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Editorial Policy

The *Journal of Applied Case Research (JACR)* was established by the Southwest Case Research Association to publish cases and papers dealing with issues in all business-related disciplines that are related to case writing or teaching with cases. *JACR* will publish cases based on field research or research from secondary sources. *JACR* does not accept synthesized or fictional cases. Submissions will be evaluated on the basis of relevance to and adequacy for clearly stated teaching goals. An instructor's manual or teaching note must accompany each submitted case. Teaching notes are not published but are an important aspect of the review process.

Submissions are subject to an initial editorial review. Manuscripts meeting the minimum standards of *JACR* will receive a blind review from three referees who are either Editorial Board members or *ad hoc* reviewers in the appropriate discipline. Previously published cases or papers (except those appearing in the *Proceedings* of the Southwest Case Research Association) are not eligible for consideration.

All rights, including the right to use cases in printed or electronically produced textbooks are reserved to the Southwest Case Research Association (SWCRA) and to the authors, who share copyright for these purposes. SWCRA charges fees for these publications rights, in order to fund its continuing programs. A Case may be released for publication after a publication date has been established by *JACR's* Editor-In-Chief.

Case Format

Cases submitted for review may be single-or double spaced with 1" margins. Papers are to be double-spaced. Figures and tables essential for the reader's understanding of the case content should be included in the text and numbered separately. Exhibits are to be grouped at the end of the case. Citations should be included in the text, wwith bibliographic information restricted to a "Reference Section" at the end of the case.

Authors' full names and affiliation should be listed on a separate cover page. The postal address, telephone number, fax number, and email address of the "contact: author should also be included on the cover page.

Instructor's Manual or Teaching Note

The following comprehensive elements should be included:

1. The intended course and the audience should be identified including specific teaching objectives. Any associated readings or other material that instructors might utilize in teaching the case should be so identified in the "Teaching Note."
2. A brief one-page synopsis of the case.
3. Assignment questions for students accompanied by a full explanation of each question.
4. A teaching plan, including the expected flow of the discussion, key questions, role plays, and the use of handouts or other material.

Manuscript Submission

1. Four copies of all manuscripts including the teaching note should be submitted. All accepted manuscripts must be submitted on 3.5 inch discs in MICROSOFT WORD
2. Authors of field-researched cases should submit an authorization from an appropriat officer of the organization so studied.
3. Manuscripts should be sent to: Daniel F. Jennings, Department of Engineering Techn Texas A&M University, College Station, Texas 77843-3367.
4. No submission fees are required for SWCRA members of good standing. A submiss fee of $50 is required for other manuscripts. This submission fee does not include membership benefits or a subscription to JACR (see last page for journal applicatio form).

Editor's Comments

Welcome to the first issue of the *Journal of Applied Case Research.* In 1993 the Offic SWCRA appointed Carl Ruthstrom as editor with the task of developing a suitable public Unfortunately, in 1995, Carl resigned because of the pressure from the many activities in wh was involved and I was then appointed editor. Taking on such an assignment in the midst of required much more work than I had expected. During Carl's tenure, 38 cases were submitte 9 being accepted, 12 rejected, and the remaining 17 in the review process. During my tenure, cases were submitted (folks were probably wondering if the journal would make it), 5 were drawn (the authors had submitted their work elsewhere), 15 were rejected (remember I starte 17 cases in the review process), 2 have been accepted, and 3 are now in review. This first contains 11 cases of which 9 were accepted during Carl's tenure. So, in essence, the contents issue are the results of Carl's efforts. The officers and members of SWCRA thank Carl for hi work.

The Journal of Applied Case Research
Volume 1, Number 1, 1997

Contents

Countryside Theological Seminary

Roderick S. Barclay, University of Texas at Dallas
Patricia Noell, Texas Tech University

History

Reverend William S. About, his wife Abigail and Reverend Richard B. Good were residents of the Southeastern United States and were extremely interested in furthering the religious acumen of the general population and increasing the overall membership of their denomination's view of the Protestant religious doctrine. This motive provided the impetus for them to consider founding the Countryside Theological Seminary. They thought about the possibilities and the accompanying problems for many years. William, Abigail and Richard had no business experience and had been eking out their existence serving at many small churches, and devoutly believed that God was their savior and would provide for their needs. However, they understood that in order to establish a Theological Seminary and have success in its operation, there must be a definite source of students and the students in turn must have the financial capability to pay for their schooling.

Richard had located a tract of wooded land that was available at no cost as long as it was used to further the denomination that had ordained Richard. Countryside Theological Seminary was ultimately founded on this land at the end of World War II to serve the needs of many individuals returning from the emotionally turbulent war years. It was perceived by the founders that many individuals, some of the people that remained at home as well as those who went away to serve in combat theaters, were in need of the help that can best be provided by religious organizations. An observation was made that the existing seminaries would not be able to supply the resources to meet the increasing demand for ministers. Another observation that did not escape notice by the founders was the fact returning military personnel had available a guaranteed source of funds for education provided by the G. I. Bill.

Richard passed on shortly after Countryside was established and was followed in a few short years by William and Abigail. Members of the faculty and advisory committee assumed management of the school, and over the years there have been many changes in personnel.

The school was founded, grew slowly but steadily, maintaining a noticeable presence in the denomination. Countryside was never financially "flush" but managed to maintain its existence and continue in operation.

Current

The years have passed, and we are viewing Countryside Theological Seminary from the perspective of the 1990s. Culture has changed, technology has changed, perspectives of economics are different, and ethics concerns are resurfacing as an educational requirement and business necessity.

The institution has presented a $3,500,000 operating budget to the Board of Trustees for each of the past several years. The Operating Fund currently has a deficit of $3,459,521, most of which has accumulated during the past decade. The Endowment Fund has a balance of $7,346,123, of which

$3,249,990 is a receivable from the Operating Fund. As a result of these fund balances and other fiscal events and conditions, the institution has been warned (off-the-record) by several sources that its accreditation may be in jeopardy.

As a result of these circumstances, the general members of the Board of Trustees overrode the Finance Committee and approached your accounting firm, Hippie, Yippie, and Yuppie, CPAs, for assistance in the solution of current problems. If they are satisfied with your work, it is likely that you will be engaged as the auditor for Countryside Theological Seminary. Due to your broad experience in accounting systems, auditing, and management assistance engagements, you were assigned responsibility for this client. The managing partner of the firm reminded you of current developments in the area of accountant's legal liabilities and various lawsuits concerning auditing and personal behavior that are even now progressing through the legal system. You and the managing partner also had a long discussion concerning community obligations and engagement risk issues.

Requirements

During your ensuing discussion with client representatives, the question was raised as to the extent of your responsibilities and the scope of your activities. It was determined that the structure of the engagement is to be:

1. You are to perform a preliminary analysis of the organization based on the facts presented in this case and appropriate research in the local University Library. Thoroughly document your work.
2. Based on this analysis, you are to determine if the school has a control and record keeping system and potential for future existence sufficient for you to perform an audit and render an opinion. Completely document your decision and the underlying logic, be specific.
3. As a substitute for the audit, in the case you decide it cannot be performed, or you are unwilling to assume the accompanying audit risk, you are to present to the Board of Trustees a written synopsis of the control structure and detail actions that in your view should be taken by management to preserve and enhance the institution. In the event your opinion is that the audit can be performed, the same written synopsis should be presented as a Management Letter in conjunction with the audit. You are to prepare detailed backup for this letter, since you will likely be required by the client to substantiate your observations, particularly if some of your recommendations are controversial. You also must have the documentation for evidence during regulatory investigation—which may be pending.
4. Do not limit your investigation, analysis, response or solution to accounting information and issues. Remember, you were assigned this case because of your broad management and business expertise and knowledge of ethics and personal behavior as well as your technical accounting and auditing knowledge.
5. After you complete all the tasks, and prior to submitting any information to the client, you are to submit the entire package to your managing partner (the professor) for review and critique.

General Information

During its first 25 years the institution has been recognized as a leader in its academic specialty. The institution has been headed by President John Shields for the past 10 years. President Shields' hope was to use his presidency as a springboard into an episcopacy of the denomination.

During President Shields' term there have been three business managers. The first two were highly respected in church circles prior to joining Countryside. In fact, it was because of this respect that they were chosen to join Countryside Theological Seminary. The first business manager was asked to leave due to misappropriation of funds in the neighborhood of $50,000. The second business manager of President Shields' term was convicted of embezzling $350,000. The accounts receivable balance includes a remaining $150,000 which the institution is unable to document sufficiently for insurance company purposes, and the insurance company refuses to pay additional claims. The third business manager, a retired military officer, has just been asked to leave Countryside because of sexual harassment charges brought against him by three students.

When the continuing accreditation of the institution became critical and morale on campus was at an all-time low, the Board of Trustees opened a search for a new President. At the time of the search, President Shields was two years from retirement so the Board scheduled him for a sabbatical during his final two years. During the term of the sabbatical he was to receive full pay, benefits, and perquisites. The Academic Dean had three years remaining before retirement. The Board scheduled him for sabbatical during his final year (over his vehement objection).

The search process for the presidency narrowed to three candidates. Two removed themselves from consideration after visiting the school and evaluating circumstances and conditions. The remaining candidate was Steven Charter. The Board, acknowledging him as a consensus-builder and as a fund raiser, was pleased they could induce him to accept the post as President of Countryside Theological Seminary. The Fiscal Year 1991 operating budget was increased to approximately $4,000,000 upon the arrival of the new President. President Charter's primary mandate was to "restore the endowment and improve morale."

President Charter immediately made two important policy decisions. For the subsequent five year period; (1) all earnings of the endowment would be added back to the endowment corpus, and (2) the income from all trusts and estates would be added to the endowment fund. The primary purpose for increasing the endowment fund was to raise the amount available to students, thereby increasing the number and amount of available student scholarships.

During your first evaluation of the institution, and as part of your preliminary investigation of the control environment, you became aware of the following information. A large part of your information concerning personnel was obtained from the new business manager. Michelle Masters has been employed by Countryside since November 1992. You are now at the end of the 1992-1993 fiscal year. Michelle has been a very valuable resource and provided you with information outside the realm of financial statement data but extremely relevant to the engagement because of the management orientation of your engagement rules. She has also provided much information, some relevant and some irrelevant, concerning the personalities and operational events that could have a major impact on your evaluation and description of the control environment. Some of the information has also been obtained through Michelle's relationships with some of the other staff members. All of the following information does not fall into the realm of data available during a normal audit. However, the information available from Michelle, and the information normally available during audit activities, is not segregated. Rather, it is placed in substantially chronological order to facilitate your understanding.

CAST

Board of Trustees

1st Finance Chairman: Robert Crash. President major manufacturing company for aerospace industry, Stanford MBA. Voluntary position; holds temporary adjunct faculty position in Church Finance and Administration, donates salary back to institution.
2nd Finance Chairman: I. Raise Pricenow. Chairman, Retired CEO public utility company. Attorney. Long-time general member of Board; heavy donor.

Senior Staff

President: Steven Charter. State Senator for 12 years, ran losing race for Governor, taught public policy at Miscellaneous State University and served as a national campaign official for an aborted presidential campaign, raising more than $7,000,000. Ordained in the denomination under which Countryside operates, had been pastor-in-charge of inner city congregation prior to entering the political arena. Continues to function as an active official with his political party and has continuing responsibilities therein. Compensation: $105,000

Academic Dean: Ben Diabolical. 35 year career at Countryside Theological Seminary, moving through faculty ranks to become (about 10 years ago) Interim Dean, then Dean. Ordained in denomination. He remarried 10 years ago to a student who subsequently joined the faculty. She is now Chair of the Faculty Policy Committee. Compensation: $78,000

Business Manager: Michelle Masters. MBA, 2 years entrepreneurial activities after receiving graduate degree, 5 years paraprofessional accountant while graduate student, taught high school mathematics 5 years, and recorded record sales in retail and real estate industries 5 years. Single mother for 20 years, raising and educating 3 children. Compensation: $41,000

Director of Development: Position open.

Mid Level Staff

Personnel Director and Intern Coordinator: Marvin Milqetoast. Former Director of Development for approximately 10 years. Current position created for him. Ordained in denomination. Wife teaches in local school district. Her parents gave substantial trust fund to institution. Reports to President for most matters, to Academic Dean as Intern Coordinator. Compensation: $50,000

Controller: Barnaby Butler. CPA in private practice 35 years. Licensed in 2 states. Reports to Business Manager who suspects his credentials may have lapsed. Long-time, close friend of I. Raise Pricenow. Pricenow's company employed Barnaby's sister years ago and promoted her progressively to Executive Vice President (she is now retired). Compensation: $45,000

Director of Admissions: Eddie F. Closedeal. Second year at institution. Has been in admissions 15-20 years at 3-4 public and private institutions. Wife is secretary in development office. Ordained in denomination. Compensation: $39,000

Director of Student Services: Betsy Burnem. Has served in position 10 years. Oversees registration, housing, and financial aid. Ordained in denomination. Compensation: $33,000

Support Staff:

Coordinator of Financial Aid and Housing: Grinda Gritch. Single mother of 4 year old. Finishing undergraduate credits for Bachelor of Arts in organization behavior. Paid $2,000 more than average secretary but resents her salary. Complains constantly about "this cheap outfit". Father is tenured professor of Christian Ethics. Compensation: $21,000

Registrar: Wilhelmina Boots. Former playground teacher's aid. Has been Registrar for two years following rapid turn-over of four previous registrars. Compensation: $20,000

Auditors: Swindle, Cheatem & Stealem, CPAs. Have audited institution for eight years. Partner-in-Charge: Ralph Irving. Long-time friend of Robert Crash. Audit Manager: Sally Stealem (partner's daughter), has supervised institution's audit for several years. Audit Senior: George Groupie, has been in charge of institution's audit field work for two years.

Events of the Current Year

President Charter interviewed Michelle Masters as a candidate for the Business Manager's position. The President was impressed with her demeanor and credentials. He arranged for Robert Crash to interview Masters.

Crash introduced himself to Masters, saying: "I'd like to start this interview by telling you about myself. I am a Stanford MBA." Then he described the 20 year high-level progression of his career. When he finished he picked up Masters' resume, tossed it in the trash, saying "This is not important, what have you got to say for yourself." During their conversation Crash stated "I want to see cash flow projections. The School has not had them before.... I nominated Charter to this position, and I don't intend to see him crash and burn.... I will do whatever it takes to make his tenure successful.... I am opposed to his selection of you. You do not have the experience to keep up with a dynamic President, and I will tell him this.... I want him to have what he wants, however.... If he does not hire you, then I would like to talk to you about a place in my company."

Charter offered Masters the job as Business Manager. As his charge to Masters, he said

"This is the middle of November and there is ample time until the end of the fiscal year. I want you to dig into everything, question everything. Your assignment is to return integrity to the business office, to clarify the financial reporting system and prepare to put in a computerized accounting and reporting system, and to coordinate the budget process. Because of previous embezzlements, you, I, and three trustees are the only ones authorized to sign checks. We are each limited to $500 without a second signature. My choice of you as Business Manager is probably the most important hiring decision I will make. My success depends on that choice."

Masters, who was relocating from out of state, found temporary living accommodations. On Monday morning she arrived to meet her staff. The Controller, Pauline Straitlace, and Corinda Ceylon, the Payroll and Accounts Receivable Clerk, were moving Pauline's desk and personal items from the Business Manager's office to a smaller one.

Straitlace, a native of the Philippine Islands with a BBA in general business from the Christmas Island University, had served two years as Controller. Prior to being hired as controller, her background was comprised of paraprofessional accounting work, including financial aid reporting, for a proprietary school. She met with the President four times about being promoted to Business Manager and had arbitrarily occupied the Business Manager's office for the past several months. Late Friday afternoon she was informed of the hiring decision and asked to vacate the Business Manager's office. On Tuesday morning Straitlace precipitously left the premises, without informing anyone of her intentions, and never returned.

Tuesday both the President and Director of Personnel were out of town. Masters had not been introduced to anyone on the staff and had only managed to introduce herself to her own staff. Dean Diabolical came to her office: "I'm sure the President informed you that during his absence I am in charge." No mention had been made to Masters of the Dean's duties by either the President or Director of Personnel prior to the Dean's arrival in her office.

Masters called Swindle, Cheatem & Stealem and asked to borrow copies of the audit workpapers. Sally Stealem and George Groupie personally delivered them two days later.

In October, the Accounts Payable and Payroll Clerk had resigned to marry the previous Business Manager. Payroll responsibilities were assigned to Corinda Ceylon, the Accounts Receivable Clerk. Two years earlier Corinda had been hired by Pauline Straitlace. Neither of them disclosed the fact that the two were cousins, a fact that became general knowledge subsequent to Corinda's employment. A new accounts payable clerk, Patty Precise, with many years of large corporate experience, was hired.

Corinda had no prior experience in payroll and had been given no training. Preparation of the payroll checks and tax forms was contracted to Control Data Corp. They keyed in the data from reports and payroll records prepared by Corinda. The payrolls for the end of November and mid-December were prepared in this manner. However, there were numerous mistakes and many hours were spent re-issuing corrected payroll checks. Masters decided that the first step in returning integrity to the business office was to administer a clean payroll. She moved the payroll processing contract to ADP effective January 1 because they had a system whereby the data could be transmitted by modem. She also sent Corinda to five days training in payroll and ADP reporting procedures.

In mid-December Barnaby Butler, who had interviewed for the Business Manager position, was hired as Controller. Also relocating from out of state, and with prior plans for the last 10 days of December, Butler started immediately, working only one week in December.

During Butler's first week, Masters made appointments for the two of them to meet most of the staff individually, to discuss their jobs, and to learn what financial decisions, data, and reports originated from each. This would be the first opportunity Masters had to meet most of the staff personally since she was extremely busy and neither the President nor the Dean had introduced her to the institution's other staff members. On Butler's first day, the Director of Personnel showed him around the campus and introduced him to staff and faculty.

In January the Business Manager and Controller audited the payroll and personnel records in conjunction with W-2 preparation. Several categories of payroll reporting irregularities were identified as a result of this investigation.

1. Five ordained staff and faculty members, including Dean Diabolical and Marvin Milquetoast, were claiming to be self-employed for tax purposes but were taking advantage of Salary Reduction Annuities (IRS Code § 403[b]) and Cafeteria Plan (IRS Code § 125) benefits.
2. Student workers were reported as independent contractors to avoid payroll taxes.
3. Adjunct faculty were considered independent contractors. Also, travel allowances provided in compliance with their contracts were unreported.
4. Pension discrimination was obvious and rampant.

During the process of auditing the payroll records, an occasion arose to inspect the Benefit Plan documents. They could not be located. Faculty Handbook and Staff Handbook statements on benefits were inconsistent. Providers of the medical plan, cafeteria plan, and pension plan provided to Masters copies of what they believed to be current plan documents. A review of all existing minutes of the Board of Trustees revealed the only reference to adoption of a pension plan was in 1985. Minutes in 1988 indicated that Robert Crash was to look into the pension plan, but there were no other references in the minutes. The insurance company which funded the pension identified a plan document which they had helped develop in association with the previous Business Manager and the currently inactive Vice President of the Board, Richard Roadrunner, an attorney from Cleveland, Ohio. During discussion with Richard, Masters learned he did not know approval of the pension plan had been dropped, and was in fact ignorant of any events that occurred after he helped develop the plan.

Diabolical was concerned that the business office was reviewing payroll and benefit administration. In early January he came into the public area of the business office where Masters was at a file cabinet and began yelling at her: "Who do you think you are! You are trying to make policy and only the faculty make policy here! You are making decisions that are mine to make! You do not have the authority to make policy decisions and have no business examining payroll or pension information."

Diabolical began complaining to Charter about Masters' review of the payroll and pension. Charter advised Masters that whenever possible pass the "heat" to an outside person. He then arranged for an employee benefits attorney to consult with the School on a pro bono basis. In February, Masters took her analyses of the benefits problems to the attorney. The attorney stated that he was "impressed with the analyses. [He had] never had a client who had the problems so well organized." The attorney promised to review and recommend policy on benefits and on employee status of clergy and adjunct faculty. However, paying clients had a priority and as late as mid-December the attorney had not attended to this review.

Paperwork flow was confusing, even chaotic, throughout the administration. Purchasing was done by anyone, at any time. Purchase requisitions were located that did not agree with related purchase orders, however, both had been approved. These were found to have been prepared and signed after the purchase had occurred and the goods were received.

The Development Office brought a daily Gift Report along with checks and cash received to the Business Office for deposit on an irregular basis. The Gift Report total was equal to the deposit. The Gift Report was prepared by Thelma Tripp, department secretary for 28 years. Thelma made most of the decisions about purposes of gifts. The Planned Giving officer in the Development Office communicated settled estates by memo, telephone, or personal delivery. The Alumni/Event Coordinator in the Development Office kept all collections in her desk drawer, because the Business Office could not account for them correctly. When she needed a check, she would take the appropriate cash to the Business Office, which hopefully located the invoice and wrote the check. The Director of Foundation Gifts in the Development Office personally took her deposits to the Business Manager accompanied by verbal instructions as to the purpose of the gift. The Development Office did not provide backup documentation relating to the stipulated requirements concerning gift proceeds. The personnel in the Development Office said that the Business Office did not need any of this information as it was "duplication" of filing, the "Business Office can't keep good accounts anyway," and if the auditors needed the information they could get it from the Development Office files.

Spring registration in January dramatized the chaotic financial reporting system. Dean Diabolical stated that student bills were the responsibility of the Registrar. The Student Services office had designed a registration form which crowded billing amounts for tuition, fees, grants, scholarships, payments and billing information on the bottom two lines.

Just prior to Spring 1993 registration, Wilhelmina Boots got a list of student account balances from Corinda. At the registration counter all fees were calculated, grants and scholarships awarded, student loan checks disbursed, and bills calculated. The process was time consuming and very public. The student was sent across the hall to the business office to pay all or part of his bill, as he chose. The student had 90 days to pay his bill without interest, and did not need to have his account cleared until registration for the following semester. Student loan checks made payable to both the School and the student were endorsed by the School to the student.

Some scholarship checks were made directly to Countryside and were to be used for student assistance. These checks were recorded as payments by the student, rather than added to the Development Office records and accounted for as institutional funds.

During January, Masters began receiving numerous complaints from vendors. Late in the month, Masters located a six month collection of unpaid office supply invoices in the desk drawer of Krafty the switchboard operator's basement office. Krafty said she had kept them because she had not had time to type up purchase requisitions and purchase orders for signature after she had ordered the supplies. In addition, three different travel agencies were begging for payments long overdue. The business office had no corroborating invoices. Eventually these invoices were located in briefcases and desk drawers belonging to the President, the Director of Admissions, the Dean, and the Director of Personnel. Additional invoices were attached to expense reports which faculty members had already submitted for and received reimbursement.

Masters wrote a purchasing policy (subsequently adopted by administrative resolution) to streamline the system and to clarify paperwork and reporting requirements for cash disbursements. It is significant to note that the policy did not include definition of paperwork flow for recording encumbrances in the formal accounting records. Encumbrance accounting was not included in the formal accounting structure or the master Chart of Accounts. The purchasing policy included a corporate travel program arranged with the Academic Dean's favorite travel company. The travel company agreed to special financing of the school's flight travel and preparation of a monthly invoice rather than individual invoices for each flight.

Dean Diabolical did not like the new purchasing policy and refused to use it for his travel. He did not inform the faculty of the policy. He, his wife, and the faculty continued to charge their travel to personal credit cards, and when the card payment was due submit expense reports and demand immediate reimbursement.

The budgeting process for the next fiscal year began during February. The Business Manager's responsibilities included budget oversight and planning. Masters prepared a budget planning document in accordance with budgetary procedures as prescribed in existing management and accounting literature. Masters presented this budget methodology to Charter. He disregarded Masters' effort and dictated the following budgetary procedures.

1. Take current payroll and decide raises. While the faculty salary differences based on gender and ethnicity had previously been aligned, there were still serious discrepancies in staff salaries based on gender. Charter budgeted a raise for everyone "to increase morale," but larger raises for staff women to "narrow the gap." The increases total approximately $250,000 annually.

2. Adjust the current year's budget upwards for unfavorable expenditure variances to obtain the new budget amount.

3. Decide what numerical combination of increase in FTE[1] students and increases in private gifts would be required to bring the revenue budget in balance with the expenditure budget.[2]

Stating that he wanted "the budget to have a whole new look" Charter arbitrarily moved budget line items from one department to another. Under Robert Crash's direction, the Business Office had developed a 75 page chart of accounts which lent itself to preparation of reports for any outside regulatory bodies. Without asking why the current chart of accounts existed, Charter ordered changes.

Current restricted funds included fee-based programming. Because of this, coupled with Charter's directive that all endowment income be returned to the endowment corpus, Masters added expenditures for all restricted accounts to the budget, particularly current restricted operating funds and transfers. Charter was concerned because the budget had increased so much.

Diabolical blamed Masters for adding the restricted funds. He declared that "all those funds are off budget. They don't count." Diabolical's administrative assistant also complained about Masters: "She's changing everything. These funds don't count as part of the budget."

Eddie F. Closedeal was informed of his new budgeted FTE student enrollment requirements. He stated that he did not believe he could meet this enrollment budget due to problems with course scheduling, professor class assignments, and tuition rates. Faculty preferred full-time students, partly because they did not like teaching night classes, and partly because they did not believe part-time students were as committed as full-time students. Prior to each semester the full-time faculty decided which classes they wanted to teach that semester. The remainder were taught primarily by whatever collection of adjunct faculty that could be found. Closedeal noted that students perceived a difference in faculty knowledge and teaching ability between the full-time and adjunct faculty and were becoming more agitated and vocal because of their perceived mistreatment by the school. The part-time students also noted that their tuition rates were the same as, sometimes even greater than, those paid by regular, full-time students.

