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Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

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LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies*. The editorial content of this journal is under the control of the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the *JACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note for each case in this volume will be published in a separate issue of the *JACS*.

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader must correspond directly with the Executive Director of the Allied Academies: info@alliedacademies.org.

We intend to foster a supportive, mentoring effort on the part of the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

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Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

ACCOUNTING FOR RETAILER-ISSUED GIFT CARDS: REVENUE RECOGNITION AND FINANCIAL STATEMENT DISCLOSURES

Janice L. Ammons, Quinnipiac University
Gary P. Schneider, Quinnipiac University
Aamer Sheikh, Quinnipiac University

CASE DESCRIPTION

This case deals with the appropriate accounting for and disclosure of gift card revenue on the financial statements. Secondary issues examined include materiality, the quality of reported earnings, and contingent liabilities. Underlying these specific issues is the general issue of accounting policy choice and its effect on the comparability of reported financial results across companies. The case requires students to find and review authoritative accounting literature (including appropriate professional standards) and relevant financial filings (for example, Forms 10-K) for several companies. This case has a difficulty level of three, four, or five. The case is designed to be taught in two class hours and is expected to require five hours of outside preparation by students.

CASE SYNOPSIS

Using example disclosures from Best Buy Co., Inc. and other retailers, students learn about the use of retailer-issued gift cards and identify issues that arise in accounting for their issuance and redemption. Students also learn about the more general topic of how accountants apply financial statement disclosure rules to new business practices as they emerge.

INTRODUCTION

Retailers have sold gift certificates in one form or another for more than a hundred years (Waits, 1993). In recent years, a specific form of gift certificate known as the gift card or shopping card has become quite popular among consumers. The gift card has also become widely used as a business promotion tool, issued by retailers to their frequent customers much as airlines use frequent flier mileage plans. Gift cards are also used by companies as small-denomination performance awards for employees and as “thank-you” gifts to customers, vendors, partners, and others (Horne, 2007).

Recent estimates of U.S. sales of gift cards include \$83 billion in 2006 and \$97 billion in 2007 (Mitchell, 2008). Gift card sales outside the United States are growing rapidly, also (Horne,

et al., 2005). Although gift card sales were down somewhat in the 2008 holiday shopping season, retailers expect them to begin increasing again when the economy recovers (Bohen, 2008; *BusinessWeek*, 2008).

CHARACTERISTICS OF GIFT CARDS

Consumers find gift cards appealing because they allow a person to purchase a gift when they do not know the intended recipient well enough to guess what the recipient will find pleasing or suitable (Horne and Kelly, 1995). This reduces the loss to both parties (the gift-giver and the gift-recipient) that results when a suboptimal gift is purchased and must be returned or simply not used (Waldfoegel, 1993).

Despite their benefits and efficiencies, gift cards do expose the giver and recipient to the risk of losses (Horne, 2007). Some gift cards have expiration dates. If a gift recipient does not use the card, or misplaces the card, the value of the gift is lost. Some gift cards also have a small dormancy fee that reduces the value of the card each month it is not used after some time period (typically a year) of inactivity. The purpose of this dormancy fee is twofold. First, it prevents the issuing company from accumulating a large liability over time; second, it avoids any requirement the issuer might have to pay over the balance to a state government under that state's escheat laws (Kile and Wall, 2008). If a gift card issuer enters bankruptcy protection, any unspent balances on gift cards it has outstanding could become worthless unless allowed to remain by the bankruptcy court judge (*Consumer Reports*, 2008).

Open-System and Closed-System Gift Cards

Two kinds of gift cards exist, open-system and closed-system. An open-system card is issued by a bank, bears the logo of a well-known credit card (for example, American Express, Discover, MasterCard, or Visa) and works very much like a bank debit card. A closed-system gift card is a stored-value card that represents money on deposit with the issuer (retailer). Instead of drawing down the balance in a checking account as a bank debit card would, the open-system card draws down the stored value of that card. Open-system gift card issuers can earn substantial profits from cards that expire or that remain unused long enough to yield dormancy fees. These cards also yield the standard interchange fees charged to merchants by any branded credit or debit card. Thus, an open-system issuer earns more profit on cards that are misplaced or not used.

Closed-system gift cards are issued by retailers and bear that store's logo. The retailer benefits by gaining the use of the funds (the value of the float) on unredeemed balances and can profit from cards that expire or are misplaced and can earn dormancy fees on cards that are not used. Unlike the issuers of open-system cards, however, closed-system issuers are motivated to have consumers use their gift cards (Horne, 2007). When a consumer enters a store with a \$50

gift card, chances are good that that consumer will spend more than the value of the card. Also, a consumer that carries a retailer-branded gift card will be reminded frequently of the retailer's brand and market presence as a shopping destination. Retailers spend millions of dollars each year to accomplish these objectives.

This case deals with the accounting procedures and financial statement disclosures for retailers who issue closed-system gift cards. In these transactions, the retailer sells a card that contains a specific denomination of stored value to a customer. The customer gives the card to another person, the gift recipient, who will visit the retailer (in person or online) and spend the stored value. Of course, the retailer hopes that the gift recipient will enjoy the environment of its physical location (or its Web site), find its products enticing, and decide to spend additional money while browsing.

REVENUE RECOGNITION ISSUES

Most of the profit that a retailer earns in a gift card transaction is the profit on the sale that occurs when the card recipient spends the stored value on the card. However, the retailer does earn other income from a gift card transaction.

Two Sources of Revenue

The retailer receives cash from the card purchaser at the time the card is sold. The retailer has the use of that money starting at that point in time. The effect is similar to a sale transaction in which a customer makes a cash deposit when placing an order for an item to be delivered later. The retailer must record the cash receipt, but has not made a sale yet.

A second source of revenue from a gift card transaction occurs because not all gift cards are redeemed. Even if the retailer does not impose a dormancy fee or enforce an expiration date on the card, at some point in time, the retailer will decide that the likelihood a gift card will be redeemed has dropped close to zero and the gift card should be written off. The revenue a retailer earns because some gift cards are never used (or because they expire or are consumed by dormancy fees) is called breakage, breakage revenue, or breakage income (Kile, 2007).

This situation requires an accounting procedure that is similar to (although opposite in effect) the accounting for money owed by a company's customers on their accounts that is unlikely to be collected. In the case of uncollectible accounts receivable, the company estimates an uncollectible accounts expense in the period of the sale and sets up an allowance for doubtful accounts as a contra-asset account. When a specific account receivable is identified as uncollectible (which could easily happen in a year subsequent to the recognition of the sale and its related uncollectible accounts expense), that receivable is written off against (reduces) the allowance for doubtful accounts.

Generally Accepted Accounting Principles (GAAP) and Unearned Revenue

GAAP requires that revenue be recognized at the earliest point in the firm's operating cycle when it meets both of the following criteria: revenue is realized or realizable, and revenue is earned. If a firm receives cash in exchange for a promised future delivery of products or services, it records the increase in cash (an asset account) and the increase in unearned revenue (a liability account).

When the product is delivered or the service is provided, the firm recognizes revenue (by crediting the revenue account) and reduces the liability, unearned revenue (by debiting the liability account). The transaction is recorded as follows:

FINANCIAL STATEMENT DISCLOSURE ISSUES

Recent accounting literature on accounting for gift cards includes articles (Feinson, 2008; Kile, 2007; Kile and Wall, 2008) and a speech made by a Securities and Exchange Commission (SEC) staff member (Schlosser, 2005).

The relevant Statement on Financial Accounting Standards is Statement 140 (FASB, 2000). Although the basic premises of disclosure are not very complex for gift cards, the issue is perceived by the SEC staff (Schlosser, 2005) and by accounting academics (Marden and Forsyth, 2007) as one that is new and not particularly well settled. As new business practices are developed, accountants must apply their existing rules and interpretations to those new practices. An important disclosure issue for new practices is always how best to report the accounting information in a way that maintains the quality of earnings reported (Bellovary, et al. 2005).

One good way to learn how companies are reporting a new business practice is to search the financial disclosures filed by companies in the industry. One of the most useful financial disclosure filings is the Form 10-K, which is required by the SEC to be filed annually by U.S. companies whose shares are publicly traded. Forms 10-K are available on companies' Web sites or on the SEC Web site for its Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System (SEC, 2009).

QUESTIONS FOR DISCUSSION

1. Provide a broad definition of the term "liability" as it is used in accounting. When is a liability satisfied?
2. When does a closed-system gift card become a liability for the retailer who sells the gift card? Is it when the card is placed on a rack for sale in the store? When it is sold to a customer? Or is it when the holder of the card (either the original purchaser or the gift recipient) redeems the card for merchandise at the retailer's store or Web site?

3. Obtain the fiscal 2008 annual financial statements or Form 10-K for Best Buy, the consumer electronics retailer. Does the value on the unredeemed gift card liability account on the balance sheet (\$531 million) represent the dollar value of the gift cards that Best Buy sold during that year? If not, describe what it does represent.
4. Continue to use the Best Buy financial statements or Form 10-K for fiscal 2008 for this question. Best Buy's unredeemed gift card liability increased from 2007 to 2008. Would you interpret this as favorable or unfavorable news for Best Buy?
5. Why would a retailer not record revenue when it receives cash for the sale of a gift card?
6. Prepare two journal entries, one for the sale of a gift card with a stored value of \$75, and another for the subsequent partial redemption of that gift card for goods that have a selling price of \$50 and a cost of \$40.
7. In what way (if any) would the journal entries for recording the redemption of a gift card differ from the journal entries for recording the expiration of an unused gift card? Explain.
8. What is gift card breakage? Why and how does it occur?
9. Obtain the annual financial statements or the Form 10-K for a retailer other than Best Buy that issues gift cards and discloses information about gift cards. Compare the treatment of gift card liabilities and revenues (or earnings) in the two companies.
10. Does GAAP require firms to record any cost of goods sold as an expense when they record breakage as revenue? Explain how your answer to this question might affect an analysis of gross profit percentages over time or across firms.
11. Review the different choices described in Kile (2007) that various firms made about how to report unredeemed gift card liability. Critique these choices by considering the following questions: Which disclosure choice do you believe would best serve a financial statement user? Why? Which option(s) do you think could mislead a financial statement user? Explain.
12. Review Kile (2007) to identify the different choices that various firms made regarding how to report gift card breakage on their income statements. Which disclosure choice do you believe would provide the best information to a financial statement user? Why? Which option(s) do you believe are potentially misleading to a financial statement user? Explain.
13. Briefly define the term "quality of earnings." How might the accounting for and disclosure of gift card breakage affect the quality of earnings reported by a particular firm?
14. Does the breakage income that Best Buy (2008) reports, \$34 million, represent a significant percentage of Best Buy's fiscal 2008 earnings?
15. Review Best Buy's (2008) financial statements or Form 10-K for fiscal 2008. Can you determine or estimate the amount that gift card sales contributed to that year's earnings? Was it more than \$34 million, approximately \$34 million, less than \$34 million? Explain.

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DEVELOPMENT OF A STRATEGIC PLAN FOR HEALTHTRUST UTAH

Richard E. McDermott, Weber State University
Stephen L. Walston, University of Oklahoma

CASE DESCRIPTION

Critics charge that the American healthcare delivery system is broken, that while consuming an ever-increasing portion of the Gross National Product, it fails to provide accessibility and quality. Many charged with fixing the system lack the tools to address the problem including an understanding of how the healthcare industry differs from other industries. This case study provides an overview of problems facing a cluster of hospitals owned by a large hospital corporation as it tries to compete in a continually changing environment.

The case is based on an actual strategic plan prepared for the Utah division of HealthTrust, Inc. and explains the steps one might follow in preparing a strategic plan. The names of all individuals have been changed.

The case can be covered in one class period. Student preparation time is approximately two hours. The case can be used in any business course addressing the topic of strategic planning or in a course on health administration where the instructor wishes to provide the student with an overview of the problems facing large healthcare organizations. The case has a difficulty level appropriate to students who are juniors in a bachelor's degree business program.

CASE SYNOPSIS

Dr. Richard Mallory, a professor, consultant, and former hospital administrator has signed a contract to develop a strategic plan for the Utah division of HealthTrust, a large for-profit hospital corporation headquartered in Nashville, Tennessee.

The division's six hospital administrators initiated the contract. It was the outgrowth of their increasing frustration with corporate management, whom they believe do not understand the unique characteristics of the Utah market. This has caused the corporation to impose a management model the local administrators believe is incompatible with Utah's competitive environment.

Mallory is considering a traditional format for the strategic plan that will include an environmental scan and an evaluation of the strengths and weaknesses of both HealthTrust and its Utah competitors. He plans to evaluate several generic marketing strategies for their applicability to the healthcare industry. These include cost leadership, product differentiation, innovation leadership, niche marketing, and a copycat strategy.

Students will assume the role of Dr. Mallory. Using Mallory's research, including interviews with major stakeholders, they will propose and vigorously defend one or more strategies for the Utah division of HealthTrust.. At the conclusion of the exercise, the instructor will reveal the actual strategy chosen and review the impact it had on the Utah division.

INTRODUCTION

Richard Mallory, a university professor, consultant, and former hospital administrator, finished reading a request for proposal (RFP) he had received from the Utah division of HealthTrust. HealthTrust was a large for-profit hospital corporation that operated approximately one-hundred hospitals in the United States—six of which were in Utah. He laid his glasses on the table and gazed out the window of his office as he contemplated the contents of the request.

The six hospital administrators of the Utah Division had written the RFP. Although he had consulted with approximately twenty hospital and healthcare organizations over his career, this would be his first opportunity to write a strategic plan for a hospital network.

Proposed Steps For Development of Strategic Plan

In preparation for his first meeting, Mallory turned his attention to an outline of the steps he would propose for the preparation of the strategic plan. These would include:

1. Interviews with all stakeholders to define the purpose of the study and scope of the resulting action plan.
2. The performance of an environmental scan.
3. A review of the history, organizational structure, resources, strengths, and weaknesses of HealthTrust Utah.
4. A review of the history, organizational structure, resources, strengths, and weaknesses of HealthTrust Utah's major competitors.
5. The identification of opportunities to solidify and expand the division's share of the Utah market.
6. The formulation of a strategy that would allow it to compete more effectively in the Utah market.

THE FIRST MEETING

Several days later, Dr. Mallory drove to Ogden, Utah for his first meeting with HealthTrust Utah's hospital administrators. The meeting was held in the boardroom of the Ogden Regional Medical Center.

Mallory's first item of business was approval of an interview schedule with all stakeholders. The list included the administrative and medical staffs of all six hospitals, hospital board members, community leaders, and so on.

To his surprise, Mallory would not be meeting with the division vice president or with the corporate personnel in Nashville, Tennessee. Troy Landers, the administrator of the Brigham City Hospital explained why. "There is no reason to involve them at this stage as they don't understand our problems and don't see a need for a change in paradigm. They are the audience for the report," he said.

Carl Graham, the administrator of the Lakeview Hospital in Bountiful expanded on Troy's message. "The purpose of the study, Dr. Mallory, is to get the attention of the corporation. Their 'one size fits all' philosophy doesn't work—at least not here. If you can highlight how the market here differs from that faced in other states, we are hopeful the corporation will give us the resources, and yes, the autonomy to implement strategies not approved in other parts of the country."

Mallory took notes and then moved to the second item on his agenda—a discussion on whether the strategic plan would be goal based or issue based. Mallory explained that goal-based strategic plans begin with an evaluation of an organization's mission, values, and goals and then proceed to an action plan (who will do what when).

Issue based plans, on the other hand, begin by examining the most difficult issues facing the organization, and then developing strategies and action plans to address these issues. The subsequent discussion revealed that the administrators certainly had issues. A summary from Mallory's handwritten notes is given below.

Division vice president

- * *A former division controller, he has no in-hospital operational experience.*
- * *Cannot focus.*
- * *Micromanages.*
- * *Is not a systems thinker.*
- * *Spends most of his time fighting fires.*

Utah division

- * *Best described as a loose confederation of hospitals—certainly not an integrated system. Administrators are encouraged to manage their own facilities with little cooperation or coordination between operating units.*
- * *HealthTrust has no presence in Utah's largest market (Salt Lake City). Their hospitals are all in secondary markets like Ogden or Provo, or small rural markets.*
- * *Most of the division's hospitals, therefore, are small and provide mostly primary care.*

- * *Specialty care is outsourced to LDS Hospital (an IHC Hospital) or to the University of Utah Hospital.*
- * *Referrals to hospitals outside the 'system' results in lost revenue.*
- * *The ownership of HealthTrust's six hospitals has changed several times. There has been no continuity of leadership. As soon as a division vice president starts to understand the issues, he is transferred or fired.*

Corporate image

- * *Doesn't exist.*
- * *No effort has been made to establish a network identity.*
- * *Advertising budgets have been cut. Where advertising does take place, it highlights individual hospitals rather than the HealthTrust hospital system. There is no brand recognition.*

Competition:

- * *Formidable.*
- * *Intermountain Health Care dominates the market.*

THE ENVIRONMENTAL SCAN

The objective of an environmental scan is to gather information on trends, relationships, and events in the environment that influence the organization and therefore need to be considered when writing the strategic plan. An environmental scan should include an examination of national and local environments. Dr. Mallory examined dramatic changes that occurred on national and local levels since he entered the healthcare field in 1971. These included:

1. The aggregation of independent freestanding hospitals into corporate chains
2. The introduction of prospective reimbursement
3. The development of external constraints on the practice of medicine

The Aggregation of Independent Freestanding Hospitals

In 1971, when Mallory finished his master's degree in healthcare administration, most hospitals were independently-managed charitable organizations. Many were owned by religious organizations and few were for-profit.

The industry was in a state of flux, however. Hospital costs were increasing faster than the Gross National Product. Many attributed this to the fact that they were run like charitable organizations

rather than for-profit businesses. One article that Mallory remembered described healthcare as a “pushcart industry” in an age of “supermarkets.”

The industry for the most part responded to the criticism. Hospitals updated their accounting systems, and implemented popular business practices such as total quality management (TQM) and continuous quality improvement (CQI). Greater emphasis was placed on the “bottom line.” Hospitals began competing for market share.

Formation of national hospital corporations

Nationally, independent hospitals threatened by increasing competition and decreasing reimbursement began joining hospital chains. In doing so, they exchanged local autonomy for access to capital, sophisticated management, economies of scale, and political clout. Some of these chains were for-profit corporations such as the Hospital Corporation of America, HealthTrust, and Humana.

Formation of Utah hospitals into corporate chains

In 1882, the women’s Relief Society organization of the Mormon Church opened the Deseret Hospital. Over the next one-hundred years, the Mormon Church acquired a total of 14 hospitals in Utah, Idaho, and Wyoming. Some of these were built by congregations in response to local needs. Others were acquired from Mormon communities that no longer had the resources to operate them.

From 1882 until 1970, Mormon hospitals were operated as independent free-standing non-profit organizations. Consistent with national trends, however, in 1970 the church organized these into a loose confederation known as the Health Services Corporation (HSC). This non-profit organization centralized some services in an effort to reduce costs, and provided loose supervision over their operation.

In 1970, church leaders began to question the mission of the Mormon Church in healthcare. There seemed to be little advantage to a member of the church receiving inpatient care in a Mormon hospital over one run by any other religious or secular organization. In addition, the church foresaw that the operation of hospitals would require an increasing share of the church’s resources. Consequently in 1973 they hired the consulting firm of Cresap McCormick & Paget to study the issue. The result was the divestiture of all hospitals by the church in 1974.

A secular non-profit corporation named Intermountain Health Care (IHC) was formed. The board of trustees included a Catholic sister, a Jewish physician, and Protestant and Mormon community leaders from throughout Utah. All of the hospitals previously owned by the Mormon Church were then transferred to this new hospital corporation.

Catholic and Episcopal hospitals in Utah

In 1875, the Catholic Church built the Holy Cross Hospital to treat miners in Park City who were dying of lead poisoning. The Episcopal Church followed suit in 1879 with the construction of St. Mark's Hospital, also in Salt Lake City. These hospitals expanded, and competed successfully in their respective markets until the early 1980s, when many free-standing hospitals found it increasingly difficult to compete in an increasingly complex environment.

In 1982, St. Benedict's Hospital formed the St. Benedict's Health System which struggled until October of 1986 when it joined the Holy Cross Health System Corporation in South Bend, Indiana. The Holy Cross Hospital in Salt Lake City and the Holy Cross Jordan Hospital in South Jordan followed suit.

In 1993, after considerable discussion about the future of Catholic healthcare in Utah, the Holy Cross Healthcare System withdrew from the Utah market by selling its three Utah facilities to HealthTrust, Inc. of Nashville Tennessee. HealthTrust, a spin-off of the Hospital Corporation of America, was subsequently purchased by Columbia/HCA which subsequently changed its name back to Hospital Corporation of America (HCA).

The Introduction of Prospective Reimbursement

Impact on marketing

Another factor driving competition for market share was hospital reimbursement. Traditionally, physicians and hospitals were paid under fee-for-service or cost-reimbursement payment systems. These payment systems provided few incentives for cost control. A hospital administrator didn't have to be a rocket scientist to realize that if his hospital was being paid costs plus 3%, that the easiest way to increase profits would be to increase costs. As a former hospital administrator, Richard Mallory wished he had a nickel for every time an equipment vendor had said, "Don't worry about the price, its reimbursable by Medicare and Blue Cross."

When hospital costs began to escalate in the late 1970s, private and government insurance organizations quickly identified cost reimbursement as an important causal agent. Several groups began exploring new reimbursement designs (known as incentive reimbursement). The objective was to change hospital payment from cost reimbursement in which the payer bore the risk of inefficient cost behaviors, to fixed price or prospective reimbursement where the healthcare provider (physician or hospital) bore this risk.

Medicare led the way with the development of the Diagnostic Related Group (DRG) payment system. Illnesses were divided into approximately 380 diagnostic related groups. A diagnostic related group represented a group of illnesses in one major body system that consumed approximately the same amount of resources (in dollars) to treat. For each DRG there

was a fixed payment. If a hospital was able to treat the patient for less than the fixed payment, it made a profit. If costs exceeded the fixed payment, the hospital incurred a loss.

Consistent with Medicare's expectations, DRG reimbursement changed the way medicine was practiced. Physicians who used excessive resources to diagnose and treat patients were no longer heroes to their hospital administrators. High utilization of unnecessary diagnostic and treatment products and services created cost overruns and decreased hospital profits. In one year, the national average length of stay decreased from 14 days to 7 days. In Utah, it decreased from 7 to 3.5 days.

