



Rein Chemical Company: Specialty Chemicals Division¹

A letter from Miami arrived in the office of Sales Managers of Rein Chemical Company in a rainy day of winter. Shortly after, the Division General Manager and Sales Managers resigned for “personal reasons”. Charlie Hoffman, a former regional sale manager in Colorado, was then promoted to the position of division sales managers. Two months later, by incident he uncovered a letter expressing suspicion of improper pricing. Hoffman reported immediately to Anthony Garrison, the CEO of Rein Chemical, regarding the issue.

An initial examination revealed that over a period of several years, a number of salespersons in the Specialty Chemical Division had substituted a cheaper chemical for the item ordered so as to lower the divisions’ costs and raise its profits. After Anthony Garrison was informed of this practice, he immediately called an executive meeting with the senior corporate executives and asked for a full investigation of the case.

Corporate Background and History

Rein Chemical has been in business for many decades. It is a medium listed company with \$502 million sales in 2002, ranking among the top one third in the industry. Most recent performance measures were quite satisfactory, for example, ROE reached the level of 6.1%, while ROS and ROA were about 3.8% and 3.7% in 2002. Rein has three major product lines: Inorganic Chemicals, Agricultural Chemicals, and Specialty Chemicals. Although the sales of Specialty Chemicals accounted for only 22.3% of Rein’s sales, it generated 63.2% of the companies’ profit in 2002.

¹ This case was prepared by professor Farn Cheng-Kiang, Sin Yat Ming, Shen Yifeng, Lee Tsun-siou, Tan Khee Giap and Gao Yan for the sole purpose of class discussion rather than to illustrate either effective or ineffective management.

A Senior Management Meeting

To discuss the issue, a senior management meeting was held including key executive officers of the company: Anthony Garrison, the CEO; Bob Lancaster, Corporate Controller; Charlie Hoffman, Division Sales Managers; John Wilkinson, VP Human Resource and Chief Ethics Officer and Wendy Simpson, Corporate Public Relations. Below is the excerpt of the management meeting.

Anthony Garrison: We are unfortunate to receive a letter from a major customer in Miami, complaining that the Specialty Chemical Division of our company had substituted a cheaper chemical for some items ordered. I like to know what you think about this issue.

Charlie Hoffman: I have just taken this position two months ago and I have no idea of the whole thing. It is better to have someone to answer the questions and tell the story. As far as I know, salespersons are innocent in this case. They do not get any extra money by selling this problematic product. Under the corporate policy, they are paid by their commission for what they sell. To speak frankly, the salespersons are quite frustrated now.

Bob Lancaster: I think the whole incident was not very serious since the product caused no problem to our customers. No salesperson has profited from the incident. However, we have to admit that it reflects a potential serious problem at a control system level. I think the issue arisen because our company is highly decentralized, most sales were closed based on a 'relationship sales' mode, and we did not have a formal system to monitor it. We just installed a new control system recently. It may help us to resolve this issue. In addition, we were unable to notice the problem since we did not have a system for cost control at a product item level, but it will be in place in the future.

Wendy Simpson: I happened to talk to someone in our R&D division before I came to the meeting. I was told that the substituted product, though cheaper, may perform as well as and possibly even better than what had been ordered. The substitution was virtually impossible to detect without special laboratory testing. I suggest that we should have a series of investigations to find out the facts. Until we find out more details pertaining to the episode, I think it is better for us to keep quiet, so that it will not cause any damages to the company's image and reputation.

Garrison: If there is no objection, I recommend that we should set up a committee to

investigate the matter. Before we get any results, may I request everyone to follow Wendy's suggestion.

John Wilkinson: I agree with Bob that salespersons did not gain any additional money from the sale of this product. Under our existing compensation system, a salesperson is paid a flat base salary plus a bonus that is a proportion of the sales amount that s/he accomplished. In addition, according to our HR policy, if someone drifted apart from the standard operating procedures of the company, s/he may be subjected to dismissal. I do not see any reason why they did it in that way. However, according to our current reward system, only the compensations of senior managers are related to the profit achieved.

Charlie Hoffman: I noticed that the morale of our sales force was affected severely by this event. We need to do something quickly.

Wendy Simpson: We have to improve further the corporate compliance and internal controls of our company. After the completion of the investigation, the report should be made public and necessary actions should be taken to ensure such incident would not happen again. Meanwhile, we the company would rely on the goodwill from our customers which has been carefully built up over decades.

Initial Report on Investigation

Two weeks after the meeting, Garrison received an initial report. The report revealed that the use of cheaper substitutes in Specialty Chemicals products had been widespread, involving hundreds and possibly thousands of accounts. In many cases, it was difficult for the company to determine whether a customer had been cheated because prices were typically negotiated informally with orders often placed by phone and field sales records poorly kept.

Projecting from this instance, it was estimated that the overcharge to customers might have exceeded \$1 million. The investigation also concluded that damages to most customers were relatively small. There was evidence that the then senior division manager had condoned and even encouraged the practice.

Garrison called for another senior management meeting to discuss how to handle this crisis.