Closedeal mentioned that throughout the higher education industry the marked trend is to part-time students and to mid-life career changes. Countryside followed this trend. Closedeal believed that he could not meet the FTE requirements unless the full-time faculty agreed to adjust to more part-time students and cease discriminating against them. He eventually shrugged off the budget problems by stating "We're already oversupplying the market with our graduates anyway, so a few less won't really matter."

The state legislature passed a law requiring a formal, detailed risk management policy be implemented by all not-for-profit organizations by July 1. The Insurance Committee of the Board brought this to Charter's attention. He directed Masters to meet with the Insurance Committee and write the policy, which she did. He then refused to allow the proposed policy on the administrative council agenda. The Insurance Committee did not bring the question up again.

In March, after Charter and Diabolical decided when faculty and staff raises would be implemented, Masters derived the first draft of cash flow projections. The disbursement projections were made from source documents; the receipts projections were based on historical patterns. Charter ignored the cash flow projections, except that he asked Burnem and Masters to review tuition payment policies of similar institutions and to recommend a new tuition payment policy to the staff for approval.

At the end of June the staff approved a new tuition payment policy: "Tuition is due at the time of registration or the first day of classes, whichever is later. A late fee will be assessed for accounts not paid in full." While Betsy Burnem was not a member of the faculty, as a member of the academic staff she attended faculty meetings. The faculty was not part of the decision process concerning the tuition increase or tuition payment policy decisions. However, the faculty, via Professor Gerald Gritch and the faculty policy committee did not like the new plans. Grinda Gritch loudly declared that no student would be able to register.

Charter did not want the Development Office to see the amount or the timing of the Private Gifts revenue budget. He directed Masters not to disclose this information, stating "It will scare them to death."

During the spring, Masters asked Charter, who functioned as Director of Development, for time to discuss cash projections.

In April, Charter refused, saying: "Don't you believe in God?"

Masters: "What?"

In June, Charter: "Don't you believe in God? He wants us to succeed."

Masters: "What does that have to do with cash budgeting?"

Charter: "They already tried to kill this school once and didn't succeed. I came. God wants us to succeed and will provide."

In July, Charter: "I don't want to talk about it. Don't you believe in God?"

Using accounts payable as the balancing number, Masters developed the Private Gifts receipts monthly budget projection. In September a new Development Director came on board with the immediate task of raising the record setting budgeted amounts of $225,000 in September and $290,000 in October.

Throughout the spring, Charter ordered Masters to pay only those invoices he personally authorized. This directive was not communicated to Diabolical who charged Masters with refusing to pay vendors he did business with. Charter demanded that Masters be the last stop for vendors demanding payment. He instructed her to say whatever was necessary to placate them temporarily and that he was managing the cash on a "squeaky wheel" policy. A week after the end of the fiscal year, Charter borrowed another $250,000 from the endowment to meet past due payroll obligations.

In mid-July Corinda took another job and departed Countryside the same day. Using Corinda's departure as an excuse, Charter reorganized the Business Office clerical staff in order to Terminate Patty, stating: "She doesn't smile enough." Masters began a search for one accountant to handle accounts payable, accounts receivable, and payroll, as directed by Charter. Diabolical immediately brought the resume of a faculty wife and handed it to Masters. Leaning over her desk he said: "I cannot emphasize enough how much my wife and I want this woman to be hired for this job." The Dean's candidate was hired to start August 5.

After Butler departed on a July vacation which was approved by Charter, Masters examined the general ledger. (Remember the 75-page chart of accounts.) Completing her analysis, she made an appointment with Charter.

Masters: "I have conducted an analysis of the operating fund budget and reviewed the controller's journal entries. I believe that the operating fund will run a deficit of approximately $250,000 before any audit adjustments."

Charter stared coldly: "Why?"

Masters: "Butler's journal entries transfer all Additions to Restricted Operating Funds to Income from Restricted Funds. There is no similar transfer for the deletions to Restricted Operating Funds to the departmental expense accounts. This is basic fund accounting—matching revenue and expenditures."

Crash was summoned to meet with Charter, Masters, and Butler after Butler returned from vacation.

Crash to Butler: "Why did you make these entries."

Butler: "Charter wanted to see all the income."

Crash: "What about the deletions?"

Butler: "I assumed they would be used up and go away by year's end."

The denomination's national office has been managing trust annuity funds set up by donors in their wills. The donors are alive. The trust annuity funds, currently totaling more than $10,000,000, would eventually benefit the seminary. Robert Crash suggested the funds be brought onto the financial statements as they are future resources of the seminary and would improve the going-concern situation. He offered to argue the proposition either way.

Pricenow, who had become Finance Committee Chairman in June, wrote a letter at once to Charter, stating: "Michelle Masters must be terminated immediately. It is clear that she has no understanding of fund accounting." Charter subsequently fired Masters.

Additional Financial Information

You have been provided the Income Statement, Detailed (Appendix A) and Summary (Appendix B), and the Balance Sheet (Appendix C) for Countryside Theological Seminary for the fiscal year ended June 30, 1993. You also have been provided with a copy of the Budget (Appendix D) prepared by Michelle Masters for the succeeding fiscal year. The computational basis of the budget has been previously discussed.

During your perusal of the financial documents, you perceived many items that needed further explanation before you could make your initial evaluation and proceed to the next step of the engagement. The explanations you were provided, largely by Michelle Masters, are detailed below.

1. The first issue was actually unrelated to the financial statements. The issue you wished to have explained further was the determination and history of FTE.[3] FTE is a measurement tool used to convert the total number of students enrolled, and the number of credit hours for which they are rolled into the equivalent number of full-time students. (Note: Review your thoughts on equivalent units.) You were supplied the following history of student enrollment:

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Total	374	380	426	369	382	352	346	390	397	426	424
FTE	174	192	221	209	205	177	162	183	177	195	197

2. Operating Fund Investments consist of miscellaneous plots of donated land.
3. Operating Fund cash includes approximately $65,000 in restricted funds.
4. Gifts to the Endowment Fund are being utilized to make down payments on faculty homes.[4]
5. Approximately 50% of the Endowment Funds investments are being managed by an outside trustee who will not relinquish management to the seminary due to the seminary's perceived mismanagement.
6. An endowed chair in Administration and Finance has not been filled for 5 years. The designated endowment income has been used to supplement operating funds.
7. All items categorized as Endowment Funds and Annuity and Life Funds are restricted as to their use.
8. The Plant Funds amount of $357,179 due from Operating Fund is for yearly physical plant operating expenses (including all library costs).
9. The Operating Fund Land, Buildings & Equipment balance is for unused land.

10. The Operating Fund Note Receivable amount includes the amount of $150,000 due from the insurance company related to a prior embezzlement.
11. Approximately $90,000 of endowment funds managed by the seminary is Pastoral Care Center money. Income from these funds is intended to support the Pastoral Care Center.
12. Plant Funds Notes payable includes the principal amount of $400,000 to a trustee, the remainder is for unpaid property improvements.
13. Net Investment-plant funds is the amount of original gifts used to build the physical plant.
14. Operating Fund Unearned revenues-Restricted is for canceled bible manuscripts, contained in an Agency Fund.
15. Operating Fund Unearned revenues-Unrestricted is related to a Russian Language program, also contained in an Agency Fund.

You are not particularly satisfied with the information you have been given and have some serious reservations about whether or not all answers have been completely truthful. However, the information presented herein, including the appendices, is all of the information available and it is this information upon which you must base your decision and complete the engagement.

Summary

You have been presented a case comprised of complex, sometimes potentially confusing and very comprehensive information. It has been designed and constructed to as closely as possible duplicate the type and extent of information you might be presented as a fairly experienced member of an accounting firm. Firms often are asked to accept clients and engagements that are not clean and neat.

The most important aspect of this case is that you are required to make an evaluation with awkward, vague, and incomplete information. You are expected not only to compile evidence to make a decision concerning auditability and an appropriate management letter, but to also recognize the probability that you will be called upon to defend your decision. You may be asked by your accounting firm management to defend your conclusion or, more likely, you will be called by the potential client to justify your decision and explain why situations are inappropriate. Likely you will then be asked what changes to make and how to make them to improve the operations of Countryside Theological Seminary. There exists even a remote possibility that you may be called by a governing or accrediting agency. Make sure you keep all these possibilities in mind as you complete your work.

APPENDIX A

Countryside Theological Seminary
Operating Fund
Statement of Revenues, Expenditures & Transfers
For The Year Ended June 30, 1993

	Actual	*Budget*	*Variance*	*Variance Percent*
REVENUES:				
Tuition-Regular	965,299	940,000	25,299	2.7%
Tuition-Professional Development	56,707	67,333	(10,626)	-15.8%
Tuition-Interterm	15,240	15,000	240	1.6%
Summer School	150,323	107,000	43,323	40.5
Student fees	47,143	39,081	8,062	20.6%
Denomination Support	735,547	762,717	(27,170)	-3.6%
Local Church Congregations	16,096	20,333	(4,237)	-20.8%
Private Gifts-Restricted	741,309	968,786	(227,477)	-23.5%
Individual (Undesignated)	181,392	121,917	59,475	48.8%
Alumni/Students	5,122	6,737	(1,615)	-24.0%
Trustees	24,275	33,000	(8,725)	-26.4%
Organizations	250	0	250	0.0%
Staff	4,239	2,750	1,489	54.1%
Faculty	1,369	550	819	148.9%
Foundations	79,415	60,000	19,415	32.4%
Government Grants	32,497	36,667	(4,170)	-11.4%
Interest/Other	27,836	32,083	(4,247)	-13.2%
Estates & Bequests	359,416	183,333	176,083	96.0%
Endowment Income	212,186	192,500	19,686	10.2%
Dormitory rent	230,684	231,000	(316)	-0.1%
Cafeteria sales	30,231	26,000	4,231	16.3%
TOTAL REVENUES:	$3,916,576	$3,846,787	$69,789	1.8%
EXPENDITURES:				
Presidents Office	350,537	254,376	96,161	37.8%
Business Office	182,351	151,569	30,782	20.3%
Dean's Office	212,888	108,435	104,453	96.3%
Student Services	109,378	111,169	(1,791)	-1.6%
Admissions	82,126	81,817	309	0.4%
Library	162,455	176,635	(14,180)	-8.0%
General Services	512,276	453,959	58,317	12.8%
Development	390,334	319,663	70,671	22.1%
Instruction	1,150,498	1,038,545	111,953	10.8%
Campus Services	322,017	267,966	54,051	20.2%
Cafeteria	65,432	65,567	(135)	-0.2%
Housing	91,181	99,204	(8,023)	-8.1%
Scholarships	444,131	476,881	(32,750)	-6.9%
Transfers	88,150	77,077	11,073	14.4%
TOTAL EXPENDITURES	$4,163,754	$3,682,863	$480,891	13.1%
SURPLUS (DEFICIT)	($247,178)	$163,924	($411,102)	-250.8%

APPENDIX B

Countryside Theological Seminary
Statement of Revenues, Expenditures & Transfers
For The Year Ended June 30, 1993

	Unrestricted	*Restricted*	*Total*	*Budget*
REVENUES:				
Tuition & Fees	1,234,711		1,234,711	1,168,414
Denominational Support	751,643		751,643	783,050
Private Gifts	216,647	741,309	957,956	1,156,657
Foundations		79,415	79,415	60,000
Campus Enterprises/Federal	288,752	32,497	321,249	325,750
Endowment Income/Estates	323,263	248,339	571,602	352,916
TOTAL REVENUES	$2,815,016	$1,101,560	$3,916,576	$3,846,787
EXPENDITURES & OTHER DEDUCTIONS				
Instruction & Academic Support	1,283,386	115,353	1,398,739	1,146,980
Library	162,455	4,247	166,702	176,635
Student Services/Admission	191,504		191,504	192,986
Administration/General Institution	1,444,290		1,444,290	1,127,870
Auxiliary Services	156,613		156,613	484,434
Scholarships/Grants/Aid	249,067	456,372	705,439	476,881
Transfers	88,150	12,318	100,468	77,077
TOTAL EXPENDITURES AND OTHER DEDUCTIONS	$3,575,465	$588,290	$4,163,755	$3,682,863
SURPLUS (DEFICIT)	($760,449)	$513,270	($247,179)	$163,924

APPENDIX C

Countryside Theological Seminary
Balance Sheet
June 30, 1993

	Operating Fund	*Loan Funds*	*Endowment Funds*	*Annuity & Life Funds*	*Plant Funds*
ASSETS					
Cash	$118,099	$4,767		$80,363	
Investments	16,226		$4,096,133	654,765	
Receivables:					
Student accounts	111,658	592,416			
Note, less allowance	68,263			63,805	
Deposits & Prepaid Expenses	4,420				
Land, Buildings & Equipment	412,500				9,574,609
Due from Operating fund	______	286,696	3,249,990	21,982	(357,179)
TOTAL ASSETS	$731,166	$883,879	$7,346,123	$820,915	$9,217,430
LIABILITIES AND FUND BALANCES					
LIABILITIES					
Notes Payable	$60,000				$411,614
Accounts Payable	225,963				2,795
Accrued Medical Claims	54,464				
Student Deposits	51,674				
Unearned Revenues					
Restricted	170,085		$31,490		
Unrestricted	(64,609)				
Auxiliary Funds	134,442			$14,667	
Due to Non-expendable Funds	3,558,668				
TOTAL LIABILITIES	$4,190,687	______	$31,490	$14,667	$414,409
FUND BALANCE (DEFICIT)					
Operating Fund	(3,212,343)				
Perkins Fund		487,613			
Loan Funds		396,266			
Endowment Funds			7,330,948		
Annuity & Life Income Funds				806,248	
Net Investment-Plant					8,803,021
Fund Balance-Beginning of Year	($3,212,343)	$883,879	$7,330,948	$806,248	$8,803,021
Net Increase (Decrease)	(247,178)	______	(16,315)	______	______
FUND BALANCE-END OF YEAR	($3,459,521)	$883,879	$7,314,633	$806,248	$8,803,021
TOTAL LIABILITIES & FUND BALANCE	$731,166	$883,879	$7,346,123	$820,915	$9,217,430

APPENDIX D

Countryside Theological Seminary
Budget
For The Fiscal Year 1993 - 1994

	TOTAL	JUL	AUG	SEP	OCT	NOV	DEC
REVENUE SOURCES							
Tuition / Fees	1,335,837	50	50	436,691	50,050	25,050	50
Less: STC Scholarship	(276,700)	(7,431)		(130,919)			
Net Tuition	1,059,137	(7,381)	50	305,772	50,050	25,050	50
Auxiliary Services	258,636	23,630	8,816	22,040	22,040	22,040	22,040
Denomination Support	1,235,669	94,801	60,228	74,237	71,329	105,355	135,922
Private Gifts	1,666,922	-0-	189,385	56,421	320,403	140,573	183,973
TOTAL RECEIPTS	$4,220,364	$111,050	$258,479	$458,470	$463,822	$293,018	$341,985
FIXED COSTS							
Direct Scholarships	125,000	5,000	10,000	10,000	20,000	30,000	10,000
Notes Payable	146,608	12,614	12,935	13,611	22,414	13,761	12,534
Contracts / Agreements	64,400	1,829	28,647	12,194	1,909	2,807	2,009
Utilities/Insurance/Taxes	286,016	26,498	22,864	42,078	27,170	13,783	25,436
Funds & Affiliates	90,497	8,527	8,527	9,027	6,608	6,652	6,877
Interest Expense	31,020	6,835	460	460	6,835	460	460
Payroll	2,952,534	222,156	221,079	221,655	233,125	234,118	234,966
TOTAL FIXED COSTS	$3,696,075	$283,459	$304,512	$309,025	$318,061	$301,581	$292,282
AVAILABLE FUNDS	$524,289	($172,409)	($46,033)	$149,445	$145,761	($8,563)	$49,703
Budgeted Variable Costs	$637,086	$45,028	$45,028	$54,703	$54,703	$54,703	$54,703
TOTAL GENERAL EXPEND	$4.333.161	$328,487	$349,540	$363,728	$372,764	$356,284	$346,985
SURPLUS (DEFICIT)	($112,797)	(217,437)	($91,061)	$94,742	$91,058	($63,266)	($5,000)

	JAN	FEB	MAR	APR	MAY	JUN
REVENUE SOURCES						
Tuition / Fees	40,050	480,265	60,050	15,055	114,238	114,238
Less: STC Scholarship		(138,350)				
Net Tuition	40,050	341,915	60,050	15,055	114,238	114,238
Auxiliary Services	22,040	26,240	22,040	22,040	22,040	23,630
Denomination Support	35,473	333,155	43,797	166,962	57,423	56,987
Private Gifts	282,292	10,085	255,889	61,667	156,149	10,085
TOTAL RECEIPTS	$379,855	$711,395	$381,776	$265,724	$349,850	$204,940
FIXED COSTS						
Direct Scholarships	5,000	5,000	5,000	10,000	10,000	5,000
Notes Payable	12,048	11,501	11,264	12,063	5,982	5,881
Contracts / Agreements	3,337	2,832	2,029	1,909	2,909	1,989
Utilities/Insurance/Taxes	12,268	14,316	36,787	13,578	15,096	36,142
Funds & Affiliates	9,455	7,679	7,133	6,649	6,711	6,652
Interest Expense	6,835	460	460	6,835	460	460
Payroll	261,653	257,574	264,400	267,902	254,038	279,868
TOTAL FIXED COSTS	$310,596	$299,362	$327,073	$318,936	$295,196	$335,992
AVAILABLE FUNDS	$69,259	$412,033	$54,703	($53,212)	$54,654	($131,052)
Budgeted Variable Costs	$54,703	$54,703	$54,703	$54,703	$54,703	$54,703
TOTAL GENERAL EXPEND	$365,299	$354,065	$381,776	$373,639	$349,899	$390,695
SURPLUS (DEFICIT)	$14,556	$357,330	$0	($107,915)	($49)	($185,755)

NOTE 1

Financial Ratios

The following financial ratios have been developed by AICPA (American Institute of Certified Public Accountants) and NACUBO (National Association of College and University Business Officers).

Ratio of expendable fund balances to plant debt [FINANCIAL VIABILITY]

Indicates total fund balances in relation to outstanding debt (related to the financing of plant assets) at the end of the fiscal year. A ratio of 1:1 or greater means sufficient expendable fund assets are available to cover related liabilities and plant debt without needing to liquidate any plant or capital funds assets.

State minimum standard: 0.2

Ratio of plant equity to plant debt

Depicts the correlation between excess of assets cost over related debt (equity) and the balance of related debt. A ratio of 3:1 would probably leave little margin for securing substantial additional long term loans.

State minimum standard: 2.0

Ratio of expendable fund balances to total (unrestricted) expenditures & mandatory transfers [AVAILABLE FUNDS RATIO]

This ratio provides a measure of the size of the institution's financial reserves by presenting this relationship. A ratio of 2:1 would mean that the institution has sufficient financial reserves to continue for 6 months without reserve inflow.

State minimum standard: 0.2

Ratio of net total revenues to total revenues

State minimum standard: positive values in the last 3 consecutive years

Ratio of available assets to general liabilities

State minimum standard: 2.0 (using market value of assets)

Debt service as % of total unrestricted current fund revenues

State minimum standard: less than 5.0
S&P "A" rated issues: 7.5% (lower is better)
S&P "AA" rated issues: 5.2%

Debt as a percent of unrestricted endowments & operating fund balance.

Moody's "A" rated issues: 80.0% (lower is better)
Moody's "AA" rated issues: 40.0%

Student enrollment (Total FTE student body)

Moody's "A" rated issues: Stable
Moody's "AA" rated issues: Stable to increasing

Ratio of acceptance to admissions

As this ratio increases and the institution accepts a greater percentage of applicants, the probability also increases that the college will be affected by fluctuations in student markets.

Moody's "A" rated issues: 50% - 70%
Moody's "AA" rated issues: 25% - 50%

Student/faculty ratio

FTE students to FTE faculty (FTE = full time equivalent)

Moody's "A" rated issues: 16:1 (lower is better)
Moody's "AA" rated issues: 13-10:1

NOTE 2

Non-Profit Organizations

"The non-profit sector of the economy (not including government) has doubled in size since the end of World War II, from 2% to 4% of national income.... Assets of the nonprofit sector equal nearly 50% of the assets of the federal government.... Because nonprofit organizations are typically labor intensive, they are...important as employers of labor...[estimates are that] the nonprofit sector accounts for employment of from 7.9 million to as many as 10.3 million workers."[5] Not-for-profit organizations are accountable to their donors' restrictions for appropriate use of donated funds, whether for endowments or continuing operations. Recently, the higher education segment of the not-for-profit sector of the economy has seen a notable increase in public attack, largely because of failure to comply with donor restrictions on fund utilization. For instance, a group of Ivy League universities has been charged with price fixing. Also, Stanford University has been found guilty of charging the Federal government for activities not properly related to research grants. Twelve percent of private colleges in existence in 1970 failed during the following decade.[6] Since 1980, the proportion of college and university failures is twice as large as business failures.[7]

Education

The public is also concerned about the rapidly escalating costs of education for their children. There is frustration and anger that after spending great sums of money for education, students are graduating without the skills and capabilities most desired by employers. Congress has responded by appointing a number of new committees to investigate various aspects of higher education. In addition, the availability of governmental funds is decreasing due to budgetary limitations and decreased tax revenues.[8]

All of these circumstances have placed greater emphasis and attention on the management of educational institutions. Questions have been raised about the adequacy of fiscal management as well as academic policies.

NOTES

[1] FTE is defined as Full Time Equivalent students or professors. In order to properly allocate school resources, industry practices convert all part-time students and instructors to their Full Time Equivalency.

[2] Schick, Allen G. and Peter Lorenzi, "Bureaucratic and Political Models of the University Budgetary Process: Consensus on Departmental Merit," *Research in Governmental and Nonprofit Accounting*, Vol. 2, 1986, p 192, state:

> Some scholars believe that budgets and budgetary processes are of central importance to understanding organizational decision making because priorities are thereby set and policies established...researchers use 'politics' to describe a process in opposition to the organization's bureaucratic administration and its exercise of rational authority...political activity occurs when organizational sub-units use force, deception, or similar self-serving behavior, without regard to the welfare of the organization as a whole. Thus, within the political-bureaucratic dichotomy, these varying interpretations about budgeting imply different views about the legitimacy and rationality of organizational behavior.

[3] Full Time Equivalent students and faculty are measurements used in the industry by accrediting and other reporting bodies.

[4] The President wanted to "invest" endowment funds in residential real estate. The school is to share in the gain or loss at the time the faculty person moves on or dies. The attorneys and a group of out-of-state real estate developers associated with the Board drew up a document/contract to be signed by the President and the faculty/staff purchaser. This document is to be confidential in-house. It proposes that the school is not liable for problems related to ownership, spells out the terms of what is essentially an interest free loan. The document cannot be filed at the courthouse to clarify the property rights.

The authors wish to thank participants in the 1992 Southwest Case Research Association Case Workshop and the various referees and editors who have made positive contributions to the preparation of this case.

[5] Weisbrod, Burton A., The Nonprofit Economy, Harvard University Press, Cambridge, Massachusetts, 1988.

[6] Fadil, Virginia Ann and Nancy A. Carter, Openings, Closings, Mergers, and Accreditation Status of Independent Colleges and Universities Winter, 1970 through Summer, 1979. Washington, DC: National Institute of Independent Colleges and Universities, 1980.

[7] Kim Cameron, Ellen Chaffee, Myung Kim, and Davide Wheeten, "The Aftermath of Decline," Review of Education 10, No. 3 (1987): 215-16 as quoted in James Martin, and James E. Samels. "Achieving Academic Excellence Through Strategic Mergers: A New Approach" in James Martin, James E. Samels & Associates, Merging Colleges for Strategic Growth. Baltimore, MD: The Johns Hopkins University Press. (1994) p. 3.

[8] Seminar Speaker, National Association of College and University Business Officers (NACUBO), San Diego, CA, May 1991.

Lithonia Lighting

Robert N. Carter, Troy State University
Charlotte S. Stephens, Columbus College

At 8:30 a.m., Charlie Davidson went to the conference room adjacent to his office and wrote o the board with a red marker: "Meeting Topic: Improving Performance." He filled his coffee cup an began to pace impatiently, eager for the 8:45 a.m. meeting to begin. He was followed into th conference room by Dr. Eileen Richardson. She had been "shadowing" this Chief Information Of ficer (CIO) for a week now, at the request of both Charlie and his friend of thirty years, the Presiden Bill Miles. Charlie and Bill had given her two assignments. First, she was to write a profile fo Lithonia Lighting's Chief Information Officer. Charlie had created this role at Lithonia long befor the role had a title. To the President and other Lithonia executives, Charlie was the role. They coul not imagine a CIO by any other name. But Charlie was anticipating retirement. The second part o Dr. Richardson's assignment was to review current managers in view of this profile. Did Lithoni Lighting have a viable in-house candidate for CIO? Prior to the observation, Dr. Richardson ha studied the industry, company, and information technology group's background (Appendices A-D and Exhibits 1-5).

The CIO in Action

Charlie and his key Information and Management Services (I&MS) staff members (Exhibit 3), some three levels away from him in the formal structure of the I&MS organization, were to attend this meeting, called hastily yesterday afternoon. Charlie began the meeting by pointing to the topic on the board. "We're here to identify measures we can take immediately to improve performance. We have already gained approval to expand mainframe capacity, increasing the number of access channels. This upgrade will be effective in 30 days."

He looked around the room, examining each familiar face, gauging the impact of this announcement. Red Stout, VP of I&MS, had not yet arrived. Charlie continued, "For some months now, I have not been involved in day-to-day operations. Now, I'll be looking at daily performance measures. During the Seniors (Exhibit 1) meeting yesterday, I was told that a distributor in Dothan, Alabama, had switched to another supplier because of the downtime experienced with systems and computers. Mona Lee told me that the distribution managers who used facsimile machines to fax orders to sales agents and to send shipping instructions to warehouses were heroes! They should be given medals for entrepreneurship! At least they were responding when the system wasn't working."

