect in the deregulated market.*

## MESA COMPANY BUILDS A NEW ELECTRIC GENERATION PLANT

Mesa International, a producer of electric energy in the deregulated global market, has decided to build a new generation facility, with the capacity to produce 10 megawatts of electric energy. Mesa has historically generated electric energy in plant facilities fueled with oil, gas and coal.

However, because of the international focus on the effects of fossil fuels on CO2 emissions and global warming, Mesa's managers are contemplating changing technologies by building a 10-megawatt Solar Power Tower in the California desert. The plant would use more than 1,800 sun-tracking mirrors known as heliostats to heat water in a receiver atop a 300-foot tower. This modern technology plant would be outfitted with molten-salt energy storage to enable it to produce power day or night.

However, before Mesa makes a final decision whether to go with the new environmentally friendly technology, management wants to look at a total cost comparison for the project's estimated 30 year life. Julie Kenyon is in charge of capital budgeting analysis for new generation projects. Julie's job requires both an engineering degree and an MBA degree. In addition, she has considerable practical experience gained from working in various line and support functions for Mesa. This duality of education and experience is necessary because she needs to aid management in solving construction technology decisions, in using management accounting information, and in using techniques to control plant construction and subsequent electric energy generation production costs. One of Ms. Kenyon's subordinates, Frank Christianson, has developed an estimate of construction costs and production operating costs comparing the two types of generation technology, on a before-tax basis.

Figure 1
Cost Comparison of a Fossil Fueled 10 Megawatt Electric Generation Plant
with a Solar Fueled 10 Megawatt Electric Generation Plant

| | Fossil Fueled Plant | Solar Fueled Plant |
|---|---|---|
| Construction Costs | $ 1 Billion | $10 Billion |
| Annual Operating Costs | $100 Million | $100 Million |
| Annual Fuel Costs | $955 Million | None |

Noting that the basis difference between the two technologies is a trade off between either $9 billion in additional construction costs at the outset or $955 million in annual fuel costs, Frank decided to do an incremental present value analysis, utilizing the company's cost of capital discount rate of 10 percent.

Figure 2
Present Value Comparison of Additional Construction Costs of
Solar Fueled Plant versus Additional Fuel Cost of Fossil Fueled Plant

| | Fossil Fueled Plant | Solar Fueled Plant |
|---|---|---|
| Present Value of Additional Construction Costs | $ None | $9 Billion |
| Present Value of Additional Fuel Costs | $9 Billion | $ None |

Subsequently, Frank concluded there was no real total project cost difference between the two technologies, on a before-tax basis. However, when Frank did an after-tax comparison, utilizing the corporate tax rate of 35 percent and the 5 year MACRS Depreciation Schedule, he got the following results.

Figure 3
Present Value Comparison of Additional Construction Costs of
Solar Fueled Plant versus Additional Fuel Costs of Fossil Fueled Plant
on an After-Tax Basis

| | Fossil Fueled Plant | Solar Fueled Plant |
|---|---|---|
| Present Value of Additional Construction Costs | $ None | $6.57 Billion |
| Present Value of Additional Fuel Costs | $5.86 Billion | $ None |

Now, Frank discovered there is a real after-tax cost difference between the two technologies. When discussing this difference with Ms. Kenyon, Frank pointed out that a much more thorough evaluation of the effect of current tax laws would be needed before an informed decision could be made. Julie Kenyon added that it would be desirable if environmental issues could also be brought into the capital budgeting model in some purposeful way.

## QUESTIONS/EXERCISES

1. First, verify Frank Christianson's before-tax present value incremental cost analysis (use a 10 percent discount rate and a 30 year project life).
2. Second, verify Frank Christianson's after-tax present value incremental cost analysis (use the 5 year MACRS depreciation schedule).
3. Suppose that you are Julie Kenyon and you have to explain to Mesa's Board of Directors why electric generation by either technology is comparable, on a present value basis, before-tax considerations but that the traditional fossil fueled method is less costly on an after-tax basis.
4. Find some current proposed tax policy changes and analyze their potential affect on these two different technologies that are currently cost neutral on a before-tax basis but are not on an after-tax basis.
5. Formulate some of your own ideas into tax policy changes and analyze their potential affect on these two different technologies, in terms of improving tax neutrality.

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# CLASH OF TITANS: A CASE STUDY OF THE EARTH MOVING INDUSTRY

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## CASE DESCRIPTION

*This case provides information for analysis of the construction machinery industry and allows for the evaluation of the competitive strategies of two of the industry's major companies: Caterpillar and Komatsu. Two prevailing issues are suggested that link the organizations. The first is each company's effort to successfully make the transition from a domestic producer to a multinational competitor under adverse conditions over the last two decades. Achieving this necessitated a global competitive strategy to cope with an array of international threats and opportunities. The second issue is a production problem: to offer a high quality product line at competitive prices, mandatory to each company's domestic and international success.*

*Issues such as favorable exchange rates, national monetary, and fiscal policies, and the overall world economy are addressed in their relation to develop a competitive pricing position. On a micro level the companies are examined with an eye towards management to develop an operational (functional strategy) of cost minimization, which influenced each companies decisions concerning product mix, quality goals, and inventory philosophy as well as manufacturing location.*

## CASE SYNOPSIS

*Table 1 contains the critical elements associated with multinational transition and production, which tend to be interdependent. For example, favorable exchange rates are crucial to competitive pricing. In turn, exchange rates are influenced by the monetary and fiscal macroeconomic policies of the given countries. Moreover, economic policies influence national debt levels and interest rates, which in turn both influence sales for the industry. In addition, politics influences government policy on trade restrictions, and both affect the location of production operations.*

*The primary operational issue as stated in the literature is cost minimization, which affects decisions concerning product mix, quality goals, and inventory philosophy as organizations evaluate economies of scale and scope. Quality has become a consumer mandate as well as a means of achieving lower costs according to those who maintain it is cheaper to produce high quality products than to deal with consequences of inferior products. Inventory philosophies are also important operational considerations within the industry since they affect availability and production costs.*

Table 1
Primary Issues in the Construction Machine Industry

Multinational Issues

- Exchange Rates
- Political Issues
- Protectionism
- International Macroeconomic Conditions
- Location of Production Facilities
- Logistical Coordination

Operational Issues

- Cost Minimization
- Product Lines
- Product Quality
- Inventory Maintenance

## CLASH OF TITANS

The construction machinery industry is a compilation of a number of segments. All organizations do not compete in each of the segments. In the aggregate, market structure parameters define the industry as an oligopoly: the industry is dominated by a few large organizations.

There are two primary reasons why organizational size and concentration are significant in the competitive process. First, the industry enjoys substantial economies of scale (in production distribution, service, and research and development) which have a major impact on cost structure, and hence price, a basis of competition. Second, there are significant barriers to entry and exit. The manufacture of construction machinery entails large capital outlays which tend to dissuade new market entrants, and the experiential elements of large scale production result in average cost reductions. Additionally, market exit barriers are significant, particularly during periods of overcapacity as in the early 1980s.

As a result of the oligopolistic structure within the industry, mutual interdependence is germane to the definition of organizational strategies. Given a company's relative size, strategic decisions have meaningful effects on competitors. Therefore, efficacious response by competitors is mandated. These responses can be expected primarily in the areas of price, product differentiation and mix, production, distribution, and markets served. Strategic changes in any of these areas will tend to evoke competitor response.

## INDUSTRY MARKETS AND PRODUCTS

Four primary market segments comprise the overall industry: earth-moving machinery, cranes, forestry equipment, and special function machinery. Of these segments, earth-moving machinery and cranes are the most significant since they represent the vast portion of worldwide sales. In order to provide a more thorough understanding of the aggregate industry, its segments may be identified by the markets which are served. The earthmoving segment of the industry primarily serves the building construction market: mainly residential, commercial, industrial, and governmental. Buyers include construction companies, contractors, state and local governments, mining and industrial companies, logging companies, and farmers. The construction machinery business, as it relates to Caterpillar and its chief competitors, is highly dependent upon large governmental infrastructure projects, many of which have been delayed, particularly in less developed countries, drying up a once strong source of demand. This situation is compounded by a global switch to rigorous maintenance and repair in lieu of replacing such expensive equipment.

The remainder of the analysis will be devoted to providing a synopsis of current industry conditions, and analyses of both Caterpillar and Komatsu. Consideration is devoted to prognosis for the future given the scenario that managerial actions are successful, and given the situation where actions are ineffectual and conditions deteriorate.

## CONDITIONS IN THE INDUSTRY

The industry has experienced three significant periods of growth within the past 50 years which are attributed to: the rebuilding following World War II, the interstate highway program in the U.S., and the rise of developing nations as new sources of demand. Recently, however, sales growth has been arduous, and companies have reexamined bold growth strategies. The precipitous changes have been both domestic and international in origin and scope.

## DOMESTIC CONDITIONS

American competitors have greatly reduced their product lines in order to help reduce the large inventory costs associated with a broad array of equipment offerings. For example, Terex, a leading manufacturer of mining ore trucks (Lectra Haul) and construction cranes (Koehring) competes only in the mining ore truck segment of Caterpillar (Siegal, 1992). John Deere has concentrated a majority of its efforts on farming equipment, however they do compete in the track hoe segment (Siegal, 1992). Case industries (a division of Tenneco) completely downsized their construction division, saving the backhoe segment which today is the market leader in backhoe sales.

The industry is susceptible to economic cycles. Many companies such as Manitowoc (Crane and Excavators) diversified to help assuage the effects of the business cycle (Rho, 1992). For instance, Manitowoc owns and operates one of the largest manufacturers of ice machine companies. The ice machine business is a cash cow (31% sales, 70% profit) and has allowed Manitowoc to survive the latest economic downturn in demand for mining equipment.

## INTERNATIONAL CONDITIONS

The decline in the world economy has provided new challenges for this industry. The current world recession affects the ability of firms to compete on the large scale construction projects used in development around the world (Leach, 1992). Therefore, several competitors have dropped portions of their product lines in favor of a niche strategy where market domination of a particular segment is preferable to competing against full line suppliers such as Caterpillar and Komatsu. Historically, Caterpillar has been an aggressive merger and acquisition giant that has defended their claim of being the principal competitor in the track driven machinery manufacturer.

Many American firms have changed their production strategies from total integration to overseas, third party suppliers and subcontractors. The move towards forming international strategic alliances has greatly enhanced many of their opportunities to expand markets in their chosen niches. Clark corporation exemplifies the benefits of strategic alliances.

During worldwide economic downturns, corporations have turned to bartering in an effort to counterbalance cyclical business. In 1985, Caterpillar was willing to use barter exchange through Universal Trading Company (Univex) to trade Caterpillar equipment for caskets made by a Latin American sawmill operator (Zinman, 1986). International competition in the industry is intense. The justifying argument for letting Caterpillar sell pipeline-laying equipment to the former Soviet Union was that if they were not allowed to, the Japanese (Komatsu) would (Zinman, 1986).

Exposure to foreign regulations has threatened many multinational corporations. Several countries, primarily those with lesser developed economies, fear the financial clout of the multinationals. This concern is manifested in regulation and threats of nationalization of assets. The result is heightened political risk associated with multinational operations. Foreign exchange rates are critical to a competitor analysis within the industry (See Table 2). A relatively high value of the home currency tends to inflate the price of an exported product. Caterpillar lobbied congress in the latter 1980s to lower the value of the dollar in order to help their competitiveness in the export segment of the world economy. Moreover, exchange rates also impact international financing decisions. The ability to service debt in the foreign country without fear of changes in the exchange rate was affected when laws were eased, allowing subsidiaries to borrow money independently of the parent company. This isolation of the parent company also allows the national company the advantage of competing on equal footing with other foreign companies.

## CATERPILLAR

Following World War II, Caterpillar made the decision to become the dominant global firm in the heavy equipment industry. Caterpillar's global strategy has caused the firm to function differently from competitors limiting themselves to domestic strategies.

Sensitivity to host-country issues is important for multinational firms, and Caterpillar is no exception. When Caterpillar began selling in Brazil, the company was confronted with tight credit problems. Before the Brazilian venture, Caterpillar had been doing business exclusively with one bank. Tight credit in Brazil caused Caterpillar to open several bank accounts, which gave the firm access to additional credit markets. Currently, Caterpillar operates using local banks in host-countries. In an effort to promote its image as a good citizen in host-countries, Caterpillar has made a film to support its positive impact on host-country societies (Daniels and Radebaugh 1989, 303).

Table 2
Currency Exchange Rates

| **Year / currency** | **1967** | **1977** | **1987** | **1989** | **1991** | **1993** | **1995** | **1997** |
|---|---|---|---|---|---|---|---|---|
| **U.S.** | 1.00 | 1.22 | 1.29 | 1.28 | 1.37 | 1.40 | 1.52 | 1.37 |
| **Japanese YEN** | 362 | 191 | 187 | 160 | 187 | 148 | 155 | 122 |
| **French Franc** | 4.37 | 4.71 | 5.34 | 5.78 | 5.18 | 5.90 | 4.90 | 5.86 |
| **British Pound** | 2.40 | 1.90 | 1.87 | 1.60 | 1.87 | 1.48 | 1.55 | 1.64 |
| **German Mark** | 3.99 | 2.11 | 1.58 | 1.70 | 1.51 | 1.73 | 1.43 | 1.75 |
| **Swiss Franc** | 4.32 | 2 | 1.28 | 1.55 | 1.36 | 1.48 | 1.15 | 1.45 |
| **S.A. Rand** | .713 | .87 | 1.93 | 2.54 | 2.74 | 3.40 | 3.65 | 4.62 |
| **Italian Lira** | 624 | 872 | 1169 | 1271 | 1151 | 1704 | 1585 | 1716 |

Global firms in some industries are faced with worldwide logistics problems. Caterpillar, though, has addressed those problems by maintaining a worldwide distribution and service organization, considered to be one of the industry’s best. In addition to serving customers, Caterpillar's distribution and service structure also acts as a barrier to entry from new competition, as does its worldwide production scale. Another advantage of this system is foreign assembly and manufacturing plants because they reduce manufacturing and transportation costs. In particular, heavy equipment manufacturing costs are capital intensive and sensitive to economies of scale.

Companies doing business globally may find that their products require alteration for acceptance in different markets. Caterpillar has found that acceptance of its products is influenced by host-country factors. Some of these factors include specific regulations, environmental differences, and local preferences. Caterpillar has addressed these problems by establishing assembly plants in each of its major markets where local product features are added to the equipment (Hout, Porter, and Rudden, 1982).

U.S. multinational companies having a high percentage of their sales resulting from export activities are concerned about the value of the dollar in relation to the value of their competitors' currencies. A high relative value of the dollar creates problems in price competition for U.S. exporters. Caterpillar experienced this problem in the early 1980s when the U.S. dollar strengthened against the yen. As the dollar strengthened, Caterpillar found it more difficult to compete with Komatsu and lost U.S. market share to the Japanese firm (Daniels and Radebaugh, 1989).

Firms doing business internationally are affected by protectionist policies. Importing or exporting companies are affected by quotas, tariffs and nontariff barriers. In his 1991 letter to stockholders, Caterpillar CEO Donald Fites expresses management's position when he says, "We are concerned about the U.S.- Japan bilateral trade relationship. But protectionism isn't the answer. We stand behind efforts to restore balance by lowering -- rather than raising -- trade barriers. We also support completion of the General Agreement on Tariffs and Trade (GATT) and expansion of the North American Free Trade Agreement (NAFTA) to include Mexico" (Caterpillar Annual Report 1991).

## CURRENT ACTIVITIES

Starting in 1982, Caterpillar experienced significant changes in its previous business success; Komatsu, Caterpillar's major competitor, gained significant market share and Caterpillar's earnings turned negative for the first time in 50 years. Caterpillar's management had enjoyed many years of successful expansion and failed to react quickly to the increasing competition of Komatsu. Labor disputes erupted at Caterpillar, the company had excess capacity, and sales declined. The average number of Caterpillar employees has been reduced by 27,500 (32.9%). Caterpillar is committed to remaining the worldwide leader in construction equipment, and has invested for long-term growth.

In 1985, Caterpillar launched a worldwide factory modernization program and is now undertaking a program to revamp every plant in the company. The new modernized factories have instituted a Flexible Management System (FMS). The FMS is designed to respond to shifts in demand or technology. Caterpillar refers to the modernization program as, "The Plant with a Future", or PWAF. The PWAF program was a six-year, $1.2 billion plan for modernization (Eckley 1989; Henkoff 1988).

In 1990, the company launched a complete company-wide reorganization. A decentralized product and geographic matrix organization comprised of 17 divisions has replaced the former highly centralized, functional structure. Decision making is being delegated to lower levels, and divisions are now being held responsible for their actions. A union dispute between Caterpillar and the United Auto Workers (UAW) began in November 1991. The UAW had signed a "pattern" agreement with Deere & Co., and expected the contract to be accepted by Caterpillar. However, Caterpillar did not accept the "pattern" contract. Caterpillar was seeking ways to keep pace with Komatsu, to reduce wages and health care costs, and to decentralize the organization effectively. Caterpillar made a bold move and confronted the powerful UAW. The strike ended in mid-April after a company threat to replace workers. The terms of the new agreement were mostly dictated by the company (Kelly, 1991; Slutsker, 1992).

## PROGNOSIS FOR THE FUTURE

If management actions undertaken by Caterpillar are successful, the company can expect a continued worldwide leadership position. Caterpillar has invested heavily in the modernization of its plants. The organization has positioned itself on the leading edge of industry technology. Caterpillar has demonstrated the fact that current management is willing to commit financial resources to future growth. Not only has the company committed resources for capital improvements, the company has also maintained a commitment to research and development. In 1991, the company spent over $441 million on R & D, the highest amount spent in the last five years. Since 1982, the company has also invested in an effort to maintain market share by reducing some of its prices in selected markets.

Although it appears recent labor negotiations went in favor of Caterpillar, there is a risk that employee moral has been damaged. Caterpillar management held the line on concessions and the union membership backed down. Management's decision to oppose the UAW may have generated an underlying situation of employee discontent and a lack of loyalty. If the company is unsuccessful at overcoming this potential problem, future productivity and quality may suffer.

Caterpillar has tried and succeeded in positioning itself at the forefront of technology, resulting in placing a large financial burden on the company. If the worldwide recession continues or if demand for heavy duty equipment falls, Caterpillar may find itself faced with excess capacity and burdened with high overhead costs.

The functional, highly centralized organization structure served Caterpillar successfully, in the global market, for 50 years. Management was developed around this type of organizational structure. The new structural design has been implemented to focus on specific customer groups. It is anticipated that the new design will allow the company to respond more quickly to change and to customer needs. Each of these profit centers is being measured against performance criteria. The most critical performance criterion for each profit center is a return on assets. If Caterpillar is unsuccessful at developing responsible decision-making managers in a decentralized organization, productivity and quality may suffer. Also at risk will be the newly instituted Just-In-Time (JIT) inventory system. Two of Caterpillar's main competitive advantages have been its highly regarded worldwide distribution system and its customer service reputation. If Caterpillar's management has underestimated its ability to manage a decentralized matrix organization and is ineffective at controlling the JIT inventory system, Caterpillar's two main competitive advantages may be lost.

## KOMATSU

The effects of international trade and Komatsu's responses to them are made clear in the cases provided. In its early development Komatsu used competitive advantages, such as Japan's low cost capital and the high quality culture of its workforce, to garner international market share. Later reversals in some of those competitive advantages sent Komatsu scrambling.

Komatsu management chose a low cost strategy as a way to rebuild after World War II. That strategy did not lead to the development of internationally competitive products so the firm relied on heavy tariffs to protect it from larger international firms. In 1964 Japan substantially lowered tariffs on machinery markets, since MITI did not consider heavy machinery to be a priority. The change put Komatsu at substantial risk. Komatsu responded by putting forward a major effort to redesign its products, and eventually, its manufacturing processes. The company responded to Japan's cheap capital and labor shortages by implementing strict productivity enhancement policies. In the process, it developed production costs that were by far the lowest cost in the world. Combined with what at the time was a very cheap yen, Komatsu had up to a 40% price advantage over international competitors.

Komatsu used that advantage to push aggressively into international markets. It began by providing a very limited set of low cost products. It eventually expanded to a far wider range of machinery. Komatsu had limited international marketing skills so it relied heavily on joint ventures and trading partners for sales. Komatsu's strategy worked extremely well into the mid-1980s. By that time, Komatsu had captured up to 40% of the world's major heavy machinery markets, making it the world's second largest producer of such equipment. As the 1980s progressed, however, many of the competitive advantages on which Komatsu depended began to disappear.

In the latter half of the 1980s, Japan's low cost advantages began to disappear. The yen appreciated almost 100% against the dollar, making it very difficult for Komatsu to compete on price. Even though Komatsu still had significant advantages in productivity, its high currency exchange rate cost it much of its savings. Profits shrank between 1985 and 1986. Sales dropped only slightly, but for a company which was accustomed to double digit growth, the loss had a significant emotional impact.

Komatsu management responded with substantial strategy changes. First, a significant portion of production was moved abroad, thus eliminating the exchange rate problem. Second, a diversification program away from heavy machinery was initiated. Finally, the company began selling many of the technologies they had developed to give themselves such high productivity.

## CURRENT ACTIVITIES

Since 1987, Komatsu has continued to grow in profits and in sales. Komatsu has continued to move production to other countries, and has further come to rely on sales of goods other than heavy machinery. Japan's loss of capital cost advantages is now almost complete. In response, Komatsu has moved much of its heavy machinery manufacturing abroad (Shinohara, 1989). For example, in the U.S., the company created a joint production venture with Dresser Industries. The joint venture has shown many of the strains that have become common in U.S.-Japan joint ventures (Kelly, 1991), but has helped Komatsu capture a large share of many American markets (Green, 1990). Although, as discussed below, the heavy machinery business is becoming less important to Komatsu, it has continued to keep extreme pressure on Caterpillar, the market leader.

Since the factors that gave Komatsu an international competitive advantage in heavy machinery disappeared in Japan, Komatsu has moved to eliminate most of its reliance on producing heavy machinery for export. Komatsu still benefits from a large and growing market within Japan, but has moved to avoid relying on exports. This has been accomplished by diversifying into a broad range of other products that the company felt could benefit from its productivity-enhancing technologies and from selling those technologies themselves.

Komatsu has moved so far in the diversification effort that heavy machinery is hardly mentioned in the 1991 annual report, and none of the 20 pictures showing its products are pictures of heavy machinery. Komatsu now depends on sales of such high tech items as micro-chips and robotics for most of its exports from Japan. Komatsu does not report results by divisions, so it is impossible to tell how much it earned from each product line, but the annual report makes it very clear that heavy machinery is no longer the core concern at Komatsu.

Komatsu's move from heavy machinery production in Japan is a logical development considering the shift in the factors that make up Japan's competitive advantages. It should be expected that we will see more of the same in the future.

## PROGNOSIS FOR THE FUTURE

This case analysis began as a discussion of Komatsu as a Japanese heavy equipment manufacturer. Even though Komatsu has a significant lead in many world markets and in automated equipment types (Schwind, 1992), it is not appropriate to consider Komatsu as a Japanese heavy equipment manufacturer any longer. Much, if not most, of Komatsu's heavy equipment manufacturing is now done in countries other than Japan. Most of Komatsu's activities in Japan are in areas other than heavy equipment.

Komatsu has made strong moves to keep its manufacturing in line with the competitive advantages of the country in which the manufacturing is done. If Komatsu is able to maintain this nimble approach, it is likely to remain successful for many years to come. Komatsu will probably never again make significant amounts of heavy equipment for export in Japan, but it is not likely that it will lose much of its technological advantage in the countries to which it moves production operations.

Komatsu has been praised by many for its strong strategic vision in keeping up with a changing landscape. For instance, it was used by Michael Porter (1990) as an example of an excellent global competitor. Its current diversification path, however, runs a significant risk of costing the company its focus. Komatsu's high quality reputation, heavy research and development, and facilities investments should keep it a strong competitor in the heavy equipment arena for some time to come. Its lack of focus, however, may provide Caterpillar the opportunity it needs.

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# STRATEGIC MANAGEMENT IN THE COMPUTER INDUSTRY: DELL COMPUTER CORPORATION

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## CASE DESCRIPTION

*The primary subject matter of this case is strategic management. Archival data is presented to allow students to develop an appreciation for Porter's Five Force Model of Industry Competition (in the PC industry) and also Dell's Value Chain. The case is appropriate for a one hour and fifteen minute undergraduate policy class and it should require 2-3 hours of outside preparation by the students.*

## CASE SYNOPSIS

*Dell Computer Corporation (Dell) is one of the PC industry's real success stories. Begun in a dorm room at The University of Texas -- Austin in 1983, Dell today employs 11,000 people at three facilities (Texas, Ireland, and Malaysia). Net sales for the fiscal year ended 2 February 1997 were $7.8 billion. Net income was $518 million.*

*This case requires the students to assess the components of the competitive environment (from a Dell prospective), to consider Dell's Value Chain and to discuss Dell's competitive advantages and generic strategy. Although Dell has been inordinately successful from its inception, new competitive pressures (as of 1997) may compel Dell to adopt new strategies for handling difficult situations. The case provides twenty-eight bibliographic citations and seven discussion questions.*

## INTRODUCTION

The history of the personal computer (PC) industry has been dynamic and fraught with much uncertainty. Technological advancements and innovation change the industry drastically from one day to the next. Product life cycles tend to be less than eighteen months. In the midst of uncertainty and change, one company has managed to show continuous growth and promise from conception -- Dell Computer Corporation (Dell). The volatile industry coupled with the "beating-the-odds" history of the company makes Dell Computer Corporation a firm to watch.

While attending the University of Texas as a pre-med student, Michael S. Dell began rebuilding and selling PCs. In order to earn extra money, Dell sold disk-drive kits and random access memory (RAM) chips at computer conferences in Austin, Texas. In 1983, Dell made enough money to purchase IBM computers from dealers who were having problems meeting their quotas. Dell modified these computers and sold them to local companies. By April 1984, he was grossing $80,000 per month and revenues were $6 million for the first year. Dell dropped out of school and sales reached $257 million by 1988. In the early years, Dell sold his computers as "PC's Limited," but changed the name to Dell in 1988. Dell expanded sales internationally to Canada, France, Italy, Germany, Finland, and the Netherlands between 1988 and 1991. In 1993, Dell entered the Japanese market. Moving into these international markets has allowed Dell to consistently reach record revenues every quarter. By 1993, sales had reached $2.8 billion and for the last fifteen quarters (through November 2, 1997), Dell has reported record revenues. Revenues for the quarter ended November 2, 1997 were $3.2 billion and increased 58% over the third quarter of 1996. As of 1997, European sales accounted for 23% of total revenue, while Asia Pacific and Japanese sales accounted for 7% of revenue.

Dell is headquartered in Austin, Texas, with over 11,000 employees throughout the world. The financial statements for Dell Computer Corporation are presented in table 1.

TABLE 1
DELL'S FINANCIAL DATA

| | | | *Fiscal Year Ended* | | |
|---|---|---|---|---|---|
| *(in millions, except per share data)* | *2/2/97* | *1/28/96* | *1/29/95* | *1/30/94* | *1/3193* |
| Statement of Operations Data: | | | | | |
| Net Sales | $7,759 | $5,296 | $3,475 | $2,873 | $2,014 |
| Gross Margin | 1,666 | 1,067 | 738 | 433 | 449 |
| Operating income (loss) | 714 | 377 | 249 | (39) | 139 |
| Income (loss) before extraordinary loss | 531 | 272 | 149 | (36) | 102 |
| Net Income (loss) | 518 | 272 | 149 | (36) | 102 |
| Income (loss) before extraordinary loss per common share: | | | | | |
| Primary | 2.77 | 1.34 | .85 | (.27) | 0.65 |
| Fully diluted | 2.70 | 1.32 | .79 | -- | -- |
| Weighted average shares outstanding: | | | | | |
| Primary | 191.8 | 194.2 | 166.2 | 149.3 | 156.9 |
| Fully diluted | 197.1 | 197.4 | 189.3 | -- | -- |
| Statement of Financial Position Data: | | | | | |
| Working capital | 1,089 | 1,018 | 718 | 510 | 359 |
| Total assets | 2,993 | 2,148 | 1,594 | 1,140 | 927 |
| Long-term debt | 18 | 113 | 113 | 100 | 48 |
| Total stockholders' equity 806 | 973 | 652 | 471 | 369 | |

Source: Annual Report -- 1997 (Dell)

Dell's commitment to its corporate culture of responsiveness, customer focus and satisfaction, and high intensity levels is consistent at all locations. Dells' commitment to customer satisfaction and service is exemplified by it's "no questions asked" thirty-day money back guarantee. Secondly, Dell's commitment is seen through their twelve hour a day, toll-free technical support line. When it comes to customers service, a definite chain of command is followed, with the end of the chain landing on the desk of Michael Dell himself. He openly invites customers to call or write with questions and comments about the quality of Dell's products. This commitment to the customer has made Dell number one when it comes to customer satisfaction according to J. D. Power and Associates. It has also made Dell the world's leading direct sales computer systems company.

Dell's product lines are divided into four categories -- Desktops, Enterprise, Portables, and Peripherals. Desktops accounted for 73% of System sales in 1997, while Portables accounted for 19% and Enterprise accounted for 8%. Peripherals accounted for the balance of sales. Dell offers a very competitive and broad product line, from inexpensive models to state-of-the-art technological advancements. Dell's entire product line is sold through telephone representatives and, recently, the Internet. Sales are made by these representatives and orders are immediately downloaded to assembly facilities several times a day. Through Dell's wholly owned subsidiaries, Dell has access to over 70% of the available worldwide PC market. Dell has sold through middlemen such as Electronic Data Systems and Anderson Consulting, and has contracted with superstores in the past. However, superstores are not brand loyal, and in 1994 Dell abandoned any efforts to sell through discount stores.

## COMPANY OPERATIONS

Dell designs, develops, assembles, markets, services and supports a wide range of computer systems, including; desktops, notebooks, and network servers, and also markets software, peripherals and service and support programs. The company markets its computer products and services under the Dell brand name directly to its customers. These customers include major corporate, government, medical and education accounts, as well as small-to-medium businesses and individuals. The company conducts operations worldwide through wholly owned subsidiaries; such operations are primarily concentrated in the United States and Europe (http://www.dell.com). Dell accomplishes this through their commitment to customer satisfaction and customer service. Their aim is to be number one in the world in this area and they are succeeding, according to J. D. Power and Associates. Other accolades include "Product of the Year" and "Most Valuable Product" by PC/Computing magazine at the Fall COMDEX computer tradeshow in Las Vegas, November 21, 1997 (http://www.dell.com/dell/media/97). These honors were for their Dell Dimension desktop PC's. In all, Dell collected nine awards at the latest tradeshow, recognizing the company product line for its performance, reliability, service, and low prices. On top of all the awards, Dell landed two "Editor's Choice" awards. Other awards came from Computer Shopper, Home Office Computing, C/Net, and Home PC magazine. For the entire year, Dell Dimension desktop PCs have been recognized with more than 120 product awards from industry leading, high tech publications. Their Dell Dimension XPS D300 has also been selected as "Product of the Year" and "Most Valuable Product" by PC enthusiasts.

Dell is particularly aware of the "Year 2000" problem. That is a technical problem arising because programmers historically defined date fields with a two digit year when writing programs. This will work fine until the year 2000, when programs will not be able to differentiate between the years 2000 and 1900. This problem affects all areas of life. From turning on a computer, to using a credit card; computers will think credit cards with an expiration date of January 3, 2000, are actually expired on January 3, 1900; therefore, making it impossible for some computer systems to function after 1999. Dell established a team in February of 1997 to address this problem (http://www.Dell.com/year2000/ exec. /y2kprob.ht). This team is focused on finding software and hardware answers to the “Year 2000” problem. In an effort to eliminate the problem, Dell is also focused on driving their business partners into the project. Through the efforts of Dell Computer and their commitment to service, performance, and satisfaction; solutions can be found that will make life better for Dell and for their customers.

## MARKET ENTRY

Entry into the PC market is fairly easy for several reasons (Pitts & Lei, 1996). First, capital requirements for PC assembly are modest. Second, customers face few switching costs when changing suppliers and probably would not hesitate to buy any kind of an IBM-compatible PC from a new supplier if the price/performance was right. Third, product differentiation and economies of scale become more and more elusive as the PCs become more and more like a commodity.

Numerous firms can quickly enter this business through subassembly and subcontracting their manufacturing activities (Porter, 1980; 1985; 1991). For example CompuAdd and Micron, have entered the computer market as value added resellers who assemble PCs to sell through direct sales and retail outlets. These firms compete with Dell using one of Dell’s strategies--direct relationship marketing, or selling directly to customers (Middlebrook, Keafe, & Ross, 1998). A new threat that Dell currently faces, is from its rival Compaq Computer Corporation because of Compaq’s decision to slash desktop prices by as much as 22 % and moving to a cost-saving, build-to-order manufacturing system (Jacobs, 1997). Thus, Dell faces threats of new distribution methods and operations employed by new entrants and its current competitors, which might eventually depress Dell’s long-term profitability.

## BUYERS

The PC industry has knowledgeable and powerful buyers (Savvy consumers, 1992). With hundreds of suppliers to choose from, customers are ruthless in their search for higher value and better quality (Savvy consumers, 1992). Dell’s Customer Service Representatives efficiently assist their customers by matching the users to market segment specialists. Dell’s market segments are divided into Corporate/ Business users; Government, Education, or Healthcare users; and Home/Homeoffice users.

Business users in the PC industry want high performance, reliability, and value in a system for their computing needs. State-of-the-art technology, the ability to network and communicate with other systems, customer service and support, and cost are primary purchase determinants for the business user (Middlebrook et al., 1998). Dell gets 90 % of its orders from business-to-business customers. Many of them are Fortune 500 Companies and have worldwide operations (Blankenborn, 1997).

The Government, Education and Healthcare user segment represents a large, important part of the market, yet they typically yield lower margins than either the business or home/home office markets. Typical purchase decisions in these segments are based on a bidding system, with the contract going to the lowest qualified bidder. The education market was considered important for its proposed ability to generate long-term brand loyalty among early users (students). It is questionable, however, whether or not the long-term benefits of brand loyalty by early users are actually realizable. This segment, like the business segment, is interested in integrated systems designed to meet the buyers' specific needs. There has been increased competition in this market.

Most home/homeoffice users are price conscious and plan to spend less than $1,200 for a system. Also, they value ease of operation and service, as well as support from the manufacturer.

## SUPPLIERS

Some of the most important suppliers to the PC industry are the manufacturers of microprocessors, memory chips, and circuit boards. Dell handles only the assembly and testing of the PCs, leaving the manufacture of all components to its suppliers (Boudette, 1989). The company purchases a significant number of components from single sources. For example, the company often establishes a working relationship with a single source when it is advantageous to do so when considering performance, quality, support, delivery, capacity, and price, even when multiple suppliers are available (Annual Report, 1996).

In terms of the PC industry as a whole, suppliers of memory chips, microprocessors, integrated circuits, and other key components are comparatively few and highly concentrated. Since PCs require specific types of microprocessors and other specialized chips to function, the chip suppliers often pass on price increases to PC makers (Pitts & Lei, 1996). Therefore, the dynamics of pricing on the supplier side significantly impact the product pricing on Dell's side.

## COMPETITION

Major competitors of Dell include the other traditional PC manufacturers like IBM, Compaq, Apple, Zenith, Gateway, Digital, Micron, Tandy and Packard Bell as well as many new upstarts (Middlebrook et al., 1998). By the end of 1993, the top five PC makers (IBM, Apple, Compaq, AST, and Dell) commanded just 48 % of the U.S. market. Thus competition in the PC industry is unrelenting (Pitts & Lei, 1996). The rivalry is intense between some firms such as that between Dell and Compaq, who have aggressively tried to hire one another's managers and key technical people. Both companies also have attempted to undercut the other in getting new products to the market faster (Pitts & Lei, 1996).

As previously mentioned, Dell uses a direct sales model meaning it sells computers directly to customers on a made-to-order basis (Kirkpatrick, 1997). On the other hand, industry leaders like IBM, Compaq, HP, send PCs on lengthy odysseys that make it impossible for them to price the machines as low as Dell. Having watched as more and more customers started buying directly from Dell, and having watched Dell's stock price soar considerably above industry average in a short period of time, IBM, Compaq, and HP are changing the way they do business by trying to mimic Dell without alienating the resellers they depend on. As a result, this cut-throat industry is about to get a lot more competitive; therefore, Dell will have to work harder than ever to maintain its extraordinary growth (Kirkpatrick, 1997).

IDC reported that in terms of shipments to large and medium U.S. businesses, Dell commanded the top position among all desktop PC suppliers with an 18.4 % share during the April-

June 1997 quarter, pushing Compaq into the No. 2 spot with a 16.5 % share, followed by Hewlett-Packard (13.8 %), IBM (9.3 %), and Gateway 2000 (6.6 %). Also, Dell ranked No. 1 in desktop unit sales to federal, state and local government agencies in the U.S., with a 14 % share of shipments, according to IDC's Worldwide Quarterly PC Tracker Report for the second quarter of 1997. On the worldwide front, Dell moved to No. 2 from No. 3 in shipments of desktop PCs to large and medium-sized businesses.

## SUBSTITUTES

The main substitute for PCs in the early 1980s was timesharing computer systems (arrangements through which remote terminals were tied to a central mainframe). Although timesharing arrangements were lower in cost than PCs at the time, these arrangements were far less convenient, and convenience was a high priority for PC users. Therefore, manufacturers feel little profit pressure from timesharing arrangements. Furthermore, this pressure would decline over time, since the cost of PCs relative to timesharing systems continues to fall rapidly (Savvy consumers, 1992).

There are several reasons that explain why the PC industry could experience high demands in the coming years, instead of experiencing a threat of substitutes (Middlebrook et al., 1998). First, the Gartner Group, a market research firm, estimates that the number of customers replacing their outdated systems is expected to outnumber first-time purchasers by 1995 (Middlebrook et al., 1998). This means that former PC users are expected to update their systems or buy systems with higher performance rather than look for substitutes for their personal computer.

Second, an investment report on the PC distribution industry shows that PC saturation rates are relatively low. Only about 33 percent of white-collar workers use PCs on the job, and only 17 percent of all domestic households have a PC. This becomes more important when one considers that the largest growth opportunities are in small-to-medium-sized accounts (businesses with fewer than 500 employees) that employ more than 70 percent of white-collar workers. This evidence substantiates the fact that demand for personal computers is going to grow more in years to come (Middlebrook et al., 1998).

Third, the ratio of price to performance for equivalent functions continues to improve approximately 20 to 25 percent per year, which makes the purchase of state-of-the-art PCs attractive to many user segments (Middlebrook et al., 1998). However, the personal computer industry may be threatened by the rise of new hand-held personal computers that can recognize handwriting and even voice commands (Savvy consumers, 1992).

## INBOUND LOGISTICS

Dell purchases a significant number of components from single sources. In some cases, alternative sources of supply are not available. In other cases Dell may establish a working relationship with a single source, even when multiple suppliers are available, if the company believes it is advantageous to do so when considering performance, quality, support, delivery, capacity and price (Annual Report, 1996). Key components currently obtained from single sources include the company's displays, applications, specific integrated circuits, and other custom chips, microprocessors, unconfigured base notebook computers and lithium ion batteries used in some of the company's notebook computers (Annual Report, 1996). Additionally, Dell often initially uses custom components obtained from a single source in its new products until it has determined whether there is a need for additional suppliers. If the supply of a critical single-sourced material or component were delayed or curtailed, Dell's ability to ship the related product in desired quantities and in a timely manner could be adversely affected. Even where alternative sources of supply are available, qualification of the alternative suppliers and establishment of reliable supplies could result in delays and a possible loss of sales, which could affect operating results adversely (Annual Report, 1996). Dell has implemented JIT practices on its manufacturing floor, as well as with its inventory strategy. It sees suppliers as key to JIT (Minahan, 1997).

## OPERATIONS

Dell's product strategy is to provide products that customers want to buy, rather than new technology that is interesting and exciting but not particularly applicable to customer needs (Dell, 1993). Dell's computers for the domestic market are assembled in facilities located in Austin, Texas. The purchase of a 126,000-square-foot manufacturing facility in 1989 doubled Dell's manufacturing capability. Also, the 135,000-square-foot facility in Limerick, Ireland, is expected to satisfy the growing European demand for Dell systems (Middlebrook et al., 1998).

Dell designs and builds computers with the most advanced and flexible technologies available (Why Dell - The Direct Business Model - Fast Time to Market). Dell also maintains close relationships with key technology leaders like Intel, Microsoft, Novell, 3Com and others in order to engage in cooperative research and development (Why Dell - The Direct Business Model). The manufacturing strategy utilized at Dell is one of building each computer system to the buyer's specifications. Buyers can add options to customize their systems for their own needs. The order is then assembled and shipped with peripherals and upgrades requested by the customer. Manufacturing at Dell actually consists of the assembly and testing of vendor-procured parts, assemblies, and subassemblies. In addition, Dell utilizes a total quality approach where enthusiastic workers compete in product-quality competitions for bonuses and recognition (Middlebrook et al., 1998).

Dell has implemented JIT practices on its manufacturing floor, as well as with its inventory strategy (Minahan, 1997). All production activities are sequenced in such a way that in-process material continually moves toward the completed product. At Dell's new Metric 12 facility in Austin, this process, known as flow manufacturing, is complemented by a high-level of automation. Dell also reduces the need for rework and the chances for faulty parts through its stringent quality control process (Minahan, 1997).

## OUTBOUND LOGISTICS

Dell is probably most known for establishing a direct distribution system. According to Dell Computer Corporation's CEO Michael Dell, Dell has essentially built an enormous electronic superstore to maintain efficient distribution (Dell, 1993). The company has replaced traditional retailers with telephone lines, the Internet, and a network of trucks supplied by shippers, such as the United Parcel Service (Pitta, 1992). System support at Dell is such, that even before a computer reaches a customer, the customer can track its order status on-line (Why Dell - The Direct Business Model). Each PC is made to order, yet the whole process from phone call to loading onto a delivery truck takes just 36 hours (Serwer, 1997). Thus, faster turnaround is a significant advantage; Dell typically delivers its PCs within five working days (Boudette, 1989). The company provides its products and services through a virtual warehouse (internally known as, "Stealth Warehouse"), as described by the company's chairman and CEO, Michael Dell. Thus, Dell sells a number of products-software, peripherals and accessories-that do not reside on its shelves, but are delivered to customers within the next business day using a variety of distribution partners who are more capable of rapidly packaging and providing those products. In Michael Dell's opinion, his company is more of a vertically connected organization rather than a vertically integrated one (Dell, 1993).

## MARKETING & SALES

Dell's sales force is channeled according to the market it serves: small/medium business and home users, corporate buyers, and government/education/medical users. Each of these sales channels is supported by its own marketing, customer service, and technical support organization. This organizational structure ensures high accountability for the satisfaction of each customer. PC makers dealing through the retail channel do not have this advantage and are not able to respond as quickly to market and service demands as the direct channel. Additional face-to-face exposure occurs at industry shows (Middlebrook et al., 1998).

Dell's entire product line is sold by telephone sales representatives who answer more than 25,000 incoming calls on a busy day. In addition to answering customer-initiated calls, the Austin-based sales force responds to sales leads and supports the efforts of its team members in the field (Middlebrook et al., 1998; Dell, 1993). Sales orders are downloaded to the manufacturing facility several times each day, and all systems are custom-configured according to the customer's specifications. Trucks load at Dell's manufacturing facility throughout the day, and overnight services are utilized for expedited orders. Lead times on most systems vary from three to seven days (Middlebrook, et al., 1998). Internationally, Dell is similar in marketing approach and culture to its domestic operation. Dell's wholly owned subsidiaries give it access to over 70 percent of the available worldwide market for PCs (Middlebrook et al., 1998).

Dell sells to major buyers through a small (twenty-five person) sales force located in major metropolitan areas throughout the United States and services those accounts with management teams consisting of sales, customer service, and technical support representatives. Dell believes that the small-to medium-sized business represents the greatest growth potential for PC-based systems (Middlebrook et al., 1998).

Dell has also used the capabilities of the Internet to its advantage (Green, 1997). According to a recent news article, Dell is selling more than $2 million in computers and related products daily over the Internet. On its Web site, Dell sells computers and hardware for consumers and small and midsize businesses. Customers can look up information about Dell's products and can order merchandise over the Internet or by phone (Green, 1997). For its corporate customers, Dell has what it calls Premier Pages, small password-protected subsites with addresses known only to its corporate client. Dell has also tried to build more international sites, in order to boost to its Web business (Blankenborn, 1997).

## SERVICE

Dell provides its customers with various amenities, such as unlimited calls to a toll-free technical support line and a 30-day money-back guarantee (Middlebrook et al., 1998). The technical support representatives over the phone solve 95 % of their customer problems in less than six minutes. Dell has special account teams made up of employees with sales and technical backgrounds, who give personalized service to its corporate customers (Middlebrook et al., 1998). According to Michael Dell, the company receives around 25,000 service and support calls a day. Dell views his company as a consumer advocate rather than a technology advocate (Dell, 1993). J. D. Power and Associates, known for its automobile rankings, again in 1994 rated Dell number one in customer service and satisfaction in its third annual end-user survey for the computer industry (Middlebrook et al., 1998).

In addition to its traditional methods of providing support and service to customers, Dell has also recently employed a new way of providing service-through the Internet (Dell Enhances, 1997). According to a recent news article in Round Rock, Texas on November 20, 1997, Dell has introduced new Internet service and support features that help customers diagnose problems with their PCs and track orders from the factory floor to their homes or offices. Also, available now on www.dell.com are service features that provide customers with on-line access to much of the same technical reference materials used by Dell telephone support personnel. The new features are the latest advancements in Dell's strategy to extend its direct sales and service via the Internet (Dell Enhances, 1997).

Today, Dell sells systems and services over the Internet in excess of $3 million a day (Dell Enhances, 1997). Approximately 80,000 Dell customers visit the technical support pages every week and download an average of 30,000 files including system BIOS and drivers. The new Dell Internet self-diagnostic tools include more than 100 system-and symptom-specific trouble-shooting modules that interactively walk customers through common system problems (Dell Enhances, 1997). In addition to order tracking and trouble-shooting diagnostic tools, Dell has introduced services such as an on-line communications center for sending comments and questions to Dell service representatives and an up-to-date file library with the latest system drivers, files and utilities (Dell Enhances, 1997). Many of the services and features offered to consumers and small businesses are currently available on customized, secured Internet sites that Dell created for its corporate and public-sector customers (Dell Enhances, 1997). Such Premier Pages provide one-stop access to service and support information customized to the customer's products, flexible reporting tools, manufacturing status for systems, and listings of approved configurations. Dell has created more than 500 Premier Pages worldwide (Dell Enhances, 1997).

## ISSUES AND CONCERNS

Dell is presently changing its customer base to include the second and third time home computer buyers. This is a market that needs to be entered by Dell to remain competitive because there are so many households that have a home computer. Dell is entering the market through on-line Internet sales instead of the traditional retail sales. The new techniques for selling made-to-order PCs on the Internet is setting Dell apart from other PC manufacturers, but concerns of whether or not this technique will generate market share face Dell within the new target market of small business and home PC users.

Another concern for Dell is that many other PC manufacturers are trying to mimic Dell by moving toward the direct selling of PCs. The direct sales model used by Dell is its major competitive advantage and this may no longer be the case. Due to the deterioration of the competitive advantage, Dell may need to find a way to adapt their competitive advantage in order to regain their edge on the competition.

Dell competes on price as well as on service, performance, and satisfaction. However, price is no longer a large advantage to Dell over its competitors because the competition is cutting prices to meet Dell.

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# CREDITED CLASS WORK AND STUDY ABROAD PROGRAMS: MAKING ORDER OUT OF CHAOS

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## ABSTRACT

*The recent process of reaffirmation of accreditation undertaken by the Walker College of Business focused faculty and administration on appropriate course offerings during summer study abroad programs. Study abroad courses, both offerings and curriculum content, were assessed. The faculty developed a new course designed to reinforce the multicultural experience of the program and to provide a course in which a large number of students would satisfy the prerequisites. Finally, all courses, including the newly established course were assessed to ensure that they were consistent with the College's mission and delivery of high quality instruction.*

## INTRODUCTION

Increasingly, university business schools are stressing the importance of an "international" focus to undergraduate business education. Concurrently, business schools are focusing on providing students with theory derived practical skills which facilitate job search processes and future career progression.

These mutually interactive goals have manifested themselves in numerous business school activities including internships, campus recruiting "job skills" seminars, class guest speakers, executive in residence programs, international events, and, the focus of this case, study abroad programs. Typically, study abroad programs provide for a student to either: 1) enroll in a foreign university for courses taught for credit toward degree completion; or, 2) traveling overseas, often during the summer, with classes taught by the student's university-supplied instructor.

Appalachian State University has offered both types of study abroad programs. A small number of Appalachian business students have participated either in a semester- or year-long study abroad program in England through ISEP or in Sweden through our own agreement with Göteborg School of Economics and Commercial Law. These programs have had a mixed response from students because they have been rife with difficulties in transferring credit back to Appalachian in order for students to graduate on schedule. Therefore, students who have participated in these programs have done so by delaying their graduation date. On a positive note, these programs, together with programs based on other university agreements, have brought approximately 40 students from 24 countries to study in our college in 1997, expanding the international experience for on campus students.

In contrast, the summer semester study abroad programs have been widely accepted and endorsed by students who, each summer sign up in large numbers for one of several trips sponsored by the College of Business. In fact, Appalachian State University ranks fourth in the nation (of masters' institutions) in the number of students that study abroad. In 1994-95, three hundred and twenty-five students participated in a study abroad experience (See *The Chronicle of Higher Education*, December 6, 1996, page A67). Of this total, more than 100 students were from the College of Business. The Walker College offers study abroad programs in China, Denmark, Scandinavia, England, France, Mexico, Australia, and Italy/Switzerland. These summer programs carry with them six hours of course credit provided by two three-hour courses taught by the accompanying Appalachian faculty.