Decreased hospital length of stays reduced hospital occupancy rates. Hospitals had high fixed costs and, therefore, high break-even points. Since DRG reimbursement limited the ability of hospitals to increase revenues by increasing charges, the only way for hospitals to cover increasing costs was to increase patient volume. As the number of patients in any geographical area are relatively fixed, this meant capturing market share from competing hospitals. Hospital marketing was born.

Intermountain Health Care launched an aggressive three-pronged program to capture patients from competing facilities. The elements of this plan included:

1. The development of an advertising campaign to tout IHC as the high quality provider in the state.
2. The incorporation of a wholly-owned for-profit insurance company to direct patients to IHC hospitals.
3. The purchase of primary care physician practices in key markets whose exclusive referral pattern would be to IHC hospitals.

Impact on cost control

In addition, IHC responded to prospective reimbursement with a series of programs to reduce costs and increase revenues. These included:

1. A new management structure designed to eliminate costly competition between IHC hospitals by reducing the autonomy of the hospital administrator and expanding the authority of the corporate office. This allowed central planning to reduce the duplication of equipment and facilities.
2. The development of centralized services to reduce costs through economies of scale. These included a centralized laundry, blood bank, billing center, purchasing program, and a centralized cash management program.
3. The development of new profit centers.

External Constraints on the Practice of Medicine

When Dr. Mallory entered the healthcare field, primary care physicians practiced with few restrictions or controls. Most practices were small, hospital peer review was weak, and insurance companies were not yet willing to challenge physician practice patterns. In the intervening years, things had changed.

Managed care, the necessity of lowering costs through economies of scale, and the acquisition of practices by hospital corporations, had all lowered the resistance of physicians to the concept of group practice.

As physicians joined group practices, they soon recognized the actions of other physicians could influence their own income through such things as the inefficient use of resources, the possibility of joint malpractice suits, and so on. This led to a greater willingness of physicians to participate in meaningful peer review.

Also, as medical costs increased, insurance companies and government third party payers began reviewing the practice patterns of panel physicians. This in turn led to:

1. The implementation of formularies specifying which drugs physicians could and could not use to treat patients.
2. Requirements that physicians receive precertification before ordering expensive diagnostic procedures such as CAT scans and MRIs.
3. The demand that payment for expensive surgical procedures be approved only upon receipt of a second physician opinion.
4. Mandates for the development of protocols and clinical pathways to standardize the diagnosis and treatment of disease.

HISTORY OF HEALTHTRUST

At the time of Dr. Mallory's study, HealthTrust was a for-profit corporation that operated 104 hospitals, 6 of which were in the Utah division. HealthTrust was a spinoff of Hospital Corporation of America (HCA).

Hospital Corporation of America had been founded in 1967 by a group of physicians in Nashville, Tennessee. From its inception, it grew rapidly and soon became the largest hospital corporation in America. By 1987, however, profits had begun to lag. In response, the company formulated a plan to increase return on equity. It sold its troubled less profitable facilities (primarily small and rural hospitals) to their employees in exchange for a valuable asset—their pension plan. This transaction created a new corporation which they named HealthTrust. It also created considerable controversy. An article in Newsweek stated:

How's this for a hot investment? A new company owns 104 hospitals, most of them fairly small and rural (one of the weakest segments of the health-care industry). Some of the firm's biggest customers, the federal and state governments, have sharply restricted payments for Medicare and Medicaid patients. To top it off, a lot of the company's debt is in junk bonds. Even with those high yields, bond-holders have been nervous enough about the firm's prospects to demand that some of the debt be guaranteed. Now that you've heard all about the firm, here's an offer you can't refuse: how'd you like your entire company pension invested in it?

That's a real life question for nearly 30,000 employees of Health Trust, Inc. Last month the workers became part owners of their firm in one of the largest employee stock-ownership plans (ESOP's) yet created. Formed by the restructuring of giant Hospital Corp. of America (HCA), which chose to shed the troubled hospitals, HealthTrust is determined to succeed. But questions about its viability (and the fate of its ESOP) are at the heart of a debate now raging over employee stock-ownership plans. As their critics see them, ESOP's have become just one more wrinkle in the unproductive asset shuffling of America.¹

In the few short weeks Mallory had worked with HealthTrust, he observed how the uncertainties of the ESOP had taken a toll on employee morale.

AN ANALYSIS OF HEALTHTRUST UTAH

All six of the Utah hospitals owned by HealthTrust were in rural or secondary markets. As a part of the study, Dr. Mallory visited each facility and found their hospital administrators to be bright and honest. More importantly, he found that they understood the Utah market, something that could not be said of the three division vice presidents that had presided over the division since the corporation's inception.

Three Division Vice Presidents

The division's first vice president was Roy Gould, a former hospital administrator appointed shortly after HealthTrust's incorporation. Gould was given 21 hospitals to supervise. He was fired after two years.

Utah's hospital administrators believed Gould's centralized management style led to his downfall. Unwilling to delegate, he required hospital administrators to receive his approval on most decisions. The volume of decisions created by 21 hospitals, however, made it difficult for anyone to get through to him. Eventually Gould stopped answering his phone, and directed his secretary not to ring anyone through. Momentum ground to a halt. It took 5 months, for example, to complete the first year's budget.

HealthTrust replaced Gould with Jerry Wainwright who was given 12 hospitals to supervise. Unlike Gould, Wainwright made himself available to his administrators and was a good listener. During the first month of his administration, however, the corporation mandated that he increase division profits by 18 to 20 percent a year. As some hospitals were already running margins as high as 31 percent, this was an impossible task. Wainwright's career was saved when HealthTrust's COO was fired and Wainwright assumed his position.

Wainwright chose Larry Cook as his replacement. Cook was the division's chief financial officer and was the division vice president at the time Mallory was hired to create a strategic plan.

The six Utah hospital administrators felt that Cook was a disaster. An accountant who had never run a hospital—he rapidly morphed into a micromanager. He consumed hours of administrator time, for example, reviewing their general ledgers line by line, focusing on things as inconsequential as a department's monthly copy expense.

"We desperately need to develop an integrated system to stay competitive," one administrator told Mallory. "Cook, however, doesn't believe in the systems approach. He has directed each of us to focus solely on the financial performance of our own units. He doesn't believe in teamwork, either, and has discouraged cooperation and communication. He sees himself as operating six hospitals, rather supervising an integrated healthcare delivery system."

Cook had introduced a yearly bonus that could be as high as 50 percent of base salary. Eighty percent of that bonus was determined by the profit of an administrator's own hospital.

Corporate Mission

When HCA created HealthTrust, the management of the new corporation received a multimillion-dollar stock options package which they apparently hoped to exercise within five years. To increase the value of their options, corporate management made short-term profitability their primary objective. They cut investment in the purchase and maintenance of plant and equipment, eliminated expenditures for advertising, research, and employee training. In short, they eliminated any expense that could decrease short-term profits. Management adopted a "harvest strategy." Employees were asked to do more with increasingly less.

THE COMPETITION—IHC

Utah's healthcare market was dominated by a formidable competitor, Intermountain Health Care that operated 16 hospitals in Utah, Idaho, and Wyoming. As a former IHC hospital administrator, Mallory was familiar with the corporation and its objectives.

Strategic Planning

IHC's first president, Art Glissman, was a master of strategic planning which he used to develop a totally integrated healthcare delivery system. With support from a strong corporate board, he served as president from 1974 until his retirement in 1997. This provided IHC administrators a continuity of management. During the same time period, the six hospitals Mallory worked with passed from the Hospital Corporation of America, to HealthTrust, to HCA/Columbia, and back again to HCA.

Geographical Coverage

IHC owned hospitals in all of Utah's primary and secondary markets, and in many of its rural markets. In contrast, HealthTrust Utah had no presence in its primary market and limited presence in its secondary and rural markets. HCA had only dumped its weakest hospitals with the formation of HealthTrust.

IHC's had a natural referral network. Rural primary hospitals such as those in Fillmore and San Pete County referred their patients to IHC secondary hospitals such as the Utah Valley Regional Medical Center in Provo, and the McKay Dee Hospital in Ogden. IHC's secondary hospitals, in turn, referred their patients to IHC tertiary hospitals such as LDS Hospital and Primary Childrens' Hospital, both of which had national reputations for specialty care.

IHC had tertiary, secondary and primary care hospitals. HealthTrust had two secondary care hospitals, the rest were primary care facilities.

Visibility and Political Power

IHC had descended from the Health Services Corporation (HSC) of the Church of Jesus Christ of Latter-day Saints (Mormon) that had previously operated 14 hospitals in Utah and Idaho. While the divestiture was an attempt on the part of the LDS Church to separate itself from the practice of healthcare, it was the perception of the six HealthTrust hospital administrators that IHC's management recognized the value of the church's name in a market that was then 70% Mormon.

IHC, for example, had lobbied the Church to allow them to retain three hospital names closely associated with the Mormon culture, the LDS Hospital (LDS is an acronym for the Mormon Church), the Primary Children's hospital (named after the Church's educational program for children), and the David O. McKay Hospital (named for a former president of the LDS Church). Mallory reflected that in the state of Utah, the Mormon Church's brand was more valuable than that of Coca Cola.

IHC's visibility was additionally increased by its practice of placing the most prominent church, business, and political leaders on its corporate and local hospital governing boards. This gave the corporation significant political power.

Public Relations

IHC's first president was not only good at strategic planning, but he was a master at public relations. One of his first acts was to hire the state's largest advertising agency to develop a program that would portray IHC as a high quality, compassionate, charitable, integrated healthcare delivery system.

In addition, IHC had involved its tertiary care hospitals in research that had won the corporation national awards for its quality of care. While HealthTrust hospitals had also won awards for quality, few people knew about this as corporate management had gutted the advertising budget.

Horizontal and Vertical Integration

As mentioned earlier, IHC was highly integrated, both horizontally and vertically. IHC owned primary care clinics, surgical centers, software companies, home health agencies, durable medical equipment rental units, occupational medicine units, a captive insurance company, and geographically positioned hospitals with multiple levels of care.

One disadvantage of this integration was high overhead costs. IHC had leased three floors of the Beneficial Towers, a high-cost prime location in Salt Lake City. HealthTrust Utah on the other hand had a corporate staff of less than a dozen people.

THE COMPETITION--OTHER HOSPITALS

At the time HealthTrust's strategic plan was developed, Utah had 54 hospitals. Of these, IHC owned 14, and HealthTrust owned 6. The remaining hospitals included the University of Utah Medical Center, a nationally recognized tertiary care facility, St. Mark's Hospital, a strong secondary care hospital, and three dozen or so independent rural facilities.

Mallory felt it important that HealthTrust have a flagship hospital in Utah's primary market—Salt Lake City. He felt this should be a tertiary care facility to capture referrals presently leaving the system, and to enhance the corporate image.

IHC's captive insurance company did not include non-IHC hospitals (with the exception of rural Brigham City Hospital) in its hospital panel. Health insurance coverage for HealthTrust hospitals, therefore, were only available through non-IHC insurance plans.

Most non-IHC insurance companies were forced to use the University of Utah Hospital when their enrollees required tertiary care. The University of Utah hospital was a teaching

facility. Teaching hospitals have high costs. This created a distinct cost disadvantage to the only health insurance companies that could offer HealthTrust hospitals.

For these reasons, Mallory and the six Utah administrators were interested in having HealthTrust purchase St. Mark's hospital. It was located in one of the fastest growing areas of Salt Lake City (a primary market), and as a high-end secondary hospital had the potential of becoming a tertiary care facility.

Mallory also speculated about pulling Utah's non-affiliated rural hospitals into a loose confederation that might trade patient referrals for access to specialized personnel and expertise available within the HealthTrust Utah division—resources not commonly affordable to small rural hospitals.

DEVELOPMENT OF A STRATEGIC PLAN

To compete in the healthcare industry, HealthTrust would need to perform a wide variety of activities. When taken together, these would need to be viewed by the customers as providing superior value. The company's strategy would determine those activities.

Dr. Mallory considered several possible strategies including:

- * Cost leadership,
- * Product differentiation,
- * Innovation leadership,
- * Niche marketing, and
- * A copycat strategy

Cost Leadership Strategy

Cost leadership typically focuses on price-sensitive customers. To achieve cost leadership, a company must be able to operate at a lower cost than its competitors. Cost reduction can be achieved through high asset turnover, low direct costs, reduced overhead, and control over the supply chain. By successfully adopting a cost leadership strategy, Wal-Mart became the largest corporation in terms of revenues in the world.²

There is a perception that cost leadership is only found in companies that have captured large market shares. This is not true. For example, Southwest Airlines from its inception was able to compete with major airlines by offering cheap no-frill services at a significantly lower price than its larger competitors. Could HealthTrust Utah pull off a cost leadership strategy?

Innovation Leadership

An innovation leadership strategy involves being the first to offer innovative products and/or services. The University of Utah Medical Center and LDS Hospital currently used this as one of several strategies in marketing their facilities to the public.

Product Differentiation Strategy

Mallory also considered product differentiation. Companies who adopt this strategy attempt to distinguish their product from that of their competitors including quality, function, design, or service.

Product differentiation works best with customers that are not price sensitive. Those who adopt this strategy are sometimes able to charge premium prices. Companies that have adopted product differentiation as their strategy include Mercedes Benz, Nike, and Apple computer.

One variant of the product differentiation strategy is the shareholder value model. This model holds that possession of specialized knowledge can induce customers to select an organization from its competitors. Might this model work for HealthTrust which provides knowledge-based products and services?

Niche Marketing Strategy

Companies that focus on a few specific markets engage in niche marketing. Many of these are small companies that lack the resources to compete in large mass markets. A niche market consists of customers with similar demographics and a similar need or want. To provide sufficient opportunity, the niche must be large enough to produce the volume of business needed, and must be easily reached. Niche marketing is often accompanied with either a cost focus or differentiation focus. Were there niche markets in healthcare that HealthTrust might exploit?

Copycat Strategy

A copycat strategy involves selecting a successful company and duplicating its market strategy. Duplication is less costly than innovation and eliminates the risk involved with untried ideas. Many of HealthTrust Utah's administrators felt that HealthTrust should attempt to duplicate IHC's models of horizontal and vertical integration.

Vertical integration

Vertical integration is the common ownership of businesses that provide products and/or services to other divisions within a company. Vertically integrated firms can potentially lower transaction costs, and more efficiently synchronize supply and demand.

Horizontal integration

Horizontal integration is the expansion and coordination of businesses that are in the same stage of production in an industry. The benefits of horizontal integration include increased market power and greater economies of scale and scope. Larger companies have greater market power and can require financial concession from suppliers thus lowering their costs.

OTHER POTENTIAL OPPORTUNITIES

Alternate Physician Model

While Intermountain Health Care had embarked on a program of employing physicians through the purchase of primary care clinics, HealthTrust's founder, the Hospital Corporation of America believed that physicians should be partners rather than employees. HealthTrust had adopted that philosophy.

Dr. Mallory knew that there were a significant number of physicians in the state who felt threatened by IHC's model, which reduced physician autonomy and had the potential to reduce incomes. He wondered if HealthTrust Utah could use this dissonance to its advantage by offering an alternative model. Might this cause IHC physicians to change hospital memberships or referral patterns?

Non-IHC Insurance Companies

IHC owned a captive health insurance company that offered multiple products. Product designs heavily penalized patients who chose non-IHC physicians and hospitals. IHC competed with every other insurance company in the state including Blue Cross/Blue Shield. Might HealthTrust Utah do more to support the sales efforts of insurance companies offering the HealthTrust Hospitals?

SUMMARY

Dr. Mallory had met with many of HealthTrust Utah's stakeholders to collect information he would use to develop the division's strategic plan. In addition, he had performed an

environmental scan and had reviewed the strengths and weaknesses of HealthTrust Utah and its major competitors. He had also identified additional opportunities that might solidify or expand the company's share of the Utah market. He had evaluated several common marketing strategies used in retailing and manufacturing to see if they might have application to the healthcare industry. Having done all of that, he was now ready to make a proposal.

QUESTIONS

1. What ethical problems do you see with the way Hospital Corporation of America chose to increase its return on equity through the creation of HealthTrust?
2. What impact might the large stock options received by HealthTrust's corporate management have had on the way it operated the company? Did this create incentives to optimize short-run or long-run profits?
3. Why did the six administrators of HealthTrust Utah decide to exclude the division's vice president in the preparation of their strategic plan? What risks were there to this approach?
4. How might Mallory address the obvious disconnect between the corporate view of how the division should be run and that of its six hospital administrators?
5. Mallory reviewed five marketing strategies (cost leadership, product differentiation, innovation leadership, niche marketing, and a copycat strategy). How might each of these be applied to the healthcare industry?
6. IHC has chosen to emphasize a corporate brand in all of its advertising, while HealthTrust Utah has decided to let each hospital promote its own identity. What are the strengths and weaknesses of each marketing approach?
7. Place yourself in the position of Dr. Mallory and propose a strategy for HealthTrust Utah. This strategy can include one of the strategies explored by Mallory (or a combination of these strategies), or a strategy that you develop on your own. Vigorously defend your proposal.

ENDNOTES

¹ The Foibles of ESPO's, *Newsweek*, October 19, 1987.

² Porter, Michael (1980). *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York, N.Y. The Free Press, A Division of Simon & Schuster.

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A TEACHING CASE FOR UNDERSTANDING THE DATA STRUCTURE OF AN ACCOUNTING DATABASE: COMPARING A COMMERCIAL SYSTEM TO REA

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CASE DESCRIPTION

This case concerns design of a database for an accounting system. It compares two databases: a database from an actual market-leading accounting system and a database designed using the REA database design methodology. REA is often taught in accounting information system courses. This course is written for students that have had some exposure to both REA and database design. Its most common use would be in an accounting information system course, either at the undergraduate or the graduate level, but it could also be taught in a database design course if the students were to spend extra time learning the REA methodology. The case is designed to require approximately one hour in-class discussion and two hours out-of-class student preparation for students familiar with both REA and database design basics. Other students will need to spend additional time mastering these topics based on the level of their knowledge.

CASE SYNOPSIS

A recent college graduate is hired as an accountant attempts to reconcile what he learned in college with an actual accounting system. The underlying database structure of the actual accounting system is significantly different than how he learned a database system should be structured. In understanding the actual accounting database, he attempts to work out why the actual system is different. This case is designed to help students develop skills in analyzing accounting databases and understanding the structure of accounting databases. Textbooks, research, and educational cases related to databases focus on using REA as a design methodology of accounting systems. Although accounting systems in practice include some elements of REA, they also include elements that REA eliminates. In this case, students compare an accounting database from Great Plains to the REA methodology and evaluate why the differences exist.

THE DATABASE CASE

John Taylor was recently hired to be controller of Jackson Behavioral Health Center (JBHC). He now manages an accounts payable, accounts receivable, and payroll clerical staff. He personally performs budgeting, financial reporting, and contract reporting on major contracts.

JBHC obtains the majority of its funding through grants and contracts from various government agencies. Each of these contracts requires distinct financial reports. John spends a large part of his time preparing these reports. All of the reports use information from JBHC's accounting system, but all are prepared offline, as JBHC's accounting software does not include the functionality to prepare the reports.

JBHC uses two major information system applications. For accounting and financial reporting, JBHC uses Great Plains. Great Plains provides accounts payable, payroll, and financial reporting. Client appointments, medical histories, and funding information are kept in BHS, specialized software used in the behavioral health industry. BHS also manages accounts receivable.

Services provided by JBHC may be paid by the individuals receiving services, insurance companies, Medicaid, or government agency contracts. BHS tracks the funding for each individual and prints the appropriate bills for individual, insurance, and Medicaid billing. John uses information from BHS as well as accounting information from Great Plains to generate billings and reports for government agency contracts. Furthermore, he uses data from BHS to update revenue and receivable account balances in Great Plains.

John finds it frustrating integrating data from Great Plains and BHS for contract reporting. The standard reports provided by the software are not sufficient for his purposes. He has decided to understand the underlying data to more efficiently prepare the reports. He feels confident that he will be able to navigate the applications' databases, as he had enrolled in an accounting information system class in college and had developed several small databases using Microsoft Access. Luckily, he has a manual that describes the data structure of Great Plains left from the prior controller (Whaley, 2005). In examining the manual, he is surprised to note many differences between what he had learned in class and Great Plains' data structure.

REA

John had taken a class on accounting information systems in college that had included a module on the structure of accounting systems. The module was based on a methodology for designing accounting systems known as REA. REA is "a framework for building accounting systems in a shared data environment..." (Dunn & McCarthy, 1997). It is an adaptation of accounting to relational databases using entity relationship diagrams as the documentation method (McCarthy, 1979; McCarthy, 1982). At the time REA was introduced, relational

databases were a relatively new technology. Now business systems are largely built upon relational database systems.

Existing accounting systems have a set of fundamental problems which REA is designed to overcome (McCarthy, 1982):

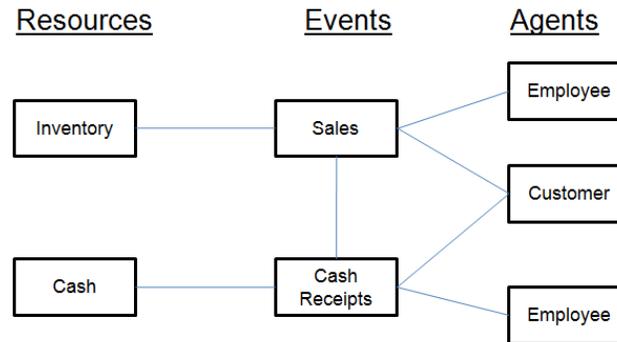
1. Accounting is expressed exclusively financially, which leaves out useful information.
2. Accounting uses inappropriate classification schemes based on the chart of accounts that limit the value of the information to different decision makers.
3. Accounting information is too aggregated, which removes flexibility.
4. Accounting systems are not sufficiently integrated with other areas of an organization.

REA overcomes these weaknesses by removing accounting artifacts and modeling actual business processes. Accounting artifacts are components of accounting that exist only for financial reporting such as journals, ledgers, double-entry accounting, and a chart of accounts.

An accounting system built using the REA methodology is based on a duality of business events in which business resources are either incremented or decremented in exchanges with an outside agent. For example, a sales event in which inventory is reduced when delivered to the customer is paired with a cash receipt in which cash is incremented. Each event is modeled as a conceptual entity that in a physical database is implemented as a table. Each event is related to two agents, or parties to the transaction: one external agent and one internal agent. For example, a sales entity is related to the customer entity and to the sales person entity. Each event is also related to the resource exchanged, such as inventory or cash. Additional commitment events such as sales orders may also be included in a system that is compliant with REA. Figure 1 shows an example of an entity relationship diagram created using REA for the sales process. Each rectangle represents a data table that would be present in an REA-inspired database.