He paused, waiting for this accusation to sink in, then lowered his voice: "Senior executives are keeping numbers and logs of problems. Their numbers may not be correct and we may not agree with them, but the very fact that they feel the need to keep numbers is a bad indication. They are saying that we are losing business because we can't keep our systems up." There was no sound in the room. He had their attention.

"Our problems are very visible. The business depends on our performance. We know what the long term solution is: distributed database management using the client server model. With this, we won't have the same mainframe access problems. In the interim, we can do better, much better. It is the level of expectation which we have created by our own past performance to which we are presently being compared." Everyone at the meeting knew that Lithonia Lighting's (LL) use of information technology had been a major factor in the company's dominance of the commercial lighting market (Appendix A,B,C). When the Society for Information Management had awarded Charlie and Bill their prestigious Partners in Excellence Award, the Information and Management Services (I&MS) group had gained international recognition.

Identifying the Problem

"We're not here to throw blame on anyone, but rather to identify what I'll term responsiveness problems which we can control." Charlie cited an example. A warehouse microcomputer failed to receive its nightly update for SOS (Stock Order System). The modem continued to try to make a connect all night, resulting in an all night long distance call but no transmission. Charlie asserted that this should never happen. I&MS should be following procedures to monitor transmissions, and he thundered, "respond to a failure like a parent responds to an electrical failure when he has a baby on a iron lung. Maybe, kids are like customers: Expendable...Power failure...Throw them away...Have another...File a malfunction report in triplicate."

Ellen Badcock, the manager of the customer support function spoke up: "We've had so many calls lately, more than we can handle. Instead of calling for help, yelling that we have an emergency because we have so many people on hold or call back, we have just become tolerant of customers having to wait to talk to us. We've just become tolerant of all the lines being busy—what we don't get to today, we'll get to tomorrow. We may need some help until some of the problems causing calls are resolved, but we can get our attitudes about problem calls straightened out." Charlie nodded, "Good," and looked around the room for further discussion. "What mainframe performance measures are we reacting to?"

Since the Director of Data Processing position was open, Ed Lambert, who had been Operations Manager for several months now, responded, "A weekly report is issued..." and looked around the table for help. Charlie held up one hand. "You mean the kid has been dead for a week before you know it?" The operations manager admitted that he was really responding to customer complaints rather than preventing them. "Reacting to the kid screaming?" Charlie asked. "We should know the power went out before he does. I want you to identify your pulse points, the places to monitor so that problems can be intercepted. Then, use measures of these pulse points as a basis for action," Charlie paused as Red Stout who had just arrived slumped down in his chair. He looked tired.

Charlie reviewed the main points made thus far. Then he listed on the board some pulse points or some areas where the group should devote continuous attention. Red Stout quickly became the only participant in the discussion. Others answered only when directly addressed and, then, with some hesitation. Red pointed out that the connect problem, the reasons for modems hanging up, was a Novell Netware problem. He complained that Novell was mainly a marketing company and provided little technical assistance. Charlie responded that systems software could be written to compensate for this problem with Netware: "Can you think of a better use of that time? When the connect is not made, we suffer in the market."

Quick Response

Red Stout responded that he would get back to Charlie on this assignment after talking with the systems programmers. Systems programmers were currently assigned to other projects and a shift in assignments would have to occur. Charlie nodded. He added "shorter connect time" to the action list on the board.

Identifying pulse points to measure and monitor in each area was already on the action list. Then, he looked up and asked quietly, "Where is the SOS machine located now? Who sits beside it to know when modem lights are not blinking, when the screen delivers an error message?" Red Stout responded that the computer was currently in room by itself because they were "short handed" the last couple of weeks. Vacation time had been granted to several people at the same time.

After a short coffee break, Charlie reiterated, "We must take very visible and effective action now. For us, the customer—who includes the agent, the distributor, the warehouse-is our baby in an iron lung" (Appendix A). And then he said, "Two items remain on the agenda: eliminating the faxing of orders now and formulating a plan to help Lithonia Lighting (LL) sell lighting products to a major new customer. So, why are our agents, warehouses, and distributors in the fax business for order anyway?"

Red Stout responded. His Northern accent indicated that he was not one of the local hires. He had been recruited because of his technical competence and experience in different industries. "When the mainframe is down or there is partial availability, orders cannot be processed. Product availability must be confirmed and inventory allocated to process the orders. This requires the mainframe's inventory database. Although orders may be entered by distributors (DIAL-L) and warehouses (SOS+), all orders must be processed through the agent (ACE+) who is on-line with the mainframe (Appendix C). If the mainframe is down, the order is not processed and no bill of lading is created for the distribution center or warehouse to ship the product. Distribution centers faxed copies of the order to the warehouse so that the warehouse could use the paper order to assemble and then ship the order."

Charlie listened patiently and then added, "So orders are shipped from inventory which may have been allocated to another customer and inventory is depleted without changing the inventory database and thus the manufacturing schedule. Correct?" Red Stout, paused and replied, "Yes, sir." A discussion specifying some technical solutions and deadlines for implementing these solutions followed, and then Charlie changed the subject of the meeting.

Information Technology as Competitive Weapon

"During the meeting today we're looking at both sides of the coin. At the same time that our systems are causing critical problems, we are proposing them as the key factor in our marketing strategy for a major new opportunity. We have a major customer who is currently doing $12 million in sales with us annually. They have decided to use one source for lighting, which will mean $30-40 million in business with the prospect of this amount increasing to $100 million. They've looked at all the major lighting companies and settled on two, one of which is Lithonia Lighting. Despite the performance problems experienced lately, the Seniors all agreed yesterday that our systems are our main competitive advantage in this situation.

We can install the distributor system (DIAL-L) at the customer site and let the customer enter orders, confirm orders, and check order status. The Seniors agreed that this service and quick turn around on orders is what we can do that our major competitor can't do. So I want you to leave with things in perspective. Our systems are critical. They provide a competitive advantage no one else has. Thus, it's urgent to fix failures. Expectations of our systems' performance must be met on a second-by-second basis, and we must figure out how to do this without being here twenty-four hours a day."

Finding Front-line Information Technology Warriors

Following the meeting, Charlie interviewed two applicants, one for a micro engineering position and the other for the critical job Data Processing Director. Both Technical Services Manager and Operations reported to this position (Exhibit 7). Benjamin Miller had been with the same company for twenty years. In that position, Ben had been responsible for Operations and Technical Services. After his children left home, he and his wife, Molly, decided to look for a challenge and a change. He assured Charlie that they had not regretted the move to Atlanta. Both Ben and Molly liked Atlanta, and he had enjoyed the opportunity to work with new technology, even though he had been among those included in a massive reduction in force at the high tech firm. The firm had abruptly dismissed several hundred employees with less than two weeks notice and bankruptcy rumors abounded.

During the interview, Charlie confided in the applicant that he was very concerned about the I&MS group now. He also confided that he had hoped to retire in two years. After investing twenty-four years in the organization, he wanted to be sure the competitive advantage provided by information technology would be sustained and not backfire, as it seemed to have done in the last few months. He asked the applicant if Red Stout had told him about the turnover problem among the technical staff. The applicant nodded, but seemed interested in hearing the Charlie's reasons.

Charlie continued, "We made a decision that the Data Processing Director was not a good fit for the pressures accompanying a $1 billion sales volume, which is where we're heading. As you know, we've grown rapidly. This Director was a well-liked member of the Lithonia family. Of our 5,000 employees, over half have been with Lithonia for over ten years. Because we compete with our systems, the pressures on the I&MS group have been enormous. Long hours and a lot of frustration—along with great success. Anyway, we lost some of our technical people when we lost the Director."

Ben responded that Mr. Stout had given him two goals for the open position:

(1) rebuild the Technical Services staff

(2) stabilize Operations.

Charlie listened with head bowed and hands pressed together, almost in a prayerful position. He quietly added a added a third goal: provide a high level of customer service. "We're about lighting not about computers." He provided an example to illustrate his point. "If you ask a farmer what their critical task is, they don't say, 'ride a tractor.' No, they say, 'raise corn.' Our customers are our agents, distributors, and engineers who specify our product; warehouses which carry our product; and contractors who install the product (Appendix A). If you were hired, we'd make a lighting business man out of you first and a computer person second—send you to school on lighting, teach you to calculate the appropriate lighting for a room, be sure you understand our products and how our customers work on a day-to-day basis."

Ben nodded and replied: "I've been to the library to read what I could find about Lithonia Lighting. I read the article where you said that we had to know the business, not run around like three headed yo-yos serving the data processing god.'" He chuckled. "What I've read is one of the reasons I've stayed interested in the job. I know getting along with one's boss is important. I've spent enough time with Mr. Stout to feel comfortable about working for him. I've explained that I like to work within guidelines, but want the "how" left to me. I think most technical people need a certain autonomy." Charlie nodded knowingly, then changed the subject to a discussion of Lithonia's future architecture before the interview ended.

Reporting to the President

Charlie was scheduled to deliver a speech before the parent company's Board of Directors Saturday morning. Following the interviews, he met with Bill Miles to preview the speech and visual aids to accompany his Saturday speech for the President. The topic was the Management, Information, and Electronics Services (M.I.E.S.) Division. Charlie's administrative assistant also attended the meeting so that changes could be noted and brought to closure. They had worked together for twenty years. She was a master of detail and organization and would handle many of the changes herself.

The presentation emphasized a theme begun by the company founder in the 1950s. This philosophy and the division itself were symbolized by the picture of a runner wearing the number 421: four groups to one goal, "Making Lithonia Lighting easy to do business with." Bill Miles listened closely and many details were changed. He liked the presentation, but seemed concerned, even a little distracted.

After the preview, Charlie told him that he would meet with Mona Lee and Bob Johnson, Senior Vice President for Sales, this afternoon concerning their discussion yesterday. He also told him that he thought the staff meeting this morning had been productive and watched his friend's face carefully. Bill nodded and simply responded, "Good."

Working with Peers

Charlie began the meeting with Mona Lee and Bob Johnson by saying that the problems being experienced were his fault. Because of the plan to used distributed processing, upgrades to the mainframe had been delayed. An upgrade was scheduled for installation within the next thirty days. Response time would improve and less downtime would be experienced with order processing. Bob responded enthusiastically, "Boy, Charlie, that's great. Thirty days you say," and made a note in his calendar. "You know, until we talked last night, I had no idea how important these phone lines are, too. Charlie was telling me that if a bird happens to, uh, go to the john on a line somewhere, an agent could be hung up for hours, not able to connect." They all laughed. Charlie responded, "I want ya'll to understand where we're headed," and began to draw a picture of where distributed data bases and dedicated lines were planned.

As he drew, Red Stout, spoke up, "I want you guys to know that we're working on one cause of terminals hanging up." He explained the problem with locked records, when more than two agents try to check order status on one record, and he explained the work now being done to correct this network problem. Mona Lee, Bob Johnson, and Carl Randal, a Distribution Manager who accompanied Bob to the meeting, listened to these technical explanations politely.

Then, Charlie slapped the picture drawn on the board and pointed to dedicated lines between key distribution centers, warehouses, agents, and to distributed data base sites. Very little detail was given. He moved on quickly, "But during this thirty days we're not going to be sitting on our hands. The work which is improving our systems for the future—but is also using mainframe capacity-has been halted as of today. This should cause a noticeable improvement in response time." Mona Lee interrupted, "Charlie, are you sure that's been done? I was told that this had been done two weeks ago but I haven't noticed any difference. In fact, some of my sources tell me this activity is still going on." She glanced at Red and then looked back at Charlie. There was a heavy silence. Charlie did not respond.

Red Stout responded, "I've put the word out. No more changes. I'll follow up on that and make sure." Charlie nodded. Then he looked up and smiled brightly. "Now we've got to stop building Towers of Babylon with fax machines! We can't keep the mainframe from ever going down or prevent all connect problems and so on. However, we can give distributors and agents who are going down the ability to print entered but unconfirmed orders when problems occur. I understand the Los Angeles Distribution Center should be our first target." Mona Lee became very interested. Bob Johnson nodded briskly.

Charlie explained that the use of printers would be enhanced over time, allowing customers to select ranges of orders to print or just one order. The print out in a rough, usable form would be available Tuesday. The mood of the meeting shifted as the Charlie's responsiveness to the complaints received yesterday became evident. Bob said, "Charlie, this is great. Appreciate it," and stood up to leave. Mona Lee shook hands with Charlie, "We can live with this, Charlie. Thanks."

Red Stout stayed over to tell Charlie that the systems program to bypass Novell's Netware connect problems could be ready in two weeks if one systems programmer did nothing else. Charlie responded, "Can you think of a better use of this resource now? Two weeks, then." He added, "I'm for hiring Ben Miller for the Data Processing Director job." They discussed the offer to be made.

As Dr. Richardson and Charlie walked back to his office, Charlie, still full of energy, laughed, "Eileen, we need to do the 'Me and My Shadow' routine as we walk into the next meeting!" And he began to sing as he tap danced. "Seriously, is observing me helping you to create a specification for Lithonia Lighting's CIO?" Dr. Richardson laughed, "It's the next thing to walking in your shoes! Of course, the background research was helpful too, but watching you at work has been invaluable. I'll be able to provide some useful guidelines within the next couple of weeks. Hopefully, you and Bill can use these guidelines when you begin your search."

DISCUSSION QUESTIONS:

Using the case, appendices, exhibits, and references, discuss the following questions:

1. Compare the work life of a CIO doing only "bread and butter" applications (transaction processing systems such as payroll, inventory, general ledger) and that of the Lithonia Lighting CIO.
2. What do you think it would be like to work at Lithonia Lighting in the I & MS? Consider personal relationships, job security, challenges, and opportunities for advancement and development.
3. Why did Lithonia Lighting give priority to market entities when developing systems rather than first developing internal systems?
4. What are the advantages of the CIO having responsibility for product divisions? the disadvantages?
5. Support the statement, "The CIO is a skilled communicator," using specific examples from the case.
6. What is the "bottleneck" in the Lithonia's Lighting's telecommunications network, called Light*Link (Exhibit 5)?

7. How important is the CIO's familiar relationship with other senior executives? What factors contribute to this familiarity?
8. Do you agree with the CIO's recommendation on the Director applicant? Why? Cite specific reasons from the case.
9. List reasons for the current crisis. What situations or events have led to the current crisis? Remember that positive situations and events can precipitate a crisis.

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APPENDIX A

Industry Background

The commercial and industrial lighting market is dominated by nine companies who together control 50% of the over four billion dollar market (Exhibit 1). LL is the number one company in the market, having one close competitor in the over $500 million in sales category. In the 1980s, a series of acquisitions and mergers reduced the number of lighting companies, leaving only one-third the number existing in the 1960's. The giants remaining offered a wider variety of lighting products, striving to gain contracts for the entire package of lighting used in a construction project.

The CIO, speaking to a local meeting of the Society for Information Management (SIM), identified four critical success factors for the lighting industry:

> One is product; that is what kinds of products—a broad or narrow product line—do we have. Two is price as it relates to the competition. Three is availability; that is, do we make an inventory of standard items available to the local distributors and contractor and how fast can we get our customers non-standard fixtures from one of our factories as compared to our competitors availability. Four is service; how do we stack up one competitor to the other in the service we give to our customers.

Market entities to be serviced are agents, distributors, specifiers, warehouses, and contractors (Exhibit 4). Independent agents who employ marketing representatives earn commissions on products sold. They usually have exclusive rights to a company's products within a given territory, and can not carry competing products. Agents act as the primary interface between the lighting company and the market. In fact, they are the center of the lighting company's universe. Agents have gradually assumed many of the roles, particularly that of providing technical expertise, played by the distributors in the 1960's and 1970's.

In the commercial lighting industry, specifiers or specifying engineers influence the product purchased by specifying a brand name rather than a generic product. They use the architect's plans to develop building specifications, including a bill of materials for lighting products. Specifications are issued to all contractors bidding on a job. Contractors, in turn, deal with an agent or distributor to price the lighting products specified. These quotes form part of the total bid. The contractor awarded the job will then order from an agent or distributor. Stock items are inventoried at independent warehouses, but customized products must be ordered from the company's product divisions.

As lighting companies grew larger and offered a wide range of lighting products, the agent became capable of providing the entire job package. Agents now define what specific products are needed for a job by reading specifications or blueprints supplied to them by contractors or architects. They then price the products, including their own commissions. Agents know the local markets and cultivate relationships with local contractors and specifiers. The distributor, who had previously assembled a package for a contractor by contacting many agents, now primarily provides readily available inventory and financing to contractors.

Once a quote is converted to an order, communication regarding order status and shipping dates is required so that the contractor can effectively schedule labor at the job site. The high degree of coordination required in the construction industry makes information and timely communication of that information a very valuable service. Thus, access to that information gives an agent a competitive advantage and increases the sales revenue of the company the agent represents.

APPENDIX B

Company Background

Lithonia Lighting is organized by product group divisions (Exhibit 3). Three of the six Senior Vice Presidents head product group divisions. The President and the Senior Vice President are known as the "Seniors" or the "Senior Seven." The Chief Information Officer (CIO) role is assigned to a Senior Vice President of one of these product group divisions, Management, Information, and Electronic Systems (M.I.E.S.). In addition to his responsibility for Information and Management Services (I & MS), he is responsible for the Controls, Emergency Systems, and Reloc (relocatable lighting) product divisions (Exhibit 1).

The Fluorescent division is the oldest division and is the world's largest manufacturer of fluorescent lighting fixtures. The company was founded as a manufacturer of fluorescent fixtures in 1946, with the first location being in Lithonia, Georgia. When growth continued to call for increased capacity, the company was moved to nearby Conyers, Georgia, its present corporate headquarters.

The Hi-Tek division was established in 1971 to capture a new and growing market: high intensity discharge lighting. Begun as a result of a lighting market analysis, the group was led by a manager who had been responsible for Materials Management and Information Systems in Conyers. The present CIO had reported to this manager at that time.

Through new product development and acquisitions, LL came to offer products for most segments of the commercial lighting market. In 1989, LL had 3.3 million square feet of facility space and 13 manufacturing sites in six states and in Canada. Total employment exceeded 5,000.

Lithonia's Lighting's telecommunications network, called Light*Link, links agents with the Lithonia manufacturing divisions, sales team, field warehouses, distributors, and building specifiers. Field systems and a telecommunications link was being provided to contractors at the time the case was written (Exhibit 5). Systems supporting each of these entities were integrated, allowing Lithonia Lighting and its stakeholders to act as a virtual organization.

APPENDIX C

Information and Management Services (I&MS Background

The Vice President of I&MS was one of four Vice Presidents or Division Managers reporting to the Chief Information Officer whose official title was Senior Vice President and General Manager of Management Information and Electronic Systems. In addition to Information and Management Services, the CIO has responsibility for three manufacturing divisions whose products are based on electronic systems (Exhibit 1).

The Vice President of I&MS has four direct reports (Exhibit 2):

1. Director of Data Processing—responsible for operations, hardware services, and data communications
2. Director of Information Systems—responsible for developing and maintaining application systems, and for customer support
3. Manager of Systems Engineering—responsible for network management, technical services
4. Manager of Systems Training—responsible for field training for market entities, internal systems training, and a support line for the field and within the company.

Of these four direct reports, two positions were open due to a separation and a resignation: Director of Data Processing and Manager of Systems Engineering.

APPENDIX D

Lithonia Lighting's Systems' Success

In 1988, the Society for Information Management (SIM) commended LL for Light*Link (Exhibit 5). Light*Link is a network of personal computers located in 35 warehouses, 84 agent's offices, and many distributor and specifier offices as well as in manufacturing locations and sales offices. The CIO and President of LL were honored with the 1988 SIM Partners in Leadership award during the 1988 SIM Annual conference in Minneapolis, Minnesota. Excerpts from the nomination speech follow:

> In 1976, Lithonia Lighting embarked on an explicit strategy of improving its competitive posture—long before it was popular to talk of using information technology to gain competitive advantage. The central feature of the strategy...was to increase sales and profit level by posturing Lithonia in a manner that enabled it to be a company that was "easy to do

business with" and to deliver the "best value in lighting".... During the following seven year period (1981-1988) over which Light*Link evolved, Lithonia invested $5 million and added to its staff individuals with unique expertise in underlying technology critical to the system plan.

Light*Link could not have emerged as an information systems project without the partnership between [the CEO] and [the CIO]. It was not an information systems project, it was a top level, yet fundamental, business strategy. It was a corporate commitment. [The CIO] became the catalyst that forged information technology enabling the firm to pursue its strategy.... When the Light*Link vision was being created, the quality of data communication services had not yet advanced to current levels. Vendors were not able to offer adequate business solutions....

[The CIO] recognized early on that personal computers could become an awesome competitive weapon for Lithonia and its agents if the appropriate network of support systems was established. The decision and the commitment to proceed occurred before the IBM PC had become the industry standard (and while many corporate staff members considered PC's to be nothing more than toys). Personal computers, along with computer networking became the means of linking agents, specifiers, etc. into the Light*Link system.

Instead of using jargon, Light*Link systems were named with acronyms which made sense. Agents were provided with an ACE in the marketplace. That is an Agency Communications Environment for processing orders, determining order status, and generating engineering layouts and calculations. They were also provided agency management systems, including training for using widely available microcomputer software such as spreadsheets and word processing. Light*Link bonded the agent to LL and raised switching costs (the cost to change to another lighting supplier). Likewise, field warehouses were given help by SOS, a Stock Order System.

While these field systems were being developed and enhanced (ACE+, SOS+), two programs for internal systems were begun in the mid '80s. The CIO called these programs EXCEL(EXcellence through Customer service Emphasis at Lithonia) and OLA (One Lithonia Architecture). The EXCEL and OLA programs followed Lithonia's philosophy of continuous improvement at each process in order to stay ahead of the competition.

The EXCEL program involved the following subsets:

SELL (Sales Environment at Lithonia Lighting)
A2P (Available to Promise)
MILL (Manufacturing Information at Lithonia Lighting)
ESS (Effective Scheduling System)
ROLL (Routing Orders at Lithonia Lighting)
Credit system
BILL (Billing Information at Lithonia Lighting)

OLA's goal was to provide one face to the market for LL, integrating product lines from different divisions and restructuring existing systems to provide the foundation needed for a $1 billion sales volume. As volume, products, and product customization increased, the present hardware and software foundations became increasingly susceptible to unanticipated problems. A priority was to upgrade the present software and hardware foundations while continuing to support business functions.

LL has worked toward the client server model with the mainframe acting as a central repository and database server while most of the processing is distributed throughout the organization and among market entities. Portions of selected databases would be distributed as well. Extract databases would continue to be used.

The CIO and President of LL are committed to using information technology to change how companies compete in their market. Speaking before a group of CIO's at a local SIM meeting, he challenged these CIO's to do likewise:

> Many of you CIO's would like to change the way your company competes with information systems. But there you stand doing what I call "bread and butter" noncompetitive applications such as payroll, budgets, general ledgers, accounts payable, some manufacturing systems, and maybe a little order entry. But you aren't identifying, getting approved, and doing those things which can greatly affect the way you compete . You and the CEO must examine every project, every expenditure, every person you hire, and every move you make on the information technology side of your business to make sure they address the question, "Does this address those areas that we have found where information systems technology can change the way we compete?" And this process should be an ongoing and forever thing.

Planters and Merchants Bank

Raymond M. Johnson, Auburn University at Montgomery

Amy Walker was thinking about the circumstances that led to her appointment as the portfolio manager and investments officer of Planters and Merchants Bank located in the farming community of Tilton, Georgia. Tilton, located in the heart of Georgia's peanut growing area, is a prosperous farming community with a population of a little less than 20,000. The town is served by three banks, two of which are owned by Atlanta holding companies.

Planters and Merchants Bank is an independent unit bank owned by the A.J. Pearce family since it was started in 1894. Planters and Merchants serves only the city of Tilton and the surrounding area. Although it has five branches in communities within a fifty mile radius of Tilton, Planters and Merchants, under the direction of the Pearce family, has no plans to expand beyond the immediate market area.

Peanut farming is the economic base of the area. Planters and Merchants' loans and deposits are distributed between agricultural, commercial, and consumer sources, but the economy of the area is dependent on the cash crop, peanuts. Although soybeans and livestock are also grown in the area, over 90 percent of the market value of agricultural products from this part of Georgia is derived from peanuts.

Planters and Merchants' market share is approximately 40 percent of the banking business in its market area. Despite increased marketing efforts, the other two banks have not been able to expand their share of the Tilton market. Each of these two holding company banks has about 30 percent of the market. The local community has a very favorable impression of Planters and Merchants Bank. The bank's facilities are modern, attractive and conveniently located. Bank personnel are friendly, experienced, and well known and liked in the community. The Pearce family and the bank officers are very active in local civic and community activities.

Ms. Walker is a newly appointed officer in the Investment Department at First Atlanta Bank. First Atlanta, a large regional holding company with member banks in four states, maintains active correspondent relationships with numerous banks throughout the United States. Correspondent deposits with First Atlanta account for about 12 percent of total deposits, ranging from $700 to $900 million. In exchange for the deposits, First Atlanta performs a number of services for its correspondents. First Atlanta participates with its correspondents if the correspondents wish to make loans that are larger than the correspondent bank's legal lending limit of 10 percent of capital. Also, First Atlanta provides its smaller correspondents, such as Planters and Merchants, access to the Federal funds markets. Often these institutions desire to buy or sell Federal funds but the amounts involved are less than the $1 million minimum established in the Federal funds market. First Atlanta determines the needs of it correspondents and purchases or sells funds in multiples of a million dollars, enabling the correspondents to balance their reserve accounts through the Federal funds market. When First Atlanta purchases Federal funds for one of its correspondents, it is making a large, unsecured, short-term loan to the correspondent. If the bank were to fail, First Atlanta would have to absorb the loss.