Over the years, College of Business study abroad programs have offered catalog classes, usually those with "international" in their title. Alternatively, faculty have offered independent studies specifically designed for the trip. Professors leading these trips would generally decide on the course(s) offered with the understanding that course offerings on all trips would be balanced across disciplines.

During the assessment of our study abroad programs in the self-study year for reaffirmation of our accreditation, the faculty expressed their desire to change the *ad hoc* nature of this process, and to review the relevant course offerings recognizing that certain courses were more appropriate during study abroad programs. This process was designed to ensure their high quality of delivery and their integration into the total study abroad experience. In essence, the faculty wanted to make sure that the course delivery would be equivalent to that on campus while adding the richness of the global experience.

An examination of the course structure and teaching processes determined that these were highly variable depending on the faculty member and the country. Several models employed were: 1) all class work was essentially completed before the trip departed by conducting weekly meetings with the trip representing the experiential component of the course; 2) all class work was completed during the trip with in-class meeting times allocated each day to cover required material; 3) class work split between pre-trip and during the trip; and, 4) in the case of some independent studies, students were required to complete assignments with no actual formal class meeting required at all. These class structures and teaching processes were possible for any of the classes offered on these trips, whether the course was required for the major or an elective. One additional problem associated with this method of course offerings was the enforcement of prerequisites.

Another concern of the trip was the ability of the professor to grade the student for their participation in the many scheduled activities (especially attendance at art galleries, museums, plays, historical sites) of the trip, their cultural awareness and sensitivities and their general ambassadorial responsibilities as a member of the university community and a citizen of the U.S. A student code of conduct was developed, consistent with the *Student Handbook*, but far more reaching in its scope. Professors wanted a meaningful way to incorporate this code within the overall scope and grade of the course (See Appendix 1).

A traditional SWOT analysis was conducted, having in mind the College of Business mission statement (See Appendix 2). Focusing this statement on our undergraduate teaching, it was apparent that our programs provided students with a wide variety of international opportunities, but that it was necessary to reevaluate, and in some cases, standardize the structure and teaching processes.

Strengths: The College of Business has an outstanding faculty that is well-published and dedicated to high quality teaching. The administration and faculty are committed to the study abroad program and are willing to modify teaching processes to work with the program. Further, the program itself supplies students with the opportunity to learn about international aspects of business simply by being in foreign cultures, seeing foreign businesses in operation, and living daily surrounded by customs and traditions different from those of the U.S. Most students on these trips have not traveled extensively so these initial impressions of international culture and business are, for them, powerful. Upon returning from these trips, participants speak glowingly of the experience and sell the trip to others who may, in turn, participate the following year.

Weaknesses: The Study Abroad program was variable in carrying out the details of the teaching mission of the College of Business. While study abroad courses often displayed the same syllabus content as its on campus equivalent, faculty, particularly those teaching in a study abroad program for the first time, found it difficult to provide the same delivery as they were accustomed to on campus. This led to faculty frustration because of teaching facilities, the inability to complete all of the syllabus material and other teaching-related problems. Further, extra curricular activity engaged in by students was too often not associated with academic learning. On a related note, the College of Business had a continuing concern with safety issues heightened by several well-publicized study-abroad disasters involving other University students in foreign lands (See *USA Today*, "The Perils of Studying Abroad," September 12-14, 1997). A troublesome student conduct problem for trip leaders has generally been associated with excessive alcohol consumption. Nonetheless, it was recognized that this problem created by a very small minority of participants, presented substantial risk to all trip participants and consequently to the University itself.

Opportunities: With the increased awareness of risks faced by the University and growing concern from faculty trip leaders over their responsibilities in supervising students, along with our desire for continuous improvement of these programs, it seemed the time was appropriate for a restructuring of many aspects of these trips. The opportunity was further enhanced by the Assistant Dean's presence on several of these trips. His intention was to strengthen the weak areas and make the strong areas great. With the support of the administration, the faculty was eager to help create a more carefully delineated learning experience, and one which more fully addressed student conduct within this environment.

Threats: A universal concern was that the strengths of the study abroad programs could be jeopardized by any program weakness, especially academic concerns of course delivery and safety issues while abroad. First, without adequately monitoring and addressing academic content of the courses within the context of delivery in an international setting and without administrative enforcement of prerequisites, the College of Business would face a deterioration of the academic component of the study abroad program and its subsequent consequences. Second, without consistency of academic rigor across all courses in study abroad programs, students would not take the course work seriously and this attitude would color the entire trip experience as a "holiday" rather than "learning" atmosphere. Third, student conduct was putting the students themselves at risk and had the potentially damaging effect on our reputation with our hotels, restaurants, and bus lines. Each of these threats represented a realistic risk to the program and required immediate pro active attention.

## DEVELOPMENT OF THE ACTION PLAN

One of the first actions required was a self-study of study abroad programs within the context of the mission of the College of Business. Careful review of our recently reformulated mission statement served to emphasize the importance of high quality undergraduate teaching and hence this served to provide us direction in our recreation of the classes supplied with our study abroad program.

Concurrently, it was recognized that, in general, two classes, for a total of six semester hours was expected by students attending the study abroad program. Further, it was recognized that years of experience in carrying out study abroad programs has indicated that faculty could not be expected to carry out appropriately a class load of more than six hours. Therefore, one of the first considerations was the limitation on faculty's prior tendency to offer a wide range of "individual study" classes to study abroad program students in order to get the needed enrollment for a trip. It was determined that if all trips were so limited then no one trip could make course promises that another trip would then be forced to duplicate. In total, therefore, each trip would be held to offering a very limited number of courses.

Recognizing further that study abroad programs, in general, were expected to supply somewhat similar learning experiences to students, a general course entitled "Cultural Aspects of International Business" was developed and presented to the trip leaders for those trips commencing in the summer of 1998.

This class, which was to be required of all trip attendees, would cover the specific cultural aspects of the countries visited by each trip in conjunction with traditional business abroad considerations. In such a way students would learn about areas to be visited and the interface of these specifics with the more general considerations of establishing, maintaining and doing international business. Students would study four country specific topics: history; government; culture (art, music, literature) and geography. In addition, students would also learn about comparative economics and business practices. These country topics would then be applied to understanding business considerations applicable to those companies/businesses that were to be visited while on the trip. Site visits would be an integral part of the learning process and were to be part of the written assignments each student would submit. (A syllabus for a prototypical Cultural Aspects of International Business can be seen in Appendix 3).

Several other considerations were implemented to align more closely study abroad program class work with the College of Business mission statement. First, specific required classes for graduation (such as "International Business") would no longer be offered on a study abroad program and the focus would be on electives. College of Business administrators and faculty were concerned about the ability of these classes to be taught on equivalent terms with on campus delivery. Further, recognizing that a finite pool of students is interested in study abroad trips, every effort would be made to provide consistency in course offerings, to provide realistic expectations in evaluation of student performance across trips and to enhance before, during and after components of courses. Gone are the programs designed simply to attract sufficient number of students to justify the program—programs which offered a cafeteria menu of classes and programs in which students had expectations of 'As' simply for participating. Consistency of class work and evaluation across trips is now a paramount consideration. Finally, students are now made aware that their trip conduct and overall cultural experience will be a part of the class work and that grades can be raised or lowered by a student’s conduct during the trip.

These changes are being implemented for the summer of 1998. Faculty and students seem to have responded positively and appropriately to these changes. We hope to be able to update the results of these changes at future meetings.

# PRODUCT LIABILITY AND TOTAL QUALITY MANAGEMENT: A CASE STUDY

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## CASE DESCRIPTION

*"Mckenzie v. S K Tool Corp.: An Application of Total Quality Management to Products Liability" demonstrates the interrelationship between the law (specifically tort law) and total quality management (TQM). The product liability issue is primary with the TQM issue secondary. The case is appropriate for Juniors, Seniors. and/or first year graduate students (levels 4, 5 and 6). The case is designed to take one hour of classroom discussion and students could be expected to devote two hours of outside of class.*

## CASE SYNOPSIS

*In recent years, increasing attention has been given to the area of law known as products liability. Any company that produces a product that will be released into the stream of commerce must anticipate the threat of litigation in the event that the product causes injury. The threat of products liability lawsuits has a substantial impact on manufacturing costs, product research and development and the introduction of new products into the marketplace. It is not surprising, then, that manufacturers must do everything they can to avoid the likelihood of being confronted with a products liability lawsuit. The growth of products liability lawsuits and the disastrous financial impact they can have led to a search for new methods of defending product liability lawsuits.*

*An issue that arises is whether total quality management (TQM) and statistical quality control (SQC) would have any applicability to products liability lawsuits. Specifically, would a manufacturer's use of TQM and SQC enable it to avoid being found liable in a products liability lawsuit? To investigate this issue, a lexis search was performed in several data bases using the search terms "failure in design" or "failure in manufacturing." This search produced one case that could be used to illustrate the relationship between statistical process control and products liability.*

*In McKenzie, v SK Hand Tool Corp., 72 Ill. App. 3d; 630 N.E. 2d 612, (Ill. 1995)), the plaintiff attempted to submit evidence of failure in the design specifications to substantiate his claim that a product was defectively manufactured. The details from the case provide some insight into how the end results of TQM and SQC could have relevance in a product liability lawsuits.*

## INTRODUCTION

The judicial system has long recognized the devastation that defective products could have on the life of ordinary consumers. Judicial decisions since 1970 began to reflect a growing concern for the rights of the consumer over the rights of the seller. Public sentiment led to court decisions designed to assist the consumer in seeking redress from negligent manufacturers. Disgruntled consumers demanded compensation from firms that had previously taken a somewhat irresponsible approach to selling a defective product. Product liability lawsuits, almost unheard of prior to the 1950's, skyrocketed. Punitive damage awards climbed into the hundreds of thousands of dollars as juries demanded accountability on the part of the manufacturer. In a report released in 1995 by the U.S. Department of Justice, the median award in a product liability lawsuit in the nation's 75 largest counties was reported at $727,000, with 15.4% of plaintiffs winning judgments of $1 million or more. The five largest jury awards in 1990 ranged from $26.3 million to $55.7 million (Smith: 1991). These figures represent only the amount awarded the plaintiff, and do not include the resources expended in the actual litigation of the lawsuit. Product liability cases can continue for years, with numerous appeals filed on behalf of the plaintiff or the defendant. In addition, the company often has to have legal counsel on retainer at all times to protect against the threat of a product liability lawsuit.

## PRODUCTS LIABILITY THEORY

In order to understand how the use or non-use of TQM methods can be applied to product liability, it is important to understand the legal issues relevant to a product liability lawsuit. Negligence, strict liability, and breach of warranties are three theories of recovery available to a plaintiff in a product liability lawsuit. At the onset of a product liability lawsuit, a plaintiff will typically maintain that a defendant is liable under all three theories.

Negligence requires the breach of a duty toward someone--the omission to do something that a reasonable person, guided by those ordinary considerations which ordinarily regulate human affairs, would do, or the doing of something that a reasonably prudent person would not do. A manufacturer of a defective product will be found liable if it is determined that it did not exercise "reasonable care" in the design or manufacture of a product. That is, did the manufacturer violate the "duty of due care" that it owed to the consumer.

The manufacturer can be held liable for injuries caused by a either a manufacturing or design defect in its product, as long as the product is being used in a foreseeable way. A product is defective in design "if it fails to perform as safely as an ordinary consumer would expect when used in an intended or reasonable foreseeable manner or if there is a risk of danger inherent in the design which outweighs the benefit of the design." (*Soule v. General Motors Corporation,* 8 Cal. 4th 548; 882 P .2d 298; *Cal 1994*.)

In a negligence claim, the burden of proof rests with the plaintiff. The plaintiff must prove that there existed a duty to the plaintiff on the part of the defendant, that the duty was in some way breached, and that the breach of this duty was the cause of the plaintiff's injuries.

In addition, a plaintiff may claim that injuries were a result of a breach of warranty. A warranty is a promise that arises out of a contract. Violation of this contract would permit the injured party to recover actual damages. Unlike negligence, the plaintiff does not have the burden of proof in a warranty claim.

There are several different types of warranties that may arise in connection with the sale of goods. The one most applicable to TQM is the **implied warranty of merchantability.** The Uniform Commercial Code, Section 2-314 sets forth the description of an implied warranty of merchantability:

> (1) Unless excluded or modified (Section 2-316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. Under this section the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale.

In simple terms, an implied warranty of merchantability exists by operation of law any time a sale of goods is made, unless the warranty is disclaimed. Basically, the goods are guaranteed to be salable.

The legal theory of strict liability is quite different from the theory of negligence and breach of warranty--the concept of strict liability is derived from the idea that whoever unleashes something "unreasonably dangerous" is strictly liable for any damage that occurs as a result--liability for virtually any defect. Under strict liability, an injured party need not prove negligence; he or she need only show that the product was "defective," i.e., not fit for its intended use or reasonable misuse; that injury or damage was a result of the defect; and that the defect originated while the product was under the manufacturer's control. The plaintiff or injured party is more likely to recover under the theory of strict liability because he or she does not have the burden of proving that the defendant/manufacturer was negligent.

## TOTAL QUALITY MANAGEMENT

The costs of poor quality can be divided into three categories (Stevenson: 1996):

1 Appraisal Costs--related to inspection, testing and other activities that serve the purpose of uncovering defective products or services, or to guarantee that there are no defects.

2. Prevention Costs--costs incurred to prevent the defect from occurring. Usually include planning costs, working with vendors, training, quality control procedures, and added attention in both the design and production phase.

3. Failure Costs--costs caused by defective parts or products.

Internal failure costs are discovered during the production process; whereas external failure costs are not recognized until after delivery to the customer. The results of external failure costs can include warranty work, handling of complaints, replacements, product liability, and loss of customer goodwill.

In traditional systems, most quality costs are expended in the failure and appraisal categories. It is in the category of external failure costs where manufacturers experience the highest losses. External failure costs include those associated with defending a product liability lawsuit, which can become quite high for small to medium-range manufacturers.

The TQM philosophy rests on a redefinition of the nature and function of a business and its constituent parts, as well as its relationships with customers and suppliers. TQM includes four components for the successful operation of a business: work force empowerment, process improvement, customer obsession, and strategic planning (Anschutz: 1995). The TQM approach assures the consumer of quality products at a competitive price. TQM can also be used to guarantee that product safety is part of product quality. By implementing TQM techniques throughout every function of the business organization, Japanese manufacturers were able to produce products that were unrivaled in superior quality.

At this point, it is important to take an in-depth look at the role of continuous quality improvement, statistical process control and the philosophy of Total Quality Management in the American manufacturing process. In a continuous quality system, the focus is on prevention--it is more economical in the long run to produce a defect-free product than to have to rework and repair the product. The problem with traditional quality control procedures is that firms are using inspection to find defective products--the company is therefore paying workers to make mistakes and then find and correct them. Quality experts claim that 80% of defects are caused by design problems or from purchasing supplies based on lowest price instead of on highest quality; the defect is already present before the production process even begins (Ryan: 1996). The key to quality is to prevent the error from occurring in the first place--this is the goal of TQM. It has been reported that for most businesses, every dollar invested in prevention costs could save $10 in internal failure costs and $100 in external failure costs (Ryan: 1996).

At the heart of the Total Quality Management philosophy, is an increased awareness of the need for process improvement. It is in this area that companies can have the greatest impact on the quality of the product, thereby reducing product defects to almost zero. To illustrate how the manufacturing process can be improved requires an understanding of Statistical Process Control (SPC) and the use of control charts. The use of Statistical Process Control is a focal point for ensuring that products are made in conformance with design criteria and specifications.

Statistical Process Control begins with a control chart, used to plot the output from a production process over time. If a component part for an automobile is being produced, for example, it must fall within a specified tolerance level set by the engineering design. Engineering designs always have a specified tolerance level, otherwise known as upper and lower specification limits. A production process is determined to be capable or "in control" through an engineering study. Measurements are then taken periodically during the production process from the product being produced, a bolt that must be 2 inches long for example. The first bolt might have a measurement of 2.002 inches, second bolt 1.99 inches, etc. These measurements are then posted on the control chart, and any variation in the process is highlighted.

Measurements of process output will always display some random variation--processes are rarely perfect. Random variation is referred to as "common variation" and is considered inherent in the process. By taking a sample mean, this randomness effect is removed from the observation. When the sample mean falls within the upper and lower control limits, the process is considered to be in control. It is "special" or non-random variation that is the enemy of quality. "Special cause" variation occurs when something cause the process to become out of control, or outside the control limits. Special cause variation provides an opportunity to improve the process. Every time the control chart exhibits a special cause event, the process conditions that prevailed at the time can be examined, and improvements made to the process, making it increasingly stable and less likely to produce an abnormal or special cause outcome again.

The traditional approach to quality control involved producing a product that would consistently fall within approximately 99.7% of the design specifications for the product. For example, if a component part had to be 3 inches long, then each piece produced would have an upper and lower control limit based on the design specifications for the part. Each piece might fall within a range of 2.99 inches (lower control limit) to 3.01 inches (upper control limit) 99.7% of the time. A quality control operator would generally measure a random sample during each production run and plot these measurements on the control chart to ensure that the majority of the parts were falling within the specified range and that the process was in control. If the measurement fell outside the control limits at any time during the process, then product would be stopped and the cause of the variation would be investigated. The problem with this approach is inconsistency--at least .3% of the time the pipe was falling outside of the necessary guidelines. This may seem acceptable, but if a production line is producing one million component parts per month and .3% fall outside of the standards, then you have 3000 parts that are defective. If this defect is caught before the product is shipped, only the cost of scrap and/or possibly rework is lost. However, because of the prohibitive cost of inspecting every piece, it is impossible to guarantee that some of this defective product won't reach the consumer. If the defective product, in the hands of the consumer, causes personal injury or property damage then there is the potential for a costly product liability claim. These costs multiply when one considers lost goodwill, lost sales, and negative public image.

Applying Total Quality Management techniques to the manufacturing process ensures that virtually every pipe produced will fall within the specified range. The idea is to set an upper control limit lower than the necessary upper specification. This is done by finding three standard deviations about the mean within the specification limits through process capability improvements. For example, the upper control limit might be 3.005. A lower control limit is also set that is higher than the lower specification, possibly 2.995. The worker at the machine takes a periodic sample at different intervals throughout the production process. Anytime the sample mean is above or below the control limits, the worker makes necessary adjustments. Because the upper and lower control limits are set within the range of the limits required by the design specifications, the process should consistently be "in control". Under most circumstances, this guarantees that the product never falls outside the required design specifications. The manufacturer, in effect, is producing a product that is free of defects.

The benefits derived from the use of TQM techniques are substantial: increased productivity, decreased scrap and rework costs, and a higher degree of quality. But can the use of TQM have an impact on a company's product liability costs? As knowledge of TQM and statistically-based manufacturing spread, they will become validated and ever more widely accepted. With an increasing focus on quality, the way in which Total Quality Management is used as a defense against product liability lawsuits may well become a revolutionary idea for reducing product liability. TQM could be used by the defendant to show proof that a defect was not possible; therefore, the injury had to occur for another reason, outside the control of the defendant. Conversely, a plaintiff in a lawsuit may argue that the nonuse of TQM constitutes evidence of negligence on the part of the manufacturer.

## MCKENZIE V. SK HAND TOOL CORP. CASE

Ronnie McKenzie (plaintiff), was injured on September 10, 1987, while working on a truck at his place of employment. He was using a 3/4 inch ratchet wrench manufactured by SK Hand Tools Co. (defendant) while performing an engine overhaul on a large truck. When he experienced difficulty in removing one of the bolts, the plaintiff placed an extension on the wrench and, in a second attempt to remove the bolt, the wrench came apart and plaintiff fell off the truck backwards hitting his right side and shoulder on the concrete floor. The plaintiff sustained injuries to his neck and shoulder. All pieces of the wrench were recovered by the plaintiff and saved for later testing. The plaintiff subsequently commenced a products liability lawsuit against the defendant in the circuit court of Williamson County. Illinois.

Following a court trial, the jury returned a verdict in favor of the defendant and the plaintiff appealed to the Appellate Court of Illinois, 5th Division. The plaintiff's appeal rested on two contentions, the one which is of interest here was that Judge Paul Murphy had erred in striking all evidence regarding the defendant's wrench specifications, measurements of the component parts of the wrench in question, and plaintiff's expert witness's testimony with respect to those measurements and specifications at the trial. (Plaintiffs other contention, that the trial court had erred in admitting evidence of an absence of prior accidents or incidents because defendant failed to establish the proper foundation for such testimony, is not relevant to the issues in this case.) On appeal, the Appellate Court of Illinois reversed and remanded for new trial on the grounds that the evidence just discussed should have been admitted by the trial court judge. To reach this conclusion, the appellate court examined the evidence and proceedings from the original trial court.

At trial, a manager from SK Hand Tools Co testified that the wrench in question was a 3/4-inch-drive ratchet wrench manufactured by the company. Some components of the inner body of the wrench were manufactured by other companies and purchased by the defendant, but the drive body, the pawl, the handle, and the reversing stem were manufactured by SK Hand Tools.

The defendant produced blueprints that contained the design specifications relating to the size of each component of the wrench. The components had to comply with these specifications in order to be considered acceptable. Each measurement had a tolerance level, or upper and lower specification limit (e.g., 1"+ or -.1"long). A part was acceptable if its actual measurement fell within the tolerance limits. If the measurement of the part did not fall between the upper and lower limits, the machinist knew the part was not acceptable for use.

Component parts of the wrench in question were measured by four individuals, two testifying for defendant and two for the plaintiff, using a Rockwell C Scale. (The Rockwell C scale is the standard by which all other gauges are measured. It is an absolute precise measuring device that will guarantee an exact measurement.) The measurements were compared to those required by the design specifications. The plaintiff's experts measured the hardness of the snap ring several times on a Rockwell C scale and the results were several different hardness ranging from 45-51. The design specifications required a hardness range of 48-52. The conclusion of the plaintiff's expert was that the ring did not meet the hardness required in the specifications (48-52) and that this failure to comply with the specifications could have affected the snug fit of the ring in the grooves of the driver and thus its ability to properly hold the driver and the handle together. It was also stated that the variance in hardness was the result of manufacturing and not use.

Plaintiff's expert found the measurement of the outside diameter of the snap ring groove in the handle to be 2.3130-2.3125 inches. Defendant's expert's measurement for the same part was 2.315 inches. The manufacturer's specifications required 2.290 inches with a tolerance of .005 inches so a measurement between 2.285 and 2.295 inches would have been acceptable. However, the measurements obtained by both plaintiff's and defendant's experts exceeded defendant's specifications.

Plaintiff's experts also noticed a tapering in the radius of both the inside and outside edges of the snap ring groove in the handle that should not have been present. They also stated that it was common knowledge in the industry that the dimensions of a groove which retains a snap ring must be perpendicular and parallel and that the edges must remain sharp. A taper is like a ramp which allows the snap ring to be ejected. It was the expert's opinion that the tapering was done during manufacturing and did not result from use.

When asked for his theory on the possible cause of the accident, the plaintiff's expert stated that the failure of the parts to comply with the defendant's specifications would have created a manufacturing defect which could have contributed to an incident of the sort involved here. Plaintiff's expert testified that, in his opinion, the wrench in question was defective and unreasonably dangerous because the snap ring groove did not comply with the defendant's specifications.

At the close of all evidence, the plaintiff moved for a directed verdict. At this point, the trial court instructed the jury to disregard all evidence concerning the measurements and specifications of the wrench due to the fact that the expert's opinion regarding the relationship of the accident to the defect was speculation. On appeal, the plaintiff contended that the trial court had struck this evidence erroneously. The Appeals court agreed and remanded the case for a new trial.

In its decision, the appeals court determined that the design specification and measurement evidence was a crucial component of the plaintiff's case. By allowing this information to be introduced as evidence, the court in effect, recognized the importance of the quality control techniques used in the manufacturing process. It is important to examine the language of the appeal court's decision to ascertain how a relationship may exist between TQM and product liability defense. According to the Court:

> "Strict liability applies if the product is found to be unreasonably dangerous when it fails to perform in the manner reasonably expected in light of its nature and function. A product may be found to be unreasonably dangerous by virtue of a design or manufacture defect.......Furthermore, the issue of whether a product is defective is a question for the jury. Thus, the issue of whether a defendant's failure to meet its own design specifications constitutes a defective condition that was unreasonably dangerous to a plaintiff is a question of fact and is properly presented to the jury. In the present case, the evidence is sufficient to establish the presence of a defect in the wrench....(272 Ill. App, 3d at 616).

The court decision goes to discuss the relevance of the product defect to the non-conformance of the product design specifications. Considerable emphasis is given to the fact that the component parts of the wrench failed to fall within the acceptable control limits. Attention is given to the fact that the defect occurred as a result of the manufacturing process.

If a manufacturer is doing everything possible to produce a defect-free product, under the definition of negligence, no duty has been breached. The first duty is that of the supplier to the manufacturer and/or the public to produce a "reasonably" safe product; the second duty is that of the manufacturer to the public to produce a safe product. With statistical process control guidelines in place, no duty will have been violated since the manufacturer did the best that is possible, which is all that negligence theory would require.

## DISCUSSION QUESTIONS

1. Q) After examining the details of the preceding case, the first question one might ask is what impact might the use of TQM have had on the defendant’s position in the case?

2. Q) Consider the theory of negligence. Ultimately, given the legal definition of negligence, is a manufacturer that is not employing quality control techniques breaching the “duty of due care” owed to the consumer?
3. Does the manufacturer have a “duty” to the consumer to use all available resources to produce a product that will not cause harm?

## EPILOGUE

As mentioned in the body of the case, the Appellate Court of Illinois, 5th Division reversed the trial court’s decision to suppress the plaintiff‘s attempt to introduce evidence regarding the defendant's wrench specifications, measurements of the component parts of the wrench in question, and plaintiff's expert witness's testimony with respect to those measurements and specifications at the trial. Thus, the case was remanded for a new trial at which the plaintiff’s evidence would have been admissible. Before the new trial could take place, however, the parties settled the case. Frequently, a defendant will settle as case like this only when it expects to lose at trial. With the admission of the plaintiff’s evidence showing the failure of the wrench to conform to the specifications, the defendant would have had difficulty preventing the plaintiff from recovering.

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# MORE OLDER STUDENTS ON CAMPUS: THE MIXED-AGE COLLEGE CLASSROOM

**Nini Yang, Clayton College & State University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns age effects in the U.S. higher education. Secondary issues include demographic changes in the U.S. workforce, increased non-traditional students in higher education, and their implications to higher education institutions. The case is designed to reveal some major questions and challenges raised by increased non-traditional students to effective teaching and learning. The case is documented in four ways: (1) the case synopsis that summaries the general purpose and an overview of the case; (2) the case background that provides specific information about some significant shifts in relative sizes of different age groups in a senior college of the United States; (3) a senior citizen's experience in accomplishing a college degree after retirement; and (4) an instructor's resource manual for the use of the case that include questions, recent data, and references to facilitate the case analysis.*

*The case lends itself for either undergraduate or graduate courses in management, education, or career-related training programs. For undergraduate courses, 20-30 minutes are sufficient for case reading and small group discussions. For graduate courses or training programs, the case is suitable for individual or group assignments.*

## CASE SYNOPSIS

*The case is focused on the increased student age diversity in the U.S. higher education. In the context of the rising average learning age in colleges and universities nationwide, the case depicts a real-life example of the mixed-age college classroom from a senior citizen's perspective. It challenges some widespread assumptions about age effects on learning, behavior rigidity, team-orientation, and adaptability in the changing environment of education institutions.*

*The case is designed to: (a) reveal age-related concerns in higher education, (b) enhance an understanding of major forces that drive the significant increase of older students in higher education, and © generate discussions and research interests in the area of age effects on learning, quality of education, strategic planning, and mission implementations in transformational times.*

*To facilitate the case analysis, recent data and research findings about significant shifts in relative sizes of student age groups and their implications to higher education are summarized in the instructor's resource manual. Discussion questions, guidelines for the search of answers, and references of suggested readings are also provided.*

*The case is suitable for courses of organizational behavior, leadership, principles of management, and diversity training programs.*

## CASE BACKGROUND

As the median age of the U.S. population continues to rise, so does the average learning age of the students in higher education. Prior to the 1980's, college students were primarily recent high school graduates who were studying full time to obtain higher degrees. This traditional student population is shrinking dramatically. On average, today's students are older, with about 57% of all students enrolled in American colleges and universities being 25 years of age or older. Many of these students are non-traditional. They tend to be married, working, and have household costs or child care responsibilities (see American Council of Higher Education, 1993; Moore & Diamond, 1995; Rice, Solis, Roger & Dalton, 1996; Yang, 1997; 1998). As one example, at Clayton College & State University in Morrow, Georgia, female students increased by 4% in the first quarter of 1996. Meanwhile, students of 31-40 and 41-60 years of age increased by 4% and 5% respectively, making up almost one-third of the total enrollment. By the spring of 1998, the average age of the students is 28. Minorities and female students compose about 30% and 67% respectively. Nearly 60% of the students hold full-time jobs.

Clayton College & State University is a four-year college with over 5,000 students, as well as a large continuing education constituency. Many of its full-time students are also permanent employees who work for companies such as Coca-Cola Co., Ford Motor Co., Delta Airlines, Home Deport, Wachovia Bank, and Nations Bank. Looking at those non-traditional students and sometimes evaluating them as future employees and managers, who work 40 hours a week and take 10 to 15 hours of college courses, one really have to admire what they are accomplishing.

## A DREAM COMES TRUE: A SENIOR CITIZEN'S PERSPECTIVE ON THE MIXED-AGE COLLEGE CLASSROOM

"I enjoyed it. It was fun to work on," said L.C. Thomas when asked to describe how he felt about pursuing a college degree after retirement. Anyone who knows L.C. Thomas understands what it is meant by the word "fun" here. He is a retired manager of the Nabisco, Inc.. Many people call him simply by L.C..

L.C. Thomas started the college in 1953 but was unable to complete the degree as his job responsibility increased quickly. He spent 35 years in Nabisco, Inc. and retired as a regional sales manager for the division at Atlanta, Georgia. Although very successful and experienced in the field of business, L.C. always wanted to complete the college, a dream that he and his wife Wynelle talked about during those years of working. "Some day, I will do it," he told himself many times. So after being retired for a year or so from Nabisco, L.C. talked about his dream with a business professor at the Clayton College & State University, and was advised to start with one course first, a critical thinking class, "because that will help you clue what's going on in the world today at the college level," said the business professor. It was not an easy start, however. Many of the subjects being taught today were not even created 40 years ago. The first time in the class, a question about one's sexual life was raised for answers. "It was a real shock," said L.C., "but nothing would surprise me anymore after that one."

L.C. had a lot of support from his wife Wynelle and their three children. There was also encouragement from his friends: "If you want to do it, do it." That did not, however, call off the concern about whether the college would accept someone of his age until he became an actual part of the college. "I found in the first class that they will (accept older people). We had one thing in common, that course we were undertaking in that one class. So you can have that in common all the way through, and they will accept," said L.C.. "I felt that was very pleasant."

"I also felt I'd better do my homework, especially to stay up. If you had a lot of reading, you'd better read. If in accounting, you'd better do all that work, to stay up. It might be hard to compete against those young folks first," said L.C.. "I think one of the most front things of those young people is they did not enjoy as much as I did for the group study, the group projects, because in group projects, you really have to learn the personalities of other people regardless of the age background. It could be cultural barriers, it could be racial variables, because of being born in a foreign country. But if you fall into groups of your class, study groups, I think it is the most fun part of the college. I think it is the most learning part."

L.C. followed the foot steps of his daughter and a stepped grandson. One by one, they completed Clayton College & State University, having the same teachers sometimes. His experience was not unusual. Oftentimes, you see in upper level courses, several students are following the foot steps of their children. "It is kind of the issue, sharing your needs with your children, but you are not the first one to go. You are the last one to go. That's the humor side of this education," said L.C.. "I knew they would want to see my report card. They wanted to see my grades."

L.C. completed his "biggest report" in August, 1995. With a college degree in hand, he is planning to go international. He applied to join a Study Aboard Program in London through the University System of Georgia. "I really want to continue on international studies. I became interested in international through my teachers," said L.C.. "It was just a dream that I worked completely to get a degree, but what I really want to do with all of this, the change that occurred? I would like to teach at the college level, that would require something else."

"I think of the changes of the American country. The education facilities and the means of communication like PCs are great things to get involved with, not too old to learn at my age," said L.C., "because our children are involved, and our grandchildren, and we just need to learn."

L.C. Thomas took an active part in the college education and was creative in group projects. Both the students and the School of Business faculty enjoyed having him as a team member, a colleague, a student and a friend. Off the campus, L.C. is active in the community and is a member of the local Kiwanis Club. As today's colleges and universities are getting more diversified in terms of gender, age, and ethnicity, students like L.C. Thomas are real valuable assets to the quality of education. They bring with them rich experiences, high motivation, and creative ideas. They are making today's education both a challenge and a fun activity to work on.

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# HORIZONTAL GROWTH AT RENTALS, INC.

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## CASE DESCRIPTION

*The primary subject matter of this case involves horizontal growth of an organization, and recommendations for future strategies. This case is appropriate for an undergraduate course in small business or in strategic management. It is designed to be taught in a one hour class session.*

## CASE SYNOPSIS

*The case of Rentals, Inc. illustrates how a smaller firm can achieve market power and survive through horizontally integration. Growth, however is only the beginning of a successful strategic process. It does not insure long-term success, as there are numerous strategic challenges for this and other firms in similar circumstances. The firm has reached a size that could attract the attention of larger competitors. This new level of competition would increase the hostility and complexity of the external environment. Due to the new larger size, the firm will also encounter internal problems in such areas as management and logistics. The name and some numerical information for the firm have been disguised to avoid disclosure.*

## THE COMPANY

Rentals, Inc. is a small and relatively new firm. It initially was located in the eastern U.S., and was incorporated over ten years ago with more than one hundred retail rental stores. These stores appealed to the desire of consumers lacking cash or credit to rent products for a short time period. The firm struggled along, fighting problems that come from small size and inadequate cash flow. Being small meant paying high interest rates for a line of credit, and lacking clout when buying additional supplies and equipment for its stores. After nine years of slow growth, Rentals, Inc. decided to change strategies. The time appeared to be ripe for faster horizontal growth.

Rentals, Inc., using financing from a friendly bank, bought out a similar-sized competitor located in its competitive area for $ 20 million in cash. In addition, it purchased 51 percent of the stock of a larger rental firm in the southeastern U.S. for $ 18 million. These actions meant that in one year it had more than tripled in size and in the market it served.

It then organized itself geographically, with three layers of management below the president. Store managers reported to 55 regional managers, who in turn reported to 11 regional vice-presidents. Compensation for both regional and store managers was tied to store performance. Corporate headquarters has centralized purchasing, financial planning, personnel, training, individual store evaluations, and site selection.

## THE INTERNAL ENVIRONMENT

### STRENGTHS

The firm has an excellent MIS system that each unit of merchandise and each rental agreement. The computer at each store is connected to the main computer at corporate headquarters. Each day's activity is compiled for stores by region. Management has access to daily, weekly and monthly data in order to make precise decisions about personnel, about merchandise, about stores, and about regions. Since all merchandise goes directly from vendors to stores, no warehouse or storage costs are incurred. Various vendors are used to help keep merchandise prices competitive. Growth rates in revenues per store have been increasing at 18 percent a year.

### WEAKNESSES

The biggest weakness facing Rentals, Inc. is the inefficiencies associated with absorbing the two chains it purchased. Regional managers and store managers must learn new methods and new information-gathering guidelines. Organizational cultures are slow to change.

## THE EXTERNAL ENVIRONMENT

### OPPORTUNITIES

The rent-to-own industry has been consolidating for several years. The biggest problem facing the independent store or the small chain is a lack of adequate financing. Rentals, Inc. was fortunate that it found a bank to provide the cash needed for expansion. Current and future trends indicate that industry consolidation will continue. Rentals, Inc. should aggressively continue to seek acquisitions or merger partners to avoid being left out of the industry changes. If smaller firms will be squeezed out of the industry, Rentals, Inc. must pursue growth to insure survival.

Current social trends appear to be growing. The U.S. continues to be an itinerant society. People move more, so they need to own less. People want to do more, but lack storage for ownership of things. Many people lack both cash and credit, so the purchase of furniture and appliances is difficult. Rentals and rent-to-own activities will continue to be a growth industry. Rentals, Inc. must take advantage of this trend to enhance per store sales and increase cash flow for repayment of bank loans.

### THREATS

The rent-to-own industry is highly competitive. In 1994, the ten largest firms accounted for 37 percent of the total industry sales. The rental industry must also compete with discount and department stores for customers.

Another serious threat is the growth of the credit industry. Credit cards are available to almost anyone, giving people more choices when considering a major purchase. Rent-to-own stores may lose potential customers to big discount and department stores that offer easy credit or access to their credit cards.

The rent-to-own industry is heavily regulated and further legislation at the national level is being considered. Restrictions on interest rates and fees, on contract language and disclosure, and on lending in general would increase costs and further limit the profit potential of the industry.

Other near term costs that are expected to increase are shipping rates, taxes, fuel/energy, and paper costs. Investors will shy away from an industry where profits are falling and firms are consolidating.

## DISCUSSION

1. What strategies are available to this firm?

    1) More horizontal growth as the industry consolidates
    2) Increase store sizes/activities/products to generate more cash
    3) Diversification
    4) Closer ties to and agreements with suppliers
    5) Improved target marketing

2. What are the problems and benefits associated with each strategy?

    1) Although growth is painful, it appears to be necessary in order to be competitive. Growth could also lead to economies of scale. Rentals, Inc. could attempt to buy out smaller chains located in the western U.S. to allow it to compete nationally.
    2) More cash is needed for debt service. Larger stores could lead to more sales and more profits.
    3) Diversifying, while it is a way to reduce risk, may not be an option. Rentals, Inc. must focus now on what it knows best. After consolidation it may be a future consideration.
    4) Avoiding supplier agreements is currently keeping merchandise costs down. Agreements should be entered into carefully, and then only if they will provide lower prices and more dependable deliveries.
    5) To increase single-store performance, each store must increase traffic of potential customers without incurring excess costs. A variety of promotional activities could include newspaper flyers, billboards, newspaper ads, or on-site radio broadcasts.

3. What would be the best choice of action?

    The best course of action appears to be to continue to grow through horizontal acquisition and merger. As long as bank funding is available, the use of leverage should provide positive returns. When a track record has been established Rentals, Inc. may want to consider an IPO.

4. Given that this choice was implemented, what might the future hold for Rentals, Inc.?

As long as Rentals, Inc. can manage the larger size, it needs to continue growing to stay competitive. Eventually, it may become large enough to require a more professional management team. Future concerns include new federal and state regulations limiting rental activities, territory encroachment by larger competitors, and logistical problems associated with size.

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# FROM GRITS TO SOUTHERN APPEAL

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## CASE DESCRIPTION

*The primary subject matter of this case involves marketing decisions in a small business. Secondary decisions involve management issues concerned with growth and expansion.. The case is designed to be taught in a one class hour at a senior level, and should require two to three hours of outside preparation.*

## CASE SYNOPSIS

*This is an excellent case for use with any type of business course, but especially marketing, management, business policy, or small business, to demonstrate the difficulty of expansion in a small business situation, along with the marketing and management decisions that must be made. The history of the original company and its founders is summarized and a brief description of the new company is given, along with the expansion plans. The mission statement is provided, which should allow the student further insight into the company. Students are asked to develop marketing and product strategies based upon research into the "Cottage Industry" and the catalog sales market today.*

## INTRODUCTION

GRITS, Inc., opened its doors in July, 1996 in Birmingham, Alabama, selling t-shirts with southern sayings embroidered on them. All of the sayings were centered around the word "grits," which stands for "Girls Raised In the South." It all began in the garage of the founders, Deborah and Jim Ford, and outgrew two warehouses and doubled the company's initial projections within the first year.

Deborah started with the creation of a slogan for her high school girls team, for which she was a coach and liked to give them t-shirts to wear. The idea was appealing, but was one of many ideas. Deborah had always been creative, using her ideas to create what she termed "memory-wear." She liked to work with clothing that brought a kind of nostalgia to mind. She had always searched for previously owned materials, such as chenille bedspreads and quilts, and used them to make clothing; for example, jackets, dresses, and hats. Her line of shirts using the GRITS slogans began as a part of her southern heritage that reminded her that certain southern behaviors, like them or not, were part of the tradition of growing up for southern "girls" (Taylor, 1995).

GRITS, which began in a garage, then moved to a 1000 square-foot warehouse, and finally to an 8000+ square-foot warehouse within a year, now has more than 1250 accounts. These primarily are speciality shops, but are beginning to include large retail chains, such as Mercantile, which owns

Gayfers, Maison Blanche, J.B. White, Bacons, McAlpines and Castner Knotts stores in the Southeast. They have also struck a deal with Hallmark stores and Cracker Barrel stores throughout the country. This was possible by expanding the slogans to include ones such as "Girls Raised in the Snow," "Girls Raised in Texas," an ethnic line "Brown Sugar Girls," and others for different regions of the country. They have expanded their line well beyond t-shirts and sweatshirts to include hats, mugs, beach bags, visors, aprons, nightshirts, and sundresses to name a few (Tomberlin, 1997).

## THE ENTREPRENEURS

It was due to the marketing expertise of entrepreneur Jim Ford that GRITS began to expand beyond the hallways of a high school. He recognized the potential for this company because of his previous industry experience. Jim owned the rights to an exclusive line of golf apparel based upon the fictional Bushwood Country Club from the movie "Caddyshack." He is also a founder-owner in a company that produces golf accessories under the Carrera label. He took one look at the t-shirts and decided that this was an opportunity not to be missed in marketing these products. So instead of giving away shirts, a new business was created (Tomberlin, 1996).

Because of the success of their first venture, the Fords have now started a second company, known as Southern Appeal. This company has products made from chenille fabrics, such as dresses, hats, pillows, and a doll. However, they not only sell products created internally, but also assist others who are developing a product that is "southern-made," and don't know how to get that product to market. They have done this by producing a vehicle to assist with the sales and marketing of these products. This vehicle is a catalog that will allow home-based manufacturers with limited resources the capability of growing their own business. An alliance or partnership can be created depending upon whether Southern Appeal will manufacture the product or simply market it through the catalog. The items are carefully chosen to ensure that they will be an asset to the products of Southern Appeal. The catalog concept is to introduce people in other areas to southern traditions, as well as provide Southerners with items that bring back nostalgia (Business Plan, 1997).

## MISSION

"Southern Appeal sells products created internally, as well as assisting others from the concept stage through the development process. The company will assist in all phases of product development from designing to outsourcing. Customers can always expect innovation, practicality, and comfort with a southern flair. We recognize the importance of our customers and offer a commitment to quality and innovation in the industry. We recognize the importance of integrity and ethical standards, as we value our reputation in the marketplace." (Southern Appeal Business Plan, 1997, p. 2)

## MARKET ANALYSIS

The market for women's apparel in the United States is very diverse. There are low barriers to entry, but many competitors both large and small. Women want their products to be on the cutting edge. The Southern Appeal line has been selected to be very specific using catalog sales to bolster

sales efforts. A three-year test market study has been conducted with this line of products to determine which items will sell. The intent is to attract a special clientele that want unique products, but would not want to see them at a "flea market." In addition, the convenience of shopping through catalogs is evident.
(Southern Appeal Business Plan, 1997)

In order to define the potential market, a student (or the entrepreneur) should answer the following questions:

4. Evaluate the cottage industry of home-based manufacturing and the catalog sales industry. How successful is each considered to be? What are the problems in each area?
5. How did the owner go about getting information to potential users of the catalog, as a vehicle for the sales of their products?
6. Define types of unique products acceptable in a specialty catalog.
7. Identify the target market(s) for these products.
8. How could Southern Appeal insure a strong customer base with loyal customers and repeat purchases?

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# AN INSTRUCTIONAL CASE IN PARTNERSHIP ETHICS: ADVENTURE TRAILS, INC.

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## CASE DESCRIPTION

*This instructional case considers a legal dispute between joint owners of a corporation. The focus is on the ethical issues that may arise when a the corporate form of organization is selected over a partnership solely on the basis of its perceived economic advantages. The objectives of the case are to consider the fundamental differences between corporations and partnerships and the ethical obligations shared by co-owners in a mutual agency. The case has a difficulty level of three and is directed to an undergraduate accounting course at the Principles, Intermediate, or Advanced level. However, it is also appropriate for a seminar or workshop in entrepreneurial or small business issues.*

*This case has been used in an undergraduate accounting courses in Principles and Intermediate. At the Principles level, the case required a total of about one and one-half hours of class time to review the concepts of mutual agency and discuss the results of the written assignment in class. The students invested approximately three to four hours of time outside of class to review the legal concepts of agency at the library, review the chapter material in the accounting text, and write answers to the case questions.*

## CASE SYNOPSIS

*Adventure Trails, Inc. was a travel tour company created by two people, Collins and Johnson, who were friends and co-workers. Although the organization was legally a "C" corporation, it had many elements of a partnership. Each person invested the same amount of capital, worked the same number of hours, shared in the decision-making, and received the same compensation and benefits. However, both Collins and Johnson agreed to a 55-45 percent split of the stock because the idea for the business venture belonged to Collins.*

*The corporate form of organization introduced a hierarchy of control and status which gave one co-owner a substantial advantage over the other. Collins, the chairperson of the board, president, and majority stockholder, held 55 percent of the stock. Johnson, the vice-president, secretary-treasurer, and minority stockholder, owned 45 percent of the shares issued. The business was extremely successful, but eventually there was a disagreement over working hours. Collins fired Johnson and continued to operate the corporation on her own.*

*The most interesting facet of this case is the importance of ethics in the corporate form of organization. The law recognizes and supports equality among partners who are co-owners and share in decision-making. One partner may not terminate another. However, the law supports a hierarchy of control and authority in a corporation. A superior may terminate a subordinate. Thus,* *co- owners who operate a corporation must rely on a strong system of ethics or construct carefully defined legal agreements to protect their co-owner relationship.*

*This case illuminates the issue of trust between co-owners and places the economic value of tax-savings and limited legal liability in a different perspective.*

## BACKGROUND OF CASE

Adventure Trails, Inc. was established in 1988 by Jennifer Collins and Patricia Johnson for the purpose of developing and promoting motor coach tours that would be of special interest to retired persons. The two women were personal friends and each had several years of experience as travel agents. In July 1987, Collins proposed the tour concept to Johnson over lunch. Several months later, they formed a corporation, Adventure Trails, Inc., to design and conduct motor coach tours.

Based on personal knowledge and contacts with hotels, restaurants, a motor coach charter company, and tourist attractions, they developed a Fall Color Tour package for a nearby mountain area. Their marketing efforts focused on suburban, church-sponsored, senior-citizens organizations. Individuals in these groups had the time, interest, and financial ability to support touring. Church group meetings provided a venue for selling tours to a good prospect group. The initial tour was a notable, immediate success. Thus, both Collins and Johnson terminated their employment as travel agents to devote full time to their own tour business.

At the time of incorporation, each party invested $20,000 in cash from personal savings. Since Collins initially conceived the concept of selling tours to senior citizen church groups, she proposed that she should own 55 percent of the corporation stock. Johnson would own 45 percent of the common stock of Adventure Trails. Further, it was mutually agreed that Collins would be designated Chairperson of the two-person board of directors and President of the corporation. In exchange for $20,000, Collins was issued 55 shares of common stock. For her $20,000 investment, Johnson received 45 shares and was designated Vice-President and Secretary-Treasurer. Thus, 100 shares were issued and outstanding. In recognition that each party, in fact, contributed the same amount of investment capital and provided personal services of equal value, each received the same annual salary and fringe benefits.

Over the next five years, the business revenues and profitability increased. The success of the business was due, in large part, to Collins and Johnson who served personally as tour guides. From this experience, they gained a better understanding of the special interests of their clients. Adventure Trails, Inc. attracted a high degree of customer loyalty and repeat business. The loyal client base encouraged them to create new tour packages. The corporation compiled a customer profile database that facilitated direct-mailings of well-targeted, high-response-rate tour announcements. Expanded tour offerings led to the selective hiring and training of additional tour guides.

After five years of active life on the road, sales presentations to prospective church groups, and office work, Adventure Trails had become a major time commitment for both parties. The business was a great success. Each earned annual salaries and bonuses in excess of $100,000. The company provided each shareholder-manager with a leased luxury automobile, medical benefits, and contributions to a 401K retirement plan.

## THE DISAGREEMENT

In late 1993, Johnson indicated to Collins her desire to "quit the road" and no longer act as a tour guide for 1994 and future years. Johnson wished to limit her activities to 40 hours per week devoted to office work and making sales presentations. Collins responded quite negatively to this proposal. For the first time in their business relationship, Collins began to refer to Adventure Trails as "my company." She pointedly noted to Johnson that the Adventure Trails concept was hers and that she was the majority shareholder, Chairperson, and President.

The preceding conversation took placed several days before Christmas week closing. Christmas was a slack time for business and all of the employees took a holiday during the week between Christmas and New Year's Day. On December 30, 1993, Johnson decided to go to the office to catch up on some paper work. She attempted to unlock the door to the store front office. However, her key did not fit the lock. Upon returning home, she noted a letter from an attorney. The letter informed her that she had been terminated as an Adventure Trails employee. Furthermore, she was prohibited from entering the business, contacting customers, or in any way interfering with the operations of Adventure Trails, Inc. Her personal property would be delivered to her and arrangements would be made to retrieve the corporation's automobile. No mention was made of her ownership in the company.

In response to the attorney's letter, Johnson immediately telephoned Collins to discuss the situation. In reply, Collins reiterated the contents of the letter and briskly terminated the conversation. Soon thereafter, Johnson contacted her attorney and filed a dissenting shareholder suit in civil court.