A distinguishing feature of REA is it eliminates the chart of accounts and general ledger. Rather, it stores data at the most basic level without aggregation or classification. The system models business processes rather than accounting structures. Calculation of accounts receivable serves as an example of the difference between a traditional accounting system and a system based upon REA. In a traditional system, the accounts receivable balance in the general ledger would be updated either after each transaction or on a regular basis, often monthly. The change in accounts receivable occurs from sales and customer cash receipts. Under an REA accounting system, no accounts receivable balance is maintained. If a user desired to know the accounts receivable balance, the user can query the systems for total sales and total customer cash receipts. REA allows the user to obtain any combination of information without relying upon the pre-formatted organization of the general ledger of a traditional system.

Figure 1: REA Diagram



GREAT PLAINS

John finds Great Plains to be similar to REA in some ways, but to be very different in other ways. Great Plains, like other accounting software, fulfills three functions:

1. Prepare financial statements.
2. Process of transactions.
3. Provide decision support.

In Great Plains a transaction table is basically the same as an REA event table. When a business event associated with an accounting entry is entered into a transaction table, the associated accounting entry is also entered into a distribution table. The distribution table is the computerized version of an accounting journal. At some point master tables such as inventory and customer are updated for changes in balance. Master tables are the equivalent of accounting subsidiary ledgers. The accounting transactions are then posted to the general ledger, where transactions are recorded by account. In traditional manual accounting systems, transactions were usually posted as monthly summaries. In computerized accounting systems, transactions are often assigned to batches, and batches are posted to the general ledger as summaries.

For example, when a sales invoice is entered in Great Plains, an entry is made in the Sales Transaction Work Table to record the transaction (Whaley, 2005). An accounting entry is made in the Sales Distribution Work Table, with debits to accounts receivable and cost of goods sold and credits to sales and inventory. The Inventory Quantity Master Table and the Customer Master Summary table are updated with new inventory and customer receivable balances. Eventually the GL Transaction Work table is updated with the accounting entries.

Tables also exist to record sales quotes and orders and to perform audit trail and system flow requirements. When a cash receipt is received, it is entered into a Cash Receipts table and

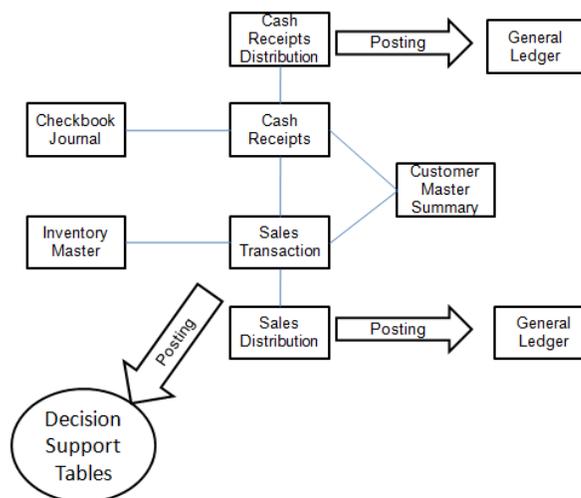
the Customer and Checkbook tables are updated. John created Figure 2 to help him understand Great Plains database.

In Great Plains, when transactions are posted a set of tables used for decision support is also updated. Great Plains incorporates an interface for querying the data in these tables. For example, when a sales transaction is posted, summary information may be updated in the following decision support tables depending upon the nature of the transaction:

- Customer Master Summary
- Customer Period Summary
- Sales Person Master Summary
- Sales Territory Master
- Inventory Sales Summary
- Inventory Transaction Amounts

John thinks he has a better understanding about Great Plains database, but he is a little puzzled about the differences between accounting databases he learned in school and the Great Plains database.

Figure 2: Great Plains Database



ADVANCED GAME PRODUCTS, INC.

Jane E. Baird, Minnesota State University, Mankato
Robert C. Zelin II, Minnesota State University, Mankato

CASE DESCRIPTION

This case primarily concerns the application of financial reporting standards and current tax law to certain transactions of a company called Advance Game Products, Inc. (AGP). Internal control issues are also presented. Specifically, the case involves issues related to the accounting and tax treatment for two types of sales rebates, licensing arrangements whereby professional athletes permit their likeness to be used in the company's video games, and a contract with another company under which it will be the primary creative force behind the development of certain new games while AGP will take on the primary role of marketing those games. Students are also asked to identify potential concerns over the processing of the rebates and make recommendations on what internal controls the company should implement. The case has a difficulty level of 4, although the assignment could be easily adapted for use in a second Intermediate Accounting course or junior level business tax course. The case is designed require 1 to 4 hours of class time and require 12 to 15 hours of student preparation outside of class if all questions are assigned.

CASE SYNOPSIS

Jamie Jetson, a recent college graduate with an Accounting degree, has been assigned to the Advanced Game Products, Inc. (AGP) client engagement. The company operates in the dynamic video game industry, where creativity is paramount. Jamie's firm has been hired to do the audit and tax work for AGP. There were several big changes at AGP during the year, and Jamie's accounting firm has to determine how to deal with those items. AGP has recently signed contracts with celebrities for the rights to use their likenesses in video games under development. Unfortunately, one of the professional athletes, who already received a large advance, was involved in a big public scandal, so AGP has cancelled the development of his game. Another big change was that the company recently started a sales rebate program for both games sold in stores and games downloadable from the Internet. AGP has also signed a new agreement with another company to help it develop new games to work with new gaming platforms. With these new developments come both opportunities and concerns for AGP.

ADVANCED GAME PRODUCTS, INC.

Jamie Jetson recently graduated from Galactica State University and landed a job in the Chicago office of a regional public accounting firm. She has been assigned to work on the engagement team for Advanced Game Products, Inc. (AGP). Jamie's firm does both the audit and tax work for AGP. The team has been gearing up for the audit of the 2010 financial statements and the preparation of the 2010 tax returns. Jamie has been asked by the engagement manager to do some research on the proper accounting and tax treatment for transactions that are new to AGP in 2010. The following information has been gathered from the audit planning documents.

Advanced Game Products, Inc. (AGP) designs, produces and distributes video games for electronic platforms, including game consoles (Nintendo Wii, Microsoft Xbox 360, and Playstation 3), handheld game devices, cellular phones, and computers. The company was founded in 1995 by Jackson Packman, who began with one game he designed in the basement of his home. Since then, the company has had one hit game after another, along with many game designs that never came to fruition. Revenues have grown an average of 15 percent per year for the past five years, despite a downturn in the economy. However, the company has had very minimal profits due to high research and development costs combined with short product life cycles. The company now has 1200 employees, but is still privately held, with Mr. Packman retaining 75 percent ownership and five other investors owning the remainder. The company's main headquarters is in Chicago, Illinois. AGP is an accrual-basis taxpayer and is taxed as a corporation.

The company now has hundreds of games in its product mix, and introduced 25 new titles in 2010. Many of the products are sold in disk or cartridge format at retail stores, while others are sold in downloadable format or online-only format directly to consumers via the Internet. A majority of the products are designed in-house by staff developers, while others are purchased from independent developers. Management is hoping to take the company public some day, but before that can happen the company needs to boost its profits to attract investors. The management team has decided to approach that goal through both increasing sales and decreasing costs.

As part of the company's efforts to increase sales, it recently began a sales incentive program. The games sold in retail stores range in price from \$29.99 to \$79.99. The company is offering mail-in rebates on select games sold by retailers. If the game retails for \$49.99 or more, the rebate is \$10. If the game retails for less, the rebate is \$5. There is a maximum rebate per household of \$25. The rebates still allow AGP to earn a good profit margin on each product. The company has never offered rebates before, and management does not know what to expect in terms of additional sales generation or how many customers will actually return the rebate requests. The rebates will be offered for one month at a time, with an additional 2-week window for customers to return the rebate forms and receipts. The company plans for 10 games

to have rebate incentives at any one time, with rebates offered on and off through the year on different titles.

A second type of rebate incentive will be offered as a sort of customer loyalty award. These rebates will be offered only on download products and online game products. The products sold on the company's website are not available elsewhere—they are not the same products that AGP sells to retail stores. The download products are primarily games for cellphones or handheld devices, but there are some downloadable games for the Wii and other game consoles. The online games are not downloaded, but are played online. For every \$100 a customer spends on these products, the customer will be eligible for a \$10 rebate. There is no rebate for purchase increments of less than \$100, but the rebates are based on cumulative purchase levels rather than one-time purchases. However, the cumulative totals must be achieved within a six-month time frame, with no carryover of amounts. So, for example, a customer making one purchase of \$30 in January and another purchase of \$75 in March would be eligible for a \$10 rebate, but if the same customer made the second purchase in July instead of March he would not be eligible for the rebate. The customer must apply for the rebate by submitting an online form. If the customer has met the purchase criteria, then a rebate check is mailed to the customer.

Also new in 2010 is a line of sports-based games using the names and likenesses of real professional athletes. This requires AGP to sign license agreements with those individuals for the rights to use their names and likenesses in the games for a specified period of time. There is quite a bit of competition to negotiate license arrangements within the video game industry, and AGP has now become a big enough player in the industry to land some of these contracts. The licensing arrangements required AGP to pay nonrefundable, upfront fees to the athletes as advanced minimum royalty payments. The agreements state that the athletes are entitled to the minimum royalty amount regardless of the level of sales of the product, and beyond that will be entitled to 10 percent of the gross receipts from the product. During 2010, AGP paid \$250,000 each to four different athletes for the advanced minimum royalties. One of the games has already achieved a high enough sales volume that AGP owes additional royalties on the sales. These royalties have not yet been paid. Two others launched just before the Christmas sales season had respectable sales, but as of December 31, 2010 the royalties earned by the athletes were still less than the advance amount, so no additional amounts were owed. Unfortunately, one of the athletes was involved in a major scandal shortly after the agreement was signed and the company decided it was in its best interests to cancel the game's release. AGP did not have a morals clause in the contract and, therefore, was obligated to pay the fee even though the athlete will not be associated with the product. The game is now being reworked to include a different athlete who signed a licensing arrangement with AGP in April 2011.

As part of its cost control efforts, AGP has pursued ways to expand into new markets without locking into greater fixed costs in terms of facilities and fulltime employees. As a result, in December 2010, AGP entered into a contract with another company, Creative Designs Inc.

(CDI) to design, produce and market downloadable games for the Apple iPad and similar new devices as they hit the market. CDI is a smaller company, but has already achieved success in game design. Under the arrangement, Creative Designs Inc. (CDI) will be the creative force behind the game development, from initial idea inception to the completion of the game programming. Under the agreement, CDI is prohibited from working with other companies to develop or market any iPad games, but is free to pursue arrangements with other companies for game development for other platforms. AGP will provide all of the marketing expertise, and provide the sales function through its already established Internet platform. AGP will also take care of the arrangements with the technology developers, such as its agreement with Apple for rights to create games for the iPad. Each company is assuming 50 percent of all costs and will share any profits equally. No separate entity has been formed as a result of this contract. AGP hopes to pursue other arrangements of this type if this one proves to be successful. As of December 31, 2010, three games were in early stages of development. AGP has not yet incurred any marketing costs, but has paid a fee to Apple. CDI has incurred costs for product development, but had not yet billed AGP for its share of those costs.

COMMUNITY HOSPITAL HEALTHCARE SYSTEM: A STRATEGIC MANAGEMENT CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns strategic management of community hospitals in the United States. This case has a difficulty level of five; appropriate for first year graduate level students. This case is designed to be taught in four class hours and is expected to require twenty-four hours of outside preparation for students. For the graduate student, it should be a half semester long group project with a presentation and report at the end of the semester.

CASE SYNOPSIS

This case study analyzes the turbulent social, legal and technological issues that are affecting today's suburban community hospitals in United States. The soaring health care costs, increasing number of uninsured or underinsured patients, reduced payments by government agencies, and increasing number of physician owned ambulatory care centers are squeezing the lifeline of community hospitals whose traditional mission has been primary care. Furthermore, with the enactment of Patient Protection and Affordable Care Act in March 2010, community hospitals are facing new challenges whose full impact is unknown. This case study would help students learn about Strategy Formulation including Vision and Mission Statements, internal and external analysis, and generating, evaluating & selecting appropriate strategies for a healthcare organization.

COMMUNITY HOSPITAL HEALTHCARE SYSTEM

With the enactment of Patient Protection and Affordable Care Act in March 2010 (Health Act), and President Obama's professed goal of making health care in the United States more accessible and affordable, the next few years are sure to be very turbulent in the healthcare industry. The Health Act is expected to provide healthcare coverage to 95% of Americans, which will include an additional 32 million persons nationally (New Jersey Hospital Association, 2010). The Health Act goes into effect in 2010 with many of its requirements not becoming effective until 2019. Directly because of the enactment of the Health Act, insurance premiums are expected to increase anywhere from 2% to 9% depending on who is quoting them (Wall Street Journal, 2010). The Health Act requires children to remain on their parents' health plans

until age 26, eliminates copayment for preventive care, bars insurers from denying coverage to children and adults (in 2014) with pre-existing conditions, eliminates lifetime caps on insurance coverage, and requires setting up of insurance exchanges in all states (by 2014) through which individuals, families and small business can buy coverage (Adamy, 2010; Pear, 2010).

United States spends approximately \$2 trillion annually on healthcare expenses (Underinsured Americans: Cost to you, 2009). This amount is more than any other industrialized country in the world and counts for 16% of the U.S. GDP. This percentage is higher than any developed country in the world (Johnson, 2010). Despite the substantial healthcare spending, access to employer-sponsored insurance has been on the decline among low-income workers, and health premiums for workers have risen 114% in the last decade (Johnson, 2010). Furthermore, healthcare is the most expensive benefit paid by U.S. employers (Johnson, 2010). Despite this outlay, approximately 49 million Americans are uninsured and about 25 million underinsured--those who incur high out-of-pocket costs, excluding premiums, relative to their income, despite having coverage all year (Abelson, 2010; Kavilanz, 2009). Overall, the healthcare industry in America is besieged with high cost, uneven access and quality (Flier, 2009). The intractable issues of high cost, uneven access and quality have made everyone unhappy from patients, hospitals, doctors to employers.

The American healthcare industry is composed of approximately six major interest groups: hospitals, insurance companies, professional groups, pharmaceuticals, device makers, and advocates for poor (Goldhill, 2010) with the Physicians--part of the professional groups--having the biggest influence on the industry. Although hospitals constitute only 1 percent of all healthcare establishments--hospitals, nursing and residential care facilities, offices of physicians & dentists, home healthcare services, office of other healthcare practitioners, and ambulatory healthcare centers--they employ 35% of all healthcare workers (U.S. Department of Labor, 2010).

Community Hospital Healthcare System

Community Hospital Healthcare System is a not-for-profit organization located in Monmouth County, New Jersey. With its 282 beds and 2400 employees including 450 physicians, Community Hospital serves approximately 340,000 residents in four suburban counties of central New Jersey. The Community Hospital Healthcare System is a holding corporation made up of (i) Community Hospital Medical Center, (ii) Applewood Estates, (iii) The Manor, (iv) Monmouth Crossing, (v) Community Hospital Healthcare Foundation Inc., and (vi) Community Hospital Healthcare Services, Inc. (a for-profit-corporation).

Community Hospital Medical Center (Community Hospital) is a general, medical and surgical community hospital offering an array of primary and secondary services, including: cardiology services, magnetic resonance imaging (MRI), diabetes services through Novo Nordisk Diabetes Center, emergency services, endovascular surgery, inpatient psychiatric

services, maternity care (single room) and special care nursery, oncology, radiation oncology, rehabilitation, short stay unit, Sleep Disorders Center, Women's Health Center, and dialysis unit. Community Hospital Medical Center operates a Family Medicine Residency program in affiliation with the Robert Wood Johnson/UMDNJ Medical School.

Community Hospital has been selected as one of the best places to work in New Jersey by *NJBiz*--a business publication--and landed at 20th place among 100 best places to work in healthcare by Modern Healthcare magazine in 2009. The American Nurses Credentialing Center has re-designated Community Hospital Medical Center a magnet status for excellence in nursing and patient care in 2010 (Community Hospital Healthcare System, 2009 Annual Report). Only 6% of hospitals in U.S. hold Magnet designation and only 3% have earned re-designation one or more times (Community Hospital Healthcare System, 2009 Annual Report). Community Hospital is also a designated Primary Stroke Center. Finally, a nationally recognized firm has ranked Community Hospital among the top 5% of hospitals in the U.S. for patient satisfaction (Community Hospital Healthcare System, 2009 Annual Report).

Applewood Estates is a continuing care retirement community with 290 apartments, 20 cottages, 40 residential health care units, and 60 bed skilled nursing facility.

The Manor provides nursing services for 123 elderly residential units including sub-acute, rehabilitation and intravenous therapy.

Monmouth Crossing provides assisted facility for the elderly consisting of 76 units. Community Hospital Healthcare Foundation Inc. seeks and invests funds for the benefit of all components of the Community Hospital System except for the Community Hospital Healthcare Services, Inc.

Community Hospital Healthcare Services, Inc. is a for-profit entity that provides related services or participates in joint ventures of related services that do not meet criteria for being tax-exempt. Examples include an ambulatory diagnostic imaging business and a public fitness club. It also holds certain real estate in support of the Community Hospital.

Vision--an organization of caring professionals trusted as our community's healthcare system of choice for clinical excellence.

Mission--to enhance the health and well-being of our communities through the compassionate delivery of quality healthcare.

Community Hospital's mission and vision is borne out of six Strategic Imperatives--known as pillars. They are: (i) growth and development, (ii) community involvement & outreach, (iii) physician integration, (iv) customer service, (v) high performance and (vi) renown. According to John Gribbin (personal communication, August 16, 2010), CEO of Community Hospital, use of technology underpins each of the six strategic imperatives and is used to achieve goals pertaining to the Strategic Imperatives.

COMMUNITY HOSPITAL DILEMMA

Traditionally community hospitals have defined themselves to be center of Primary care, i.e., place for general medical and surgical care. Unfortunately, under the current health care industry practices, general medical and surgical care which form the core of a community hospital tend to be less profitable than specialty care--heart, trauma and, transplant centers. Additionally, while primary care is increasingly viewed as the long-term solution to U.S. health crisis, many argue that the Health Act does little to change the economics of specialty vs. primary care. For community hospitals like Community Hospital, this is not good news. Community Hospital's mission is primary care, but it is challenged as to how to develop other services that which are complementary to its mission of primary care that effectively subsidize its commitment to primary care.

Based on market share, Community Hospital faces two direct competitors and other peripheral competitors as it tries to maintain its position as the community's healthcare system of choice for clinical excellence and meeting the health delivery needs of residents in central New Jersey.

Shore University Medical Center (SUMC)

Shore University Medical Center is a 502 bed regional medical center that specializes as the region's only advanced pediatric clinical care hospital. SUMC is also a Level II Trauma Center, with an affiliation with the University of Medicine and Dentistry of New Jersey — Robert Wood Johnson Medical School. It is located in Neptune, NJ and competes with Community Hospital in eastern region of Monmouth County, NJ.

SUMC is part of the three-hospital member Meridian Health Systems. SUMC has also received the prestigious Magnet award for nursing excellence three times. It has been designated by J.D. Power and Associates as a Distinguished Hospital for Inpatient Services (2006) and received the New Jersey Governor's Award for Performance Excellence (2005). With their Meridian partner hospitals, SUMC has also received the following awards: FORTUNE'S "100 Best Companies to Work For" (2010), Best Places to Work in New Jersey" for five consecutive years by *NJBiz*, New Jersey's Outstanding Employer of the Year in 2003 and 2009, One of the top 100 Most Wired Health Systems in the United States for 10 consecutive years, and John M. Eisenberg Award for Patient Safety, one of the highest recognitions in the nation for hospital quality.

University Hospital (UH)

UH is unique among the three hospitals because of its size and breadth and depth of medical services provided and specialties offered. UH is a 610-bed academic medical center and

a teaching hospital of UMDNJ-Robert Wood Johnson Medical School in New Brunswick, NJ. UH competes with Community Hospital in the northern and western part of Monmouth County and eastern and northern Middlesex County. Since it is a teaching hospital, UH provides services and speciality care that Community Hospital would not be able to provide even it desired to do so. UH is a Level 1 Trauma Center, with a separate Bristol-Meyers Squibb Children's Hospital (BMSCH) with research and rehabilitation facilities. Moreover, UH specializes in cardiac procedures including heart transplants, has a cancer hospital, offers state of the art robotic surgery and provides kidney transplant services.

UH is recipient of many awards and recognitions: (i) one of America's best hospitals according to U.S. News and World report, (ii) "Hospital of the Year" by *NJBiz*, (iii) top-ranked cancer programs, (iii) recognized exceptional U.S. hospitals in quality and safety, (iv) recipient of Magnet Award for nursing excellence, (v) award for excellent stroke care by American Heart Association, and (vi) high patient satisfaction ranking by the patients of BMSCH.

Tables 1 to 5 below provide data that should be used to determine the competitive advantage/core competencies of Community Hospital. The tables represent data and ratios about hospital finance (tables 4 & 5), safety and mortality rates (tables 2 & 3), and patient experience (table 1).

Table 1: Hospital Experience Survey (%)				
	CMC	SUMC	UH	NJ Avg.
Patients who reported that their nurses "Always" communicated well.	74	75	73	72
Patients who reported that their doctors "Always" communicated well.	78	75	76	76
Patients who reported that they "Always" received help as soon as they wanted.	60	59	59	56
Patients who reported that their pain was "Always" well controlled.	69	69	67	66
Patients who reported that staff "Always" explained about medicines before giving it to them.	59	57	58	55
Patients who reported that their room and bathroom were "Always" clean.	64	62	64	66
Patients who reported that the area around their room was "Always" quiet at night.	48	49	49	50
Patients at each hospital who reported that YES, they were given information about what to do during their recovery at home.	77	76	81	77
Patients who gave their hospital a rating of 9 or 10 on a scale from 0 (lowest) to 10 (highest).	68	62	66	60
Patients who reported YES, they would definitely recommend the hospital.	69	68	74	64
<i>This table provides data from a survey that asks patients about their experience during a recent hospital stay. http://www.hospitalcompare.hhs.gov/ August 11, 2010.</i>				

	CMC	SUMC	UH
Death Rate for Heart Attack Patients	No different than U.S. National Rate	No different than U.S. National Rate	No different than U.S. National Rate
Death Rate for Heart Failure Patients	Better than U.S. National Rate	Better than U.S. National Rate	No different than U.S. National Rate
Death Rate for Pneumonia Patients	No different than U.S. National rate	No different than U.S. National Rate	No different than U.S. National Rate
Rate of Readmission for Heart Attack Patients	No different than U.S. National rate	No different than U.S. National Rate	No different than U.S. National Rate
Rate of Readmission for Heart Failure Patients	Worse than U.S. National Rate	No different than U.S. National Rate	No different than U.S. National rate
Rate of Readmission for Pneumonia Patients	Worse than U.S. National Rate	No different than U.S. National Rate	Worse than U.S. National Rate

This table measures the hospital mortality rates for the three hospitals and compares those results with U.S. National Mortality Rates. <http://www.hospitalcompare.hhs.gov/> August 11, 2010.

