that he did not understand the relevance of the division manager's remark, adding, "I don't see why the return on an old asset should be higher than that on a new asset, just because the old one cost less."

The 1997 results both disappointed and puzzled Carl Randall. Return on assets fell from 4.8 percent to 4.6 percent, and gross return dropped from 9.5 percent to 9.4 percent. At the same time, return on sales (net income divided by sales) rose from 4.3 percent to 4.6 percent, and return on owners' equity also increased, from 7.6 percent to 7.8 percent. These results prompted Randall to say the following to Hubbard:

> You know, Henry, I've been a marketer most of my career, but until recently I thought I understood the notion of return on investment. Now I see in 1997 our profit margin was up and our earnings per share were up; yet two of your return on investment figures were down while return on owners' equity went up. I just don't understand these discrepancies.
>
> Moreover, there seems to be a lot more tension among our managers the last two years. The general manager of Professional Services seems to be doing a good job, and she seems pleased with the praise I've given her. But the general manager of Industrial Products seems cool toward me every time we meet. And last week, when I was eating lunch with the division manager at Consumer Products, the product development manager came over to our table and expressed her frustration about your rejecting a new product proposal of hers the other day.
>
> I'm wondering if I should follow up on the idea that Karen Kraus in HRM brought back from the organization development workshop she attended over at the university. She thinks we ought to have a one-day off-site "retreat" of all the corporate and divisional managers to talk over this entire return on investment matter.

Questions

1. Why was McNeil's new product proposal rejected? Should it have been? Explain.
2. Evaluate the manner in which Randall and Hubbard have implemented their investment center concept. What pitfalls did they apparently not anticipate?
3. What, if anything, should Randall do now with regard to his investment center measurement approach?

Case 22–5

Piedmont University*

When Hugh Scott was inaugurated as the 12th president of Piedmont University in 1991, the university was experiencing a financial crisis. For several years enrollments had been declining and costs had been increasing. The resulting deficit had been made up by using the principal of "quasi-endowment" funds. For true endowment funds, only the income could be used for operating purposes; the principal legally could not be used. Quasi-endowment funds had been accumulated out of earlier years' surpluses with the intention that only the income on these funds would be used for operating purposes; however, there was no legal prohibition on the use of the principal. The quasi-endowment funds were nearly exhausted.

Scott immediately instituted measures to turn the financial situation around. He raised tuition, froze faculty and staff hirings, and curtailed operating costs. Although he had come from another university and was therefore viewed with some skepticism by the Piedmont faculty, Scott was a persuasive person, and the faculty and trustees generally agreed with his actions. In the year ended June 30, 1993, there was a small operating surplus.

In 1993, Scott was approached by Neil Malcolm, a Piedmont alumnus and partner of a local management consulting firm. Malcolm volunteered to examine the situation and make recommendations for permanent measures to maintain the university's financial health. Scott accepted this offer.

Malcolm spent about half of his time at Piedmont for the next several months and had many conversations with Scott, other administrative officers, and trustees. Early in 1994 he submitted his report. It recommended increased recruiting and fundraising activities, but its most important and controversial recommendation was that the university be reorganized into a set a profit centers.

At that time the principal means of financial control was an annual expenditure budget submitted by the deans of each of the schools and the administrative heads of support departments. After a dean or department head discussed a budget with the president and financial vice president, it was usually approved with only minor modifications. There was a general understanding that each school would live within the faculty size and salary numbers in its approved budget, but not much stress was placed on adhering to the other items.

Malcolm proposed that in the future the deans and other administrators submit budgets covering both the revenues and the expenditures for their activities. The proposal also involved some shift in responsibilities, and new procedures for crediting revenues to the profit centers that earned them and charging expenditures to the profit centers responsible for them. He made rough estimates of the resulting revenues and expenditures of each profit center using 1993 numbers; these are given in Exhibit 1.

Several discussions about the proposal were held in the University Council, which consisted of the president, academic deans, provost, and financial vice president. Although there was support for the general idea, there was disagreement on some of the specifics, as described below.

CENTRAL ADMINISTRATIVE COSTS

Currently, no university-wide administrative costs were charged to academic departments. The proposal was that these costs would be allocated to profit centers in proportion to the relative costs of each. The graduate school deans regarded this as unfair. Many costs incurred by the administration were in fact closely related to the undergraduate school. Furthermore, they did not like the idea of being held responsible for an allocated cost that they could not control.

