

CASES in FINANCIAL MANAGEMENT

Third Edition

VISCIONE - ARAGON

Cases in Financial Management

DEDICATION

Jerry Viscione wishes to dedicate this book to his mother and father, and sister and brother.

George Aragon wishes to dedicate this book to his mother and father, and Mummoo.

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Preface

The third edition builds on the strengths of the prior two. New cases and revisions to existing cases reflect recent developments in theory and practice of financial management. However, the basic framework — variety of case types — has been retained.

The case method of instruction has long proved to be a useful vehicle for teaching financial management. Cases provide an opportunity for students to develop the ability to implement financial training by learning to do the following:

1. Identify problems in unstructured contexts
2. Resolve multi-issue problems
3. Formulate alternatives
4. Make decisions and develop plans of action

Many students accustomed to courses that focus on lectures, discussion of readings, and/or homework problems have difficulty adjusting to the case method, particularly if they have had little or no management experience. To help students with the adjustment process and to increase the benefits gained from this useful method of instruction, we provide three types of cases. This range enables students to bridge the gap between end-of-chapter problems and exercises and unstructured cases.

The first type of case is similar to the more extended end-of-chapter problems and exercises. Because these are the most structured cases in the book, they are tailored to emphasize skill development rather than problem identification and decision making. However, in almost all these cases the student will be required to do some issue specification and decision making. These cases will be guided and will have something close to a “right” answer or a narrow range of “right” answers. Approximately 40 percent of the cases in this book are of this type, and many are based on our work or on consulting experiences.

The second type, comprising about 25 percent of the cases in the book, provides the central span of the bridge and is more open-ended than is the first type. In these cases, emphasis shifts from technique development to identifying problems, formulating alternatives, choosing the appropriate analysis, and reaching a decision. The situations are presented more in context than are the cases of the first type; however, these cases are structured to some extent to help the student apply concepts and techniques to decision making and to demonstrate to students that problems and decisions are interdependent. For example, often the solution to one particular problem has problematic implica-

tions for other issues confronting the manager; the second case type demonstrates this kind of situation.

The third type, approximately 35 percent of the cases in this book, presents the situations in contexts similar to those that confront managers in reality. These cases emphasize the importance of defining issues clearly, of making and defending a decision, and of designing a program of action to implement the decision. These resemble the more traditional type of cases, and they are sometimes referred to as Harvard-type cases.

The fifty-eight cases are divided into six parts — Financial Statements and Time Value of Money; Financial Analysis and Forecasting; Working Capital Management; Capital Budgeting; Long-Term Financing and Dividends; and Comprehensive Cases. We include in each section, except for the last, some of each of the three types of cases. The Financial Analysis and Forecasting and the Capital Budgeting sections include a larger proportion of type one cases because of the importance of learning techniques such as the preparation of cash budgets; however, a number of type two and three cases are also included in these two sections.

We noted in the preface to prior editions that many users would appreciate the large number and the great variety of cases on financial analysis and working capital. The third edition strengthens that feature. We should mention that this emphasis has not been at the expense of other vital areas, such as capital budgeting and long-term financing. Moreover, we continue to include a number of cases that expose students to financial management in not-for-profit organizations.

CHANGES FROM THE SECOND EDITION

1. The first section of the book was expanded to include the time value of money. Two cases on this topic — Marvex Computers, Inc. and The Smiths' Mortgage Alternatives — were added. Each is designed to enable the student to review and extend his or her understanding of the time value of money.

2. Risk-Return Illustrations and Capital Budgeting Exercises, new cases, have been added, and Cost-of-Capital Illustrations has been revised. We have found that it is sometimes useful to review problems before turning to type-one cases. These exercises facilitate this process.

3. Other new cases are Newko Distributors, Inc.; Fun-Tek, Inc.; Regent Manufacturing Company; and XXX, S.A. These deal with cash budgeting, financial forecasting, trade credit, capital budgeting, and leasing. More detailed descriptions of the nature and scope of all new cases are provided in the Instructor's Manual.