	CMC	SUMC	UH	Top 10% of Hospitals scored equal to or higher than	Top 50% of Hospitals scored equal to or higher than
Heart Attack Overall Score	96	99	98	100	97
Pneumonia Overall Score	93	96	83	99	96
Surgical Care Improvement Overall Score	90	97	95	98	95
Heart Failure Overall Score	89	97	91	100	96

This table compares Heart Attack, Pneumonia, Surgical Care and Heart Failure Care among the three Hospitals and other hospitals in State of NJ. New Jersey Department of Health and Senior Services, Web.doh.nj.us/.../scores.aspx?list..., downloaded August 13, 2010

	CMC	SUMC	UH
Average Length of Stay (days)	3.6	4.6	5.0
Medicare Average Length of Stay (days)	4.7	5.7	6.5
Occupancy Rate for Maintained Beds (%)	78.8	77.7	82.1
Operating Margin Ratio (%)	2.4	2.9	0.1
Total Margin Ratio (%)	8.7	9.3	8.6
Current Ratio	3.97	2.23	1.51
Modified Days Cash on Hand Ratio	241.6	194.4	250.2
Net Patient Service Revenue	6,206	7,287	8,653
Total Expenses per Adjusted Admission	6,286	7,405	8,783
Charity Care Charges as percentage of total Gross Charges	4.0	4.4	5.0
Provision for Bad Debt as Percentage of Net Patient Service Revenue	1.9	4.3	5.0

This table provides ratios for Utilization, Financial Health and Operational Performance for three hospitals. FAST Reports, New Jersey Hospital Association.

Table 5: Key Statistics for Community Hospital

	2007	2008	2009
Beds	271	276	282
Births	2,026	1,869	1,749
Emergency Department Visits	60,344	60,828	64,460
Family Medicine Center Visits	18,424	20,046	19,482
Health Promotion Visits	53,291	51,072	50,880
Patient days (including same-day surgeries)	83,968	82,533	76,635
Physical/ Occupational Therapy Treatments	92,911	106,856	122,871
Radiology/Imaging Procedures	125,117	130,108	127,913
Surgeries	15,092	14,033	13,309
Employees	1,664	1,743	1,770
Uncompensated Healthcare	10,537,747	10,885,754	10,390
Bad Debt	2,750,418	2,930,189	3,561,270
Senior Living Communities Occupancy Rates (avg. in %)	90.5	91.4	89.3
<i>This table provides key statistics for Community Hospital for past three years. 2007- 2009 Community Hospital Healthcare System Annual Reports.</i>			

Outlook

The population of Monmouth County, NJ is set to increase from 646,088 to 657,798 from 2009 to 2014. The median age will also increase from 40 to 41, and per capita income will increase from \$40,189 to \$42,166 during the same period (North Carolina Department of Commerce, 2008). The CEO of Community Hospital worries that with each passing day the continued viability of his hospital becomes difficult. Moreover, he believes that the Health Act will hurt Community Hospital's bottom line by about a \$1 million per year. However, the CEO believes that Community Hospital is well positioned to meet its challenges and will succeed, albeit with hard work, talented employees and some luck.

Federal government through Medicare and Medicaid provides Community Hospital's revenue of about 45%. Generally, Medicare and Medicaid payments to hospitals are approximately 20% less than the actual cost (Arnst, 2010). Remaining revenue of Community Hospital comes mainly from insured patients. Community Hospital, like most hospitals across the country receives most revenue from treating complex health care diseases such as surgeries and procedures that require hospital stay and care. Ominously for Community Hospital, due to diffusion of health care technologies, services with most revenues are moving away to private surgery centers owned by physician groups. Additionally, the enactment of the Health Act will lead to reduction of approximately \$1 million to Community Hospital's bottom line. The challenge for strategists at Community Hospital is to provide primary care and charity care (NJ law requires every hospital to medically stabilize anyone--regardless of insurance or ability to pay--and treat those patients to the full extent of services offered by the hospital) in a weakened economy with increasing charity care expenses and rising bad debt. The strategists must find

new sources of revenue to allow Community Hospital to support its mission while secure enough funds to meet its commitments to primary and uncompensated care.

CONCLUSION

Community Hospital is in a challenging environment due to changing demographics, highly regulated health care industry and having an uneven playing field compared with physician owned surgery centers. Matter of fact, one-third of the nation's community hospitals had operating losses in 2008 (Nussbaum & Tirrell, 2010). Patients with good jobs and appropriate health insurance are leaving the region, while physicians are taking high revenue procedures to privately owned surgery centers. Additionally, with the reduced Medicare and Medicaid reimbursements and increasing charity care/bad debt cost; Community Hospital needs to create a new sustainable business model. Please prepare a strategic plan that will steer Community Hospital through the turbulent times ahead.

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EHARMONY: MORE THAN TRADITIONAL INTERNET DATING

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CASE DESCRIPTION

This case will allow students to analyze marketing strategy and target markets, be informed about and able to discuss legal and ethical issues in the marketplace and also about branding of a company and how the brand can continue to keep the company going one way even if going another way is in the company's best interests. This case has a difficulty level of three to four and is best utilized in higher-level undergraduate or graduate courses. This case is designed to be taught in one and a half class hours with students having two hours of out-of-class preparation.

CASE SYNOPSIS

EHarmony is an online dating company that was started in 2000, under the premise that it matched couples scientifically on "29 dimensions of compatibility." Unlike other dating sites, eHarmony focuses specifically on creating lifelong "matches" and has marketed the company accordingly. Originally, eHarmony was based on strong Christian principles, using the number of marriages produced from the site as a marketing tactic. However, competition and a more mature market have led the company to expand in order to survive and still hold a competitive advantage. Now, it has gone after the secular market in order to compete with the largest online dating company, Match.com.

In trying to expand, however, eHarmony has made several mistakes. First, eHarmony has excluded gays and lesbians and been sued for doing so. They eventually settled out of court and agreed to provide gays and lesbians with a separate service for matching. Furthermore, other lawsuits allege that eHarmony's matching system is not scientific and allows online predators and scam artists to connect with unknowing singles. That case is still in the court system.

Another way that eHarmony has tried to expand is by creating specific sites for different countries. In Britain, it created a new method of matching for British singles, but for its Canadian and Australian sites, eHarmony utilized the same system as in the United States. Ignoring the sociological differences could be extremely detrimental to the company as a whole.

Finally, eHarmony has chosen to advertise in traditional ways, utilizing television and print advertisements instead of advertising online or creating applications for mobile devices. In

doing so, eHarmony has missed out on a large part of the market – the younger generation that is constantly on the go and rely on mobile devices and computers rather than television and print.

INTRODUCTION

In 1997, after practicing clinical psychology for 35 years, Dr. Neil Clark Warren came to believe that there was a better way to find love than by simply leaving it up to chance. Dr. Warren set out to test this theory and identify the characteristics between spouses that were consistently associated with the most successful relationships. After three years of research, Warren's team developed the Compatibility Matching System. This system allows matchmaking between compatible persons with whom they are likely to enjoy a long-term relationship. Based on this model, eHarmony was launched in 2000 and since then, millions of people have used eHarmony's Compatibility Matching System to find compatible long-term relationships, many of them leading to marriages. In the beginning, Warren started marketing eHarmony primarily to Christian sites, touting it as being based on Christian principles. Now in marketing through TV or radio ads, (\$50 million spent last year, \$80 million projected this year) there is no mention of its Christian connection. EHarmony is increasingly seeking out secular audiences through online partnerships with various media outlets.

EHarmony's matchmaking service has grown into the fourth-largest dating site on the Web, behind Match.com, Yahoo! Personals and Spark Networks, according to Internet measurement company comScore Media Metrix. While other leading dating sites allow users to find their own matches by searching through online ads, eHarmony has its users fill out a 436-question test designed to evoke thoughtful and revealing responses. EHarmony then emails users potential matches, encouraging people to get acquainted before they even see each other's photos. Matches on eHarmony are based on "29 areas of compatibility" such as character (curiosity, intellect, appearance), "emotional makeup" (anger, mood, and conflict issues), family values (background, education, spirituality), and traits (humor, sociability, ambition). Whereas some singles found the questionnaire tedious and exhausting, others applauded its thorough nature and found the results revealing and insightful. The length of the questionnaire was intentional; Warren and his team believed that only those truly committed to finding an appropriate match would complete the entire process.

Once an interested person completed the questionnaire, eHarmony would search its database for matches, but only for individuals who met at least 25 out of the 29 compatibility areas, on either a local or worldwide basis. The results, according to the company's web site, would be "matches unlike those on any other online dating service" and "scientifically evaluated to be uniquely compatible" with each prospective eHarmony member. Once a match was found, however, love-seekers needed to officially become an eHarmony member by paying \$49.95 for a one-month trial membership, \$99.95 for three months, \$149.95 for six months, or \$249.95 for a

year-long membership. eHarmony guaranteed at least one match per month (though there were often dozens), with the hope of falling in love.

The proprietary nature of its system does not allow eHarmony to reveal exactly how the 29 dimensions are used to match people. Eharmony does not accept members who are already married, have been married more than three times, or those it judges to be emotionally unfit to enter a relationship, such as the severely clinically depressed. Furthermore, eHarmony reserves the right to declare someone “unmatchable.”

EVANGELICAL CHRISTIAN CONNECTION

Dr. Warren is an evangelical Christian with strong ties to the conservative Christian community, including a prior business relationship with the Focus on the Family leader James Dobson. About a dozen questions in eHarmony’s Personality profile touch on faith, but the questions are nondenominational. The research that eHarmony has developed to match couples has been based on traits and personality patterns of successful heterosexual marriages with no thought to gays and lesbians. This would prove detrimental to the company. In 2005, Eric McKinley sued EHarmony for discrimination, filing a lawsuit in the State of New Jersey based on the fact that he was denied access to eHarmony because he is gay. McKinley’s lawyers believed the suit to be the first of its kind against the Internet’s largest dating site of 12 million members. In an interview on National Public Radio, Dr. Warren said:

“I have a deep desire for gays and lesbians to be matched well if they’re going to be together. I had some people come to me who were actually gays, and they wanted to know how I would advise that they try to build a site to do a good job. And I spent a lot of time with them talking about the need for research, the need to look at what really does work for gays and lesbians in terms of the couples and how you develop research instruments that will help them to do that job well. And I’ve tried to be helpful in those ways, but we’ve taken the position that right now we don’t choose to [match gays and lesbians].”

In the interview, Warren indicates that he has not done enough research about same sex coupling and that he imagines the principles of coupling might be different for homosexuals. After legal battles, eHarmony settled the case by announcing that it would match gays and lesbians under a new service (and website) called “Compatible Partners.” Compatible Partners draws on the same body of knowledge, and a disclaimer at the site informs users that the means employed to match prospective partners has not been modified to accommodate additional research involving same-sex couples. In other words, Compatible Partners uses the same theories and assumptions about who will be a good fit for gays and lesbians as eHarmony uses for heterosexuals.

But what the move hasn't done is clear up eHarmony's legal problems: a second suit alleges that by relegating gay dating services to a separate site, eHarmony is still discriminating and denying users access to the site they wish. For some among the religious right, eHarmony's agreement with the state of New Jersey to create a new site for gay users constituted surrender to the demands of gay "activists" determined to "criminalize Christianity." In January 2010, eHarmony again settled a lawsuit with the promise that they would link their straight and gay websites and allow people to use both without paying double fees. They also agreed to pay about \$500,000 to an estimated 150 Californians to settle the class-action suit, plus around \$1.5 million in court and attorney's fees.

Expansion to Britain

eHarmony launched its British website in October 2008. In Britain, the service cost 34.95 pounds (\$61.78) for a month, or 14.95 pounds per month for a six-month period after a seven-day free trial. Before going live in Britain, eHarmony spent about a year working with researchers at England's Oxford Internet Institute to gather compatibility characteristics unique to Britain by interviewing married couples. Since it opened in June of 2008 eHarmony.co.uk now has more than 800,000 singles registered. In September 2009, 5 million singles visited British dating sites. On average, about 4 percent of people have used a dating site in Europe. In Britain, online dating is twice as popular as the rest of the continent, with 8 percent of the population having visited a dating service. eHarmony now charges £33.95 for one month's membership, Dating Direct charges about £25 a month and Match.com charges around £22, although the monthly rates decrease as you sign up for longer subscription periods.

eHarmony has 800,000 registered singles compared to 6.5 million for Match.com, but the latter has been in Britain much longer than eHarmony. JupiterResearch, an Internet and technology analysis firm, predicts that revenue from the online-dating market in Europe will reach £430 million by 2011, compared with £250 million last year. The number of people paying to use online-dating sites in Europe is also expected to grow to six million by 2011, compared with 2.8 million two years ago. The British market is particularly strong — together with Germany, it accounts for more than half of European online personal spending. In contrast, American online dating —, which is set to reach 11.7 million paid users next year - has virtually reached saturation. Mr. Waldorf, CEO of eHarmony, is confident that there is a niche in the UK for his company, which he argues is the home of more serious daters looking for a long-term relationships: "The UK has a very strong market for online dating and that strength is combined with a gap in the market for matchmaking services. He points out: "The stigma has gone. There are lots of dating sites for flirting or casual relationships — but in terms of the brand and space that eHarmony operates in, we offer something different."

eHarmony also operates websites specifically focused on singles in Canada and Australia. Unlike the British site, for these two the same scientific matching system is used and

the only difference appears to be that the singles live in Canada or Australia as opposed to being in the United States. The subscription rates also remain the same in Canada and Australia as they do for US subscribers. The Canadian site was the first international eHarmony site, launched primarily because Canadians made up the second highest percentage of eHarmony users (on the original eHarmony site).

The site in Canada was launched in 2007, while the Australian site was launched in late 2008. Both sites offer special free communication weekends and specials where one can subscribe with a coupon code and get a percentage off of the subscription fee. These specials are often offered on Canadian or Australian holidays and free communication days can last for up to 10 days at a time. Competition is thinner in the foreign markets, as fewer large dating sites are specifically catered to foreign singles, however there are several national sites that exist specifically for users in Australia and Canada.

The main challenge is that each national market requires an entire new set of sociological research to underpin the matching software. However, eHarmony has refused to research the local cultures, needs and wants before launching the new sites and the questionnaires still remain the same for each eHarmony user, regardless of location, culture, religion, etc. This could prove problematic as not each country is marriage-focused as others (i.e. as a whole, the United States is more focused on marriage than say, Australia), and many people could be looking for different types of matches based on sociological or location differences. As of print time, eHarmony has not changed its types of questionnaires or surveys based on sociological differences and only time will tell if it will.

Competitors

Major competitors to eHarmony include Match.com, Spark.com, Yahoo Personals, PlentyOfFish.com, Chemistry.com (which is Match.com's "Sister Site"), and PerfectMatch.com. Match.com and eHarmony.com, which both use matchmaking systems based on user-created and questionnaire generated profiles, still dominate Internet romance, with Yahoo Personals steadily gaining subscribers and still growing (see table 1). A host of other competitors are also gaining traction with new ideas on how to put people together (see table 4). Most of the competition is financially insignificant when compared with Match.com, whose 20 million users and \$350 million in revenue blow most serious competitors out of the water, while eHarmony.com comes in second at 20 million subscribers and \$250 million in revenue (see table 2 for subscription fees). Match.com also claims that it is responsible for 472 marriages occurring each day, while eHarmony boasts that it is responsible for 236 (see table 3).

Table 1: Subscribers

Match.com	29,000,000
eHarmony	20,000,000
Chemistry.com	4,000,000
Perfect Match	4,000,000
Spark.com	1,000,000

Table 2.: Subscription prices in 2010 (price is per month)

	eHarmony	Match.com	Chemistry	Yahoo! Personals
1 month	\$59.95	\$34.99	\$49.95	\$29.99
3 months	\$39.95	\$19.99	\$33.32	\$19.99
6 months	\$29.95	\$16.99	\$26.65	\$15.99
12 months	\$19.95	n/a	n/a	n/a

Table 3: Marriages created from online dating sites

eHarmony	236 per day
Match.com	472 per day
Perfect Match	not released
Spark.com	not released

OkCupid is free to join and one does not have to pay to communicate, adding to its appeal. This advertising-supported site has 1.2 million members who have logged on in the month of March 2010 and ads are targeted to users based on their profiles. OkCupid also tripled its revenue in 2009. Free sites are rare, especially when it is free to communicate with matches. Most of the other sites allow free sign-ups, but some charge money for questionnaires, communication or other nuances that the subscriber could want.

AreYouInterested, another online dating company, switched to a subscription-based model last year. In this model, its users pay \$20 per month each month, or \$10 per month for a six-month plan. The site also makes money selling “virtual gifts” on Facebook. HowAboutWe charges \$16 a month, \$30 for three months or \$48 for six months. Match.com, like eHarmony, is free to join, but only paying members, who are about 1.4 million strong, can communicate on the site, also similar to eHarmony’s paying model.

The fledgling sites are growing fast, both because they are small and have room to grow, but also because they cost significantly less than sites such as Match.com and eHarmony. The AreYouInterested Facebook application has been installed 15 million times, and a companion iPhone app has posted more than 110,000 downloads. AreYouInterested parent company SNAP Interactive Inc. had revenue of \$3 million in 2009.

When it comes to advertising, online relationship service eHarmony is outspending its nearest competitors nearly 2-1, with well over \$100 million spent in 2008 alone. According to tracking service Nielsen, for the first nine months of 2008, eHarmony spent \$93.2 million on advertising, almost twice as much as second place Match.com, which spent \$47 million on

advertising in that same time period. Coming in third was Chemistry.com with \$28.2 million. No other online dating service spent more than \$1 million on ads in that same time frame.

So what do most of the ad dollars go to? The highest amount of that money goes to commercials that air on cable television, with the second highest amount of that money going to commercials that air on network television. But what makes the eHarmony story so special from an advertising standpoint is that the company has harnessed a fusion of brand-building advertising and direct response. This hybrid is called "brand-building direct response" and it is the secret weapon of the new generation of dot coms that want the branding power of offline and the accountability of ROI positive advertising. In this new hybrid, brand advertising and DR are no longer mutually exclusive; rather, they are inextricably linked. This is an Internet company that has largely been driven by old media. TV advertising (featuring testimonials from wedded couples) has driven it this far. Consumer research shows that 24 percent of all Americans can identify what eHarmony does with no help, though the research does not specify the age level of those 24 percent (table 5 shows who utilizes online dating).

With the prevalence of the Internet and new media, one would think that eHarmony would begin advertising in a different medium. However, eHarmony has still not advertised nearly as efficiently online as it has via print and television advertisements. If eHarmony is not careful and does not market to the younger generation, it could seriously miss a large part of the online dating market and fall even further behind leading frontrunner, Match.com.

Match.com	29%
Yahoo Personals	21%
eHarmony	11%
MySpace.com	7%
American Singles	4%
AdultFriendFinder	4%
BlackPlanet.com	3%
True.com	2%
Jdate	2%
AOL Profiles	2%
Salon Personals	1%
Christian Mingle	1%
Other	26%
Don't Know/Refused	19%

Legalities

In recent years, eHarmony has had legal issues, stemming from its refusal to let gays and lesbians be matched up on the eHarmony site. As explained previously in this study, that lawsuit was settled and eHarmony created a separate site for gays and lesbians looking for partners.

However, that has not been the end of eHarmony’s legal troubles and a recent lawsuit could cause eHarmony serious harm and jeopardize its standing in the online dating market.

In April of 2010, eHarmony was sued in a US District Court in Los Angeles. The plaintiffs, Lynda Kelly and Miranda Soegi, who are also trying to make sure the suit has class action status, allege that eHarmony’s matching system is not scientifically accurate. Furthermore, the plaintiffs argue that eHarmony is fraught with scam artists and not true singles that want to meet other people and be sincere.

Claiming to use algorithms to match up the singles, eHarmony vehemently denies these charges, going so far as to say that the claims are “baseless and meritless.” However, eHarmony has not outright denied that there are people in their matching system that are not sincere and therefore, could be out to scam other singles.

Kelly and Soegi who are seeking \$5 million in damages, argue that there are no measures in place to make sure that the people are being sincere and open when filling out the survey and eHarmony has no implementation to make sure that people are who they say they are. In the lawsuit, it is mentioned that Kelly was matched with a scam artist in Africa who was only after money.

If the plaintiffs win the case, it could be extremely detrimental to eHarmony, who has sought a competitive advantage through their patented matching system. It is an extremely large draw for new subscribers and has been eHarmony’s primary marketing strategy for years, especially since eHarmony has relied primarily on television advertisements to draw in older singles instead of the young twenty-something’s that are not always looking for serious relationships with online dating.

Table 5. Who utilizes online dating?

	Online Daters	Not online daters
All internet users	11%	89%
Sex		
Men	12%	88%
Women	9%	91%
Ethnicity		
White	10%	90%
Black	13%	86%
Hispanic	14%	86%
Location		
Urban	13%	87%
Suburban	10%	90%
Rural	9%	91%
Age		
18-29	18%	82%
30-49	11%	89%
50-64	6%	93%

Table 5. Who utilizes online dating?		
	Online Daters	Not online daters
65+	3%	97%
Household Income		
Less than \$30,000	14%	86%
\$30,000 to \$49,999	13%	87%
\$50,000 to \$74,999	10%	90%
\$75,000+	9%	91%
Home Internet Speed		
Broadband	12%	88%
Dialup	9%	91%
Education Level		
Less than high school	14%	86%
High school grad	10%	90%
Some college	11%	89%
College +	10%	90%

SALES ORDER PROCESSING AND INTERNAL CONTROLS

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CASE DESCRIPTION

In this case the students will be presented with a change in marketing strategy that will result in high growth in sales. The students are required to analyze the financial information and assist in the designing and developing an effective system to support the company's internal control objectives. The student is required to make an assessment of the inherent risks and exposures associated with the operations of the organization and design adequate internal controls. The case intentionally avoids any lengthy discussion of the marketing strategies. This case is written primarily for accounting majors in an undergraduate business program. It is suited for students who have already been exposed to the introductory accounting, finance and management courses. It can be taught in an introductory Accounting Information Systems course or an upper level accounting class after at least a brief discussion of accounting information systems. The case could also be taught at the graduate level to business students who need to understand and support the accountants in designing and enforcing internal control issues. The case can be assigned as an individual project or as a group project. The case can be tailored to meet the time constraints of any class schedule.