A dissenting shareholder's appraisal and buy-out right entitles the dissenting stockholder to sell his/her shares to the corporation at fair market value. The purpose of this right is to effect a compromise between the majority shareholders and the dissenter who refuses to accept a position different from that bargained for when the stock was purchased (Dunfee et al. 1984, 751). The suit in this case was based on an unwarranted lock-out by Collins and claimed fair market value for Johnson's 45 percent of the common stock of Adventure Trails, Inc.

## ANNOTATED BIBLIOGRAPHY

Anderson, R., I. Fox, and D. Twomey (1992). Business Law. Cincinnati, Ohio: South-Western Publishing Co.

Four chapters of this text (741-819) are devoted to defining agency relationships, creation and termination of agency, duties and rights of principals and agents, and employment as agency.

Bowie, N., and R. Freeman, ed. (1992). Ethics and Agency Theory. New York: Oxford University Press, Inc.

This volume contains eleven essays written on various aspects of agency relationships as they relate to ethical issues. Terminology is well-defined and strengths and limitations of agency theory are discussed.

Dunfee, T., F. Gibson, J. Blackburn, D. Whitman, F. McCarty, and B. Brennan (1984). Modern Business Law. New York: Random House.

Chapters 25, 26, and 27 cover agency concepts and the nature and operation of partnerships (613-698).

Henry, E., and J. Jennings (1997). Central Power & Light Company: A Management Ethics Case. The Journal of Accounting Education (Summer)15:3.

This case considers ethics and agency theory in an early extinguishment of debt. The teaching note specifically considers the integration of the law of agency with agency theory in accounting, finance and economics.

Holmes, O.W., Jr. (1881). The Common Law, edited by Mark DeWolfe Howe. 1963. Cambridge, MA: The Belknap Press of Harvard University Press.

This book contains the eleven lectures that Holmes prepared on the significance of the common law as a model for contemporary law. The editor's introduction is very helpful in identifying common themes that were developed in Holmes' later works.

Jensen, M., and W. Meckling (1976). Theory of the firm: managerial behavior, agency costs, and ownership structure. Journal of Financial Economics 3 (October): 305-360.

This landmark article was one of the first to use the common law concepts of agency to analyze the modern corporation. Ethics are not addressed per se, but the authors acknowledge the importance of a legal framework to define and support contractual relationships.

Larson, K., with B. Chiappetta (1996). Fundamental Accounting Principles Chicago IL: Irwin (484-523).

This text is one of many that present corporations and partnerships as choices of organizational form. Chapter 13 presents partners as agents and provides good coverage of the characteristics of mutual agency and limited liability.

# PERFORMANCE PIPING GOES TO ASIA

**Jim Pearce, Western Carolina University**
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## ABSTRACT

*This case is about a United States based company and their quest to chase their changing market. Performance Piping's market has become an emerging one in Asia. Performance Piping's story is based on facts, the names and locations have been changed to protect those involved. The case chronicles the real life struggles of a company and its managers.*

*Performance Piping purchases an existing company in Asia that services the same markets in Asia as does Performance Piping in the domestic market. The new company is called Performance Piping Asia (PPA). PPA retained the services of its original owner as managing director. The honeymoon first year was a success. All the major customer and sales targets were hit and the company made a profit in its first year.*

*Now PPA is into their second year, now they are not landing any of their target projects. The company is operating at a loss. The swashbuckling managing director has not concerned himself with any of this. He continues to look to the future and plan for manufacturing site all over southeast Asia.*

*Performance Piping's president is now faced with how to handle the situation when he is located half way around the world from PPA. The case concludes with a confrontation between the two differing views. Clearly, the reader is not left with any obvious answers.*

## INTRODUCTION

It is a hot and humid evening just like every other evening in Singapore. Mike Bliss is sitting all alone in Singapore's oldest and most famous hotel and bar, Raffles.

"My name is Vanitha, may I serve you a drink sir?" the waitress said in a thick Singaporian accent.

"Give me a double, double anything," Mike responded.

"Yes sir," responded Vanitha.

As Mike slowly took his first drink he could not help but wonder how did he get himself in this situation.

Mike brought his glass to his lips for the second time, he began to survey this historic location. He wondered to himself if this was the right place for this meeting to occur. He could see so many potential weapons. Would Jack break a bottle and use it to cut Frank? What kind of hospital care would he get? "Excuse me, I am going to need another drink," Mike blurted out to the Vanitha.

"Right away sir," Vanitha said as she made her way back to the bar. Mike began his second drink. His brain continued to spin, should I hide the silverware, that could be a weapon too. This could get bloody.

Mike's apprehension and hysteria were being driven by the meeting he was about to referee. Mike's boss Frank Cowan was on his way from the United States to meet with Jack Jacobsen. Jack also works for Frank as general manager of Asian operations. Mike now knows the time has come, he sees Frank and Jack approaching his corner table from across the room.

## BACKGROUND

Hello, I am Mike Bliss. I am the one telling this little story about our company. I guess you are wondering who I am. Well, Mike is a young engineering manager from Performance Piping in the United States. Mike is responsible for the capital spending for all of the Performance Piping divisions. Before we can finish this story, here is some background that you need.

Performance Piping is a United States based company that produces corrosion resistant pipe, valves and fittings. Performance Piping is one of thirty divisions that belong to a financial holding company. The corporate parent is involved in businesses ranging from aerospace to home plumbing. Performance Piping's products are used in the chemical process industry and petrochemical industry to convey corrosive chemicals. These chemicals are processed through pipes, valves and fittings manufactured by Performance Piping. These chemicals transferred by the piping components can be used in the processing of products or they may be the finished product. Typical chemicals that require lined pipe are sulfuric acid, hydrochloric acid and phosgene(mustard gas). The piping components consist of a chemical resistant fluoropolymer lining inside of a metal housing. This liner is most often made of Teflon®. This liner protects the metal housing from being consumed by the fluid that it is carrying. Performance Piping has been manufacturing these products for thirty plus years in the domestic market.

Performance Piping invented lined piping in the 1950's. The market has evolved since that time and now Performance Piping has two major competitors in the United States market. However, Performance Piping controls the major market share in this market. The target of this industry, up until the last ten years, has been to convert the chemical manufacturers away from using exotic alloy metal piping in their chemical processes to convey these corrosive chemicals. Rare metals such as Hastelloy or Zirconium are often used in these corrosive services because of their chemical resistance properties. These exotic alloys have been replaced by the more cost effective plastic lined steel piping.

Over the last five years, most of the conversion from exotic alloys has been completed. The domestic Chemical Process Industry has stopped the past practice of building chemical capacity ahead of demand which led to over-capacity and depressed chemical prices. The cautious capital spending of the last two years will continue to be the norm and will limit Performance Piping's potential for overall pipe and fitting sales growth.

With this cautious course has come the practice of cost reduction and continued shifting of special requirements, such as painting; (heretofore, subcontracted) back to the piping vendors. Additionally, the static demand for lined pipe and fittings is being, for the most part, competed for by three suppliers each with sufficient capacity to supply 50% of the total market. Thus, Performance Piping is competing in a "buyers" market where the past manufacturing practice of "make to stock" has changed to one of a "mass customization" where price is still the primary buying influence.

In the past 2-3 years, Performance Piping's top competitors have attempted to align themselves with commodity type distribution to take advantage of the industries trend to "integrated suppliers," which is a move to lower their cost by reducing their vendor base.

For Performance Piping, new growth must develop from either new markets or new products. Recent new product introductions have been reasonably successful, but in this mature market, new products can not produce the kind of increases to revenue that are needed to sustain growth.

Performance Piping has recognized that its growth must occur through new markets. In order to make this happen , Performance Piping president Frank Cowan has pursued a presence in Asia. The Asian market , at this time, is equivalent of the United States market thirty years ago. It is an emerging market that is being influenced by multinational firms locating plants in the region.

Heretofore, most of the investment in the region was Petroleum based Petrochemical with relatively little use for lined piping. Additionally, local tariffs promoting inside the country development of manufacturing caused importing of lined piping to be costly. Thus, cheaper and lower quality corrosion resistant piping was and is being utilized, i.e.; rubber coating, spray on linings and solid plastic piping, all of which are available locally.

The investment by the Chemical Process Industry is now shifting to pharmeucitical grade chemicals and plastics production, especially in the Singapore and Malay Peninsula. This type of investment will continue to grow throughout the region with Indonesia and the Indochina area being the next big growth opportunities. These types of chemicals require the qualities of lined pipe.

European (mostly German) companies are leading the way in the investment with American and Japanese firms following. Currently, the majority of lined pipe is being imported from those three countries, but due to the complexity of piping systems and short lead-time requirements, the need for local support and fabrication is essential to continue any growth.

While new plant construction business will be the bulk of the volume for the next 2-3 years in the Asian region, the emerging conversion market (converting to fluoropolymer lined piping from previously discussed corrosion resistant materials) is the real plum and can only be served by local facilities.

Based upon the above, Performance Piping president Frank Cowan has proceeded with the acquisition of a Singaporian company that will allow Performance Piping access to these markets. This method was chosen over starting a business from the ground up. Cultural issues and differences, along with the much quicker access this purchase gives Performance Piping to these markets, makes this approach more attractive to Frank Cowan.

As part of the purchase, Performance Piping retained the services of the previous owner Jack Jacobsen as the managing director. Also, Performance Piping Asia (PPA). has part ownership in a Thailand company that is in the same markets.

Jack Jacobsen is a true entrepreneur. He traveled to Singapore with some knowledge of lined piping that he had gained through a distributorship in Australia and contacts in Holland and very little else. Jack took residence in a government owned flat along with six other people and began building a much needed business. All that he had to lead him were his dreams and not much else.

Jack had built a business that was based very much upon his self. His personal knowledge of the different cultures and markets made him a crucial part of Performance Piping's purchase. Jack's language capabilities include; English, Dutch, German, Thai and Mandarin Chinese. Jack's first factory location was in an old furniture factory located in a rain forest on the Singapore peninsula.

His office consisted of a construction trailer parked along side the factory. As darkness would fall upon the factory, the lights of the office trailer would draw in hundreds of locusts through the holes in the trailer. The locusts would have to be battled away before any further work could be done.

Many times production would have to be halted in the factory because of some unwanted guests. As a male monkey gets older, they are pushed out by the rest of their family and are left to defend for themselves. One of these monkeys that had been pushed out of the family stumbled upon the factory in the rain forest one day. This monkey discovered that food was easy to come buy if you stole the workers lunch. After a couple days of this, the monkey decided to go back and invite his whole family to feast at this new found factory. Hoping that this wealth of food would bring him back into favor with his family. Needless to say, this created very hazardous working conditions. This monkey's entire family would hang from the I-beams of the factory waiting to steal the worker's lunch.

One of Jack's favorite stories to explain the cultural diversity of the region involves the capture of a Tarantula. During work one afternoon, one of the workers discovered a huge Tarantula spider located in the corner. There soon was a major conference to decide the faith of this creature. The Malaysian workers wanted to set the spider free because they felt its large size showed its wisdom. To kill the spider would bring bad luck. The Chinese and Indonesians wanted to cook the spider. The disagreement between these two groups was that the Chinese wanted to cook the spider with the head still on while the Indonesians do not like to cook anything with the head still on it. Well, it was the spider's lucky day, the Malaysian workers won the discussion and the spider was on its way.

## CURRENT SITUATION

PPA had a very respectable first year. All of the projects came in that were targeted at the beginning of the year. Half way through their second year of operation, business is no where near last year. PPA is functioning at a loss. The new construction projects that were targeted have not come about. Recent declines in the Thai and Malay financial markets have forced the cancellation or postponement of many projects. PPA is completely reliant on project based work and they are currently staffed to handle more business than the previous year. Therefore, their overhead is causing them to function at a loss. Performance Piping Asia does not have any maintenance and replacement business to fall back on. Maintenance and replacement business refers to that part of the business that services existing customers. In an emerging market, there are very few established customers. The nature of the business is that it will be new construction driven, but they need maintenance and replacement business to cover their expenses when new construction is scarce.

Being the dreamer that he is, Jack Jacobsen has not concerned himself with the operational side of the business. A good example of this is how Jack arrived in Singapore, with a little money and no where to stay. Jack sold his business in Australia and left his wife and two daughters there while he flew 10 hours to Singapore to start his own business. Jack still believes that sales will rebound during the second half. His focus is on growth into other Asian markets. Jack's core philosophy is that details will be handled at the time they arise. This philosophy has been painfully apparent in the surprises that have been sprung upon Frank Cowan this year. Jack's swashbuckling style and loose truths have severely strained Frank's patience and understanding.

Frank Cowan's main concern at this point is how to grow the business. Frank comes from a twenty year sales background. He is a visionary with an expressive's personality. Frank has loads of energy and his personality style leads him to work with people. He understands the need for confidence and a few loose truths, but he knows when to draw the line. Performance Piping has spent substantial capital in their Asian location during the first two years. This capital equipment has been targeted at lowering their manufacturing costs and bringing their products up to Performance Piping's quality standards. The person who has been responsible for this capital strategy is Mike Bliss. Mike's strategy for capital spending thus far has been centered around bringing PPA's product up to Performance Piping production standards. PPA's products must represent PP's good name. Mike believes product quality standards can not be lessened just because PPA is selling into lesser developed countries.

Jack Jacobsen's plan for growth is to move towards a regional manufacturing approach as compared to their current centralized approach. Currently, Jack is pushing Frank very hard to move towards the regional manufacturing approach. Jack's targets are to have fabrication facilities in Thailand, Malaysia, Indonesia and China.

On Mike's last trip to Singapore he was accompanied by Frank Cowan. Mike's goal was to install two more pieces of capital equipment that he had recently shipped over. Frank was not scheduled to make this trip originally but decided a discussion was needed with Jack when Jack decided to sign a lease for manufacturing space in Malaysia without Frank's knowledge. Frank discovered that Jack had signed a lease through discussions with the accounting department in the US.

Needless to say, Frank was very concerned when he learned this. His expressive personality soon turned to that of an irate driver. No more management by consensus, it was now his way or no way. Frank Cowan agrees with Jack that these are valid markets to be in, but they disagree on how this should take place.

The day Frank discovered that the lease had been signed he called Mike Bliss into his large front office on that Wednesday. Frank's office has few furnishings and is very neat. Mike has always wondered how he keeps his desk so clean. Frank is a midwest educated accountant. He was brought into this business quite by accident. It seems that someone decided to mentor Frank, but not in accounting. This mentoring took place in the fine art of selling.

Frank asked Mike to sit down. Then Frank said to Mike, "Are you flying to Singapore this weekend?" Mike answered yes.

"Well I am going with you, you will not believe what that flaky Jack is trying to do," Frank said with an angry voice.

"What is it?" says Mike.

"He is trying to move the factory to Malaysia without my permission. I have a meeting set up with Jack at the Raffles Hotel in Singapore for Monday evening, I need you there. I am afraid that I may fire him on the spot without someone to help calm both of us down," Frank said as he fell back into his chair.

"I will be there Frank," says Mike.

It was an even longer than normal flight for Mike to Singapore because he knew what was waiting for him once he got there.

Everyone is very cordial in their greetings to each other even though they sense what could happen. As everyone begins to sit down, Mike makes sure he is sitting between Jack and Frank. The waitress approached their table and asked if they would like to order a drink. Mike thought to himself that he should pass on another drink and that they sure did not teach this at North Carolina State University in the engineering program.

"No thanks, I have had enough," said Mike.

"Give me a gin and tonic," Jack declares.

Frank says, "I will have a beer." Frank only drank when it was required socially. As they take their first drinks, it is obvious that Jack has been tipped off that Frank knows about his lease agreement because Jack is being much more congenial than normal.

"Can I start this meeting?" Jack says after a couple of drinks of his gin and tonic. Mike cringes as Frank nods his head as if to say go ahead if you are that brave.

Jack states, "I believe that costs are too high in Singapore and these costs are handicapping my ability to sell product and make a profit."

Frank agrees, "Labor costs and operating costs are higher in Singapore, but that all of Asia can be accessed from there because of its open trade laws." Frank's main argument to Jack is, "Jack if we cut our labor costs by 79% by moving to other countries, we would only save $80,000 because labor is such a small part of the overall cost. Therefore, labor cost is not an issue."

"Jack I agree that these are valid markets to be in, but I disagree with you on how this should take place," Frank said as he drank the last of his beer.

At this point Mike starts to see Jack squirm in his chair.

"Jack I believe that all of Asia can be accessed from Singapore. Singapore is the technical center of Asia," Frank preached to Jack.

"But Frank, costs are extremely high in Singapore. Much higher than those of surrounding countries," Jack exulted.

Frank continues to bash Jack's idea of regionalism by making the following statements. "Jack, all of the countries, that you want to put fabrication facilities in, have trade and business issues as well as local law concerns. These countries have laws concerning foreign enterprise ownership. These laws all center around minimum export requirements. A wholly owned company in Malaysia must export 80% of what it manufacturers. China requires that a wholly owned company export 70% of its production." Jack continues to underestimate Frank's knowledge of local laws and customs. Jack makes another attempt at convincing Frank that moving to Malaysia is the best thing to do.

"Frank, you are under estimating the fact that our customers want to buy from local manufacturers not from other countries."

Frank's question of Jack is, as he slams his glass on the table, "how can we be in all these countries and export these high percentages."

Jack usually responds with some futuristic view of how he envisions it will work. Today Jack was smart and thought better of that approach. Jack just became silent. Frank knew that Jack still felt his views were correct, he was just out gunned.

Frank continues his lecture of Jack. To this point in the conversation Mike has not been needed. Frank has done an excellent job of maintaining his composure. "Jack you know the purpose of these countries export laws is to help these developing countries to develop their own technology. More often what happens is that these countries end up taking the technology and pushing out the western firm," as Frank continues his assault. This is one of the main reasons that Frank likes to stay in Singapore. Jack turns and looks at Mike as if he is asking for help. Mike's brow began to gather a heavy sweat. Technology ownership is the wrong subject to ask for help on. Mike Bliss is determined to keep Performance Piping's core technology in the U.S. Mike will never let it out of his sight. Without their core technology, a company has lost its competitive advantage. If these countries develop this technology through our help, then Performance Piping has no sales advantage.

At this time in the company's infancy, Frank would like to see Jack and his sales force focus on selling the maintenance and replacement (MRO) items.

"Furthermore Jack, this potential MRO business would provide a constant baseline of activity when new construction projects are scarce. Also, this MRO business is typically taken at higher margins than new construction business," Frank says as if pleading with Jack.

Frank's vision is that if the MRO business can cover expenses, then new construction work becomes incremental business and the money will flow to the bottom line.

Under Jack's leadership and swashbuckling style, he has trained the sales force to focus on new construction work. "Frank, new construction work is higher profile work than is MRO business, there is higher sales dollar potential," Jack demands. "However, there is a great amount of risk with new construction work, Jack. If you loose the order, there is nothing to fall back on. Seeking out MRO business is the grunt work. The recognition is small, but the margins on selling the product are attractive. This baseline MRO business is required in order to cover the operating overhead," Frank slumps back into his chair.

At present Jack obviously has not bought into the above philosophy. Frank feels he needs to influence more closely how Jack runs the business. Asia is a huge area, distance and communication barriers are significant problems. Most flights that the salesman take are at least 8-10 hours in length. These flights take the salesmen into different countries with completely different languages and cultures. The customers that they are serving are not located in a big city with all the amenities that we are accustomed to in the United States. Many times they are traveling deep into the jungles of Indonesia to a pulp and paper mill. Survival is the first rule of the game, not selling lined pipe. The salesmen must pack enough bottled water to last them the entire trip. Earlier this year, one salesmen was rushed back form the jungles of Indonesia and spent two weeks in a Singapore hospital recovering from food poisoning. Each country has such different cultures and eating styles that a person can not adjust to all of them.

Performance Piping (Asia) is 13 hours ahead of Performance Piping in the U.S. management, and communication from the U.S. is very difficult because of these differences. Frank is grappling with how Performance Piping provides the resources to administer the growth that Jack and Frank are striving for. In providing the resources, Frank has considered sending an expatriate to go and live in Singapore. Another option he is weighing is whether to rotate the Asian employees through the U.S. plant for training. At this time, Frank sees no apparent successors to Jack within the current organization. There are no other leaders within the organization.

Because of Mike Bliss's recent trips to Singapore, Frank has asked Mike to do some research and make recommendations on the direction Performance Piping should take. Mike is very conscious of the importance of his recommendations. There are great opportunities for growth if the right decisions are made. Performance Piping's main growth must be through their Asian operations. Building of US chemical plants is almost unheard of these days. Mike feels that Performance Piping must follow its customers. Failure is certain if control is lost over the operations. Frank's corporate bosses are observing this situation very closely. Performance Piping is out in front in these markets and many times is setting corporate policy.

"Mike, you have traveled to the jungles with me to visit customers and we share many stories, do you not see my side of this argument? You know how these countries show favoritism to in-country manufacturers. We have to be located in these countries. It is obvious that Frank does not place any stock in my vision. You can help sway him Mike," Jack says in his most convincing way.

Mike swallows real hard and thinks to himself that the third drink would be helpful right now. Mike looks over at Frank, Frank's jaw has dropped in disbelief.

Frank takes another drink and says, "All right Mike, what would you recommend"?

APPENDIX A

1998 Sales: Performance Piping Asia By Region

| | $'s |
|---|---|
| Singapore | 2.5M |
| Indonesia | 1M |
| Malaysia | 1M |
| China | .5M |
| | 5M |

# PAMELA SMITH VS KATV CHANNEL 7: A CHARGE OF DISCRIMINATION

**Sandra Rodgers, Henderson State University**
**Ramona Akin, Henderson State University**

## CASE DESCRIPTION

*This case centers around a discrimination charge against a television station in Little Rock, Arkansas. Its primary focus is discrimination in the employment process, which would fall under the legal and regulatory perspective, with a complementary issue of demographic diversity in the workplace. The most appropriate course for this case is senior-level Human Resource Management. The case is designed to be taught in two class hours, with minimal outside preparation by students.*

## CASE SYNOPSIS

*Little Rock television anchorwoman Pamela Smith filed a federal discrimination lawsuit against her employer, KATV Channel 7. During a time period when KATV was experiencing unusual turnover activity in its news anchor positions, Smith contended that she was passed over twice for the weekday anchor position. Smith asserted that KATV followed a pattern of placing only people of European descent in the weekday anchor position when it failed to promote her.*

## INTRODUCTION

Dale Nicholson was concerned. The recent and steady turnover of news anchors at his television station was being noticed and questioned by loyal viewers. In addition, the only black news anchor had filed a racial discrimination lawsuit against the station for failing to promote her to one of the emerging plum positions.

## BACKGROUND

Little Rock is the home for three television stations. Despite changes in news directors, sets, and program formats by the other stations to try to increase their viewer ratings, KATV Channel 7 has consistently maintained its Number 1 ratings for its newscasts.

Jim Pitcock, news director for the popular station, explains it this way: "The key to our success is personnel selection. Our newscasters are confident and comfortable with their positions. They are relaxed and relate well to each other on camera. This is reassuring to the viewer who in turn feels at ease and accepts the reporters as family members.

"Sure, we have lost key people over the years. To our credit, they've all gone on to larger markets, and we've been successful in filling the void they have left with qualified, likable personalities."

The departure of KATV's news anchors began in 1993 when Andy Pearson moved to Nashville; a second departure was by Betsy Pilgrim, the 5 p.m. anchor, who left the station in the spring of 1994 to become press secretary for an Arkansas gubernatorial campaign. Andy's co-anchor and station veteran of six years, Gina Kurre, soloed the 6 and 10 p.m. newscasts for a year before leaving for a similar position in St. Louis. At that time, Karen Fuller, who had been at the station for only nine months, was tapped to be anchor for the 5, 6, and 10 p.m. newscasts. (Rengers, 1994, August 12)

Turnover at KATV was also experienced in the reporter positions and supporting station positions at this time. In the one-year time span from August 1993 through August 1994, at least 15 of about 40 newsroom employees left their jobs for one reason or another.

The one constant on-air talent has been Pamela Smith, who serves as weekend anchor and weekday reporter for KATV. In July 1994, Smith sued KATV for the job of weekday anchor, saying that since she was hired in 1990 she had been passed over twice for an anchor position because of her race. (Rengers, 1994, August 12)

## KATV AND THE TELEVISION NEWS INDUSTRY

KATV Television, Inc. is a Delaware corporation authorized to do business in the State of Arkansas by virtue of a license from the Federal Communications Commission. The station has a general coverage area which extends over 80% of the State of Arkansas and into portions of Oklahoma, Mississippi, Louisiana, and Texas. (Smith, 1994, July 7) KATV operates news bureaus in Pine Bluff and Hot Springs and is the only station in Arkansas with a live hook-up to Fort Smith and Fayetteville in northwest Arkansas.

KATV employs 49 persons in its newsroom--40 or 81.7% are white, 8 or 16.3% are black, and 1 or 2.0% is Asian-American. (Smith, 1995, November 14)

Television is the main news source for 70% of the U. S. public. (*TV Industry Page,* 1998) In addition, local newscasts represent from 45 percent to 50 percent of a station's advertising revenue, according to Pat Baldwin, the general advertising manager at KATV. One national media broker, R. A. "Pat" Walsh, believes that advertisers go to local news because it provides more eyes and more ears for their commercials and generally reaches an older and higher-income adult audience. Advertisers also choose newscasts for subliminal reasons--most notably, the credibility a news or weather environment gives to its product. (Donald, 1997, July 27)

Every television station needs advertisers to help offset the costs of producing its news program. The exact rates stations charge for advertising is a closely guarded secret, but based on the standard rate cards distributed to local media buyers on June 1, 1997, KATV charges more for its 30-second spots than do its two competitors, KARK-TV and KTHV-TV. One reason KATV is able to do this is that it is Number 1 in the ratings in the Little Rock area.

According to the general manager of one of KATV's competitors, keeping up with the latest technology is the most expensive part of producing a newscast. (Donald, 1997, July 27) In the Little Rock market, only a couple of on-air personalities earn $100,000 or more, with the majority of the anchors receiving $50,000 to $75,000 as an annual salary. The salaries account for very little of the expense of airing a news program.

Each television station strives to present the news, weather, and sports in a manner that will establish a unique identity with the public. In the Little Rock industry, 40 to 50 people are directly involved in producing the news, with only a handful being anchors and on-air personalities. However, the on-air personalities are the ones the public sees and hears, and, therefore, they play a key role. The way an anchorman smiles or a weatherman conveys information about a possible storm can contribute to the popularity of that station's newscast. (Donald, 1997, July 27)

Television journalists may or may not be hired for their educational training in television news. They may be chosen because they possess expertise in a certain field (economics, law, medicine, business, or sports, for example), may be good writers, may have name recognition (Blohowiak, 1987), or may have good rapport with the camera. According to Neal Ardman, the chief operating officer at KKYK (a low-power television station in Little Rock), what works over time is a credible, comfortable news report. (Brummett, 1998, March 5)

## PAMELA SMITH'S COMPLAINT

Pamela Smith filed a formal complaint with the United States District Court, Eastern District of Arkansas, Western Division, on July 7, 1994. Named as defendants were KATV Channel 7 Television, Inc., Jim Pitcock, News Director for KATV, and Dale Nicholson, Station Manager of KATV. In her suit, Smith asked to be placed into the position of weekday anchor at KATV and to receive monetary compensation due to the violation of her civil rights. She charged KATV with maintaining a racially discriminatory work environment including "... word-of-mouth recruitment, failing to post notice of vacancies, placement of people into positions on the basis of friendship and nepotism, placement of people into positions such as anchor and upper management positions ... without predetermined objective and subjective job related criteria and placement of people into positions on the basis of race or color." (Smith, 1994, July 7)

The suit further stated that KATV had a history of placing only persons of European ancestry into weekday anchor positions and management positions. Black employees were limited to the lowest paying jobs within the station. At the time the complaint was filed, Smith contended she was the only non-white person in the news department staff which consisted of more than 20 nonphotographer news staff.

Even though Smith had received favorable work reviews, the complaint says that she was not considered for two weekday news anchor vacancies (created when Betsy Pilgrim and Gina Kurre resigned), was not given notice of the vacancies, and was not given the opportunity to fill the vacancies while KATV conducted an overall search for the positions. She also claimed that the person who eventually filled the position, Karen Fuller, had less experience.

## QUALIFICATIONS: SMITH AND FULLER

Some similarities exist between the backgrounds of Smith and Fuller, one of which is that they were both hired by KATV as general assignment reporters. Some differences also exist. Pamela Smith is a graduate of Oral Roberts University, Tulsa, Oklahoma, with a Bachelor of Science degree in telecommunications, specializing in broadcast journalism. Before joining the KATV news team, she worked as a free-lance producer and on-air announcer for a religious program and as a Public Relations Assistant for the City of Little Rock.

After being hired by KATV in 1990 as a general assignment reporter, Smith was promoted to the weekend anchor position along with her weekday general reporting duties by 1992. KATV's WEB page recognizes her as the "Weekend Anchor for the award-winning Channel 7 News Weekend Report." It also states that she took first-place honors in the Associated Press' Best Documentary Category of 1994 for her three-part series, "From Arkansas to Africa." (*KATV News Team*, 1998, March 11)

Karen Fuller earned a Bachelor of Arts degree in Radio/Television from Drake University in Des Moines, Iowa. She began her broadcasting career as a weekend anchor in Mason City, Iowa, at KIMT-TV. After seven months, KIMT promoted her to weekday morning and noon anchor. She also worked as an intern for another Little Rock television station where she remains the only intern in station history to have a story reach the air.

In November, 1993, KATV hired Fuller as a general assignment reporter. She was promoted to the 5 p.m. anchor position in March, 1994, and then promoted to the 5, 6 and 10 p.m. anchor in August, 1994.

Fuller is part of the Channel 7 News Team that received first place awards at the 1995 Arkansas Associated Press Broadcasters Association Annual Awards Presentation in the category of Newscast, as well as others. The Channel 7 News Team was also named the Television Class A Overall Winner. (*KATV News Team*, 1998, March 11)

## KATV'S ANSWER

On July 18, 1994, KATV Channel 7 Television, Inc., Jim Pitcock, and Dale Nicholson filed an answer to Pamela Smith's complaint in the same court in which it had been filed.

The defendants asserted in their answer that all actions taken with respect to Pamela Smith's employment with KATV had been made ". . . without regard to her race, based upon defendants' best judgment of her abilities as a reporter and anchor as compared with other available candidates for the news assignments in question." (Smith, 1994, July 18)

In the Plaintiff's Pre-Trial Conference Information Sheet, filed in court on November 14, 1995, the defendants conceded that during her tenure with KATV Smith had received evaluation ratings of "good," "very good," and "outstanding." Smith had never received a rating of "unsatisfactory" or "fair."

The information sheet also pointed out that KATV does not generally post vacant positions for news anchor.

## THE TRIAL

Pamela Smith's case went to trial in April of 1996 before an all-woman jury. Three of the jury members were black. While Smith's attorneys argued that race was the determining factor in Smith's being denied promotion, KATV's attorneys contended that Smith's lack of anchoring skills was the determining factor.

The testimony in the trial centered around Smith's qualifications vs. Fuller's qualifications to be promoted to weekday anchor at KATV. Spencer F. Robinson, attorney for KATV, said a November 1993 evaluation of Smith's work stated that she needed to continue improving her anchoring skills. This evaluation had been signed by Smith. (Caillouet, 1996, April 13)

Both Smith and Fuller had visited Audience Research and Development, a Dallas firm that evaluates and coaches broadcast journalists. According to Robinson, while Fuller had received high marks from the Dallas firm, Smith's evaluation ". . . centered on the inflection in her voice, her delivery of the news, the way she ad-libbed, pitched a story to a reporter or got it back from the reporter. It said that she appeared to struggle at times." (Caillouet, 1996, April 13)

The trial revealed that Fuller's salary was $77,500 a year plus a $4,000 annual clothing allowance, a $1,500 annual hair allowance and a $1,176 annual health club membership. (Caillouet, 1996, April 13) At that time, she anchored 15 newscasts a week. Smith's annual salary was about $30,000 for anchoring four weekend newscasts and working as a reporter another three days a week. (Caillouet, 1996, April 18)

Near the end of the trial, video tapes were played of both Smith's and Fuller's on-air performances in August of 1994. Robinson asked Dale Nicholson to evaluate those performances. "I felt Ms. Smith's delivery was wooden. I didn't feel like she was as comfortable. And she didn't have consistency in her pace and her voice was sing-song," Nicholson replied.

However, Nicholson thought Fuller had "terrific eye contact, read with an extremely good pace and put emphasis on the words that get your attention. She is very confident in herself."

John Walker, an attorney for Smith, countered that if Fuller were better than Smith, it was due to Fuller receiving advantages Smith did not receive, such as greater hair and clothing allowances and a larger crew with which to work. "If you give one person fewer tools to work with than another, who will succeed?" Walker asked Nicholson.

Nicholson's response: "The one who has the most abilities." (Caillouet, 1996, April 18)

## THE DISPOSITION

After hearing testimony for three days, the jury started deliberations at 4:30 p.m. on Tuesday, April 16, 1996. They were sent home at 9:00 p.m. after failing to reach a verdict. The next day the jurors continued deliberations until just before 5:00 p.m. when the jury foreman sent a note to U.S. Magistrate Judge Jerry W. Cavaneau, who was sitting in for Chief U.S. District Judge Stephen M. Reasoner. The note said, "We are deadlocked--exclamation point." (Caillouet, 1996, April 18) Although eight of the twelve jurors sided with Pamela Smith, a unanimous verdict was required. Judge Cavaneau declared a mistrial.

On Thursday, April 18, KATV's attorneys asked Judge Reasoner to rule on the case himself rather than go through the time and expense of another trial. Judge Reasoner denied Robinson's request and ruled that a second jury trial would be held. (Caillouet, 1996, April 27)

The second trial was to begin on Monday, July 14, 1997. On Thursday, July 10, John W. Walker, an attorney for Smith, confirmed that her federal discrimination lawsuit with KATV had been settled. In his statement Walker said, "It has been resolved. The terms are private and between the parties." (Newscaster in LR settles bias lawsuit, 1997, July 11)

## CURRENT STATE OF AFFAIRS

Pamela Smith continues to work at KATV as weekend anchor and weekday general assignment reporter. Karen Fuller also remains in her position as news anchor for the weekday newscasts. KATV Channel 7's news programs are still rated Number 1 of the three television stations in Little Rock.

## THE FUTURE

The out-of-court settlement has reduced or eliminated much of the publicity that the case generated from the time the suit was filed until it was settled, and the station weathered the negative publicity to retain its standing. But the question that remains in the minds of some viewers is, "Did KATV discriminate against one of its employees on the basis of race?"

The visibility of the primary players serves as a reminder of Pamela Smith vs KATV. A current concern in the station's human resource department might well be the development of a strategy for the purpose not only of avoiding discrimination charges in the future but also of allaying any concerns viewers might have about the motives and intentions of KATV.

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# ZULU BUILDING SOCIETY, LTD.

**D.K. (Skip) Smith, Southeast Missouri State University**

## CASE DESCRIPTION

*South Africa, the creation and evaluation of corporate mission/vision statements, the financial services context: these are the issues and settings. The case may be of special interest for professors wishing to expose students to strategic issues in a developing world (especially South African) setting. The case does not involve sophisticated quantitative or qualitative analysis. It does assume a familiarity and/or access to fundamental strategic management concepts and models. For that reason, the case is appropriate for and has a difficulty level of 4 (seniors) and higher. The case is designed to be taught in one class session of approximately one hour and fifteen minutes, and is likely to require two hours of preparation time from students.*

## CASE SYNOPSIS

*John Gosmos, Manager of Planning, has been charged by senior management of Zulu Building Society, Ltd. to develop a mission/vision statement for the organization's new corporate banking division. The case provides the information Gosmos has to work with (history of the company, characteristics of the market area, various managerial pre-dispositions and biases, current product and service mix, etc.) and then asks students to take up Gosmos' challenge: to develop the draft mission/vision statement which Gosmos must present to his senior managers.*

## THE CHALLENGE

June 1987. John Gosmos, Planning Manager for Zulu Building Society Ltd. (hence, ZBS) did a last minute check on his materials before leaving his office for the brainstorming session with senior ZBS executives. The purpose of this meeting with his superiors was to review with them the draft mission/vision statement he had prepared for the new Corporate Division of ZBS, approved the week before by the ZBS Board of Directors.

## BUILDING SOCIETIES AND THE FINANCIAL SERVICES ENVIRONMENT IN SOUTH AFRICA

Building societies are institutions formed with the objective of helping their members build or buy houses. The first was Keightley Building Society of Birmingham, England, which was formed in 1775. These societies build their financial resources by collecting a weekly or monthly contribution from each member. A lottery or bidding process will then held, to see which member will be the first to be loaned the money to build or buy a house. Because members of these early building societies tended to be artisans or tradesmen, members often assisted in the building of the houses. Early societies were "terminating building societies," which means that after every founding member of the society had built or bought a house, the society would be terminated. Later, however, after the objectives of building societies expanded to include savings and other financial services not related directly to houses, building societies became permanent and did not terminate when all founding members had acquired houses.

The building society movement in South Africa began in Durban in 1856. The Durban Building and Investment Society was formed in August of that year. Over the next year, several additional building societies were formed in Durban. In 1858, Natal's Legislative Council passed a law (Law 12) based on British practice to regulate the activities and conduct of building societies in the province. In 1934, a law governing both the building societies in Natal Province and 75 other building societies elsewhere in the Union of South Africa (the Building Societies Act) was passed. The primary impact of these laws was to restrict the operations of building societies to the financing of residences for individuals.

## THE COMPANY

Zulu Building Society (hence, ZBS) was founded in Durban, South Africa in 1880. The organizers were Allison James and Paul Williams. James had been secretary to the company constructing the Panama Canal, until he contracted yellow fever and was forced by health problems to leave Panama. Williams had grown up on a farm outside of Durban, and had started out in business owning and operating a shipping and commission business. Subsequently, Williams became a town councillor, Mayor of Durban, and then a member of the Natal Legislative Council. Williams was also engaged in public accountancy and in the provision of home and personal insurance.

The founders of ZBS set three objectives for ZBS: (1) to provide a simple and convenient way for members to save; (2) to enable borrowing members to purchase or build their own homes; and (3) to provide saving members with a way to earn interest and/or dividends on their savings. By the end of the first year, initial installments of funds had been collected and fifteen loans to enable members to build or purchase houses had been granted. Over the next several years, the society experienced ups and downs, as indicated below:

1. When gold was discovered near Johannesburg in 1886, several ZBS members quit Durban (and their obligations to ZBS) to seek their fortunes in mining.
2. At the turn of the century, the society suffered from the Boer War, because ZBS members fled their homes and obligations when Boer commandoes invaded Natal from the Johannesburg area.
3. By the decade of 1910, the society had achieved such success that contributions from members had to be limited because the amount of funds offered exceeded the cost of the ongoing projects approved by ZBS management.
4. After the First World War, demand for housing in Natal, and ZBS's efforts to provide that housing, increased enormously.
5. During the depression of the 1930s, many ZBS members were not able to meet their obligations to the society. Most were allowed to defer payments, and nearly all ultimately resumed payments and paid off their loans.

In the mid to late 1930s, with new enabling legislation plus the problems associated with the Great Depression behind it, ZBS began to broaden its scope of operations. After opening its first branch outside of Natal in Johannesburg in 1939, ZBS continued its geographical expansion across all of South Africa. In 1957, ZBS set up an all-Indian sub-branch in the center of Durban, to better serve Indian members of society. Around the same time, ZBS branch managers began making sales calls on executives of major companies, in hopes of generating substantial volumes of new customers for the ZBS product line which now included savings schemes not only for houses but also for cars, holidays (vacations), and other major expenditures made by individual consumers. The late 1950s also saw ZBS mounting its first nationwide advertising campaign.

ZBS continued to grow and evolve in the 1960s, when computers and cash machines were introduced. In the 1970s, the society began to partner-up with private investors, to develop entire housing estates, blocks of flats, and/or townships. Initially, these efforts involved developments targeted at whites only. By the late 1970s, however, ZBS had involved itself in township and estates development targeting colored and Indian consumers as well. In 1978, in Soweto, ZBS opened its first facility in a black township, even though the business of making housing loans to Black South Africans was complicated by the fact that Blacks were not allowed to hold title to land. In 1979, when Blacks were allowed to acquire 99 year land leases against which ZBS could file a mortgage, this problem was solved as well. Given the huge number of black South Africans, ZBS and other building societies seemed well-positioned, as they entered the 1980s, for a period of prolonged growth and profitability.

## THE CHANGING ENVIRONMENT BRINGS NEW CHALLENGES & OPPORTUNITIES

Even before the opportunity to provide mortgages for black South Africans opened up, many of the building societies in South Africa had over the years experienced considerable success. Thus, it was no surprise that in the 1980s, when the very large local commercial banks began looking for additional opportunities in South Africa, they attacked the lucrative residential market. By the mid-1980s, all the large commercial banks including Amalgamated Banks of South Africa, Standard Bank, 1st National Bank, and the Nedcor Group were vigorously pursuing residential mortgage opportunities.

Unfortunately for ZBS and other building societies in South Africa, while the government was willing to allow commercial banks to offer mortgage products and services competing directly with the mortgage-related financial services offered to individuals by ZBS, it was not at first willing to change the Building Society Act of 1934. That act restricted building societies to the offering of home purchase and/or construction and/or related loans for individuals. For these reasons, and in this situation, both the revenues and profits of building societies in South Africa declined dramatically in the mid-1980s.

Early in 1987, the Government of the Republic of South Africa finally revised the Building Society Act of 1934. Suddenly, building societies were allowed to apply for banking licenses allowing them to offer a full range of financial services not only to individuals but to corporations and institutions as well. June of that same year, Zulu Building Society applied to change its name to ZBS Bank, Ltd. While the change has not yet been approved, no problems are anticipated. In any case, the rules had changed so rapidly that ZBS really hadn't yet had time to sort out how it would take advantage of the new opportunities now available to it.

While ZBS branches now covered the country, a substantial portion of the bank's business as well as corporate headquarters continued to be in Durban. Based on past experience, Gosmos expected that a good way to win support from the bank's directors for his suggestion would be to come up with a mission/vision statement which would be particularly appropriate to the local situation. For this reason, Gosmos conducted an intensive review of Durban's industrial base, so as to remind himself one of the business and commercial characteristics of the local economy. As source documents for this study, Gosmos used two documents prepared by the Durban Regional Chamber of Business: "Catalogue of Manufacturers and Exporters," and "Trade and Services Directory." Tables 1 and 2 summarize the information in those reports.

As he considered the attached data, Gosmos knew he would have to keep in mind certain other characteristics of the Durban area not yet captured by his analysis, together with characteristics of ZBS bank and the attitudes of its management team. Considerations which appeared especially relevant to him included the following:

1. Durban is the most active harbor in all of Africa. There is a huge amount of transportation activity and equipment (port equipment, trucks, etc.) in the Durban area.
2. Given the huge volume of harbor and port activity, one might suspect that providing import/export finance to this group would be high on the list of potential services which ZBS might offer. Because of its status as the largest port in Africa, however, the extremely specialized business of import/export finance is a specialized area which, at least in Durban, is already served extremely well by existing banks.

For this reason, Gosmos thought it unlikely that ZBS senior management would support a mission/vision statement which focused on international trade financing.

3. Construction lending is a very risky business, requiring intense day-by-day monitoring of job sites by the financial institutions providing the financing. Gosmos knew that while senior bank management were very interested in providing mortgage financing for industrial and commercial projects which had been completed (the mortgage loan pays off the lender who has provided the funds to construct the project), they were not interested at this time in entering the construction lending market. Thus, Gosmos also thought it unlikely that ZBS senior management would be interested in targeting working capital lines of credit to construction companies and contractors.
4. Sugar cane production is an activity which is very unique and very important to the Durban area. Small numbers of very large vertically integrated plantations are involved in this activity. This activity is also important because three members of the ZBS Board of Directors own and operate huge sugar plantations. In any case, large sugar cane producers require lots of machinery, including equipment for preparing, planting, tending, and harvesting the fields; trucks and other transportation equipment; and sugar cane processing equipment.

PRODUCT/SERVICE OPTIONS AND RELATED CONSIDERATIONS

As he considered specific products and services which ZBS Corporate might wish to highlight in its mission/vision, statement, Gosmos identified the following possibilities:

1. Accounts. Like individuals, corporations use a variety of demand deposits (that is, checking) and time (savings) accounts. Positives for ZBS of offering these sorts of products and services include the fact that since every organization has multiple accounts, the market potential is very large. Negatives include the fact that ZBS has no special skills or competitive advantage in this area. In fact, relative to other providers of such services, ZBS is disadvantaged by the fact that it has relatively few branches and thus relatively few locations where customers needing these services could come.
2. Corporate finance. Many corporate activities require some sort of finance. For example, when a corporation needs a new machine or a new truck or some other piece of new equipment, that equipment will typically be acquired using funds borrowed from a financial institution. Alternative approaches used by corporations to acquire equipment in South Africa include those listed in Exhibit 1. Positive aspects of this opportunity from ZBS' point of view include the fact that there is lots of this business available and it is quite profitable. Negatives include the fact that, at the moment, ZBS has very few staff who are knowledgeable in this area.
3. Professionals and other high net worth individuals. Like corporations, it is not unusual for these individuals to have needs for various sorts of expensive equipment (for example, dental equipment including chairs, x-ray plus drilling equipment, and so on). Positive aspects of this opportunity from ZBS' point of view include the fact that ZBS already knows many of the people in this market, having worked with them in the past to finance homes, vehicles, etc. Negatives include the fact that the number of people in this target market may be relatively small, and the amount of business ZBS could reasonably expect to generate in the short run might be small as well.
4. Trust facilities. Like wealthy individuals, many organizations own securities of various sorts. One example of such a security and the reason for holding it would be purchase by an organization of short-term certificates of deposit, so as to earn interest on monies it will be holding for a relatively short period of time. Another example would be purchase of stocks and bonds as an investment by a employee retirement fund. As in the case of accounts, one advantage of this service area is that nearly every organization is engaged in these sorts of activity, so market potential is high. The offsetting disadvantage is that ZBS has no special skills in this area.
5. Working Capital facilities. Like individuals, corporations and institutions have day-to-day needs for cash. Because the amount of cash available on a particular day may not be sufficient to meet cash demands, corporations typically arrange large short-term lines of credit available from banks to cover day-to-day shortfalls. Loans under these working capital facilities are often unsecured. In the case of companies which are less credit-worthy and/or involve high levels of risk, however, the companies providing

the working capital loans may require the corporation to pledge accounts receivable and/or inventory as collateral for the working capital facility. Companies which secure their working capital loans by filing a security interest in accounts receivable are known as factors.

As he mulled over the product/service alternatives and the characteristics of his service area, Gosmos made a few additional mental notes to himself:

1. Table 2 indicates that six factoring firms are already well established in the Durban market. This suggests that the area of secured working capital loans is already well served, and that it may be difficult for ZBS to offer superior value to its customers in this product/service area.
2. Several of the big banks already have bricks and mortar (that is, offices) throughout the city of Durban and the province of Natal. ZBS has a small number of offices in a small number of locations. The implication is that it may be difficult for ZBS to offer superior value to large numbers of relatively small and relatively dispersed business customers. Gosmos' assumption is that identifying target markets characterized by relatively small numbers of relatively large and geographically-concentrated customers is likely to be a more effective and efficient approach for ZBS.

## YOUR ASSIGNMENT

Assume you are John Gosmos. Show the draft mission/vision statement you have prepared for the new corporate division, and indicate the supporting arguments you will use when presenting it to senior executives.