First Atlanta also provides investment services for those correspondent banks that lack the time, expertise, or market access to effectively manage their portfolios. Members of the investment department work on a day-to-day basis with the officers of the correspondent banks by executing the correspondent's investment decisions and carrying out the correspondent's investment strategy. First Atlanta maintains physical custody of the correspondent's investment portfolio, enabling First Atlanta to facilitate the necessary transactions and provide associated clerical work such as collecting and crediting interest earned, reinvesting funds from maturing securities, and handling necessary correspondence concerning the investments.

Planters and Merchants has maintained its investment portfolio at First Atlanta for a number of years. The previous bank officer assigned to the Planters and Merchants account had simply managed the account according to the directions of A.J. Pearce. Mr. Pearce's investment strategy had been to invest available funds in securities that would mature in the spring when Tilton farmers and merchants would be in greatest need for loans and the bank would face its largest liquidity needs of the season.

When Amy Walker, a native of Tilton and long-time acquaintance of Mr. Pearce, was assigned the Planters and Merchants account by Mr. Bradford Maynes, Vice President and Chief Investment Officer, Mr. Pearce was very pleased. After several discussions, both Mr. Pearce and Ms. Walker decided that a complete review of Planters and Merchants asset/liability management performance would be appropriate. And based on this evaluation, a course of action would be recommended.

As Ms. Walker began to collect and analyze the Planters and Merchants' data, she formulated a number of questions that she felt were relevant:

1. What is the past and expected profitability of the bank?
2. What is the risk exposure of the bank?
3. What has been the asset/liability performance of the bank?
4. What asset/liability changes should she recommend for Planters and Merchants?
5. Should First Atlanta continue the present correspondent relationship with Planters and Merchants?

Ms. Walker believed she should address these questions in light of what she thought the banking climate and economy would be like during the decade of the 1990s. She agreed with the opinion of First Atlanta's economists that the Federal Reserve Board would continue to allow interest rates to fluctuate according to the dictates of the free market forces, intervening only to prevent the most drastic swings in rates. The likely result will be a continuing high volatility of interest rates and a high level of uncertainty in the capital and money markets.

The 1990s, in Ms. Walker's opinion, will continue to experience mild inflation, averaging less than two percent per annum. Interest rate risk then will most likely be associated with market uncertainty plus credit risk.

Weak or marginal financial institutions will continue to find it difficult to survive in the 1990s, the weeding out process will likely continue. Ms. Walker and First Atlanta's top management agree with those who think that the Federal Deposit Insurance Corporation Insurance Fund will be insolvent by 1992 unless it is increased by some congressional authority. Likewise the Resolution Trust Corporation, which is handling the liabilities of failed institutions, could exhaust most, if not all, of its $80 billion allocation by the end of 1991. It is also widely speculated that 60-70 fairly large banking institutions could fail over the next two to three years.

Congressional response to these conditions will likely take the form of omnibus legislation that will impose many reforms on the banking system. The exact nature of the reforms is speculative at the moment. But, along with other reformation measures, many believe that financial institutions may be required to increase their capitalization resulting in much less leverage for the institutions. These moves, although designed to impose a more conservative banking climate, will put some institutions in a more difficult position by reducing their profitability. Caution and concern, then are likely to be the prevailing attitudes of bankers and bank customers during the 1990s.

Exhibit 1

Planters and Merchants Bank and Peer Group
Average Balance Sheet Expressed in Percentages

	Year 1		Year 2	
	P & M	Peer	P & M	Peer
ASSETS				
Cash and due from banks	11.00	12.53	10.75	12.22
Investment securities				
U.S. treasuries	17.30	9.45	17.72	8.90
Federal agencies	1.50	1.22	1.40	1.18
State and local government	3.25	9.30	3.32	9.47
Other	1.15	0.68	0.45	0.59
Total Investments	23.20	20.65	22.89	20.14
Federal funds sold	3.20	4.49	3.33	4.21
Interest-bearing bank balances	0.20	3.77	0.19	3.52
Loans				
Real estate	0.53	14.49	0.49	15.21
To financial institutions	0.15	3.32	0.19	3.10
Farm	20.00	0.77	20.45	0.71
Commercial	18.00	18.10	19.10	18.31
Consumer	15.00	12.68	16.42	13.32
Other Loans	4.50	4.13	2.15	3.91
Total gross loans	58.18	53.49	58.80	54.56
Less				
Reserve for loan losses	0.56	0.47	0.62	0.58
Total net loans	57.62	53.02	58.18	53.97
Direct-lease financing	0,62	0.65	0.73	0.79
Acceptances	0.10	0.79	0.93	0.76
Bank premises	2.86	1.62	1.27	1.60
Other Assets	1.20	2.48	1.73	2.79
Total Assets	100.00	100.00	100.00	100.00
LIABILITIES & EQUITY				
Deposits				
Demand deposits	47.44	30.59	47.22	27.98
Savings deposits	20.52	17.38	22.11	14.89
Time deposits, (over $100,000)	6.86	16.34	5.91	16.68
Other time deposits	8.81	15.09	8.97	17.24
Total deposits	86.63	79.40	84.21	76.79
Federal funds purchased	5.20	10.10	6.10	10.77
Other borrowings	2.13	1.00	0.33	2.19
Other liabilities	1.12	2.71	1.38	2.48
Subordinated debt	0.00	0.74	0.00	0.70
Total liabilities	92.08	93.95	92.02	92.93
Equity capital	7.92	6.05	7.98	7.07
Total liabilities and equity	100.00	100.00	100.00	100.00

Exhibit 2

Planters and Merchants Bank and Peer Group
Percentage of Average Total Assets

	Year 1		Year 2	
	P & M	Peer	P & M	Peer
INCOME				
Interest income				
Loans				
Agricultural	1.43		1.41	
Commercial	1.39		2.28	
Consumer	1.34		1.38	
Real Estate	.89		.83	
Other loans	.73		.62	
Total loan interest income	5.78	9.01	6.52	10.43
Investment securities				
Treasury	.63		.78	
Federal agencies	.27		.25	
State and local government	.36		.35	
Federal funds sold	.13	.35	.10	.49
Other	.03	—	.02	—
Total investment securities income	1.42	.35	1.50	.49
Total interest income	7.20	9.36	8.02	10.92
Other Income				
Lease financing income	.07		.09	
Fiduciary activities income	.07		.09	
Fiduciary activities income	.10		.10	
Service charges	.36		.36	
Miscellaneous income	.33		.35	
Total other income	.93	.89	.99	.91
Total Gross Income	8.13	10.25	9.19	11.83
EXPENSES				
Operating Expenses				
Salaries and related costs	1.52	1.56	1.57	1.60
Net occupancy expense	.10	.43	.10	.46
Depreciation	.18		.19	
Taxes other than income taxes	.23		.20	
Other operating expenses	1.16	—	1.23	—
TOTAL OPERATING EXPENSES	3.19	3.02	3.29	3.13
Interest expenses				
Deposits expense				
Savings deposits	1.05		1.00	
Time deposits	2.30	—	3.32	—
Total deposits expense	3.35		4.32	
Federal funds purchased	.31		.59	
Other borrowings	.23		.19	
Total interest expense	3.89	4.13	5.10	5.43
Provision for loan losses	.35	.30	.34	.30
Net Interest expense	3.54	.383	4.76	5.13
Total Expenses	6.73	6.85	8.05	8.26
Income before taxes	1.40	8.40	1.14	3.57
Income taxes	.54	1.43	.09	1.36
Net income	.86	1.97	1.05	2.21

Exhibit 3

Additional Consideration for Planters and Merchants Bank and Peer Banks
(Various Balance Sheet and Income Statement Rating)

	Year 1 P & M	Year 1 Peers	Year 2 P & M	Year 2 Peers
1. Investment Securities				
Maturities				
One Year or Less	66.38	21.05	67.42	20.43
One to five years	32.62	37.20	31.58	36.92
Five to ten years	01.00	19.91	01.00	21.00
Over 10 years	00.00	21.84	00.00	21.65
Total	100.00	100.00	100.00	100.00
Market value/book value				
Taxable securities	97.25	95.14	96.41	94.11
Tax-exempt securities	98.40	93.72	97.19	91.49
2. Loan Losses and Loan Reserves				
Past-due loans as a percentage of category total				
Farm	5.23	5.10	5.93	5.01
Commercial	4.84	3.24	5.01	3.97
Consumer	3.91	3.02	4.25	3.47
Real estate	5.42	5.04	5.92	4.61
Other	4.72	4.63	4.98	4.91
Earnings Coverage of net loan losses	16.20	14.15	15.87	13.95
3. Profitability Ratios				
Asset utilization	11.92	9.10	11.69	10.51
Return on average assets	0.79	0.82	0.67	0.89
Equity multiplier	12.63	16.53	12.53	14.14
Return on average equity	9.98	13.55	8.40	12.58
Cash dividend payout ratio	35.62	40.00	34.29	42.71
4. Leverage analysis				
Equity capital/assets	7.92	6.05	7.98	7.07
Total capital/assets	7.92	6.79	7.98	8.18
Net loans/equity capital	7.71	8.76	7.73	6.79

5. Annual growth rates as a percentage of total assets	P & M	Peer
Equity capital	0.0076	0.1690
Gross loans	0.012	0.020
Total deposits	0.007	-0.033

	Year 1 P & M	Year 1 Peers	Year 2 P & M	Year 2 Peers
6. Miscellaneous Information				
Deposit service charges/average demand deposits	0.61	0.67	0.72	0.76
Personnel expense per FTE employee	$16,510	$18,410	$16,890	$18,990
Full-time-equivalent employee per $1,000,000 in assets	1.31	1.10	1.24	1.03
Gap/total assets	4.63%	5.30%	0.78%	(0.56)%

C-Tech, Inc.: The Development of a Management Information System

Melissa R. Bowers, University of Tennessee
Robert Cathey, University of Tennessee

"Phenomenal" was the only word Michael could find to describe it.

The success of C-Tech's new innovative product line surpassed everyone's expectations. C-Tech's primary product, *PhotoMaster*, offers a quick, simple, inexpensive method for making high quality photographic enlargements and color overhead transparencies without the need for a negative.

Only two years ago Michael Palmer, C-Tech's Vice President of Sales and Marketing, established the marketing directives leading to C-Tech's wild sales success. In view of C-Tech's rapidly changing sales and marketing information needs, Michael scheduled a meeting with Elizabeth Reynolds, C-Tech's Director of Management Information Systems and Phillip Andrews, Director of Sales.

"Now that our sales history is established and sales growth is a bit more predictable, I think it's time we put in place a formal system to help us assess our sales and marketing effectiveness," suggested Michael.

"I couldn't agree more. Our clerical staff is overburdened with the task of manually tracking prospect reports sent by the sales force. With so many new leads popping up every day, the workload is becoming prohibitively large for a paper-based system," Elizabeth responded.

Several problems plague the current prospect reports (see Exhibit 1 in the Appendix for sample forms). C-Tech's sales force generates a prospect report on each sales call. Every two weeks, each salesperson submits reports collected during the last period. Often, the reps wait until the last minute to fill out the reports, forgetting key information. At the home office, the information from the reports is entered into a simple database and used on a regular basis for storing and retrieving information on prospects. Unfortunately, the format of the printed forms does not exactly match that of the computer entry screen, slowing the entry process. Until growth took off, these problems were merely inconveniences. Now, they promise to be major headaches. A new system must be implemented which is fast, easy to learn and use, and flexible enough to grow in size and function in the future.

"I expect the system we install will probably be with us for several years. As you know Elizabeth, the current system is hardly a system at all. Our prospect report doesn't match the format of the template in our existing computer database. Also, we need information that is not being gathered, either because the questions aren't being asked on the report sheet or the sales force is simply turning in incomplete reports."

"You're exactly right, Michael. Necessary information is not being collected, but I don't think we can blame it all on incomplete reports from the salesforce. Could you comment on that Phillip?"

"I'm glad you realize that the salesforce is not solely responsible for the absence of necessary information. First, as Elizabeth stated, the prospect report form does not match the format of the template for the existing contact database. So, often times information actually recorded by the salesforce is overlooked when the data is keyed into the computer-based system. Also, vital information is just simply not being collected. From a management perspective, I need information on the progression of sales, the performance of the salesforce, the effectiveness of marketing strategies, and prospect demographics. Some of the information is being captured but the rest is not. I need the information to make good decisions for C-Tech. For example, I need some summary stats and reports.

1) I could really use a selling cycle module which generates weekly reports to reflect the average number of days between sequential stages of the selling cycle for all prospects currently in the contacts database - such as the average number of days from the date of demonstration to date of closing a sale. Also, the current prospect report form tries to combine post-contact sales cycle class (e.g. First Call, Follow-up Call, Demo, etc.) and the means of the initial contact (e.g. direct mailing, telemarketing, etc.) into one field. It's very confusing. These are clearly two different issues and two different kinds of information. In addition, we don't even record the date on which a prospect moves into a particular post-contact sales cycle class. These are serious problems for the salesforce and marketing in general.
2) I'd like to see a call module which generates weekly reports displaying an alphabetical listing by salesperson reflecting the average number of prospects called on/contacted per representative per day based on prospects currently in the contacts database.
3) I could use a lead module which generates for each stage in the sales cycle(e.g. Follow-up Call, Demo, etc.) an alphabetical listing of all prospects currently in that stage based on prospects currently in the contacts database. The report should be generated weekly and also display the total number of prospects in each category.
4) A promotions module is a must for use in evaluating the effectiveness of promotional efforts. Again, we MUST collect the necessary information. I need to know if the first initial contact is by either word of mouth, direct mailing, advertisement, PR, or telemarketing. Right now, the contact report form does not permit us to collect this information. It has only two choices: (0) direct mail or unsolicited inquiry; or (1) telemarketing. So all I really get data on is telemarketing. Direct mail and something called ***unsolicited inquiry*** are lumped together. I don't know what unsolicited inquiry means except possibly ***everything else under the sun***! So, as stated I would like initial contact to be categorized in one and only one of 5 possibilities: (1) Word of Mouth, (2) Direct Mailing, (3) Advertisement, (4) PR - other, (5) Telemarketing. The promotions module should generate a performance evaluation report of promotional efforts and report the current number of leads generated from each of the five categories listed up through a specified week ending date.
5) I would also like some demographic information on prospects. A prospect demo module which generates a report on request listing all contacts located in a specified city or of a particular age would be nice."

"Now, that's what I'd like. However, I think my salesforce has more important and immediate needs. Without those guys we'd be out of business, right? First and foremost, the salesforce needs to be able to communicate directly with the home office. Every day some salesman is disturbed because he has been out of town for two weeks and made two or three quotes using an old price list. Of course he's mad because his commission decreases, but more importantly, so does our profit margin. We've got to get some sort of remote access to make daily updates to product and supply files. I also think that if the salesforce could enter prospect, order, quote, and customer information directly only one time, we'd see a drastic improvement in the quality of information and observe a decrease in the salesforce's overall level of frustration. They could use several online modules.

1) They would love an automated quote/order entry system so they could simply enter customer specific information and requested products/supplies and the system would automatically perform all the calculations for them. On occasion, a salesman will make a computational error in a quote or order. These kinds of errors should disappear. I think that you should use the same format for a quote or an order to keep things simple. To keep things more manageable, the size of any order or quote should never exceed 10 items. It is not unusual for a salesman to go back and view an old order. So, orders should be kept for one year. When a contact becomes a customer, I think the system should move the record to the customer database automatically. It also seems to me that orders should be dumped to some sort of order file for use by the production planning and scheduling guys. I spend a lot of wasted time on the phone with production. They're always after the sales department for any order information they can get their hands on. If we could automate this, everyone would be happier.
2) The salesforce could really use a separate new-prospect module to append information on a new prospect to the contacts database on request.
3) Once a prospect is added, they should be able to update, edit, view, browse, or delete records in the contacts database as needed with a separate sales call module. They should be allowed to search based on either the contact telephone number or company name.
4) As our prospect list grows, it's easier for a salesman to overlook a follow-up call. A follow-up omission may mean a lost sale. The salesforce would benefit greatly from what I would call a "To Do" module which will generate a new list each day of things "to do" over the next five working days for each salesman. In my mind, the list should appear in three different ways: (1) in order of post-contact prospect class, (2) in order of post-contact sales cycle class, and (3) in order of location of prospect.

That summarizes our needs. Can we do it, Elizabeth? It seems as though everyone would be better served if we could design and implement a new information system."

"I couldn't agree more. We have been in need of a new information system for a while now. With a lot of work and top management support I believe we can make things happen rather quickly. I wouldn't want to speak prematurely, but we should have all the software and hardware necessary to allow the salesmen to link directly with the main office and databases. They should be able to transmit sales orders electronically as well. The direct data link should not only reduce data processing efforts but also decrease the error rate. With a little patience, I think we can build the system we want, gentlemen. We have several things going for us. First, over 90% of all CTI employees are computer literate. Also, we can juggle our schedule so that the MIS staff can devote 50% of its time to the development of this new system if we so choose. Let me suggest that we each list the requirements we have for the new system."

Product and Company Background

PhotoMaster represents a truly innovative way to make photographic enlargements and color overhead transparencies quickly and conveniently with a level of quality and cost-effectiveness previously unattainable. The main benefit of *PhotoMaster* is the ability to create enlargements without the need for a negative. Non-technical people can produce high-quality photographic enlargements simply by inserting the original photograph or slide. The color, brightness, or cropping of the original photograph or slide is adjusted simply by pressing a button. *PhotoMaster* requires no special plumbing. Enlargements or transparencies are ready in four to twelve minutes, depending on the model.

PhotoMaster is also very cost effective. The average *PhotoMaster* unit pays for itself in about 24 months, with some paying for themselves in as little as eight months. Service and training are included in the purchase price. C-Tech provides customer support around the clock with a toll-free 800 number hotline and customers are generally very pleased with service.

C-Tech was formed in June of 1989 by three photo-processing engineers. It was built around a revolutionary method of developing photographic films and papers. After securing startup funds from several venture capital firms, C-Tech developed prototypes, refined them and built several beta-test machines. C-Tech started full production in January of 1991. By May of 1991, C-Tech's initial product, *PhotoMaster* 501 (targeted at commercial photo labs servicing a very demanding, quality conscious clientele) was so successful that management decided to go ahead with production of three new models. *PhotoMaster* 511 is targeted at the office machines market; *PhotoMaster* 515D at the military and defense / surveillance markets; and *PhotoMaster* 515M at hospitals and medical education markets. Each new product has special appeal to its target market.

Sales of all *PhotoMaster* units were exceeding forecasts. Michael and his sales and marketing managers (see Exhibit 2 in the Appendix for organization chart) recently analyzed historical sales/demand data for the four products. Revised market forecasts are both exciting and alarming (see Exhibit 3 in the Appendix for historical performance of *PhotoMaster* units and revised growth trends). With current plant capacity, sales growth is expected to exceed production capacity in approximately one year. Richard Head, C-Tech's VP Manufacturing is heading an expansion effort which shall deliver the needed manufacturing capacity and thus avoid a production backlog. In an effort to maintain their established marketshare, Richard, Michael, and Steve Warren agreed upon a new product release strategy. To avoid "diluting" an exceptional product line, C-Tech's research and development efforts will focus on improving its current product line. Thus, over the next 5 to 6 years, any new products will gain market share at the expense of a current offering as C-Tech either replaces or improves existing products. C-Tech's supplies product line will also grow as a result of any new additions to the major product line. C-Tech will of course maintain a supply base for the older products still in use. Thus, they estimate C-Tech's supplies product line will grow at a rate of no more than 5% per year.

C-Tech's current system is both cumbersome and inefficient. This system worked well until sales began to explode. A new system must be developed quickly. C-Tech currently has 575 regular customers. The number of leads or contacts in the system is over 12,000 and the contacts database is so large that no one can effectively use or manage it.

C-Tech's People

C-Tech has about 1,500 employees distributed nationally. *PhotoMaster* is assembled at the corporate headquarters in Independence, Florida.

G. Fredrich Van der Haar is C-Tech's President and CEO. Fredrich had twenty years of experience in the photographic industry working for Agfa, AG of Germany. With his former employer, he was Vice-President of International Operations with 20,000 people reporting to him. At age 45, Fredrich took early retirement to run C-Tech, and investors regard his contribution to the firm as vital.

Terri Giovani is C-Tech's Vice President of Internal Management and is responsible for accounting, controllership, information systems, legal affairs and customer leasing. She has a law degree from Georgetown and uses it to structure special deals with customers and write warranty and service contracts for *PhotoMaster* sales.

Elizabeth Reynolds is Director of Management Information Systems. She has a master's degree in business administration with a concentration in information systems from the Ohio State University and is responsible for developing a sales and marketing management system that will meet everyone's needs.

Richard Head is C-Tech's Vice President of Manufacturing Operations and is responsible for all inventory, shipping, receiving and product assembly, as well as engineering and customer support. Richard has extensive experience in engineering management in the photographic industry. The close-knit manufacturing team works hard to keep up with whatever the marketing wing throws at it in the way of increased sales.

Michael Palmer is C-Tech's Vice President of Sales and Marketing and is responsible for developing and implementing plans to bring in collected orders. He has two assistants: Robert Winchester, Director of Marketing; and Phillip Andrews, Director of Sales. Phillip has four territorial managers in different geographic regions of the United States. Each territory manager is responsible for managing the selling efforts of several salespeople. See Exhibit 4 in the Appendix for a description of the sales territories.

Steve Warren is an original founder and C-Tech's Vice President of Research and Development. He is instrumental in turning the abstract formulas and theories of C-Tech's processing technology into a useful product. Before coming to C-Tech, Steve worked for ten years as Director of Processing Research at IMAGen, an international manufacturer of processing equipment. Steve has a doctorate in applied processing theory from the Rochester Institute of Technology.

System Requirements

At Elizabeth's request, Michael compiled a list of system requirements (see Exhibit 5 in the Appendix). Elizabeth also constructed a list of system requirements (see Exhibit 6 in the Appendix).

Michael: Here's that list you wanted. I hope this articulates our needs as Phillip and I see them. Please keep in mind that we need to make sure our new system gathers all of the information we need in order to calculate some of the things Phillip and I want. I know that our current Prospect Report does a poor job gathering the information we need. Somehow we must collect the required data.

Elizabeth: Your list of requirements looks just fine. On the subject of collecting the right information, I also think we can do a much better job outlining the information we need to collect. Honestly, I think we'll have to redesign the contact database. Direct data entry should easily take care of any inconsistencies between manual report forms and screen templates.

I have also prepared a list of requirements based on our current system configuration. I do have some good news. Just as I thought - we shouldn't have to make any major software/hardware purchases at this time. We already have multiuser software on our local area network and all the software and hardware necessary to allow the salespeople remote system access. I made some rough preliminary estimates and we're in good shape with respect to required data capacities as well. We'll know for sure when we do a more detailed analysis of system requirements.

Michael: It sounds as though all systems are go. When can I expect to see a rough draft?

Elizabeth: Give me a week to write the outline, then you can look it over to make sure we're communicating about what kind of system we need. Then I'll develop the outline into some specifics and we'll talk them over. After that we can start making some decisions and get the system development underway. This is my top priority, Michael, and I'll be devoting almost all of my time to it.

Michael: Great! Let's get started today!