CASE SYNOPSIS

BodyBrace Inc, located in Richmond, Virginia manufactures and sells customized compressive sportswear that reduces injury, enhances physical performance and athletic longevity in the human body. Unfortunately the company has not realized the growth it had anticipated 10 years ago at inception. Based on the recommendations of a marketing consultant, Mr. Davis the founder and CEO of the company has decided to expand from customized to mass production of the sportswear. A proposed change in the marketing strategy is expected to result in rapid growth in sales. However, this will require a large infusion of cash from a creditor. The company is looking for funding from a bank to finance the expansion. Every bank approached thus far wants assurance that a well designed accounting system will be in place soon. BodyBrace now needs to establish an effective Accounting System to enable it to keep track of its activities as well as establish a sound internal control system to ensure the integrity and reliability of its financial statements and other data. The case encourages students to apply the

internal control guidelines laid down in Statement of Auditing Standards (SAS) No. 78 and use data flow diagrams (DFDs) to explain the sales order process.

INTRODUCTION

BodyBrace Inc., was formed in February 1997 with a mission to design, manufacture and sell a range of customized compression sportswear under the brand name 'BodyBraces'. Mr. Davis, CEO and President, owns 85% of the shares and Mr. Williams, an attorney, owns the rest. The business office is currently located in Mr. Davis's home. He is the only salesperson for the company and is responsible for all company operations; there are no other employees. BodyBrace does not own any manufacturing facilities as it outsources all its manufacturing. Mr. Davis forwards the orders he receives to the manufacturing facility and products are shipped by the manufacturer directly to the customer. The products were invented to cushion sensitive joint ligaments, to help minimize possible sports related injuries and to enable quick recovery from such injuries. The invention was the work of Mr. Davis a physics major. He is so proud of his product that he is quick to tell you about the Ergonomic Study conducted by the Central State University Human Performance Laboratory. The findings of the study were published in a sports journal a couple years later. An additional finding of the study was that wearing BodyBraces also enhanced overall performance of the athlete.

At the launch of the 'BodyBraces', Mr. Davis believed that the product would appeal to every athlete and thus tap into the \$50 billion sports apparel market. The initial business plan projected annual sales of \$5 million by the third year of operations. 10 years later those projected annual sales have not been realized. In fact in the 2005 fiscal year, total sales were under \$250,000. See Tables 1 and 2. In a meeting with the newly hired marketing consultant, Mr. Davis was told "While you have a unique and innovative product, my analysis as a seasoned brand manager is that you have narrowly defined your target market. BodyBraces is a totally different concept in sports muscle-injury management and have many attributes that anyone involved in any sporting activity or even just a fitness program should be aware of. My strategy therefore would be to build product awareness in the market through mass production and mass distribution of the product." BodyBrace now needs external financing and proposes to finance this expansion by establishing a line of credit with a local bank. Mr. Davis is surprised that all the banks indicate that his ability to obtain financing is contingent upon proof of the establishment of a business model with effective internal controls. It is from this perspective that BodyBrace Inc. now seeks the services of an accountant to set up an adequate system with internal controls for his business.

CURRENT MARKET AND ACCOUNTING SYSTEM

Initially BodyBrace's target market was only the professional sports teams. The first BodyBraces were sold in April 1997 to the Washington Redskins. Since then the company has produced prototypes for various professional football teams. Currently 22 of the 32 NFL teams use the BodyBraces for soft tissue muscle injuries. Mr. Davis developed a special relationship with a professional football team after its defensive back severely injured his groin. Mr. Davis contacted the training coach and offered the BodyBrace to enable the player to recoup quickly and play in the NFL Championship game. Mr. Davis is proud to let everyone who will listen know that "Eight days later, the player played in that championship game. In fact, he states that he could not have played without his BodyBrace." Based on this success the professional team has made the BodyBrace a standard part of their injury reduction regiment since 2002 and continue to use it today. Numerous other Sports Performance and Athletic Training Programs have started using the BodyBraces as standard equipment in their muscle treatment regiments. BodyBrace Inc has also won contracts with the government and Mr. Davis is very proud to have provided his BodyBraces to the US Armed Forces and the US Olympic teams.

Table 1			
BodyBrace Inc.			
Income Statement (year ended December 31)			
	<u>2004</u>	<u>2005</u>	<u>2006</u>
Sales	\$ 205,000	\$ 245,000	\$ 294,000
Cost of Goods Sold	27,500	32,800	40,000
Gross Margin	177,500	212,200	254,000
Operating Expenses:			
Salary Expense	90,000	100,000	140,000
Advertising Expense	25,000	40,000	50,000
Rent Expense	12,000	12,000	12,000
Telephone Expense	13,000	13,500	14,000
Travel & Entertainment Expense	19,600	22,000	24,300
Other Expenses	3,500	6,500	3,500
Total Expenses	163,100	194,000	243,800
Income before taxes	14,400	18,200	10,200
Income Taxes	5,040	6,370	3,570
Net Income	<u>\$ 9,360</u>	<u>\$ 11,830</u>	<u>\$ 6,630</u>

Table 2			
BodyBrace Inc.			
Balance Sheet			
	<u>12/31/2004</u>	<u>12/31/2005</u>	<u>12/31/2006</u>
<u>Assets</u>			
Cash	\$ 5,000	\$ 3,500	\$ 6,000
Furniture & Equipment (net)	15,000	11,000	7,000
Investments	1,500	1,000	3,500
Other Long Term Assets	<u>25,000</u>	<u>22,000</u>	<u>34,500</u>
Total Assets	<u>\$ 46,500</u>	<u>\$ 37,500</u>	<u>\$ 51,000</u>
<u>Liabilities and Equity</u>			
Current Liabilities	3,000	8,000	3,500
Other Liabilities	0	0	16,000
Common Stock	25,000	25,000	25,000
Retained Earnings	<u>18,500</u>	<u>4,500</u>	<u>6,500</u>
Total Liabilities and Owner's Equity	<u>\$ 46,500</u>	<u>\$ 37,500</u>	<u>\$ 51,000</u>

The company has used various methods to reach new customers. In most cases Mr. Davis used the direct selling approach; he reached out directly to the team trainers and coaches to create awareness of his product. He has also used mass mailing to various organizations and club members. Mr. Davis has appeared on Real Sports TV with Brian Gumbel as well as on the Brooklyn Public Sports Television in New York. He has been on the local Richmond radio and television shows. He had articles about his company published in the Baltimore Business Journal. Unfortunately none of this celebrity patronage has brought him the desired results.

An examination of the current accounting system reveals that BodyBrace's current accounting system will not be able to handle a rapid growth in sales. "Is this all, Mr. Davis?" Ms. May an accountant asked, "You mean all the information about the sales and the expenses of running your business is contained in this spiral notebook?" "Yes, Ms. May that's where I keep all the information," Mr. Davis replied. "When I need a statement prepared or my taxes done, I take this book to my niece who puts the numbers together and gives me the information to take to the bank or whoever needs the information. Sometimes she asks for a bank statement or a credit card statement to get some more information. She prepares the income taxes from that information. She said all I need to do is to try to remember the date as well as to make sure I write everything down as soon as it occurs so I don't forget anything. Believe me I am very good at keeping all the receipts and invoices and if I lose any I can always get the information from my credit card company. I have a very simple way of keeping track of all my activities I tell you. My niece recommended that I do it that way. She also recommended that I get a software

package, which I did, but I haven't gotten around to using it yet. Since we are expanding I might have to, is that what you are talking about?"

NEW MARKETING STRATEGY AND PROPOSED ACCOUNTING SYSTEM

Failure to achieve the desired sales volume has compelled the company to change its marketing strategy. Recently Mr. Davis retained a marketing consultant to develop and implement a more effective and focused marketing strategy. In addition to custom made products, the new strategy calls for mass production of the BodyBraces and to sell to a larger market segment. The target market includes physically active people of all ages. The company will pursue an aggressive advertising campaign using several media channels to create product awareness. BodyBrace will display its products at various schools, colleges, and sporting events. Brochures will be placed in hospitals, gyms, health spas, doctor's offices, and other medical facilities. The projection is to sell at least 50,000 items in the first year (2007). A competitive pricing strategy will be adopted to allow the company to focus on building product awareness. The strategy is to build revenue while creating product awareness through aggressively selling the lower priced items. Sales are projected to double for the year 2008 and will grow at a reduced rate after that. The projected sales are given in Table 3. The company will continue to outsource manufacturing of the product but will now need to keep sufficient inventory on hand to facilitate timely shipment of the products to customers. A new office and warehouse will be rented in Richmond, Virginia. It is estimated that a total of 10 to 12 employees would be required to run to the business. All the employees will earn a base salary. Initially some employees may be temporary. Sales orders will be received as follows:

1. By sales associates from the customers over the phone or the fax (credit card only).
2. Through the Internet (credit card only). The web site will be checked for orders periodically throughout the day, printed and processed by the sales associates.

The order will be fulfilled, i.e., picked, packed and shipped by the employees in the warehouse.

Financial projections indicate that BodyBrace needs to secure a \$500,000 line of credit from the bank. This would enable the company to stock up on inventory as well as buy some fixed assets such as furniture and equipment that it needs to start operating at this scale. These funds would also cover the company's operating expenses for a period of six months. See Tables 4 and 5 for the five years projected financial statements.

To keep up with rapid growth in sale the company now needs to establish a better system to keep track of all its transactions. "The banks will demand audited financial statements for the amount of credit you are seeking Mr. Davis. Without the financing, you may not be able to realize the expansion you have envisioned." On hearing this from the accountant, Mr. Davis's response was "Well I guess we will go with the system that you are proposing. I have never

bothered before because I have never needed a loan from the bank. The product was customized and the cost of the goods was so low that I have always had the money to finance my activities. Right now all the business owes is \$16,000 for some legal work I needed done with the patent.” The accountant said “Mr. Davis, you will be pleased with the accounting information system we will design for your company. We will design a system that will accurately capture all the financial and nonfinancial transactions of the business to allow efficient day-to-day operations as well as assist you and the management in making decisions for the company.

Table 3								
Projected Sales Under New Marketing Strategy								
Item	Selling Price	Cost	Gross Profit	Projected Sales in Units				
				2007	2008	2009	2010	2011
Shoulder Brace	269.99	35.00	234.99	2,000	4,000	6,000	9,000	10,350
Shorts	169.99	35.00	134.99	2,000	4,000	6,000	9,000	10,350
Elbow Brace	39.99	7.00	32.99	12,000	24,000	36,000	54,000	62,100
Shin Splint	39.99	7.00	32.99	12,000	24,000	36,000	54,000	62,100
Knee Brace	24.99	7.00	17.99	12,000	24,000	36,000	54,000	62,100
Ankle Brace	21.99	7.00	14.99	<u>12,000</u>	<u>24,000</u>	<u>36,000</u>	<u>54,000</u>	<u>62,100</u>
				<u>52,000</u>	<u>104,000</u>	<u>156,000</u>	<u>234,000</u>	<u>269,100</u>
<i>Sales will double in 2008, increase by 50% in 2009 and 2010 and increase by 15% in 2011.</i>								
<i>Manufacturing cost per item is held constant as per agreement with manufacturer.</i>								
<i>Increase in other costs will be offset by increase in selling price.</i>								

The system will provide monthly and annual financial statements as well as support management by providing regular summary reports, exception reports, and interim reports necessary for decision-making. The system will establish adequate internal controls for your company which most banks are interested in. All procedures will be documented with appropriate flowcharts to facilitate with training new employees.”

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Sales	2,500,000	5,000,000	7,500,000	11,250,000	12,937,500
Cost of Goods Sold	<u>476,000</u>	<u>952,000</u>	<u>1,428,000</u>	<u>2,142,000</u>	<u>2,463,300</u>
Gross Margin	2,024,000	4,048,000	6,072,000	9,108,000	10,474,200
Operating Expenses:					
Salary Expense	450,000	750,000	1,125,000	1,687,500	1,940,625
Advertising Expense	200,000	400,000	500,000	500,000	500,000
Rent Expense	60,000	60,000	60,000	60,000	60,000
Insurance Expense	20,000	20,600	21,000	22,000	23,000
Telephone Expense	60,000	61,800	63,000	65,000	67,000
Travel & Entertainment Expense	100,000	140,000	140,000	150,000	150,000
Interest Expense	20,000	20,600	22,000	24,000	24,000
Other Expenses	50,000	50,000	50,000	125,000	150,000
Total Expenses	960,000	1,503,000	1,981,000	2,633,500	2,914,625
Income Before taxes	<u>1,064,000</u>	<u>2,545,000</u>	<u>4,091,000</u>	<u>6,474,500</u>	<u>7,559,575</u>
Income Taxes	372,400	890,750	1,431,850	2,266,075	2,645,851
Net Income	<u>691,600</u>	<u>1,654,250</u>	<u>2,659,150</u>	<u>4,208,425</u>	<u>4,913,724</u>

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
<u>Assets</u>					
Cash	10,000	50,000	100,000	100,000	200,000
Accounts Receivable	200,000	300,000	360,000	300,000	250,000
Inventory	60,000	100,000	100,000	80,000	75,000
Other Current Assets	10,000	10,000	10,000	15,000	20,000
Furniture (net)	20,000	30,000	28,000	23,000	350,000
Equipment (net)	75,000	75,000	250,000	240,000	350,000
Investments	50,000	60,000	75,000	310,000	645,000
Other Long Term Assets	<u>650,000</u>	<u>690,000</u>	<u>1,000,000</u>	<u>1,600,000</u>	<u>2,150,000</u>
Total Assets	<u>1,075,000</u>	<u>1,315,000</u>	<u>1,923,000</u>	<u>2,668,000</u>	<u>4,040,000</u>
<u>Liabilities and Equity</u>					
Current Liabilities	40,000	50,000	60,000	33,000	25,000
Long-Term Notes Payable	200,000	30,000	30,000	50,000	40,000
Long Term Liabilities	115,000	40,000	20,000	60,000	50,000
Common Stock	10,000	10,000	10,000	10,000	10,000
Contributed Capital	15,000	15,000	15,000	15,000	15,000
Retained Earnings	<u>695,000</u>	<u>1,170,000</u>	<u>1,788,000</u>	<u>2,500,000</u>	<u>3,900,000</u>
Total Liabilities and Equity	<u>1,075,000</u>	<u>1,315,000</u>	<u>1,923,000</u>	<u>2,668,000</u>	<u>4,040,000</u>

She explains to Mr. Davis that Statement of Auditing Standards (SAS) No. 78 defines internal control as a process effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: a) reliability of financial reporting, b) effectiveness and efficiency of operations, and c) compliance with applicable laws and regulations. The term process is used because internal control is viewed not as one event or circumstance, but as a series of actions conducted through basic management of the entity. Internal control is a dynamic process.

While Mr. Davis is excited about the new direction his company has to take, he is a little apprehensive. After meeting the marketing consultant, Mr. Davis's biggest worry was that for the new plans to be implemented he will have to increase the company's debts from \$16,000 to \$500,000. Now that he has met with the accountant his worries have grown. So far he has not had to deal with any employees. He is well aware of the fact that even the best employee needs to be trained and supervised. He does not know what internal controls are needed to safe guard his company's assets and has never heard of SAS No. 78 until now.

DISCUSSION QUESTIONS

1. What financial statements, summary, exception and interim reports are produced by an accounting system?
2. What are the four broad objectives of an internal control system?
3. What are the five components of internal control as defined in SAS No. 78 and briefly discuss some elements of the components as they relate to BodyBrace' operations?
4. Identify the six control activities classifying each control procedure within the SAS No. 78 Framework. Identify the areas where these controls would be required for BodyBrace's operations.
5. Identify the transactions that will be performed in the sales order processing at BodyBrace Inc. Specify the departments involved, the documents that will provide the audit trail, support the internal control objective as well as enable financial reporting. Identify the risks associated with the transactions and recommend the controls that reduce the risk.
6. Draw a context, physical and logical DFD to graphically explain the sales order process.

TERMINATION OR NEED FOR A CROSS-CULTURAL COMPETENCE TRAINING PROGRAM: A CONFLICT BETWEEN TWO TOP MANAGERS

James J. Thelen, Argosy University

CASE DESCRIPTION

The primary subject matter of this case is conflict. Secondary issues explored include management, cross-cultural implications, and entity/incremental theory. The case has a difficulty level of 4, appropriate for a senior level. The case is designed to be taught in one and one half hour and is expected to require three hours of student participation outside of class.

CASE SYNOPSIS

The case explores conflict from a managerial and cross-cultural perspective. The case takes place in a manufacturing company that prides itself on maintaining a diverse workplace in order to create success. Because the company works to support cultural diversity, discrimination, cultural stereotypes and biases are not tolerated and have been dealt with by termination in the past. A manager has terminated employees for blatant acts of discrimination in the past. The conflict in the present case is between this manager and a manager more recently hired about the possible termination of an employee engaging in similar acts. The newer manager is culturally different from the existing manager. The existing manager views others from an entity theory while the newer manager views others from an incremental theory. The existing manager attempts to create cultural diversity within the organization by hiring people of diverse cultures. The newer manager believes cultural diversity within the organization becomes successful through cross cultural training and education.

BACKGROUND

Tippers is a small beverage production company that has been in production for twenty-five years. The company is located in Central New York. Since the business started, the company has grown at a slow and steady pace. Tippers is proud to have a culturally diverse workforce and strives to maintain that diversity. The company employs both blue and white-collar employees.

Five years ago an employee was terminated from Tippers because of blatant racial slurs. The employee was a white male who reported missing money from his work desk. The employee then demanded from his top manager (Rob) that he interrogate all the black male

employees about his missing money because he knew they were all thieves and were always up to no good. When Rob asked why he thought they were always up to no good, the employee responded “because the black guys are always together talking and joking around the office and are always avoiding me.”

Shortly after the employee reported the missing money he found that he had misplaced it in a different drawer and let Rob know. Immediately after that, Rob terminated the employee because he felt the employee’s racial comments were intolerable at Tippers and were detrimental to the organizations continuous attempt to maintain a multicultural environment.

Since the employee was terminated, Tippers has continued to grow, but Rob and his boss Cindy made a point to eliminate racial bias and stereotyping within the organization. They did so by enforcing an open door policy where any employee was welcome to enter their offices to discuss direct or indirect discrimination or stereotyping in the workplace. Tippers is still focused on developing their cultural diversity.

CHARACTERS

Cindy identifies herself as a white female and has been the CEO at Tippers for ten years. Rob identifies himself as a white male and was the only top manager, other than the CEO Cindy, five years ago. He personally holds an entity theory towards others, which is a belief that human qualities – such as goodness or intelligence-are fixed (Dweck & Ehrlinger, 2006). Rob helps Tippers to maintain a culturally diverse environment by hiring culturally diverse employees. Mike identifies himself as an African-American male. He has recently joined Tippers as a top manager along side Rob. He personally holds an incremental theory towards others, which is a belief that human qualities are malleable and can be developed (Dweck & Ehrlinger, 2006). Mike believes that cultural diversity can be increased through cultural competence training and education. Brian identifies himself as a white male. He has been with Tippers for four years as a lower level employee, and seems to get along well with all the other employees. Brian is friends with employees from many cultures different from his own. Chris identifies himself as a white male and is also a lower level employee similar to Brian. He has been with the company for two years. Chris is a model employee and gets along well with everyone.

DEFINE PROBLEM

Chris utilized the open door policy with both Rob and Mike one day claiming that Brian had been making several bias and stereotypical comments to him since they have been working in the same office. Chris said these comments did not offend him, but he understood the general policy at Tippers and thought it should be brought up. The first instance was when Brian and Chris were appointed to crunch some numbers and calculate statistics. Brian mentioned to Chris that the job should have been appointed to an Asian employee because they are usually better

with numbers and math. He explained how this would be better for Tippers. The second instance was when Brian and Chris were talking about a basketball game the night before. Brian mentioned that he was really good at basketball in high school and probably would have been able to play in college if he were black because he would have been good enough for a scholarship. The last instance was during a discussion about the top manager Mike between Brian and Chris. Brian had informed Chris that he thought Mike was a very good manager, he seemed like a good guy, and was happy to be working for him. Brian then discussed how the decision to hire Mike must have been difficult because he knew two other employees that applied from within (a white male and a Mexican-American female) that would have been great for the position. Brian ended the discussion mentioning that they were probably all great candidates and Mike possibly beat them out because he is African-American, and Tippers tries to hire people from all different races.

CONFLICT

Both Rob and Mike agree that the comments made by Brian were bias and built off of stereotypes Brian possesses. Immediately Rob is considering termination because these stereotypes and biases are intolerable and detrimental to Tippers' organizational plan to maintain diversity. Mike agrees that termination is an option however, he also feels Tippers could be doing more to eliminate biases and stereotyping through organizational training and education rather than termination. Despite the objective decision the managers must make to handle this situation, Mike also understands how his personal feelings may influence his decision. Mike mentioned that his feelings were hurt when he heard that his subordinates might believe he is in his position because of his cultural identity.

INTERNAL CONTROL FAILURES AT THE PINE GROVE YMCA

Raymond J Elson, Valdosta State University
Susanne O'Callaghan, Pace University
Phyllis Holland, Valdosta State University
John P. Walker, Queens College/CUNY

CASE DESCRIPTION

The primary subject matter of this case concerns internal control failures in a nonprofit organization which resulted in two overlapping but unrelated fraud. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in one class period and is expected to require five hours of outside preparation by students. This case can be used in an internal or external auditing class, a fraud course, or a nonprofit accounting class.

CASE SYNOPSIS

The case relates to accounting control failures in a nonprofit organization which resulted in two unrelated fraud. It is loosely based on a real world situation and so, the organization's name and the fraudsters' identities are disguised.

The first fraud involved the accounting manager, who stopped paying both state and federal payroll taxes on behalf of approximately 150 YMCA employees. She continued to file false quarterly payroll tax returns for a number of years, retaining the money in the organization's operating account. These actions resulted in the organization incurring a tax liability of approximately \$1.4 million. In addition, the accounting manager wrote more than 168 checks for approximately \$40,000 to herself from the organization's bank account over a five year period, disguising most as payroll checks. She also used her purchasing card to acquire approximately \$23,000 worth of personal merchandise.

The second fraud involved the executive director, who hired a local contractor to perform landscaping and renovations at the YMCA locations. The contractor was also hired to perform renovations on the executive director's personal residence. As part of the 'contractual relationship', approximately 26 of the contractor's employees were placed on the YMCA's payroll with the executive director's approval. In addition, materials and equipment brought with the organization's funds were used for landscaping projects at the executive director's residence with the contractor's employees performing the work. Approximately \$377,000 of the

organization's funds was diverted to the landscaper's employees with an additional \$487,000 paid to the contractor for construction and repairs services.