TABLE 1
DURBAN AREA MANUFACTURERS AND EXPORTERS

| | |
|---|---|
| Basic Metals | 199 |
| Chemicals | 77 |
| Clothing | 106 |
| Electronics | 33 |
| Food & Beverages | 59 |
| Footwear | 43 |
| Furniture | 62 |
| Haircare Products | 1 |
| Hardware | 3 |
| Household | 28 |
| Investment | 1 |
| Medical | 3 |

TABLE 1
DURBAN AREA MANUFACTURERS AND EXPORTERS

| | | |
|---|---|---|
| Other | | |
| | Agricultural | 3 |
| | Automotive | 51 |
| | Boats & Yachts | 10 |
| | Building Products | 44 |
| | General | 9 |
| | Industrial Products | 3 |
| | Machinery & Equip | 13 |
| | Paper & Paper Prod | 9 |
| | Pharmaceutical&Vet | 9 |
| | Screenprinting | 4 |
| | Packaging | 46 |
| | Plastics | 41 |
| | Rubber | 4 |
| | Sporting & Toys | 16 |
| | Stationary/Gifts | 10 |
| | Textiles | 32 |

TABLE 2
DURBAN AREA TRADES AND SERVICES

| | |
|---|---|
| Accommodation/Retirement Establishments | 21 |
| Accountants & Auditors | 164 |
| Advertising Agents | 48 |
| Advertising Signs | 10 |
| Aerial Crop Sprayers | 1 |
| Aerial Surveys | 4 |
| Agricultural Contractors | 5 |
| Agricultural Machinery | 23 |
| Air Filtration | 2 |
| Air Cargo Agents | 15 |
| Air Brake Equipment | 8 |
| Air Conditioning Distributors/Engineers | 40 |
| Airways | 5 |
| Aluminum Products | 23 |
| Animal Breeding Consultant | 3 |
| Architects | 44 |
| Armature Winding f/electric motors | 6 |
| Asphalt & Bituminus | 4 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Audio & Video Tapes | 2 |
| Authors | 6 |
| Auto Electric Repair | 26 |
| Automotive Accessories | 15 |
| Auto/Industrial Friction Materials | 2 |
| Automated Electric Door Control | 1 |
| Automotive Engineering | 21 |
| Auto Spares (that is, spare parts) | 51 |
| Bakers Equipment | 4 |
| Banks | 19 |
| Barcoding Access Control | 1 |
| Bearings | 8 |
| Biochemical Consultants/Analysts | 1 |
| Blasting | 4 |
| Board Merchants | 1 |
| Boilers & Heating Equipment | 23 |
| Brake & Clutch | 18 |
| Brick & Tile | 10 |
| Brokers & Agents | 142 |
| Building Demolishers | 2 |
| Building, Hardware, & Material Wholesalers | 42 |
| Building Refurbishment | 15 |
| Bulk Liquids | 3 |
| Butchers Supplies | 4 |
| Buying/Selling Agencies | 8 |
| Cane (Sugar) Transport | 3 |
| Car Cleaning Services | 11 |
| Car Airconditioning Sales & Service | 4 |
| Cargo Repairs & Recovery | 8 |
| Carpet & Upholstery Cleaning | 7 |
| Carpet & soft Furnishing | 4 |
| Cartage (moving) Contractors | 44 |
| Caterers | 21 |
| Catering Hotel Equipment | 16 |
| Ceramic Tile Merchants | 4 |
| China/Ceramic Wholesalers | 3 |
| Cigarette Wholesalers | 5 |
| Cleaning Materials | 1 |
| Clearing/Forwarding Agents | 59 |
| Clothing & Soft Goods Agents | 27 |
| Clothing Machinery | 2 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Clothing & Soft Goods Wholesalers | 42 |
| Coal Merchants | 1 |
| Commercial/Industrial Cleaning Services | 2 |
| Commercial Vehicle Body Builders | 10 |
| Commission, Financial, & General Agents | 38 |
| Communications Design | 2 |
| Computer Services | 136 |
| Concrete & Cement Products | 18 |
| Conference Organizations | 1 |
| Construction Companies & Building Contractors | 239 |
| Construction & Project Management | 29 |
| Container Sales & Rentals | 6 |
| Control Instruments | 34 |
| Cosmetics, Perfumery, & Toiletries | 13 |
| Credit Information | 6 |
| Customs Consultants | 2 |
| Customs Auditors | 6 |
| Cycle Wholesalers | 2 |
| Dairies & Dairy Products | 5 |
| Damaged Goods Traders | 1 |
| Debt Collectors | 1 |
| Design & Drawing Services | 49 |
| Detectives | 5 |
| Development of Small Businesses | 6 |
| Diesel Repairs | 38 |
| Direct Mail | 5 |
| Display Supplies | 3 |
| Distribute/Install Car Monitor Systems | 1 |
| Divers | 3 |
| Domestic Hardware Reps & Wholesalers | 6 |
| Drilling Contractors | 3 |
| Earthmoving Contractors | 31 |
| Electrical Appliances Wholesalers | 25 |
| Electrical Contractors | 101 |
| Electrical Equipment | 70 |
| Electrical Powerline Equipment & Parts | 1 |
| Electrical Switchgear & Electrical Industrial Supplies | 23 |
| Electronic Components | 12 |
| Electronic Design & Manufacture | 1 |
| Electronic Equipment | 17 |
| Electronic Repair | 44 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Electroplating | 8 |
| Development Agencies | 33 |
| Engineering Supplies | 73 |
| Engineers-Consulting | 87 |
| Engineers-Structural | 42 |
| Environmental Consultants | 1 |
| Factoring | 6 |
| Factory Agents | 10 |
| Fancy Goods & Novelties Wholesalers | 20 |
| Farmer Supplies | 4 |
| Fastener Distribution | 6 |
| Filtration | 3 |
| Finance Companies | 27 |
| Financial Management Services | 39 |
| Fire Equipment | 2 |
| Fire Protection Equipment | 6 |
| Foodstuff & Confectionary Wholesalers | 16 |
| Food Packaging | 4 |
| Footwear Manufacturing Equipment | 5 |
| Footwear Wholesalers | 17 |
| Fork Lift Trucks | 5 |
| Frozen Food Wholesalers | 11 |
| Fumigators | 4 |
| Furniture Agents | 3 |
| Furniture Removal & Storage | 11 |
| Garden Services | 10 |
| Garment Exporters | 3 |
| Gas & Oil Equipment | 14 |
| General Dealers Wholesale | 32 |
| Gift/Glassware Engravers | 1 |
| Haberdashery Wholesalers | 4 |
| Hairdressing Suppliers | 2 |
| Handling Equipment | 10 |
| Hardware Merchants | 32 |
| Health/Stress Management Services | 1 |
| Heavy Vehicle Rebuilding | 13 |
| High Pressure Water Contractor | 1 |
| Hot Dipped Galvanizing | 1 |
| Hotels | 51 |
| Hydraulic Equipment | 27 |
| Import/Export Agents | 248 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Income Tax Consultants | 36 |
| Indent Merchants/Agents | 33 |
| Industrial Cleaning Equipment | 8 |
| Industrial Embroidery | 1 |
| Industrial Equipment | 7 |
| Industrial Linings | 11 |
| Industrial Spray Painters | 1 |
| Industrial Construction | 13 |
| Inspection & Calibration | 3 |
| Industrial Radiators & Tanks | 3 |
| Installations & Repairs | 20 |
| Insurance Assessors | 16 |
| Insurance Brokers/Agents | 119 |
| Insurance Companies | 18 |
| Interior/Exterior Decoration | 40 |
| Jewelry Wholesalers | 15 |
| Joiners | 14 |
| Kitchen Manufacturers | 9 |
| Labelling Equipment | 3 |
| Laminating Machines | 1 |
| Landscape Gardening | 15 |
| Land & Quantity Surveyors | 42 |
| Land Surveying Equipment | 1 |
| Laundry Equipment | 4 |
| Lawyers | 102 |
| Library Products & Furniture | 2 |
| Lifting Equipment | 6 |
| Lighting Protection | 2 |
| Lithographers | 67 |
| Livestock Agents & Engineers | 2 |
| Locksmiths | 3 |
| Machine Tools | 14 |
| Machinery | 25 |
| Machinery Maintenance & Repair | 23 |
| Maintenance Services | 12 |
| Maintenance Welding | 1 |
| Management Consultants | 76 |
| Manufacture & Fit Stainless Steel Exhausts | 5 |
| Manufacturing Representatives | 144 |
| Marble & Granite Products | 1 |
| Marine Engineering | 19 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Marine Engines & Outboards | 11 |
| Mechanical Engineering | 29 |
| Market Agents | 14 |
| Market Research | 7 |
| Meat Traders Wholesale | 6 |
| Millers | 4 |
| Mining, Machinery, & Equipment | 7 |
| Molasses | 2 |
| Monumental Masons | 1 |
| Motor Car Service/Repairs | 89 |
| Motorcycle & Scooter Dealers | 10 |
| Newspaper Publishers | 7 |
| Office & Factory Cleaners | 12 |
| Office Equipment & Supplies | 13 |
| Overseas Buyers | 13 |
| Painters/Decorators | 12 |
| Panelbeating | 36 |
| Paper Cutting/Winding | 1 |
| Paper Distributors | 8 |
| Paving Contractors | 3 |
| Pest Control Services | 12 |
| Pharmaceutical Distributors/Wholesalers | 18 |
| Photo & Cinema Distributors & Importers | 4 |
| Piling Contractors | 2 |
| Plastic Machinery Suppliers | 4 |
| Plastic Distributors | 13 |
| Pneumatic Equipment | 12 |
| Polyurethane Products | 1 |
| Postal/Delivery/Courier Services | 2 |
| Poultry Distribution | 3 |
| Power Protection Specialists | 5 |
| Press Cutting Agencies | 1 |
| Printers Supply | 7 |
| Printers | 6 |
| Produce Merchants | 9 |
| Professional Artists | 3 |
| Promotional Literature | 4 |
| Property Investment/Development | 126 |
| Property Marketing & Development | 33 |
| Protective Clothing | 4 |
| Psychologists/Psychiatrist | 3 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Public Relations | 17 |
| Publishers & News Agents | 28 |
| Pumps | 29 |
| Rail Sidings | 2 |
| Rapid Paging | 2 |
| Recording & Transcription Services | 8 |
| Refrigeration | 46 |
| Rice Milling | 1 |
| Roofing | 27 |
| Rubber Goods | 9 |
| Rustproofing | 5 |
| Sales Promotions | 14 |
| Sales/Service Tachograph Equipment | 3 |
| Sand Merchants | 4 |
| Sanitaryware (Toilets & Fixtures) | 8 |
| Saw Sharpening | 1 |
| Scientific Equipment | 1 |
| Seating (Heavy Vehicles) | 1 |
| Secretarial/Bookkeeping/Accounting Services | 60 |
| Security Services | 53 |
| Ship Chandlers | 8 |
| Shipowners/Agents | 27 |
| Shipping, Customs Clearing, Forwarding | 32 |
| Shipping Insurance | 1 |
| Shipwrights/Ship & Cargo Representatives | 4 |
| Shock Absorbers & Exhausts | 7 |
| Shopfitters | 25 |
| Shopping Centers | 2 |
| Signwriting | 8 |
| Silk Screen Litho Print | 9 |
| Solar Instrumentation | 1 |
| Sports Goods Representatives | 10 |
| Stationary Wholesalers & Agencies | 8 |
| Steel Importers | 2 |
| Steel Merchants | 26 |
| Steel Shelving, Windows, & Doors | 7 |
| Stevedores | 5 |
| Stockbrokers | 3 |
| Stock Feed Manufacture | 3 |
| Storage/Management of Archives | 1 |
| Storage Tanks & Containers | 3 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Sugar Growers/Millers/Refiners | 7 |
| Swimming Pool Contractors | 10 |
| Tea and Coffee Importers/Exporters | 2 |
| Technical Consultants | 24 |
| Telephone Equipment | 15 |
| Temperature Measurement | 1 |
| Textile Distribution/Agents | 49 |
| Textile Machinery | 18 |
| Textile Printing | 8 |
| Textile Suppliers | 1 |
| Textile Weaving | 1 |
| Thatching Contractors | 2 |
| Threadmakers Distribution | 1 |
| Timber Growers & Millers | 2 |
| Timber Importers | 5 |
| Timber Merchants | 18 |
| Time Control Equipment | 2 |
| Tools | 14 |
| Tool Wholesalers | 13 |
| Tourism Developers/Operators | 5 |
| Town Planners | 6 |
| Toy & Hobby Wholesalers & Reps | 4 |
| Trade/Commerce/Research Associations | 25 |
| Training | 67 |
| Transportation Consultants | 8 |
| Transport Operators | 62 |
| Transport Operators-Passenger | 12 |
| Travel Agents | 9 |
| Trophies/Engraving | 4 |
| Truckers Parking/Rest | 1 |
| Truck Parts | 13 |
| Trust Companies | 8 |
| Tyre Wholesalers | 5 |
| Umbrella Reps | 1 |
| Used Cars | 17 |
| Valuers (Appraisers) | 16 |
| Vehicle Testing Centers | 1 |
| Venetian Blind Distributors | 4 |
| Wall Coatings | 3 |
| Warehousing | 8 |
| Waste Paper Recovery | 3 |

DURBAN AREA TRADES AND SERVICES (cont.)

| | |
|---|---|
| Water Purification Units | 1 |
| Waterproofing | 17 |
| Wattle Bark Growers | 2 |
| Welding | 2 |
| Wheel Alignment | 9 |
| Wholesale Merchants | 42 |
| Windscreen Replacements | 4 |
| Wine/Spirit/Beer Distributors | 6 |
| Wool Broking and Buying | 1 |
| Wool Merchants & Exporters | 4 |

EXHIBIT 1
CORPORATE FINANCE-RELATED OPPORTUNITIES

| | RENTAL | LEASE | FULL MAINTENANCE LEASE | INSTALLMENT SALE | SECURED TERM LOANS | CASH PURCHASE | PROPERTY | PART BONDS |
|---|---|---|---|---|---|---|---|---|
| Capital outlay payment terms | Monthly, quarterly, bi-annual or annual payments. Rentals can also be specially structured to suit user's requirements | Monthly, quarterly, bi-annual or annual payments. These payments can also be specially structured to suit user's requirements. | Monthly | Monthly, quarterly, bi-annual or annual payments. These payments can also be specially structured to suit user's requirements. | Terms of repayment are negotiated. These payments can also be specially structured to suit user's requirements. | Up to 100% | Monthly, quarterly, bi-annual or annual payments. These payments can also be specially structured to suit user's requirements. | Quarterly in advance. |
| VAT | Payable on each rental | Included in contract | VAT payable on each rental | Included in contract | N/A | N/A | Discuss the implications of VAT with your NBS Corporate Financial Consultant | Discuss the implications of VAT with your NBS Corporate Financial Consultant |
| Keeping up-to-date with new technology<br>- Upgrade by addition | New contract will have to be entered into | New contract will have to be entered into | New contract will have to be entered into | New contract will have to be entered into | New negotiation | Up to 100% | N/A | N/A |
| - Upgrade by replacement | Existing agreement has to be settled and new agreement entered into for the new asset. Will not refinance any asset retained | Existing agreement has to be settled and new agreement entered into for the new asset. Will not refinance any asset retained | Not permissible. Only in cases of loss or accident write off. Contracts up to 5 years or maximum kilometers | Existing agreement has to be settled and new agreement entered into for the new asset. Will not refinance any asset retained | New negotiation | N/A | N/A | N/A |
| - Shortfall between book value of equipment which has been traded in and value received as trade-in | Included in rental. Can however, be taken out by paying a corresponding balloon payment | Write off | N/A | Write off | Write off | Write off | N/A | N/A |
| Ownership | Owned by Rentor | Owned by Lessor | Owned by Rentor | Secured by the credit grantor, until final installment is paid. | Owned by User | Owned by User | Owned by mortgagor, bonded to mortgagee | Owned by mortgagor, bonded to mortgagee |
| Termination alternatives | End of rental options | End of lease options | End of rental options | N/A | N/A | N/A | N/A | N/A |
| Cancellation of contract | Hirer may cancel by settlement | Leasee can settle | Hirer can settle | User can settle | Subject to terms of loan | N/A | Repayment of debt | Not within first 5 years / negotiable |

EXHIBIT 1
CORPORATE FINANCE-RELATED OPPORTUNITIES

| | RENTAL | LEASE | FULL MAINTENANCE LEASE | INSTALLMENT SALE | SECURED TERM LOANS | CASH PURCHASE | PROPERTY | PART BONDS |
|---|---|---|---|---|---|---|---|---|
| Tax recoupment on termination | Applicable if user obtains ownership on termination. Also applicable if goods are sold | Applicable if user obtains ownership on termination. Also applicable if goods are sold | N/A | Tax is payable on the profit on sale of the fixed asset | Tax is payable on the profit on sale of the fixed asset | Tax is payable on the profit on sale of the fixed asset | N/A | N/A |
| Taxation | 100% of rentals paid are tax deductible | 100% of lease payments paid are tax deductible | 100% of rental payments are tax deductible. VAT credit on Maintenance portion | Wear and tear allowances claimed by user plus interest | Wear and tear allowances claimed by user plus interest | Wear and tear allowances claimed by user plus interest | Interest portion tax deductible 2%Allowance p.a. deductible | Interest portion tax deductible 2%Allowance p.a. deductible |
| Effect on balance sheet | None at all | The liability is mentioned in the notes to the accounts | Totally "off Balance Sheet" | Asset must be capitalized and the liability reflected in balance sheet | Loan is reflected in balance sheet. Asset must be capitalized which increases gearing and utilizes available credit facilities | Asset must be capitalized which reduces liquidity | Shown as fixed asset in B/S liability shown as well | Shown as fixed asset in B/S liability shown as well |
| Existing lines of credit | Utilizes any further credit line facilities | Utilizes any further credit line facilities | Utilizes any further credit line facilities | Utilizes any further credit line facilities | Utilizes any further credit line facilities | Not utilized | Utilizes any further credit line facilities | Utilizes any further credit line facilities |
| Interest rates | MARKET RATES APPLIED | | | | | Nil, but opportunity of investing funds elsewhere or of recalling the funds is foregone | MARKET RATES APPLIED | |

# BABYLOVE BRAND BABY PRODUCTS

**D.K. (Skip) Smith, Southeast Missouri State University**

## CASE DESCRIPTION

*Finding growth opportunities in a shrinking developing world economy (Nigeria), evaluation and management of customer value, creation of promotional campaigns, the critical importance not only of strategy but also of execution: these are the issues and settings. Unlike cases featuring clever heros or heroines converting pigs' ears to success stories, this very comprehensive case demonstrates how a firm offering good customer value into a growth market can be destroyed by its inability to implement. The case does not involve sophisticated qualitative analysis, but does require calculation and comparisons in two areas:*

1. *Customer value scores for competing products.*
2. *The planning of and budgeting for promotional campaigns, in a developing world setting.*

*Given the above characteristics and requirements, the case is most appropriate for (and has a difficulty level of) 4 (seniors) and higher. The case is designed to be taught in one class section of approximately one hour fifteen minutes, and is likely to require at least two hours of preparation time from students.*

## CASE SYNOPSIS

*Mrs. S.A. Omoshule is Group Product Manager in the division of the Nigerian subsidiary of a multinational company which is contemplating the re-launching of a line of baby care products in Nigeria. While the re-launch will be expensive (ten million naira) and the Nigerian economy is very troubled (over the last thirty years, GDP has fallen from $1000/capita to less than $300/capita, students are reminded that the baby market is one of the few growth markets left in Nigeria. Comparative data indicate that while Babylove's products are not perceived as offering especially good value, these low scores are largely due to controllable factors such as a lack of distribution and a lack of awareness. The case provides considerable data on media options in Nigeria and the costs of those alternatives, and invites students to propose a promotional campaign targeting the issue of increasing awareness in major markets around the country while at the same time staying within budget. The epilogue provides information on the actual solution implemented and the reasons that this well-planned and initially well-executed effort failed.*

## THE CHALLENGE

Mrs. S.A. Omoshule, Group Product Manager for the PRET Division of Auriel Nigeria, Ltd., locked herself into her office and began organizing her request to the Board of Directors for the maximum promotional budget allowable under current corporate guidelines (approximately 10 million naira). Her plan was to use these funds to re-launch her "Babylove Brand Baby Products" line. Mrs.

Omoshule knew that the details of the proposed re-launch, including the copy strategy (that is, target consumers, benefits promoted, reasons for buying, character of the brand, and focus of sale), plus executional details (including timing and expense of the various initiatives she expected to make on behalf of the brand) would be closely scrutinized. Also, Mrs. Omoshule knew that the Directors would be very interested in hearing arguments explaining why it made sense to invest large sums of money to re-launch a consumer product line in an environment as problematic (both politically and economically) as Nigeria's.

## THE COMPANY

Auriel Nigeria, Ltd. (hence, ANL) was incorporated as Auriel Limited in 1959. ANL is the successor company to Auriel Plc (Manchester), which has been doing business in Nigeria since 1890. The company adopted its present name in 1990, in response to the Companies and Allied Matters decree of 1990.

Forty percent of ANL's equity is held by Auriel Group (Manchester) Limited, a subsidiary of MNC Plc. Because the remaining shares are held by more than 50,000 Nigerians, however, Auriel Group Ltd. is the largest single shareholder and thus enjoys considerable control over the management of the company.

ANL's widely diversified businesses are divided into five strategic business units. In several of the businesses in these units, ANL companies are the market leaders in Nigeria. ANL business units and their activities are as indicated below:

Marine Group: manufactures fiberglass boats and markets a well-known brand of outboard motors. Holds more than 50% of the boat and outboard engine market in Nigeria.

Leasing Group: leases motor vehicles, electronics (including air conditioners), and boats and outboard engines. The group is one of the largest lessors in Nigeria.

Auriel Limited Investments: holds investment in property plus investments in other businesses and subsidiaries including PRET.

Technical Group: assembly, marketing, and support for well-known brands of petrol-powered products in Nigeria including motorcycles and mopeds, generators, and heavy-duty gen sets. Also, manufactures plastic crates and crown caps for the Nigerian beer and soft drink industries, and provides sales and service for motor vehicles.

Trading and Services Group: One of the largest distributors of pharmaceuticals in Nigeria (includes pharmaceuticals produced locally plus those sourced from overseas); sea- and air-freighting, including clearing, warehousing, and forwarding of goods; and the manufacturing, distribution, and sales of ploughs and other farming equipment. This group is also involved in the manufacturing, distribution, and sales of personal care products, fragrances, and the Babylove Brand line of baby care products. PRET is one of the firms and businesses in this group.

Revenues, profits, and other quantitative and qualitative assessments of ANL's presence in Nigeria are presented in Exhibit 1. As indicated, with revenues exceeding three billion naira, nearly 3000 employees, and market leadership positions in several businesses, ANL is a major player in the Nigerian economy.

## THE PRET DIVISION: PRODUCTS AND PERFORMANCE

As indicated above, PRET and its Babylove Baby Products line are part of ANL's Trade and Services Group. PRET's product line includes several personal care products, including the following:

Texide: A scented and colored petroleum jelly used in Northern Nigeria and neighboring countries on skin and hair.

Mobilene: Petroleum jelly to be applied to the skin. This product is known by U.S. readers as vaseline.

Shelene: A hot balm for colds (applied to the chest). A "cure-all" product.

Promea: A skin creme, manufactured under license.

Talc: talcum powder.

MFI: an Afro range of hair products, licensed from the U.S. At some point, PRET hopes to make the product in Nigeria. The manufacturer is not able to control export of the product from Europe, so substantial amounts of product from Europe enter Nigeria informally (illegally, through smuggling). This reduces the value of this franchise to PRET, because these parallel importers avoid import duty on products they bring into Nigeria and thus enjoy substantial cost advantages over products PRET imports legally.

Babylove Baby Products:

- baby lotion (a lightly-medicated cream)
- baby oil
- baby powder (talcum powder)
- nappy rash cream
- perfumed jelly (to keep baby's skin moist)

PRET's performance with these products over the last three years (turnover and profits), plus the number of tons of each of the products it sold each of those years, are as indicated in Exhibit 2. Elaborative comments on PRET's performance during these years are as indicated below:

1. The 17 million naira loss in 1991 was a function of several factors. First among them was a nearly total lack of planning by PRET management as regards the amounts of various stocks (raw materials and other inputs such as packaging, for US readers) needed at any point in time so that PRET would be able to supply its customers with the amount of PRET products wanted at the times customers want them. For example, while many of PRET's products were then and continue to be packed in glass jars, in 1991 PRET management had no ongoing relationship or regular position in the production schedule of the one company in Nigeria which manufactured glass packaging.

Because needed stocks were procured in random amounts at random times, in 1991 PRET manufactured products infrequently, and only when all needed inputs were actually available. This led to a total lack of continuity of supply and no ongoing relationship between PRET and its customers. In addition, because the high temperatures and humidity common in Nigeria led certain stocks (for U.S. readers, raw materials) to deteriorate fairly rapidly, this lack of planning led to large stock write-offs as well.

2. A second contributing factor to the large loss in 1991 was the total lack of control on expenses. For a time, expenses including daily fresh flowers for the office were running at 60% of turnover.
3. A third factor contributing to the 1991 loss was a lack of sales training and sales systems. While each of the 40 salespeople had a job description, a price discount structure, and the requirement that they file journey plans (sales plans and reports), the sales area lacked strong leadership.
4. A fourth contributor to the 1991 loss was PRET's pricing system. At that time, PRET based its selling prices on costs. Because PRET was an efficient processor of inputs, costs tended to be low. As a consequence, PRET's prices in the marketplace tended to be very low compared to the prices of competing products.
5. A fifth contributor to the 1991 loss were PRET's distribution policies. While many of PRET's products sold best in Northern Nigeria during the Harmattan season, almost all of PRET's finished goods inventory was held in the South, near the factory. Also, Northern buyers accounting for substantial cross border trade were compelled to come to Lagos if they wanted to negotiate with PRET over prices, terms, and/or conditions.
6. A sixth contributor to the 1991 loss was product proliferation. At this time, the PRET product assortment included 84 products. Having decided that turning the business around required focusing on strong brands (plus elimination of losers), PRET management conducted during 1992 an in-depth analysis of the strengths and weaknesses of most of these lines. Ultimately, the number of products was reduced to 16.

During the course of the 1991 post-mortem conducted by ANL's Board of Directors, most of the above issues were corrected. Intense training in stock planning was initiated, and initial steps were taken to construct ongoing relationships and commitments not only between PRET and its suppliers but also between PRET and its customers. Meanwhile, the managing director took control of expenses by requiring that all expenditures require his signature and by implementing a total ban on advertising until stock planning and other revisions to PRET's operating policies had been implemented. Intensive training for sales personnel was initiated, and a new national sales manager was hired. As one of his first actions, the new national sales manager reduced the number of salespeople from 40 to 15. Pricing was converted to a market-based (as opposed to cost based) system, which resulted in substantial price increases for all PRET products. In addition, a distribution planning manager was hired and given the mandate to review PRET's distribution policies and to set up a system which ensured that finished stocks (finished goods inventory) would be held at the times and areas where it was most likely to be needed.

As exhibit 2 indicates, the immediate results of the above steps were very positive. From its 17 million naira loss in 1991, PRET moved to a small profit in 1992. Unfortunately, however, and as indicated in Exhibit 2, PRET's 1992 profits turned to losses in 1993 and 1994 (12 million and six million naira, respectively).

The factors causing the losses in 1993 and 1994 were different. The 1993 loss of 12 million naira reflects and was caused by final resolution (stock charge-offs, etc.) of some of the problems from 1991 which now, finally, disappeared forever. However, PRET's six million naira loss in 1994 was caused primarily by external factors. The primary issues included:

1. Workers' general strikes (that is, lost production) and the shortage of petroleum products not only as raw materials and energy for PRET's factories but also as fuel for trucks shipping finished products from PRET's factory to customers. These strikes and petroleum shortages in 1994 reflect political turmoil associated with the second anniversary of the military government's refusal to allow the winner of the June 12 1993 Presidential elections (Chief Moshood Abiola) to assume the office of President. On that anniversary, Abiola unilaterally proclaimed himself President of Nigeria. When Nigeria's military government responded by throwing him in jail, most unionized workers in Nigeria including members of various petroleum and transportation unions went on strike. The ensuing shortages of fuels including diesel and petrol (gasoline) made it very difficult for workers wanting to work to get to their factories.
2. During this time, most manufacturers in Nigeria including PRET were hurt by shortages of raw materials and supplies plus an inability to ship finished products to their customers.
3. The CFA franc (the currency for francophone West Africa) was devalued by 50% during the later half of 1994. This devaluation was important because a considerable percentage of PRET's sales are purchased by traders near Nigeria's borders who re-sell these products in neighboring countries. The 50% devaluation had a very negative impact on this cross-border trade, and on PRET's revenues.

While the last four years had been difficult for PRET, reasons to be optimistic about PRET and particularly the Babylove Baby Products line did exist. PRET management had all seen a recent analysis conducted by Research International LTD. of London, indicating that Nigeria's population was expected to continue growing at 2.9% per year for the foreseeable future. Given its population of nearly 100 million people, and given the fact that 20% of babies born in Nigeria die before their fifth birthday, it is clear that the annual "new baby" market in Nigeria exceeds more than three million newborns per year. In short, while growth markets are difficult to find in Nigeria, "newborns" clearly is such a market.

## COMPETITORS

While having a growth market is an important plus, the magnitude of the business opportunity associated with that market is also impacted substantially by the quantity and character of competitors. As a first step toward a systematic analysis of Babylove's competitors, Mrs. Omoshule had early on conducted a SWOT analysis of PRET and of each of her major competitors. The results of this analysis are set forth in Exhibit 3. Primary findings from the analysis, together with additional elaborative comments, are as indicated below:

1. PEARS. This is the market leader in baby products in Nigeria, with about 70% of the market. The products are manufactured and marketed by a company called A. J. Seward (hence, AJS). While AJS had been a subsidiary of the United Africa Company of Nigeria (UAC-N), it became in 1994 an affiliate of Lever Brothers Nigeria, the huge (and over the years, very successful) Nigeria subsidiary of the British-Dutch multinational, Unilever. At the same time, Unilever restructured its involvements in Nigeria and dramatically reduced the scope of its Nigerian operations. This restructuring included Unilever's sale of its equity in United Africa Company of Nigeria, the holding company under which AJS had been operating.

Pears Baby Products line remained strong in 1994. However, Mrs. Omoshule's perception was that turmoil over UAC-N's restructuring and the shifting of the company and its line to Lever Brothers Nigeria had distracted AJS leadership and weakened their focus on the baby products market and the needs of that marketplace. Mrs. Omoshule's contention was that while AJS's leadership was distracted, share could be gained from them relatively easily and quickly. Specifically, her own observations plus the observations of PRET's salespersons over time led Mrs. Omoshule to believe that AJS's packaging is dated and vulnerable to shelf wear (labels easily scuffed, for example). In addition, as she had often told her team, Babylove Brand products (lotions, oils, powders, and creams) tested out as being at least as effective technically as any of the competing AJS products, even though same-sized Pears products were 50% more expensive.

2. VASELINE. This brand, with about 15% of the baby products market, is marketed in Nigeria by Lever Brothers Nigeria (LBN). As indicated above, AJS has now become part of Lever Brothers Nigeria. Thus, the LBN/AJS organization has 80-85% of the baby care market in Nigeria. Like PEARS, same-sized Vaseline products are priced approximately 50% higher than the "Babylove Brand" perfumed baby jelly manufactured and marketed by PRET.
3. Johnson & Johnson. In Nigeria, J&J is manufactured and marketed by a company called HCP. While the brand has good name recognition, HCP is not financially strong. For this reason, J&J products do not receive the high ongoing levels of promotional support needed to fully exploit the power of the international brand name and image.
4. Patterson Zechonis (PZ). This firm, a major trading company in Nigeria, imports a baby products line. The major weakness of the PZ line is that much of it is imported. Because the value of the naira is low, the cost of imported consumer packaged goods products like these is often more than twice as high as the price of products produced locally by PRET or by Nigeria competitors such as Lever Brothers Nigeria.

There is one other major source of baby care products in Nigeria besides PRET, Lever Brothers, and PZ. That source is the informal market, or cross-border trade. It consists of products smuggled into Nigeria by market ladies and others. These products are often purchased by Nigerians traveling overseas, and then brought by them back into Nigeria as "personal effects." Materials brought into Nigeria like this often pay little or no duty; when this happens, prestigious overseas brands can be priced quite reasonably.

The downside or risk for consumers of purchasing consumer products in the informal market (street vendors, etc.) is that some of the people trading in the informal market are very unscrupulous. Such individuals may use the overseas products themselves, refill the empty overseas packages with untested materials produced in Nigeria, and then claim that these local products in overseas packages are actually the original imported products. In short, consumers buying in the informal market are never completely sure of the quality of the product they are buying. Some mothers of new babies will not be willing to run the risk of inadvertently using untested counterfeit products on their babies' skin.

## FORECASTS AND UNDERLYING MACRO-CONSIDERATIONS

Based on the SWOT analysis and prior to her presentation to the board, Mrs. Omoshule decided to quantify the magnitude of the business opportunity which Babylove Brand Baby Products represented for PRET. Her analysis depended on a number of assumptions not only as regards the intensity of PRET's marketing activities but also those of PRET's competitors plus the characteristics in the future of the overall business environment in Nigeria. In any case, Mrs. Omoshule reached the following conclusions:

1. The baby products market in Nigeria is growing at least 10% per year.
2. Assuming reasonably stable economic, political, and social conditions, PRET should by 1997 be able to sell 300 tons (approximately 13% share of that year's total market) of baby products, up from 49 tons (approximately 3% of this year's total market) of Babylove Brand products in the 1994 year. This means that PRET's volumes of Babylove Brand Baby Products in 1997 would be six times its 1994 volumes (380 tons to 66 tons, respectively) and the 1997 turnovers (revenues for U.S. readers) generated by Babylove Brand Baby Products would be ten times the comparable 1994 revenues (153 million naira versus 16 million naira, respectively). Given the positive consumer perceptions of PRET products shown in Exhibit 4 and the very low level of in-house presence, Ms. Omoshule felt it was reasonable to assume that vigorous promotion of the Babylove Brand Product Line could lead to the levels of turnover and market penetration shown in Exhibit 5.

The primary imponderable and risk in the above forecast is the macros (that is, economic, political and social conditions) in Nigeria. While the country has a large population and earns billions of dollars each year selling petroleum, the assumption of stable economic, political, and social conditions which underlies the forecast is problematic. Specific factors contributing to Nigeria's difficulties include:

ECONOMIC: GDP per capital has fallen from $1000 per capita in 1960 to slightly more than $300 per capita today. Many professionals who had viewed themselves as “middle class” are struggling to avoid falling back into poverty. Also, income inequality is very high. In other words, most people earn very little but a fortunate few receive enormous amounts of money. Finally, the 1970s-vintage infrastructure built to support a modern industrial economy (generation & distribution of electricity, creation & maintenance of roads and rail systems, creation and maintenance of communications systems, etc.) has not been maintained, and is now falling apart. As Nigerian firms attempt to re-create infrastructure themselves (private boreholes or wells, stand-by generators, etc.), costs skyrocket. As a result, Nigerian producers find themselves priced out of the regional markets and/or cross-border trade which would have provided opportunities for Nigerian firms and jobs for Nigerian workers.

POLITICAL: Political problems created when the Presidential election of 1993 was annulled have not yet been resolved.

SOCIAL: Historically, the country has been plagued by several divisive issues including (1) tensions between major ethnic groups (Yoruba in the West, Igbo in the East, and Hausa in the North); (2) tensions between major religious groups (Christians in the South, Muslims in the North); and 3) tensions related to the fact that although levels of education tend to be higher in the South, Northerners have dominated the government. Also, while the Nigerian civil service had an extremely good reputation in the early days of independence, levels of service have fallen and levels of corruption have increased.

## MANAGEMENT OF BRANDED CONSUMER PRODUCTS IN NIGERIA

Even with the problematic macros, Ms. Omoshule was convinced that the forecasted levels of turnovers and profits for PRET set forth in her forecast would be achievable, given an aggressive re-launch. She also knew, however, that the Board of Directors would want to hear supporting arguments for her recommendations on the promotional mix plus timing and other details of her promotional initiative. For this reason, she talked with her agency and several professional colleagues, to cross-check one more time the accuracy of her information on the size of Nigeria’s major markets plus the promotional tools available in those markets. Exhibit 6 indicates the location and population of each state in the federation. Exhibit 7 identifies many of the major promotional tools available in Nigeria (print, radio, and television), plus the costs of each of these tools.

As she talked with her agency and professional colleagues, Mrs. Omoshule was reminded of several heuristics (that is, rules of thumb) regarding the use of mass media in Nigeria. Examples include the following:

1. Media specialists recommend that advertisers wishing to get maximum benefit from a radio media buy should purchase between 6-8 spots per day, for 3 or 4 days a week, for somewhere between 6 and 12 weeks.
2. Media specialists recommend that advertisers wishing to get maximum benefit from a TV media buy should purchase between 2-3 spots per day, for 3 or 4 days a week, for somewhere between 6 and 12 weeks.

3. Media specialists recommend that advertisers wishing to maximize the awareness created by a media buy in the North will probably buy radio and use the Hausa language. Advertisers wishing to get maximum benefit from a radio buy in the South will probably want to use "Pidgin" English.
4. Media specialists recommend that advertisers wishing to get maximum awareness from a media buy in the South will probably buy TV and use "Pidgin" or standard English.
5. Professional colleagues (that is, other brand and/or product managers) believe that "events" are a very effective way to win high levels of product awareness and interest from direct customers (that is, distributors, major retailers, etc.). In the case of new products, it is very common for manufacturers to stage a series of "new product launches" all across the country. Typically, this will involve a buffet luncheon or dinner at a fancy hotel, followed by speeches from senior executives. The event may conclude with short responses from senior executives at major customers. The cost of one such launch in one major metropolitan area in Nigeria ranges from 100,000-200,000 naira.

As she began to organize her thoughts, Mrs. Omoshule found herself thinking about two additional issues:

1. She knew the directors would expect her to operate within the broad parameters of a model ANL had recently adopted to guide thinking regarding the management of branded consumer products in Nigeria. The model's key concepts, together with elaborative information on those concepts, are as indicated in Exhibit 8.
2. She knew it would be important to ensure that her promotional initiatives were based on and in tune with key characteristics of mothers and babies in Nigeria, including:
   a. 20% of infants born live in Nigeria die before they are five years old.
   b. 49% of adults in Nigeria are illiterate.
   c. By the time they are 20 years old, 50% of Nigerian girls have had a child.
   d. 87% of married women in Nigeria want more than 4 children.
   e. 1% of Nigerian newborns are breast-fed only (that is, receive all their nourishment in this way) for 4 months.

## YOUR ASSIGNMENT

Assume you are Mrs. Omoshule. Prepare your request to the Board of Directors for N10,000,000 to re-launch the Babylove Brand Baby Products line. Make sure to be very specific and detailed regarding the promotional mix you recommend and why, plus the executional details of the re-launch. Remember that your total budget is limited to 10 million naira.

EXHIBIT 1
QUANTITATIVE ASSESSMENTS
AURIEN NIGERIA, LTD

(000 of Naira)

| | **1993** | **1992** | **1991** |
|---|---|---|---|
| Turnover | 2881302 | 1740511 | 1127348 |
| Gross Profit | 1112134 | 594039 | 286303 |
| Operating Profit | 752704 | 352899 | 113526 |
| Pretax Profit | 430469 | 235483 | 192067 |
| | | | |
| Current Assets | 1628595 | 1093220 | 696583 |
| Non-Current Assets | 834082 | 560435 | 405504 |
| Total Assets | 2462677 | 1653655 | 1102087 |
| IB Liabilities | 857352 | 600320 | 382076 |
| Non-IB Liabilities | 681713 | 455497 | 316959 |
| Total Liabilities | 1539065 | 1055817 | 699035 |
| Shareholder Equity | 923612 | 597838 | 403052 |
| | | | |
| Average # of Staff | 2718 | 2436 | 2569 |
| Real Sales Growth | 5.2% | 4.7% | -13.8% |
| Gross Margin | 38.6% | 34.1% | 25.4% |
| Asset Turnover | 1.7 | 1.5 | 1.3 |

EXHIBIT 2
QUANTITATIVE ASSESSMENTS
PRET DIVISION

(YEAR ENDING 31 SEPTEMBER)

| Millions of Naira | **1994** | **1993** | **1992** | **1991** |
|---|---|---|---|---|
| Turnover | 140 | 91 | 52 | 26 |
| Operating Profit | 11 | 9 | 7 | (2) |
| Pretax Profit | (6) | (12) | 0.25 | (17) |
| | | | | |
| Tons of Product Sold | | | | |
| Texide | 350 | 510 | 380 | |
| Mobilene | 250 | 280 | 250 | |
| Shelene | 23 | 24 | 27 | |
| Babylove | 49 | 52 | 48 | |
| Promea | 6 | 14 | 15 | |
| Talc | 28 | 72 | 45 | |
| MFI | 120 | 25 | 0 | |
| Other | 34 | 43 | 35 | |
| Total Tons Sold | 860 | 1020 | 800 | |

EXHIBIT 3
SWOT ANALYSIS

| TENDERLY | SWOT ANALYSIS | | | | 94/95 |
|---|---|---|---|---|---|
| PRODUCTS | % SHARE | STRENGTH | WEAKNESS | OPPORTUNITY | THREATS |
| BABYLOVE (pret) | 3% | Good Quality - Medicated antiseptic properties. Reasonable acceptance. | Low consumer awareness. No soap. Patchm distribution. Weak advertising support. Unattractive pricing. | Change packaging/ presentation. Increase awareness with concerted A & P support. Increase distribution and shelve space. Compete range to include soap. High market growth rate. Low market share. Hugh gap between market leader & others. Export potential | Could fade away with lack of development and support. Possible reaction of Brand Leader Pears to active competition. |
| PEARS (A J SEWARD) | 65% | Brand Leader. Good Quality. Full range. High awareness. Good distribution. | Pears standard has slipped packaging wise. Withdrawal of nappy rash cream. High price. | Seward now part of UNILEVER Group. | Loss of share to quality alternatives. |
| VASELINE (LBN) | 15% | Strength of brand name. | Relatively poor distribution. Untidy presentation. | | Might become less of a priority with Pears being in the same stable. |
| JOHNSON & JOHNSON (HCP) | 3% | International Brand name. | Low consumer awareness. Manufacturer (in Nigeria) not very strong. | Increase awareness. Greater involvement of franchise owner in marketing of product. | Full potential and International brand name might never be realized if low level support continues. |
| OTHERS | 12% | Typically cater for more price conscious bottom end of the market. | Low awareness. Erratic availability. Doubtful efficacy. | Growing usage of baby products among lower income groups. | Increasing cost of production might see these products out of the market. |

EXHIBIT 4
RESEARCH FINDINGS
PERCEIVED BENEFITS OF BABYLOVE BRAND AND COMPETING PRODUCTS
(RESPONDENTS ARE MOTHERS WHO HAVE TRIED ALL THREE)

| | Rating on this Dimension (1=very low; 7=very high) | | |
|---|---|---|---|
| Dimension | Babylove | PEARS | Vaseline |
| Makes baby smell nice | 6 | 7 | 5 |
| Prevents and/or treats minor skin rashes | 7 | 5 | 4 |
| Ongoing availability | 1 | 7 | 6 |
| Recognized product name | 2 | 6 | 7 |
| Product safety (relates to tamper-resistant packaging) | 5 | 5 | 5 |
| USER CHARACTERISTICS<br>Young<br>Educated<br>Modern<br>Mostly Urban<br>Busy | | | |
| COMPETITIVE INFORMATION | | | |
| | Babylove | PEARS | Vaseline |
| Brand awareness trial (ever bought) | 35% | 93% | 64% |
| % of those aware | 83% | 98% | 86% |
| % of total | 29% | 91% | 55% |
| Awareness of advertising | 21% | 74% | 45% |
| In-home presence of brand | 5% | 49% | 23% |
| 1994 media expenditures | 400,000 | 11,000,000 | 1,250,000 |

NOTE: PACKAGING PREFERENCES

Showing a baby bear is better than showing a baby. It is important that packaging looks clean and proper. Softer, more maternal colors are better than strong ones.

EXHIBIT 5
POST-RELAUNCH PERFORMANCE PROJECTIONS:
BABYLOVE BABY PRODUCTS

Number of Years after Re-Launch

| Measure | 0 | 1 | 2 | 3 |
|---|---|---|---|---|
| Tonnes (tons, in U.S.) | 66 | 212 | 315 | 380 |
| Share | 3% | 8% | 11% | 12% |
| Turnover (million naira) | 16 | 85 | 127 | 153 |
| Gross Margin (million naira) | 6 | 26 | 38 | 46 |

EXHIBIT 6A
MAJOR MARKETS IN NIGERIA: LOCATIONS & POPULATIONS

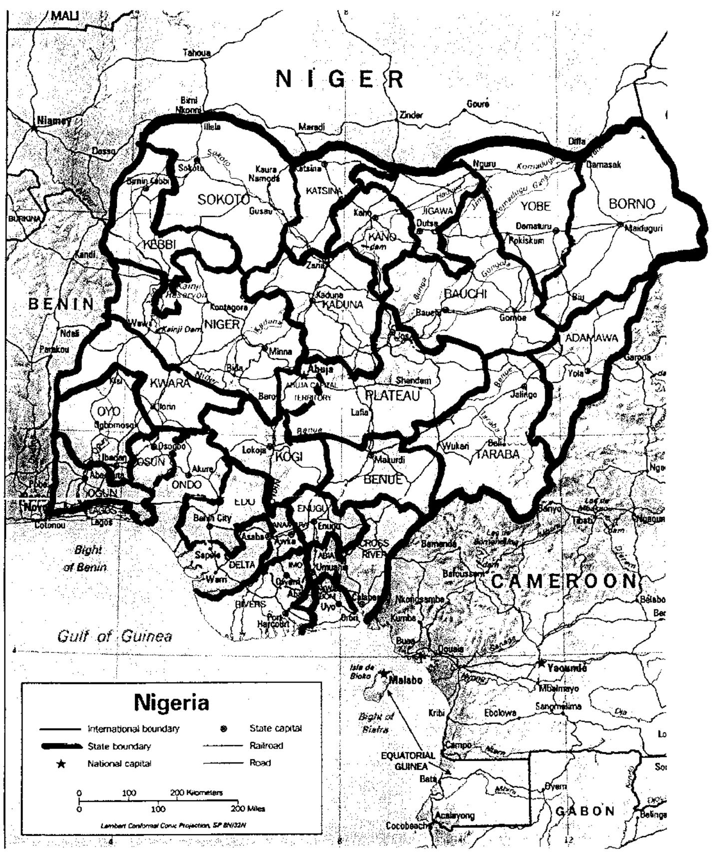

FIGURE 6B
1991 CENSUS FIGURES

| | State | Capital | Males | Females | Total |
|---|---|---|---|---|---|
| 1 | Lagos | Ikeja | 2,999,528 | 2,686,253 | 5,685,781 |
| 2 | Kano | Kano | 2,858,724 | 2,773,316 | 5,632,040 |
| 3 | Sokoto | Sokoto | 2,158,111 | 2,234,280 | 4,392,391 |
| 4 | Bauchi | Bauchi | 2,202,962 | 2,091,451 | 4,294,413 |
| 5 | Rivers | Port-Harcourt | 2,079,583 | 1,904,274 | 3,983,857 |
| 6 | Kaduna | Kaduna | 2,059,382 | 1,909,870 | 3,969,252 |
| 7 | Ondo | Akure | 1,958,928 | 1,925,557 | 3,884,485 |
| 8 | Katsina | Katsina | 1,944,218 | 1,934,126 | 3,878,344 |
| 9 | Oyo | Ibadan | 1,745,720 | 1,743,069 | 3,488,789 |
| 10 | Plateau | Jos | 1,645,730 | 1,637,974 | 3,283,704 |
| 11 | Enugu | Enugu | 1,482,245 | 1,679,050 | 3,161,295 |
| 12 | Jigawa | Dutse | 1,419,726 | 1,410,203 | 2,829,929 |
| 13 | Benue | Makurdi | 1,385,402 | 1,394,996 | 2,780,398 |
| 14 | Anambra | Awka | 1,374,801 | 1,393,102 | 2,767,903 |
| 15 | Borno | Borno | 1,327,311 | 1,269,278 | 2,596,589 |
| 16 | Delta | Asaba | 1,273,208 | 1,296,973 | 2,570,181 |
| 17 | Imo | Owerri | 1,178,031 | 1,307,468 | 2,485,499 |
| 18 | Niger | Minna | 1,290,720 | 1,191,647 | 2,482,367 |
| 19 | Akwa Ibom | Uyo | 1,162,430 | 1,197,306 | 2,359,736 |
| 20 | Ogun | Abeokuta | 1,144,907 | 1,193,663 | 2,338,570 |
| 21 | Abia | Umuahia | 1,108,357 | 1,189,621 | 2,297,978 |
| 22 | Osun | Oshogbo | 1,079,424 | 1,123,592 | 2,203,016 |
| 23 | Edo | Benin City | 1,082,718 | 1,077,130 | 2,159,848 |
| 24 | Adamawa | Yola | 1,084,824 | 1,039,225 | 2,124,049 |
| 25 | Kogi | Lokoja | 1,055,964 | 1,043,082 | 2,099,046 |
| 26 | Kebbi | Bimin Kebbi | 1,024,334 | 1,037,892 | 2,062,226 |
| 27 | Cross River | Calabar | 945,270 | 920,334 | 1,865,604 |
| 28 | Kwara | llorin | 790,921 | 775,548 | 1,566,469 |
| 29 | Taraba | Jalingo | 754,754 | 725,836 | 1,480,590 |
| 30 | Yobe | Damaturu | 719,763 | 691,718 | 1,411,481 |
| 31 | Federal Capital Terr | Abuja | 206,535 | 172,136 | 378,671 |
| | **Country Totals** | | **44,544,531** | **43,969,970** | **88,514,501** |