4. Ten cases have been revised to update their context. In addition, some names have been changed to reflect the new context. These are Super Sounds; Paducah Portrait; Children's Memorial Hospital (A); Ellen Cosmetics Company, Inc.; Capital Budgeting Exercises; The Daily Ledger; Note on the Capital Asset Pricing Model; Javits Company; Cost-of-Capital Illustrations; and Beaver Corporation.

5. Finally, we have carefully reviewed all cases and teaching notes retained from the prior edition.

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Jerry A. Viscione
George A. Aragon

Note on Case Analysis

This note provides an overview of the case method of instruction and addresses several issues that are especially relevant to students unaccustomed to this educational technique. The case method of instruction has two distinct and important aspects: *case analysis*, which involves the identification of relevant issues and problems for resolution, the design of solutions that are both workable and theoretically proper, and the phased implementation of the proposed solution or plan of action; and *case presentation*, which involves the cogent reporting of the analysis, the “selling” of the case analysis publicly, anticipating and rebutting criticisms and questions, modifying the preliminary analysis and solution when necessary, and building an effective consensus in support of the proposed plan of action.

The two aspects of the case method are interrelated, the second being a verbal presentation and defense of the first. However, the second aspect involves a separate, crucial characteristic of the case method: the process of synthesizing counterarguments, criticisms, and concerns. This is a political process of building a consensus around the most workable solution, which may not be the solution initially proposed. Indeed, the case method is not usually concerned with the “correct” or “ideal” solution to case issues and problems: such a solution may never be discovered or may be impossible to implement. Because case presentation is essentially an oral and evolutionary process, this note is concerned with the first, analytical, aspect of the case method.

Case analysis should begin with clearly specified objectives and goals. This permits a systematic approach to collecting and classifying relevant evidence¹ and, by logical inference, relates case facts to their probable effects. Out of the process of relating facts to probable effects emerge working hypotheses about what is “wrong” or “right” about the company’s financial management. The working hypotheses represent an interpretation of case facts and the identification of problems or issues. Consider, for example, a case in which the corporate objective is specified as maximizing shareholder wealth. The case facts include the following:

1. Evidence in a case context comes in a variety of forms: deductions, opinions, and calculations. With *all* case evidence, the student should consider the source: the evidence is only as reliable as the source. Thus, if project manager X has consistently overestimated the profitability of past projects, his or her future estimates of profitability should not be taken at face value.

1. The firm does not use analytical capital budgeting techniques (deduction).
2. The firm's president is quoted as saying that he wants to have the "largest company in the industry" (opinion).
3. Return on investment is 8 percent, whereas typical rivals are earning 15 percent (calculation).

Logical inference may be used to identify these as being relevant facts in the following manner:

1. If the firm does not use analytical capital budgeting, it may make unprofitable investments (although not necessarily).
2. Becoming the "largest" firm may take the company into large-scale but unprofitable activities.
3. The low return on investment is likely to be reflected in a relatively low price-earnings multiple and thus lower share prices for every given level of profits.

Out of these case facts emerges the working hypothesis that the capital budgeting system is a relevant problem area. This is still a working hypothesis because it may in fact turn out that the real problem is poor management of profitable investments or simply a poor year with phenomenal future profitability. Case analysis attempts to construct those particular hypotheses that are most likely to identify the real problems.

Once the problem areas or issues in need of resolution are identified, a case analysis should design workable solutions. This involves the development of a plan of action that will both facilitate the effective pursuit of objectives and be practical in the context of real-world constraints. Students unaccustomed to the case method will often latch onto the design stage as a place to demonstrate familiarity with theory (or assigned readings). This is usually a mistake. Theoretical discussion should be built into the development of working hypotheses and the design of realistic solutions, but explicit theory is out of place in case analysis. Everything should relate *directly* to the unique facts of the particular case. It follows that unworkable solutions, however theoretically elegant ("Fire the president"), are useless in a case situation. Likewise, workable plans of action ("Buy a computer") are worse than useless if they lead to greater problems.

