CASES IN FINANCIAL MANAGEMENT

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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 purpose of this book is to supply cases that have sufficient breadth and depth for undergraduates and first-year graduate students.

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 how to do the following things:

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

In our use of available cases and from our discussions with other instructors, we have found that many of the existing cases have serious deficiencies when used in undergraduate courses and first-year graduate courses. The available cases are often too complicated, too subtle, or too extensive to fit neatly into the course textual material. Putting it another way, there is a gap between end-of-chapter problems and exercises and highly unstructured cases.

The principal purpose of this casebook is to provide a strong bridge over that gap. We build this bridge by providing three basic types of cases. The first type is similar to the more extended end-of-chapter problems and exercises. Because these are the most structured cases in the casebook, they are tailored to emphasize skill development rather than problem formulation and decision making. However, in these, as in all cases, the student will be required to do *some* formulation 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 one-third of the cases in this book are of this type; they are based primarily on our work and consulting experiences.

The second type, comprising approximately one-fourth of the cases in this book, provides the central span of the bridge and is more open-ended than the first type. In these cases, emphasis shifts from technique development toward integrated considerations and the formulation of alternatives. We accomplish this by presenting the situations considerably more in context than we do with the first type. However, these cases are structured to some extent in order to demonstrate to the student that financial problems and solutions are interdependent; that is, that the solution of one particular problem has problematic implications for other financial considerations.

The third type, comprising the remainder of the cases, resembles the typical ICCH (Intercollegiate Case Clearing House) case in its realism and unstructured presentation. (In fact, a number of ICCH cases are included which will be familiar to many instructors.) These cases emphasize the importance of making and defending a decision and the implied program of action in support of the decision. They require the student to formulate the problem, do the "technical" operations, consider impacts on other financial variables, formulate alternatives, make a decision, and develop a plan of action.

The fifty-five cases are divided into six parts—Financial Reporting, Financial Analysis and Forecasting, Working Capital Management, Capital Budgeting, Long-Term Financing and Dividends, and Comprehensive Cases. Each part, except for the last, includes each of the three types of cases, but in different proportions depending on the topic. For example, the earlier sections, which emphasize considerations of techniques and financial statements, include more of the first type than do later sections, which focus on more general considerations. Still, the number of type two and three cases in each section is sufficient to provide the needed variety.

All cases have been thoroughly class-tested, many at both the undergraduate and graduate levels. Student input was quite useful in helping us to improve the structure of many cases.

In addition to the three types of cases, the book has several features that the user may appreciate. First, in the areas of financial analysis and working capital management there are a larger number and a greater variety of cases than in other casebooks. This emphasis, however, has not been at the expense of capital budgeting, the cost of capital, or long-term financing and dividends. Indeed, some of these cases provide an opportunity to discuss the application of modern capital markets theory. Second, several cases involve computer applications, and they are flexible enough so that the user can write a program or rely on a canned program that we supply. Third, the casebook can be used with most financial management texts. Finally, there are a number of cases dealing with nonbusiness financial management. For example, we have a case on cash management in a congressional campaign to emphasize the relevance of financial management in temporary organizations. We also provide cases dealing with financial management problems in a university, a hospital, and a mutual fund, as well as a case that focuses on social responsibility.

In writing this book, we received help from many kind and competent people. We were fortunate to have the encouragement of our families and friends, the cooperation of many busy executives, and the assistance of reviewers, editors, graduate assistants, secretaries, and others.

We owe a substantial debt to Gordon Roberts of Dalhousie University and Donald Thompson of Georgia State University for reviewing each case and providing numerous comments. We have incorporated many of their excellent ideas.

Managers of the organizations upon which the cases in this volume are based provided a great deal of assistance. Not only did they give us the necessary information, but they also gave us advice on how to structure the cases and commented on the initial drafts. We would like to give specific thanks to Robert Pink, Sr., Robert Pink, Jr., and Phil Smith of Joseph A. Pink & Sons; Joseph Raimo of Dutch Kitchen, Inc.; Frank Campanella, executive vice president of Boston College, who provided information and assisted in writing two cases; Robert Aragon of Shafer Brothers; Dr. John G. Preston, a colleague and trustee of a hospital, who assisted in writing the cases on hospitals; Richard Garvey of the Fund for Government Investors; John Rees, Richard Driscoll, Robert Linden, and Al Roitfarb of New England Merchants National Bank; John Balboni of United Brands; Ronald Porter, a real estate executive; Kenneth E. Frantz, who wrote the Hammond Publishing Company case; Robert Tyhurst and Gary Koenig of Itel Corporation; and Robert Rosenberg and Richard Hart of Dunkin' Donuts. Finally, we thank the President and Fellows of Harvard College for allowing us to include a number of their cases.

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CONTENTS

Note on Case Analysis

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, 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. Since 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 a clear specification of objectives and goals. This permits a systematic approach to the collection and classification of relevant evidence,[1] and, by logical inference, relates case facts to their probable

[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.

impacts. Out of the process of relating facts to probable impacts 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 the maximization of shareholder wealth. Some of the case facts are the following:

1. The firm does not use analytical capital budgeting techniques (deduction).
2. The firm's president is quoted as saying 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 the identification of problems and issues in need of resolution by relating various facts to their impacts on 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.

PART I

Financial Reporting

Fulton Flying Lessons, Inc.

In early November, Joseph Zampanti, president of Fulton Flying Lessons, Inc., was preparing for a second meeting with Joan Lestille, whom he hoped would invest in his company. At a meeting held in October, Ms. Lestille indicated interest but noted that she could not rely on the firm's financial statements to make a sound investment decision.

BACKGROUND

Joseph Zampanti had always wanted to own and manage a small business, and in August he decided to form Fulton Flying Lessons, Inc., in Silver Spring, Maryland. His plan was to sell flying lessons, which would be given by pilots retained on a contract basis. His investigation revealed that he could charge $25 for a lesson. The fee for the pilot would be $10, and he estimated that other lesson-related expenses would be $3.25.

On September 1 Zampanti started the business by investing $200,000 and borrowing $125,000 at an annual interest rate of 9 percent. The loan was to be repaid in five equal annual installments of $32,136, commencing in one year. (These installments include interest and principal.) On September 1 he purchased, for cash, two airplanes for $150,000 each and office equipment for $6,000. He estimated that the useful life of the airplanes would be ten years and that the useful life of the office equipment would be five years. Moreover, he estimated that the salvage value of these fixed assets would be negligible at the end of their useful lives. His final transactions on September 1 were to pay an annual rental fee of $12,000 for office space and a hangar and $6,000 for a one-year insurance policy.