The executive director converted approximately \$850,000 in federal YMCA funds for his use, disguising them as payments from the YMCA to the contractor. He then concealed his actions by destroying the records. The executive director also converted approximately \$58,000 of the organization's funds for personal purposes.

INTRODUCTION

"I can't believe this is happening to me," thought the accounting clerk as she slumped into her chair. The executive director had just informed her of the accounting manager's emergency two-week vacation. On one hand, her dream of having more responsibility had finally come true, but on the other hand it was the beginning of the month. There was so much to do – close the books, reconcile the general ledger accounts including the bank accounts, and prepare monthly financial statements - in addition to her normal duties. Clearly, she would need to prioritize her tasks and try to accomplish as much as possible while waiting for temporary help or the accounting manager's return.

The accounting clerk thought that reconciling the bank accounts was a logical starting point. Pine Grove YMCA only had two bank accounts, the operating and payroll accounts, and the accounting manager never complained about reconciling them. In fact, reconciling the bank accounts was the accounting manager's first priority each month. The accounting clerk found the unopened BB&K bank statements with the bank reconciliation file (containing the previous bank reconciliations) on top of the accounting manager's desk. The only missing item was the cash balance from the general ledger and so she printed the cash summary from the system. She was now ready to proceed with the easiest task of the day.

The accounting clerk compared the cash balance for the operating account on the bank statement to that on the general ledger and could not believe her eyes. The general ledger balance was significantly higher than the bank balance. Alarmed, she tried to identify reconciling items such as deposits recorded in the general ledger but not in the bank and outstanding checks but found only outstanding checks. She recorded these on the bank reconciliation but this only increased the difference. Still puzzled, she looked at the previous month's bank reconciliation for any reconciling items or unusual activities. The only reconciling items were outstanding checks which cleared the bank as noted on the current bank statement.

However one item caught her attention, the previous month's ending bank balance on the bank reconciliation should be the same as the beginning balance on the current month's bank statement, but it was not. The general ledger balance is correct, she thought, so the bank made a mistake within their system and sent a statement with the wrong beginning balance.

The accounting clerk called her account manager at the local BB&K branch, explained the problem and requested a corrected bank statement. The account manager promised her that

he would investigate the matter and contact her before the end of the day regarding its resolution. Assured that the matter would be resolved, the accounting clerk thanked him, concluded the phone call, and placed the reconciliation in her pending file.

In the interim, the account manager contacted his branch manager to inform him of the recent conversation with the YMCA's accounting clerk. The BB&K branch manager placed a call to the YMCA's executive director to discuss the conversation that took place between the accounting clerk and the account manager regarding the discrepancy in the YMCA's bank account.

This conversation triggered what would later be considered one of the unfortunate events in Pine Grove, Michigan. Soon everyone – from the accounting clerk to the local newspaper editor – would be talking about the funds that were stolen from the YMCA.

No one could understand how such respected members of the community, the executive director of the “Y” and the accounting manager, could breach their fiduciary duties by stealing from such an important institution in the community. An angry community wanted to know how two individuals could steal over \$2.5m from the institution over a five year period without detection.

There were so many unanswered questions: “Was there no supervision?”, “How could the Independent accountant not be aware of this fraud”? “What were the board members doing over the last five years?” “How many employees at the YMCA knew about the fraud, and did nothing?”

BRIEF HISTORY OF THE YMCA

The Young Men's Christian Association (YMCA or the Y) was founded approximately 166 years ago in London, England, in response to unhealthy social conditions arising in the big cities at the end of the Industrial Revolution. The YMCA came in North America in 1851 and was first established in Montreal, Canada on November 25th and in Boston, Mass on December 29th. Today, YMCAs serve thousands of U.S. communities assisting approximately 21 million children and adults of all ages, races, faiths, backgrounds, abilities and income levels. The mission of the YMCA is putting "Christian principles into practice, through programs that build healthy spirit, mind and body for all."

In 1967, the community leaders of Pine Grove, Michigan came together with a common goal - to bring a YMCA affiliate to their town that would emulate the “Y” mission of developing character by teaching and demonstrating positive values.

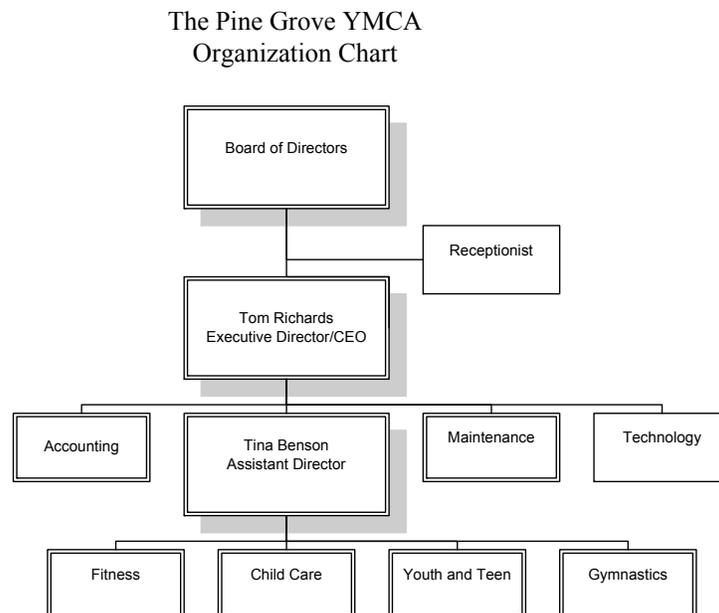
THE PINE GROVE YMCA

Organizational Structure

The Pine Grove Y grew so that by 2000 Tom Richards became the executive director and chief executive officer reporting to a 12-member board of directors. The board of directors, like most nonprofit boards, was a volunteer board and its membership consisted of prominent community leaders. These leaders were invited to serve on the board by the executive director. Board members served for an initial three-year term, and could be elected for a second term. Terms were staggered so that 1/3 of the board members were elected each year. The board did not have separate committees due to its size, but it had four elected officers who served one-year renewable terms. The officers at the time of this incident in 2008 consisted of the President (who was an attorney); a Vice President (a retired banker); a Treasurer (a CPA); and a secretary (a retired real estate developer).

The executive director was supported by an assistant director, Tina Benson who ran the day to day activities of the YMCA. All programs directors reported directly to Ms. Benson. However, supporting services such as maintenance and accounting all reported to the executive director.

The organizational structure is illustrated below:



The executive director was the driving force behind the Pine Grove YMCA, and its budget, membership and programs, all grew under his 10 year leadership. Among his various

accomplishments were opening of a satellite YMCA location in a neighboring town, opening of a gymnastics center, creating a Big Brothers/Big Sisters program, and opening a day care facility.

Funding Sources

The organization relied on membership dues for a significant portion of its budgeted income, with memberships available on an individual or family basis. Pine Grove created a number of flexible options in order to attract more members. For instance, it offered discount memberships to employees of the largest employers in Pine Grove and the surrounding county. Members could pay their dues via payroll deductions, cash, credit cards and bank drafts. Members could also make payments on a monthly, quarterly, semi-annual or annual basis. Limited scholarships were also available for prospective members who were able to demonstrate financial hardship.

Other income sources include donations from the United Way, summer camps, day care, and the annual golf tournament. As noted earlier, the organization's budget increased under the executive director's leadership from approximately \$100,000 annually when he arrived in 1998 to the current \$8 million in 2008.

The Accounting Department

The accounting department consisted of two accounting personnel, the accounting manager (Sue Jackson) and the accounting clerk (Tiffany Overlook). Ms. Jackson, an eight year YMCA veteran, was the main bookkeeper and served as a 'quasi-department head' since the organization did not have a controller position. Ms. Jackson was responsible for the cash receipts and disbursement functions which included depositing funds in the bank, preparing and processing all cash disbursements, preparing monthly bank reconciliations of the two bank accounts, and preparing monthly financial reports. She also served as the payroll clerk and this role included remitting taxes withheld from employees' paychecks to the various taxing jurisdictions and filing the related payroll tax returns.

The YMCA began using purchasing cards (i.e., YMCA credit cards) for daily purchases, and Ms. Jackson was responsible for this function. However, the executive director and accounting manager were the only YMCA employees provided with these purchasing cards. Ms. Overlook worked at the YMCA for approximately one year and served as the accounts receivable clerk. She was primarily responsible for updating members' accounts to reflect payments received as well as sending reminder notices to members regarding upcoming and delinquent payments.

The board of directors' treasurer reviewed the monthly financial reports and the executive director generally met with the board monthly to discuss financial and other YMCA matters.

The accounting manager did not attend board meetings or interact with the board members. The YMCA also employed a local accounting firm to review its financial statements on a quarterly basis.

THE ETHICAL FAILURE AND FRAUD

Two unrelated but overlapping ethical breakdowns occurred at the YMCA during the five year period, 2003-2007. The first involved the accounting manager, Ms. Jackson, who stopped paying both state and federal payroll taxes in 2006 on behalf of approximately 150 YMCA employees. She continued to file false quarterly payroll tax returns for a number of years, retaining the money in the organization's operating account. These actions resulted in the organization incurring a tax liability of approximately \$1.4 million over the course of five years. In addition, Ms. Jackson wrote more than 168 checks for approximately \$40,000 to herself from the organization's bank account for the five year period 2003-2007, disguising most as paychecks. She also used her purchasing card to acquire approximately \$23,000 worth of personal merchandise from a local store during the same time period. These personal items included school supplies for her two elementary age daughters, a new flat screen television for her family room, and food.

The accounting manager developed an elaborate scheme to cover up her wrongdoings. Using her work computer, she created fraudulent bank statements which she sent to the independent accountant in lieu of the original statements received from the bank.

The second incident involved the executive director, Mr. Richards. He hired a local contractor, Tim Jones, to perform landscaping and renovations at the YMCA locations. The contractor was also hired to perform renovations such as building an addition and a screened in porch, on the executive director's personal residence. The contractor was hired based on personal relationships, without a competitive bidding process, or board of directors' approval. The executive director and the contractor attended the same church, at which the contractor was both a deacon and Sunday school teacher.

As part of the 'contractual relationship', approximately 26 of the contractor's employees were placed on the YMCA's payroll with the executive director's approval. In addition, materials and equipment brought with the organization's funds were used for landscaping projects at the executive director's residence with the contractor's employees performing the work. These employees were paid by the YMCA for landscaping projects performed for other clients of the contractor. The contractor was also paid with the organization's funds for ongoing landscaping work at the executive director's residence. Approximately \$377,000 of the organization's funds were diverted to the landscaper's employees with an additional \$487,000 paid to Mr. Jones for construction and repairs services.

The executive director converted approximately \$850,000 in federal YMCA funds for his use, disguising them as payments from the YMCA to the contractor. He then concealed his

actions by destroying the records. These funds were the accumulated payroll taxes retained in the organization's bank account by the accounting manager as noted above. The executive director also converted approximately \$58,000 of the organization's funds for personal purposes using his company issued purchasing card. Items purchased included suits, shoes and toiletries.

THE FRAUD UNRAVELS

Upon concluding the phone call with the bank, the executive director contacted the chairman of the board and the treasurer to inform them of the discrepancy in the YMCA's bank balance. An emergency board meeting was initiated by the chairman and the treasurer was authorized to investigate the issue on behalf of the board. The treasurer contacted a local accountant, Ms. Ellen Graves, who was also an accounting instructor at Pine Grove Junior College and asked her to investigate the matter. Ms. Graves was a CPA with five years of public accounting experience in a regional accounting firm. The treasurer also notified the executive director of the investigation and asked for his full cooperation. The executive director agreed to provide the accountant with an office on the organization's premises and pledged his cooperation with the investigation.

Ms. Graves' first action was to review the bank reconciliation of the organization's bank balance in order to understand the extent of the problem. Her first step was to review the accounting clerk's bank reconciliation to ensure its validity. Since she had access to the bank reconciliation file, she also reviewed previous months' bank reconciliations including the supporting documents such as bank statements. She could not believe what she saw – the current month's bank statement showed that the YMCA had only approximately \$3,000 as compared to the \$25,000 on the accounting manager's bank statement from the previous month. Ms. Graves immediately notified the executive director and the board of the problem. The board chairman and treasurer were furious and demanded that the accounting manager be terminated. The executive director complied with the board's direction and the accounting manager was terminated on April 15, 2008 and the police were contacted. Thus began the formal investigation of the former accounting clerk, Ms. Jackson.

At this point, the board had no confidence in the financial information of the YMCA and asked Ms. Graves to expand her investigation to include all financial activities of the organization for the past three years. Ms. Graves started her review of cash disbursements for the most recent year, 2007. She noted a number of payroll checks that were written from the operating account. This created a red flag since all other payroll checks were written from the separate payroll account. She simply cross referenced the payee names on the checks to YMCA employees listed on the detailed organization chart and concluded that these were ghost employees. Again, Ms. Graves contacted the board and discussed her concerns with the treasurer and chairman. Another emergency meeting was held between Ms. Graves, the

treasurer, the chairman, and the executive director. The executive director was clearly relieved that the questions were being asked about the fictitious employees and other matters.

The executive director shared that these employees actually belonged to a local contractor and not the YMCA but the YMCA was paying their salaries. The executive director was terminated by the chairman of the board on May 15, 2008. The assistant director assumed temporary leadership of the organization until the current issues were resolved. The police were again contacted and a formal investigation began on the activities of the executive director.

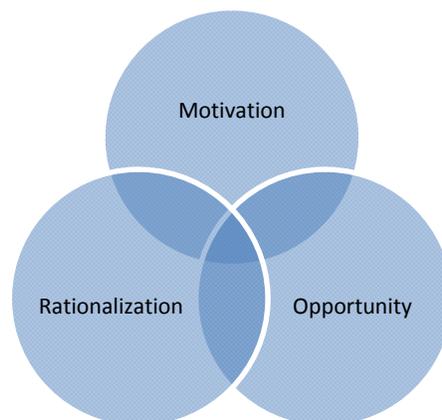
A second and larger accounting firm with more experience with fraud issues and forensics accounting was hired by the board to investigate the extent of the fraud committed by the accounting manager and executive director.

On July 1, 2008, indictments were handed down by the United States District Court of Warren County, Michigan, against the former accounting manager and executive director of the YMCA, and against the landscaper. The accounting manager was charged with embezzlement, mail fraud and mailing fraudulent financial statements. The executive director and landscaper were both charged with conspiracy to commit embezzlement from an organization receiving federal funds. The executive director was also charged with making false statements to FBI agents.

A CALL TO ACTION

Assume that you are the independent accountant hired by the organization when the discrepancies were discovered.

- 1. Using the fraud triangle below, explain to the board of directors how the fraud was perpetrated without timely detection by organization personnel or the board of directors.**



2. Using the COSO framework as a guide, identify the control concerns (or weaknesses) you might find in the organization that provided the opportunity for the fraud to take place. Using Appendix A as a guide, write a formal report to the board of directors to discuss these weaknesses and your recommendations to address the control deficiencies.
3. Explain the difference between an ethical failure and a criminal or illegal act to the board of directors.

APPENDIX A– FORMAL REPORT

Date: (date work was completed)

To: The Board of Directors
The Pine Grove YMCA

From: Independent Accountant

Audit Results

This section provides a high level summary of the significant business issue(s) identified from the COSO framework.

Issues and Recommendations

The details of each issue along with the recommended remediation activity are provided in this section. Students should limited themselves to no more than three business issues.

KYLE'S KAYAKS MANAGERIAL BUDGET CASE: SALES TO FINANCIAL STATEMENTS

Geri B. Wink, Colorado State University – Pueblo
Laurie Corradino, Colorado State University – Pueblo

CASE DESCRIPTION

The primary subject matter of this case concerns the budget cycle used in a manufacturing facility. Secondary issues examined include the interrelationships between each component of the budget. For more advanced students, decision making involving cost cutting, price setting, and ethical considerations is also included. The case has a difficulty level of two, appropriate for sophomore level but may be slightly altered to accommodate students at levels three (junior), four (senior), or even five (first-year graduate). The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

Sarah has just been hired by Kyle's Kayaks, a manufacturing company that specializes in the production of one model of whitewater boats. An avid kayaker herself, Sarah is excited to begin her career with the company. The company's controller, Jessica, has assigned Sarah to the task of creating the company's budgets for the year. Sarah understands the importance of accurate cost figures to the survival or at least continued prosperity of a manufacturing facility. She has recently learned, though, that her success with this task will not only influence her future promotion opportunities but, even more importantly, her continued employment with Kyle's Kayaks.

KYLE'S KAYAKS

Sarah has decided to begin her accounting career at a manufacturing company in its cost accounting department. She is an avid kayaker and has been a loyal customer of Kyle's Kayaks' products for a number of years. As a result of this personal connection, she is even more eager to begin employment with the company. As one of her first tasks, she has been asked to assist the chief financial officer (CFO), Jessica, with the oversight of the annual budget preparation. Sarah is excited about this high level opportunity.

On the first day of her new project, Sarah was called into Jessica's office to discuss the details for the budget to which she had been assigned. Aside from providing an overview of the budgeting process in the company, Jessica was quick to inform Sarah of the fiasco that had

occurred the previous year as a result of the former budget coordinator, Steven's, failure to consider all of the variables that could impact the overall budget as a result of the interrelatedness of the specific pieces as well as the financial statements. As part of the meeting, Jessica stressed the importance of this task in terms of Sarah's continued employment with the organization. Shocked by the impact of the assignment on her career and her impending dismissal if she should fail, Sarah exited Jessica's office with the same determination she had demonstrated when learning to first paddle and then roll her kayak.

Before she could actually begin preparing the budgets, Sarah first needed to recall the steps and individual pieces involved in the budgeting process as well as to identify the necessary contacts within the organization itself. She remembered taking Principles of Managerial, Cost, and graduate level Managerial Accounting classes and determined that her textbooks would be an excellent starting point for deciding which budgets needed to be prepared and the relationships between them. She was also given access to last year's budget workpapers to assist in the endeavor. Sarah will utilize those reference documents to locate which employees will be best able to assist her in compiling the information needed to complete the budgeting process.

After doing some research, Sarah decided to complete fourteen budgets in the following order: a sales budget, a schedule of expected cash collections, a production budget, a direct materials budget, a schedule of expected cash disbursements for hulls, a schedule of expected cash disbursements for seats, a schedule of expected cash disbursements for drain plugs, a direct labor budget, a manufacturing overhead budget, an ending finished goods inventory budget, a selling and administrative budget, a cash budget, a pro forma income statement, and a pro forma balance sheet.

Using some of the organizational skills she learned from her accounting professors in college, Sarah designed a step-by-step system for preparing the budgets. After consulting with Jessica, she decided to prepare all the budgets on a quarterly basis.

Budget #1: Sales Budget

Travis is the manager in charge of sales. As Sarah remembers from her accounting classes, the entire budget is only as good as the sales budget. It "drives" the remaining budgets and sets the goals and objectives for the company for the upcoming year.

Sarah has asked Travis to provide the number of kayaks the company is expecting to sell each quarter for the upcoming year. In addition to the current year budget numbers, Sarah has also obtained sales figures for the two quarters prior to Quarter 1, Year 1 (Q1-Y1), the budget year, as well as two quarters after Q4-Y1 (the last quarter of the budget year) to successfully complete budgets later on in the process.

The kayaks had been selling for \$800 in Y0, the year prior to the budget year, and Travis informed Sarah that the kayaks would continue to sell for that price in Y1 and in Y2. Because the

economy is in such a slump, the business decided not to increase the sales price in the hopes of keeping sales volume high. The budgeted sales numbers Travis provided were as follows:

Table 1: Sales Budget Data	
Quarters:	Budgeted Sales in Units
Q3-Y0	1,500
Q4-Y0	800
Q1-Y1	500
Q2-Y1	3,000
Q3-Y1	2,000
Q4-Y1	1,000
Q1-Y2	600
Q2-Y2	2,500

Budget #2: Cash Receipts Budget: Schedule of Expected Cash Collections

Sasha is the accounts receivable manager. According to her, the expected accounts receivable balance at the beginning of Q1-Y1 is \$632,000. Having recently completed a statistical analysis of the collection pattern of receivables, she has provided the following estimates for cash receipts: 20 percent is expected to be collected in the quarter of sale with 70 percent in the next quarter followed by the remaining 10 percent two quarters after the sale.

Budget #3: Production Budget

Bob, the production manager, has determined from his 15 years of experience in the business that the desired ending inventory should be 15 percent of the next quarter's sales. There is no finished goods inventory on hand at the beginning of Q3-Y0.

Budget #4: Direct Materials Budget

Kyle's Kayaks' production guru, Bob, also believes that the desired ending inventory of raw materials is equal to 10 percent of the next quarter's production needs. Bret, the cost accountant, informed Sarah that the production cost of each hull is \$225, of each seat is \$73, and of each drain plug is \$2. Each kayak requires one of each of those parts.

Budget #5: Schedule of Expected Cash Disbursements for Kayak Hulls

The accounts payable supervisor, Andrew, stated that cash disbursements for the hulls occur 25 percent in the quarter of purchase with 75 percent paid in the following quarter.

Budget #6: Schedule of Expected Cash Disbursements for Kayak Seats

Andrew was again put on the spot and asked to provide data related to kayak seats. He has cited payment terms as 50 percent in the quarter of purchase with 50 percent paid in the quarter immediately following purchase.

Budget #7: Schedule of Expected Cash Disbursements for Kayak Drain Plugs

Andrew has proudly conveyed that drain plugs are paid for immediately upon purchase.

Budget #8: Direct Labor Budget

Chris, the human resource management supervisor, has notified Sarah that the wage rate is \$10 per direct labor hour (DLH). From information provided by Bob, Sarah understands that each kayak requires two hours of direct labor.

Budget #9: Manufacturing Overhead Budget

Jessica's assistant keeps track of all overhead costs for the company. Based on her records, she has noted that variable overhead equals \$4 per DLH while fixed overhead totals \$50,000 per quarter. Included within that fixed overhead is depreciation expense of \$15,000 per quarter.

Budget #10: Ending Finished Goods Inventory Budget

Sarah realizes that in order to correctly value the ending inventory and cost of goods sold on the financial statements, she must determine the total product cost for each kayak.

Budget #11: Selling and Administrative Budget

Again, Jessica's helpful assistant was able to provide us with information for the selling and administrative (S&A) budget. Variable S&A expenses are \$150 per unit. She also provided the following data regarding the fixed S&A expenses per quarter.