APPENDIX

Exhibit 1A

C-Tech Sample Forms

C-Tech Contract Report

Name: ______ Address: ______
Contact: ______ City: ______
Title: ______ State: ______ Zip: ______
Phone: ______ Fax: ______

Prospect found out about C-Tech from: ______
Date business started: ______ Model of *PhotoMaster* considering: ______
# of branches or outlets: ___ Business structure: ____ (Partnership, Proprietorship, Corporation)
If corporation, is this headquarters: ______ (Y/N) If no, where is HQ: ______

Maintenance facilities in house, capable of handling *PhotoMaster*: ______ (Y/N)
Services offered: D&P[1]: ______ (Y/N) Rolls per week: ______
Copy work[2]: ______ (Y/N) Orders per week: ______
Black and White work[3]: ______ (Y/N) Orders per week: ______
E-6[4]: ______ (Y/N) Rolls per week: ______
Video transfer[5]: ______ (Y/N) Orders per week: ______
Hard goods[6]: ______ (Y/N) $ Volume per year: ______
Enlargements: ______ (Y/N) Units per week: ______
Sales Rep: ______ Report date: ______
Last contact results: ______

Recommended action: ______
Due date for completion of recommended action: ______

Post contact sales cycle class: ______
(5) signed order; (4) demonstration; (3) follow-up call; (2) first call;
(1) telemarketing primary contact by telephone;
(0) direct mail reply or unsolicited inquiry

Post contact prospect class: ______
(5) extremely interested; (4) interested; normal prospect; (3) somewhat interested; needs attention;
(2) minimal interest; some chance of a sale; (1) no hope; minimal interest

Exhibit 1B

Home Office Screen Template

(Sample screen from Sales Prospect database)

Name: ______
Owner: ______
Address: ______
______
City: ______ County: ______
State: ______ Zip: ______ Country: ______
Fax: ______

Customer Referred by: ______
Lead source: ______
Needs or wants *PhotoMaster*: ______ (Y/N) Date business started: ______
Business structure: ______ (Ptnshp, Prop, Corp) # of branches or outlets: ______
If corporation, is this headquarters: ______ (Y/N) If no, where is HQ: ______

General business experience: ______ (0 - 5; 0 is highest)
Technical experience in house: ______ (Y/N) D&P: ______ (rolls per day)
Copy negs: ______ (negs per day) Enlargements: ______ (per day) E-6: ______
Black and White: ______ Location: ______
Other ancillary services: ______

Sales Rep: ______ Report date: ______
Last contact results: ______

Recommended action: ______

Due date for completion of recommended action: ______

Post contact sales cycle class: ______
(5) signed order; (4) demonstration; (3) follow-up call; (2) first call; (1) telemarketing primary contact by telephone; (0) direct mail reply or unsolicited inquiry

Exhibit 2

C-Tech Organization Chart

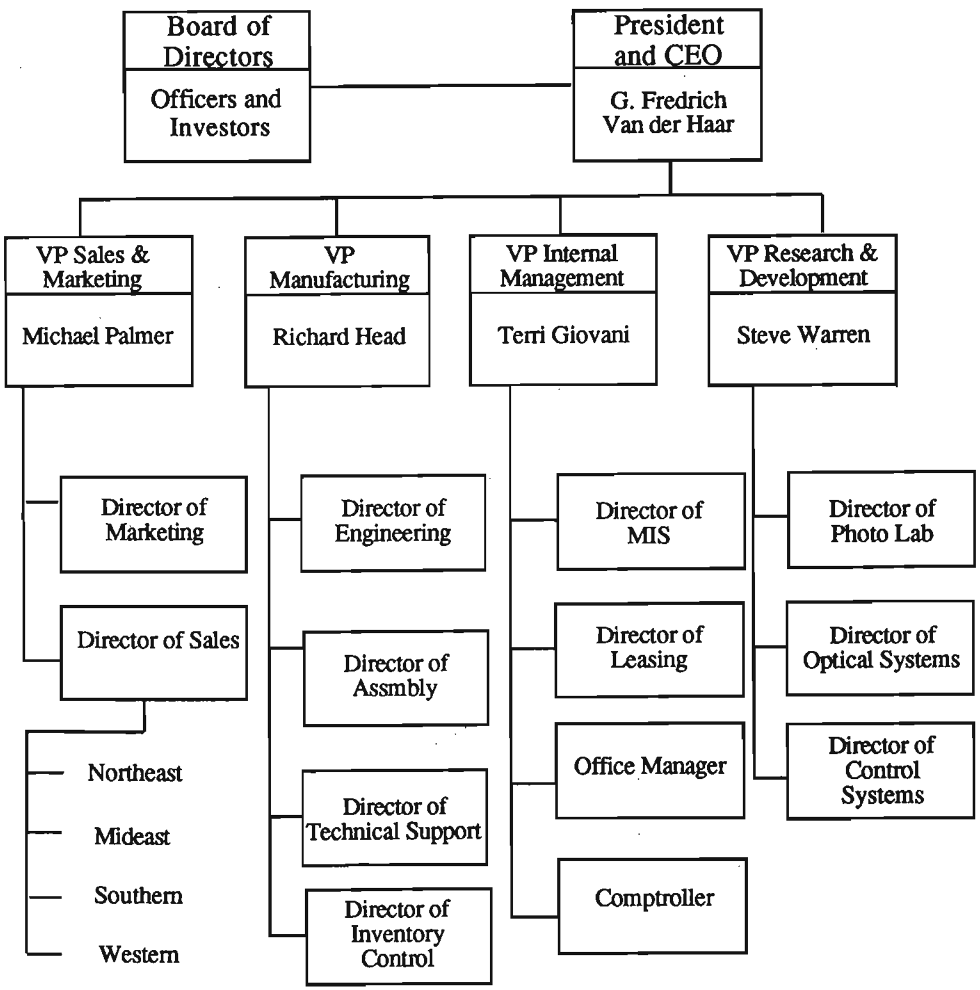

Exhibit 3

C-Tech Historical Growth Trends

Based on Recent Sales Information

Product	1991 actual unit sales[7]	Predicted Growth trends
501	246	20% growth through 1994, then 15% through 1997
511[8]	126	35% growth through 1995, then 20% through 1997
515D	8	15% growth through 1995, then 10% through 1997
515M	41	25% growth through 1995, then 15% through 1997

Exhibit 4

Sales Territories Information

Northeast Territory
Territory Manager: Alex Donahue
States Covered: Maine, Vermont, New Hampshire, Connecticut, Massachusetts, Rhode Island, Delaware, New York, Pennsylvania and New Jersey
Number of Sales Representatives: 4

Mideast Territory
Territory Manager: David Torrence
States Covered: Michigan, Ohio, Indiana, Kentucky, Virginia, West Virginia and Maryland
Number of Sales Representatives: 3

Southern Territory
Territory Manager: Skip LeHaye
States Covered: Tennessee, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, Louisiana, Texas, Arkansas and Missouri
Number of Sales Representatives: 3

Western Territory
Territory Manager: Hal Masters
States Covered: Wisconsin, Illinois, Iowa, Montana, Minnesota, North Dakota, South Dakota, Kansas, Nebraska, Colorado, Oklahoma, New Mexico, Nevada, Idaho, Washington, Oregon, California, Alaska and Hawaii
Number of Sales Representatives: 5

General Sales Information:
Number of prospects a salesperson can visit per day:
average of 2.6 calls per day. Salesmen work 240 days/year.

Close Ratio:
Number of calls that eventually become sales:
estimated that 4.5% of all calls made eventually become sales.

Exhibit 5
Michael's Requirements for New System

DAILY updates/reports on the following information:

1) 5-Day "To do" list printout for salespeople, based on when "recommended actions" are to be done. For instance, every morning, each salesperson should have a list of "things to do" over the next five working days based on items previously written in the "recommended action" field. If a salesperson (or Phillip) notes that a prospect needs a follow-up call on the 23rd of the month, then on the morning of the 19th that follow-up call should first appear on the appropriate 5-Day To do List displaying the prospect and recommended action. As the current "day one" ends, the time window should shift forward one day to incorporate a new day five. A salesperson's list should be arranged in three different ways based on:
   - post contact prospect class - post contact sales cycle class - location of prospect (city)

WEEKLY reports on the following information:

2) Alphabetical list by salesman displaying the average number of prospects called on per representative per day.
3) Average number of days between stages of the sales cycle:
   - first contact (telemarketing, unsolicited inquiry, etc.) to first visit from salesperson
   - first call to follow-up call - follow-up call to demonstration - demonstration to close
4) Performance evaluation of promotional efforts by showing the current number of leads generated from word of mouth, direct mail, advertisements, public relations, and telemarketing up through a specified week ending. Again, we need to make sure that the template of information we use has fields for all of the information we need in order to calculate these numbers.
5) Report of lead positions in the sales cycle (first call? follow-up? demo? close?) - for each stage in the sales cycle an alphabetic listing of all prospects in that stage along with numerical totals reflecting the number of contacts in each stage.

AS-NEEDED updates/reports on the following information:

6) Computer-based quotation/order generator for sales force use based on:
   - # of units ordered (qty discount - shipping costs
   - years of service contract purchased - supplies ordered
   - optional equipment ordered

   Essentially we need to support order pricing (quotation only) and order entry (pricing and order placement). The format of the quote generator should also be used for order entry to make it easier on the salesforce. Order information should be transmitted electronically to our main office on a regular basis. Orders should be kept in an active database for one year only. Prospects should be moved from the contacts database to the customer database upon closing a sale. All contacts that have not become customers after one year should be dropped from the contacts database.
7) Phillip should be able to view contacts/prospects by demographic categories listed below:
   - geographic location (city where prospect is located)
   - # yrs in business - up to 2 year - 2 to 5 years
   - 5 to 10 years - 10 to 25 years - over 25 years
8) Salesmen need the ability to search, browse, edit, update the contact/prospect and customer databases. The salesmen should be able to search either database by telephone number or customer/contact name.
9) Salesmen need the ability to append new prospects to the contacts database.

Exhibit 6
Elizabeth's Requirements for New System

- The system must work in concert with existing hardware and software consisting of:

Hardware:
- (2) 486/33 file servers with 350 MB hard disk and tape backups
- (1) 386/20 PC equipped to send/receive off-site information (230 MB hard disk)
- (8) 386/20 PCs (230 MB hard disk)
- (15) Compatible laptops each with portable printer and built-in fax/modem (120 MB hard disk)
- (8) Dot matrix printers
- (2) High Quality Laser Printers

Multiuser Software: Available on File Server and/or Individual Machines (as appropriate):
- Appropriate Disk Operating Systems, Relational Database Management System, Spreadsheet Software, Word Processing Software, Fortran and C - Programming language compilers, Linear optimization software

- System must be cost effective, and allow for prospect base growth for at least the next five to six years. The system should include five major databases based on current paper forms:
  1) Contacts Database
  2) Supplies Database
  3) Products Database
  4) Order Database
  5) Customer Database

  and a salesforce database to store C-Tech sales ID and personal information on sales representatives. To simplify matters the system should be organized into a salesforce component for use by sales representatives and a management portion for use by management. The salesforce component should offer the following functional modules:

  Quote/Order Modul New Prospect Module
  "To Do" Modul Sales Call Module

The management portion should offer the following functional modules:

  Selling Cycle Module Calls Module
  Lead Module Promotions Module
  Prospect Demographics Module

- System must connect with salespeople in the field, allowing them to access databases and send information to home office via computer.

  We'll do daily remote transmits to/from the salesforce. At a specified time each evening, the salesmen can download all new information and changes to the following:
  (1) Customer database
  (2) Contact/prospect database
  (3) Order database

  At 6 AM each morning, the salesforce can then upload the most recent version of the following:
  (1) Customer database
  (2) Contact/prospect database
  (3) Order database
  (4) Supplies database
  (5) Product database

Exhibit 7
Product Information

Price:	501	511	515D	515M
1-3 (qty disc)	29,500	14,950	150,000	119,950
4-6	7%	5%	3%	5%
7-10	8%	6%	4%	6%
11-more	12%	10%	8%	9%
Service contract costs	7% of purchase price per year	6% of purchase price per year	12% of purchase price per year	11% of purchase price per year
Shipping costs	$1.50 per mile + $500 city delivery charge[9]	$.75 per mile; no city delivery charge	$3.50 per mile + $1,000 city delivery charge	$3.00 per mile + $750 city delivery charge

Exhibit 7
Continued

	Slide unit[10]	High-volume kit[11]	PC interface[12]	Dura-LP film transport kit[13]	Process dynamics controller kit[14]	Illumination controller kit[15]
501						
1-3	2,295	1,995	9,995	N/A	N/A	N/A
4-6	4%	4%	6%			
7-10	5%	6%	8%			
11-more	7%	10%	12%			
511						
1-3	1,995	1,695	7,995	4,295	N/A	N/A
4-6	7%	8%	8%	9%		
7-10	9%	9%	9%	12%		
11-more	12%	11%	11%	13%		
515D						
1-10	N/A	N/A	N/A	N/A	42,500	N/A
10-more					6%	
515M						
1-10	N/A	N/A	N/A	N/A	39,500	16,950

Exhibit 7
Continued

Supplies list

Enlarging paper (8% discount for quantities of 10 or more)

	100'	500'
5" glossy, lustre or matte finish	299	1,199
11" glossy, lustre or matte finish	429	1,719
16" glossy, lustre or matte finish	539	2,159
30" glossy or lustre finish	1,195	4,780

Overhead transparency film

11" regular film	659	2,639
11" Dura-LP film	1,159	4,639
16" regular film	889	3,559
16" Dura-LP film	1,559	6,239
30" regular film	2,390	9,560

Chemistry

	10 gal	50 gal
First developer	55.95	195.89
First developer activator	29.95	105.95
Color developer - part A	149.95	524.89
Color developer - part B	119.95	419.89
Bleach - fixer	229.95	805.95
System super flush (cleaner)	44.95	112.39

Spare parts

Color cell	149.95
General cell	99.95
Roller	48.75
Processor turnaround	84.95
Quartz halogen exposure bulb	34.95
Wratten exposure filters (full set)	75.95
Water filter element	14.95

Exhibit 7

Product Information

	501	511	515D	515M
Price:				
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515D						
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Wratten exposure filters (full set)	75.95
Water filter element	14.95

NOTES

[1]D&P is industry terminology for Develop and Print. This is the term given to regular photo processing, or what is done when someone "has a roll of film developed."
[2] Copy work is a term given to the process of copying a photograph or slide so that an enlargement can be made from it without a negative. *PhotoMasters* render this process obsolete.
[3] The ability to develop and print black and white film.
[4] Slide film developing.
[5]The process of copying 8mm or 16mm movie film to videotape.
[6] Hard goods is short for any camera hardware that the prospect's store might sell (cameras, lenses, etc.)
[7] Actual sales figures
[8] Figures for 511, 515D and 515M represent sales beginning in May 1991.
[9] City delivery charge only applies if installation site is located within one of the ten most dense metropolitan areas in the United States (New York, Los Angeles, Chicago, Dallas, Atlanta, Miami, Houston, San Francisco, Detroit and Washington D.C.). Also, a $1,500 shipping charge is attached for installations in Hawaii and Alaska.
[10] Slide unit option allows users to make enlargements or transparencies from slides just as easily as they can make enlargements or transparencies from other prints.
[11] High volume kit allows installations to run machine at full capacity without having to maintain the machine as often, thereby decreasing the need to shut the machine down for maintenance.
[12] PC interface kit allows users to make enlargements or transparencies from computer generated slides and electronically manipulate images before they are printed. Used for image enhancement where detail is poor, etc.
[13] Dura-LP film transport allows users to make large transparencies (up to 20"x30") on a special kind of film (Dura-LP film) which allows users to back-light the transparency by "piping" light into the side to the transparency rather than evenly illuminating the transparency across its back. This saves a tremendous amount of display space.
[14] Process dynamics controller allows users to electronically control processing variables such as development time, chemistry temperature, chemistry concentration and chemical agitation. The benefit is that users can easily and quickly manipulate processing variables and see the probable results on a computer screen before the print is actually made. Before, this process took hours in a darkroom. Now, it takes about ten minutes.
[15] Illumination controller gives users the ability to selectively expose originals to manipulate the level of detail in the final print or transparency. This option provides some of the benefits of the process dynamics controller at a lower cost.

Communication Audit at Memorial Hospital

Cynthia K. Shinabarger Reed, Saint Louis University
Thomas J. Kramer, Saint Louis University
Renee M. Kurowski, Saint Louis University

Edward Stone, 47, is the Vice-President of Human Resources at Memorial Hospital, which is located in the northern United States. During the six years he has been with the hospital, he has found great satisfaction in his work. He has enjoyed being a part of a facility which places great emphasis on quality patient care. Memorial Hospital has the approval of the Joint Commission of Hospitals (JCAH) and holds membership with the American Hospital Association (AHA). It is part of Memorial Medical Center, which is a general medical and surgical institution. Memorial Hospital is a 600-bed hospital that admits an average of 24,242 people each year. It has an occupancy rate of 83.2 percent, employs 2,108 people, and over two-thirds of its patients are hospitalized for less than thirty days.

Recently, Edward has been considering the importance of maintaining an effective communication system at the hospital. After reading about a communication study performed at another institution, Edward began thinking about the possible benefits of performing such a study at Memorial. He believed having an effective communication system was an important factor in hospital efficiency and in maintaining good staff relations.

Edward has recently formed a group to address hospital communication issues. This group consists of Mr. Stone; his Assistant Human Resource Director, Sherri Gant; a psychiatrist from the hospital's psychiatric division, Dr. John Knight; the Director of Marketing, Joanne Rogers; the Director of Social Services, Corinne Matthews; and the Director of Public Relations, Robert Kingston. At their first meeting, Edward discussed his thoughts and concerns regarding effective communication with this group and suggested this be one of the first discussion items on the agenda.

The other members of the communication committee shared Edward's concerns and also agreed that communication was an important factor in efficiency and staff relations. Edward mentioned that recently an assessment group from the business school of a local university, called the Organizational Development Group (OD Group), offered their assessment services. Since the hospital communication committee was serving mainly as a planning committee and would not actually be conducting any major assessments, Edward thought it would be a good idea to invite some people from the OD Group to the committee's discussions for extra input. The other group members agreed so Edward contacted Mark Peterson, one of the OD Group's project directors, and invited him and two of his project coordinators, Ashly Cordtland and Linda Bennett, to attend the committee's next meeting.

At the committee meeting, the group discussed factors of the communication system and what aspects should be assessed. Mark, Ashly and Linda asked questions to clarify what the committee was looking for in an audit, and provided some suggestions. At the close of the meeting, it was agreed that the OD Group would submit a proposal for the assessment project.

In their proposal, the OD Group suggested several factors of the communication system to be addressed and proposed to work further with the committee to develop the specific questions for the assessment. They also proposed to use eight focus groups to gather the information. The proposal also included an estimate of the time to analyze the data, write and prepare a final report. Edward and the committee were satisfied with the proposal so it was submitted to Richard Gannon, the hospital CEO. Mr. Gannon gave his approval and the proposal was accepted.

Mark, Ashly and Linda met two additional times with the committee in order to develop and finalize the questions for the assessment. The assessment contained four key questions in seven different sectors, and a sector consisting of some general questions. The seven areas these questions applied to were: benefits, compensation, person/organization fit (information regarding how the employee's position fits with the rest of the department and the overall hospital), hospital plans and decisions, annual goals, policies and procedures, and performance feedback.

The four questions asked in each area were:

1. Do you receive information regarding this area?
2. In what form do you receive this information (ie. from supervisor, department meetings, grapevine, etc.)?
3. In what form would you prefer to receive this information?
4. How important is it to you to receive this information?

The general questions consisted of:

1. How timely do you receive information?
2. Is the information you receive believable?
3. Are there channels available for you to send information back to the organization? Can you identify these channels?
4. Which of these channels are most commonly used?
5. Of the seven sectors previously discussed, which ones do you feel to be the most important?

After completing the planning of the methodology for the assessment, eight focus groups were scheduled by Sherri Gant. Ashly Cordtland and Linda Bennett coordinated the focus groups. Two groups had to be canceled due to lack of a sufficient number of participants. Ms. Gant rescheduled one of these, but opted not to reschedule the second one, which was from a night shift. The hospital has limited staff during this shift, making it difficult for people to leave their departments. Thus, a total of seven focus groups, ranging in size from 4 to 16 participants, were conducted. A total of fifty-four staff members participated in the groups.

Mark Peterson and Ashly Cordtland met with the communication committee to present the final report. The results of the assessment indicated that 76% of the participants were receiving information regarding the areas discussed. Overall, they were receiving the information in the forms preferred. However, they did indicate a few areas where change was desired. Participants stated they would like improved written correspondence about compensation, performance feedback, and hospital plans. They indicated that communication from supervisors was timely and effective except in the areas of performance feedback and policies and procedures. Hospital publications could be used more effectively to communicate the annual goals of the hospital along with important hospital plans and decisions. Employees reported they are most concerned about receiving communications

that effect them directly, the work they do, or their department. They are less interested in, and aware of, communication regarding hospital plans and goals and changes in policies and procedures that do not effect them directly.

The OD Group encouraged the committee to report the results of the focus group meetings to the employees in some form. In a later meeting of the hospital communication committee, Mr. Stone discussed this with the other committee members. Dr. Knight and Ms. Matthews were opposed to disseminating the information. They believed it could possibly create problems. Others disagreed and indicated the information should be disseminated at least to those who participated in the audit. Those who felt feedback should be given disagreed on the format for doing so. Some believed that a meeting was the appropriate means; others that an article in the hospital newsletter would be sufficient. Some debated about what action, if any, should be taken based on the assessment. While some agreed the results of the assessment should be used to evaluate current communications and make improvements, others thought it should simply be put away for future reference

Discussion Questions

1. Should the committee disseminate the information from the assessment? If so, how should it be disseminated and to whom? If not, why shouldn't they?
2. Should the OD Group and the hospital communication committee have discussed what would be done with the results of the assessment before conducting it? Why or why not?
3. Is it necessary to make any changes in hospital communications based on the information from the assessment? Why or why not? If not, what should be done with the information?
4. Is the audit valid without night shift participation? Explain.

Sae Ryun Corporation

John F. Nash, East Tennessee State University
Michelle Khim, East Tennessee State University

"If we could make the furniture from start to finish here in Seattle, we could increase our gross margin by 50 percent." It was May 1991, and Kitty Clayton, manager of Red Tiger Furniture, a division of Sae Ryun Corporation, was trying to explain the plan to staff person Bob Poindexter.

"But, Kitty, a large chunk of that difference would come from eliminating the transfer-price markup. Corporate profits wouldn't increase that much," Poindexter pointed out. "You must somehow convince corporate management that the plan is good for them, too. And won't the production guy in Korea object?"

"Yes Bob, it's going to be a tough sell," lamented Clayton. "We're up against Korean conservatism, and yours truly doesn't have a lot of political clout with the patriarchs in Seoul."

Company Background

Sae Ryun Corporation manufactured high-quality furniture for the domestic South Korean and export markets. The company, which had an international reputation for its hand-crafted wood products, supplied full lines of residential and corporate furniture, including dining suites, bedroom furniture, sideboards, desks, conference tables, and credenzas.

Sae Ryun[1] was founded in Seoul, South Korea, in 1978. From supplying retail stores just in the Seoul area, the company expanded to become one of the largest furniture suppliers in Korea. In the early 1980s, it started exporting its products to other parts of Southeast Asia, Australia, the Middle East and North America. Then, in 1985, Sae Ryun established a wholly owned subsidiary in Seattle, Washington, to provide a permanent foothold in the U.S. market. Within three years, the subsidiary, incorporated as Red Tiger Furniture, Inc., had achieved annual sales of $56 million.

Although Sae Ryun's record of profitability had been good for most of its corporate life, the company made a substantial loss during 1989 and managed only a partial recovery in 1990, the most recent full year of operations. Comparative income statements for 1988-90 are shown in Exhibit 1. Part of the downturn was attributed to economic conditions, but management wanted to improve internal efficiency so as to regain the favorable level of performance enjoyed until the mid-1980s.

Korean Economy

Although the Korean economy remained strong though the early 1990s, growth slowed somewhat in the mid 1980s. There were several reasons for this slowdown, some economic and others political. Korean labor unions grew in strength, and strikes became more frequent as workers pressed for improved workplace safety and higher wages. By 1990, a blue-collar worker could expect to earn about $5 per hour, and an entry-level college graduate could earn a monthly salary of $1,000. In turn, higher industrial wages fueled a sharp increase in the general inflation rate to around 10 percent per year (Exhibit 2).[2] Some economists expected labor costs to reach 50 percent of U.S.

rates by 1992 or '93 and to reach parity by the end of the decade. Some comparative data on hourly wage rates in Korea and the U.S. are shown in Exhibit 3.

Because of high inflation, Korean industry faced increasing competition, in world markets for its goods, from Mexico, Sri Lanka, Indonesia, and other developing countries where labor rates remained substantially lower. Moreover, Korea's competitive advantage relative to the U.S., Japan, and the European Community became less significant. As in many other developed countries, real-estate prices fell during the late 1980s, and the construction industry went in recession. Korea depended on imports of rice and other foodstuffs for 50 percent of its needs.

Possible reunification with North Korea was another uncertain factor hanging over the economy. North Korea was hungry for western-style products, its factories were ripe for modernization, and its labor costs were only one-half of those in the South. However, even if reunification could be achieved, it might turn out to be a mixed blessing. Korea watchers pointed to the economic problems that followed the reunification of Germany.

Instances of human rights abuses, high-level corruption, and civil unrest damaged Korea's international standing and created anxiety among foreign investors. In 1977, Korean dissidents appealed for U.S. help in the face of alleged repression and political persecution. At about the same time, an ex-director of the Korean Central Intelligence Agency identified a prominent Washington influence peddler as being a KCIA agent, and two U.S. Congressmen were subsequently convicted of accepting bribes from Korean government officials. Also, foreign competitors several times accused major Korean firms of patent and copyright infringements. Student riots expressed discontent at the results of presidential and congressional elections and at the presence of U.S. troops on Korean soil.

Finally, the famed Korean work ethic, although still strong by world standards, began to erode. As conditions improved, workers put more emphasis on leisure activities, especially sports. Moreover, they started vacationing abroad more frequently as a result of higher personal incomes and the relaxation of travel restrictions. Contact with other cultures was expected to reduce further any attitudinal differences between Koreans and citizens of other Pacific-rim nations.

Nevertheless, the South Korean economy continued to grow, and GNP reached $188 billion in 1990. The nation enjoyed a favorable trade balance of more than $14 billion with the rest of the world, and the Korean currency, the won (₩), rose versus the U.S. dollar in four of the six years through 1990 (Exhibit 4). The Korean government vowed to turn Seoul into the world's leading manufacturer and research and development center for electronics, particularly computers. And it established important new relations with China and Russia.

The Republic of Korea experienced an economic boom during the late 1970s and early 1980s, achieving real growth approaching 10 percent per year. Its gross national product (GNP) exceeded $75 billion in 1983 and $118 billion by 1987, approximately 40 percent of which was contributed by manufacturing industry. The combination of natural resources, low industrial wages, and one of the world's strongest work ethics ensured Korea's rapid penetration of world markets for manufactured goods. Moreover, the Korean government pursued a consistent policy of support for and partnership with private industry to produce a growth economy. Korean automobiles, household appliances, consumer electronics products and data processing equipment achieved wide recognition throughout the developed world. Samsung, Hyundai, Gold Star and Daewoo—among the largest companies in the world—have long been household brand names in the U.S. The 1988 Olympic Games focused international attention on Korea and provided further help to its growing economy.

Sae Ryun's Korean Operations

Sae Ryun Corporation was founded by Sung K. Kim, an engineer by training and long-time divisional production manager of the Daewoo Group. In the company's early years, management intended to keep its operations in the Ulji-ro Chung-ku district of Seoul. But sharply rising real-estate prices in the early 1980s restricted plant expansion in that city of 9 million people, and the decision was made to move Sae Ryun's manufacturing plant to Pusan, 280 miles to the south. Pusan's land prices were high by U.S. standards, but they were significantly lower than Seoul's. The city offered a large labor pool and good transportation facilities, including the largest port in South Korea. Furthermore, the Kyung Sang Nam Do provincial government (whose jurisdiction included Pusan) offered a long-term land lease and attractive tax incentives for Sae Ryun to locate there. By 1990, the company's Pusan plant covered 24 acres and employed 900 people.