GIFTS AND ENDOWMENT

The revenue from annual gifts would be reduced by the cost of fund-raising activities. The net amount of annual gifts plus endowment income (except gifts and income from endowment designated for a specified school) would be allocated by the president according to his decision as to the needs of each school, subject to the approval of the Board of Trustees. The deans thought this was giving the president too much authority. They did not have a specific alternative, but thought that some way of reducing the president's discretionary powers should be developed.

ATHLETICS

Piedmont's athletic teams did not generate enough revenue to cover the costs of operating the athletic

EXHIBIT 1 **Rough Estimates of 1993 Impact of the Proposals (millions of dollars)**

	Revenues	Expenditures
Profit center:		
Undergraduate liberal arts school	$ 42.0	$ 40.9
Graduate liberal arts school	7.8	16.1
Business school	21.4	17.2
Engineering school	23.8	24.2
Law school	9.4	9.1
Theological school	1.7	4.8
Unallocated revenue*	7.0	—
Total, academic	$113.1	$112.3
Other:		
Central administration	$ 14.1	$ 14.1
Athletics	3.6	3.6
Computers	4.8	4.8
Central maintenance	8.0	8.0
Library	4.8	4.8

* Unrestricted gifts and endowment revenue, to be allocated by the president.

department. The proposal was to make this department self-sufficient by charging fees to students who participated in intramural sports or who used the swimming pool, tennis courts, gymnasium, and other facilities as individuals. Although there was no strong opposition, some felt that this would involve student dissatisfaction, as well as much new paperwork.

MAINTENANCE

Each school had a maintenance department that was responsible for housekeeping in its section of the campus and for minor maintenance jobs. Sizable jobs were performed at the school's request by a central maintenance department. The proposal was that in the future the central maintenance department would charge schools and other profit centers for the work they did at the actual cost of this work, including both direct and overhead costs. The dean of the business school said that this would be acceptable provided that profit centers were authorized to have maintenance work done by an outside contractor if its price was lower than that charged by the maintenance department. Malcolm explained that he had discussed this possibility with the head of maintenance, who opposed it on the grounds that outside contractors could not be held accountable for the high quality standards that Piedmont required.

COMPUTERS

Currently, the principal mainframe computers and related equipment were located in and supervised by the engineering school. Students and faculty members could use them as they wished, subject to an informal check on overuse by people in the computer rooms. About one-fourth of the capacity of these computers was used for administrative work. A few departmental mainframe computers and hundreds of microcomputers and word processors were located throughout the university, but there was no central record of how many there were.

The proposal was that each user of the engineering school computers would be charged a fee based on usage. The fee would recover the full cost of the equipment, including overhead. Each school would be responsible for regulating the amount of cost that could be incurred by its faculty and students so that the total cost did not exceed the approved item in the school's budget. (The mainframe computers had software that easily attributed the cost to each user.) Several deans objected to this plan. They pointed out that neither students nor faculty understood the potential value of computers and that they wanted to encourage computer usage as a significant part of the educational and research experience. A charge would have the opposite effect, they maintained.

LIBRARY

The university library was the main repository of books and other material, and there were small libraries in each of the schools. The proposal was that each student and faculty member who used the university library would be charged a fee, either on an annual basis, or on some basis related to the time spent in the library or the number of books withdrawn. (The library had a secure entrance at which a guard was stationed, so a record of who used it could be obtained without too much difficulty.) There was some dissatisfaction with the amount of paperwork that such a plan would require, but it was not regarded as being as important as some of the other items.

CROSS REGISTRATION

Currently, students enrolled at one school could take courses at another school without charge. The proposal was that the school at which a course was taken would be reimbursed by the school in which the student was enrolled. The amount charged would be the total semester tuition of the school at which the course was taken, divided by the number of courses that a student normally would take in a semester, with adjustments for variations in credit hours.

Questions

1. How should each of the issues described above be resolved?
2. Do you see other problems with the introduction of profit centers? If so, how would you deal with them?
3. What are the alternatives to a profit center approach?
4. Assuming that most of the issues could be resolved to your satisfaction, would you recommend that the profit center idea be adopted, or is there an alternative that you would prefer?