EXHIBIT 7
IDENTITY & COSTS OF MAJOR PROMOTIONAL TOOLS AVAILABLE IN NIGERIA

| TELEVISION RATE (AAA BELT) | | | | |
|---|---|---|---|---|
| STATION | 60" | 45" | 30" | 15" |
| NTA MID-NEWS AT 9 P.M. | 103,660.00 | 86,400.00 | 69,120.00 | 51,840.00 |
| NTA MID-NEWS AT 7 P.M. | 18,000.00 | 14,400.00 | 12,600.00 | 10,800.00 |
| NTA 2.5\NTA 10 | 11,440.00 | 9,485.00 | 7,592.00 | 5,034.00 |
| NTA IKEJA\ IBADAN | 5,544.00 | 4,642.00 | 3,476.00 | 1,848.00 |
| NTA ABA \ABUJA \BENIN | 3,212.00 | 2,530.00 | 1,848.00 | 1,540.00 |
| NTA CALABAR\ ENUGU | 3,212.00 | 2,530.00 | 1,848.00 | 1,540.00 |
| NTA \ILORIN\JOS\KANO | 3,212.00 | 2,530.00 | 1,848.00 | 1,540.00 |
| NTA KADUNA \P\H\ MAIDUGURI | 3,212.00 | 2,530.00 | 1,848.00 | 1,540.00 |
| NTA SOKOTO | 3,212.00 | 2,530.00 | 1,848.00 | 1,540.00 |
| NTA ABEOKUTA \AKURE MINNA | 2,750.00 | 2,112.00 | 1,628.00 | 1,320.00 |
| NTA BAUCHI \LOKOJA \KATSINA | 2,750.00 | 2,112.00 | 1,628.00 | 1,320.00 |
| NTA MAKURDI \UYO \YOLA | 2,750.00 | 2,112.00 | 1,628.00 | 1,320.00 |
| ABIA TELEVISION | 3,098.00 | 2,608.00 | 2,124.00 | 1,634.00 |
| ADAMAWA TV YOLA | 2,964.00 | 2,371.20 | 2,074.80 | 1,482.00 |
| AKWA IBOM TV UYO | 3,034.00 | 2,427.00 | 1,820.00 | 1,517.00 |
| BCOS TV IBADAN | 5,311.00 | 4,584.00 | 3,516.00 | 2,188.00 |
| BORNO TV MAIDUGURI | 3,086.72 | 2,308.80 | 1,422.72 | 1,094.08 |
| CTV KANO | 3,250.00 | 2,665.00 | 2,431.00 | 2,080.00 |
| CLAPPER BOARD TV LAGOS | 5,496.00 | 4,560.00 | 3,648.00 | 2,424.00 |
| DBN TV LAGOS | 7,150.00 | 5,928.00 | 4,645.00 | 3,146.00 |
| DESMINS IND TV KADUNA | 1,400.00 | 900.00 | 600.00 | |
| DELTA TV WARRI | 2,404.00 | 1,923.00 | 1,528.00 | 927.00 |
| EDO TV BENIN | 3,121.09 | 2,496.87 | 1,900.54 | |
| ENUGU STATE TV | 3,693.14 | 2,474.94 | 2,163.72 | 1,529.42 |
| IMO BROADCASTING CORP | 3,003.00 | 2,539.00 | 2,078.00 | 1,733.00 |
| MINAJ TV OBOSI | 5,500.00 | 4,560.00 | 3,650.00 | 2,420.00 |
| PRTV JOS | 2,470.00 | 1,827.00 | 1,235.00 | 650.00 |

| RADIO RATE (AAA BELT) | | | | |
|---|---|---|---|---|
| STATION | 60" | 45" | 30" | 15" |
| RAY POWER 100 FM | 1,970.00 | 1,525.00 | 1,130.00 | 680.00 |
| OGBC 11 ABEOKUTA | 2,106.00 | 1,612.00 | 1,235.00 | 741.00 |
| RADIO RIVERS FM P/H | 1,111.00 | 902.00 | 693.00 | 440.00 |
| DELTA RADIO FM | 1,246.00 | 1,065.00 | 868.00 | 667.00 |
| KADUNA RADIO | 1,274.00 | 695.00 | 652.60 | 462.15 |
| RADIO KANO | 1,365.00 | 1,170.00 | 891.00 | 741.00 |
| ENUGU RADIO FM | 1,594.63 | 1,252.81 | 924.77 | 687.65 |
| BCOS RADIO 11 IBADAN | 1,852.00 | 1,383.20 | 1,038.00 | 642.20 |
| AKWA IBOM RADIO FM UYO | 1,348.62 | 1,117.42 | 832.80 | 655.04 |
| RADIO KWARA ILORIN | 1,232.00 | 990.00 | 704.00 | 550.00 |
| ONDO RADIO AKURE | 1,549.18 | 1,155.96 | 774.59 | 576.99 |
| RADIO BENUE | 1,108.80 | 823.68 | 739.20 | |
| OSUN RADIO OSOGHO | 1388.14 | 1,076.92 | 721.24 | 494.00 |
| EDO RADIO BENIN | 1,618.34 | 1,379.25 | 1,125.13 | |
| PLATEAU RADIO FM JOS | 1,313.00 | 1,040.00 | 715.00 | |
| ABS RADIO AWKA | 1,993.63 | 1,210.79 | 1,098.16 | 934.00 |
| RN KADUNA \RN 1 LAGOS | 1,751.00 | 1,292.00 | 875.00 | 439.00 |
| RN 3 LAGOS \ABUJA\IBADAN | 1,507.00 | 1,131.00 | 750.00 | 481.00 |
| BAUCHI RADIO | 1,963.65 | 1,743.82 | 1,244.80 | 913.93 |
| CROSS RIVER RADIO FM | 1,527.50 | 1,085.50 | 767.00 | 468.00 |
| IMO RADIO FM OWERRI | 1,385.00 | 1,153.00 | 923.00 | 751.00 |
| KATSINA RADIO | 1,294.67 | 924.77 | 693.50 | 416.14 |
| ABIA RADIO | 1,396.00 | 1,151.00 | 909.00 | 727.00 |
| KOGI RADIO | 1,383.00 | 790.00 | 590.00 | 371.00 |

EXHIBIT 7(CONT.)
IDENTITY & COSTS OF MAJOR PROMOTIONAL TOOLS AVAILABLE IN NIGERIA
NEWSPAPER RATES ANNOUNCEMENT

| | | | | | | PRESS | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | NEWSPAPER RATE ANNOUNCEMENT | | | | | | | | |
| NO | MEDIA HOUSE | 1 X 1 | F P S | D P S | 3 TRIP (2X6) | 6X2 (rop) | 8 X 4 | 10 X 5 | 1/4 PAGE | ½ PAGE | FULL PAGE |
| 1 | THE GUARDIAN | | | | | 6,960 | 18,560 | 29,000 | 16,240 | 28,429 | 45,920 |
| 2 | DAILY BUSINESS TIMES | 500 | | | | 6,960 | 18,560 | 29,000 | 13,000 | 25,000 | 48,000 |
| 3 | WEEKEND TIMES (Saturday) | | | | | | | | | | |
| 4 | VANGUARD | 500 | | | | 6,000 | 18,000 | 30,000 | 10,500 | 20,000 | 39,500 |
| 5 | THIS DAY | 550 | 23,000 | 15,000 | 12,000 | 6,800 | 17,600 | 27,000 | 12,000 | 23,000 | 45,000 |
| 6 | NATIONAL CONCORD | 580 | 15,000 | 12,000 | 12,500 | 6,300 | 18,750 | 28,700 | 12,450 | 24,650 | 45,000 |
| 7 | WEEKEND CONCORD | 590 | | 14,900 | 11,770 | 6,470 | 17,240 | 27,500 | 12,800 | 25,360 | 46,350 |
| 8 | SUNDAY CONCORD | 580 | 18,700 | 14,840 | 11,650 | 6,400 | 17,070 | 27,240 | 12,690 | 25,110 | 45,900 |
| 9 | NEW NIGERIAN | 490 | 14,200 | | 4,860 | 5,840 | | 19470 (10 X 4) | 10,220 | 21, 900 | 38,500 |
| 10 | TRIBUNE | 593 | 14,300 | 12,350 | 9,860 | 14,352 | 21,528 | 29,200 | 14,352 | 19,136 | 40,300 |
| 11 | SUNRAY | 343.75 | 11,275 | 9,825 | 9,625 | 4,125 | 11,000 | 17,188 | 8,190 | 18,825 | 32,500 |
| 12 | A M NEWS | 550 | 18,000 | 15,000 | 12,500 | 6,600 | 17,600 | 27,000 | 11,550 | 20,500 | 38,500 |
| 13 | THE PUNCH | 500 | 16,800 | 14,350 | 11,950 | 5,750 | 16,000 | 23,850 | 10,050 | 20,100 | 40,000 |
| 14 | DAILY/SUNDAY CHAMPION | 480 | 14,400 | 11,400 | 14,400 | 5,760 | 15,360 | 24,000 | 11,400 | 22,200 | 40,500 |
| | | | | | | | | | | | |
| | | | | | | | | | | | |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | |
| | SPECIAL RATE (obituary, inmemoriam, birthday Iwuyo, goodwill messages | | | | | | | | | | |
| | company news, annual reports, half year reports, balance sheet, legal notice | | | | | | | | | | |
| | disclaimer, auction sales, club registration, sale of shares, political adver.) | | | | | | | | | | |
| | MEDIA HOUSE | 1 X 1 | 3 X 2 | 6 X 2 | 1/4 page | 13 X 3 | 10 X 5 | | ½ page | FULL PAGE | |
| | GUARDIAN | 610 | 3,660 | 7,320 | 17,030 | | 30,500 | | 27,860 | 48,295 | |
| | DAILY/BUSINESS TIMES | 550 | 2,980 | 7,200 | 14,500 | 25,500 | | | 27,000 | 52,000 | |
| | NEW NIGERIAN | | | | 11,320 | | | | 20,720 | 40,440 | |

| | | | MAGAZINE RATE | | | | | |
|---|---|---|---|---|---|---|---|---|
| NO | MEDIA HOUSE | F/P (IBC) | F/P (IFC) | F/P (ROP) | BOTT. STRIP | F/P (COL) | F/P (b/w) | B. STRIP (b/w) |
| 1 | THE NEWS | 71,900 | 80,000 | 90,000 | 65,500 | 35,000 | 41,500 | 18,000 |
| 2 | TELL | 68,990 | 76,889 | 89,899 | 65,850 | 32,000 | 32,160 | 13,680 |
| 3 | NEWSWATCH | 85,000 | 88,000 | 98,000 | 68,000 | 38,000 | 42,000 | |
| 4 | THE WEEK | 49,355 | 58,692 | 47,560 | 45,140 | 32,500 | 28,210 | 15,625 |
| 5 | AFRICAN VISION | 75,000 | 78,000 | 88,000 | 56,000 | 28,000 | 37,000 | |
| 6 | AFRICAN TODAY | $ 3,600 | | $ 5,200 | $ 2,800 | | $ 1,800 | |
| 7 | THE MERIDIAN | 85,500 | 75,500 | 88,000 | 64,000 | 36,500 | 30,500 | 10,500 |
| 8 | HINTS | 52,000 | 54,000 | 59,500 | 47,000 | | 30,000 | 10,000 |
| 9 | FAME | 48,750 | 52,500 | 56,250 | 45,750 | 29,532 | 30,000 | 7,300 |
| 10 | HEARTS | 45,000 | 48,000 | 52,500 | 40,000 | 21,000 | 26,000 | 10,000 |
| 11 | TODAYS CHOICE | 45,000 | 48,500 | 50,000 | 19,000 | | 28,000 | 6,500 |

EXHIBIT 8

MANAGEMENT OF BRANDED CONSUMER PRODUCTS: KEY CONCEPTS

The five key elements of ANL's newly-adopted approach to building and maintaining consumer goods franchises, plus elaborative information on each of those variables, are as indicated below:

1. Build brand awareness. ANL's objective is to have the name of their brand recognized as the leader in the category, both by direct customers (in the baby products industry, this might include wholesalers, clinics, and hospitals) and indirect consumers (that is, mothers). ANL works toward this objective by striving for communications which are different and memorable, creating jingles, slogans, and/or symbols for brands to which indirect customers will be able to relate. ANL also takes all possible advantage of publicity, sponsoring events, brand extensions as appropriate, using packaging as cues, and maintaining high levels of advertising voice (both to direct and indirect customers), relative to other brands in the category.
2. Strive for high perceived quality. To learn what perceived quality means, ANL systematically conducts qualitative research on the perceptions of indirect customers as to the relative quality offered by competing brands in various product categories. Within the baby products context, numerous focus groups conducted over many years confirm that the following factors influence mothers' perceptions of product quality, with approximately the relative importance shown:

| FACTORS IMPACTING POSITIVELY ON PERCEIVED QUALITY | IMPORTANCE OF THIS FACTOR (Points, out of 100) |
|---|---|
| *Makes baby smell nice | 10 |
| *Prevents and/or treats minor skin rashes, etc.) | 30 |
| *Ongoing availability | 15 |
| *Recognized brand name | 20 |
| *Product safety (relates to tamper-resistant packaging) | 25 |
| Total | 100 |

3. Build brand loyalty. ANL attempts to develop habitual buyers. The idea (and ideal) is that when direct and/or indirect consumers make a purchase in a product category where an ANL brand is available, they will nearly always purchase that brand. ANL's experience is that the five key factors involved in building brand loyalty are: (1) treat customers right; (2) stay close to the customer; (3) measure and manage customer satisfaction; (4) create costs which customers who switch to another brand will have to pay; and (5) provide extras.
4. Manage brand associations. ANL's objective is to position its brands in such a way that they are perceived by consumers as superior to competing products. To accomplish this objective, ANL employs a three-step process: (1) analyze the strengths and weaknesses of our own products; (2) review the positioning and associations of leading competitors; and (3) make sure to understand reasons target market members make purchases in our product categories.
5. Build and maintain competitive advantage, relative to competing brands and products.

# STP PHARMA, LIMITED

## D.K. (Skip) Smith, Southeast Missouri State University

## CASE DESCRIPTION

*Generic strategies, the pharmaceutical industry, a developing country environment (Nigeria): these are the issues and context. The case does not involve sophisticated quantitative or qualitative analysis. It does assume a familiarity with basic marketing and strategic decision making concepts and frameworks. Consequently, the case is appropriate for and has a difficulty level of 4 (seniors) and higher. The case is designed to be taught in one class session of approximately one hour and fifteen minutes, and is likely to require at least two hours of preparation time from students.*

## CASE SYNOPSIS

*Ernest Adefope, newly-appointed managing director of STP Pharma Ltd. must decide what strategy he will use to bring STP into the 21st century. The company's primary activities include:*

1. *Local manufacturing of pharmaceuticals.*
2. *Marketing and sales not only of its own products but of various pharmaceutical products imported from overseas.*

*The case provides a substantial amount of the sort of data a managing director would need to make such a decision, including information on the company itself; information on its customers and competitors; and information on the various threats and opportunities posed by the environment. It then asks students to take up Adefope's challenge: to decide which of Porter's generic strategies STP should use to enter the 21st century, and why.*

## THE CHALLENGE

January 15, 1995. Ernest Adefope shook hands with the bankers and the Vice President of CPG Ltd.'s International Division, and then left his former office at the Nigerian soap plant for the last time. Nine months later than planned, NICONGLO Ltd.'s sale of this factory to CPG had finally been consummated. Now, Adefope, newly-appointed Managing Director for STP, Ltd. (formerly, Huckstone Nigeria, Ltd.) would be able to focus his full attention and energy on developing and executing a strategy for STP, a business NICONGLO had acquired 5 July, 1994 from the Huckstone Foundation, Ltd. in England. Smiling to himself as walked to his vehicle, Adefope contemplated the luxury of focusing his time and energy on one single strategic challenge, that is, the question of which of Porter's generic strategies (differentiation, niche, or low-cost producer) maximizes the potentials/minimizes the risks to STP as it pursues opportunities in the Nigerian pharmaceuticals industry.

COMPANY HISTORY (NICONGLO, LTD.)

Established in 1951 by BRITCONGLO Limited (a British holding company), NICONGLO is a Nigerian holding company. NICONGLO's subsidiaries are engaged in three major types of activities, specifically:

1. Sole authorized importer and distributor in Nigeria for the branded consumer products of several major European manufacturers. Examples include Cow and Gate Babyfood, Coast Evaporated and Coast Powdered Milk, and a wide range of distilled spirits (that is, alcoholic beverages) for various clients including Guiness plc, Campari, Martini and Rossi, and Sogrape Vinhos SA of Portugal.
2. Local manufacturing (under license from European and/or North American owners of major international brands), plus distribution and sale in Nigeria of a wide assortment of these products including vitamins and pharmaceuticals (several companies, including Roche and Wyeth International, and until very recently, the Huckstone Foundation), glucose (Nutricia Export B.V.), dried yeast (Quest/Distillers Yeast), custard powder (Kraft Jacobs Suchard), toilet soap (Colgate-Palmolive), and toilet rolls (Scott Paper).
3. Manufacturing, distribution, and sale of private brand/ private label products developed for the Nigerian market.

Examples of private label products which NICONGLO and/or its sister companies manufacture, distribute, and sell include PCB Vegetable Oil, ATB Soap, MKO Detergent, ABS Detergent, plus two brands of paper tissues.

The importation of pharmaceuticals is an area in which NICONGLO has longstanding activities and involvements. Furthermore, starting in 1985, a NICONGLO subsidiary began manufacturing a variety of Over-the-Counter (OTC) products (for example, "Anacin" products) under license from overseas pharmaceutical firms. Subsequently, the same subsidiary began manufacturing a line of generic pharmaceutical products marketed under the NICONGLO name. While the perceived quality of most pharmaceuticals manufactured in Nigeria is very low, NICONGLO's branded generic products have been so successful that the company was not able to produce enough to satisfy demand. For this reason, NICONGLO was interested in acquiring addition pharmaceutical manufacturing facilities in Nigeria. Thus, when the Huckstone Foundation decided to try to sell Huckstone Nigeria, Ltd., NICONGLO stepped forward to indicate its interest.

In support of its product-related activities, NICONGLO is deeply involved in transportation, distribution, and sales. The company has branches/depots in major markets across Nigeria, including Lagos, Ibadan, Oregun, Aba, Onitsha, Kaduna, and Kanu. Exhibit 1 indicates the location of these depots, and the population of each of the 30 states in Nigeria plus Abuja, the Federal Capital Territory. To move products (imports from the port, locally manufactured goods from its factories to its warehouses), NICONGLO has over the years developed a series of solid arrangements with haulage (for U.S. readers, trucking) firms all across Nigeria. To handle movement of these products from warehouses to local distributors, NICONGLO built up over the years a sizable fleet of sales and delivery vans. In addition, several of NICONGLO's sister companies have salesforces responsible for selling NICONGLO's imported, licensed, and private brand products into major markets all across Nigeria. NICONGLO's distribution and sales capabilities are in sharp contrast to other consumer products companies in Nigeria, many of whom lack nationwide distribution and/or rely on third parties to provide the distribution and sales functions. In the pharmaceutical industry, for example, only the market leader (Smith/Kline Beecham) has a nationwide distribution and sales capability similar to that of NICONGLO.

In running its consumer goods businesses, NICONGLO has developed a system which focuses attention on five key areas. The five key elements of NICONGLO's approach to building and maintaining consumer goods franchises, plus elaborative information on each of those variables, are as indicated below:

1. Build brand awareness. NICONGLO's objective is to have the name of their brand recognized as the leader in the category, both by direct customers (in the pharmaceuticals industry, this would include pharmacists, doctors, clinic and hospital personnel, etc.) and by indirect consumers (that is, final and/or individual consumers or patients). They work toward this objective by striving for communications which are different and memorable, creating jingles, slogans, and/or symbols for brands to which indirect customers will be able to relate. NICONGLO also takes all possible advantage of publicity, sponsoring events, brand extensions as appropriate, using packaging as cues, and maintaining high levels of advertising voice (both to direct and indirect customers), relative to other brands in the category.
2. Strive for high perceived quality. To learn what perceived quality means, NICONGLO systematically conducts research on the perceptions of direct and indirect customers as to the relative quality offered by competing brands in a product category. Within the pharmaceutical context, NICONGLO's experience is that factors such as efficacy, manufacturing processes in conformance with specifications, availability, safety, recognized brand name, tamper-proof packaging, and price are often important to direct and/or indirect customers.
3. Build brand loyalty. NICONGLO attempts to develop habitual buyers. The idea (and ideal) is that when direct and/or indirect consumers make a purchase in a product category where a NICONGLO brand is available, they will nearly always purchase that brand. NICONGLO'S experience is that the five key factors involved in building brand loyalty are: 1) treat customers right; 2) stay close to the customer; 3) measure and manage customer satisfaction; 4) create costs which customers who switch to another brand will have to pay; and 5) provide extras.
4. Manage brand associations. NICONGLO's objective is to position its brands in such a way that they are perceived by consumers as superior to competing products. To accomplish this objective, NICONGLO employs a three-step process: 1) analyze the strengths and weaknesses of our own products; 2) review the positioning and associations of leading competitors; and 3) make sure to understand reasons target market members make purchases in our product categories.
5. Build and maintain competitive advantage, relative to competing brands and products.

## COMPANY HISTORY (THE HUCKSTONE FOUNDATION, LTD.)

Huckstone, Ltd. was established in London in 1901, when a deed of partnership was established between two American pharmacists, John Huck and Alex Stone. Huck died in 1906, but Stone lived on to lead the company until his death in 1937.

Early on, Stone recognized the importance of and need for research. He established the Stone Physiological Research Laboratory in 1910, and the Stone Chemical Research Laboratories in 1912. He was also an internationalist, establishing a Publication Trust Fund in China in 1908 to publish medical texts for Chinese students; a Medical Hospital Dispensary in Uganda in 1905, and the Lady Stanley Maternity Hospital in Uganda in 1927.

In 1924, all of Stone's commercial business, research laboratories, and his museum were brought under the umbrella of The Huckstone Foundation Ltd. When he died in 1937, the Huckstone Trustees became the sole shareholders of the Huckstone Foundation Ltd. Their obligation, as set forth in Stone's will, was to devote all income of the foundation to specified charitable purposes including research in medicine and allied sciences and the maintenance of research museums dedicated to those sciences. The Huckstone Foundation continues today to pursue those objectives.

In the early 1980s, the Huckstone Foundation in the UK decided to invest heavily in the area of antivirals. As it happens, antiviral medicines are likely to be quite expensive on a "per dose" basis (US$400.00 per dose is not unusual). Given the Huckstone Foundation's decision to invest in antivirals, it is not surprising that UK home office management decided that low income markets like Nigeria were no longer attractive to the foundation.

Because developing expertise and later new products in the antiviral market turned out to be very expensive, and based on the conclusion that Nigeria was no longer an attractive market, the Huckstone Foundation decide to see whether its business interests in Nigeria could be converted to cash. As indicated earlier, on 5 July, 1994, NICONGLO agreed to purchase HNL from the Huckstone Foundation. Through this purchase, NICONGLO's STP subsidiary was granted the right to manufacture and/or import and then sell Huckstone products in Nigeria. Both OTC and prescription medicines were covered by the purchase agreement.

## COMPANY HISTORY (STP PHARMA, LTD.)

The company was founded in the 1950s by a group of Italian investors. At that time, it was called "Blondet." While its charter indicated that the company intended to sell pharmaceutical products in Nigeria, Blondet targeted primarily the Lagos area. At that time, the company's product line consisted primarily of antibiotics. It did well, and in 1962, the Huckstone Foundation bought a portion of Blondet. At that time, the company changed its name to "Huckstone Blondet Nigeria, Ltd." Shortly thereafter, the company built a new factory 25 kilometers north of Lagos (one of the first pharmaceutical factories in Nigeria), and expanded distribution of its products to cover major markets all across Nigeria.

In 1974, the Huckstone Foundation bought out the Italian shareholders, and the company's name was changed again, this time to Huckstone Nigeria, Ltd. (hence, HNL). Also during 1974, the Nigerian Government enacted a decree whereby foreign owned companies were required to divest themselves of a minimum of 40% of their shareholdings to Nigerian citizens. As 7% of the shares in

Huckstone Nigeria were already owned by Nigerians, the Huckstone Foundation donated one third of its shares in HNL to "The Huckstone Nigeria Fund."

After the purchase by the Huckstone Foundation, HNL expanded again, this time into a broad range of ethical (that is, sold to and through pharmacists) pharmaceuticals. Important products included blood tonics named "Prakel" and "Ladies First," which were designed to provide iron to individuals needing iron supplements. Other products marketed across Nigeria by HNL at this time included de-worming products. Later, after a four million pounds sterling expansion of the manufacturing and administrative facilities in 1976 and an additional expansion of manufacturing, filling, and packaging facilities in 1985, HNL broadened its product line by adding antibiotic suspensions and tablets for chest, urinary, and sexually-transmitted diseases (Tripsin), plus syrups and tablets for colds, congestion, and drying-up runny noses (Tifact). Over time, the various sizes and formulations of Tripsin and Tifact replaced the blood tonics and de-worming products as HNL's key products. By the end of the 1980s and on into the 1990s, the various Tripsin and Tifact formulations accounted for a very substantial portion of HNL's total volumes.

While turnover for both the Tripsin and Tifact product lines were very strong, profitability of the two lines differed dramatically. Because the generic ingredients for the Tifact-based products could be acquired at reasonable cost from any one of a large number of competing suppliers, margins on the various sizes and formulations of these products were very high. In the case of Tripsin-based products, however, HNL was required to import Tripsin's active ingredients from its parent company in the United Kingdom, at more than twice the price of the generic equivalents. For this reason, margins on the Tripsin-based formulations were far lower than the margins for other HNL products.

Information on key HNL products and the primary products of major competitors is shown in Appendix 1. HNL's product line includes both pharmaceutical products imported in finished form from the UK and pharmaceuticals where HNL imports the active ingredients from overseas and then manufacturers and packages the pharmaceuticals locally. It also includes both OTC preparations as well as the ethical pharmaceuticals which are sold only by registered pharmacists. While approximately 70% of HNL's revenues are currently generated by ethicals (OTC accounts for most of the rest), it appears that growth is far more likely to occur in the OTC category. In any case, promotional activity for the two categories of products differs considerably. For OTC products, HNL has found both print (newspapers and magazines) and radio to be highly effective. For the ethical products, however, the primary vehicle for advertising is trade journals targeting chemists (for U.S. readers, pharmacists) and other medical professionals. Other elements of HNL's promotion mix to chemists include twelve pharmacists (specialized pharmaceutical training, on salary, provided with company car, etc.) and a large number of sales representatives (college graduates, no company car, bulk of compensation is commission, etc.).

Over the years, HNL experienced substantial success and established a good reputation for itself in Nigeria. Within the industry, HNL was known and respected for insisting on especially high quality and taking an especially aggressive approach to the maintenance of Good Manufacturing Practices (GMP). Industry perceptions as to the GMP practices of several competitors are indicated in Appendix 2. In any case, Huckstone products were known nationwide, and had a reputation of being extremely high quality and efficacious.

1993 results for HNL and several competitors are as indicated in Appendix 3. However, starting in the 1980s, changes in the economic and social environment of Nigeria and changes in the pharmaceutical industry in Nigeria impacted powerfully on HNL and its performance. Some of these changes (for example, the fact that many government hospitals and clinics which had been HNL's biggest customers in the 1970s were in dire financial straits and that private clinics plus hospitals had become much more important to HNL's success) simply changed the nature of the business. Other developments, however, impacted very negatively on HNL's performance. We turn now to those issues.

## THE NIGERIAN ENVIRONMENT AND CHANGES IN THAT ENVIRONMENT

With a population of approximately 90 million people, Nigeria is Africa's most populous country. Nigeria's gross national product (GNP) of approximately 32.9 billion dollars makes it the third largest economy in Africa. In sub-Saharan Africa only South Africa, with a GNP of 106 billion dollars, is larger.

At the time it became independent from Britain in 1960, Nigeria's economy was primarily agricultural. At that time, the largest export was groundnuts (peanuts, for US readers), which were grown in the northern part of the country. In those days, the annual groundnut harvests were bagged and then gathered at rail depots throughout Northern Nigeria and stacked there in huge piles or pyramids until they could be shipped to ports in Southern Nigeria for export. Other important agricultural exports at the time of independence included cocoa beans from Western Nigeria and palm products (palm kernels and the results of pressing them, palm oil and palm by-products) from Eastern Nigeria. At this time, Nigeria's millions of small farmers grew both the export products listed above and enough food (maize, rice, and yams are staple food items in Nigeria) to feed the entire country.

In the early 1950s, oil was discovered in Nigeria. By the late 1970s, when oil was selling for $40.00 per barrel, the oil and the huge amounts of money generated by its sale had dramatically altered the Nigerian economy. Over this period, the Federal Government of Nigeria made massive investments in roads, bridges, and buildings for public sector (administrative buildings, housing estates and apartments, etc.) purposes. The government 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.

Unfortunately, very few of the projects described above generated any financial returns on the huge sums which had been invested. Regardless, during these years, huge numbers of people left the countryside and moved to the oil areas, the project areas, and/or the large cities, especially Lagos. Their hope and objective was to find better-paying and higher-status jobs in the oil and/or oil-related sectors, or working on private and public projects financed by the steady inflow of petrodollars.

As a consequence of the massive cash inflows 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 and Nigerians no longer produced enough food to feed themselves. The shortfall in food production was made up by importing numerous food products, including both traditional staples and alternative foodstuffs such as wheat.

In the early 1980's, the price of oil collapsed. Over the next ten years, the price varied considerably but was often in the range of slightly less than $10.00/barrel to slightly more than $20.00/barrel. The annual impact of this price collapse depended on the level of production, which varied somewhat from year to year. However, it is probably correct to say that in an average year, each decrease of $1.00 in the price of a barrel of oil reduced Nigeria's export earnings by at least $250,000,000 dollars. Thus, the total reduction in revenues to Nigeria of the oil price decrease over the decade of the 1980s undoubtedly exceeded 60 billion U.S. dollars.

It took several 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. Subsequently, manufacturing activities which relied exclusively on imported equipment, raw materials, and supplies began to suffer. For companies in these industries, the cost of imported equipment, spares, raw materials, and supplies escalated sharply, as large amounts of local currency chased an ever-shrinking pool of hard currencies including dollars. Between 1985 and 1995, the value of one naira (Nigeria's unit of currency) fell from $1.00 to less than $0.02. The resulting increases in the costs of overseas inputs led many industries to substitute local materials for imported ones (for example, brewers substituted sorghum for malt). Companies not able to find local substitutes increased prices, downsized their operations, or dropped out of business entirely.

Over time, the drying up of oil revenues had several additional negative effects on the quality of life and economic activity in Nigeria. Among these was the fact that proper functioning of the massive infrastructure investments in roads, bridges, communications, and buildings constructed during the oil boom required on-going maintenance and up-grading. Unfortunately, the huge decrease in Nigeria's overseas earnings meant that it was not possible to provide maintenance and upgrading in an ongoing fashion. Over time, therefore, basic services like roads, electricity, water supply, and telecommunications began to deteriorate and/or fail. 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 generating equipment for electricity and private boreholes (wells, for U.S. readers) and/or water trucking for water. In addition, because Nigeria's "hard-wire" phone equipment barely functioned due to service overloads and lack of maintenance, numerous businesspersons invested large amounts of money first in dedicated radio/microwave links and later, cellular telephone equipment. Of course, the need to make such investments increased very substantially the cost of doing business in Nigeria, and reduced dramatically the international competitiveness of Nigerian products and industry.

Another very debilitating 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 not able to continue paying the same levels of salaries and benefits as had been available to public sector employees in the past. As prices of goods and services containing imported materials increased (most goods did include some overseas parts or components), and as public sector salaries did not keep up with inflation, many civil service and public sector employees searched for alternative sources of funds so as to be able to maintain their standards of living. Ultimately, many public sector employees started accepting and then demanding bribes before they would act on requests for service and/or assistance by individual and/or corporate customers. By the late 1980s, Nigeria and especially its international airport in Lagos, Murtala Muhammed Airport, had a very ugly reputation as a den for thieves and crooks.

As the economic pressure on individuals increased, signs of the intense nature of their struggle to survive began to manifest themselves in the private sector as well. A small number of well-organized Nigerians became involved in a series of scams known as "419". In a typical "419" scam, a wealthy individual in a developed world nation receives a letter on the letterhead of a major Nigerian para-statal like the Nigerian National Petroleum Corporation (NNPC) indicating that a rich Nigerian businessperson needs access to an offshore account so as to be able to "park" some petrodollars for a few weeks or months. The letter invites the wealthy overseas individual to provide such an account, and promises that at the end of the "parking period," this individual will be reimbursed for their assistance by being allowed to keep a percentage of the parked funds. The hope of the perpetrators of the scheme is that the overseas "target" will provide them names and numbers for an existing bank account in the target's own country which has real money in it. Immediately on receipt of the names and numbers for real accounts, the Nigerian perpetrators utilize electronic funds transfer mechanisms to steal the target's funds and move them into their own accounts.

The above problems (that is, the scams, the infrastructure deterioration and the attendant increase in the costs of doing business, the inability of private sector firms to procure the foreign exchange needed to fund their ongoing operations and maintenance, the huge decrease both in the value of the naira and therefore the hard-currency equivalents of any profits earned in Nigeria, the corruption, and so on) led numerous multinational investors and companies to stay away from Nigeria. Furthermore, many of the multinational investors and/or corporations which had come to Nigeria in the 1960s and 70s decided to withdraw.

## THE PHARMACEUTICAL INDUSTRY IN NIGERIA & CHANGES IN THAT INDUSTRY

The pharmaceutical industry in Nigeria, like the national economy as a whole, has gone from boom to bust. During the oil boom (basically, the decade of the 1970s), the Nigerian pharmaceutical market was dominated by multinational companies. Due to the over-valued naira and the seemingly ever-expanding economy, a large number of multinational pharmaceutical firms including Glaxo, Hoechst, Pfizer, Sterling-Winthrop, Wellcome, and Huckstsone made substantial investments in Nigeria during this period.

Unfortunately for these multinational investors, Nigeria's oil boom was short-lived. Over the decade of the 1980s, the lower prices Nigeria received for its oil (as compared to the prices it hoped to receive, based on the experience of the 1970s) reduced Nigeria's earnings from oil by approximately 60 billion dollars. As indicated earlier, this magnitude of revenue reduction did impact negatively on the plans and budgets of nearly all private and public sector entities including hospitals and clinics.

A second change in the environment which over time impacted heavily on many sectors of the Nigerian economy including the pharmaceutical industry was the Nigerian Enterprise Promotion Decree of 1977. This decree required that foreign ownership of all firms operating in Nigeria be reduced to 40% or less. Due to this requirement, and the lack of control on technology which it implied, very few multinationals had any interest in inserting their latest and most current technology into the marketplace. Thus, rather than siting plants capable of manufacturing from intermediate products, as is done in many other developing countries, most multinationals limited the amount of technology transferred to Nigeria.

A third change in the environment, which directly impacted the pharmaceutical industry, was the passage in 1989 by the Federal Military Government (FMG) of a decree called the Essential Drug

List (EDL). The purpose of the EDL was to signal to all interested parties which pharmaceutical products could be sold in Nigeria. To be sold in Nigeria, pharmaceuticals not only had to be on the EDL but also had to show in large letters on the packaging of the product the generic family of the drug. Clearly, this legislation helped generic and/or private brand manufacturers, at the expense of firms such as HNL which imported expensive active materials from overseas and maintained very strict (and expensive) controls on GMP and on quality.

In addition to the main effect described above, the EDL generated some important side effects. For example, the EDL did not permit the sale of preparations which were mixtures of different drugs. Thus, products such as blood tonics which had in fact been mixtures of various products were suddenly not saleable as currently formulated. Interestingly, during the mandated reformulation process, several of these products became less efficacious. In any case, both the primary and secondary effects of the EDL impacted negatively on HNL's business.

As the decade of the 1990s began, the serious economic problems over the previous decade plus the effects of the NEPD (and, for pharmaceutical firms, the EDL as well) led many multinationals to rethink their commitment to Nigeria. Ultimately, many of them decided to leave. As the multinationals left, however, the resulting shortages of pharmaceutical products plus low barriers to entry in the pharmaceutical industry led local trading firms and/or manufacturing companies to begin importing low cost pharmaceutical preparations and/or ingredients of uncertain quality and efficacy (that is, effectiveness) from India and various locations in East Asia. In January 1995, 166 manufacturers of pharmaceuticals were registered to do business in Nigeria.

By and large, the remaining multinationals continued to monitor very carefully the materials going into their products, their production processes, and the characteristics and efficacy of the products coming off their production lines. However, many of the new pharmaceutical companies were not so careful. In a recent incident, one local manufacturer of pharmaceuticals had used the wrong alcohol in one of its children's cough syrups, and several children had died. Industry leaders had expressed the fear that low quality, low-priced products would drive out the highly efficacious but more expensive products which STP and other serious manufacturers were producing in Nigeria for Nigerians. Another concern was that the reputation of Nigerian pharmaceutical manufacturers and their products would sink so low that few direct or indirect consumers would be willing to buy any pharmaceutical product produced in Nigeria.

## PRESCRIBING HABITS IN NIGERIA/CHARACTERISTICS OF THE MARKET

The prescribing habits of health practitioners in Nigeria are shaped by both professional and "other than professional" factors. These factors include:

1. Disease pattern. The incidence of particular diseases in a particular area impacts very directly on the prescribing habits of health professionals in that area. Thus, if a particular area has a high incidence of malaria and respiratory diseases, the bulk of the prescriptions prepared by health professionals are likely to be for malarial and respiratory treatments.
2. Efficaciousness of drugs. If a health professional has a long history of success using a particular drug to treat a particular illness, that individual is very likely to continue

prescribing that highly efficacious drug. In such a situation, persuading a health professional to try some other drug may be quite difficult.

3. Scarcity of drugs. As the financial squeeze on hospitals and clinics (that is, direct customers) intensifies, health professionals find that certain drugs are no longer available. Health professionals in Nigeria are likely to keep lists of what drugs are available, so as to avoid being caught in a situation where they prescribe something that is no longer available.
4. Cost. As the financial squeeze on individuals (that is, indirect customers) intensifies and the standard of living continues to fall, the cost of drugs has become an important consideration. Publication of the Essential Drug List (EDL) in 1986 required all manufacturers in Nigeria to indicate the generic names of their pharmaceutical preparations. Recognizing the financial hardships of their clients, many health practitioners have moved to prescribing generic (as opposed to branded) products. Of the top nine pharmaceuticals prescribed in 1994 by the pediatric out-patient services unit of the University of Nigeria Teaching Hospital, only one is a branded product. At the far end of this generic continuum is the importation into Nigeria of cheap generic preparations from all over the world. The quality and efficacy of these cheap generics is unknown.
5. Quackery. There are a number of untrained individuals practicing at different levels of the health care system in Nigeria. Due to a number of factors including the high cost of professional health services and the growing inadequacy of many hospitals and clinics, a substantial percentage of the population patronizes these individuals. Also, self-medication is on the increase.

## YOUR ASSIGNMENT

Assume you are Ernest Adefope, M.D. of STP. Please indicate which of Porter's generic strategies (product differentiation, niche, or low-cost producer) you will recommend to your Directors, and why.

EXHIBIT 1A
STATES AND NICONGLO WAREHOUSE LOCATIONS IN NIGERIA

**EXHIBIT 1A**
**STATES AND NICONGLO WAREHOUSE LOCATION IN NIGERIA**

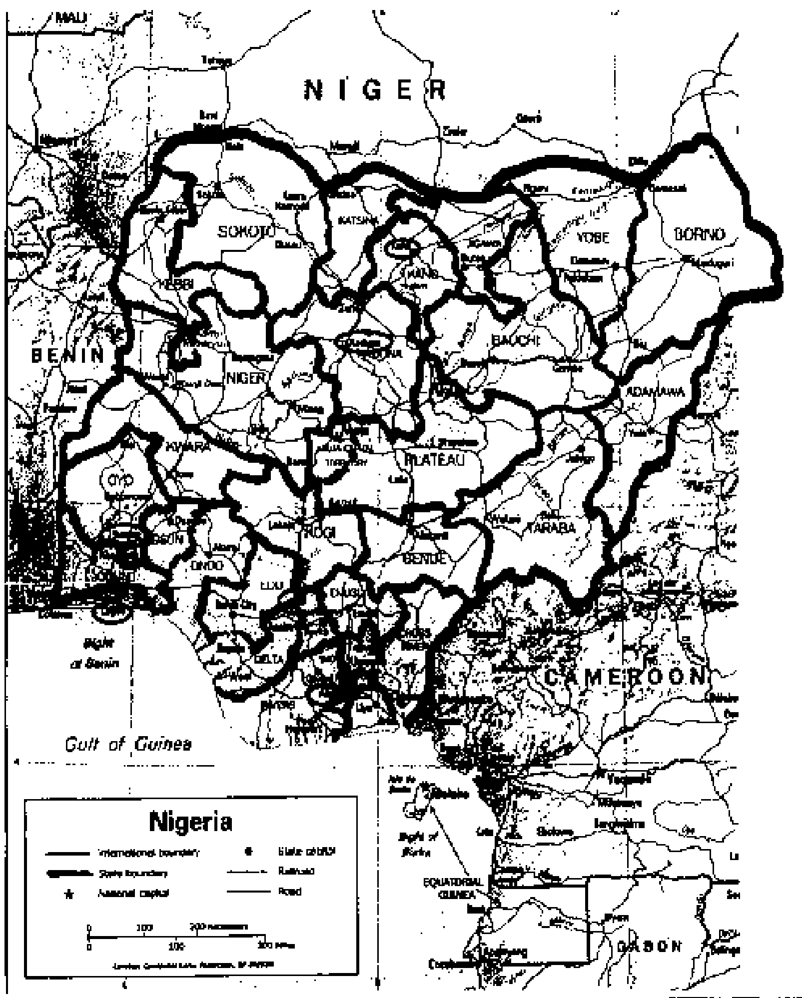

EXHIBIT 1B
1991 CENSUS FIGURES

| | State | Capital | Males | Females | Total |
|---|---|---|---|---|---|
| 1 | Lagos | Ikeja | 2,999,528 | 2,686,253 | 5,685,781 |
| 2 | Kano | Kano | 2,858,724 | 2,773,316 | 5,632,040 |
| 3 | Sokoto | Sokoto | 2,158,111 | 2,234,280 | 4,392,391 |
| 4 | Bauchi | Bauchi | 2,202,962 | 2,091,451 | 4,294,413 |
| 5 | Rivers | Port-Harcourt | 2,079,583 | 1,904,274 | 3,983,857 |
| 6 | Kaduna | Kaduna | 2,059,382 | 1,909,870 | 3,969,252 |
| 7 | Ondo | Akure | 1,958,928 | 1,925,557 | 3,884,485 |
| 8 | Katsina | Katsina | 1,944,218 | 1,934,126 | 3,878,344 |
| 9 | Oyo | Ibadan | 1,745,720 | 1,743,069 | 3,488,789 |
| 10 | Plateau | Jos | 1,645,730 | 1,637,974 | 3,283,704 |
| 11 | Enugu | Enugu | 1,482,245 | 1,679,050 | 3,161,295 |
| 12 | Jigawa | Dutse | 1,419,726 | 1,410,203 | 2,829,929 |
| 13 | Benue | Makurdi | 1,385,402 | 1,394,996 | 2,780,398 |
| 14 | Anambra | Awka | 1,374,801 | 1,393,102 | 2,767,903 |
| 15 | Borno | Borno | 1,327,311 | 1,269,278 | 2,596,589 |
| 16 | Delta | Asaba | 1,273,208 | 1,296,973 | 2,570,181 |
| 17 | Imo | Owerri | 1,178,031 | 1,307,468 | 2,485,499 |
| 18 | Niger | Minna | 1,290,720 | 1,191,647 | 2,482,367 |
| 19 | Akwa Ibom | Uyo | 1,162,430 | 1,197,306 | 2,359,736 |
| 20 | Ogun | Abeokuta | 1,144,907 | 1,193,663 | 2,338,570 |
| 21 | Abia | Umuahia | 1,108,357 | 1,189,621 | 2,297,978 |
| 22 | Osun | Oshogbo | 1,079,424 | 1,123,592 | 2,203,016 |
| 23 | Edo | Benin City | 1,082,718 | 1,077,130 | 2,159,848 |
| 24 | Adamawa | Yola | 1,084,824 | 1,039,225 | 2,124,049 |
| 25 | Kogi | Lokoja | 1,055,964 | 1,043,082 | 2,099,046 |
| 26 | Kebbi | Bimin Kebbi | 1,024,334 | 1,037,892 | 2,062,226 |
| 27 | Cross River | Calabar | 945,270 | 920,334 | 1,865,604 |
| 28 | Kwara | llorin | 790,921 | 775,548 | 1,566,469 |
| 29 | Taraba | Jalingo | 754,754 | 725,836 | 1,480,590 |
| 30 | Yobe | Damaturu | 719,763 | 691,718 | 1,411,481 |
| 31 | Federal Capital Terr | Abuja | 206,535 | 172,136 | 378,671 |
| | Country Totals | | **44,544,531** | **43,969,970** | **88,514,501** |

APPENDIX 1
Major Pharmaceutical Companies in Nigeria and Their Products

| | Analgesic | Anti Malarial | Antibiotics | Blood Tonics | Worm Expellent | Laxative | Cold-Related | Other |
|---|---|---|---|---|---|---|---|---|
| Smith Kline Beecham | *Phensic (1) | *Halfan | *Ampiclox<br>Augmentin<br>Amoxil | Extravite | Zentel | | Contac | *Macleans Toothpaste<br>Aquafresh Toothpaste |
| Nigerian Hoechst | *Daga (2)<br>*Novalgin<br>Tabalon | | *Taravid | Vitahext | | | | |
| Sterling Products Nigeria | *Panadol (2)<br>*Cafenol (1)<br>Hedex (1) | Norolon<br>Malaraquin<br>e | | | | *Andrews Liver Salt | Bre | *Izal Disinfectant |
| Pfizer | Feldene | | Terramycin<br>Vibramycin<br>Fasigny<br>Zithromax | | Combantrin<br><br>Banmith<br>(for animals) | | | TCP Disinfectant<br>Diflucan Anti-fungal<br>Trosyd Anti-fungal |
| Evans (Fomerly Glaxo) Nigeria) | | Paraquin | *Dequadin<br>Fortum<br>Zinacef | Ferbelan Tonic | | | *Cofta | Calamine Lotion Skin Treatment<br>*Betnovate Skin Treatment<br>*Dermanovate Skin Treatment<br>*Betnovate-C Skin Treatment<br>*Betnovate-N Skin Treatment |
| STP (formerly, Huckstone Nigeria) | Anacin | | *Tripsin | Plakel<br>Ladies First | Lynben | | *Tifact | |

(1) Aspirin-based
(2) Paracetamol-based
* One of the Company's strongest products, according to chemists.

APPENDIX 2
EXPERT PERCEPTIONS:
QUALITY/GMP LEVELS OF NIGERIAN PHARMACEUTICAL MANUFACTURERS

Bayer

"Taken over by Nigerians, current GMP standard uncertain."

Smith/Kline Beecham

"They are a strong company with their major strength in the analgesic market, which is a very important market in Nigeria."

Boots

"Taken over by Indians, current GMP standard uncertain."

Evans (formerly, Glaxo Nigeria, Ltd.)

"The presentation (packaging) of the locally produced products is very poor; and GMP standards are also low. Unless change occurs . . . they are not a force to be reckoned with."

Hoechst

"Taken over by Nigerians, current GMP standard uncertain."

Pfizer

"This is a well-run company externally and their products appear well-made. They have recently introduced a new rationalization (that is, downsizing) plan, and have spent US$1.5 million on equipment."

Roche

"They are also up for sale. They have an extremely high standard of GMP, but very limited capacity."

Sterling

"This is a well-run company with an advanced MIS system. However, they have recently been taken over by Smith/Kline Beecham, and it appears there will be some downsizing."

Wellcome

"A relatively small but well-run company with a high standard of GMP."

APPENDIX 3
1993 TURNOVER & PROFITS OF MAJOR PHARMACEUTICAL FIRMS IN NIGERIA
(000 of naira)

| Company | Turnover | Gross Profit | Operating Profit | Pretax Profit | Profit Retained |
|---|---|---|---|---|---|
| Evans(1) | 257710 | 109224 | 34914 | 19346 | 2268 |
| Nigeria/ Hoechst | 427519 | 218945 | 110212 | 45409 | 18914 |
| Pfizer | 261666 | 145336 | 86536 | 39584 | 15125 |
| STP (2) | 89960 | n.a. | n.a. | 24109 | 12864 |
| SmithKline/ Beecham | 806888 | 324846 | 195812 | 159418 | 61003 |
| Sterling Prod Nigeria | 398683 | 206966 | 81222 | 41617 | 7113 |
| Wellcome Nigeria | 100021 | n.a. | n.a. | 26812 | 14303 |
| (1) formerly, Glaxo Nigeria plc. | | | | | |
| (2) formerly, Huckstone Nigeria. | | | | | |

# TEACO, INC.

**George S. Vozikis, University of Tulsa**

## CASE DESCRIPTION

*This case can be used for an entrepreneurship or a strategic management course. It is a junior level case and it requires minimum or no preparation time, since it can be used directly in the classroom, even without prior study on the part of the students.*

## CASE SYNOPSIS

*This is a classic dilemma that a family business faces quite often, and it deals with the question of: "to grow or not to grow?" It is based on the translation of the mission statement into action, and the extension of the family business values that have sustained the family business for a long period of time quite successfully, into the realm of bigger, impersonal, diversification for the sake of growth, survival, and added value. Fundamental discussion issues here, could be: selling the business, compatibility of strategy and structure, the importance of family values and strong work ethic, "how did we get here?", "who is Madeline Teague?", being market driven vs. product driven, etc.*

## INTRODUCTION

Madeline Teague, President of TEACO, Inc. was wondering whether her life, her family and her fiber optics and cable business were at crossroads. She had just given an interview on how she started her business, and where she is going with it, and that interview started some soul searching for her. As she was driving away from downtown Tulsa in her native Oklahoma, her life almost flashed in front of her eyes. She had just been elected Vice Chairman of the Board for Tulsa's Chamber of Commerce. She considered herself honored for that appointment and more importantly, she realized that a lot of good visibility and recognition for her company could materialize as a result of this, especially now that what she considered a very important transformation was taking place in TEACO's headquarters.

She had never really given much thought about the firm's development and future, but rather had taken things in stride and going from day to day. All of sudden, out of the blue it seemed, a new division had to be created to take advantage of an opportunity to service the communication systems of midsize airports, such as Tulsa's or Little Rock's, which were due for a major updating and upgrading. TEACO was poised in becoming a major player in this field, but she knew deep down that they could not really take advantage of this enormous window of opportunity, unless they ceased to be a mere subcontractor and make the transformation into a general contractor that could actually bid on the contracts on their own. Until now, they have been subcontractors for SITA (Societe Internationale des Telecommunications Aeronautiques) headquartered in Paris and employing 10,000 employees. SITA is a network connector of airports worldwide for air traffic, weather, and communications, second only to AT&T, and owned jointly by all the world's airlines. They also subcontracted for AR, Inc. (Air Radio, Inc.) the pioneer in air to ground communications. TEACO took care of the local needs of SITA and AR, Inc. by designing a computer core room inside the airport and installing the computer racks, equipment, cable terminals, and their proprietary software systems. The plan was now for TEACO to duplicate SITA's setup for the smaller mid-size airports across the nation.

Risk taking was never an issue with her or her husband Patrick, TEACO's Executive Vice President. However this time things were different because the decision to become a general contractor really constituted a major shift in direction for the company, and a serious financial commitment. Once the decision was made, she knew deep down that there was no way back. But "why go back?" she said to herself, "we are good at what we are doing, we always plan well, and we have developed strong relationships with our vendors, our bank, and our customers. These factors by themselves would take care of any amount of risk involved."