When the manufacturing operations were moved to Pusan, upper management discussed the possibility of moving the corporate headquarters there also. However, Korean society is not as decentralized as in the U.S., and a corporation's status is measured at least in part by its presence in the nation's capital. Also, Sae Ryun's headquarters was close to the major financial institutions in Seoul, including the Korea First Bank, with which the company had an important long-term relationship. For these reasons, the decision was made to keep the corporate headquarters and offices in the capital. Travel, by managers and others, between Seoul and Pusan would not pose a problem because the flying time from Seoul Kimpo Airport to Pusan was only 50 minutes, and a high-speed rail link was planned. Also, a high-capacity telecommunications channel between the two facilities was leased from the Tong-Shin Gongsa Public Communications Corporation.

All administrative and accounting functions, including customer billing, accounts payable, and payroll continued to be handled from the corporate headquarters. The Pusan plant was established as a manufacturing division and evaluated as an investment center. When the manufacturing plant moved to Pusan, two sales divisions were created, one in Pusan, to cover the southern part of Korea, and the other in Seoul covering the northern part, up to the Demilitarized Zone (DMZ) along the border with North Korea.

By 1991, Sung Kim was semi-retired, serving only as Chairman of the Board, although he and his family still owned 40 percent of the corporation's stock. Kim turned over day-to-day operation of the company in 1988 to Min S. Park, a 10-year Sae Ryun veteran. Earlier, Park had worked for several years for the Hyundai Group, after receiving a masters degree in business administration from Yeon-sei University. As Sae Ryun's president, Park's salary was ₩100 million, or roughly $140,000 per year, with bonuses and other perks. The Pusan manufacturing division was managed by Myung Soo Choi, who had earned an engineering degree from the University of Michigan and an MBA from the Wharton Business School. Education was considered the key to advancement in Korean business, and degrees from major schools in the U.S. and Western Europe were held in high regard. The sales manager for southern Korea was Soon S. Lee, a former Samsung regional sales representative. Choi and Lee made ₩40 million and ₩30 million, respectively.

Initially, Sae Ryun purchased lumber from local suppliers in Korea. But as production volume increased, local suppliers were unable to meet the company's raw materials needs, and lumber sources were sought in the United States and Canada. The lumber was purchased from saw mills throughout North America and transported by rail to Seattle, Washington, where it awaited the departure of cargo vessels bound for Korea. Shipment time, from the lumber's arrival at the docks in Seattle to its delivery to the Pusan plant, was six to eight weeks. In 1990, approximately 75 percent of Sae Ryun's lumber was imported from North America. Despite relatively high trans-Pacific shipping costs, the net cost of lumber raw materials (Exhibit 5) was still less than prices charged by

Korean lumber merchants. Another 5 percent of the company's lumber was purchased from a variety of sources, mostly at costs comparable with imports from the U.S.

Export Business

Sae Ryun's export business flourished as its reputation for fine furniture spread worldwide. Export sales increased not only in North America but elsewhere. By the early 1990s, exports to countries other than the U.S. accounted for more than 40 percent of total corporate sales. Sae Ryun implemented organizational changes to exploit this growth. In 1989, the Seoul sales division was split into a domestic sales division covering the division's original territory, and an international sales division with responsibility for all exports except those to the U.S. So far, Sae Ryun had not opened sales offices or assembly plants in other countries. The company continued to sell through import-export intermediaries or "middle men" with connections in the various countries where the company's products were marketed.

However, with improving economic relations between Korea and the People's Republic of China, upper management foresaw the possibility of opening a Seattle-type subsidiary on the Chinese mainland. Not only did China, with a population of one billion, offer a huge market for quality goods, but it also had extensive hardwood lumber resources. Assuming that remaining trade and investment restrictions could be circumvented, Sae Ryun might be able to import a substantial proportion of its raw materials from China, at prices significantly lower than the cost of North American lumber. If Sae Ryun proceeded with this plan, it would probably establish the plant in Guangdong Province, around Canton, which was developing a reputation for hard-hitting entrepreneurial capitalism, despite the efforts of the central government in Beijing to preserve the purity of Maoist Communism. Min Park and other senior managers were watching the Chinese political situation carefully, waiting for an opportune time to launch the venture.

United States Operations

The Seattle division, Red Tiger Furniture, Inc., was operated—like its Pusan counterpart—as an investment center. The division manager was Kitty Clayton, a former regional sales manager for the American firm, Thomasville Furniture Company. Her undergraduate work was in marketing, but Clayton took a year's leave of absence from Thomasville to return to school and earn a master's degree in operations management. At the end of the program, instead of returning to her former company, she accepted a position with Sae Ryun. For the first 18 months, Clayton worked as assistant division manager under Chun Yong Hwan, an elderly Korean manager sent to establish the Seattle operation. When Hwan retired early in 1988, Clayton was appointed Red Tiger Furniture's permanent manager.

Clayton's three assistant managers included two Americans and one Korean national. All senior employees were expected to acquire some knowledge of Korean. Also, corporate management was drawing up plans to offer RTF's senior employees two- or three-year tours of duty in Seoul or Pusan. So far, Clayton had not been invited to spend an extended period at any of the Korean facilities, although she made numerous trips ranging from a few days to a month. As was common among Asian companies, Sae Ryun's policy was to encourage long-term loyalty among its employees by offering prospects for steady advancement through the corporate ranks. Or rather, this had been the traditional policy for male employees.

Clayton grew up in Korea when her father, a career military officer, was stationed in the country during the 1960s and 1970s. Her knowledge of the Korean language and culture, together with her experience in the furniture industry and management training, proved invaluable in her dealings

with the corporate parent and management. On the other hand, women had not yet made significant inroads into the upper echelons of Korean business, and even those in the lower ranks were expected to resign if they married. Clayton turned 36 in February 1991 and was still single. Her appointment was indicative of Sae Ryun's willingness to hire female managers. She wanted to stay with Sae Ryun, but opportunities for her future advancement in the company were not yet assured.

Clayton had overall responsibility for both lumber purchases and the distribution of furniture products in the U.S. and Canada. Hardwood does not grow in the immediate vicinity of Washington state, so purchasing agents had to travel, sometimes as far as the East Coast, to inspect and order raw lumber.

Most of the company's products were sold directly to major retail chains, but some were distributed through catalog stores and wholesalers. Thirty-two sales representatives were responsible for the five major North American sales territories. The sales people spent virtually their entire time traveling, either from Seattle or from bases at small sales offices in the other four territories.

Partial Manufacture in Seattle

Initially, all furniture was shipped to the U.S. in final form, ready for immediate sale. However, upper management soon decided to ship some furniture in unassembled, or "knocked-down," form for completion at the Seattle plant. In 1990, sales of furniture completed in Seattle accounted for more than 50 percent of total U.S. sales. Completion of the unassembled furniture was substantially more complicated than assembling the familiar bookshelf kits purchased from discount stores or mail-order stores. Skilled personnel assembled and finished the furniture, providing an end-product whose quality was generally comparable to that of the furniture manufactured entirely in Korea. Approximately 250 production personnel were employed for this purpose, out of Red Tiger Furniture's total payroll of 324.

Shipment of either finished or knocked-down furniture across the Pacific was somewhat faster than shipment of raw lumber because furniture commanded a higher freight charge and received a correspondingly higher priority at the docks. But the total transportation time was still on the order of four to five weeks.

The decision to ship knocked-down, rather than completed, furniture from Korea to the U.S. involved a number of trade-offs. The most compelling reason, from the corporate standpoint, was a reduction in transportation costs. For example, shipping a completed oak entertainment center cost approximately $95, while shipping the components in a flat carton cost less than $25 (Exhibit 6). However, the $70 difference did not all translate into corporate profits. Total labor increased from 12 to 14 hours, and the part of the work performed in the U.S. was subject to conversion costs that, on average, were 60 percent higher than in Korea.[3] The wholesale price of the oak entertainment center was about $500. This price provided a corporate gross margin of $134 if the item was completed in the U.S., versus $122 if it were completed in Korea. The percentage difference in gross margin was roughly the same throughout the product line, even though gross margin itself varied considerably as a percentage of sales.

The gross margin recorded on Red Tiger Furniture's books was different from the corporate gross margin because of the internal markup contained in transfer prices. Company policy allowed a 10-percent markup on the full cost of any raw material or manufactured product transferred from one division to another. The U.S. division marked up the lumber transferred to Korea, and in turn the Pusan manufacturing division marked up the completed or partially completed furniture transferred to Seattle. Taking account of the internal markups, Red Tiger Furniture's share of gross margin was $109, if the item were assembled and finished in Seattle, versus about $92 if it were completed in Pusan.[4]

Red Tiger Furniture achieved an 11-percent return on investment in 1990, down from 13 percent the year before. The 1990 figure was based on a replacement-cost asset investment of roughly $60 million or W43 billion. Kitty Clayton expected that her division's ROI would rebound to the 13-14 percent level as the U.S. economy recovered. However, she was under pressure to increase it to the corporate target of 18 percent within the next couple of years. By the 1990s, Red Tiger's market share was relatively stable, and substantial increases in marketing effort would be needed to increase sales enough to reach an 18-percent ROI. Instead, Clayton was looking at the possibility of trimming costs.

One way to reduce costs would be to bring more of the manufacturing work to the U.S. Clayton viewed the shipment of lumber to Korea, followed by the return shipment of furniture to Seattle, as a waste of time and resources. She wanted to manufacture some furniture from start to finish in Seattle.

Clayton realized that such a plan would not be greeted with unanimous applause from Korea. In particular, she anticipated opposition from Myung Soo Choi, manager of the Pusan manufacturing plant. Choi was likely to resist surrendering more of the production work to another division. Even though his plant—that supplied both the Korean domestic market and all non-U.S. exports—was operating at 75 percent of capacity and had little room for growth, Choi could easily exploit concern among his employees for the safety of their jobs. There was a deep-rooted paranoia in Korean society about losing jobs to foreign competition, and Korean firms were known to operate for relatively long periods at break-even or below in order to avoid layoffs.

Nevertheless, Clayton decided to approach the corporate management in Seoul with a formal proposal laying out the benefits of her suggestion. With a lot riding on the outcome, she looked to her staff people and possibly to outside consultants for help in preparing the proposal.

Required

1. Evaluate the transfer-pricing policy adopted by Sae Ryun Corporation from the standpoint of (a) fairness and (b) potential for motivating division managers toward functional behavior. Does U.S. tax law influence the setting of transfer prices?
2. Kitty Clayton's long-term goal was to manufacture some furniture entirely in Seattle. What advantages (if any) would there be for (a) Sae Ryun Corporation, (b) Red Tiger Furniture, in doing so?
3. What problems would have to be overcome in bringing a much larger percentage of the manufacturing work from Pusan to Seattle? Do you believe Clayton could sell corporate management on the idea? As a consultant to Clayton, outline a strategy for gaining corporate approval.
4. Discuss the possibility of a conflict in objectives between a major operating division such as Red Tiger Furniture and its foreign corporate parent.

Exhibit 1

Comparative Consolidated Income Statements
Intracompany profits eliminated
Data in Thousands of Korean Won (₩)

	1988	1989	1990
Sales:			
Domestic	22,676,402	21,432,604	24,435,900
Export—US	40,817,524	42,865,207	42,762,825
Export—other	27,211,683	42,865,207	54,980,775
Total sales	90,705,609	107,163,018	122,179,500
Cost of goods sold:			
Transportation in	2,726,170	4,394,944	5,208,705
Materials—domestic	9,885,627	9,766,633	10,574,900
Materials—imported	9,087,234	14,649,814	17,362,350
Direct Labor—domestic	6,955,568	6,895,195	6,601,980
Direct labor—US	2,847,261	4,933,198	6,344,130
Manufacturing overhead	23,526,790	28,388,143	31,070,664
Total cost of goods sold	55,028,650	69,027,927	77,162,729
Gross margin	35,676,959	38,135,091	45,016,771
Operating expense:			
Shipping—domestic	2,715,657	3,351,392	3,912,035
Shipping—US	7,431,315	6,702,785	6,424,071
Shipping—other	4,189,144	7,378,481	9,680,088
Marketing	7,857,411	9,288,439	10,144,129
Administration	7,354,901	8,094,632	9,890,447
Interest expense	3,942,970	4,295,392	4,575,800
Total operating expense	33,491,398	39,111,121	44,626,570
Net income before tax	2,185,561	(976,030)	390,201
Tax (25%)	546,390	(244,008)	97,550
Net income	1,639,171	(732,023)	292,651

Exhibit 2

General Inflation Rate, South Korea

Year	Rate (Percent)
1985	2.8
1986	2.8
1987	3.0
1988	7.1
1989	9.5
1990	11.2
1991 (Estimate)	9.8

Exhibit 3

Relative Hourly Compensation Costs for Production Workers 1975 U.S. Costs = 100

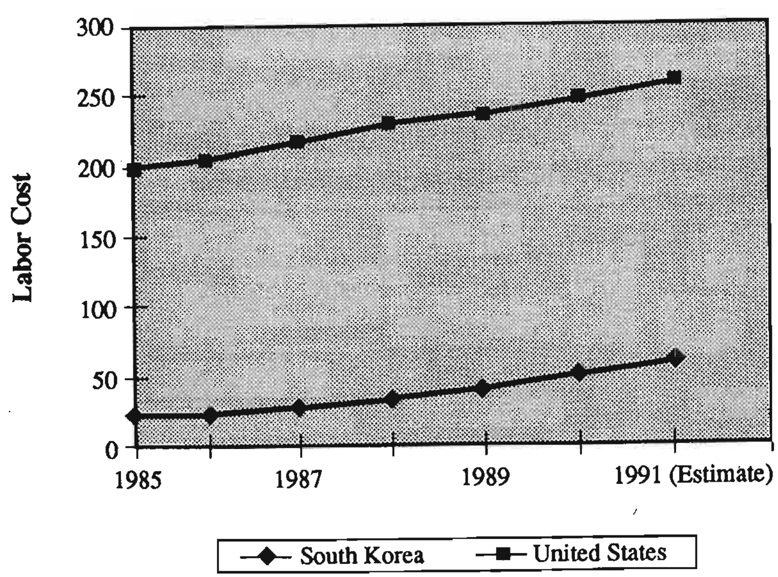

Exhibit 4

Average Currency Exchange Rate South Korean Won (₩) to U.S. Dollar

Year	Exchange Rate
1985	861.9
1986	884.6
1987	825.9
1988	734.5
1989	675.2
1990	714.5
1991 (Estimate)	724.3

Exhibit 5

U.S. Suppliers' Average Wholesale Lumber Prices Data for 1990

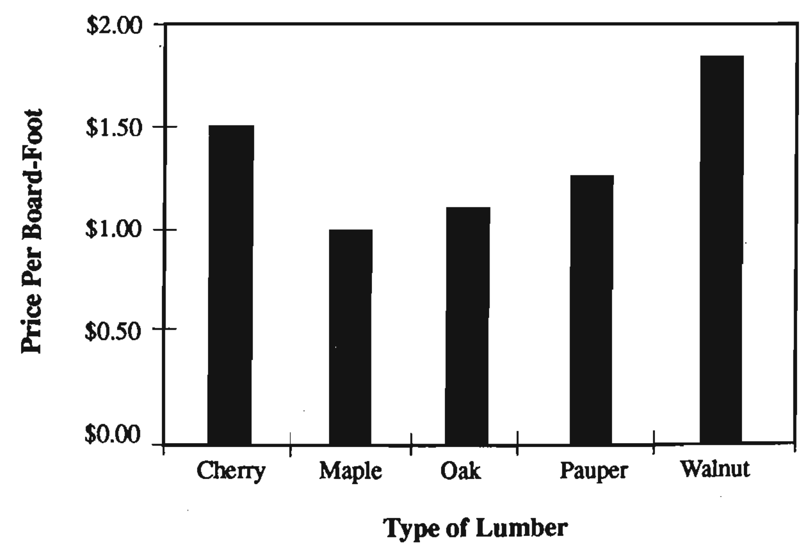

Exhibit 6

Cost Comparison: Oak Entertainment Center
Data in U.S. Dollars

Cost Item	Completed in: Korea	United States
Materials cost[5]	$175.24	$175.24
Conversion cost:[6]		
Korea	121.13	80.75
United States		97.97
Markup on Korean product	29.64	25.60
Shipping cost	94.75	24.90
Total cost	$420.75	$404.46

Exhibit 7

Comparative Income Statements—Red Tiger Furniture
Data in U.S. Dollars

	1988	1989	1990
REVENUE:			
Ready for sale	44,568,624	45,137,977	29,625,750
Assembled in U.S	11,003,226	18,347,223	30,224,250
TOTAL REVENUE	$55,571,850	$63,485,200	$59,850,000
COST OF GOODS SOLD:			
Transportation in	9,728,132	8,549,478	6,925,161
Imported finished goods	19,407,630	11,427,934	8,327,732
Imported parts	2,210,441	7,570,906	7,061,514
Labor	3,876,462	7,306,277	8,879,118
Overhead	4,651,754	8,767,532	10,654,942
TOTAL COST OF GOODS SOLD	$39,874,419	$43,622,127	$41,848,467
Gross margin	$15,697,431	$19,863,073	$18,001,533
OPERATING EXPENSES:			
Shipping	5,001,467	5,713,668	5,386,500
Marketing & administration	2,148,192	2,416,974	2,991,584
Allocated corporate costs	2,778,593	3,174,260	2,992,500
TOTAL OPERATING EXPENSES	$9,928,252	$11,304,902	$11,370,584
Segment margin	$5,769,179	$8,558,171	$6,630,949

NOTES

[1]Sae Ryun (pronounced "SAY Ree-UN") is a Korean term meaning "modern," "stylish," or "fashionable."

[2]Inflation remained relatively high in Korea in the early 1990s, despite its decline in other industrialized countries.

[3]Labor costs were about 2 1/2 times higher in the U.S., but overhead rates based on direct labor cost were lower by a factor of two.

[4]These figures include the $12.60 markup on lumber originally purchased in Seattle and shipped to Korea.

[5]Lumber was assumed to be imported from the U.S. The cost included a $12.60 markup on invoice cost and $36.00 shipping cost.

[6]Completion of the entertainment center in Korea required 12 hours of labor. Partial completion in Korea required 8 hours of labor followed by an additional 6 hours in the U.S.

The Causes of Poor Performance Overseas

Gerald E. Parker, Saint Louis University
Doris Eschbach, Blackburn College

Past Expansion

Six years ago, SMALL APPLIANCE CORPORATION selected managers for expansion into several foreign locations. Many of these managers were not as effective and productive in their assignments as anticipated. Others returned early and/or went to other companies, including competitors.

Present Expansion

You are the assistant to the Executive Vice-President of Human Resources of SMALL APPLIANCE, a multinational consumer appliance corporation. The president has asked you to select managers for overseas assignments in the current expansion. Because of global competition in the new areas, management would like to gain market share in these new areas more quickly than they did in the last expansion of international locations six years ago. It is imperative to gain market share relatively quickly this time because several of your competitors, including one from Germany and one from Korea, have entered or are expected to enter the same new markets. As improvements have been made to several appliances, it is imperative to gain market share before competitors also make improvements to their product line.

Chance for Advancement

The Vice-President of Human Resources, your boss, is in ill health, and he is expected to retire soon. You are being considered for his job; however, much depends on whether you can handle the successful placement for these overseas assignments.

Poor Past Performance

Six years ago when managers were chosen for expansion into several foreign locations, effective and productive managers were selected. No training was provided by the organization as these managers were familiar with company operations. No plans were made for repatriation at that time as the managers were to be on the international assignments for several years. Although effective and productive managers were selected for the previous expansion, many did not perform as well as expected, or worse, returned earlier than planned, and several left the company. Now executives, especially the Vice-President of Marketing, are asking if something can be handled differently by your human resources in this expansion in order to ensure that the managers who are selected and sent overseas remain effective and productive, and that these managers will remain an asset to the company when they return.

How Can Poor Past Performance by Explained?

The executives are asking you why the managers who were sent previously did not perform as anticipated, based on their past effectiveness and productivity in their assignments in the U.S., and, also, they want to know why these fast-track managers did not remain with SMALL APPLIANCE.

As you were not involved in the selection of the expatriate managers who did not perform well overseas six years earlier, you listed items to investigate. You are hopeful that the personnel files of the expatriate managers, who were not very productive, who returned early, or who left SMALL APPLIANCE, will provide you with some insights because if the managers selected in the current expansion do not remain productive when sent overseas, someone else will become the new Vice-President of Human Resources.

Issues

You wonder if other multinationals send their effective managers overseas and whether any other selection criteria is used. You are planning to ask the members of the Human Resource Management Association how their firms handle the selection of expatriates, if any training is provided, what type of training is offered, and how repatriation is handled. The following questions need to be answered in three major areas: selection, training, and repatriation.

1. What criteria, if any, besides being an effective and productive manager is necessary? Do expatriates from other multinationals remain effective and productive overseas? Were the wrong managers selected six years ago?
2. Could cross-cultural training for the specific location enable the expatriate managers to remain successful and productive overseas as they are in the United States? Would poor productivity have been avoided if cross-cultural training and/or language training had been provided? If so, what kind of training would be needed and how will you convince the executives to make the investment in training? Do other corporations provide training? What kind of training? Is it successful?
3. Why are many of the returning managers leaving SMALL APPLIANCE for other companies? What can be planned now so that the managers in the new locations will remain with the firm?

Expatriate Records

Following are personnel files from the earlier international expansion.

Jack Wright's file indicates a productive manager who was well liked by his subordinates. He and his wife frequently traveled for pleasure and both were anxious for the overseas assignment. Jack was sent to Spain and after about six months he was performing adequately in his new position. Upon his return to the states, he reported to the person who had taken over his job at the time of the transfer. Jack left the company shortly afterwards.

Michael Kelly was assigned to Mexico. Mike had given no indication of interest in this assignment. His parents, brothers, sisters, and friends lived nearby and Mike had been happy with his job in the U.S. Mike made no effort to learn Spanish or to adapt to Mexican customs. He alienated customers and did not get along well with his staff although he did not appear to exert much control. Mike stayed in Mexico for nine months then he quit to take a job with another company back in his hometown.

Ron Smith and family were sent to Saudi Arabia where they lived in a compound with other expatriates. However, the Saudis required that they send their 13 and 14 year old sons to school

outside the country; the Smiths requested an early return. Ron has indicated that he does not want any foreign assignments in the future.

Steve Hogan's file indicates that his assignment in Kuwait was cut short because his wife did not like the country. Everything was different; she found little of interest to do. She was not allowed to work as she had in the U.S. Steve requested to return after only six months.

Henry Schmidt was a successful manager in the U.S. despite always requiring everything to be done his way and not tolerating any questioning from subordinates. He was sent to Australia where he had trouble meeting his objectives. He complained that his subordinates were disrespectful and did not follow orders. Henry was not meeting deadlines and had cost overruns.

Robert Wren was noted for getting jobs done on time and on budget in the U.S. and for following rules, regulations, etc. to the letter. Robert was sent to Panama where he felt the operation was loosely run, with employees expecting time off for Carnival and other events, taking too long for lunch, and not finishing work promptly. New work rules were put into effect and many employees quit, which affected the operation adversely. Robert reported that the employees had bad attitudes toward work and that close supervision was needed to keep them working.

Jennifer Adams, a single woman, was sent to Korea. Her file indicated that she had requested extensive information before the assignment, and that she had studied about the country and had taken language lessons. However, Jennifer seemed to have difficulty in managing overseas, and after the first nine months she was not as productive as in the States. Korean customers directed much of their communications to her male subordinates who then had to come to Jennifer, making tasks take longer than necessary and causing deadlines to be missed.

Tom Hancock felt that an overseas assignment would broaden his knowledge of company operations. He began studying about the country Brazil and about the Latin American area, as well as the Portuguese language as soon as he learned about the assignment. Tom was an effective and productive manager soon after his arrival and remained effective until he was transferred back to the home office. Tom has been transferred frequently since his return and keeps asking for a position where his skills could be better utilized. You are aware that he has become more and more involved in activities outside the company and seems to seek satisfaction away from his job.

The other files indicate similar situations.

Questions

1. What insights can be drawn from the personnel files of managers from the previous international expansion? How might this information assist you in making future decisions?
2. Using your answers to (a) the preceding question and (b) the Issues section, formulate a plan for the selection and preparation of managers that are to be assigned to the new overseas posts by SMALL APPLIANCE.

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American Health Concepts, Inc.

Clifford E. Darden, Pepperdine University

In late September 1991, as he mentally reviewed the list of "action items" which had emerged from the recent senior management retreat, Andre Walker, president of American Health Concepts, knew that several problems (which had been heatedly debated) would have to be resolved, preferably before the beginning of the new year.

Specifically, relations between the regions and the corporate office had continued to worsen over the 1991 fiscal year, leading to the loss of one of AHC's top Regional Vice Presidents. Further, the disparity in compensation among fitness center staff in different locations, and between certain of these staff and other AHC personnel, had continued to provoke resentment within the firm. Finally, overlaying both issues were the rising frustrations experienced by corporate executives in ensuring unified direction of, and control over, AHC's geographically dispersed operations.

Company Background

American Health Concepts, Inc. (AHC) was founded in 1980 by 38-year-old Andre Walker, a former staff attorney for the Sierra Club, an environmental advocacy organization headquartered in San Francisco. Convinced that the growing fitness "movement" which swept across the country in the early 1970s represented a permanent concern for healthier living, Walker envisioned a firm whose mission would be that of "help[ing] companies achieve operating effectiveness by enhancing the health, productivity and vitality of their employees." American Health Concepts (AHC)—which was incorporated in 1979, with Walker as the sole shareholder—was founded to pursue this mission.

In 1980, AHC launched its mission with the opening of a fitness facility in the Levi Strauss & Company headquarters in downtown San Francisco. Run by Walker and an aide, the site gradually gained corporate membership, as news of Levis Strauss' employee fitness program spread to other firms in the Bay Area. By the third year, growth of AHC's corporate clients began to accelerate.