When the design of workable solutions has been accomplished, case analysis should take up explicitly the implementation of the solution. This stage will normally include direct concern for behavioral and organizational factors. In the short run, few substantive changes can be implemented in any but the most urgent circumstances. In the long run, substantive changes are more likely: key personnel may be educated to the virtues of various changes, trust and confidence in the proposed direction of solutions (if not specific solutions) may develop, and

organizational resistance may diminish. Thus a plan of action should propose workable solutions with both short- and long-run perspectives.

In summary, case analysis involves the general stages of *investigation*, *design*, and *implementation*. Investigation results in identifying problems and issues in need of resolution by relating how various facts affect the pursuit of established objectives. The design stage considers workable answers that are theoretically valid. The implementation stage is primarily concerned with the management of proposed solutions. Finally, proposed solutions should explicitly incorporate both short- and long-run perspectives. The completion of a case analysis then leads to its presentation and defense.

ADJUSTING TO STUDYING BY THE CASE METHOD

Students new to the case method, especially those with little or no prior work experience, frequently encounter problems in making the transition from a lecture course to a case method course. This section addresses some of the issues and problems that often arise.

Incomplete Information

Students frequently conclude that the first few cases they study share one common feature: they do not include enough information to enable one to solve them. Although the reaction is understandable, it is an incorrect inference. In some situations there is enough information, whereas in others the reader is given all the information available to the manager at the time.

Managers seldom have all the information they would like. Even if it exists, the manager may not have the time or the resources to gather it. Cases simply reflect this basic fact of life.

Unfortunately, the only advice available to students is to do the best analysis possible and to be sure to make a recommendation. The good news is that the uncomfortable feeling will diminish.

Facts versus Opinions

Cases include facts and opinions; the former should be accepted at face value, but the student should scrutinize opinions. Suppose, for example, that a case states: "Last year was the most profitable in the firm's history." The student should not question this statement. Now, suppose that a case includes the following: "Ms. Joan Jones, president

of the XYZ Company, thought that last year's profit level was fabulous." Her view is important information in terms of what decision she might accept. However, it is an opinion not a fact, and the reader should not automatically agree that the profit level was fabulous.

Assumptions

To perform many kinds of financial analysis, one must make assumptions. Very often the reasonableness of assumptions is a key concern. Thus, if the case presents an analysis, the student should evaluate the reasonableness of the underlying assumptions. Naturally, the student should exercise care in making assumptions for any analysis that he or she performs and also should be prepared to defend them during a class discussion.

Time

A typical question students ask is: "How long does it take to prepare a case?" To do an adequate job on the cases in this book, one generally must spend between two and five hours. (Students usually spend more time on written case assignments.) Expect to feel frustrated at first; it is not possible to be as thorough as one would like within a limited time. The time constraint is just another reflection of the managerial environment. Decision makers typically are pressed for time, and they learn to set priorities and to perform tasks in less time.

Unfortunately, there is no magic formula for dealing with the time constraint problem. One needs practice and experience to learn how to cope with the pressures of time. Realize, however, that the impossibility of doing a thorough job in a limited time is intrinsic to the case method and is not due to any deficiency in one's background or ability. More important, perhaps, the student should not deal with the sense of frustration by spending enormous amounts of time on the cases. This approach may ease the initial frustration, but it will not help one to adjust to the case method and learn how to cope with the time pressure of a manager's job.

Library Research

Most cases use disguised companies, but sometimes the actual name is disclosed. If it is, the students wonder if they should look up information about the company in a library. Unless the instructor asks the class or certain members to gather these data, the student should not do so

on his or her own initiative. Such information often harms the case discussion by discouraging participation.