She started thinking about how she and her husband started the business from scratch. Her husband worked for the oil industry and when, during the mid-eighties that industry was experiencing a slump, they started thinking about the "what if..." of his being laid off. They decided together, like they always had, not to wait for what seemed to be the inevitable, and started thinking about a business of their own. They figured that their life experience, their strong family values, and their desire to become independent and succeed were enough prerequisites.

They had no idea what to look for, and tried to figure what the "right" opportunity was for their humble journey toward independence. After much deliberation, they decided to try to buy an existing business that would already have its own clientele, and most importantly, somehow would have survived the initial critical stages of potential failure. But what kind of business? They figured that this issue was not important, as long as it was a good deal."

That opportunity soon presented itself in the form of a wire and cable distribution company with $350,000 of sales. The Teagues not only knew nothing about the wire and cable business, they did not even know the difference between a wire and cable. Regardless of these shortcomings, they decided to risk everything they had and buy the business. After looking at the mirror, they figured that nothing worthwhile happens without taking some risk, working hard, and willing to sacrifice. And sacrificed they did, during the early years when work always came first, before family needs, before entertainment, before realizing any fruits from their labor. Everything was going back into the business.

Their timing and luck must have been good because after the first year they made just under a million dollars in sales by selling door to door. They also got extremely lucky in finding a banker that was out of the ordinary by being entrepreneurial himself, and by not only securing for them the funds necessary to get started, but also by becoming a true advisor providing them with direction and guidance. They looked upon the bank as their "planner" who would set goals for them, especially since they were "extinguishing fires" all day, and did not have time to plan themselves. Their thinking was that, as long as the bank was happy, they must be moving in the right direction, otherwise the bank would surely let them know. This relationship with the bank became very close-knit over the years, and to this day they see them as partners rather than just a source of funding. This strategy seemed to be working fine so far, and their sales for 1997 were close to six and a half million dollars. Exhibits 1 and 2 show TEACO's balance sheet and income statement for 1997, compared with comparable industry data of computer integrated systems design firms (SIC# 7373) with 1996 sales between 5 and 10 million dollars (Sources: TEACO, Inc. and Robert Morris Associates, 1996.)

Exhibit 1
TEACO, Inc., and Subsidiary and Computer Integrated Systems Design Industry
(5-10MM in 1996 sales)

| BALANCE SHEET | TEACO | INDUSTRY in % |
|---|---|---|
| *ASSETS* | | |
| Current Assets | | |
| Cash | 199,390.16 | 9.4 |
| Accounts Receivable | 636,159.15 | 50.6 |
| Inventory | 67,506.46 | 8.8 |
| All other Current Assets | - | 5.1 |
| Total Current Assets | 903,055.77 | 73.9 |
| Fixed Assets | | |
| Furniture & Fixtures | 3,574.00 | |
| Machines & Equipment | 40,602.15 | |
| Reserve for Depreciation | (40,602.15) | |
| Automobiles | 25,350.00 | |
| Reserve for Depreciation | (23,740.29) | |
| Office Equipment | 52,558.48 | |
| Reserve for Depreciation | (43,562.86) | |
| Total Fixed Assets | 14,179.33 | 13.4 |
| Other Assets | | |
| Investment in Subsidiary | 500.00 | |
| Total Other Assets | 500.00 | 12.7 |
| *TOTAL ASSETS* | 917,735.10 | 100.00 |
| *LIABILITIES & OWNER'S EQUITY* | | |
| Current Liabilities | | |
| Accounts Payable | 596,428.51 | 17.8 |
| Accrued Taxes Payable | 65,778.02 | 1.3 |
| Other Current Liabilities | - | 36.2 |
| Total Current Liabilities | 662,206.53 | 55.3 |
| Long Term Debt | - | 12.4 |
| Shareholder Equity | | |
| Issued Common Stock | 1,000.00 | |
| Retained Earnings | 203,044.31 | |
| YTD Net Income | 51,484.26 | |
| Total Shareholder Equity | 255,528.57 | 32.3 |
| *TOTAL LIABILITY/OWNER EQUITY* | 917,735.10 | 100.00 |

Exhibit 2

TEACO, Inc., and Subsidiary and Computer Integrated Systems Design Industry

(5-10MM in 1996 sales)

INCOME STATEMENT

For fiscal year ending 6/30/97

| | Year-to-date | *TEACO* % | *INDUSTRY in %* |
|---|---|---|---|
| *INCOME* | | | |
| Sales | 6,467,503.64 | 98.65 | 100.00 |
| Sales - Labor | 89,678.00 | 1.37 | |
| Returns & Allowances | (1,196.00) | -0.02 | |
| Total Sales | 6,555,985.64 | 100.00 % | 100.00 % |
| | | | |
| *COST OF GOODS SOLD* | | | |
| Purchases | 4,424,768.94 | 67.49 | |
| Production Salaries | 311,956.66 | 4.76 | |
| Contract Labor | 51,616.53 | 0.79 | |
| Freight | 4,339.50 | 0.07 | |
| Shop Supplies | 1,609.46 | 0.02 | |
| Total Cost of Goods Sold | 4,794,291.09 | 73.13 % | |
| | | | |
| Gross Profit Before Commissions | 1,761,694.55 | 26.87 % | |
| Commissions | 134,989.50 | 2.06 | |
| | | | |
| Gross Profit | 1,626,705.05 | 24.81 % | |

| | | | |
|---|---|---|---|
| *OPERATING EXPENSES* | | | |
| Salaries - Officers | 236,720.00 | 3.61 | |
| Office Salaries | 88,100.35 | 1.34 | |
| Sales Salaries | 547,127.13 | 8.35 | |
| Payroll Taxes | 89,837.17 | 1.37 | |
| Payroll Benefits | 28,831.11 | 0.44 | |
| Advertising | 20,845.04 | 0.32 | |
| Accounting & Legal Fees | 3,293.77 | 0.05 | |
| Vehicle Expense | 79,938.66 | 1.22 | |
| Contributions | 7,666.00 | 0.12 | |
| Dues & Subscriptions | 4,872.10 | 0.07 | |
| Depreciation | 24,066.00 | 0.37 | |
| Meals | 29,322.35 | 0.45 | |
| Travel | 113,939.76 | 1.74 | |
| Equipment Rental | 73.38 | 0.00 | |
| Rent | 28,818.56 | 0.44 | |
| Telephone | 48,017.65 | 0.73 | |
| Electric | 4,875.59 | 0.07 | |
| Gas | 729.32 | 0.01 | |
| Water | 386.33 | 0.01 | |
| Office Supplies | 7,294.49 | 0.11 | |
| Insurance General | 35,135.48 | 0.54 | |
| Insurance Group Medical | 55,086.90 | 0.84 | |
| Seminars | 3,237.40 | 0.05 | |
| Office Expense | 62,465.56 | 0.95 | |
| Outside Services | 95,151.40 | 1.45 | |
| Interest Expense | 11,764.59 | 0.18 | |
| Trash Service | 350.00 | 0.01 | |
| Taxes Personal Property | 1,059.60 | 0.02 | |
| Taxes Franchise | 268.75 | 0.00 | |
| Taxes Other | 2,347.50 | 0.04 | |
| Postage | 1,356.29 | 0.02 | |
| Non-Deductible Expenses | 1,356.29 | 0.02 | |
| TOTAL OPERATING EXPENSES | 1,632,856.73 | 24.91 % | 95.6 % |
| | | | |
| NET OPERATING INCOME | (6,151.68) | -0.09 % | 4.5 % |
| | | | |
| Other Income | 79,673.94 | 1.22 | |
| Other Expenses | - | - | .9 |
| NET INCOME BEFORE TAX | 73,522.26 | 1.12 % | 3.5 % |
| Provision for Income Tax | 22,038.00 | 0.34 | |
| | | | |
| NET INCOME AFTER TAX | 51,484.26 | 0.79 % | |

Slowly they started looking at the business as a "concept" rather than a wire and cable distribution firm, and began to actually redefine and reinvent themselves from phone answerers, to salespeople, to finally "total communication specialists." This new concept which in itself broadened the scope of their business, is reflected in everything they do. Even their business cards convey this message. Additionally, the technological developments in the fiber optic cable business proved them right, and they found themselves constantly recreating and reinventing the limited range of opportunities that their original wire and cable business offered them. It seems that they were really the right people, at the right place, at the right time. They realized that time is money for any firm, and that seconds saved in transferring data saves a lot of money to companies that are information intensive and base their competitive advantage on a reliable fiber optics communication system (Exhibit 3).

As the years went by, TEACO was growing into all these areas, and these new divisions were reflected in their organizational chart. Salespeople were added to two other locations, in Springdale, AK, and in Dallas, while Tulsa, OK still served as the headquarters for the firm. Madeline was in charge of Administration, Sales, Public Relations, and Marketing, while her husband Pat was in charge of Operations. She had a Sales Manager reporting to her, while the many staff technicians reported to her husband. Accounting was done in house, with a former family friend and former small business owner CPA handling the TEACO finances, scrutinizing Accounts Payable, and providing valuable financial advice in direct cooperation with their bank, on the working capital requirements of the various contracts that TEACO was planning on submitting a bid. Progress payment schedules were also prepared, and specific cash flow requirements were laid out after consulting their vendors and suppliers, as well as their prospective customers, in order to "grease the skids". Their solid relationships with both past customers and vendors, always paid off for TEACO in managing the crucial issue of working capital, a critical factor for small business survival. Madeline realized that only this "team approach" could manage the growing business, and she could not possibly be everything and everywhere in meeting customers' needs, the TEACO way. This need for a "team approach" is also the reason that technical expertise is not the only thing TEACO looks when hiring new employees. "We want employees who are willing to make the commitment to customer satisfaction that we live by" she kept reminding herself.

Exhibit 3
Comparative costs for local-area networks (LAN): Category 5
Unshielded Copper cable vs. Fiber Optic Cable

| Material | Category 5 UTP Cable | Fiber Optic Cable |
|---|---|---|
| Cable-pair 24 AWG Level 5 | $29.50 | |
| Cable-duplex-62.5/125 micro meter-FDDI | $46.50 | |
| UPT patch panel 36-port RJ-45 Cat. 5 | $385.50 | |
| FO patch panel 72-port-ST couplers | | $325.00 |
| Outlet cover plate | $5.95 | $6.50 |
| RJ-45 Receptacle-Cat. 5 | $7.90 | |
| ST Plugs, PC-Ceramic (4) | | $20.00 |
| ST Couplers.Ceramic (2) | | $6.50 |
| Misc.: tywraps, labels, epoxy, etc. | $8.00 | $10.00 |
| Subtotal (base material) | $2,233.60 | $3,511.00 |
| UTP Cat 5 jumpers (3 feet) | $10.60 | |
| UTP Cat 5 jumpers (1 5 feet) | $11.80 | |
| FO PVC "zip" jumpers (3 feet) | | $25.00 |
| FO PVC "zip" jumpers (I 5 feet) | | $30.00 |
| Subtotal (Jumper cables) | $806.40 | $1,198.00 |
| Total materials | $3,040.00 | $5,491.00 |

| Labor Costs (35 drops) | Category 5 UTP Cable | Fiber Optic Cable |
|---|---|---|
| Set up for the pull | 4.5 hours | 4.5 hours |
| Gang pull to a central location | 7.5 hours | 7.5 hours |
| Thread each drop through a "stub" | 5.0 hours | 5.0 hours |
| Back pull and dress | 4.5 hours | 4.5 hours |
| Mount patch panel in IDF | 1.5 hours | 1.5 hours |
| Terminate IDF end of all cables | 1 0. 0 hours | 12.0 hours |
| Test and label all locations | 8.0 hours | 4.0 hours |
| Total Labor hours | 53.0 hours | 53.0 hours |
| Total Labor cost (&, $45/hour | $2,385.00 | $2,385.00 |
| Total installation cost | $5,425.00 | $7,876.00 |

(Source: Fahey, Michael. "Fiber vendors battle for the desktop." Business Communication Review, July 1994, v24 n7, p. 50)

Over the past 14 years, the Teague's company has evolved from a small electric wire and cable distribution company into a digital technology powerhouse, and the company has just begun to really reach its potential. TEACO's first customer was American Airlines, which hired the company to design and provide a fiber-optic system that would network its reservation system at Tulsa

International Airport. It was the first large-scale data application for fiber optics in the Southwest. Since that first installation, TEACO has designed and installed integrated systems in 30 airports, including seven outside the U.S. Today, TEACO has five divisions:

1. InfoTel Services headquartered in Dallas, a supplier of aviation and airport communication products and services
2. TEACO/Texas, which specializes in designing and installing structured premise distribution cabling systems
3. Teaco Micro Tech, Inc., a company of advanced systems integrators who install and maintain Local and Wide Area Networks throughout the United States, develop software for the Internet, software for secure access to bank databases for the bank's customers, and WebTV systems in 20 major markets around the country
4. New Document Technologies, Inc. (NDTI) which designs and delivers intelligent information management systems, and specializes in document imaging and management, combining taxes, phone messages, scanning and e-mail into one electronic processing package, eliminating paper documents. NDTI also designs and provides disaster recovery and data storage plans for businesses and governmental agencies, to prevent loss of vital information in a major disaster, and
5. WireMasters of Oklahoma that sells stocks and electrical and electronic wire, cable, tubing, and connectors.

The Teagues also realized that having a good product was not enough, as long as people did not know that they really needed it. They therefore embarked on an major campaign of educating their existing and potential customers about the benefits of switching to technologically advanced fiber optics communication systems. They decided that being "product driven" was not enough but they needed to become "market driven", in other words, it was not enough that they had a good product, but they had to create the demand for it by making their customers realize that they really needed their product. To that end, they reformulated their mission statement and publicized it widely among their customers and the community (Exhibit 4.)

Exhibit 4

TEACO, Inc. Mission and Values Statement

TEACO, INC. is a provider of world-class communication systems, including data, voice and video systems, affirming by quality our position as a leading supplier of the best services, solutions, and products that meet today's business needs and tomorrow's business goals. Through honest, ethical and profitable actions, TEACO, INC. will provide a fulfilling work environment for our employees, unparalleled service for our customers, and a spirit of responsible citizenship with our local and world community. (Source: TEACO, Inc.)

They also hired on a half-time basis Marketing Manager, Mike Dishman, a former Director of Tulsa’s Airport Authority, and notified all their customers to that effect with a personal letter. In the meantime, the Teague family was also becoming larger and prosperous, thanks to the Teagues' hard work, business acumen, and perfect timing. Their four children were still quite young, and only Patrick Jr. who is 15 years old and the only boy, has exhibited interest in the business, even though only on the "doing" side of computer applications, rather than the managing side of the firm. He often came along with his father on weekends to TEACO's labs to apply some brilliant solutions to complex computer problems that even experienced technicians could not solve.

The business had become the central element in their existence and allowed their family to enjoy the material things in life, without ever losing sight of what is really important: family and community. This is why she viewed her position as Board Vice Chairman of Tulsa's Chamber of Commerce as giving something back to the community, and maybe help somebody like herself start a business and prosper.

TEACO, Inc. also had recently decided to invest in the effort of certification as an 8A contractor, a tedious process that could open doors for the company in the very lucrative business of government procurement. Being part Cherokee native American Indian, Madeline Teague, as TEACO's president, qualified for participating in the 8A program which provides access to the huge government contract programs which are set aside for minority contractors. Selling to the government is never easy, and despite the enormous time and money investment in the 8A certification process, no additional government business had materialized so far.

With this diversity, TEACO is firmly positioned on the leading edge of digital technology, with a customer base that includes businesses as small as five employees, and as large as the U.S. Department of Energy, and is actively involved in developing Internet and intranet communications. However, Madeline knew very well that her husband Pat was convinced that TEACO should constantly be expanding to serve customers in healthcare, manufacturing, utilities, and education, in addition to its current expertise in aviation, banking, government, and the petroleum industry. As always however, Madeline was convinced that "you've got to spend money, to make money," and she wanted to be ready to capitalize on any advantage and opportunity she could find, since risks an opportunities go hand in hand. "The only way to manage risks is by exploiting opportunities", she kept telling herself "It is quite obvious that our customers are satisfied with the work we perform and that in itself leads to additional work or services being requested. We have to constantly make changes and additions in services and products to meet customer requirements, and we will continue to do so."

As she was getting ready to turn into her driveway at home after a hectic day, she thought about the new division that they were getting ready to create from scratch. TEACO's Airport Service Support Division would hopefully capitalize on the need for midsize airports to develop, update, and upgrade their communication systems. But was it a real opportunity or a downright risk? Was their decision to become a general contractor instead of remaining a subcontractor as they have always been, the right decision, especially given the major financial commitments and the change in strategic direction that such a decision entails. She thought about the "edge" that TEACO has had all along by entering the fiber optics and computer networking industries early, by pioneering their technology and expertise development and even by training companies and individuals who were their competition now. "We will never make that mistake ever again," she chastised herself. Was it time to maybe retire and sell the company in order to enjoy and spend more time with their children and grandchildren? How about taking the company public and transform it from a "personal" business to an "impersonal" corporation with more funding and improved structural configuration to face the new challenges?

As she pulled the keys to open the front door, she thought out loud: "We are going to have some interesting conversation over dinner tonight!..."

# FIELDCREST CANNON/PILLOWTEX

**Gerald E. Calvasina, University of North Carolina Charlotte**

## CASE DESCRIPTION

*The primary subject matter of this case concerns human resource management, union organizing, and the influence of the political legal environment. The case has a difficulty level of four (appropriate for senior-level courses), but would also be appropriate for masters level students. The case is designed to be taught in a maximum of two class hours and is expected to require a minimum of three hours of outside preparation by students depending on their background with technical aspects associated with union organizing.*

## CASE SYNOPSIS

*The case could be utilized in a number of different senior level or masters courses including business policy, business and society, or advanced human resource management courses. The case presents the evolution of Cannon Mills through it's current incarnation as Pillowtex and details the 25 year history of union organizing efforts that revolve around different ownership. From the benelovant paternalism of Charles Cannon, to the maverick style of David Murdock, leadership at the company has undergone radical change. The union's efforts, in addition to changes in the political and legal environment further complicate the issues and present the opportunity for the discussion of a wide range of human resource management issues.*

## FIELD CREST CANNON/PILLOWTEX

On December 4, 1997, Fieldcrest Cannon's Board of Directors met in New York for the last time. Pillowtex, headquartered in Dallas, Texas, would complete its $700 million acquisition of Kannapolis, North Carolina based Fieldcrest Cannon on December 19, 1997. The deal was expected to create a "new giant in the Big Three of home furnishings" and enhance Pillowtex's product line by adding some of the strongest brand names in the industry.

The acquisition would enable Pillowtex to save an estimated $21.6 million annually. The savings would be generated from elimination of administrative and corporate jobs at Fieldcrest Cannon's headquarters in Kannapolis. Another $8.4 million was expected to be saved in the first year of combined operation by eliminating redundant operations, exploiting economies of scale in purchasing, and reducing trade advertising and the number of outside consultants. Speculation in the community and the local press put the number of corporate jobs to be lost at more than 300.

Another very interested party to the December 19th completion of the Pillowtex acquisition of Fieldcrest Cannon, was the ten member contingent of the Union of Needletrades, Industrial and Textile Employees (UNITE). UNITE, formed by a 1995 merger of the Amalgamated Clothing and Textile Workers Union (ACTWU) and the International Ladies' Garment Union (ILGWU) and backed by committed leadership and a healthy treasury, was committed to organizing new members.

UNITE was especially committed to organizing women, immigrants, minorities, and low-wage workers. Utilizing a variety of traditional and innovative organizing methods, UNITE was poised to take advantage of what looked like a golden opportunity to finally organize Fieldcrest Cannon. Working from offices located in Kannapolis, UNITE employees and volunteers were managing an authorization card drive as part of its long running effort to organize Fieldcrest's 5,500 North Carolina workers, an effort that dated back to 1974. Coming off a defeat in August 1997 of a hard fought for rerun of their 1991 defeat at Fieldcrest Cannon, UNITE seemed undaunted in its efforts to secure union representation for the employees of the remnants of the Cannon Mills empire.

Cannon Mills, the forerunner of Fieldcrest Cannon, was a world leader in the manufacture of household textiles for the bedroom, bathroom, and kitchen; it was known at one time as the world's largest producer of towels. The company at one time employed approximately 24,000 people in 21 plants in 13 communities in North Carolina, South Carolina, and Georgia. Cannon's corporate sales subsidiary, Cannon Mills Inc. had offices in major markets though out the world. The company utilized a strategy based on strong identification with the customer that helped make the Cannon name one of the single most recognized in the entire textile industry.

Cannon Mills was founded in 1887 by James William Cannon. He built the mill and the community in 1907. The fortunes of the town of Kannapolis, Greek for "city of Looms", have been interwoven with those of the mill ever since. Over the years, the company supported the community, donating land and money for churches, schools, hospitals and, providing jobs for nearly a third of the town's residents. Following the death of James Cannon in 1921, his son Charles Albert Cannon continued to expand and develop the company. In 1928, the nine mills known as the Cannon group were consolidated into Cannon Mills Company. Charles Cannon, known fondly as Mr. Charlie during his fifty year reign, built a company whose products reached 90% of US households. Over the years, further expansion and product diversification occurred and the company gained a reputation as an industry leader in design, styling, manufacturing and marketing of textile products for the home. Cannon entered the sheet business in the early 1930's and expanded towel production to include a wide range of kitchen products. Bedspreads and coordinated draperies were added to the line in 1949. Later acquisitions included blankets and rugs manufactured at Cannon Rug Company, a consolidated subsidiary.

After Charles Cannon's death in 1971, Cannon Mills went through 3 chief executive officers in less than a dozen years before the company was purchased for $413 million by David Murdock in March of 1982. It was the first time the Los Angeles entrepreneur had actually taken operational control at a large manufacturing company. When Murdock purchased Cannon Mills, he announced that his major goals would be to provide better job security and improve the quality of life for Cannon employees, their families and the plant communities and, he invested over $200 million to that end. The total included $73 million for pay increases and new job benefits; $123 million for capital improvements; $10 million for community improvements and contributions and $5 million spent on the acquisition of Cannon Rug Company.

In 1984, many of Murdock's plans for Cannon Mills began to unravel. The company's international sales fell from $55 million in 1981 to $24 million. Faced with increasing imports and weak consumer sales, the company was forced to layoff 3,000 employees, reduce pay scales, and rescind many of the perks that the mill hands had enjoyed under more than 90 years of Cannon family rule. Employees were asked to purchase the 1600 company houses instead of renting them. Many of these changes drew worker protests and created a good deal of tension between workers and management.

The first of four union organizing campaigns that Cannon Mills would experience occurred in 1974. Fresh on the heels of a successful organizing effort by the Amalgamated Clothing and Textile Workers Union (ACTWU) at a J.P. Stevens Plant in Roanoke Rapids, North Carolina, union organizers set their sights on the 16,000 employees of Cannon Mills. Over the years, Cannon's benevolent paternalism helped it enjoy a reputation as a steady job provider in an unstable industry. The company provided low cost housing to its workers and treated workers like family members. Many believe that the company's generosity to its employees and the town of Kannapolis helped to defeat the union organizing drive by a vote of 8,473 to 6,801. The rejection of the union by Cannon Mills' workers was a bitter defeat for organized labor in the south. The 1974 J.P. Stevens vote was to many observers to be a stimulus to labor growth in the traditionally anti-union south. The bitter resistance of J.P. Stevens to the unionization effort and subsequent contract negations lasted until October of 1980 when Stevens management and the ACTWU finally signed their first contract covering the Roanoke Rapids workers. While few observers predicted the 1974 union effort at Cannon Mills would be successful, coming on the heels of the J.P. Stevens success, the defeat of the union at Cannon Mills was certainly a severe blow to union organizing efforts in the south.

Ten years later, the Amalgamated Clothing and Textile Workers Union (ACTWU) was back in Kannapolis, armed and ready for an organizing effort that would divert the attention of Cannon Mills management for sixteen long and tense months. While many employers learn of union organizing efforts by their employees only after the National Labor Relations Board (NLRB) informs them, the ACTWU efforts to organize Cannon Mills' 10,500 employees was clearly out in the open a full sixteen months before the election would eventually take place. With a union office in downtown Kannapolis and, armed with a healthy budget, the ACTWU led by Bruce Raynor engaged in one of the most sophisticated union organizing efforts ever seen. Using computerized direct-mailing to stay in touch with workers and, extensive radio and television advertising, the union effort at Cannon Mills attracted national attention.

The issues utilized by the union in their campaign for the most part were predictable. Job security was brought to the front early and was easily introduced in the wake of over 3,000 layoffs and selective plant closing by Cannon management. The union also attacked Cannon management's efforts to increase work loads and reduce wage rates in the face of the increased competition from imports. In addition, the union also repeatedly accused Cannon Mills owner David Murdock of threatening to sell or close the company if the union were to win bargaining rights for Cannon workers. As the campaign progressed, Murdock became the focal point of union rhetoric. Characterized repeatedly in the press as a wealthy Los Angeles financier, the union attempted to portray Murdock as a greedy and ruthless corporate raider not interested in the long term survival of Cannon Mills or its employees.

While Murdock became the focal point of union rhetoric as the campaign wore on, his role in management's response to the organizing effort was critical throughout the sixteen months preceding the election. With company president Doug Kingsmore leading management's campaign, backed by a sophisticated strategy developed by a law firm specializing in anti-union campaigns, Cannon Mills management was able to respond quickly to every union issue.

The Cannon strategy to defeat the union effort was composed of some very traditional elements utilized by firms in fending off union organizing efforts. It included extensive meetings with community, business, and religious leaders and groups in the community in an attempt to put pressure on workers from outside the work environment. In addition, Murdock donated extensively to help renovate downtown Kannapolis, providing a new library, YWCA, and senior citizen's center. Extensive use of anti-union films were required viewing for workers on company time. Letters home to workers with President Kingsmore and Murdock referring to workers as "associates" were utilized to develop the theme of team spirit to not only keep the union out but overcome the threat created by textile imports. Murdock and Kingsmore made repeated visits to plants to shake hands and listen to workers' concerns. The weekly Cannon Mills news letter was filled with anti-union letters from workers and community leaders. One of the most controversial elements of the campaign was a videotape produced late in the campaign which featured Murdock explaining in what press reports called a "sentimental-and often angry-appeal" to Cannon workers to vote against the union. In the tape Murdock appeals to workers, "let's be a happy family again. Let's all be able to see some smiles again." Later in the tape, Murdock describes the ACTWU as "outsiders", "carpetbaggers" and "an insidious cancer". In response to the union claims that Murdock was attempting to sell the company, Murdock tells the 10,500 workers who view the tape that "Cannon has not been and is not being sold."

In October of 1984, Cannon Mills' employees rejected the ACTWU organizing effort by a 5,983 to 3,530 vote. The large margin of defeat for the union was a surprise to most independent observers. By January of the following year, David Murdock completed a deal to sell 80% of Cannon Mills Co. operations to Fieldcrest Mills Inc. for $250 million. The ACTWU office in downtown Kannapolis remained open.

Fieldcrest Mills Inc., manufactured linen at both union and non-union plants throughout the southeastern United States. The 1985 purchase of Cannon Mills, a major competitor with approximately 11,000 non-union employees, created enhanced optimism in ACTWU ranks.

The 1991 effort by the ACTWU was characterized by many independent observers as organized labor's best chance to finally organize Cannon employees. Even though he had been gone for six years, David Murdock became a key figure in 1991. Murdock's sale of the company barely two months after employees voted by a wide margin not to unionize, severely damaged labor management relations at Cannon. In addition, Murdock's manipulation of "surplus" pension money that eventually reduced pensions for nearly 8,000 retirees by 30 percent was utilized extensively by the union. The representation election was held in August of 1991 and Fieldcrest Cannon prevailed by a vote of 3,443 to 3,053.

The ACTWU upon losing the election, filed unfair labor practice charges alleging over 100 violations of the NLRA including unlawful discrimination against 20 employees. After 36 days of hearings, involving 83 witnesses presented by the NLRB general council, 154 by Fieldcrest, and 19 by the union, filling up more than 7,800 transcript pages, the Administrative Law Judge's decision later upheld by the full board in Washington, sided with the ACTWU on virtually all counts.

The election campaign was described in the 1996 Fourth Circuit Court of Appeals decision addressing the National Labor Relations Board (NLRB) enforcement order as "hotly contested." The court went on to describe Fieldcrest's approach to opposing unionization of its workforce as "a scorched earth, take-no-prisoners approach to stop unionization without regard to statutory limitations." Campaign literature utilized by Fieldcrest included a flier depicting a mushroom cloud and the words: "There's more than one way to destroy a community. VOTE NO." Another, in Spanish, warned: "If you sign the [union card] and the government finds out about it you will be deported or sent to prison." Unlawful interrogation by supervisors and threats of reprisal if employees voted for the union by supervisors were documented. One supervisor was quoted as stating that "Fieldcrest would move to Mexico if the union prevailed." Numerous other incidents of hostility toward union supporters was documented in the more than 100 unfair labor practice charges upheld by the NLRB and the court. The NLRB affirmed the Administrative Law Judge's conclusions and the Fourth Circuit enforced the board's order detailed in Table 1. The court order set the stage for the next round in the attempt to organize the Fieldcrest Cannon associates. The voting, finally scheduled for August 13, 1997, was again expected to be preceded by another intense campaign by both sides.

The 1997 campaign to organize the 5,500 Fieldcrest employees in the seven former Cannon plants in Rowan and Cabarrus counties was described by many observers as very different from the previous three attempts. UNITE, armed with a powerful set of marching orders from the NLRB decision and subsequent Fourth Circuit Court of Appeals order, gained unprecedented access to workers at the plants (see Table I). Organizers were allowed to go inside the plants to talk with workers during breaks. Union organizers were to be given advance notice when management was to address employees on the unionization effort and, were to be given equal time to respond. Organizers also claimed that workers were more "savvy" this time around to the anti-union tactics of Fieldcrest Cannon.

Union organizers were also able to generate some support from community, support that was scarce in the past. Despite the cuts to Cannon retirees' pensions in 1991, only days before the vote local ministers encouraged workers to vote against the union. In 1997, UNITE boasted of over 50 local clergy endorsements of the union efforts to improve the lot Fieldcrest Cannon employees. The union also utilized a two-hour live television show produced at a local cable-access station to present its message to workers.

The company claimed that workers at its plants that were already unionized received the same wages and benefits as those at the non union plants. Dick Reece, vice-president for human resources was "confident the associates of Fieldcrest Cannon would see through the false promises of the union and conclude that the union is not in their best interest, the company's best interest, or the community's best interest." While Fieldcrest Cannon had lost money in 1995 and 1996, shortly before the election management took Wall Street by surprise by announcing that earnings were well above analysts expectations.

In spite of all the perceived advantages that UNITE brought to the election, the employees voted 2,563 to 2,194 not to unionize. While the outcome of the vote was immediately challenged by the union, once again organized labor had suffered a bitter defeat at "Mr. Charlie's" company. While the defeat was a bitter one, union organizers remained determined. The ten person staff at UNITE's headquarters in Kannapolis remained open and active. Bruce Raynor, UNITE's southern regional director vowed "We won't let this outlaw company get away with stealing workers' rights", and that "Cannon workers will have their day of victory. We're in this fight to win." On September 11, 1997, less than a month after the election, it was announced that Dallas-based Pillowtex had agreed to acquire Fieldcrest Cannon factories for $700 million.

The Pillowtex acquisition of Fieldcrest Cannon created the "nation's largest home furnishings company". In an interview shortly after the deal was announced, Pillowtex's CEO Chuck Hansen revealed some of the plans he had for Fieldcrest Cannon. Describing Fieldcrest as the "weak sister" of the big home-furnishings companies, Hansen revealed plans to spend $300 million to upgrade Fieldcrest factories. According to published reports, Fieldcrest, which had twice the annual sales of Pillowtex, will operate as a subsidiary. Pillowtex sales in 1996 were $491 million.

Hansen's plans included modernizing Fieldcrest's older factories and a lean approach to corporate staffing. 300 jobs were cut after the acquisition was complete, mostly from the headquarters staff and not production workers. Severance packages included two weeks' pay for every year of service with a minimum of six weeks' pay and a maximum of one year. Also announced were more specific capital spending plans for 1998 which included $12 million for Pillowtex facilities and $68 million for Fieldcrest operations, primarily in North Carolina. New looms were to be installed in the Kannapolis terry operations. Hansen planed to keep the Fieldcrest headquarters building in Kannapolis open and will maintain an office there. The headquarters building will also get a fresh coat of paint and matching carpet throughout. Hansen does not expect to reopen any of the yarn mills Fieldcrest closed in 1995 when it outsourced much of its yarn production.

> We need to start developing a sense of pride about what we're about... this is absolutely a great company. (Chuck Hansen, Pillowtex CEO, December 1997)

On December 17, 1997, UNITE announced its supporters had collected signatures of 2,924 of the 5,331 eligible Fieldcrest employees supporting the union. They called on Pillowtex to agree to a card-check recognition or another representation election early in 1998. The results of the August 1997 election were still in the process of being contested by UNITE at the NLRB. Union supporters were optimistic.

> I expect to see Pillowtex across the table from me negotiating. (Bill Douglas, 20 year Fieldcrest/Cannon veteran of Plant 6 in Concord, December, 1997)

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# A FAMILY "UNFRIENDLY" POLICY?

**Stephen D. Owens, Western Carolina University**

## CASE DESCRIPTION

*The primary subject of this case concerns the effect the Family and Medical Leave Act (FMLA) can have on labor-management relations and personnel decisions. Secondary issues include the relationship of the FMLA to other employment laws, supervisory skills, discipline policies, and interpersonal communication skills. The case has a difficulty of four and is appropriate for senior-level courses and can be taught in one and one-half hours. About three hours of outside preparation by students is expected.*

## CASE SYNOPSIS

*In a workplace with a collective bargaining agreement, it is the supervisor who bears responsibility for the day-to-day implementation of the terms of the labor agreement. In this case the responsibility is made more difficult when federal law impacts the ability of a supervisor to deal with absenteeism problems. In this case an employee is disciplined for irregular attendance; he files a grievance protesting management's action contending that the absences qualified as FMLA leave. The student is required to take the role of the arbitrator to extract the relevant facts and decide whether or not the discipline was justified. The case examines how the parties' collective bargaining relationship can be affected by a specific statutory regulation, the FMLA.*

# HARVEST ORGANIC GARDENS (A)

**Marilyn Young, The University of Texas at Tyler**
**Leslie Toombs, The University of Texas at Tyler**
**Amy Moser, The University of Texas at Tyler**
**Araeli Lopez, The University of Texas at Tyler**

## CASE OVERVIEW

*This case would be appropriate in the undergraduate classes of Principles of Marketing, Marketing Management or Entrepreneurship. The case is intended to shown the difficulty in marketing a new product. Students will identify important factors in selecting an appropriate marketing strategy for a new product.*

## CASE SYNOPSIS

*Ashley Grant is interested in starting a nursery/greenhouse business that deals exclusively in organic gardening products, services, and methods. She also plans to have gardening reference materials available for sale or loan and a Web page. This business would allow her to utilize her business management skills while pursuing an avid interest in gardening.*

*Ashley plans to seek financial assistance in the form of a Small Business Administration loan. As she finalizes her business plan and through an informal conversation with her banker, she realizes that she needs to formulate a well developed marketing plan to complete the package.*

*In order to gather market relevant data, Ashley designs and administers a competitor survey. Results are given and discussed.*

# TO SELL OR NOT TO SELL: PERSONAL/CORPORATE SOCIAL RESPONSIBILITY IN THE RECORDING INDUSTRY

**Neil Gilchrist, Truman State University**
**Val Larsen, Truman State University**

## CASE DESCRIPTION

*The primary subject matter of this case is corporate social responsibility. Secondary issues include personal ethics and personal social responsibility. This case is appropriate for junior and senior level courses in marketing and management. It is adaptable to either a fifty or seventy-five minute period and should require one-two hours of preparation for students.*

## CASE SYNOPSIS

*Time Warner (and other large recording companies) invest in small recording labels to capitalize on those labels' ability to shift quickly into new music trends and profit from those quick shifts. Some of the music on the small labels is controversial in its content and language. Feminist groups and conservative politicians have expressed their displeasure that Time Warner would own the labels and/or distribute this type of music. Time Warner executives need to respond to these groups' accusations because they create negative publicity. Is Time Warner responsible for the type of music produced and/or distributed by its subsidiaries? Would restriction of this music constitute censorship on their part? The case gives students the opportunity to think about and respond to ethical issues from both a corporate and a personal point of view.*

## TO SELL OR NOT TO SELL: PERSONAL/CORPORATE SOCIAL RESPONSIBILITY IN THE RECORDING INDUSTRY

Time Warner executives have gathered in a conference room at their Rockefeller Center headquarters in New York to plot a strategy for dealing with an on-going public relations problem. Top executives of the company, particularly company chairman Gerald Levin, have faced strong criticism from politicians and from conservative, liberal, and feminist activists who believe that music marketed by some of the company's subsidiaries is socially destructive. The company first faced an explosive nationwide controversy in 1993 when it distributed rapper Ice-T's song "Cop Killer." Levin himself became involved in that controversy, writing an opinion piece in the *Wall Street Journal* defending the company's involvement with Ice-T. However, the company eventually felt compelled to pull the record and to end its relationship with Ice-T. Now it again faces pressure to discontinue profitable relationships with controversial artists such as Dr. Dre and Snoop Doggy Dog, Ol' Dirty Bastard, Lords of Acid, and Junior M.A.F.I.A., among others. The pressures have created dissension among Time Warner's directors, some wanting the company to shed the controversial groups while others want to continue current business practices. A decision is being forced because Time Warner managers have agreed to meet with a prominent conservative, William Bennett, former Secretary of Education in the Reagan Administration, and a prominent liberal, C. DeLores Tucker, chair of the National Political Congress of Black Women, who have joined together to focus press attention and public criticism on Time Warner. The executives are trying to decide how to deal with the immediate crisis and with the longer term problem of whether they should continue to court public criticism by marketing music that many of the company's current and potential customers find repugnant.

Time Warner's situation is complicated by the fact that it is involved in many lines of business besides music. The world's largest entertainment and information company, it was born though the 1989 merger of Time Inc. and Warner Communications. Its publishing subsidiary, Time Inc., includes a magazine unit that produces more than 25 magazines, e.g., Time, People, and Sports Illustrated, and a book publishing unit that includes Warner Books, Little Brown, and Time Life, a direct marketer of books, music, and videos. The entertainment portion of the company includes Warner Bros. (movies and television programming), HBO, CNN, TBS, WB, a television network, and various cable systems that, taken together, make it the second largest cable operator in the United States. The entertainment unit also runs a theme park, the Atlanta Braves, and Atlanta Hawks. Between them, these operating units had 1996 revenues of $23.7 billion.

The focus of Time Warner's current difficulties is the Warner Music Group, a division of the entertainment unit that is the number one music company in the United States. The Warner Music Group is associated (either through ownership or distribution) with more than 25 record labels. The music it markets ranges from rap, rock, and pop, to blues, country, classical, and Christian. While much of this music is uncontroversial, the music produced by Interscope Records, a remarkably successful new subsidiary of the Warner Music Group, has been widely criticized. This new startup, half owned by Time Warner, half by Jimmy Iovine and Ted Field and now valued at $400 million, had $111 million in domestic revenues last year and has seized in only a couple of years 2% of the domestic music market, a market share that puts it ahead of such long-established labels as EMI Records and Motown. However, because it has marketed the music of its own controversial artists, Tupak Shakur, Nine Inch Nails, Junior M.A.F.I.A., and Marilyn Manson, and has distributed the music of Death Row Record's still more controversial artists, Interscope has also brought to Time Warner a disproportionate amount of public criticism. The public relations problem faced by the Time Warner executives gathered in New York derives largely, though not exclusively, from the activities of Interscope Records.

As the Time Warner executives conclude their heated discussion on what course the company might follow, Bennett and Tucker enter the conference room to make their argument. They emphasize that they are not calling for censorship--government action to block the distribution and sale of the controversial music. They are calling for personal and corporate social responsibility. Bennett and Tucker suggest that the First Amendment to the Constitution may give Tupak Shakur, Junior M.A.F.I.A., and Marilyn Manson a right to make their abhorrent music, but it doesn't guarantee them the right to have their music marketed by Time Warner or other major music distributors. If Time Warner and the other majors--Sony, Polygram, Thorn EMI, and the Bertlesmann Music Group--decline to market this music, its influence on American Life will be dramatically diminished. Bennett and Tucker declare their intention to join with Senators Joseph Lieberman and Sam Nunn to put similar pressure on Time Warner's major competitors. Before leaving, in an effort to drive home their message, Bennett and Tucker give the Time Warner executives a sheet full of gangsta lyrics and ask that one of the executives read the lyrics aloud. The executives decline to do so. Bennett and Tucker leave for a press conference where Bennett tells the press who have assembled to hear an account of the meeting, "We are asking the chief executives of these major international conglomerates to confront the horrible messages these songs are sending and to consider whether they want to make their livelihood in this way. We are going to continue to put the heat and light on these guys. We're in it for the duration." Bennett's words are borne out in subsequent weeks as his organization, Empower America, launches a radio and petition campaign against gansta music and as C. DeLores Tucker joins with feminists Gloria Steinem, Eleanor Smeal, Anita Perez, and singer Melba Moore to protest the release of "Smack My Bitch Up," a new Time Warner song by the British rock group Prodigy. To the music of "Santa Clause is Coming to Town," the feminist protesters sing, "You have a right to publish, as Klan and Nazis do, but you would never publish what endangers men like you."

Meanwhile, the top leadership of Time Warner are pondering their options. If profitability were the only question, their choice would be quite clear: continue to operate as at present, taking care to watch for any negative effects bad publicity might have on business activities in and outside the music area. But even if it turns out that the controversy won't reduce profitability, is profit the only issue? Is there any merit to the claim that the music Time Warner is marketing has a negative effect on society? If it does have a negative effect, does Time Warner have any obligation to be concerned about that effect? Is it possible, on the other hand, that the music may have some positive social value that might offset its bad effects? Does it lead to a degradation of social relationships and to increased violence against women, children, and others as critics have charged? Does it corrupt children? Assuming that it does, does Time Warner share with the children's parents any moral responsibility to protect the children? Does it corrupt adults? One executive points out that great art has often been controversial when it was first created but later became well accepted and respected. Another suggests, on the other hand, that Time Warner spends millions of dollars on advertising each year, an expenditure that earns a good return and seems to suggest that music and images can have a significant effect on people's behavior. The executives ultimately decide to take a close look at the sheet of lyrics Bennett and Tucker have left behind, a sheet that contains songs marketed by Time Warner music subsidiaries and by competitors.

Nine Inch Nails
*The Downward Spiral* (Nothing/TVT/Interscope) *"Big Man with a Gun"*

"I am a big man ... and I have a big gun, got me a big old d**k and I, I like to have fun. Held against your forehead, I'll make you suck it. Maybe I'll put a hole in your head ... just for the f**k of it. I can reduce you if I want...."

Dove Shack
*The Dove Shack* (Rush) "*Slap a Hoe*"

"...if your gal is giving you problems (and I know she is)... run out and get the amazing Slap-a-Hoe device... All you do is, uh, post up against that b**ches tilt for a bit, smack her around with the Slap-a-Hoe and I guarantee in less than 20 minutes that b**ch will be back in line... Hey, how you keep them hoes in check? Well goddamn, I had more problems than O.J. But now, I reach back with 9.6 velocity and slap the snot out of the b**ch..."

2Pac Shakur
*All Eyez on Me* (Death Row) "*No More Pain*"

"... Now fire when ready, stay watchin' out figure. Increase speed, make you motherf**kas bleed. From your mouth quicker... Line up my adversaries, blast on sight... I dare you niggas to open fire. I'll murder that *ss. And disappear before the cops come runnin'. My glocks spittin' rounds, niggas fallin' down, clutchin' their stomach."

Lords of Acid
*Voodoo U* (American Recordings) "*Young Boys*"

"Young Boys) Ooh... dressed up in leather legs I wanna make them shine. (Come now) Do my specialty... Number 69. (My boys) Shock me and thrill me you know what I desire. (You're hot) Nasty and spicy enough to quench my fire... (Young boys) Soft and so kissable I wanna feel their touch. Youthful and healthy love that never stops. (Take all) Its unbelievable squeeze you till you drop."

Cannibal Corpse
*The Bleeding* (Metal Blade) "*F**ked With A Knife*"

"Tied tight to the bed, legs spread apart. Bruised flesh, laceration, skin stained with blood. I'm the only one you love, I feel her heart beating. My knife stuck deep inside, her crotch is bleeding. She liked the way it felt inside her, f**king her, harder, harder. Stick it in, rip the skin, carve and twist, torn flesh. From behind, I cut her crotch. In her *ss, I stuck my c**ck. Killing as I c*m."

*Tomb of the Mutilated* (Metal Blade) "*Necroedphile*"

"I was a man before I transformed into this molester, freshly deceased children. You have been torn by rape. The dead are not safe, the lifeless child corpse I will violate. Pleasure from the dead, complete satisfaction. I open the coffin sick thoughts run through my head as I stare at the dead... I begin the dead sex, licking the rotted orifice. I c*m in her cold c**t, shivering with ecstasy. For nine days straight I do the same... I masturbate with her severed head. My lubrication, her decomposition. Spending my life molesting dead children."

Put yourselves in the position of executives at Time Warner and at Sony, Polygram, Thorn EMI, and the Bertlesmann Music Group. Do you think music such as this might foster violence or otherwise lead to a degradation of social relationships? Try to answer the questions the executives are struggling with in the last paragraph above. Would you be willing to devote your career to selling this kind of material?

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# MANAGING HUMAN RESOURCES IN A TRANSITIONAL ECONOMY: WILL A HUNGARIAN TOBACCO VENTURE GO UP IN SMOKE? AN INTERNATIONAL FIELD STUDY CASE IN HRM

**Norbert F. Elbert, Saginaw Valley State University**
**Robert D. Hatfield, Morehead State University**

ABSTRACT

*This case is a disguised but factual Human Resource Management case documented during a prolonged visit to Hungary in 1992. Eastern European countries, including Russia and the Ukraine, are at the same stage today that Hungary was at the time of the case. This case examines a controversial HRM decision to terminate a key "old guard" manager and highlights the broader cultural, national, and paradigm conflicts which are occurring as Western business moves into Central and Eastern Europe. In this case Hungary serves as an example of a transitional economy which is moving from a socialist to a market economy. The organizational and personal level repercussions which occur in response to this national change are dramatized. The related problems are made vivid in this perspective on the HRM and strategic problems of a U.S. firm buying and attempting to change one of the former state-run tobacco factories. The case includes Instructors Notes which contain additional background information on Hungary along with Discussion Questions and suggested answers for each section.*

# GLACIER MOTEL
# AN EXPANSION ANALYSIS

**David Coffee, Western Carolina University**
**N. Leroy Kauffman, Western Carolina University**
**John Beegle, Western Carolina University**

## CASE DESCRIPTION

*This case considers the issue of whether to invest in capital construction which will expand the capacity of the Glacier Motel from its existing 80 rooms to 120 rooms. The case has a difficulty level of four/five and is appropriate for intermediate, advanced or graduate level students. It is designed to be taught in one hour and requires two hours outside preparation by students.*

## CASE SYNOPSIS

*The expansion decision required is primarily a capital budgeting problem and can be made using traditional capital budgeting techniques using time value of cash flows and an analysis of cost and revenue behavior. The case will illustrate the impact of uncertainty and the importance of a careful evaluation of future cash flows when applying a capital budgeting model.*

# AN UNUSUAL LOAN
# FINANCIAL ACCOUNTING AND TAX ISSUES

**David Coffee, Western Carolina University**
**Roger Lirely, Western Carolina University**

## CASE DESCRIPTION

*This case considers the financial accounting and tax issues associated with a loan made by a manufacturing company to a major league baseball team. The case has a difficulty level of four/five and is appropriate for an upper level financial accounting class or tax class. It is designed to be taught in one hour and requires two hours outside preparation by students.*

## CASE SYNOPSIS

*A manufacturing company loans a major league baseball team money at an interest rate below market. The baseball team donates 20 season tickets to the company. Students are required to evaluate this transaction to determine: (1) how it should be treated for financial reporting purposes by the lender; and (2) the proper tax treatment of the transaction by the lender. The case demonstrates how financial and tax issues can be similar as well as different in a business transaction.*

# MADZI FURNITURE
# "THERE WAS AN OWL IN THE BUILDING"

**John Masten, Tennessee State University**
**Precious Givah, Malawi Institute of Management**

## CASE DESCRIPTION

*The primary subject matter of this case is business succession planning and economic costs associated with the premature (HIV/AIDS related) death of a small business owner in an African setting (Malawi). Cultural and gender issues are important secondary issues. The case difficulty is three. The case is expected to require one class hour of discussion and, at least, three outside hours of preparation by students.*

## CASE SYNOPSIS

*Mrs. Phiri worked as a nurse for the local hospital in Lilongwe, Malawi. Her husband, at age 36, started a small furniture repair business. Within 4 years, the business grew to over 50 workers. The family heavily relied on profits from the business. Mr. Phiri became ill in 1992 and he died in 1994 but, shortly before the illness began, he hired his brother to help manage the business. The brother began to divert company funds to his own personal ventures, Mrs. Phiri was forced to become involved. Three years after her husband's death the business is close to failure and Mrs. Phiri is reviewing the events that led to her problem and is pondering possible future courses of action.*

# THE CONCH HARBOUR INN

**J. Edwin Priddle, Barry University**
**Inge Nickerson, Barry University**

ABSTRACT

*Conch Harbour Inn is a case study concerned with decisions to be made in improving efficiency in the operations of a bed and breakfast enterprise located in Key West, Florida. The issue to be addressed involves the use of technology. The case is intended for upper-level undergraduate students enrolled in entrepreneurship, information systems, and/or accounting classes. Benefits to students include experience in decision-making by choosing among alternatives, application of accounting theory through preparation of cash flow statements, and exposure to real world information while researching prices of computer equipment. Time requirement is 2 hours in class and 4 hours outside of class.*

## BARBARA

Barbara Billingsly graduated from Barry University four years ago with a B.S. degree in Business, majoring in management. After graduation, Barbara accepted a job with a major fast food chain - Chicken King. She accepted this particular offer (she had several) because of her interest and background in the hospitality industry. Her grandfather owned a bed and breakfast - The Conch Harbour Inn - in Key West and she had worked there during summers and vacations while attending Barry.