Advertising	\$5,000
Executive Salaries	\$250,000
Insurance	\$8,000
Property Taxes	\$7,000
Depreciation	\$5,000

Budget #12: Cash Budget

Fred, the company's treasurer, informed Sarah that the beginning cash balance at Q1-Y1 is expected to be \$10,000. The required minimum balance at the end of each quarter is \$10,000 as well. If any borrowing is necessary, such loans are taken out at the beginning of the quarter. All loans may be repaid at the beginning of the next quarter if possible. The interest rate on all borrowings is 10 percent.

Budget #13: Pro Forma Income Statement

Sarah noted the following in regard to the income statement: Sales will come from Budget #1, S&A expenses may be found in Budget #11, and interest expense is carried over from Budget #12.

Budget #14: Pro Forma Balance Sheet

Jessica's assistant provided Sarah with the following beginning balance sheet for the company.

Kyle's Kayaks Balance Sheet As of 1/1/Y1	
Cash	\$10,000
Accounts Receivable	632,000
Inventory - RM (\$300 x 88)	26,400
Inventory - FG	26,902
Property, Plant, and Equipment	200,000
Less: Accumulated Depreciation	<u>(40,000)</u>
Total Assets	<u>\$855,302</u>
Accounts Payable	
Hulls	\$129,431
Seats	<u>27,996</u>
Total Liabilities	\$157,427
Retained Earnings	<u>697,875</u>
Total Liabilities and Retained Earnings	<u>\$855,302</u>

MARKETING TO MUSLIMS: THE GROWING IMPORTANCE OF HALAL PRODUCTS

Charles Rarick, Purdue University Calumet
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Casimir Barczyk, Purdue University Calumet
Lori Feldman, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns niche marketing in the food industry. Secondary issues examined include political and religious influences on marketing activity and strategic marketing orientation. The case has a difficulty level of three, appropriate for junior level students. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

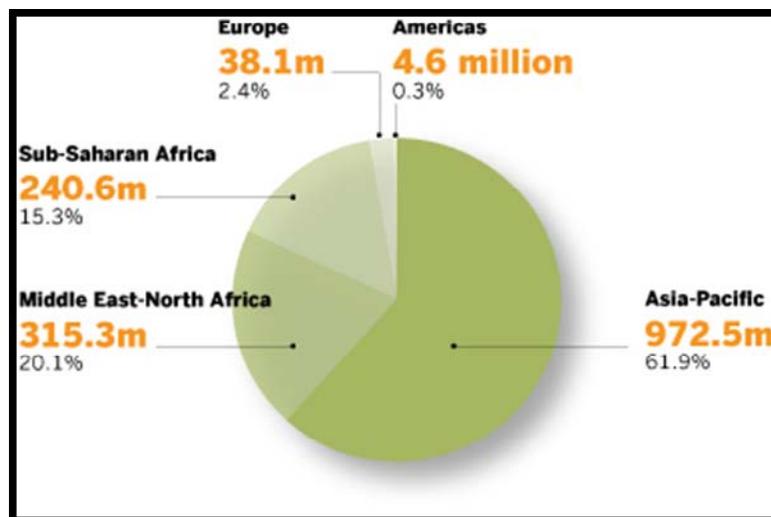
With a global population estimated at approximately 1.56 billion, a relatively high birth rate, and growing affluence, the world's Muslim population represents an increasingly attractive consumer market. Muslims are expected to avoid certain activities and substances and these prohibitions have significance for marketing activities. This case explores the Islamic practices and restrictions that apply to food products, the difficulties of meeting differing international halal standards, and the opportunities for domestic and international firms to expand into the growing Muslim market.

INTRODUCTION

While many may think that Muslims live mainly in the Middle East, in reality, they do not. According to a 2011 report by the Pew Forum on Religious and Public Life, there are approximately 1.56 billion followers of Islam – who view their religion as a culture or way of life. This represents approximately 23% of the world's population. An estimated 60% of Muslims live in Asia, 20% in North Africa and the Middle East, and the remaining 20% in various other places throughout the world (See Figure 1). While the Muslim population in the Middle East is sizable, large populations can also be found in Indonesia, Malaysia, India, Pakistan, Turkey, Nigeria, and other countries. In terms of followers, Islam is the second largest and fastest growing religion in the world.

Appealing to the Islamic consumer goes beyond the typical Middle Eastern countries. The European Muslim population has grown approximately 140% in a decade and outpaces that of non-Muslims. Approximately 30 million Muslims live in the Russian Federation. Muslim communities throughout North and South America are also large and growing. In the U.S. there are about 2.6 million Muslim adults and children, which represent 0.8% of the overall population, according to the Pew Forum report. By 2030 that figure is expected to rise to 6.2 million or 1.7% of the U.S. population. These population increases point to a rise in purchasing power and issues concerning Muslim preferences for products and services.

Figure 1: Global Muslim Population



Source: The Pew Forum on Religion and Public Life

Regardless of location, Muslims follow a belief system built on five pillars:

1. Shahada – a testimony of faith which is the basic creed of Islam
2. Salat – prayer which is performed five times daily
3. Zakat – this means supporting the needy
4. Sawm – fasting which occurs from dawn until sundown during the month of Ramadan,
5. Hajj – a pilgrimage to Mecca once during a lifetime for those who are able.

Strictly observant Muslims also follow the Sharia, which literally means “path” or “way.” It is a framework that extends religious beliefs to private, social, and political life. Though aspects of Sharia are common in the Muslim world, in practice followers do not always strictly adhere to them.

The differences in the manner Sharia principles are practiced have implications for companies interested in serving the Muslim market, which cannot be considered homogeneous, except from a regional perspective. That market represents significant sums, estimated by Reuters at \$560 billion for Islamic-approved food products. Many Muslim consumers actively seek out products with an Islamic brand. As such, three factors should pique the interest of marketers in serving this segment of the global marketplace. First the number of Muslims is increasing at a rapid rate; second, there appears to be an increased level of devotion among the followers of Islam to the religion's teaching and prescriptions; and lastly, many parts of the world with sizable Muslim populations have developed significant purchasing power.

HARAM AND HALAL

Islam, like other religions, prohibits certain actions by its followers. Muslims are prohibited from engaging in haram (haraam), the Arabic word for forbidden. Examples of haram activities would be using profane language, displaying certain images, drinking alcohol, and consuming proscribed food products such as pork. In addition, Muslims are expected to refrain from eating already dead animals, birds of prey, land animals without ears, blood, and animals improperly slaughtered. To avoid being considered haram, animal slaughter must be done in a manner that results in a quick and humane death. An animal's jugular veins and carotid arteries must be cut using a sharp knife so as to produce maximum blood flow, all done in the name of Allah (God). The process of food preparation called *dhabiha* dictates that slaughtering be conducted in a manner that reduces the animal's suffering. Sharia law also applies to food products, which may not contain additives that are not "clean" or untainted during processing, packaging, storage, transportation, or transaction. Full Sharia compliance means that food production and logistics must be carried out to avoid contact with foods that are haram, that financing for the business selling the food is transacted with permissible funds, and that safety and hygiene meet religious standards. The opposite of haram is halal, or permitted.

The process of declaring a food product halal is not always clear and unambiguous. Issue of cross-contamination of halal and haram products, as well as products that may contain haram ingredients or additives are of great concern. For example, gelatins may contain pork, and extracts such as vanilla may contain alcohol, both of which are considered haram. There is also an issue concerning the stunning or anaesthetizing of the animal before its death as to whether it is halal or haram. Additionally, differing opinions exist concerning the use of automation in the slaughtering process, and calling out the name of Allah using a tape recording versus a slaughtering by hand with a person speaking the required words. Countries and certifying bodies differ in their opinions related to these practices. Having differing standards can result in problems for firms marketing internationally. For example, Islamic scholars in Australia declared that the stunning of animals was permitted and processing companies that used this practice could be certified. In Malaysia, however, this practice is considered haram. As such, the

Malaysian government bans the import of Australian beef into the country. Food prepared according to Islamic law can be certified as halal. A number of certifying bodies that can attest to a product's halal status may exist in a country. Each has a mark that is applied to products to authenticate halal certification. However, certification is not global. An example of a Canadian certification mark can be seen in Figure 2. Halal marks can be seen on packaging and posted prominently in halal-observant restaurants.

Since there is no single unified authority in Islam, differences are found in the interpretations of its tenets. This leads to different certification standards being applied within and across countries. In addition, there is the problem of fraudulent use of halal certificates, a situation that has been reported in Malaysia and other countries. The certificates are only as good as the certifying body and its reputation. Reputation and fees for certification vary considerably. According to Koen dePraetere, general manager of the Belgian food processor Volys Star, "In Europe there are many certification bodies and some have their heart in the right place. But others have their wallet in the right place." In the United States the leading certifying body is the Islamic Food and Nutrition Council of America (IFANCA). To be seen as legitimate, marketers will need to gain halal certification from the official agencies authorized to provide their mark in the countries in which they operate.

Figure 2: Halal Certification Mark



PROBLEMS AND OPPORTUNITIES

In the United Kingdom, KFC encountered difficulties when Muslim clerics began telling followers not to eat at the restaurants because their products were haram. KFC food processors stunned the chickens and used mechanical processing in their slaughtering process. While the Islamic Council of the Muslim League, a major voice in Islamic affairs, condones the use of stunning and anesthesia in the process of slaughtering animals, local clerics have their own opinions and direct followers accordingly. When there is conflict between the opinions of local

clerics, marketing can become difficult. Uncertainty and conflict may cause consumers to avoid the products in question.

Given the sensitivity of political and religious feelings, marketers may find themselves caught in an unexpected and undesirable situation. In France, the fast-food chain Quick ran afoul of some politicians when it decided to remove all pork products from its menu and serve only halal meals in select markets. France has a sizable Muslim population, estimated at 5 million, and has experienced some political tensions relative to their cultural practices. The mayor in one French town decided to sue the restaurant chain for discrimination against non-Muslims.

Germany, which also has a large Muslim population, has been slow to embrace the Muslim consumer market. Some German retailers worry that putting Muslim-approved food in their stores will discourage purchasing by non-Muslim customers. These fears and perceptions have led to fragmentation in the retail market along ethnic and religious lines.

At least one enterprising Muslim hoped to capture the niche market he felt was not being well served. In 2005, Hakim Badaoui began Burger King Muslim in France and served an entirely halal menu. The restaurant appealed to young Muslims who found eating at other fast-food chains difficult because of their faith. One young Muslim woman interviewed about her experiences stated, "I used to go to McDonald's once a week, but all I could eat was the Filet-O-Fish sandwich. Now, I come here." Unlike some brands such as Mecca Cola, which have developed in the Muslim community to protest American foreign policy and global influence, Burger King Muslim was established to capture an underserved market. The trend towards an apolitical niche market appears to be growing.

Countries like the Philippines hope to capture the growing Muslim consumer market by introducing national standards to accredit companies that certify products as halal. By assuring standardization in certification, the Philippines hopes to attract customers in Muslim nations who may not be sure their products are really halal.

A number of international companies have also begun to take the Muslim market need seriously. Nestle, Colgate, Carrefour, Unilever, and other well-known firms have invested significant resources to serving this market. Nestle, for example, has devoted 75 of its 482 global processing plants to halal products. Nestle's halal sales are estimated to be in excess of \$3 billion annually. Tom's of Maine, an American natural care products company, recently sought halal certification from IFANCA for most of its products. In addition to appealing to a growing market niche, the certification appealed to animal rights groups. While many American companies have made modifications to their foreign offerings, not as many have adjusted to accommodate halal requirements in the U.S. Jalel Aosse, director of Midamar, an American food brand and supply chain management company states, "You have to meet the requirements of the countries you're trying to target. It's like being a guest in someone's home." His viewpoint may be gaining increased popularity. At the World Halal Forum one can now find businesspeople in Western business attire mingling with robed and bearded Islamic scholars as they discuss the future of this growing and potentially lucrative market.

DISCUSSION QUESTIONS

1. How attractive are the American and European markets for halal products? Explain your answer.
2. Should firms use a global or a multi-domestic strategy to market halal products?
3. What opportunities and threats do U.S. and European companies face in marketing halal products?

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MYTH OR REALITY: THE DYNAMICS OF THE CONTEMPORARY LEARNING ORGANIZATIONS

Devi Akella, Albany State University
Nirupama Akella, University of Southern Alabama

CASE DESCRIPTION

This case deals with Anu, a journalist who joins ABC Systems which advertises itself to be a learning organization. Anu is excited about working in a team based, participative working environment which thrives on open dialogue within the company. But she is forced to confront the reality behind the democratic façade displayed by these organizations. This case could be used to facilitate discussion on power and politics in learning organizations in Organizational Behavior, Organization Development and Organizational Learning courses at both undergraduate (at the senior levels) and graduate levels (during the first year). This case has been designed for a 50 minute session slot. The instructor should distribute the case study along with the discussion questions to the students at least 7 days before the class. Students would require approximately 60 minutes of outside class preparation.

CASE SYNOPSIS

This case critically examines the power structure of contemporary learning organizations highlighting the dichotomy existing between the myth and reality of these organizations. The company in question, ABC Systems, is a knowledge management multinational having its main office at Nebraska, USA, and branch offices in Europe and Japan. The company deals with diverse clients such as hardware, manufacturing, and pharmaceutical companies providing services of business and technical writing, public relations, and website development.

Anu Singh is an ambitious journalist in her late twenties. She is recruited by the branch office of ABC Systems in New Delhi, India, as a business editor. At the interview, she is given the company's policy guide. She is told by the MD and Finance Manager that the company believes in democracy, delegation of duties, open communication, and equal employee voice. Anu joins the company and soon finds out that things are different in reality.

The case maps out Anu's situation in the organization. Her efforts at initiating and developing healthy employee communication get her fired from her job. The management feels that she has overstepped her bounds and is causing dissension among the employees. Anu now wonders where she went wrong.

INTRODUCTION

Anu frowned as she scanned the paper summons on her desk. The paper was a summons from her boss ordering her to his office at 11.30 a.m. sharp. It gave no indication as to the reason of the sudden order. Anu stowed her bag under the table and clicked on the computer to start the day's work. But, her mind remained on the summons. *It couldn't be good news ...*

The Background

Location

This case study takes place in a suburb of New Delhi. New Delhi, the capital city of India, is the seat of power. The city attracts immigrants from all over the country and the continent of Asia. It is a culturally diverse, multi-ethnic cosmopolitan city (<http://www.aboutdelhi.com>).

The city has a varied population of different religions, languages, cultures, and values. In the 1990's, the Indian government opened doors for direct foreign investment attracting potential foreign companies to set up bases in the country. Due to its strategic location, its political and administrative prominence combined with its culture of education and achievement, Delhi became the industrial arena for foreign MNC's. In 2000, the attention shifted to the city's suburbs and the rush for acquiring land in these suburbs began. As a result the sleepy suburbs of Gurgaon and Noida became hotspots of activity. Small private owned houses were transformed into huge multi-storied apartment neighborhoods, and swanky shopping malls. Suburban Delhi became home to an extensive transportation and communication system (<http://www.aboutdelhi.com>).

MNC's such as GE, Ranbaxy, Johnson & Johnson, Penguin, Microsoft, Sony, and many more established branch offices in these suburbs. The low cost of human and industrial resources along with the inherent Indian values of obedience and acceptance made it relatively hassle free for foreign companies to control employees in their Indian branch offices, and function smoothly. A viable presence in India made it possible for them to enter the Asian market, and explore countless opportunities (<http://www.aboutdelhi.com>).

ABC Systems was one such company. ABC Systems was a knowledge management multinational concern with headquarters in Nebraska. It had offices in Canada, Europe, and Japan. The company was involved in the areas of business and technical writing, public relations and website development. As such, it had a wide clientele base with financial, pharmaceutical, fashion, agricultural, food processing, and hardware manufacturing companies. The company employed journalists, PR, advertising, digital media, and information technology specialists. The main function of the company involved the writing of content to advertise a particular company's products and services. The increase in the sales margin of the given company automatically

guaranteed a commission for ABC Systems. To ensure maximum coverage, ABC Systems advertised in the global business pages, Internet search engines, published press releases, bulletins, and created websites.

In 2005, the company decided to open a branch office in the suburb of New Delhi – Gurgaon. The timing seemed right – the Delhi State Government had recently released a directive for foreign investors relaxing all holds on foreign MNC's. ABC systems had a world-wide presence except for Asia. It entered into agreement with an Indian leasing company based in Gurgaon, EFG Contractors, and in January 2005 acquired office space in one of the busiest industrial areas of the suburb. The next course of action was to hire a team of 30 writers who would also be adept in the areas of research and editing. ABC systems flew in its HR team from Nebraska. It was this team along with their Indian partner who would conduct the entire recruitment process.

In March 2005, advertisements ran in all major Delhi and Gurgaon newspapers calling upon suitable candidates who had writing experience to mail their resumes for a position in the foreign knowledge management company, ABC systems. On the basis of the resumes, suitable candidates were shortlisted and contacted by EFG Contractors for an interview for the position of a 'Business Editor.' The interviews were scheduled to be held in the offices of EFG Contractors for a week. The Managing Director, the HR team, the Chief Business Editor, and the Finance Manager of ABC Systems comprised the interviewing panel.

The Protagonist

In January 2005, 25 year old journalism major Anu Singh was bored and tired! Bored of her routine monotonous job as a media writer for an upcoming media house in Noida, a suburb located north of New Delhi. She was tired of travelling everyday for three hours in buses from her apartment in Gurgaon to her office in Noida. Anu Singh was on the lookout for a change. She wanted to enjoy her work in a company which was near her house in Gurgaon. She wanted a career which would challenge her academic skills. She wanted a career where she could learn and grow as a professional. She wanted a career where she could get involved with daily organizational decisions. She wanted a career where her efforts and contributions would be recognized and appreciated.

Her present job was not offering her any of the things she desired. Apart from writing experience, Anu was not gaining anything from her job as a junior media writer. She was rewriting existent audio and video scripts sitting behind a small desk in a corner on the second floor of the building. She had no idea who her superiors were or what the organizational mission was. She was simply a cog in the organizational machinery – unimportant and easily replaceable. This was not the career for her and she wanted a change.

She applied for the position of 'Business Editor' at ABC Systems. She knew that being a business editor entailed business and technical writing. She was called for the test and then later

for the interview. Anu Singh by now had an idea that the company wanted someone with writing, editing, research, and PR skills – a multi-tasking person. She read up on ABC Systems to know that ABC Systems was a financially sound MNC. She also read that the company was in the process of becoming a learning organization. In fact, the company had issued policy directives in this regard calling for flexible, lean organization structures and open-ended communication channels. Anu was looking forward to her interview as she always wanted to join a ‘learning’ company. She felt that such a company would be an ideal place of work and growth opportunity. She would get the opportunity to be involved in daily organizational decision making activities. She could now voice her opinion, communicate openly, and be heard. Anu Singh was excited. Her interview took place in the third week of March. The interview began with questions about Anu’s education, her current job, and reasons for change.

“Tell us about yourself?”

Where do you work right now? What is your job there? Why do you want to leave?

The interview became intense when the Managing Editor, Mr. Wilson, and the Chief Business Editor, Tej Johri, took over.

“What is your present pay? What do you expect from this job in terms of pay?”

Why should we hire you? What can you bring to the company? We are still struggling to establish ourselves in this part of the world... we will require people who can work and contribute beyond job descriptions... walk the extra mile with no expectations... can you do that?

“Of course there will be room for growth but you have to take the initiative – there will be team leader positions – these will not be permanent but will rotate so that everyone will get a chance to be the team leader at least once. As the team leader you will not be getting any financial or other benefits but you will be responsible for the team ...a team of 30 editors... you will be responsible for letting us know their views and opinions... whether they agree with us or disagree... and in the future you may also have the opportunity to become the copy editor for our Indian branch...”

The Managing Director, Mr. Wilson, told her, *“We believe in democracy and equality – all our employees are equal and have equal voice... we believe in delegation and open communication...”*

The Finance manager also assured her that the company was designed on the format of teams where there were no hierarchical levels. In fact, designations existed in the company for

logistical purposes. Each team was led by a team leader. The position of the team leader was rotational ensuring that all team members had a chance to become the team leader. Though team members communicated with their team leader about issues, they could walk in and ‘talk openly’ to their superiors.

On her part Anu asked about her salary and job expectations. The interview lasted for an hour. Anu was told that she would be informed by mail and telephone if she were to be selected for the post. In April first week, Anu got the affirmative call. She went to the office of EFG Contractors and signed the letter. She came to know that out of 40 candidates who had been interviewed for the job, 30 had been selected. The interview panel was leaving for US, and their place was to be taken over by two senior business editors from the headquarters in Nebraska who would stay with the team for the first six months to train, guide the team, and smooth out any unforeseeable problems.

Anu got acquainted with her colleagues on orientation day. The editors came from varied academic backgrounds. Some were majors in economics – a few had worked in banks, while others had held marketing positions in event management companies. Four editors had journalism degrees and considerable reporting experience. All of them belonged to the age group of 25-35. It was a relatively young workforce. The editors were issued the organization’s policy guide. The policy guide entailed the mission and vision of the company – To inform and educate people about healthy and useful products and services...

Organizational goals were outlined in which the grading system was explained. All editors had to follow the grading system. Each business editor had to log in everyday and receive his/her assignments for the day. The editor had to research that particular company and write a brief about it. The brief was supposed to include the company description, products and services offered. It had to be 100-150 words in length, formatted in APA style. When finished, the editor had to move on to the next. At the end of the working day, at half past five in the evening, the editor had to print all the briefs written and turn them in to the senior editor for grading and editing. The editor would then log out and exit the office. The briefs would be returned the next day with edits and grades – an A grade meant a minimum of 10 edits – a B grade meant 10-20 edits while a C grade meant 25-36 edits. Editors were required to type and print a minimum of 12 briefs everyday. Turning in less than 12 briefs would mean a D grade. A “D” grade meant a poor performance, and was not looked upon favorably by the management.

The organizational goals and values spoke of a learning environment within the organization wherein there were no authoritarian figures. All employees and managers had equal voice, and right to participate in organizational decision making.

“The company will work towards maintaining a free and healthy work environment – there will be open communication... employees can talk directly to the management ... criticize and disagree... the aim will be to work towards the betterment of employee working environment to achieve optimal performance...” (an excerpt from the Organizational Manual)

The team was introduced to the EFG Contractors HR Manager who would be handling policy decisions and HR issues for the team in India. ABC Systems officially began operation on 5th May 2005. The first few weeks were spent in training and discussions on the APA writing stylistic techniques including grammar, and punctuation issues. The office bulletin board was affixed and began to be the place for official communication. Anu soon realized that everything spoken by the panel during the interview had been just ‘talk’ with no value attached to it. For instance the management viewed the bulletin board as a channel to issue one way directives and communication. Employees i.e., all the business editors were strongly discouraged to voice their opinions. This became apparent when HR Manager, Malati, posted the following note on the bulletin board without any prior discussion – which made it like a directive posted on the board for the editors to read and follow –

Editors are informed that Saturday will be a full working day ... editors are strongly discouraged from leaving the office premises before the designated official time of 5.30 p.m.