Preparing a Case

There is no one best way to prepare a case because much depends on the individual. Below are comments designed to provide the reader with ideas to consider in developing a suitable approach.

Many instructors provide suggested questions that are intended to guide the student. They are not meant to limit the nature or scope of the student's analysis. Also, in most instances the goal of a case assignment is not merely to answer the questions.

Most cases are issue cases, which means that one or several decisions must be made or problems must be solved.² Thus, one must define the issue(s) and develop feasible alternatives. It's usually a good idea to write the issue(s) in one or two sentences and to list the options. Although this is the initial task, the definition of issue(s) and the list of options are somewhat tentative. This is because once the student performs the analysis, new light may be shed on the real issue and he or she might find that some alternatives are not as feasible as they once seemed and others may become feasible.

The final task is the recommendation. This involves selecting an option, including a plan of implementation, and preparing to present it to others.

Many efficient case preparers begin by reading the case very quickly. They actually skim it to obtain a general picture. They then read it carefully, making marginal notes, underlining key points, and noting certain items on a separate piece of paper. Next they think about the problem, possible options, and the kind of analysis that may be appropriate. Notice that they do not "push numbers" until after they think about the task. This point is stressed because many novices ignore this crucial step.

2. Some cases are appraisal cases, which means that the decision(s) has been made or the problem(s) solved and that the task is to evaluate what was done.

Contents

Preface	ix
Note on Case Analysis	xii
Part I	
Financial Statements and Time Value of Money	1
Fulton Flying Lessons, Inc.	3
Capitol Corporation	13
Marvex Computers, Inc.	18
The Smiths' Mortgage Alternatives	22
Part II	
Financial Analysis and Forecasting	29
→ Valu-Hi Drug Stores (A)	31
Hollowville National Bank	43
ChemCo, Inc.	60
Newko Distributors, Inc.	62
Super Sounds	72
Fun-Tek, Inc.	74
Breau Company (A)	79
Breau Company (B)	89
Xenon, Inc.	90
Tesco, Inc. (A)	96
Tesco, Inc. (B)	103
Winston College	107
Paducah Portrait	116
Carroll Company Incorporated	120
Bolton College Food Service	125
Budin Company (A)	132
Part III	
Working Capital Management	145
Fund for Government Investors	147
Children's Memorial Hospital (A)	157
Ellen Cosmetics Company, Inc.	174
Budin Company (B)	178

Addison Electric Company	186
Midwest Grain Company	199
Swanson Corporation	230
Etech, Inc.	261

Part IV

Capital Budgeting	281
--------------------------	------------

Capital Budgeting Exercises	283
Chou Canning Company	287
The Daily Ledger	292
Regent Manufacturing Company	294
United Chemical Company	297
Jenkins Plumbing Company	299
Note on the Capital Asset Pricing Model	301
Risk-Return Illustrations	313
Valuation Exercise	318
Javits Company	320
Filtron Corporation	330
Metchler Corporation	337

Part V

Long-Term Financing and Dividends	351
--	------------

Delicious, Inc.	353
Cost-of-Capital Illustrations	367
American Forge Corporation	371
Children's Memorial Hospital (B)	380
Hammond Publishing Company	407
PODER Industries	420
Frechter Company	439
XXX, S.A.	444
Brenco Corporation	447
Quality Hardware, Inc.	455
Basic Industries, Inc.	464
Dunkin' Donuts Incorporated	470

Part VI

Comprehensive Cases	493
----------------------------	------------

Beaver Corporation	495
Winco Distribution Company	504
Electricircuit, Inc.	522

Phillips Bakeries, Inc.	534
Meditronics, Inc.	540
 APPENDIXES	 547
A. Present Value of \$1 at Discount Rate k for n Years	549
B. Present Value of an Annuity of \$1 at Discount Rate k for n Years	551
 INDEX OF CASES	 553

PART I

FINANCIAL STATEMENTS AND TIME VALUE OF MONEY