Barbara's first position was as a $20,000-a-year management trainee at one of Chicken King's franchise stores in Ft. Lauderdale. After a successful year of learning and proving herself, she was promoted to assistant manager and transferred to a store in Atlanta. As an assistant manager, Barbara's salary was raised to $25,000 per year. Her responsibilities included running the kitchen and handling customer complaints, enabling her to hone her people skills. Her evaluations by the manager of the store were excellent.

Eighteen months after moving to Atlanta, Barbara accepted an offer to manage a new company store which was opening in Boston. As manager, her duties included all hiring and firing of personnel, over-seeing quality control, local advertising and maintaining proper in ventory levels. Her salary was now $30,000 per year. The chain's inventory system was highly computerized, with a client/server networked system connected to company headquarters in Chicago. Barbara's experience with this system convinced her that the use of technology could dramatically reduce the time and cost of running a business.

Again Barbara was up to the task and received excellent ratings, after her first year in Boston, from the regional supervisor for the New England area. She received a 10% merit raise. Six months later (January of this year) she was offered another promotion and a salary of $40,000 if she would move to Chicago and work at company headquarters. At this time, though, her grandfather decided to retire, and offered Barbara a 50% interest in his bed and breakfast if she would move to Key West and run the inn. Last year's profit from the inn was $64,000 (see the Appendix for financial statements); so, if Barbara decided to accepted her grandfather's offer and simply maintained the status quo, she could expect to make $32,000 per year. This all occurred right after the blizzard of 1997 that hit Chicago and then moved eastward to blanket New England with record amounts of snow and record low temperatures. The favorable Florida weather and a chance to own her own business (or half anyway) convinced Barbara to accept her grandfather's offer.

## THE BED AND BREAKFAST

The Conch Harbour Inn

The inn has been owned and run by the Billingsly family for 32 years. Benjamin (the grandfather) took over from his father 20 years ago. The inn is located in a residential area just four blocks from Duval Street on Williams Street, but away from the main tourist attractions. It has eight large rooms on two floors for rent that share two bathrooms (European plan), there is also a private attic suite with its own bath and entrance. The suite has the traditional widow's walk of historic Key West houses where wives are said to have watched and waited (not always successfully) for their sailor husbands' return from the sea. The view from the widow's walk at sunset is spectacular. The manager's apartment takes up half of the first floor. The European plan rooms' rental rate averages $50 per night, while the Suite averages $75 per night. The inn also sells gift certificates in $100 denominations which expire if not used within two years. The gift certificates are included in the room rental revenues when used. Last year the occupancy rate for the European plan rooms was 65% and the Suite was rented 75% of the time. The inn added central air conditioning just over a year ago at a cost of $10,000. The air conditioning system is currently the only asset with a remaining depreciable cost and is being depreciated over a 10 year life using the straight line depreciation method. The inn also has a pool and offers its guests free off-street parking.

The inn has two employees - a cook who receives a salary of $20,000 per year and a maid who receives a salary of $15,000 per year. The cook buys all of the food for the inn, cooks breakfast five days a week, and washes the dishes afterward. On the cook's days off (Tuesdays and Wednesdays) a continental breakfast is served. The maid works half days, seven days a week. It will be Barbara's job to take reservations (they have an 800 number, but it only seems to be used by a few repeat customers each year), check guests in, supervise the cook and maid, keep the books and manage the finances of the inn. Benjamin plans to move on to a houseboat which he purchased a couple of years ago, but he will be available between fishing trips to help maintain the inn and do small repairs.

For the past three years, Benjamin has paid $50 a month for a local advertising business to print and distribute fliers advertising the inn to tourists on the street and at a booth at the corner of Duval Street and Truman Avenue. He thinks the fliers are generating business, but he's not sure how much. This is the only advertising the inn does.

Benjamin has always kept the inn's books manually. He insists that Barbara take over this job since he has always hated accounting.

Barbara has persuaded her grandfather to allow her to spend up to $5,000 of the inn's cash reserves to make changes to improve the inn's occupancy rate, which is significantly below the rates of other bed and breakfasts in Key West, and to reduce the time needed to run the business, since she would like to have a life (being 25 and single) outside of running the inn.

REQUIRED:

A. How can Barbara accomplish these goals through the use of technology? Develop a list of needed hardware and software along with prices.

B. Prepare Cash Flow Statements for 1997 and 1996 using either the direct method or the indirect method (assume any unidentified changes in cash are from either additional investments or withdrawals by Benjamin).

C. List the pros and cons of the bed and breakfast ownership and management versus a career with a major corporation for Barbara.

APPENDIX

The Conch Harbour Inn
Income Statement
For Years Ended December 31

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Revenues: | | | |
| European Room Rentals | $95,000 | $90,000 | $89,600 |
| Suite Room Rentals | 20,500 | 18,600 | 20,000 |
| Interest Income | 500 | 400 | 400 |
| **Total Revenues** | $116,000 | $109,000 | $110,000 |
| **Expenses:** | | | |
| Salaries | $35,000 | $34,000 | $33,000 |
| Interest | 0 | 0 | 8,00 |
| Food | 4,300 | 4,100 | 4,200 |
| Utilities | 2,500 | 2,400 | 2,400 |
| Property Taxes | 2,400 | 2,400 | 2,300 |
| Payroll Taxes | 2,200 | 2,100 | 2,000 |
| Insurance | 1,800 | 1,900 | 2,000 |
| Depreciation | 1,000 | 300 | 0 |
| Maintenance | 1,000 | 900 | 1,000 |
| Supplies | 700 | 800 | 800 |
| Advertising | 600 | 600 | 600 |
| Accounting | 500 | 500 | 400 |
| Total Expenses | $52,000 | 50,000 | 56,700 |
| Net Income | $64,000 | $59,000 | $53,300 |

The Conch Harbour Inn
Balance Sheet
As of December 31

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| ASSETS | | | |
| Current Assets: | | | |
| Cash | $11,000 | $6,000 | $4,000 |
| Food Inventory | 100 | 200 | 100 |
| Supplies | 200 | 300 | 400 |
| Prepaid Insurance | 300 | 500 | 200 |
| Total Current Assets | $11,600 | $7,000 | $4,700 |
| Noncurrent Assets: | | | |
| Land | $1,300 | $1,300 | $1,300 |
| Building (net) | 5,000 | 5,000 | 5,000 |
| Furnishings (net) | 3,000 | 3,000 | 3,000 |
| Air Conditioning System (net) | 8,700 | 9,700 | 0 |
| Total Noncurrent Assets | $18,000 | $19,000 | $9,300 |
| Total Assets | $29,600 | $26,000 | $14,000 |
| LIABILITIES | | | |
| Current Liabilities: | | | |
| Accounts Payable | $150 | $150 | $150 |
| Gift Certificates Payable | 500 | 100 | 600 |
| Payroll Taxes Payable | 250 | 250 | 250 |
| Total Current Liabilities | $900 | $500 | $1,000 |
| Noncurrent Liabilities: | | | |
| Mortgage Payable | $ 0 | $ 0 | $2,000 |
| Total Liabilities | $900 | $500 | $3,000 |
| OWNER'S EQUITY | | | |
| Benjamin Billingsly, Capital | $28,700 | $25,500 | $11,000 |
| Total Liabilities & Owner Equity | $29,600 | $26,000 | $14,000 |

# NEON LIGHTS

**Inge Nickerson, Barry University**
**Michael Broihahn, Barry University**

## ABSTRACT

*This case is based on an actual business situation. It concerns itself with the structure and operation of a Miami company which is in the business of installing auto alarms, stereos, window tinting, and accessory neon lights.*

*The value of this case is to illustrate to entrepreneurs the dangers inherent in incompetent business management. The owners could have benefited from proper business planning which would have pointed out the potential problems with the operation of their enterprise.*

## INTRODUCTION

When Maria Fernandez incorporated her business Neon Lights, Inc. in October 1994, she envisioned taking advantage of the Holiday Season to get the business off to a fast start. However, it was not until February 1995 that she was able to begin operations. The interim was taken up with securing a location for the business, adapting it to her purposes, locating suppliers, and hiring personnel.

Neon Lights is engaged in the sale and installation of top-quality auto alarms, stereo equipment, window tinting, and neon kits. The business is owned by Maria, who takes care of administrative matters and much of the sales activities. Her son, Alex, also is involved in sales. He relates especially well to the teenage customers who seek his advice on technical matters. Maria's husband, Osvaldo, is in charge of operations. As Maria explains, "Osvaldo has a knack with keeping the workers satisfied. They respect him and follow his lead."

Both Maria and Osvaldo were new to the automobile accessories business. They decided to start the business on advice of a cousin who operated a similar establishment in the Orlando area with satisfying results. The thinking was that South Florida would be a natural for this type of business.

Maria's prior work experience was in administration and sales, most recently selling automobiles. Osvaldo previously worked in the construction industry. When the opportunity arose to acquire the Bird Road facility, the Fernandezes decided to use their accumulated savings to begin operations.

During the years that Raymond Hollister owned and operated a successful automotive repair business in upstate New York, he and his family enjoyed spending their winter vacations in South Florida. It was a natural then that, after the business was sold at Hollister's retirement, he and his wife chose to locate in Miami-Dade County, Florida.

At first the newfound freedom was appealing to Ray, but after a while he became restless and decided to become involved in volunteer activities in the community. As Ray liked to say, "How many flowers can you plant before you have a nursery?" When he heard of an organization which paired retired executives with struggling businesses, he decided to give it a try. This was how Ray came to call on Maria and Osvaldo Fernandez who had requested help in energizing their sputtering business operation. They decided to meet at the Neon Lights location on Tuesday morning.

When Hollister arrived for his appointment, he was greeted warmly by Maria and Osvaldo who were eager to show off their business. As they toured the premises, Ray noticed how attractive the facilities were. The remodeling had been done by Osvaldo, who took much pride in the handsome outcome. He had maximized the limited space at his disposal.

The geographic location of Neon Lights is on one of Miami's busiest thoroughfares. It is situated on Bird Road. The area has a large number of mini malls that attract a large number of customers looking for the best product and value. The area also has a large Hispanic community to whom this kind of service is very appealing. Another important factor is that the store itself is located in a mini auto mall. On the western end of the mall there are a general auto mechanic and a tire shop, while a transmission repair shop occupies the eastern end of the mall. Neon Lights is located in the middle. (See drawing)

The advantages of the location are: (1) The mini mall concept. The customers do not have to look all over the place for different car needs. They go from one shop to another and save time. This could be the kind of service for the future and a possibility to be ahead of the competition. But a sense of cooperation is needed among all parties involved in the mall; and (2) There is a lot of traffic on Bird Road, and usually it is slow moving. This makes the store very noticeable for the people who are looking for the kind of service Neon Lights offers. Also, the intensity of the traffic gives more visibility to the store itself. The roof of the mall is blue, which provides a contrast to the location and gives more visibility to the store.

The disadvantages of the location are: (1) Bird Road is scheduled for expansion in 1999, and this would mean that construction will hurt the traffic flow. The nature of the expansion could also partially or completely block access to the business. This could be a death blow to the business if customers do not have access from one of the side roads or the back alley. The road will be widened to three lanes in each direction with the configuration shifting during the construction phase, thus making it difficult for motorists to adjust to the change. (2) Parking already is a problem, because it is limited to four to six spaces (two of which are currently occupied by a shiny new Cadillac and a sport utility vehicle belonging to Neon Lights). The situation can only get worse by the widening of the road. Also, after the widening of the road, the number of parking spaces will decrease. (3) An important problem with the present location is that the work area is very limited. There is space for two cars inside of the shop, but there is only one narrow exit. Also, the installation and tinting are done in the same area, and work on both services at the same time is not feasible. (4) There are other businesses in the area that do not have a good reputation for quality. This reputation could keep customers from coming to the area in general. The problem that the other businesses have makes most of the customers one-time users of their services. This kind of expectation can be difficult to change in customers.

## EXPANSION AT THE PRESENT LOCATION

There are two possibilities for expansion for Neon Lights at the present location. One expansion possibility is to use the back alley as an entrance into the working area of the business. This could reduce the parking problem for those who are waiting to be served. The cars could be lined up in the alley while two cars could be serviced inside the working area. In this scenario, the back alley could be used for window tinting to increase the work area, and it could separate the tinting from the installation and facilitate work flow.

The second expansion possibility is to try to take over adjacent businesses when their leases run out or if they are financially unable to stay in the business. The tire store on the west side is already in financial difficulties because of limited parking. If Neon Lights is able to take over this lease, they would have more parking spaces and work area, but this expansion would not help the parking problem when Bird Road is widening, because the space is in the same area without a side entrance.

The other adjacent property is to the east. This is a transmission repair store which does not appear to have a lot of business. This location is the most appealing because it is a corner location on Bird Road. During the expansion of Bird Road, this location would provide better access to the business.

## EXPANSION TO NEW LOCATION

The owners do not want to move out of their present location, so a new location would only be considered as a second store. The most interesting place is Sun Sound & Protection, which is located one-half mile west of Neon Lights. This expansion could reduce the congestion at the old site and increase parking without having to lose business. Presently, sites outside of the immediate area have not been considered.

## INDUSTRY AND MARKETING

There are actually two targets of this business. The first and most sought after is the 16- to 25-year old who is interested in purchasing the stereo, alarm, tinting, or neon kit. Often this target becomes just an everyday new car buyer. The other target is senior citizens. According to Maria, the seniors are a group with a lot of money. A third potential target market, presently under consideration, is the export of products to the Caribbean and Latin America.

The market share held by Neon Lights is estimated at 35% of the relevant zip code area. Thus far, the market for these products and services has been fluctuating with the South Florida economy.

Competition consists of businesses in the immediate area. On Bird Road there are two major competitors: Sun Sound & Protection and Florida Sound and Protection. The main reason for initial sales and return of customers to Neon Lights is the company's reputation for quality products, service, and competitive pricing.

The industry is a blend of three basic auto accessory businesses—the auto tint industry, the auto stereo industry, and the auto alarm industry. The three have been in existence for many years, separately. A new component, especially popular with teenage customers, is the neon trim applied to outline the underframes and license plates of cars.

With two competitors in Neon Lights' zip code, price competition is a company concern. Because of their close proximity, it is easy for the businesses to spy on one another, observing both management skills and tactics to draw customers.

A situation may arise where Neon Lights could expand its business by acquiring an area competitor. By eliminating this competitor, Neon Lights will increase capacity and increase its market share.

## CONTRACTED LABOR FORCE

Currently the business has seven independent contractors who work on the installation of car alarms, stereo sound systems and window tinting. Contractors must pay their own Social Security and income taxes as well as cover their own insurance, workers compensation, etc.

Maria lamented the transitory nature of the laborers, which created much turnover in the shop. Osvaldo found that he had to cultivate particularly the window tinters, which was seen as favoritism by the other workers, and it created tensions. It was Osvaldo's diplomatic skills which kept it all together.

## INTERNAL CONTROLS

The need for better internal control is evident in many different areas of the organization; of special importance are inventory control, cash and credit card collections for customer sales, and paperwork for all company transactions.

When Ray Hollister questioned Maria about her practice of keeping the same checking account for household and business expenditures, she replied that it was easier and cheaper to do so because there was only one minimum balance to be maintained.

## OWNER'S GOALS

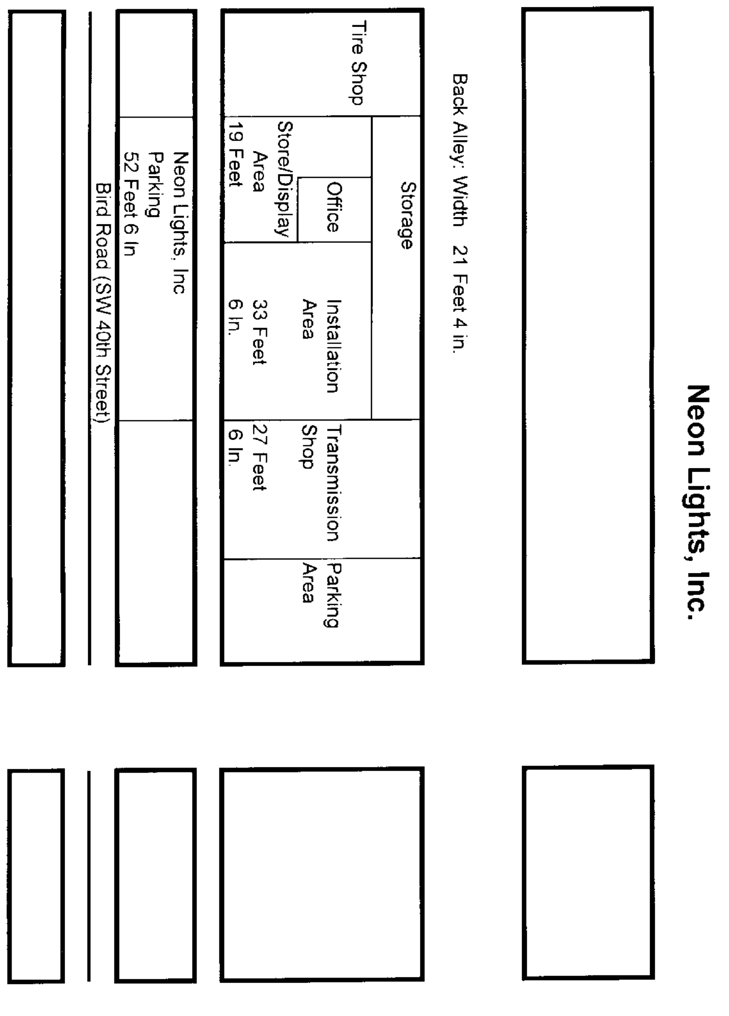
Maria Fernandez, with the consultant's help, is trying to accomplish the following:

<u>Planning</u>-- Have a better picture of goals and objectives.
<u>Organizing</u>-- Define the tasks, write job descriptions, and improve administrative efficiencies.
<u>Directing</u>-- Supervise the work of contractors to increase productivity
<u>Controlling</u>-- Control inventory, costs, expenses, and losses.

Many of the problems perceived by Maria fall within the normal range of difficulties that small businesses face especially in their initial stages. They tend to be numerous, with some not very difficult to solve while others require more correction.

## QUESTIONS

1. Prepare a Situational Analysis (SWOT) of the business.
2. What are the major problems to be addressed in this business?
3. What are your recommendations? Why?


Neon Lights, Inc.
Back Alley: Width 21 Feet 4 in.
Tire Shop
Storage
Office
Store/Display
Area
19 Feet
Installation
Area
33 Feet
6 In.
Transmission
Shop
27 Feet
6 In.
Parking
Area
Neon Lights, Inc
Parking
52 Feet 6 In
Bird Road (SW 40th Street)

NEON LIGHTS
Income Statement
For the 8 Months Ended 9/30/95
and Years Ended 9/30/96 and 9/30/97

| | 1995 | **1996** | **1997** |
|---|---|---|---|
| Net Sales | $ 196,988 | $ 472,171 | $ 449,874 |
| Cost of Goods Sold | 110,616 | 265,137 | 256,391 |
| Gross Profit | **$ 86,372** | **$ 207,034** | **$ 193,483** |
| | | | |
| Advertising | 8,500 | 15,550 | 7,250 |
| Rent | 12,000 | 18,600 | 19,530 |
| Utilities | 11,742 | 18,717 | 19,981 |
| Supplies | 1,827 | 2,874 | 3,112 |
| Finance Charge | 2,782 | 7,531 | 3,541 |
| Taxes & Licenses | 345 | 455 | 620 |
| Travel & Entertainment | 978 | 3,542 | 5,977 |
| Insurance | 1,571 | 1,841 | 2,145 |
| Wages | 32,760 | 31,597 | 34,177 |
| Contractor Fees | 0 | 76,737 | 87,182 |
| Auto Lease | 6,588 | 13,176 | 13,176 |
| Misc. Expense | 739 | 1,305 | 1,573 |
| Depreciation | 4,425 | 6,637 | 6,637 |
| Total Operating Expense | **$ 84,257** | **$ 198,562** | **$ 204,901** |
| | | | |
| Income Before Tax (Loss) | 2,115 | 8,472 | (11,418) |
| Income Tax (Benefit) | 317 | 1,271 | ( 1,588) |
| Net Income (Loss) | **$ 1,798** | **$ 7,201** | **$ ( 9,830)** |

**NEON LIGHTS, INC.**
**BALANCE SHEETS**

| **Assets** | **9/30/95** | **9/30/96** | **9/30/97** |
|---|---|---|---|
| Cash | $ 2,112 | $ 1,813 | $ 1,093 |
| Inventory | 6,445 | 7,185 | 5,128 |
| Prepaid Expense | 1,475 | 825 | 1,350 |
| Income Tax Refund | 0 | 0 | 1,588 |
| **Total Current Assets** | **$ 10,032** | **$ 9,159** | **$ 9,159** |
| | | | |
| Furniture (net) | 3,570 | 2,856 | 2,142 |
| Equipment (net) | 18,773 | 15,023 | 11,273 |
| Leasehold Improvement (net) | 10,842 | 8,669 | 6,496 |
| Deposit | 3,360 | 3,360 | 3,360 |
| **Total Long-Term Assets** | **36,545** | **29,908** | **23,271** |
| **TOTAL ASSETS** | **$ 46,577** | **$ 39,731** | **$ 32,430** |
| | | | |
| **Liabilities** | | | |
| | | | |
| Accounts Payable | 6,707 | 5,898 | 9,789 |
| Sales Tax Payable | 1,755 | 2,563 | 2,472 |
| Income Tax Payable | 317 | 1,271 | 0 |
| **Total Current Liabilities** | **$ 8,779** | **$ 9,732** | **$ 12,261** |
| | | | |
| Loans From Related Parties | 35,000 | 20,000 | 20,000 |
| **TOTAL LIABILITIES** | **$ 43,779** | **$ 29,732** | **$ 32,261** |
| | | | |
| **Equity** | | | |
| | | | |
| Common Stock | 1,000 | 1,000 | 1,000 |
| Retained Earnings (Deficit) | 1,798 | 8,999 | (831) |
| **Total Capital** | **2,798** | **9,999** | **169** |
| **TOTAL LIAB. & EQUITY** | **$ 46,577** | **$ 39,731** | **$ 32,430** |

NEON LIGHTS INC.
STATEMENT OF CASH FLOWS
For the 8 Months Ended 9/30/95
And the Years Ended 9/30/96 and 9/30/97

| Cash Flow from Operating Activity | **9/30/95** | **9/30/96** | **9/30/97** |
|---|---|---|---|
| Net Income (Loss) | $ 1,798 | $ 7,201 | (9830) |
| Depreciation | 4,425 | 6,637 | 6,637 |
| Dec (Increase) in Inventory | (6445) | (740) | 2,057 |
| Dec (Increase) in Prepaid Expense | (1,475) | 650 | (525) |
| Dec (Increase) in Accounts Payable | 6,707 | (809) | 3,891 |
| Inc (Decrease) in Sales Tax Payable | 1,755 | 808 | (91) |
| Inc (Decrease) in Income Tax Payable | 317 | 954 | (2850) |
| **Net Cash Flow Operating Activity** | **$ 7,082** | **$ 14,701** | **$ (720)** |
| | | | |
| **Cash Flow from Investing Activity** | | | |
| Acquisition of Capital Assets | (37,610) | 0 | 0 |
| Deposits - Long Term | (3,360) | 0 | 0 |
| **Net Cash Flow Investing Activity** | **$(40,970)** | 0 | 0 |
| | | | |
| **Cash Flow from Financing Activity** | | | |
| Equity Investment | 1,000 | 0 | 0 |
| Loans from Related Parties | 35,000 | (15,000) | 0 |
| **Net Cash Flow Financing Activity** | **36,000** | (15,000) | 0 |
| | | | |
| **Net Cash Flow** | **2,112** | **(299)** | **(720)** |
| Beginning Cash Balance | 0 | 2,112 | 1,813 |
| **ENDING CASH BALANCE** | **$ 2,112** | **$ 1,813** | $ 1, 093 |

# REINVENTING VALUJET: WHAT'S IN A NAME?

**Neal F. Thomson, Columbus State University**
**Robin L. Snipes, Columbus State University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns Strategy. Secondary issues include marketing and government regulation of business. This case has a difficulty level of 3 to 4, appropriate for junior and senior level classes. It is designed to be taught during a one-hour class period, and is expected to require two hours of outside preparation by students.*

## CASE SYNOPSIS

*The name AirTran Airlines may not be familiar to most people, but the company behind the name is perhaps all too well known: ValuJet. Once known as the low cost alternative to the larger carriers, ValuJet now evokes images of the catastrophic crash of ValuJet flight 592, on May 11, 1996. This tragic crash resulted in the death of all 110 people on board. The crash in itself, although distressing, was not really the problem (Planes occasionally do crash, regardless of the efforts of their companies to make them safe, as evidenced by the crash of TWA flight 800). What made the ValuJet crash so different is that it was so easily avoidable. Errors made by Sabretech, an equipment maintenance subcontractor, and ValuJet itself, were directly responsible for the downing of the plane.*

*This crash, while calamitous for ValuJet, did not destroy the company. On September 30, 1996, with the FAA's approval, ValuJet restarted operations between 5 cities, with a reduced fleet of fewer than 15 craft. Since that date, they have built operations back up to 30 planes flying to 24 cities, still down from their peak of 51 planes, to 31 cities, prior to the crash. Despite this comeback, ValuJet has suffered from an image problem that continues to hinder operations. Since the crash was due to negligence on the part of the airline, as well as their subcontractors, many people are wary of flying ValuJet. This has contributed to ValuJet's name change to AirTran Airlines, as well as their merger with AirTran Airways, a smaller regional carrier, with a fleet of 10 planes.*

*This case examines ValuJet since the crash, including a synopsis of the events that caused the crash, and the strategic decision to merge with AirTran Airways, and drop the ValuJet name. Related marketing issues such as branding and product positioning are discussed.*

## INTRODUCTION

ValuJet, a name once associated with economy and low-frills travel, now stands in infamy, associated with excessive cost cutting to the point of being unsafe. Faced with this situation, how does a company rebound? Other companies have rebuilt their reputations after crises of similar magnitude. For example, Exxon managed to recover from the hit its reputation took after their mishandling of the Exxon Valdez oil spill in Prince William Sound, Alaska. Similarly, Ford survived, and rebuilt a strong corporate image, despite the fallout of the debacle involving the exploding Pinto in the 1970's. ValuJet, however, has been unable to restore their image, or repair their reputation. After the crash of flight 592, ValuJet's stock price tumbled from a pre-crash high of $56.875 per share, to a low of $4.50, below even the $6.25 value of a share at ValuJet's initial public offering nearly two years earlier. By November 1997, well over a year after the crash, the stock was still trading below $6. Clearly something else needed to be done, but what?

ValuJet's decision to merge with a smaller carrier, AirTran Airways, and adopt their name, came as a surprise to some. While the company had not built itself back to its pre-crash levels, it had recovered to some degree. It seemed at first glance that this move constituted a surrender, giving up the ValuJet moniker for a relatively unknown name in order to distance themselves from their past. However, while some maintain "the principle reason for merging was to allow ValuJet to dump its name, so the market would more easily forget its safety record" (Further Consolidation, 1997), there may be some other, more strategically-oriented reasons for the merger. To fully understand these reasons, the problems at ValuJet that led to the crash must be examined.

The formula for ValuJet's success was straightforward: keep costs lower than prices, and prices lower than the competitors'. To meet these objectives, ValuJet varied from industry standard in nearly all areas of business. First, they replaced paper with electronic, ticketless booking. Reservations were made by a toll-free 800 number. This decreased costs for the airline, eliminating numerous expenses. Furthermore, ValuJet avoided unions, where possible, lowering labor costs. Workers received base salaries significantly lower than their union counterparts, but received large profit-based bonuses. Also, many positions, particularly in reservations, were filled by temporary workers. Additionally, ValuJet has subcontracted out many functions, including maintenance and training, saving significant sums. In fact, so many functions have been farmed out, that ValuJet had been called a "Virtual Airline" (Woolsey, 1995 p.67).

The FAA's investigation of ValuJet revealed many problems. These were that ValuJet "failed to establish the airworthiness of some of its aircraft," had widespread maintenance problems including "a lack of engineering capability in [its] maintenance", and quality assurance problems with contractors. In fact, a large part of the blame was placed on workers at Sabretech, ValuJet's maintenance subcontractor. Sabretech improperly labeled full oxygen canisters as empty, and failed to install safety caps, before allowing the canisters to be loaded on flight 592. The explosion of these canisters was identified as the cause of the crash. Later investigation by the FAA revealed widespread violations at Sabretech, which eventually resulted in the closure of both of their Florida facilities. Their facilities in Texas and Arizona are currently being investigated (Company That Packed, 1997). Assertions made by ValuJet imply an even higher level of fault for Sabretech. A company press release claimed that Sabretech deliberately mislabeled the canisters, in order to get them out of their facility, prior to an inspection by Continental Airlines, a potential client (ValuJet: Subcontractor, 1997). The Sabretech employee cited as responsible denies any knowledge of the oxygen canisters, saying he has never shipped any, however, his signature appears on the shipping documents. However, since the FAA found that many of Sabretech's employees spoke no English, and were therefore unable to read the manuals, it is possible that this is "only" a case of gross negligence, rather than deliberate mislabeling.

Suddenly, their practice of subcontracting out everything from maintenance to training, which had been lauded by many, was now the subject of intense criticism. In addition, their cost-cutting measure of purchasing used airplanes resulted in a fleet with an average age of 26 years, ancient when compared to the fleets of larger, full service carriers like American Airlines, with an average age of eight years. Furthermore, because they were buying used craft, ValuJet ended up with over a dozen different types of planes, all slightly different, which greatly complicated the job of properly maintaining the craft.

One major shortcoming of using older planes is that they were not equipped with modern equipment such as fire detectors and fire extinguishers in the cargo areas. While these are not required by law on all aircraft, the National Transportation Safety Board (NTSB) has recommended their use since 1988. The Chairman of the NTSB made the following statement shortly after the crash: "This goes back to a 1988 recommendation the board made (explained above). Had that recommendation been implemented, its only questionable whether the ValuJet accident would have happened at all" (On Eve of ValuJet Crash, 1997, p1.) Subsequent to the crash, the Federal Aviation Administration implemented rules making the equipment mandatory, but not until 2001.

The NTSB also found the FAA negligent, primarily for ignoring the NTSB's 1988 recommendations regarding safety equipment in cargo holds. However, the FAA was also noted to have too few people overseeing startup airlines (NTSB Blames Airline, 1997). In response, the FAA replaced its top leadership, added hundreds of new inspectors, and introduced special teams to monitor startups (On Eve of ValuJet Crash, 1997).

These problems, in aggregate, led to the crash of ValuJet flight 592, according to the NTSB (NTSB Blames Airline, 1997). Under these conditions, and with knowledge of the specific characteristics of Airways Corporation (parent to AirTran Airways), it can be clearly seen that this strategy involves much more than just an attempt to eliminate their name.

AirTran Airways, an Orlando, Florida-based carrier with a fleet of 11 Boeing 737-200s, has a number of similarities to ValuJet, primarily that both operate "lower cost, used aircraft and target fare conscious leisure travelers with a limited flight frequency, no-frills product. Both airlines rely on achieving and maintaining operating costs below the industry average in order to offer low fares" (Prospectus, 1997, pg.6). These similarities suggest that the two companies will be able to integrate their operations smoothly after the merger. However, there are a number of areas in which the two differ as well.

While the two companies would certainly seem to be targeting the same customer base, the way they operate within this market segment is very different. First, while both airlines use electronic ticketing to decrease the cost of booking seats, ValuJet has always operated with a single class of seat, and first-come, first-served seat assignment, AirTran, on the other hand, has two classes of seat, business and coach, and allows passengers to pre-select their seat. Second, ValuJet has always required customers to make reservations directly from the company, while AirTran is linked through computers to the reservation systems of travel agencies. Third, while ValuJet subcontracted out their maintenance function (until the crash forced them to rethink that strategy), AirTran has state of the art maintenance facilities, with an experienced force of full-time mechanics (average experience 12 years), located in their Orlando hub. Fourth, AirTran's fleet of 737-200 aircraft have greater seating capacity, and longer flight range than ValuJet's DC-9 aircraft. This allows the company more flexibility in choice of destination, but at the same time, hinders AirTran's ability to offer service to lower volume routes regularly and profitably, as a larger plane would require more passengers per flight to break even (Prospectus, 1997). However, rather than being viewed as problems, these differences are given as reasons for the merger, strengths within one company offsetting weaknesses in the other.

The merger was approved by the Boards of Directors of the companies, and was completed in late 1997. In a stock prospectus submitted to the Securities and Exchange commission, AirTran Holdings, the combined parent company, revealed their basic strategy:

> In order to return to profitability and resume growth, the Company intends to pursue a three-pronged strategy (i) to maintain its traditional cost and value leadership in the markets that it serves, (ii) to reposition its brand image with its target value-conscious customers to address the long-term adverse effects of the May 1996 accident and the subsequent suspension of operations and (iii) to gradually expand capacity as market demand warrants.
>
> The Company's strategy is to provide a safe, reliable, customer friendly alternative for affordable air transportation. The Company's operating strategy is based on its commitment to offer everyday low fares that stimulate demand from leisure and fare conscious business travelers. The key elements in this strategy are a simple fare structure and a competitive low cost structure based on a ticketless distribution system, a fleet of low cost DC-9 aircraft and relatively low labor costs. For the customer, "simple" means the service is easy to understand and use, including a simplified fare structure, with everyday low prices, simplified reservations and check-in procedures and a ticketless process. In contrast, today's airline industry is characterized by complex fares, schedules, reservations, check-in procedures and, in most cases, physical ticketing.(Prospectus, 1997, pg. 6).

This new corporation, AirTran Holdings, controlling the combined assets of the former ValuJet, and AirTran Airways, has some tough hurdles to clear. In the fiscal year prior to the merger neither company posted a profit. Both airlines were operating within a highly competitive segment of the market. Not only did they have to contend with other, more successful discount carriers, such as Southwest Airlines, but with new discount flights offered by large carriers, such as Delta's Express, which is also headquartered in Orlando and has been profitable since its inception at the beginning of 1997 (Delta Express, 1997). The sheer size of Delta's operations gives them an edge competitively, not only because of their company's strong reputation, and familiarity to travelers, but through economies of scale as well. AirTran hopes to benefit from similar economies of scale in purchasing of fuel and equipment, as well as decreased labor costs through consolidation and elimination of redundant operations.

## DISCUSSION QUESTIONS

1) How important do you think the name change was to ValuJet's decision to merge with AirTran?

2) From a marketing standpoint, what are the advantages and disadvantages of ValuJet's decision to change their name? Discuss the concept or brand franchise (or brand equity), and how it relates to this case.

3) What synergies, or competitive advantages, other than the name change, does the merger offer?
4) Was this merger a good idea?
5) In the areas in which ValuJet's and AirTran's services differed prior to the merger, which of AirTran's should be kept? ValuJet's?
6) What corporate strategy is the new combined company stating that they will follow?
7) Should the new company continue the past practice of purchasing older used planes, or should they try to upgrade their fleet?

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# PETE'S WICKED BREW: GOING "HEAD TO HEAD" WITH THE GIANTS

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## CASE DESCRIPTION

*The primary subject matter of this case concerns marketing strategy. Secondary issues include advertising, promotional strategy, and product life cycle analysis. This case has a difficulty level of three to four, and is appropriate for a junior- or senior-level class. It is designed to be taught during a one-hour class period, and is expected to require two hours of outside preparation by students.*

## CASE SYNOPSIS

*In the past, Pete's Wicked Brewing Company ("Pete's) has supported its product line primarily through creative product packaging, promotional "push" point-of-sale programs, and selective advertising campaigns. However, mainly due to recent changes in the competitive environment, in 1996 the company embarked on an estimated $15 million national TV, radio and print advertising campaign. The advertising campaign was directed to the mass market and was the biggest and most extensive advertising campaign in the company's history.*

*It was hoped that the addition of a new marketing campaign would enable the company to change recent sales trends. However, sales and profit figures for the fourth quarter of 1996 were disappointing. Management now faces the enormous task of evaluating Pete's current marketing strategy to determine what changes, if any, need to be made to enable them to continue to meet their objective of brand leadership in the specialty beer market.*

*This case examines the issues of brand equity and product positioning. The company's current strategy is evaluated and alternate strategies are discussed.*

## INTRODUCTION

It is January of 1997, and Pete's Wicked Brewing Company's new Vice President of Marketing, Mr. Omer D. Malchin, is evaluating the results the company's new marketing strategy that began in 1996. In his new position, Malchin has the responsibility of overseeing all marketing efforts in support of Pete's flagship brand, *Pete's Wicked Ale*, and at least 11 other specialty beers.

In the past, Pete's Wicked Brewing Company ("Pete's") has supported its product line primarily through creative product packaging, promotional "push" point-of-sale programs, and selective advertising campaigns. However, mainly due to recent changes in the competitive environment (including intense competition from newcomers in the specialty beer market), last year the company embarked on an estimated $15 million national TV, radio and print advertising campaign. The advertising campaign was directed to the mass market and was the biggest and most extensive advertising campaign in the company's history. According to Mark Bozzini, the company's President and CEO, the main purpose of the new campaign was to help "build brand equity" and establish Pete's Wicked Ale as a "powerhouse" brand.

It was hoped that the addition of a new marketing campaign would enable the company to change recent sales trends. However, sales and profit figures for the fourth quarter of 1996 were disappointing. Pete's realized a net income of only $6,000 during the fourth quarter of 1996. In addition, the company expects to record a net loss for the first quarter of 1997, mainly as a result of competitive market factors and other write-offs.

Malchin now faces the enormous task of evaluating the company's current marketing strategy to determine what changes, if any, need to be made to enable Pete's to continue to meet its objective of brand leadership in the specialty beer market.

## HISTORY OF THE COMPANY

In 1979, just prior to the Carter administration's legalization of homebrewing, Pete Slosberg attempted to make homemade wine in his kitchen. However, after discovering that he didn't have the patience to wait for the wine to "mature", Pete turned his efforts toward beer. In 1980, Pete joined a "home-brew" club and brewed his first beer at home. He spent the next six years trying to brew homemade batches of beer while maintaining a day job as a computer product manager. By 1986, his peers convinced him that he had a marketable product, so he started *Pete's Brewing Company* with colleague Mark Bronder. The duo named the ale after Pete, and added the name *"Wicked"* after hearing a comedy routine on a radio talk show which centered on the word.

In 1987, after begging $50,000 from friends, he convinced two wholesalers in Northern California to purchase 2,000 cases of his *Pete's Wicked Ale* brand beer. Later that same year, Maurice Coyer, the owner of the infamous Brickskeller Inn in Washington D.C., discovered Pete's new beer and added it to his already extensive menu of beers. As it turns out, Mr. Coya became one of the beer's biggest fans. Coast-to-coast distribution of Pete's Wicked Ale had begun.

Slosberg immediately realized that a bigger production facility was needed. During 1987, he approached several mass breweries located in the western part of the United States, but no one would agree to brew his beer. He decided to take his recipe to the Midwest "heartland" of beer -- Minnesota and the Stroh Brewery Company -- and the rest is history.

Slosberg once was quoted as saying, "I'd know success in this business when I look down and see a Pete's Wicked Ale bottle cap pressed into the dirt." In August of 1992, while on a river-rafting trip in Oregon, Slosberg found his measure of success: a Pete's Wicked Ale bottle cap was pressed into the dirt of a parking lot. In 1992, just six years after its inception, the company reached the $5 million sales mark. In 1993, Inc. magazine named Pete's Brewing Company as the 33rd fastest-growing private company in America, with a 3,967% increase in sales during the four-year period between 1988 to 1992. On November 7, 1995, the company went public with stock offerings at $18 a share. By 1996, Pete's was the second-largest specialty beer company in the United States, behind only Boston Beer (which produces the popular *Samuel Adams* brand).

Pete's recently entered into a nine-year Manufacturing Services Agreement with The Stroh Brewery Company. Under this agreement, the company uses the St. Paul, Minnesota and the

Winston-Salem, North Carolina Stroh breweries. Pete's may also, upon agreement with Stroh and the investment of necessary funds, have access to additional locations within the Stroh system. Although Stroh owns the breweries, Pete's supervises the brewing, testing, bottling and kegging of its beers in accordance with the company's written specifications and proprietary recipes. Management believes that this arrangement is adequate to meet its production needs for the foreseeable future.

## PETE'S MARKETING STRATEGY

Pete's began with very little marketing and advertising support. The initial communications strategy was mainly word-of-mouth and innovative sales promotions. In the beginning, Pete's promotional strategy concentrated on resellers -- wholesalers and retailers. Consistent with most other specialty brewers, the company's communications strategy for consumers consisted of its clever name, word-of-mouth endorsements, point-of-sale ads, and product placement cameos on TV shows such as *Friends*, which helped the company gain "cult-like status among hip Generation X'ers" (Wells, 1996). To further promote the brand's uniqueness, most of the company's promotional campaigns used irreverent themes, such as the *"Pete's Salary Cap Greedstakes"* -- an under-the-cap sweepstakes campaign that poked fun at the 1995 season baseball strike. This creative strategy enabled Pete's to develop an image as a fun, wacky company.

The purpose of Pete's unique communication style was to appeal to a particular segment of the market -- a technique sometimes referred to as "niche marketing." In fact, most industry analysts feel that consumers who drink specialty brews tend to drink them not just for their taste, but because the beers offer a feeling of *exclusivity*. This is partially because specialty beers aren't widely available or heavily marketed, but also because they are premium-priced (often more than double the price of a mass-marketed beer such as Budweiser and Miller).

In the past, television advertising had been done on a very limited basis, and only in selected markets. The first TV ads began in 1994 on selected shows such as the *Simpsons*, the *Late Show with David Letterman* and *Seinfeld* in selected markets. However, in November of 1996, Pete's decided to spend significantly more money on mass media advertising -- a move the company hopes will enable them to gain market share from the top-ranked specialty craft brewer, Boston (*Samuel Adams*) Beer. Pete's Brewing CEO, Mark Bozzini, insists the ads will help the brand. According to Mr. Bozzini, Pete's has "built the brand over the last 10 years almost entirely by push" and, therefore, mass media advertising is "long overdue" (Wells, 1996). The stated objective of the television campaign, with its theme line "*You Haven't Tasted Anything Yet*", was to better position Pete's in the overall beer market. As stated by Mr. Bozzini, the objective was to enable the company to "step out of the specialty craft market and say: 'if you like *beer*, you'll like *Pete's*'" (Wells, 1996).

Some industry analysts are concerned about Pete's decision to roll out a $15 million ad campaign for a product that is largely popular among ad-weary generation X-er's. According to consumer products analyst Ralph Jean, who tracks niche brewers, advertising in the mass media may be a bad idea because "niche consumers want to shop for something they've never heard of before" (Wells, 1996). Other industry analysts feel the ad campaign could work if it enables Pete's to retain its unique, iconoclastic image. Although the specialty craft beer leader, Boston Beer (*Samuel Adams*), also began its own TV ad campaign in 1996, the company claims that the ads were "just a test." According to Boston Beer Marketing Director John Chappell, "there is a question whether TV is appropriate for this upscale, niche market" (Wells, 1996).

## THE SPECIALTY BEER MARKET

According to the Institute for Brewing Studies, as of January of 1997, there are over 1,200 specialty breweries in North America. The "specialty brewing" industry (also called the "craft" brewing industry) includes brewpubs, microbreweries, regional specialty breweries and contract brewing companies. A "brewpub" is a restaurant-brewery that sells the majority of its beer on site. A "microbrewery" is a brewery that produces less than 15,000 barrels of beer per year. A "regional specialty brewery" is a brewery with the capacity to brew between 15,000 and 2,000,000 barrels, and whose flagship brand is an all-malt or specialty beer. A "contract brewing company", such as Pete's, is a business that hires another company to produce its beer.

In recent years, beer consumption in the U.S. has increased, especially in the "specialty beer" segment. According to the Beer Institute, specialty beer sales increased by 26% in 1996 over 1995, compared to a 10.2% increase in imported beer and a .1% increase in traditional (mass-marketed) domestic beer sales. However, the specialty beer segment still represents only 4% of total beer sales.

In 1996, total U.S. specialty beer sales topped $2.8 billion dollars. Also, 317 new breweries opened in the United States alone in 1996, which included 209 brewpubs and 108 microbreweries.

Although the specialty beer segment has grown a compounded 46% annually the past 10 years, in 1996 it represented just 4% of the $50 billion beer market, according to Benj Steinman of Beer Marketer's Insights. Also, many new competitors enter the market each month, and there are a large number of temporary wonders and brewers who never gain popularity. Based on the dramatic influx of new competitors entering the specialty brew industry in recent years, most industry analysts feel that an industry shakeout is inevitable. As for Pete's Brewing Company, however, many industry experts feel that Pete's brand image is distinctive enough in its appeal to give it a sustainable competitive advantage over the long run (Wells, 1996).

## FUTURE PLANS

Most of the ideas for future growth that have been discussed by management concern distribution and production issues. According to Pete's management, the company's primary goals are to "focus on strengthening competitive capabilities, including a unique brand equity, a national distribution network built on a philosophy of partnership, and a long-term source of supply based on low-cost production and investment through the brewing alliance with the Stroh Brewing Company" (1996 Company Annual Report).

One challenge that management faces is that of finding better distribution outlets, such as brewpubs, bars and restaurant chains. Another challenge is finding ways to reduce operating and production expenses (for example, in 1995, Pete's issued a notice to Stroh Brewing Company to purchase a 10% stake in the company to ensure cheaper production and distribution costs). Additionally, Pete's is looking to broaden its target market by adding different brews under a different brand name, either through product development or through company acquisition. Currently, Pete's product line consists of 12 different brews, including *Pete's Wicked Ale*, *Pete's Wicked Pale Ale*, and seasonal offerings such as *Pete's Wicked Summer Brew* and *Pete's Wicked Winter Brew*.

Pete's latest series of mass media ads have produced less than desirable results. The most recent television campaign featured Pete Slosberg vainly trying to sell, then finally giving away, his autograph on a San Francisco street. Although some observers praised the ad for maintaining the feeling of approachability of Pete Slosberg and the brand, many people feel the ad may not have captured properly that Mr. Slosberg is qualified and passionate about beer (Khermouch, 1997). A new set of radio ads were recently developed for the highest volume beer holidays. The company feels that radio will increase penetration in local markets, expand the consumer base and build brand loyalty in a highly competitive category. The company also plans to develop new television ads which are less image-oriented and more product quality/authenticity-oriented.

As imports and new specialty beers squeeze the shelf space from *Samuel Adams* and *Pete's Wicked Ale*, both are going to aggressively defend their turf. Some industry analysts feel that they "got the easy volume when they were the new kids on the block, but now other specialty brands are competing on price, and imports continue to lure away some specialty beer drinkers" (Khermouch, 1997). Even if Pete's succeeds against specialty beer competitors, it has big competitors to worry about. Shipments of imported beers grew last year by 10%, and big longtime players such as *Heineken* have embarked on new ad campaigns to boost growth. Additionally, Anheuser-Busch and Miller, which control the beer market, have deep pockets for marketing and extensive distribution networks (Wells, 1996). Anheuser-Busch's *Michelob* brand is aggressively staking out a massive claim to the specialty beer space in retail stores through the addition of a line of specialty beers. However, taking the learning afforded by numerous other specialty beer experiments, Anheuser-Busch is doing little in the way of conventional media advertising for the Michelob specialties, but rather using the product, packaging, seasonal varieties, and word-of-mouth to build sales close to Pete's current level (Emproto, 1997).

Of primary concern to the new Vice President of Marketing is the issue of building brand equity. According to one industry expert, "when there was really high consumer interest and astronomical growth, every new craft beer was cool, but once interest declines a bit all you have out there are assortments of styles of beer. What you don't have is significant differentiation by brand, and that's where brand equity is important" (Khermouch, 1997). Management has already announced that they are focusing on strengthening brand equities partially through impactful promotional programs and "targeted" consumer advertising (<u>1996 Company Annual Report</u>). However, many industry experts feel that Pete's and Boston Beer's approach to brand equity is not necessarily the best approach.

## QUESTIONS

1. Explain the concept of "brand equity," and why it should be important to Pete's management. What are some of the ways that marketers can build brand equity?
2. Explain the concept of product "positioning"? What was the company's positioning strategy <u>before</u> the television campaign? Explain how Pete's attempted to "reposition" the brand with the television campaign.

3. Do you think the $15 million mass media advertising campaign was a good strategy given the current competitive environment? Why or why not?
4. In which stage of the product life cycle is Pete's specialty beer? What are the marketing implications of this stage?
5. What other marketing strategies could the company employ to meet their objective of brand leadership in the specialty beer category? Be sure to explain the advantages and disadvantages of each.