Increased growth soon brought recognition of a growing demand for **client-owned** fitness facilities on company premises. This trend prompted, in 1982, a re-focusing of AHC's strategy to reflect a more comprehensive approach to serving corporate-sponsored fitness needs. A three-tiered service offering was devised to address a broader array of client needs. This expanded service offering consisted of facility feasibility studies, facility planning, and management of client-owned fitness facilities.

With these revamped strategic thrusts, AHC grew to become one of the top three firms in the field of corporate fitness systems by 1991. (A summary of the firm's growth during the time period, 1985 - 1991 is provided in the following table.)

Clients Served and Employee Size

	1985	1986	1987	1988	1989	1990	1991
Managed Programs	17	20	27	38	43	51	57
Regular Employees	58	67	81	136	154	185	205
Temporary Employees	75	135	165	200	250	300	370

Walker attributed much of AHC's success to its leadership in developing new concepts to serve the health and fitness market. Among the firm's innovations were

(a) its introduction of an analytical approach to evaluate the cost effectiveness of fitness program options,
(b) its application of systems analysis to fitness program planning, and
(c) its development of the first computerized fitness program.

As shown below, 1991 revenues were expected to exceed $7 million, with net profits projected at nearly $1.7 million.

Growth in Gross Revenues (in millions)

FY	Revenues	FY	Revenues	FY	Revenues	FY	Revenues
1980	$.3	1983	$1.4	1986	$2.1	1989	$4.7
1981	.8	1984	1.6	1987	2.5	1990	6.1
1982	1.1	1985	1.8	1988	2.8	1991	7.2

Note: Nearly 95% of AHC's revenues were from fitness program management services; consulting revenues yielded the balance.

AHC's Operating Environment

Emergence of the Market. The origins of the corporate health and fitness market could be traced to research—accumulating since the mid-1960s—which documented the effects of a sedentary lifestyle, on both the individual's physical health and the employers' financial health. These studies showed that a less physically demanding work environment (due to technological advances and automation)—coupled with poor health habits—were significant contributory factors in the rise of certain debilitating but preventable illnesses (e.g., cardiovascular diseases). In the 1970's, this research drew an increasingly attentive corporate audience, resulting in the 1974 launching of the first firm offering corporate health and fitness services.

During the 1980's, research continued to demonstrate the close association between poor employee health and costly workplace phenomena such as lower productivity, higher absenteeism, and increased staff turnover. One study estimated that company-borne per capita health care costs had increased by 37% from 1986 to 1990, and would continue to virtually explode upwards, if the trends continued. Another study documented that, by 1989, employee health benefits had risen to 26% of corporate earnings, and that common ailments such as employee backaches alone were costing businesses more than 200 million workdays in lost productivity and $5 billion annually in workers' compensation payments.

As the corporate health and fitness industry emerged, it was further propelled by medical research showing that persons who maintained their physical fitness through regular exercise were less prone to illnesses and had greater mental and physical stamina. Studies showing the positive effects of fitness programs on absenteeism, turnover, and health care costs greatly increased corporate receptivity to health and fitness programs. Such programs were viewed as a welcome assist in corporate efforts to contain the spiraling direct and indirect costs of poor employee health.

Market Size and Segments. An unpublished 1987 market study prepared by a Big Six accounting firm estimated a $27 billion corporate health and fitness market, (including services, foods, clothing, equipment, and buildings.) Fitness centers, including on-site centers, were estimated to have grown at an compounded rate of 11% between 1973 and 1986.

The following segments comprised the market: feasibility studies, facilities planning, program management, behavior modification programs (e.g., smoking cessation), health risk management, health education, disease prevention (e.g., cholesterol screening), safety, and recreation. AHC offered services in the first three segments: (a) feasibility studies, (b) facilities planning, and (c) program management.

Competition. Since the 1970s, scores of firms had arisen to serve a growing corporate clientele eager to realize the benefits of health/wellness programs. (See Exhibits 1 through 3 for information on AHC's chief competitors.)

Johnson & Johnson (J&J), a major producer of medical supplies and equipment, was AHC's principal national competitor. J & J was deemed strongly positioned to continue its diversification into the corporate health and fitness market. Through its Health Management division, J & J enjoyed much success with its trademarked wellness programs. The firm's growing roster of wellness program client companies had become a valuable asset in J & J's recent expansion into fitness facilities management.

Medifit—a predominantly bi-coastal firm concentrating on cardiac rehabilitation, back-care, and fitness facilities management services—was another strong competitor. Having recently bolstered its management ranks with a coterie of experienced MBA's propelled by generous bonus incentives, Medifit had readied itself to pursue, in the near future, a vigorous program of geographical expansion.

Local fitness management providers (e.g., hospitals, universities, and entrepreneurs with limited geographical coverage) were often serious competitors in particular metropolitan markets. Not infrequently, prospective clients selected a local provider, in lieu of AHC or another national firm, because of the belief that a local provider would provide better service. Additionally, in smaller towns, local providers often enjoyed an advantage because of their status as a source of employment opportunities for local residents.

Among fitness competitors, there was little differentiation via staffing and program services. All hired college-educated fitness specialists to operate their facilities. Most provided a similar array of core services: (a) fitness testing; (b) incentive programs; and (c) planning and coordination of special recreational activities and educational programs.

AHC's Business Strategy

The main influence which had shaped AHC's competitive strategy had been Walker's assessment of several trends which he believed heralded continued growth of the corporate health and fitness market. These were:

(a) continued escalation of health care costs;
(b) reduced growth rate of the work force;
(c) increasing globalization of the U. S. economy, with increased domestic and global competition;
(d) growing research evidence documenting the cost effectiveness of fitness programs; and
(e) continued corporate out-sourcing of "support" type functions (e.g., health and fitness programs).

In Walker's view, these trends promised a sustained demand for AHC's corporate health and fitness services.

Unlike the team sporting activities found to typify the health and fitness programs described by 80% of the corporate respondents to a mid-1970s survey, AHC's strategy encompassed a program concept which emphasized regular cardiovascular activity, coupled with muscle toning exercises. Further, unlike commercial fitness facilities, AHC facilities were open only to the employees of the client company, which subsidized its employees' fitness programs.

From the outset, Walker targeted, exclusively, Fortune 1000 companies. Such a prestigious clientele, he felt, would be a key future marketing tool. Within this target market, AHC's strategic approach (as outlined in an internal document) consisted of: (i) maintaining a client-oriented organizational focus, (ii) targeting companies willing to commit to long-term health and fitness programming, (iii) providing thorough program and facility planning, tailored to the client's goals and culture, (iv) hiring and retaining highly qualified, capable, and motivated staff persons, and (v) adhering to sound and effective programming.

American Health Concepts provided its services nationally, allowing the dictates of the market to determine the location of new hubs. Further, the firm's goal of forging long-term client relationships, in order to maintain and build on its existing client base and obtain referrals from satisfied corporate customers, was evident in its 95% client retention rate and its 90% new business referral rate.

In Walker's judgment, the distinctive characteristics of AHC's services were: (a) quality assurance, (b) field support, and (c) customized software for tracking facility and participant activities. Quarterly regional staff visits to each fitness center were supposed to ensure the smooth operation of facilities. Standardization of fitness testing protocols and other procedures had been imposed to ensure program quality. And, the regional and corporate staffs were supposed to provide the support network needed to minimize the isolation of widely dispersed staff and ensure direction and control.

Organization and Management

Organizational Structure. American Health Concepts was functionally organized, with the operations area divided into regional offices (see Exhibit 4). Reporting to Walker were: (i) the Vice President - Corporate Development (task: services expansion); (ii) the Vice President - Administration (tasks: human resources, legal, risk management, and internal development); (iii) the Program Development Director (task: program standards); and, (iv) the Controller (tasks: finance and budgeting).

Additionally, three Regional Vice Presidents (i.e., Western, Midwestern, and Eastern regions) were located outside the corporate offices, but reported directly to Walker at headquarters. Regional Vice Presidents were responsible for regional planning and profitability, and for signing up new clients, preparing feasibility studies, and working with clients' architects on new facility designs. They were assisted by Regional Directors, who managed existing client relationships; hired, trained, and evaluated fitness center staff; and, conducted quality control audits.

Each fitness facility was managed by a Program Director. Larger facilities also employed an Assistant Program Director, two to three fitness specialists, one or two administrative assistants, and one or two facility attendants. In 1991, the average number of professional staff per site was 2.5. [The full-time staff was supplemented by "on-call" fitness professionals, who provided specialized services (e.g., aerobic instruction). The average temporary employee logged about 15 hours of service during all of 1991.]

Regional Directors regularly visited the fitness centers to meet with staff members and the client liaison. However, telephone calls were the most frequent form of contact. Facility staff were mostly on their own ("in their own world," in the words of one Regional Director). They interacted primarily with fitness program participants and the client liaison.

Selection and Development Systems. Fitness facility managers and fitness specialists were required to have at least a Bachelor's degree in exercise physiology or a related field. They also had to maintain current certifications in techniques germane to fitness program work (e.g., CPR).

Fitness center staff hiring, training, and quality control were performed at the Regional level, based on corporate policies and guidelines. Fitness center Program Directors were viewed as being technically competent and "people-oriented," although not always managerially proficient.

Measurement Systems. Regional Directors' annual evaluations of fitness facility managers' performance were based on these factors: knowledge, leadership, planning and organization, communication, staff supervision, results orientation, problem solving, creativity, administration, and interpersonal relations. (AHC Corporate specified minimum standards of performance for each criterion of evaluation.) These factors were weighted to arrive at an overall score.

Of concern to the Vice President - Administration was the "bunching of scores on the high side." "The present system emphasizes scores," she explained, "Clearly, our people are having a difficult time giving a number value to each factor, let alone weighing the factors based on importance."

Performance evaluations of Regional Directors and Regional Vice Presidents were performed by their respective superiors, and were based on informal (i.e., verbal) assessments of their overall effectiveness. All other AHC personnel—within the fitness centers and the regional and corporate offices—received formal (i.e., written) annual performance evaluations from their immediate superiors.

Rewards Systems. Officially, AHC had a "pay-for-performance," merit-based compensation system. However, in the aftermath of its 1985 switch to cost-plus pricing (due to increased client resistance to the erstwhile fixed-priced system), AHC's initial compensation and merit guidelines had ceased having across-the-board application to all employees.

Instead, the client had evolved as the key determinant of salary levels and merit pay increases for fitness center staff. With individual clients employing their own internal compensation policy in making judgments about compensation fairness for fitness center staff, a pronounced disparity in pay had arisen among AHC fitness personnel at different locations. For example, although AHC's bonus policy did not extend to fitness center personnel, occasionally certain clients would request bonuses for their particular fitness center staff. Because such clients were usually amenable to covering the cost of these bonuses in their cost-plus contracts with AHC, their requests were invariably honored.

Insulated from client compensation systems influences, Regional Vice Presidents and Directors received compensation packages comprised of a fixed salary (adjusted annually according to the superior's evaluation of the individual's performance) and a bonus (consisting of a prorated allocation of 25% of corporate profits, based on the individual's salary).

All other employees at the regional offices and at corporate headquarters received an annual merit pay increase based on AHC's merit guidelines. These guidelines specified the performance evaluation scores required to trigger a given percentage increase in annual compensation.

Nevertheless, a 1991 study of the "pay-for-performance" system had found no correlation between performance appraisals and merit pay increases. Of this finding, the Vice President - Administration observed: "Clearly, we don't practice what we preach. But, then, it's hard to do so, given the influences exerted by our clients."

Recent Operating Experiences

During AHC's early years, Walker had maintained direct personal operational control, frequently visiting the regions and individual centers and involving himself in decisions at the lowest levels of the organization. More recently, as the organization matured and as Walker gained confidence in the capabilities of his senior managers, he had relinquished operational control to the corporate staff, whose periodic reports were supposed to keep him abreast of important developments. Indeed, in relying primarily on interactions with the corporate staff (and on the annual senior management retreat), Walker had heretofore taken pride in having sufficiently "replicated" himself in his senior managers to permit him to take periodic multi-week vacations "without being missed."

Hence, the strength of the complaints and frustrations voiced at the recent management retreat had taken Walker by surprise. "I felt I had maintained a pretty accurate grasp of what was going on," he opined. "I guess I was wrong."

Headquarters versus the Regions. From the outset, Walker had propounded the view of the AHC infrastructure as an "inverse pyramid," with clients at the top, fitness center staff in the middle, and regional and corporate staff members at the bottom. This view was meant to reinforce his philosophy that "the client's interest comes first." With growth, however, fissures had begun to develop in the relationship between the corporate and regional staffs.

The corporate staff had begun to voice resentment over their perceived "subservient role" to the regions and over the regional staffs' "arrogant non-compliance" with policy directives. Specifically, the corporate staff perceived that regional staffs had a "rules are meant to be broken" attitude, and a "don't tell me what I can't do" mind-set.

The corporate staff viewed rules and procedures as being necessary for effective control of a far-flung operation; they viewed the Regional Vice Presidents as being hostile to direction from headquarters and as being intent on running their respective regions with as little corporate input as possible. "They [Regional staff] expect us to cater to their every wish whenever they contact us," explained one corporate executive. "But, when we need their cooperation, it's a totally different story." Further, corporate staff felt that regional managers failed to hold facility managers accountable for their neglect of administrative tasks (e.g., implementing company policies and filing required reports).

The Regional staff had a different view of the sources of the friction. "The folks at corporate tend to worship all their rules and policies," stated one Regional Director. "But, as much we travel, who has time to even read the mounds of regulatory trivia that comes out of corporate every week?"

Regional staff were equally adamant in the view that the frictions emanated from the "unreality" of corporate expectations. One Regional Vice President elaborated:

> Corporate wants to keep us on a tight leash. But, they don't respond fast enough to changing circumstances out here in the field. We need more leeway to respond to events as they occur. Client needs change. Employee expectations change. . . . Why do client contract reviews, training, and budget preparation have to be handled at corporate?

Added a second Regional Director, more caustically:

> Corporate has unrealistic expectations, especially about completion times for some of our projects. We set priorities each year, but they keep changing all the time. Out here in the Regions, we're supposed to have Jaguar dreams on Ford Escort budgets. . . . Yet, look at all the 'fat' at the corporate office! For what little support they provide us, their headcount is way too high. But, when I need to hire someone, I practically have to go before corporate wearing sackcloth and ashes!

Corporate versus the Fitness Facilities. Similarly, relations between fitness-center and corporate personnel had become increasingly strained. Corporate staff complained that center employees did not read (or paid little attention to) internal correspondence, and consequently too frequently called the corporate office with "unnecessary" queries. They further complained that facilities personnel, like the regional staff, were too insistent on "maximum freedom to do whatever they please" in running the facilities. "When they first come on board," explained the Vice President - Administration, "[center personnel] find our support services very useful. But, as time goes on, they come to adopt an 'adversarial position' on corporate standards and policies."

Conversely, fitness center personnel complained of being stymied by corporate policies and standards vis-a-vis their efforts to create innovative programs responsive to client needs, and of having to spend more time on company administrative matters than on serving clients. Further, fitness center employees felt that the corporate office had complicated, rather than streamlined, administrative processes. A cited example was the 1990 introduction of a new time reporting and payment system. Although it had been touted as a means of increasing payroll accuracy and producing checks in a more timely manner, most fitness center staff viewed it as "totally unresponsive" to their needs. For example, the changing of the payday from the 1st and 15th day of the month to the 7th and 20th of the month had created hardships for many center personnel, in that the new paydays failed to synchronize with normal mortgage or rent payment due dates.

Exacerbating the tensions between these two organizational levels was the tendency of fitness personnel to measure their AHC superiors against the administrative systems and policies of the "Blue Chip" companies which they served—a comparison which often heightened their sense of alienation from AHC. One fitness center manager complained:

> Take the policy whereby all 57 of us facility managers **must** 'fax' time sheets to one—just one—dedicated payroll 'fax' machine within a 24-hour period. It seems that everybody decides to fax at the same time, which creates delays and frustrations. I can't even begin to imagine [client served] ever imposing such nonsense on **its** managers.

Finally, the often pronounced compensation disparities between certain fitness staff and corporate staff occupants of "comparable worth" positions further inflamed relations. These disparities had even begun to cause resentment among lower-level Regional staff who (like their disgruntled corporate counterparts) might find themselves earning less than those skills-equivalent personnel fortunate enough to be employed at sites managed for particularly generous clients.

Regions versus the Fitness Facilities. The chief complaint levelled by regional staff against fitness facilities personnel concerned the lack of managerial abilities in many of the newer facilities managers. Regional Directors, in particular, complained of the "unreasonable workloads and stress" created by facilities managers who were incapable of independently carrying our their broad responsibilities. One particularly outspoken Regional Director elaborated:

> They have all the trademarks of youth: energy, enthusiasm, self-confidence, personableness, and for the most part technical competence; but, they know almost **nothing** about managing. I spend far too much of my time coaching and monitoring.

While a few fitness center managers acknowledged the need for improved managerial skills, their major concern was the stress experienced in trying to "please" their Regional superiors while remaining responsive to their clients. Explained one facility manager: "The regional office seems to forget that we have a **client** to satisfy. There's more to running a center than filling out paperwork. Without a satisfied client, **none** of us has a job."

Another Program Director complained of feeling "insulted" by the time reporting requirement—a task which she felt interfered with her priority efforts in increasing the center's participation level. "As a professional," she began, "I know how to allocate my time. Why have me duplicate my own time-tracking and allocation system [by] providing my Regional Director with these ridiculously detailed breakdowns?"

Action Imperatives

Despite AHC's record of success in pursuing its corporate mission, Walker knew that increasing competition in the corporate health and fitness market necessitated removal of any and all impediments to AHC's ability to maintain its competitive vitality. Of particular concern was the prospect of diminished financial performance, absent a counter-balancing of the centrifugal forces threatening to undermine the firm's ability to serve its diverse and far-flung clientele while avoiding what Walker described as "the traps of excessive decentralization." It was imperative, he felt, that AHC's future prosperity not be compromised by indecision on the problems requiring corrective action.

Exhibit 1
American Health Concepts, Inc.
Summary Information on the AHC's Principal Competitors

American Corporate Health Programs (ACHP)

Case Base: National

In Brief: Manages fitness centers and offers consulting services for Fortune 500 Companies, hospitals and fitness clubs. [Founded and run by a former professional athlete who holds a master's degree in exercise physiology and an MBA degree.]

Chicago Corporate Fitness Associates (CCFA)

Client Base: Upper Midwest

In Brief: Runs corporate fitness centers, and owns/manages several multi-use fitness facilities. Plans to establish/manage fitness facilities in corporate development centers. Specialty services: physical therapy and back-conditioning and rehabilitation. [Run by a former regional president of the Association for Fitness in Business who started firm as a hobby. Has MBA and a master's degree in biomechanics.]

Corporate Fitness Resources (CFR)

Client Base: West Coast

In Brief: Formed from an aerobics franchise. Wide range of consulting and management services. Rapidly expanding in its corporate market. [Founder/president was a plant manager for a commercial bakery before buying the license that was the base for the firm.]

Fitness Systems (FitSys)

Client Base: National

In Brief: Largest/oldest fitness firm. Deals exclusively with corporate clients [Owner/president formerly served as executive assistant to the secretary of H.E.W. and later as a member of the White House staff. Holds an MBA.]

Health Fitness Corporation (HFC)

Client Base: National

In Brief: Founded as a health promotion/fitness consulting firm for hospitals. Forte is management contracts with hospitals that serve corporations. Also manages facilities in commercial office buildings. [Owner founded firm in 1981; sold it to Abbott Northwestern Hospital (MN) in 1982; and bought it back in 1987. Was a clinical exercise physiologist with cardiac rehabilitation experience.]

Johnson & Johnson Health Management (J&J)

Client Base: National

In Brief: Specializes in managing fitness centers that emphasize wellness programs. Owns wide range of health promotion programs and employs a training staff to implement them. Current division president is J&J executive with more than 20 years experience in marketing and management.]

Exhibit 1 Continued

Fitcorp

Client Base: New England

In Brief: Has diversified into ownership of public multi-use facilities and health clubs. Specialty services: on-site sports therapy and many extensive wellness programs. Was bought in 1989 by a venture capitalist who plans to take firm national. [Formerly, owner/president was the fitness director for a local YMCA. Holds a master of science degree.]

The Fitness Company (FitCo)

Client Base: International

In Brief: Specializes in joint ventures and upscale corporate facilities — e.g., the fitness center on top of the World Trade Center in Manhattan, which the company designed and built and now manages. Operates fitness facilities in hotels around the world. [Owners/president is a former teacher who has worked as a tennis pro and a racquet club manager.]

Medifit of America

Client Base: East and West Coasts

In Brief: Formed from merger of a rehab firm with a cardiovascular health institute affiliated with the New York City YMCA. Operates back-care centers, cardiac rehab programs, and independent fitness centers; offers technical services; and manages corporate fitness centers. [Key executive is former fitness director of two New England YMCAs. Has MBA degree.]

Sports Training Institute (STI)

Client Base: National

In Brief: Specializes in one-on-one conditioning (i.e., will provide a personal trainer for every participant in a facility). Specialties: physical therapy/ exercise for diabetics and pregnant women. Also operates facilities in hotels and commercial office buildings. [Owner has Ph.D in exercise physiology and sports medicine.]

Source: Company records.

Exhibit 2
American Health Concepts, Inc.
Company Information on the AHC's Principal Competitors

	ACHP	CCFA	CFR	FitCorp	FitCo	FitSys	HFC	J&J	Medifit	STI
Year Founded	1976	1982	1984	1979	1980	1974	1981	1986	1976	1975
Number of Current Corporate Mgt. Contracts	6	9	10	7	3	65	23	10	61	8
Average Managed Budget (in '000s)	$155	$140	$85	$150	N/A	$160	$100	N/A	$150	N/A
Number of Employees	60	19	45	32	33	141	60	90	139	N/A
% Full-Time	100%	84%	50%	56%	24%	94%	58%	78%	77%	N/A
Tenure (years):										
Specialists	3	1	1	1	2	1.3	2	1.5	N/A	N/A
Facility Mgrs	7	2	3	2	4.5	2	3	2.5	N/A	3
Minimum Credentials:										
Specialists	B/IN/C	BC	BC	BC	BC	BC	BC	BC	BC	BC
Facilities Mgrs	MEC	BC	BC	BEC	MC	BEC	BEC	MEC	BEC	BEC
Wellness Staff	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes

Credentials & Experience Required:

B = Bachelor's
M = Master's
E = 2-3 yrs experience
C = CPR certification

Exhibit 3
American Health Concepts, Inc.
Selected Information from 1991 AHC Survey of Clients of Its Principal Competitors

	ACHP	CCFA	CFR	FitCorp	FitCo	FitSys	HFC	J&J	Medifit	STI
No. of Eligible Employees (range)	900-3,300	4,800-6,000	450-2,500	1,350-7,700	N/A	1,500-2,100	1,758-4,100	750-1,370	240-4,000	500-950
% Participation (range)	13-40	25-44	27-40	11-39	N/A	33-65	10-46	40-75	25-57	53-65
Size of Contract (range, in '000s)	$120-180	$175-225	$14-30	$90-168	N/A	$250-310	$108-165	$125-205	$70-200	N/A
Cost per Eligible Employee (range)	$126-145	$29-48	$5-45	$15-70	N/A	$120-135	$45-75	$170-195	$20-150	N/A
No. of Years with Company (range)	2-4	2-3	2-5	2-4	N/A	.5-3	3-5	1-3	.5-3	4-8
Averaged 2-Year Turnover Rate:										
Specialists	35%	33%	45%	60%	N/A	12%	85%	22%	0%	6%
Managers	21%	0%	90%	25%	N/A	5%	37%	0%	20%	0%

Source: Company records.