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# MOUNTAINVIEW POLICE DEPARTMENT A CASE STUDY IN INFORMATION SYSTEMS POLICIES AND PROCEDURES

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## CASE DESCRIPTION

*Computer Usage Policies and Procedures - Mountainview Police Department is best suited for senior/graduate level MIS courses or courses dealing with business or organizational policy. Students should have at least a foundation in computer information systems to enable them to grasp the various policy and procedure implications of the case scenario. Preparation time for this case is approximately four hours. An hour to an hour and a half of class time should be allocated for the presentation and discussion of this case.*

## CASE SYNOPSIS

*Mountainview Police Department (MPD) has experienced a significant growth in both personnel and the community it serves. Information needs have outpaced even that growth and coupled with an upcoming accreditation review have forced MPD administrators to address the task of developing a Computer Usage Policies and Procedures Manual as part of their general orders. A committee has been formed to address both current and anticipated information system needs as well as draft this addition to the general orders.*

*Interviews, observation, and structured walk-throughs have been conducted by a graduate student from the local university to gather data relevant to the information system tasks at hand. Preliminary results have been provided by the graduate student to facilitate the development of a set of policies and procedures which will guide department operations. Of particular importance are the concepts of providing officers and staff with the applications they need balanced by both legal and ethical confidentiality and security concerns. The task for the committee (and therefore the student working with this case) is to develop a comprehensive set of policies and procedures which consider the needs of all relevant parties, the legal and ethical constraints, and the environment imposed by a rapidly growing police department.*

## COMPUTER USAGE POLICIES AND PROCEDURES MOUNTAINVIEW POLICE DEPARTMENT

In the everyday life of an information system, there are five components: hardware, software, people, procedures, and data. In times past there were two components almost always forgotten when systems were developed: people and procedures. The advancement of personal computers and the development of user friendly software created computer literate users who demanded not to be ignored. The same cannot be said for procedures. Unfortunately procedures still get overlooked. Many companies, institutions and government agencies with computer systems have little or nothing to guide their computer usage. Without written policies and procedures companies often operate inefficiently and are liable for anything their employees do with a computer whether intentional or not. The following case deals with just such a scenario.

Captain John Staggs with the Mountainview Police Department stared out at Main Street wondering how Mountainview had grown so large so quickly. When Captain Staggs began his police career, as Officer Staggs, the City of Mountainview was only 12,000 people strong with a police department of 15 officers. The Chamber of Commerce now boast about a population of some 30,000 and the police force has grown to nearly 90 employees. In his opinion the city and the force have grown to quickly. The issues that face the department and officers today are more complex and require more policies and procedures. "Policies and Procedures", thought Staggs "what is there to policies and procedures". "You tell the employees what to do and what not to do, that's all there is to policies and procedures". With the growth of the town and the force the department had developed policies and procedures in the form of a General Orders Manual. Staggs sweated as he thought about the process the department had gone through in developing the General Orders. Lieutenant Mayfield still wouldn't speak to him because of his opinion on promotion policies and those had been implemented over two years ago. Other than Mayfield most of the department had gotten back to normal and for the most part, the General Orders were being followed. Now, however there were sure to be fireworks again. Along with the other advancements the police department had also become computerized, primarily though the efforts of Lt. Mayfield. Staggs did not consider himself particularly computer literate but he could type a simple letter and enter numbers in a spreadsheet. So he had to wonder how Chief Blue had selected him, instead of Lieutenant Mayfield, to head the development of Computing Policies and Procedures as a section to the General Orders.

Two separate and unrelated events lead to Chief Blue requesting the creation of the Computing Policies and Procedures for the Mountainview Police Department. Evaluation of the current computer system and the resulting recommended changes require that usage and access policies be drafted for employees. Mountainview is in the process of pursuing official law enforcement accreditation from the Commission on Accreditation for Law Enforcement Agencies(CALEA). To receive accreditation the department must add a section on Computer Usage and Access to its General Orders Manual. Chief Blue has asked Captain Staggs to head the committee to develop these procedures with the following people to serve on the committee, Lieutenant Mayfield, who supervises all support functions, including the computer system, Sergeant Evers, a highly educated shift sergeant, with definite ideas on progress, and Officer Davis, an experienced street officer, whose no nonsense approach to policing followed him into the pursuit of his criminal justice degree at night. In addition to the officers the Chief had enlisted the help of Sarah Mills, a graduate MIS student at the local university who was willing to serve as a consultant on the project. The committee will need to examine the police department and its strategic plan, goals and objectives, current computer system, projected computer system and system usage. The committee will also develop the Policies and Procedures Manual and the resulting draft general order. The order will then be presented to the Accreditation Committee and passed on to the Administration for approval as a general order.

Ms. Mills has interviewed the officers, staff and supervisors and given Staggs an advanced copy of the interview compilation. He can see it is going to be a struggle balancing department needs with security and confidentiality requirements. Staggs train of thought was broken by the ringing of the phone, it was Major Johnson waiting for him to go to lunch. The group was scheduled to meet for the first time after lunch, the thought of which made Staggs lose his appetite.

## ENVIRONMENT

### Value Statement

The value statement of the Mountainview Police Department is simple but powerful: “Service with Pride and Dedication”. For over 100 years the Mountainview Police Department has delivered police protection to its community. Along with that service, the Mountainview Police Department has stood for pride and dedication. These words embody the values that the men and women of the Police Department hold as individuals and as a Department. The police department is service oriented and views itself in a partnership role with its citizens as its partners and clients. The police department constantly strives to work with the community to solve problems and to respond to the community’s needs and concerns. Employees take pride in their Department, their profession, the history and heritage of the Mountainview Police Department, and the history and heritage of law enforcement.

## GOALS AND OBJECTIVES

In 1995, the Mountainview Police Department developed Goals and Objectives Beyond the Year 2000. The purpose of General Order 1-4 establishes procedures for the development of departmental goals and objectives. According to 1-4.3, goals are stated in broad, almost immeasurable terms, and are based on the duties assigned to the department by City Code and statute. Since the goals are largely set by an external political process, goals will tend to remain the same year after year. Departmental objectives are specific, measurable, obtainable statements of actions to be accomplished. One or more departmental objectives, if satisfactorily attained during a year, should effectively contribute toward attainment of a department goal. A summary of the goals follow:

Goal # 1--Protect the life and property of the citizens of Mountainview as well as visitors to Mountainview. Investigate any crime which does occur and prosecute individuals responsible for such crimes.

Goal # 2--Commit to making the streets of Mountainview a safe place for vehicular or pedestrian traffic. To reduce the number of property damage incidents and personal injury accidents each year.

Goal # 3--Reduce violent crimes in the home as well as violent street crimes.

Goal # 4--Reduce D.U.I. incidents through aggressive enforcement and awareness programs.

Goal # 5--Increase the quality of services provided by and the efficiency of dispatch personnel.

Goal # 6--Enhance computer operations.
Goal # 7--Expand existing facility to meet future demands.
Goal # 8--Continue to involve the community in the department.
Goal # 9--Continue and expand DARE(Drug Abuse Resistance Education).
Goal # 10--Maintain a strong aggressive training program.
Goal # 11--The Criminal Investigation Division will promptly follow up on all leads which may prove to be beneficial to the solving of crimes and the recovery of property.
Goal #12--Initiate pro-active investigation within the City of Mountainview.
**Goal # 13--**Successfully attain and maintain accreditation with CALEA.
Goal # 14--The department is actively continuing to participate in local law enforcement actions. It is imperative that all officers work as a law enforcement community through other agencies and Drug Task Force operations.

## PHILOSOPHIES AND MANAGEMENT PRINCIPLES

The police department represents government's primary interface with the private lives of individuals; therefore, all its members are guided in all activities by adherence to certain basic beliefs, ideals and values held to be most important. Accordingly, the following management principles are established so as to provide the Mountainview Police Department's ethical framework.

- **Reverence for the Law**
- **Test of Police Effectiveness**
- **Crime Prevention Top Priority**
- **Public is the Police**
- **Public Approbation of Police**
- **Limit of Police Power**
- **Voluntary Law Observance**
- **Management by Objectives**
- **Management by Participation**
- **Police/Press Relationships**
- **Public Cooperation**
- **Impartial Friendly Enforcement**
- **Minimum Use of Force**
- **People Working with Police**
- **People Working with People**
- **Managers Working with Police**
- **Police Working with Police**
- **Police Working with Criminal Justice**
- **Openness and Honesty**

These principles are used in the police department's daily operation and provide direction for policies and procedures.

## STRUCTURE AND ADMINISTRATION

Figure 1 (available from authors) depicts the organizational structure of the Mountainview Police Department. Title 1, Chapter 2, Section1-204 of the Mountainview Municipal Code established the head of each department as the director. The Chief is the department head of the Police Department. Title 1, Chapter 4, Section 1-401 established that all policemen should obey and comply with such orders and administrative rules and regulations as the police chief may officially issue. The major serves as assistant chief or operations commander. He is second in command to the police chief and oversees the daily police department operation. The three captain positions, under the major, are responsible for the uniform services division, the criminal investigators division or the administrative division. Five lieutenants report to the captains, three are shift supervisors, one supervise criminal investigation and two are administrative supervisors. The criminal investigations division includes three detective sergeants. Seven patrol sergeants supervise three shifts of fourteen to fifteen officers each. First shift covers the daytime hours from 6:00 a.m. to 2:00 p.m.. Second shift encompasses the afternoon and evening hours, 2:00 p.m. to 10:00 p.m. and is the busiest shift by number of calls and accidents. Third shift, or midnight as it is referred to, runs from 10:00 p.m. to 6:00 a.m.

## ADMINISTRATION

David Blue currently holds the chief position. Chief Blue returned to the department in May of 1996 after having retired in 1993. Blue has over 50 years in law enforcement having served 23 years with the Alcohol, Tobacco and Firearms Bureau. Richard Johnson currently holds the major position. Johnson has served the department for 27 years. Only one of the three captain positions is currently filled. Captain John Staggs, who has been with the department 26 years, is commander of the criminal investigative division and interim commander of the administrative services division. In the absence of other captains, Major Johnson is commander of the uniformed patrol division. There are five lieutenant positions, 2 administrative and 3 patrol. Lieutenant Carter Rowe is responsible for training and public relations. Lieutenant Mayfield supervises all support functions. The three road lieutenants serve as the officers in charge for each patrol shift. These positions are held by Lieutenant Jason Davis, mornings, Lieutenant James Smith, afternoons and Lieutenant Mike West, midnight.

## ACCREDITATION

Accreditation is a special status that is accorded to a law enforcement agency by the Commission on Accreditation for Law Enforcement Agencies(CALEA). Accreditation in law enforcement is similar to accreditation in other fields, i.e., hospitals, colleges. The agency must meet specific standards of excellence and operate according to norms established by practitioners in the law enforcement fields from throughout the United States and Canada to become accredited. CALEA was formed in 1979 to establish a body of standards designed to (1) increase law enforcement agency capabilities to prevent and control crime; (2) increase agency effectiveness and efficiency in delivering law enforcement services; (3) increase cooperation and coordination with other law enforcement agencies of the criminal justice system; and (4) increase citizen and employee confidence in the goals, objectives, policies and practices of the agency.

Accreditation requires written directives and training to inform employees about policies and practices; facilities and equipment to ensure employees' safety; and processes to safeguard employees' rights. In summary, accreditation promotes internal and external cooperation and understanding and assures delivery of quality service to the community, other agencies and personnel. The purpose of accreditation is to provide law enforcement agencies an opportunity to demonstrate voluntarily that they meet an established set of professional standards. Seeking to establish the best professional practices, the standards prescribe “what” agencies should be doing, not “how” they should be doing it. That decision is left up to the individual agency and it's Chief.

## INFORMATION SYSTEM

In 1988, Lt. Bill Mayfield undertook the computerization of the Mountainview Police Department. At that time Lt. Mayfield developed a near state of the art system for the department. MPD has failed, however, to keep up and has now fallen behind in computerization. The department’s Systems section lacks the necessary resources to move forward in a dynamic area that is crucial to everyday operations.

## HARDWARE

The Mountainview Police Department currently has a SCO UNIX based computer system consisting of 30 PC’s/terminals and 25 remote printers. This system is currently at capacity and there is a need to expand beyond its capabilities. Additional system applications and work load will continue to degrade performance. The current hardware is overloaded and system access has become progressively slower. Many desktop units are two generations older than the latest technology. Memory(RAM) and hard disk space are minimal.

Sarah Mills has recommended to Lieutenant Mayfield that the department adopt a Microsoft Windows NT based client/server network. Further she recommends that the UNIX box be replaced with a Windows NT Server and tape back up unit be needed. At least two Additional computers/workstations should be installed in the common area or shift change room for access by patrol personnel. Several larger police forces have even gone to notebook computers in the patrol cars. Budget constraints at this time prevent this option, but it should be considered at a later time. It is recommended by patrol sergeants that three notebook computers (one per shift) be purchased. The Middleboro, Tennessee police department is beginning to implement a remote computing program by purchasing 14 notebook computers to be exchanged between officers at shift change. Their goal is to eventually equip each of 56 patrol cars. MPD could implement a similar program with 15 machines. The patrol officers and supervisors support this idea and appear eager to try it.

## SOFTWARE

The current UNIX system imposes too many limitations on system configurations and application software choices. Existing records software is not user friendly and lacks the required capacity. Access to existing records software is highly restricted with few users having the access they need to complete daily tasks. Most users feel there is other software available that would increase daily productivity. Other software applications are not being used as effectively or efficiently as they could be. In the age where Microsoft Word and Word Perfect for Windows are standard, the department has employees still using WordStar, a first generation Word Processor, and even some who type all documents including letters and memos in Lotus 123. Application requests are numerous and limitations keep most of them from being filled. In some cases officers or groups of officers who have felt a need to track certain information, either developed the method themselves or found someone externally to develop it for them. Drawings of traffic intersections for accident reports and a database of juvenile loiterers are just two such applications. Officers are required to draw the intersection where an accident occurs on each accident report. Drawing these legibly can be a tedious and time consuming process. An officer has drawn these intersections in a computer program so that they may print onto the reports. These were initially drawn in Autosketch, a program the department had on hand. They are now done at the officer's home on an Autocad program he purchased at a yard sale. According to the officer, his Autocad does a better job but he must convert them to Autosketch to be printed within the department.

Windows NT provides a more practical operating system. The new system is graphical and user friendly while providing the necessary levels of security. Coupled with changes in hardware, Windows NT will provide both faster and easier access to software and data.

Mills has also recommended that serious consideration be given to migrating toward a Microsoft Office platform. The current record system is written in FoxBASE and can be upgraded to Visual Fox Pro. Fox Pro and Windows NT are both Microsoft products and migrating to Microsoft Office allows for compatibility between packages. Information could be transferred directly from one application to another. For example, information from the databases (i.e., address) could be easily brought into word processing documents. In addition, a future recommendation is to purchase Microsoft Exchange to provide e-mail and Internet access. Regardless of which software is chosen it is recommended that site license be purchased for each application.

A computer aided dispatch (CAD) system is currently being evaluated to handle the increased volume of call data, while collecting geographic information for call histories. This system will allow for faster response and enhanced complaint tracking.

## DATA

The current database system uses an incident-based format which exhibits a high degree of integrity. Database structures are generally normalized but databases may require restructuring to achieve the desired results. According to Lt. Mayfield most databases are normalized, to what Sarah has identified as 3rd Normal Form. The databases with problems (i.e., officers) need to be analyzed and restructured to at least 3rd normal form.

Data enters the department in the form of a complaint. A card is made when a complaint is reported from a police department phone, the 911 system or an officer's radio. Once the complaint is validated the officer either completes an incident or accident report. Accident reports are completed for accidents involving vehicles and incident reports are filed for all others. The only exception is an alarm report, which is filed in the case of a residential or commercial alarm. Internal data reporting, as well as FBI National Crime Statistics reporting requires that certain data be tracked. Every call that the police department receives is documented under Total Calls for Service from the initial calls received by dispatch. This data is then separated into information on number of calls resulting in a report, number of calls determined to be false, number of calls resulting in an arrest, and number of calls received through 911 center. These are also broken down by initial call classification with a follow up investigation to determine incident type. Average response time and total time on call are also documented in this first step. Officer activity, including assigned service calls, calls assigned back-up units, and calls involving off-duty units(s) are also captured. Officer activity data also include citations issued, warning citations issued, and parking citations issued. Collecting officer activity data also includes tracking arrest made and incident reports filed.

The department also relies on external data sources, TIES, TCIC and NCIC. TIES, Tennessee Information Enforcement System, is the backbone of all the computer information needed on a daily basis. TIES includes TCIC, Tennessee Criminal Information Computer a network of information received from the State of Tennessee that supplies information about Tennessee Drivers License, Vehicle License, Outstanding State Warrants and State Criminal Records. NCIC is a national service that provides generally the same information.

It appears that adequate data are tracked and sufficient information is reported. However, employees generally feel that the data they need to complete daily tasks are not available. The systems administrator is the only person with authorized access to all parts of the system. Any incident report is public information but patrol personnel do not have easy access to this information. According to Officer Richard Davis, "Officers need direct access to past reports, arrest records, incident reports, and complaint calls that did not require a report. Currently the officer must obtain this information from records personnel. This limits the access and availability to Monday through Friday 8:00 to 4:30 p.m.. The timing of shifts and the scheduling of days off, many times necessitates an officer coming in on his day off to gather the information he requires for his reports or court cases. The third shift officers must always come in during off time to gather their information. Officer Davis and Officer Trey Brady remarked that it would be extremely convenient to have the ability to run their own drivers license check,, vehicle registration, stolen item queries and outstanding warrants. Currently officers must ask dispatchers to check this information. This increases dispatchers' workload. Usually three dispatchers per shift must fill these requests for 14-17 officers per shift plus answer incoming police and fire calls.

Patrol supervisors have the same data access request as patrol officers. They do not have access to the information they and their patrol officers need. They also need access to information about their patrol. They need to be able to verify which of their officers responded to which complaints, without going to dispatch or records. They need access to personnel performance data such as the number of citations written in a given time period, the number of arrests made in a similar time period, the number of complaints responded to and the number of accidents worked. Patrol supervisors are also unclear as to what information on the system they do have access to and why they have access to some pieces of information but not to others. According to patrol supervisors Greg Evers and Thomas Andrews, other data not computerized which would make their jobs easier includes disposition of officers' cases, including conviction rates and sentencing, incidents cleared, and personnel vacation and sick time tracking.

Currently if an officer completes a leave form request or calls in sick, the supervisor must approve or disapprove this without current information on the number of days or hours the officer has available. There are several paper steps involved in documenting a period of leave, be it one hour or two weeks. This causes headaches for patrol supervisors and the operations commander who must then process all paper requests and forward them to the city payroll department. Also, according to Sgt. Andrews and Major Johnson, there is currently a need to log warrants on file in the department. Warrants are currently not computerized and dispatchers must search through files and call the county Sheriff's Department and request a search of their files for warrants on an individual. According to records personnel they do not even have access to all the information they need.

Request are often made for special reports by the Mountainview Housing Authority, City Officers, Attorneys, Juvenile Court, and Department of Human Services. If the systems administrator is not available to run these reports, the records personnel must compile them by hand using hard copy information. These same records personnel are currently required to enter the incident and accident reports into the computer. This requires a large amount of data entry. Training records personnel to perform their own queries and allowing them to do so would eliminate the manual data manipulation.

## THE SYSTEMS ADMINISTRATOR

Lt. Bill Mayfield initially approached the police chief with the idea of computerizing the department in 1989. Since that time he has been the sole individual responsible for the computer system serving in every system capacity from wiring to programming. It has become more than he can feasibly handle as he is also responsible for finance and administration, building security, communications and the records department. The finance and administration section of his job requires that Lt. Mayfield process all budget items, all purchase orders, payroll and any other function requiring monetary responsibility. The communications responsibilities require him to supervise the communications sergeant and all communications personnel and all dispatch equipment. The records responsibility requires that he oversee all records personnel and their policies, procedures and equipment. His final responsibility includes the systems administration duties. Under this umbrella he is the hardware technician, programmer, trainer, and administrator.

Resources are needed in the areas of system administration and training. Currently there is little time available for administration, training and programming. MPD needs to hire a person responsible for the computer system. According to Major Johnson "We need someone who can stay on top of the information necessary to keep us current in this very dynamic area. We were once state of the art with our technology, but no one has the time required to bring us there again. We cannot just buy computers, we need someone selecting the best software and then training our personnel to use it."

## USER PROFILES

Sarah's research has produced the following profile of the department's computer users. MPD employs approximately 85 employees in administration, patrol, dispatch personnel, investigation and support. Everyone within the Police Department has the potential to be a system user. Employees are highly motivated toward computerization from top management down. These employees believe that change would be necessary to bring the department to where it needs to be and they are ready to do whatever it takes. A survey of all personnel was conducted to determine computer usage and needs. Summary findings from this survey include: (1) Most employees expressed a need for computer training. Patrolman, office personnel and administrators realize that they need and desire more computer education to perform their job functions efficiently and effectively. (2) Employees also expressed a desire to use the computer more in their everyday tasks. Many felt that there were areas where computerized systems could increase their personal productivity.

Interviews were also conducted of office personnel, administration, patrol personnel, patrol supervisors, investigators and dispatchers. These interviews demonstrate the need for training, computer and data access, the willingness to learn and the willingness to make the necessary changes. The department has reached a point where its users are knowledgeable enough to realize that the technology is available for the department to be better computerized than it currently is. The employees are hungry for a computer system that supplies the information timely and accurately to support them in their daily tasks.

## THE FUTURE

With lunch behind them Captain Staggs set down with the other committee members. While waiting for the meeting to convene they review Sarah's report based on her preliminary analysis. Sarah sees progress, the move toward the Windows NT system is being made slowly with a server being set up at this time. Specialized applications are being developed. New programming resources such as the MIS systems teams from Mountainview University are being employed. It is hopeful that a systems administrator position will be considered for the next budget year and the computer aided dispatch system will be installed then. The computer usage policies and procedures committee is also a positive sign. Users within the police department need access to information previously accessed only by the systems administrator. Computing policies and procedures must be developed to give users access to the information they require while insuring that data security and integrity are not sacrificed. Sarah recommends that the policies address the following issues:

- Permission
- Responsibility
- Unauthorized Access to Files and Directories
- Unauthorized Use of Software
- Use for For-Profit Activities
- Electronic Mail
- Harassment
- Attacking the System
- Theft
- Waste and Abuse
- Networks
- Enforcement
- Employee Responsibility
- Limited Access
- Routine Backup
- Input Data Validation
- Software Quality Assurance

Captain Staggs feels better after Sarah's report, but he is still in awe of the task before the committee. The next meeting is scheduled for two weeks and he has asked Sarah to have a preliminary draft of the Policies and Procedures prepared.

# PEOPLE’S BANK OF VIRGINIA BEACH

**Robert Stretcher, Hampton University**
**stre@visi.net**
**Thomas Flounders, Jefferson National Bank**

## CASE DESCRIPTION

*The primary subject matter of this case concerns financial and strategic analysis of a small bank. Secondary issues include managerial stewardship. The case has a difficulty level of three to four. The case is designed to be taught in one class hour and is expected to require two hours of outside preparation by students.*

## CASE SYNOPSIS

*This case features a situation of a small unit bank in Virginia beach, Virginia. The timing of the case is after three years of large net losses, due to nonperforming and bad loan writeoffs. The year is 1991, after a severe Savings and Loan and banking crisis and reconciliation at the hands of government officials. People's bank has survived the environment despite the destruction of the bank's equity by having started the mid 1980's with an overadequate equity base. The question at the time of the case posed to the analyst is what to do with a bank in poor but slowly recovering financial condition.*

## INTRODUCTION

People's Bank of Virginia Beach organized as a unit bank corporation in 1986 and opened its doors for the first time in April of 1988. People's had only one office and operated as a community bank. People's provides checking accounts, savings accounts, CD's, and other deposit services, and makes loans to individuals and commercial interests. The initial funding for the bank's construction, organization, and initiation of operations came from the sale of $4 million in common stock. People's deposits are FDIC insured, and is chartered in the state of Virginia.

## CURRENT SITUATION

As of December 31, 1990, People's Bank faces a dilemma. For the previous three years, People's has experienced large net losses. The shareholders' equity has fallen from $2.15 million at the end of 1989 to $1.59 million by the end of 1990. People's Bank has recognized a rather weak loan portfolio, mostly because of nonperforming assets. To a large degree, the situation has been exacerbated by a sluggish economy. The weakness in loan quality is not just a limited effect experienced by People's Bank; it has damaged many lenders. Savings and Loan associations have been overwrought with bad loans, particularly from the commercial real estate sector.

Recognizing that weak loan assets were largely the result of suboptimal mortgage originations, Tom Flounders, President and CEO of People's, has begun the process of exiting the loan origination business. The main problem with People's loan originations was that, because it is a small bank, it had to warehouse and then sell the loans to be able to continue to originate more loans. While this process was taking place, the bank earned no interest income on those assets. To complicate matters, some of the loans had not been diligently set up, perhaps because of the inexperience of loan officers, and therefore details had to be redone or corrected prior to the sale of the loans.

At the beginning of 1989, large denomination CD's were prevalent in People's Bank's liability portfolio. These instruments were very interest rate sensitive, and their return was virtually market driven and relatively high. In a strategic move, there was a restructuring of the CD liabilities from large denominations into small denominations, which carry lower interest rates. In addition, a large portion of the proceeds from the loan redemptions by the end of 1990 were invested in Treasury and Government Agency securities, strengthening the quality of the overall asset mix, accompanied by lower asset return. The net interest margin fell from 5.8% in 1988 to 5.1% in 1989 to 4.2% in 1990. Deposits were growing at a faster pace than growth in loans during this period.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 concentrated on capital requirements for banks. People's Bank, even after substantial reductions in capital, still has a total capital in excess of that required by FIRREA. The trend, however, is still disturbing. Shareholders' equity as a percentage of total assets fell from 13.3% at the end of 1989 to 10.4% by the end of 1990.

People's Bank income statements for year-end 1988, 1989, and 1990 appear in exhibit 1. The balance sheets for December 31, 1989 and 1990 appear in exhibit 2. The President's letter to shareholders and other informative exhibits are in subsequent exhibits (source: Annual report 1990).

*EXHIBIT 1*

**People's Bank of Virginia Beach**

**Income Statement (Statement of Operations)**

**Year Ended December 31**

<table>
<tr><th></th><th>1990</th><th>1989</th><th>1988</th></tr>
<tr><td>Interest Income</td><td></td><td></td><td></td></tr>
<tr><td>Loans, Including Fees</td><td>$1,232,772</td><td>$1,264,156</td><td>$430,538</td></tr>
<tr><td>Investment Securities</td><td>202,159</td><td>117,362</td><td>72,759</td></tr>
<tr><td>Federal Funds Sold</td><td>74,690</td><td>95,848</td><td>87,698</td></tr>
<tr><td>Other</td><td>-------------<br>-</td><td>-------------</td><td>26,079</td></tr>
<tr><td>Total Interest Income</td><td>$1,509,621</td><td>$1,477,366</td><td>$617,074</td></tr>
<tr><td>Interest Expense on Deposits</td><td></td><td></td><td></td></tr>
<tr><td>Demand</td><td>167,599</td><td>179,261</td><td>78,927</td></tr>
<tr><td>Savings</td><td>7,027</td><td>5,646</td><td>3,269</td></tr>
<tr><td>Certificates less than $100,000</td><td>363,589</td><td>266,805</td><td>73,887</td></tr>
<tr><td>Certificates $100,000 or more</td><td>423,598</td><td>370,951</td><td>97,568</td></tr>
<tr><td>Federal Funds Purchased</td><td>590</td><td>354</td><td>-------------</td></tr>
<tr><td>Total Interest Expense</td><td>$962,403</td><td>$823,017</td><td>$253,651</td></tr>
<tr><td>Net Interest Income</td><td>547,218</td><td>654,349</td><td>363,423</td></tr>
<tr><td>Provisions for Loan Losses</td><td>288,800</td><td>1,109,100</td><td>88,600</td></tr>
<tr><td>Net Interest Income After Provision for Loan Losses</td><td>$258,418</td><td>($454,751)</td><td>$274,823</td></tr>
<tr><td>Non Interest Income:</td><td></td><td></td><td></td></tr>
<tr><td>Service Charges on Deposits</td><td>118,419</td><td>118,730</td><td>41,316</td></tr>
<tr><td>Other Service Charges and Fees</td><td>33,004</td><td>97,997</td><td>10,561</td></tr>
<tr><td></td><td>$151,423</td><td>$216,727</td><td>$51,877</td></tr>
<tr><td>Non Interest Expense</td><td></td><td></td><td></td></tr>
<tr><td>Salaries and Employee Benefits</td><td>457,893</td><td>502,632</td><td>323,933</td></tr>
<tr><td>Occupancy</td><td>120,338</td><td>119,889</td><td>101,451</td></tr>
<tr><td>Equipment</td><td>94,532</td><td>95,475</td><td>58,499</td></tr>
<tr><td>Other (note 9)</td><td>336,280</td><td>474,480</td><td>204,508</td></tr>
<tr><td></td><td>$1,009,043</td><td>$1,192,476</td><td>$688,391</td></tr>
<tr><td>Loss Before Provision for Income Taxes</td><td>($599,202)</td><td>($1,430,500)</td><td>($361,691)</td></tr>
<tr><td>Income Tax Benefit (note 7)</td><td>-------------<br>-</td><td>-------------</td><td>3,478</td></tr>
<tr><td>|||||||||| Net Loss ||||||||||</td><td>($599,202)</td><td>($1,430,500)</td><td>($358,213)</td></tr>
<tr><td>Net Loss per Share</td><td>($2)</td><td>($4)</td><td>($1)</td></tr>
<tr><td>Weighted Avg Shares Outstanding</td><td>398,986</td><td>399,534</td><td>400,000</td></tr>
</table>

***EXHIBIT 2***

**People's Bank of Virginia Beach Balance Sheets**
**December 31**

| | **1990** | **1989** |
|---|---|---|
| **ASSETS** | | |
| Cash and Due From Banks | $531,521 | $740,515 |
| Federal Funds Sold | 480,000 | |
| Investment Securities (note 3) | 3,136,451 | 1,282,376 |
| Mortgage Loans Held for Sale | ------------- | 1,189,814 |
| Loans (note 4) | 10,039,678 | 11,398,898 |
| Allowance for Loan Losses | -630,415 | -900,331 |
| | **$13,557,235** | **$13,711,272** |
| Premises and Equipment | 1,334,226 | 1,443,248 |
| Other Real Estate Owned | 128,077 | 700,000 |
| Interest Receivable | 150,963 | 188,926 |
| Other Assets | 108,320 | 134,635 |
| **TOTAL ASSETS** | **$15,278,821** | **$16,178,081** |
| **LIABILITIES AND EQUITY** | | |
| Deposits: | | |
| Noninterest Bearing Demand | 1,864,066 | 1,690,762 |
| Interest Bearing: | | |
| Demand | 2,223,264 | 2,587,956 |
| Savings | 165,257 | 115,757 |
| Certificates: | | |
| less than $100,000 | 5,435,761 | 3,269,251 |
| $100,000 or more | 3,759,703 | 5,602,565 |
| **TOTAL DEPOSITS** | **$13,448,051** | **$13,266,291** |
| Interest Payable | 165,076 | 174,002 |
| Federal Funds Purchased | | 500,000 |
| Other Liabilities | 72,786 | 85,678 |
| **TOTAL LIABILITIES** | **$13,685,913** | **$14,025,971** |
| Shareholders' Equity: | | |
| Common Stock, par value $5; 1,000,000 shares authorized (400,000 shares outstanding in 1990; 395,000 shares outstanding in 1989) | 2,000,000 | 1,975,000 |
| Additional Capital | 1,967,406 | 1,952,406 |
| Accumulated Deficit | -2,374,498 | -1,775,296 |
| **TOTAL EQUITY** | **$1,592,908** | **$2,152,110** |
| **TOTAL LIABILITIES AND EQUITY** | **$15,278,821** | **$16,178,081** |

PEOPLE’S BANK of Virginia Beach

621 NEVAN ROAD
VIRGINIA BEACH, VA 23451
(804) 425-6500

To Our Shareholders:

While a slower economy put pressure on banks, People’s Bank of Virginia Beach made improvements. Our mission is to become profitable by strengthening the quality of our loan portfolio, reduce operating expenses, and increase deposit growth. Although we made progress in all three areas in 1990, they will continue to be our primary objectives for 1991.

Loan problems were responsible for most of our losses in 1989 and 1990. Our loan provision in 1990 was higher than normal, and our loan loss allowance at year end is considered adequate to provide protection for future losses. A softer loan demand and a conservative lending policy combined to slow our loan growth causing our interest income to decrease. Checking and savings account balances grew and offset a decline in large denomination certificates of deposits. This helped to reduce the cost of funds and strengthen our net interest margin. Also showing an improvement was a reduction in non-interest expenses in 1990, and further reductions will occur in 1991. While loan quality standards are enhanced and cost cutting programs are working, continued deposit growth is essential. As you review our annual report, you will see improvement that will provide a springboard toward growth and profitability in the future.

One of our industries biggest challenges for the future is consumer confidence. Media attention given to the savings and loan industry and funding requirements for the Federal Deposit Insurance Corporation (FDIC) reflects negatively on the banking system. Virginia banks continue to do well, and our bank, as most other Virginia banks, maintains capital above amounts required by regulatory agencies. Your board of directors and management’s commitment is to increase shareholder value, and just as importantly we recognize the need to protect our depositors. We will *not* compromise our customers’ security and the confidence they have placed in People’s bank of Virginia beach.

We will continue to work at what a locally owned and operated community bank does best...provide personal customer service to our community. As we move into 1991, your continued support is important. As an investor, you can help our bank become profitable by doing your business at People’s and introducing your freinds to us. We invite your comments and look forward to hearing from you.

Sincerely,
Thomas E. Flounders, III
President and Chief Executive Officer

## QUESTIONS

1. Evaluate the current financial condition of People's Bank. Why did the net losses occur?
2. The Board of Directors is faced with three alternatives:
   a. Go back to the shareholders and raise more capital.
   b. Direct the management to explore merger prospects.
   c. Turn over the bank to the Resolution Trust Corporation (RTC).

Evaluate each of these alternatives, listing the benefits and drawbacks to each.

3. Is it plausible that alternative a, b, or c above would actually come about? Can management simply decide to do one of the alternatives and it would happen?
4. The Bank ended up doing one of the three alternatives. Which one do you think it was?

# FOREST PRODUCTS COMPANY

**Robert H. Stretcher, Hampton University**
**stre@visi.net**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the initiation of an entrepreneurial venture. Secondary issues examined include assessing a project's financial feasibility and consideration of the role of debt in a new business from the perspectives of both the entrepreneur and the banker. The case has a difficulty level of three to four. The case is designed to be taught in one or two class hours and is expected to require four hours of outside preparation by students.*

## CASE SYNOPSIS

*This case features an entrepreneurial venture that began as a hobby type business. The timing of the case is after an eight month period of successful operation as a part time business. The owner is at the point of seeking outside funding to expand the business, hire full time workers, and enter the business as a full time occupation. The student must work with limited data, consider the reasoning behind assumptions about the future, conduct a financial feasibility analysis, and think about the character of debt and its purposes and risks from the entrepreneur's and banker's perspectives.*

## INTRODUCTION

Forest Products Company is a small, entrepreneurial venture that began in the summer of 1997 as a part time business. Its owner, Dave Stamin, was a warehouse manager for a furniture manufacturer in Spartanburg, South Carolina. Dave first began to produce lumber on a small scale one year prior to officially starting the business. In the beginning, it was just a hobby. Dave had heard of a brand of sawmill called a Wood Mizer, designed to be portable and efficient in terms of waste products. Dave purchased a sawmill for $11,898, and some accessory equipment for another $2,390 with some savings he had accumulated over several years.

## PART TIME BUSINESS

At first, Dave only cut lumber from his own trees. Dave owned a small tract of land outside of Spartanburg, worth approximately $150,000. He had done a surprisingly large volume of production just for his own use, like fencing, log barns, and rough framing timbers. In June of 1997, however, he decided that he wanted to make a business out of it, so he applied for a business license and began custom cutting jobs for other people, charging by the hour for his labor and for use of the specialized equipment. The Wood Mizer used a cantilevered bandsaw which cut the length of the log, with little waste because of the thin bandsaw blade. He pulled the mill behind his pickup truck, and found that the portability actually increased his business. Wherever he cut for a customer, the milling drew a big crowd and additional jobs.

## FINANCIAL INFORMATION

Dave charged a standard hourly rate of $20 plus the cost of saw blades, gasoline, and other materials used. If Dave encountered nails or other foreign objects in the sawlogs that ruined his blade, the customer paid for a new blade. Dave's customers were very satisfied with this arrangement, because they could have custom timber cut from their sawlogs at about a fourth the price of purchasing the lumber at the lumberyard.

Dave's monthly financial records appear in exhibit 1. The results are based completely on cash basis, although Dave was able to reduce his tax burden by depreciating his sawmill and accessory equipment. His accountant had recommended using the Modified Accelerated Cost Recovery System (MACRS) depreciation method.

In February 1998, Dave decided that the sawmill business was sufficient to support him financially if he did it full time. Dave lived by himself and had no family to support. He already had a lot of the equipment he would need. However, a loan from the bank would be necessary to expand the business. He figured the business would be organized as a subchapter S corporation. He needed the loan to provide for new equipment and for the first few months' rent and utilities on a workshop in a good location.

Dave constructed a worksheet summarizing his equipment and its 'book' value based on the depreciation he had accumulated so far. This worksheet appears in exhibit 2. He also figured out the additional equipment he needed to 'make a go of it' (exhibit 3) and the additional expenses he expected to incur from having a workshop and hiring two full time helpers (exhibit 4). Dave's banker, Tom Landers, told him that if he were to apply for a loan, he would have to provide pro-forma income statements and balance sheets to show how he intended to repay the loan over time. Landers also said that if the business turned out to be insufficient to service the loan, that Dave's personal assets as well as the business assets would be at risk.

## IMMEDIATE FUTURE OF THE BUSINESS

Dave had at least twenty jobs lined up for the business, with 2-3 days of work for each. These involved custom cutting work like he had been doing, at the same prices he had quoted before. He also perceived that, in the event he did not get any more custom cutting jobs after that, he could cut his own black oak trees and sell the green lumber to a local lumberyard that had a lumber kiln drier. If he did this, he estimated that most of the proceeds would be profit, since he didn't have to pay for the sawlogs, and the gasoline and blade wear were relatively insignificant. Dave had about forty large black oak trees he could cut and saw if he had to.

Exhibit 1: Monthly Financial Records

| | Fee Income | Expenses | Profit |
|---|---|---|---|
| June 1997 | $640 | ($124) | $516 |
| July 1997 | $680 | ($102) | $578 |
| August 1997 | $540 | ($108) | $432 |
| September 1997 | $1,080 | ($209) | $871 |
| October 1997 | $945 | ($187) | $758 |
| November 1997 | $920 | ($170) | $750 |
| December 1997 | $520 | ($92) | $428 |
| January 1998 | $1,250 | ($421) | $829 |
| February 1998 | $1,220 | ($262) | $958 |
| TOTAL | $7,795.00 | ($1,675.00) | $6,120.00 |

Exhibit 2: Book Values of Assets

| | Cost | 1997 Deprec. | Book Value |
|---|---|---|---|
| LT-40G24 Portable Sawmill | $13,890.00 | $2,778.00 | $11,112.00 |
| Blade Maintenance Pkg (sharpener) | $1,908.00 | $381.60 | $1,526.40 |
| Cant Hooks (2@43.50 ea) | $87.00 | $17.40 | $69.60 |
| Chain Saws (2@328 ea) | $652.00 | $130.40 | $521.60 |
| Log Carriage | $849.00 | $169.80 | $679.20 |
| Honda 4WD ATV | $783.00 | $156.60 | $626.40 |
| TOTALS | $18,169.00 | $3,633.80 | $14,535.20 |

Exhibit 3: Additional Equipment Needed

| | |
|---|---|
| Edging machine | $3,085 |
| Sharpening Bench | $458 |
| Work Stools (2@54 ea) | $108 |
| Mill Upgrade (Hydraulic) | $3,208 |
| Lumber Storage Racks | $1,865 |
| TOTAL | $8,724 |

Exhibit 4: Additional Expenses

| Monthly Expense Categories | Amount |
|---|---|
| Labor (2 full time workers) | $2,000 |
| Insurance | $83 |
| Utilities | $100 |
| Gasoline | $50 |
| Mill expenses | $120 |
| TOTAL | $2,353 |

## QUESTIONS

1. Is Dave leaving any key data about the future out of his estimates?
2. Conduct a Financial Feasibility Analysis for Forest Products Company for three years into the future, based on the information in the case. Adjust it (with reasonable assumptions) for any missing information. Is Dave's proposed project acceptable?
3. Construct Pro-Forma statements for Dave's application.
4. If you were in Mr. Landers' position, would you approve the loan to Dave? Why or why not?
5. What type of loan would be ideal for Dave? If you were Mr. Landers, what type of loan would you approve? What restrictions/features would it have?

# BOOKBINDERS, INC.

**Robert H. Stretcher, Hampton University**
**stre@visi.net**

## CASE DESCRIPTION

*The primary subject matter of this case concerns marketing and financial considerations. Secondary issues include human resources management. The case has a difficulty level of three or higher. The case is designed to be taught in one class hour and is expected to require two hours of outside preparation by students.*

## CASE SYNOPSIS

*Bookbinders, Inc. features a small bookbinding firm in Norfolk, Virginia. The bindery involves several aspects that can be used to illustrate classroom concepts. From a marketing perspective, bookbinding represents a niche that many predict will no longer be viable as electronic media increase in their dominance of information storage. The firm, however, has actually experienced increasing demand for the service. From a financial perspective, the case includes cost data that can be used to create an analysis of operating profit variability and breakeven point. There are also some human resources aspects of the case.*

## INTRODUCTION

Bookbinders, Inc. is a small hard-binding service located in Norfolk, Virginia. According to the Library Binding Institute, there are only thirty-one other certified library bookbinders in the United States. Alain Roullet, the firm's owner/operator, first came to Norfolk and became a bookbinder in 1975. He and an associate ran the bindery until 1991, when Roullet purchased the entire operation.

Roullet takes pride in producing a quality product. One of his major thrusts is to please the customer, which has earned loyal patrons for his business. He employs ten employees in a labor intensive process of custom and small job binding.

Roullet, a devout Christian businessman, utilizes Christian principles in running the business. He is very dedicated to his employees, and considers them to comprise a 'family' of sorts. Problems that arise among the workers or between Roullet and his employees are quickly brought out in the open and solved. Roullet provides a very secure position for his employees, and expects similar dedication from them. Bookbinders, Inc. employees enjoy a wage that is higher than similar skill level jobs in the geographic area. Employees are retained in periods of slow production, and paid overtime in periods of high production. As with many businesses, it is a policy of the firm that employees who do not become dedicated to the business and who seek employment elsewhere are not usually rehired if they wish to return at a later time. Roullet diligently seeks to treat customers, co-workers, and outside contacts in a fair and equitable manner.

Bookbinders, Inc. is officially a gender-minority business. Roullet's wife and office manager, Eileen, actually owns 51 percent of the outstanding common stock of the firm. This allows Bookbinders, Inc. to effectively bid local and federal government contracts. Roullet's daughter, Karen, serves as marketing manager for the firm.

## THE MARKET FOR BOOKBINDING

Bookbinders, Inc.'s customer base is quite diverse. About 75 percent of the bindery's business involves rebinding, or replacing a worn out binding with a new case, or cover. New books are also brought in for their initial binding. These new bindings are constructed for not only new books but also for loose periodicals brought in by area libraries. Bookbinders, Inc.'s customer base is distributed as shown in table 1.

TABLE 1. CUSTOMER BASE

| CUSTOMER | % of Bookbinders, Inc.'s Business |
|---|---|
| Colleges, Universities | 59% |
| Public Schools | 12 |
| Doctors, Lawyers, Professional | 8 |
| Private Customers | 7 |
| Churches | 4 |
| Short-Run Editions | 4 |
| Government Agencies | 3 |
| Public Libraries | 3 |

The fastest growing market segments for Bookbinders, Inc. are public school needs and short run edition books. Public schools are under increasingly tight budgetary constraints and have come to realize the cost effectiveness of having new, durable covers constructed around textbooks they have already purchased and used. The life of the textbook can be extended several years. In fact, Bookbinders, Inc.'s bindings are much more durable than almost all of the original bindings, because of the quality of the materials and workmanship. An existing book can be rebound for much less than a new copy of the book would cost, as well. This allows a tremendous cost savings for textbook budgeters.

Short-run edition books are another fast growing segment for Bookbinders, Inc. Printing costs per unit tend to decrease dramatically the larger the production run, because of high setup costs. Binding, however, does not require a large initial investment, but is rather well suited as a custom order business. Many new materials producers will have large printing production runs (2,000 to 5,000 copies at a time) but will have fewer copies bound at a time. This type of binding business is repetitive and cost effective for bookbinders, Inc. because a familiar setup is used for each small run.

The firm's products are publicized by word of mouth and by referrals from past satisfied customers. The firm gets quite a bit of repeat business, once the customer experiences the quality of the output. Bookbinders, Inc. also advertises locally in newspapers, in trade publications, and in mailings to prior customers. The firm produces a newsletter, and has printed brochures describing the firm, its products and production process, and interesting ideas as to how to utilize the firm's services. In addition, Karen Roullet recently developed a web site on the internet as another marketing outlet. The site contains much of the same information that is contained in the newsletters and brochure, and guides potential customers in how to place orders over the net. Customer services are outlined in Table 2.

TABLE 2. CUSTOMER SERVICES

| PRODUCT | SERVICE INVOLVED |
|---|---|
| Books | New Covers, Overlay, Recasing, Special Books, Textbooks |
| Newspapers | Large Casing Hard Binding |
| Periodicals | Hard Binding |
| Medical Journals | Hard Binding by Volume |
| Transcript Bonds/ Law Books | Binding per Firm Specification |
| Theses, Dissertations | Binding per College Specification |
| Bibles | Hard Binding, Leather Hard Binding, Leather/Fabric Casings, Personalizing |
| Church Hymnals, Bulletins | Rebinding, Hard Binding |

Overall, Bookbinders, Inc.'s business continues to grow, despite predictions of doom from electronic media fans. The computerization of formerly hard copy media was at one time predicted to make paper products and books obsolete. In fact, the demand for paper products and bookbinding has grown along with the information age. Mr. Roullet attributes this to the nature of the book. Books have been and will be the ultimate form of media; they don't require special equipment to view, they are relatively permanent and long lived compared to magnetic media, and the preservation of existing works will always be in demand (rebinding).

## THE PRODUCTION PROCESS

The binding of new works and the rebinding of existing works involve a multi-step process. The steps are outlined in table 3. The number of workers at each station is indicated for each step. Most of the employees of Bookbinders, Inc. are capable of working multiple duties, allowing substantial flexibility in production. The total number of workers at a given time, therefore, may be less than the total of the station requirements.

TABLE 3. STEPS IN THE BINDING PROCESS

| STEP | ACTIVITY | FACILITY/OPERATORS |
|---|---|---|
| 1 | Evaluate and Identify Needs | Preparation Area/ 1 |
| 2 | Remove Old Binding | Milling Machine/ 1 |
| 3 | Cut notches for Strength of Glue Bond | Notching Machine/ 1 |
| 4 | Cut and Fold End Papers | Work Area/ 1 |
| 5 | Glue and Cure (Glue Cures for 24 Hrs.) | Glue Vat/ 1 |
| 6 | Cut Page Edges Even | Paper Cutter/ 1 |
| 7 | Install backer and Round Off Spine | Rounder-Backer/ 1 |
| 8 | Cut hard Boards for Case | Board Cutter/ 1 |
| 9 | Emboss Cover (Standard Letters) | Computer Embosser/1 |
| | (Custom Designs) | Manual Embosser/ 1 |
| 10 | Casemaking | Casemaking Station/ 2 |
| | Trim Excess Cover Material | Trimmer |
| | Remove Air Bubbles | Roller |
| | Glue Page Packet to Case | Hydraulic Press |
| 11 | Allow to Cure and Prepare Product For Delivery | Shipping Area |

Bookbinders, Inc. provides special bookbinding services in addition to their traditional library type binding. Customers who opt to have a more elaborate design on the book cover may have their design photocopied onto an acceptable size of paper and have one side of the paper (the outside surface) laminated. This can be glued to the binder board just as the standard fabric. This laminate cover work is sent out to a custom print shop. Another option available to customers is to have a custom designed template fabricated which will allow a design, seal, or other artwork to be embossed on the cover of the book. Bookbinders, Inc. embosses the covers with 14k gold lettering or with a variety of colored inks (mainly black or white ink).

## INCREMENTAL COSTS AND REVENUES

The production process is labor intensive. The raw materials that form the casings vary according to the number of casings produced. There are, however, a variety of fixed productive inputs as well. Table 4 illustrates the variable resources required for Bookbinders, Inc.'s traditional library binding, which comprises 90% of the bindery's business. It may be accurately assumed that these cost patterns are characteristic of the firm's present business.

TABLE 4. COST ASSESSMENT

| PRODUCTIVE INPUT | PER UNIT ALLOCATION |
|---|---|
| Labor | $2.01 |
| Embossing | .09 |
| Case Material/Leather | $1.39 |
| Binder Board | .48 |
| Spine and End papers | .05 |
| **MONTHLY FIXED COSTS** | **PER MONTH ALLOCATION** |
| Administrative Costs | $1,200.00 |
| Administrative Salaries | $6,800.00 |
| Overhead Expenses | $4,814.00 |
| Fixed Payments | 211.00 |
| Interest | 115.00 |
| Lease Payments | 89.00 |
| Depreciation Expense | $2,100.00 |

TABLE 5. SALES DATA BY MONTH (UNITS, PAST YEAR)

| JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2,100 | 1,890 | 1,540 | 1,602 | 1,590 | 1,397 | 1,945 | 3,200 | 2,870 | 2,761 | 2,444 | 2,180 |

## QUESTIONS

1. What are key risks faced by Bookbinders, Inc.? (In other words, what elements of the business could result in substantial variation in earnings?)
2. Considering Roullet's employment practices, which costs are variable? Fixed?
3. According to your response in #2 above, determine Bookbinders, Inc.'s breakeven point per month. How do Roullet’s employment practices interact with the breakeven point?
4. Characterize the demand for Bookbinders, Inc.'s product (mainly the traditional library binding). Is the market seasonal? Do you think it is cyclical?
5. Over the long term, do you think the market for bookbinding will increase, decrease, or remain somewhat constant? Why?

# INDEX