Exhibit 4
American Health Concepts, Inc.
Chart of Corporate Reporting Relationships

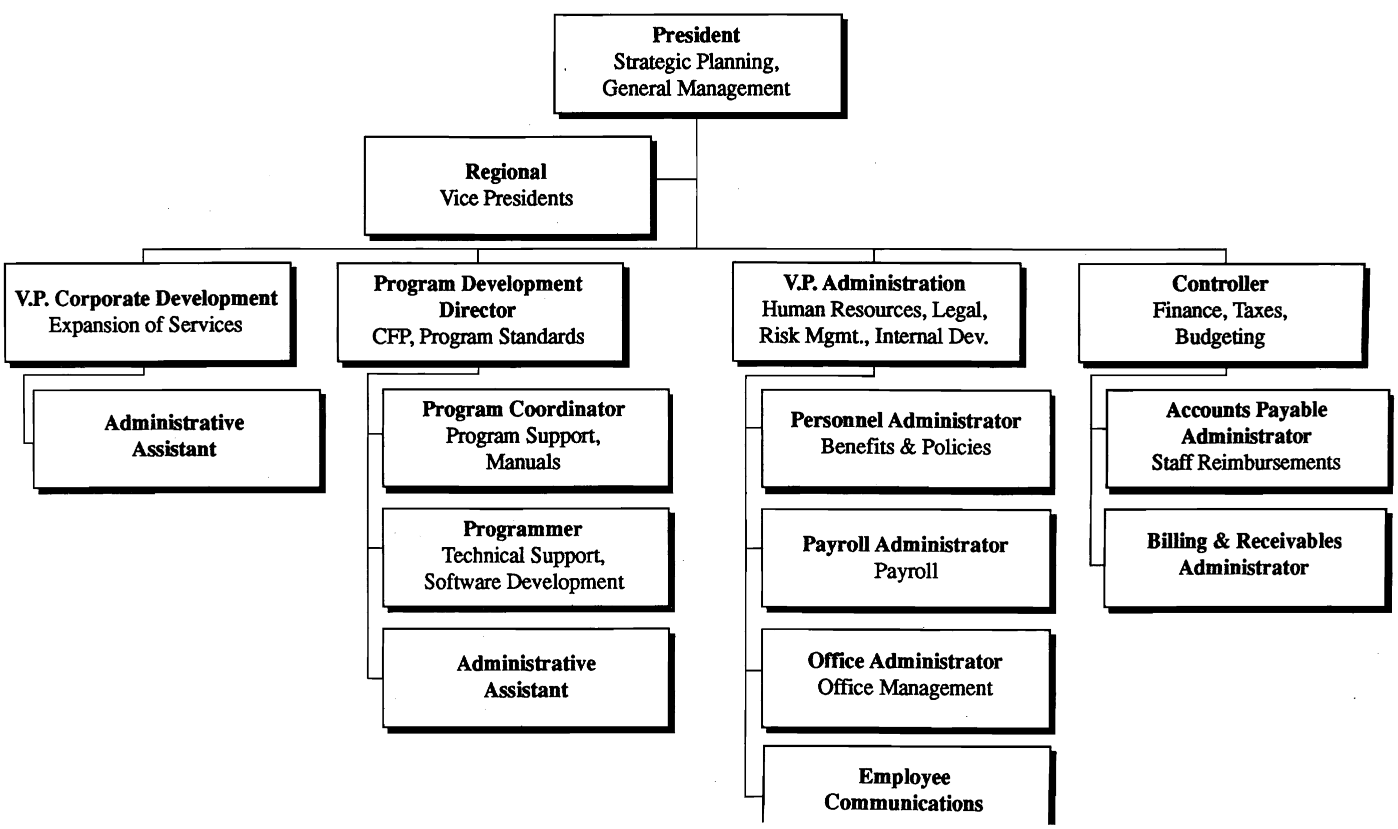
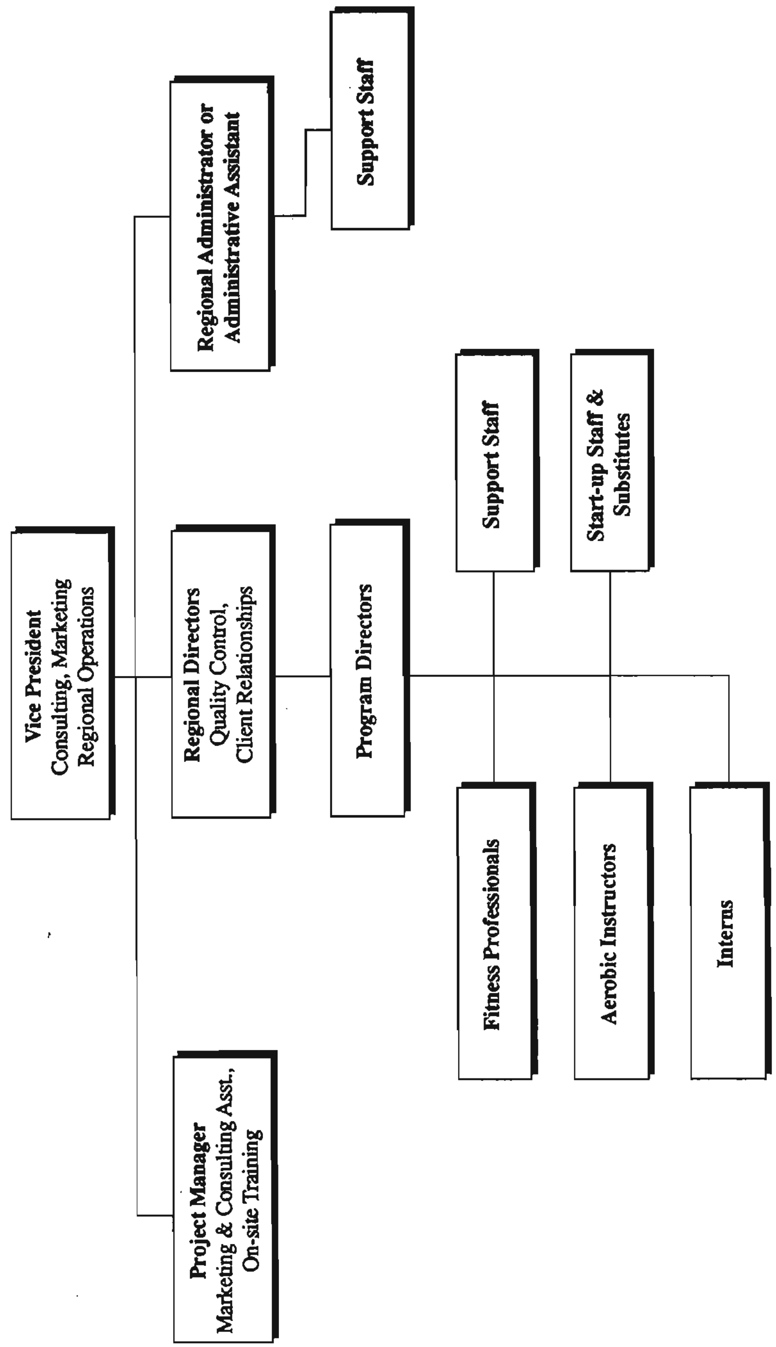


Exhibit 4 Continued
American Health Concepts, Inc.
Chart of Regional Reporting Relationships



EKU Realty and Rentals

Joe Thomas, Middle Tennessee State University

Lou Stevens was facing a difficult time in his partnership with John Rogers. John and Lou had been partners for the past six years in a small, unincorporated, apartment rental business. As partners, they also had made a profit building some apartments and houses. The main source of difficulty as Lou reflected on the situation was John. John had recently become irritable with Lou and accused him of not doing his share of the work in the partnership. The situation was compounded by Lou's recent acceptance of a new job requiring him to move approximately 80 miles away. Lou and John had been friends for a long time and their business venture together generally had been successful. Lou hated to terminate the business relationship, but did he have any choice?

History of the Partners

Lou was in his late '50s when the partnership started. Lou was raised in the mountains of Eastern Kentucky. Although his family was of "modest means," Lou had worked his way through Union College, earning his teaching certificate. While teaching high school, Lou completed a master's degree at the University of Alabama. As Lou was finishing his master's, a faculty position opened at the University. Although the job was temporary, Lou decided the work would be enjoyable and accepted the position. While working at the University, Lou started work on his Ph.D. Once he had finished his doctorate in biology, Lou accepted a faculty position at the University of Kansas.

Lou was forced to leave the University of Kansas. He was not meeting publishing expectations at the University and was denied tenure. Lou's assessment of the tenure situation was that, "I had to make a tradeoff between spending my time writing and doing research and spending time with my wife and four kids. You can find many jobs in this field, but you only get one chance to raise your family. We enjoyed spending time together, and my teaching salary let us live comfortably."

It was during his time in Kansas that Lou first met John. John had entered the University of Kansas to begin working on his doctorate in biology. Lou had helped John study for his exams and served on the committee supervising his dissertation. Despite the twenty-year difference in their ages, they worked on various projects together and became friends. Shortly before John graduated, Lou accepted a job teaching at Eastern Kentucky University (EKU) in Richmond, Kentucky. John graduated and accepted a teaching position at a university in Illinois. A few years later, Lou learned of an opening at EKU and asked John to apply. John was hired and started teaching biology at Eastern in the fall of 1984.

John had started playing the stock market while teaching in Illinois. After a couple of years of losses, John became successful at investing. Using money taken from his retirement fund when he changed jobs and some "luck," John converted his $10,000 retirement fund into nearly $40,000 in approximately one year. His teaching income and additional investment income soon put John in the 40% tax bracket.

John was happy to move to Eastern with Lou. They had been good friends in Kansas and had maintained their friendship throughout the years. After moving to Eastern, John maintained his investments in the stock market. The returns from the stock market were considerably larger than John's teaching salary. However, John continued to teach because "The stock market can be pretty fickle. A lot of people make big money in the market only to lose it in some bad stocks. We can always live on my teaching salary if we have to, but our trips, new clothes and nice cars would have to go. As much as I'd hate to, we also could live in a smaller house."

Real Estate as an Investment Opportunity

Enrollment at EKU had experienced many years of increasing growth. The Richmond and nearby Lexington areas also were growing due to a prospering local economy. Real estate prices generally were increasing at an annual rate of 10 to 12%.

In early 1985, John attended a seminar where the tax advantages of owning real estate were discussed. John saw several advantages to investing in real estate, especially rental property. First, diversifying his investments appealed to John. Second, real estate appeared to be a safer investment than many of the stocks John had been buying, although the rate of return was lower. Also, the tax advantages were substantial. Depreciation schedules allowed assets to be depreciated quickly, offsetting the income produced by the property and from other sources. Gains made from the sale of real estate were taxed as a long-term capital gain with a 60% exclusion. For example, in John's income bracket, taxes on a $10,000 profit in the stock market would be 40% or $4,000. If a $10,000 capital gain was made on real estate, the tax would only be $1,600. Tax losses resulting from accelerated depreciation schedules and other business expenses associated with rental property also could be used to offset income earned from the stock market.

A further advantage of real estate was the small down payment necessary. The equity requirement for buying stock on margin was 50% of the stock's value. Real estate could be purchased with only 10% down. John learned that with $50,000 he could buy $100,000 worth of stock or $500,000 of real estate. With "creative financing" such as the owner accepting a secondary note for the down payment, it was possible to own real estate without using any of his money.

The benefits of real estate ownership sounded attractive to John. His goal in life was to become independently wealthy. A more immediate objective was to be a millionaire by the age of 40. Investing in real estate looked like a way to move closer to this end. Unfortunately, John knew little about construction or home maintenance. John had either rented a home, or had earned enough money to hire someone to do most repairs.

John researched the local rental market. Growth in the local economy had increased house prices faster than it had rental rates. It seemed that with the current prices of houses, buying them to rent was, at best, a break-even venture. Apartments, however, seemed to have a better rate of return. John found apartments in Richmond could be segmented into two groups: student slums and contemporary apartments. Within walking distance of campus were generally the "student slums," older houses converted to apartments and sleeping rooms. Still, the apartments were readily rented by students who walked to classes. This area was considered a mature area. There were no vacant lots. The only way to increase the number of apartments in the area was to convert existing houses into apartments.

The second type of apartments was the more contemporary apartments. These complexes were equipped with the amenities of swimming pools and on-site laundry facilities. These units were at least a mile from campus. Such apartments were primarily rented by young couples, professionals, and students willing to drive to campus and search for a parking place. The University's farming

operations to the east of campus, the older sections of town south and west of campus, and rugged terrain north of school made it unlikely that the modern apartments could locate much closer to campus. Student renters would either be forced to rent older apartments close to campus or drive to and from the more contemporary units.

Forming the Partnership

At coffee one morning, John was explaining the benefits of real estate investments to a group of colleagues, including Lou. Lou asked John if he would be interested in becoming partners on some rental property. Lou was approaching retirement age and was interested in buying some rental property, using the income to supplement his retirement. Lou had a friend from church who owned a large house near the university that would make "ideal" rental property. It was within walking distance of the university and could be easily converted into apartments. For only $5,000 each in equity, John and Lou could buy and remodel the home.

After a couple of informal discussions, John and Lou agreed on the major duties of the partnership. John was a "people-oriented" person and would be responsible for renting the apartments and for collecting the rent. Lou would do most of the major maintenance such as plumbing and electrical repairs. Lou's son worked construction and could be hired to do major remodeling. Each partner would share equally in routine maintenance work such as painting, cleaning and lawn care. Lou did not want any more contact with the renters than was necessary. However, Lou did agree to be the "heavy" in dealing with problem renters.

The First Property

Based largely on fifteen years of friendship and compatible interests and abilities, Lou and John purchased their first rental property. They orally agreed to split any profits or losses equally. They each contributed $5,000 toward the down payment and remodeling. The remaining $90,000 was borrowed from a local bank. They received possession of the property in mid-July and began remodeling within a week.

The remodeling consisted of adding an entrance for access to the upstairs apartments, closing internal stairs to make more living space, and adding two bathrooms and kitchens. Lou's son Len and some of Len's college friends did most of the remodeling work. As John observed, "Their work was rough, but it was ok for rental property. However, they sure were slow. They could have finished much faster if they had planned their time better. They spent much of their time drinking beer and running to the store for building materials. But," John continued, "Len was Lou's son and we didn't have much choice but to let him do the work. Even if I had wanted to, I couldn't really fire Len. Besides, we couldn't have gone looking for another builder and had a chance of finishing the apartments in a little over a month. We were pretty well at Len's mercy."

The apartments were to have been finished by August 15. John showed the apartments to several students in late July. Although they liked the location, one block from the main part of campus, most were turned off by the mess. John finally convinced four groups of students to rent the apartments with the assurance that they would be ready when school started August 17. On August 13, Len told John that he needed to order the carpet for the apartments. John was angry that Len had waited so late to tell him to order the carpet. Len said he assumed John would know to place the order. Lou and John discussed the problem. They concluded that it was a result of their inexperience and that it was not likely to happen again. It was also at this point that John had to deal with his first set of dissatisfied renters. The apartments were not ready by the 17th. John told the renters he would not charge rent until the apartments were finished. The renters agreed and began paying rent effective August 25.

The renters John recruited soon created problems. Two sets of renters were constantly late paying their rent. Once Lou had to visit them to assure them that if the rent was not paid on time, he personally would evict them. Lou laughed about the incident later saying that he was apparently an effective "heavy" as the students started paying the rent on time.

Lou had boasted too soon, however. At the end of the fall semester, one set of renters moved out without paying December's rent. The $100 deposit was less than half of the month's rent. The biggest problem with the renters moving out, however, was that they left the apartment in serious need of cleaning. Lou had planned a trip to San Francisco to visit his daughter over the Christmas vacation and was not available to help John clean the apartment. But, as John noted, he could not rent it full of the junk the renters left behind. John and his wife spent three days cleaning the carpets, kitchen and bathroom.

As John reflected back on the experience, he observed two things. "First, you have to pick your renters carefully. If you can get good renters you have few problems. But more importantly, I learned that the best renters show up in July. We had some really good prospects look at the apartments in July, but they were not willing to accept my word that the apartments would be ready for them to move into in mid-August. If you are going to get the good renters, you have to have your apartments ready to show in early July. I guess we also learned that our deposit was too small. Some renters will skip out to avoid paying a month or two of rent and look for another apartment the next semester."

Expansion and Diversification

The partners bought their next house in May of the following year. Lou was a little concerned about how he was going to generate enough money for the down payment, but John convinced the owner to take a second mortgage in lieu of the down payment. With this bit of "creative financing," Lou and John bought the $50,000 house with no money down. This house required substantial remodeling to convert it to rental property. It was decided to convert the existing house into two apartments and to build two more apartments on the back of the home. Len did not feel comfortable doing the building part of the project. John found two men who agreed to do all of the construction work except finishing the interior. Lou convinced John that the problem with Len had been the result of the unrealistic time pressures on the first remodeling project. They agreed to hire Len to finish the interior of the building.

One small problem surfaced during the summer. Lou owned a cabin on Laurel Lake, about 60 miles south of Richmond. As Lou explained to John, "We have spent the last six summers at the lake. It is our time to spend with our kids and grandkids. We wouldn't miss this time for anything in the world. You take care of the rental property and call us if anything 'big' happens. We'll come back about August 1 and help finish the apartments."

By August 1, the apartments were not finished. However, this time Len finished one apartment at a time, and had all but one ready when school started in the fall. Fortunately, John had anticipated a late finish and had decided to wait until the start of the semester to rent the last apartment. Rather than pay Len for his work, it was agreed that he would live in the unfinished apartment rent free until it was finished. Once Len moved into the apartment he found other construction work and only worked on finishing the apartment in his spare time. This arrangement might have worked except Len's sister in California found him a job in November and Len moved. The apartment was unfinished.

Both Lou and John were upset with Len's failure to complete the project. However, they agreed that the loss of three mont's rent while Len was in the apartment was only about $600 and not all that significant. They also decided that the most pressing problem was to get the apartment finished so it could be rented in January. John had been impressed with the work done by the two builders hired earlier to frame the new construction. They agreed to finish the remaining apartment for a nominal fee. The total cost of the remodeling was about $40,000 and was financed through a local bank.

John recognized that there were some minor problems in the relationship with Lou. However, he also saw great opportunities to make money in the rental business. Two lawns to mow was not really a big problem given the possible financial benefits. Most of the other problems were dismissed as relatively minor and resulting from inexperience.

John Enters a New Partnership

John was excited by the opportunities to make money. Not only were the apartments providing a positive cash flow, but John's stocks were also making money. John wanted to expand his rental holdings to diversify out of the stock market. He also wanted to provide a tax shelter for gains from his stocks. That fall John found a large house on three lots only two blocks from campus. When John approached Lou about buying this property, Lou said that at that particular moment he could not afford the required $5,000 investment. It looked like a great buy so John approached his brother Robert about buying the property. Although Robert lived in Louisville, over 100 miles away, he trusted John's judgment and bought into the property.

John called on the two men, Charlie and Jeff, who remodeled the second house. Again, John was impressed with their work. Converting this house into apartments was relatively easy and did not take much of John's time. This slack time allowed John to plan his investment strategy and reflect on his experiences in the rental business. John developed what he called "principles of good renting" that he used in selecting renters. These principles included:

Try to rent to couples. They generally are a little more mature than many renters and are better able to pay. One or the other of the couple probably has a job.

Students are the best market for our rental property as it is located close to school. In fact, many students park in front of our property and walk to school, so location is definitely one of our strengths.

When renting to groups of students, rent to a group of girls. Girls are not as likely to damage property as guys.

Rent to quiet students. It is better to rent to people who are not very sociable. "Party people" have friends over, they spill things on the carpets, and are generally louder and harder on an apartment. Their guests also take other renters' parking places.

It is better to charge a rental rate slightly below market and select your renters carefully. Good renters will pay on time, appreciate the quality of your apartment, and will likely stay for a number of years.

Be very careful in renting to people who are moving from one apartment complex to another. If they didn't like the last complex, they probably won't like yours either. Similarly, if they are trying to get away from a "bad" roommate, watch out; they probably won't get along with your other renters either.

Match your renters to the property. The apartments Lou and I own are pretty rough and we rent them pretty cheap. If someone comes in who looks like they might be a "problem," I show them that property. The property I have with my brother is in better condition. I direct the good prospects toward it.

John and Robert also decided during the year to build a quadruplex consisting of four apartments on the oversize lot that was part of the house they had just bought. John again called on Charlie and Jeff and negotiated a contract for the new building. The builders did a good job and construction was progressing on schedule in terms of time and cost. As the project was nearing completion in late July, a realtor approached John about selling the new structure. A sale was quickly negotiated, and John and Robert each cleared about $15,000. Their only investment in the property had been the interest they had paid on the loan during construction of the building.

Entry Into House Building

The profit from the sale of the quadruplex provided unplanned capital. John began thinking about entering the speculative house business. ("Spec" houses are constructed by builders with no known buyer. The builder is speculating that a buyer will be found.) John could see no reason large profits could not be made on "spec" houses if they could be built on the same cost basis as apartments. Growth in the Richmond area had created substantial demand for houses.

Jeff and Charlie were willing to build the houses. John also liked the fact that they were willing to work on an hourly rate. The hourly rate would allow greater flexibility in changing plans. As this was John's first entry into home building, he anticipated the need to make changes in plans after construction started. John wanted a partner to share in the financial risks and rewards of the venture. He first approached his brother, Robert. However, Robert had recently accepted a transfer to Florida and did not feel that he could invest in real estate when he would be so far away.

John then checked with Lou to see if he would be willing to invest in a spec house venture. Their two apartment buildings were generating a small positive cash flow so Lou was willing to undertake another venture with John. At John's urging, two houses were started in early spring. The houses were on adjacent lots. John felt confident that significant cost savings could be obtained from building two houses simultaneously. Although Lou preferred to reduce the risk and build only one house, John convinced him the savings would be substantial.

The houses were started during the school year. Lou occasionally worked with John between classes and on weekends to plan the interior of the homes. It was at this point that their different expectations about the cost and quality of construction became obvious. Lou explained the situation as follows: "I wanted to build an inexpensive house for the neighborhood. By cutting our costs to the bone, we could build a house that looked good. Most buyers are more concerned about the color of carpets and size of bedrooms and the number of bathrooms than they are about the quality of construction. The look at the doors and say, 'Yes, it has doors.' They have no idea whether the door costs $45 or $145. With nearly 20 doors in a house, you're talking about nearly $2,000 difference in the cost of a house on doors alone.

"John wanted to build a house like he would like to live in. He wanted to sell a house of custom built quality at the price of a spec house. I'd certainly like to buy a house like that, but you can't make any money building such houses."

John had a different interpretation of the demand for houses. "There are three things in life people appreciate: quality cars, quality clothes, and well-built homes. I have always lived in as nice a house as I could afford and I think most everyone else wants to, too. Lou is an exception to this rule. He comes from a poor family and has always been content to live modestly. He probably wouldn't buy one of these houses."

John and Lou turned to a mutual friend who was a realtor to help them decide the quality of house to build. The realtor explained that it was possible to build a house with quality features the typical buyer would not recognize. She also added a competent realtor could show potential buyers those features that improved the quality of a home. Based on this advice, the houses were finished

with "quality" taste. Although the wallpaper and wood trim that John had wanted were dropped, the final package projected an image of quality construction. In fact, the realtor who had advised John and Lou on the construction advertised the homes as "custom-built quality at spec house prices." The houses were priced at the high end of houses sold in the development. John calculated that if the houses sold at the listed price, he and Lou could split a $7,000 profit from each house.

The houses were near completion in May. The realtor did not aggressively try to sell the houses until they were almost completed. She argued that to sell for top dollar the houses must be nearly finished so that buyers could see the extra quality. She also recommended that they develop a name for their construction company as it would help generate customer identification and produce a slightly higher selling price. Since Lou and John did not have time with the semester ending to decide the future focus of their fledgling business, they quickly agreed on EKU Rental and Realty. They believed the name described their rental property and gave them the option of building more houses or apartments if they desired.

Beginning in May, the realtor started hosting weekly open houses to attract buyers. Many people looked at the houses but no offers were made. Lou and John asked about lowering the price. The realtor told them to be patient, that only two buyers were needed, and that they would come along. Lou countered that the interest on the houses was running about $1,500 per month and that holding the houses was costing the partners money.

In September, offers were received for both houses. The price received for each house was about $5,000 below the asking price of $79,000. The houses were sold at a price that allowed Lou and John to recover their land, building costs and realtor's commission. The loss from the venture was the interest for the months of June through September. Lou and John agreed they had learned a lot from the building venture. They also were quite happy to have sold their first houses at only a small loss. They also concluded that the spec house business was very competitive and that any future construction, if any, should be of less expensive houses.

Future Directions for the Partnership

The population growth in the Lexington/Richmond area had been substantial. The announcement of a new Toyota plant in the area attracted a number of industries. Not only was the car plant coming to the area, but so were firms to build component parts. Service businesses ranging from McDonald's to offices of major accounting firms were moving into the area to service the anticipated growth. This growth also attracted many builders. Due to continuing low oil prices, many builders from Texas and Louisiana were moving into the area. Building officials were excited about one builder from Louisiana moving into the area with plans to build 200 new houses. A Houston builder was also rumored to be planning a new development with 600 houses. The two builders were planning to build more new houses themselves than had been built in the Richmond area in the past eighteen months. Lou was concerned that this much building would create a glut of homes, depressing prices. John was more optimistic and argued they had learned their lesson and that they could compete successfully against any firm in the home building business.

During the summer that the houses were on the market, Lou again moved to the lake for the summer. John was left with maintaining the apartments and the lawn work in addition to his teaching responsibilities at the university. While one tenant was out of town for the weekend, a water pipe broke in her upstairs apartment. The pipe flooded the apartment and leaked into the unit below, damaging the ceiling and walls of the lower apartment. Lou returned from the lake to assess the damage. Lou suggested that they hire a professional carpet cleaner to clean the upstairs carpet and remove the excess water. The tenant wanted John and Lou to replace the carpet.

Lou suggested repainting the ceiling in the downstairs apartment with a paint that would cover the water stain. The wall could be easily covered with paneling. John preferred to replace the damaged portion of the wall with new sheet rock and have the room re-papered. This would improve the appearance of the whole apartment and probably would allow them to raise the rental rate by $5 per month. Lou argued that the best way to increase their profits was to hold all costs to a minimum. The renters would not really appreciate the improvements. John had to agree that he had seen renters move to a smaller apartment if they could save five or ten dollars per month on rent. Since John was going to be the one responsible for overseeing the repair work, Lou agreed to having the wall repaired the way John wanted it. But, Lou made it clear he thought such maintenance was a waste of money.

Lou then returned to the lake to resume his visit with his daughter and grandchildren from California. During a visit with his family to his old alma mater, Union College, Lou learned of an opening for a department head in the Biology Department. Since Union was only about 20 miles from Lou's lake house and Lou had strong loyalties to his alma mater, he applied for the position. After a month of interviewing other applicants and negotiating salary, Lou was hired to fill the position.

Lou was now in a position of having to decide what to do with his property in Richmond. He had considerable equity in his personal home. His realtor friend assured Lou that since the home was relatively inexpensive, it should sell easily. However, the rental property was a potential problem.

The market for rental property was depressed. New tax laws had lengthened the time over which property could be depreciated, reducing the tax advantages of owning rental property. Earlier tax reforms had eliminated the investment tax credit, also reducing the attractiveness of rental property as a tax write-off. Many investors were electing to sell their properties. However, changes in bank lending requirements for rental property were making it difficult for investors to obtain loans. According to articles in financial publications, rental property had dropped in value by 10% to 15%. Although this drop in value was expected to be temporary, the current market value of the rental properties owned by Lou and John were about what they had invested in them. Waiting to sell the properties for a couple of years might increase their value by $30,000 to $40,000. If Lou insisted on selling the property, John would be forced to accept the depressed prices. Given the recent disagreement with John about not being available to help maintain the property, Lou was not sure if he could expect John to continue managing the property. But, John still wanted someone to be a partner and share the risks and rewards on additional spec houses. Lou reasoned that Richmond was only 80 miles away. He could help John on weekends and some during the summer. Maybe that was the solution. But, then....

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