Management knows best. Employees are required to perform their job duties and not discuss policy issues among themselves...”

Anu heard one of the editors say, “*I guess we are just supposed to work and take our pay... who cares what happens but I wish someone would ask me...*”

Anu was voted team leader by her colleagues in August 2005. She was writing 15 briefs everyday, had been getting A grades since the beginning of work, and had recently got a pay raise. Anu was privy to the views of other business editors, had the company policy guide in possession, and felt secure in her new supervisory role. She began to write articles voicing the views of the editors and posting them on the board. It started with small issues –

We, Editors, work all day and think that we are entitled to a half hour tea break along with a free snack... this will definitely refresh us and motivate us to write the required 12 briefs and more... perhaps management ought to consider this...

The editors’ request that the management consider expanding the work space... the present room is too crowded and cannot fit 30 professionals...

All the posts were aimed at the HR Manager, Malati. The board was also used to communicate office news. For instance:

Editor Siddharth Dey is having an informal gathering outside the office on Friday evening... all are invited!

Each post stayed on the bulletin board for a week allowing HR manager to notice, read the post, and take consequent action. Anu did feel that the bulletin board had shed its image of being a ‘mouthpiece for the management’ and become a real two-way communication tool. She was sure that she was acting in accordance with the ‘policy guide’ given to the team on the orientation day. Even though her posts were not discouraged, they did not seem to be having any effect as such. The editors continued to work in the cramped office space. There were no tea breaks and free snacks. In fact, the posts were ignored.

The team also saw this and one of the editors remarked, “*Why should we say anything? Nobody listens to us anyway...*”

Anu however, believed that their opinions would have an effect ultimately in the long run. After all, she had been told that ABC Systems believed in democracy and open communication. However, the effect of the bulletin-board became apparent to Anu when even after repeated posts, the run-down air conditioning system in the office was not repaired. The editors continued to complain, and sweat all through the hot afternoons. The result was another posting on the bulletin board:

Editors cannot work under such unfavorable conditions. The AC has not been working since the past two weeks. Editors request management to take notice, and immediately repair the AC system....

Even though this post remained on the board for a month, nothing happened. The AC remained broken, and all the editors continued to sweat it out in the cramped space. After a month with the AC still unrepaired, Anu removed the post. The next incident occurred when the editors were not paid their individual bonuses despite having achieved more than the original target of 30,000 briefs in a month. There was disgruntlement in the editors' room. Being the team leader, Anu felt it was her responsibility to inform the management of the general reaction and view. She did not write an article about it, but resorted to the indirect approach. Anu believed that since management was not responding to direct requests, perhaps an indirect manner of communication would make the message clear. She went home and mulled over the issue.

The next morning the board saw a new post – a write-up about how non-appreciation in the form of financial benefits lowers employee morale. The post spoke about how decrease in morale leads to poor performance. The write-up ended with a suggestion that management should consider involving employees in decision making. It should make the effort to appreciate employee contributions. Management should not just say that they care for employees but show it in their actions.

Anu was quite pleased with her post and hoped that management would get the message. The editors needed their bonuses – they needed to be appreciated for their contributions. Anu put up the post on the board in the morning. When she came back after her lunch break, the post had disappeared from the board. None of her colleagues knew and she began to feel annoyed.

The Problem

Anu finished her brief and checked her watch – *time to find out...* She got up from her chair walking into the corridor. In a few minutes she was back on her chair looking dazed and bewildered clutching an official letter. She had been fired – ‘officially terminated without notice’.

HR Manager, Malati Iyer, holding the write up sheet in her hand had said: “*You are causing dissension... this is not what we expected of you...*”

Finance Manager had said: “*You are unnecessarily inciting employees and questioning management... you ought to follow rank and protocol ... you have no authority...*”

Senior Business Editor, Charu Khanna, had said: “*The Company has no need for unprofessional people like you...*”

HR Manager had continued, “*I have talked with the Managing Director, and we have decided to let you go We need to follow a discipline and method of keeping control...*”
Anu sat in her chair blinking back tears... *where had she gone wrong?*

DISCUSSION QUESTIONS

- Q1. What features of learning organization can be found in ABC systems?
- Q2. How was ABC’s management exerting control over its employees?
- Q3. Why was Anu fired?
- Q4. What options does Anu have now?
- Q5. Did the management i.e., Managing Director, Mr. Wilson and the Finance manager, handle the situation well? What would you have done in this situation and why?
- Q6. Do you think this situation would have occurred at the US location of ABC Systems instead of the branch office in India?

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WESTERN NATIONAL INSURANCE

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CASE DESCRIPTION

The primary subject matter of this case concerns the approaches used to methodically turn a financially struggling insurance company into one of the top regional insurers in the Midwest. Strategy formulation and execution in the insurance industry, aligning functional strategies to support the organization's strategy, and leadership competencies in turnaround situations are major themes. The case has a difficulty level of 3-5 and is appropriate for junior and senior-level courses, as well as a first-year graduate course. The case is designed to be taught in a ninety-minute class period, with two hours of outside preparation by students.

CASE SYNOPSIS

An insurance company is at risk of falling into a financial death spiral and brings in a new CEO to turn the company around. The CEO and his team take specific measures to bring the company back to financial health. These include mitigating risk, branding the company, solidifying agent relationships, ramping up technology, overhauling facilities, diversifying the business, and becoming an employer of choice. Growth has stalled and the company now is considering whether to change its business model from selling insurance products solely through independent agents to also selling directly to consumers via the Internet and an internal sales force.

INTRODUCTION

In September 2009, Stu Henderson, CEO of Western National Insurance, celebrated with his employees the announcement that A.M. Best, the premier insurance rating agency, had upgraded Western to a full A (Excellent). With this upgrade, Western became the only insurance company in the nation to be upgraded three times in the past eight years on its own merits, i.e. without external capital injections. This announcement came only two months after Western was named for the fourth time in five years to the Ward's 50 Benchmark Group of top performing property/casualty companies in the United States. (Ward's is an independent consulting firm. Each year, based on published financial numbers, they select the top 50 property/casualty insurance companies among the 3,000 companies that operate in the United States. Return on

surplus, combined loss ratio, and other factors are compiled to determine this prestigious ranking.) In the crowded cafeteria, Henderson held up his can of diet ginger ale and made a toast:

At a time when the economic news has many thinking that financial stability is the exception rather than the rule, we are pleased to have first the Ward Group, and now A.M. Best recognize Western National's role as an insurance industry leader in financial strength and performance. We owe this recognition to the dedicated work of our employees, agents, and other business partners, whose commitment to serving customers with integrity continues to strengthen the financial foundation protecting our policyholders.

As Henderson looked out at the gathering of smiling employees, he savored the moment and considered how far the company had come in the past eight years. In 2001, Western was in a financially precarious state where a single catastrophic storm easily could have pushed the company into bankruptcy. Clearly, the company journeyed a long and difficult path to bring itself back to financial health.

As much as he enjoyed the celebratory atmosphere, Henderson also recalled the old adage that the moment you think you've accomplished all your goals is the moment your position of strength starts to erode. Aware of the danger of complacency, Henderson was already considering how Western could get stronger.

A dilemma that Henderson and his team had pondered for several years was whether Western should rethink its business model of selling all of its insurance products through independent agents instead of selling directly to the public. The direct sales model had several advantages, including the savings of agent commissions, having more control over the policyholder relationship, and the availability of the Internet and information technologies to provide efficiencies and superior service.

On the other hand, selling insurance directly to the public had its potential pitfalls. Several much larger companies such as Progressive were already selling insurance on the Internet. These companies had larger financial resources to advertise and move traffic to their websites. Setting up the internal sales and operations capability to sell direct was also costly, involving more staff, training expense, and additional investments in information technologies.

Although it was easier to stick with a model that worked well for Western in the past, Henderson wondered if the changing environment in coming years required an overhaul of Western's sales approach. In the past ten years the public had become increasingly comfortable with shopping on the Internet for almost anything, including insurance. If Western failed to adapt to emerging trends in the way people buy insurance, it could have significant and long-term financial consequences.

But first, it was time to celebrate. Henderson put his soda can down and announced, "Let's cut the cake!"

U.S. PROPERTY CASUALTY INDUSTRY

In 2009, the United States property/casualty insurance industry wrote approximately \$475 billion in coverage. The top ten national companies (e.g. State Farm, Allstate, Travelers, Progressive, Nationwide) write approximately 50 percent of the total coverage, or \$240 billion. There are about 3,000 companies that write some form of property/casualty insurance in the U.S.

How Insurance Companies Make Money

An insurance company is deemed financially successful if its losses paid, expenses incurred (including commissions, claim adjustment costs, salaries, and general overhead) are less than \$1.00 of each dollar of premium revenue earned. This measure is called a “combined ratio.” If an insurance company has a combined ratio under 100, it is profitable. For example, a combined ratio of 96 means that for every \$1.00 of premium earned, the insurance company is realizing a profit of 4%.

An insurance company also receives income from investments held either as loss reserves (money waiting to be paid for losses either incurred or expected to be incurred in the future) and income from investments held in the form of policyholder surplus. Today, most insurance companies are earning around 5% on money held in these two categories. So if the combined ratio is 96 (4% profit) with an investment return of 5%, total net income before taxes would be the sum of the two pools of income.

COMPANY BACKGROUND

Western National Insurance Group, headquartered in Edina, Minn., was a super-regional property-and-casualty insurance group writing over \$245 million in direct premium in nine states, serving personal and commercial customers in Minnesota, Nevada, Oregon, South Dakota, Utah, Washington, and Wisconsin, as well as commercial customers in Iowa and North Dakota. All of the group’s products were sold exclusively through professional independent agents.

Western began more than 100 years ago as a Minnesota company called “Mutual Creamery and Cheese Factory Insurance Company.” As the name suggests, it was founded to provide specialty insurance coverage primarily for creameries. Creameries were the owners of the company and paid premiums to the group in return for casualty coverage, and all sales were “direct” to the customer by company employees.

In 1955, Western hired George Klouda to expand the product line to include liability, auto, and other lines of property/casualty insurance, and to open sales through independent agents to a wide range of markets, companies, and individuals. Klouda rose to CEO and served in that role until 1997 when Don White was hired to take over the president duties. However,

despite being president, White was not given a seat on Western's board. The most important decisions continued to be made by Klouda (who retained his titles of CEO and Chair of the Board) and four other board members, all of whom had been nominated by George Klouda.

Starting in the mid-1990s, Western's financial health began to suffer. With Western trying to position itself in the market as a low-rate insurance provider, rate increases were sporadic and insufficient. Rates were increased only a couple of times in the 1990s, and by the end of the decade, rates were grossly inadequate to cover underwriting expenses and loss risks of outstanding policies. For example, by 1999, Western's combined ratio for its standard auto insurance was approximately 130 percent (i.e. the company was losing 30 cents for every dollar of premium collected). The company was also writing a substantial amount of building contractor's insurance at rates that were insufficient to cover claims for shoddy work and building code violations.

Another problem was Western's failure to maintain adequate loss reserves to fund expected future claims. Claims on liability policies, i.e., general liability, automobile liability and workers compensation may take years to resolve. As such, an insurance company estimates what those costs will be and sets aside loss reserves to cover these future payments. Despite the uncertainties in setting loss reserve levels, prior loss reserve experience clearly indicated that Western's reserves were well short of covering claim levels that could typically be expected. In addition, the company was growing homeowners business in very concentrated areas, underestimating the possible loss due to adverse weather (tornados, hail, etc.) occurring in one of these areas.

Insurance companies traditionally buy insurance themselves, called "reinsurance," to cover significant loss events. Reinsurance allows a company to absorb a huge financial shock when unusually severe storm activity results in extremely high claims. Rather than dealing with a huge financial hit of tens of millions of dollars in claims all at once, with reinsurance, a company pays annual premiums that are more consistent and predictable, tapping this coverage when a high claims year inevitably arrives.

Western carried insufficient reinsurance coverage to protect against exceptionally high storm claim events, a problem which came to light when a huge storm loss in 1998 generated claims totaling \$56 million, with the company's reinsurance covering only \$20 million. Prior to 1998, the largest claim total for Western from a single storm event was \$3 million. With inadequate reinsurance to pay the 1998 claims, Western had to draw down its surplus from \$72 million in 1997 to \$58 million in 1998.

Western's financial predicament was not surprising, given that the company did not conduct formal budgeting or planning, did not map insured properties and model storm effects, and did no industry peer-group analysis for benchmarking and strategic goal-setting. Most of the problems could be traced to poor leadership at the very top of the company. With a residence in Florida, the CEO was not fully engaged with running the company. He did not delegate major decisions-making responsibility to his officers, and financial information (balance sheets and

income statements) was prepared only on a quarterly basis to fulfill legal requirements, and not shared with the company's officers.

Most of the officers knew Western was not doing well, but they were isolated by the lack of full information and by goal conflicts among the officers in their respective roles. For example, while the actuarial department determined that personal home and auto rates were too low to cover losses and expenses, the sales department resisted rate increases for fear they would depress policy renewals and sales of new policies. The lack of top leadership meant these internal conflicts would usually go unaddressed and be allowed to inflict serious financial damage on the company. According to one long-term Western official, "Our CEO at the time, while smart, did not change with the times and his leadership was very hierarchical. Managers were followers, not leaders. They did not appreciate the desperate financial situation the company was in. They didn't understand financial statements because their jobs weren't driven by them."

The company also lagged in adopting new technology. For example, when reinsurers asked Western to map the homes covered by its policies in order to assess vulnerability to storm events, the company lacked the computer capability to conduct the analysis. Additionally, underwriting, claims processing, and billing were labor intensive and paper-driven.

Once an insurance company begins to struggle financially, it becomes increasingly difficult to reverse the decline because financial stability is the driver in writing new business and retaining existing contracts. In 1999, to communicate serious concerns with Western's financial viability, A.M. Best issued a double downgrade in Western's financial rating from A-directly to B+ (skipping B++). The A.M. Best downgrade was the result of several indicators showing that Western had entered a potentially fatal period of decline. The loss ratio (losses to premiums) was too high, the surplus was dangerously low, reinsurance continued to be insufficient to buffer against major claims, and despite low profits, dividends continued to be paid to policy holders.

COMPANY TURNAROUND

In 2000, pushed by the A.M. Best rating downgrade, Western conducted an external search for a new CEO. An executive search firm found Stuart Henderson to become Western's next leader.

Prior to joining Western, Stuart Henderson graduated Magna Cum Laude with a BA in Political Science from the State University of New York at Geneseo. He earned the Juris Doctor degree from Union University, Albany Law School, in Albany NY in 1980, and completed his Chartered Property Casualty Underwriter (CPCU) certification in 1991. Over the next twenty years, Henderson worked in a wide range of capacities as a lawyer and a manager, with most of his experiences in the insurance industry. He served as a claims counsel, and held various management positions in claims, underwriting, actuarial, product development/compliance, and a

brokerage operation. His executive management experience included participation in the demutualization and initial public offering of Farm Family (NYSE), and serving as Vice President in the Casualty Underwriting Division of Gerling Global Reinsurance Corporation of America, Senior VP of Gerling's Property Underwriting Division, and General Manager for Gerling's primary insurance subsidiary, Constitution Insurance Company.

Although Western's challenges were serious when Henderson joined as CEO, he accepted the position because he felt the company had a number of strengths that offered hope for a recovery. First, the workforce was seasoned, knowledgeable and loyal to Western. Second, the network of independent agents that sold Western policies was largely pleased with Western's service and incentives, and committed to helping Western succeed. Third, the investment portfolio was strong in terms of safety and yield rates. Fourth, the claim staff was internal to the company, not outsourced, and provided accurate and fair claim processing and high levels of customer service. Fifth, customer relationships with policy holders were solid, since Western never had failed to honor a legitimate claim. Western also had good relationships with the insurance regulatory departments in the states in which it did business and was not burdened by any significant debts, liabilities or lawsuits.

In addition to Western's internal strengths, Henderson believed that there were positive dynamics in the insurance industry that would favor chances for Western's resurgence. First, rates in general were on the rise, especially in commercial lines, although Western did very little business in the commercial area in 2001. Second, the business model of selling insurance through independent agents continued to survive, despite the conventional wisdom that it would be replaced by direct selling to consumers over the Internet. Finally, large national insurance carriers tended to be fickle, quickly pulling out of markets where significant losses were incurred. This reduced rate competition in those markets and provided opportunities to Western and other medium-sized regional carriers with a longer-term view of these markets.

Initial Actions

Stuart Henderson took the CEO helm in late 2001. Before moving to Minnesota, he took advantage of the fact that rating company A.M. Best's New Jersey headquarters office was fifteen minutes from his home and drove over to meet with A.M. Best officials. He asked them not to further downgrade Western's rating, citing Western's experienced and customer-focused staff, its independent agent network that was still selling Western policies, and its strong investment portfolio. Henderson acknowledged A.M. Best's concerns with Western's financial vulnerabilities and emphasized that he intended to immediately start working on mitigating risk, boosting profitability over premium growth, and increasing reinsurance coverage.

In his first day as CEO, Henderson met with Western's top managers (with the prior CEO and board chair) to introduce himself and to reassure the managers that no immediate major changes would occur. He told them it was his intent to work with them to review the operations

and plans of the company over the next 60 days to determine how best to move the company forward.

After meeting with top management, Henderson and the top managers held an all-employee meeting in the company cafeteria. Henderson pledged to the employees that he would learn about the company, its staff and independent agents, and preserve the good things that were part of the Western legacy. Additionally, he would seek every opportunity to strengthen the company and secure its future success, to maintain open communication channels, and to be honest and fair.

In the following weeks, Henderson held individual meetings with department heads, as well as meetings with departments as a whole to discuss processes, procedures, issues, and concerns. Henderson asked employees to critique their areas and list strengths and weaknesses. He would often ask employees, “What are your main worries concerning your area?”

Independent Agent Relationships

Henderson knew that Western’s independent agent network was the “life-blood” of the company and it was critical to convince agents that Western was a strong and trustworthy business partner. He began by sending an open letter of introduction to the agents to thank them for their past and future support and to affirm Western’s commitment to providing them with outstanding insurance products, excellent customer service, and competitive commissions. Shortly after sending out the letter, Henderson brought agents from Western’s top ten producing agencies to the company’s headquarters in the Twin Cities to meet with them personally. As Henderson recalls:

“They were a tough crowd—extremely focused on gauging where this company was headed. They told me “Don’t change the culture. We like Western’s customer orientation and prompt service.” They also told me, “Don’t take away the ‘no-surcharge’ (for accidents or traffic violations) feature of your policies, because policy holders like it, even if the majority of them never need it.”

Over the next several months, Henderson traveled to meet individually with independent agencies to continue his on-going efforts to build solid relationships with those whom Henderson called, “our primary customers.”

Reinsurance

Reinsurance was an area that needed immediate attention. Without adequate reinsurance, another major catastrophic storm could send Western into a financial death spiral. The

company's low surplus level made its financial solvency extremely vulnerable to a year of heavy storm damage claims.

To bolster Western's reinsurance, Henderson engaged a reinsurance broker at Aon Benfield with whom he had extensive experience and could trust to become a long-term partner with the company. Using \$11 million in earnings expected over the year from Western's investment portfolio, Henderson asked his new broker to give him the best reinsurance coverage possible for that amount. The broker was able to secure a policy that provided Western with better coverage and saved the company \$1 million over what the previous reinsurer would have charged for the same coverage. By making the researching, negotiating, and purchasing of reinsurance a top priority, Henderson established a strong financial safety net for the company.

Mitigating Risk

Despite the increase in reinsurance, Western still had too much exposure to catastrophic claims and it simply didn't have the funds to purchase additional reinsurance. Homeowners insurance drives catastrophic claims exposure, and 35 percent of Western's total premium came from homeowners policies in 2001. Since there were no more funds to purchase more reinsurance, Henderson and his senior management team moved to reduce Western's homeowners insurance business by 25 percent. To make the reduction as quickly as possible, Western contacted the top three homeowners insurance writers in its network, all of which were banks that were packaging Western homeowners policies with mortgage loans, and told them to move the business to other insurance companies. Although this meant a significant reduction in Western's premium revenue, catastrophic claim exposure was reduced and the disruption of important relationships with most of the independent agents was largely avoided.

To more effectively manage future growth in homeowners insurance and the attendant exposure to catastrophic claim risk, Western implemented a policy of writing homeowners policies only if they were packaged and sold with auto insurance. Additionally, Western developed Global Positioning System (GPS) mapping capabilities to identify geographic areas where Western homeowner policyholders were highly concentrated. These clusters of policyholders were more likely to occur within densely populated metropolitan areas, exposing an insurer to greater catastrophic damage claims if a storm should hit in one of these areas. The mapping technology allowed Western to stop writing new homeowners insurance in identified cluster areas.

Expansion of Commercial Lines

In 2001, Western's business was primarily comprised of auto and homeowners policies sold to individuals. As the new CEO, Stu Henderson saw advantage in broadening Western's product line by expanding insurance products for the commercial market, including the areas of

property, liability, auto, and workers' compensation. Commercial lines were a valuable source of new premium revenue for Western to replace the premium lost from the reduction in homeowner policies, and to help achieve the strategic goal of growing premium over the long term. Commercial insurance also provided Western with greater market and risk diversity in its policyholder portfolio.

To profitably expand into the commercial insurance market, Western set an ambitious goal of writing an average of \$50,000 in premium per commercial client. There were several strategic reasons why Western used this financial benchmark in pursuing the commercial market. First, it encouraged agents to package multiple insurance products (property, liability, auto, and workers compensation) for a given client, providing better overall coverage for the client at more competitive rates. Second, selling a larger and more comprehensive insurance package to commercial clients promoted the goal of developing close and long-term agent-client relationships. Finally, earning more premium income from clients who become long-term customers was an ideal strategy for controlling Western's expenses.

Increasing Profitability

In 2000, Western's premium rates in personal lines (home and auto) were too low to cover losses and expenses. Additionally, rates in commercial lines had been forced down due to market competition. In 2001, the company began to reposition itself in the market from being a low-cost provider of insurance products to being a high-service/long-term partner to its customers. This allowed the firm to begin increasing premiums to better match risks and expenses. Fortunately, this strategy to increase premium revenue coincided with the start of a period of rate increases in the insurance industry as a whole, known as a "hard market." The hard market made it easier for Western to adjust rates upward since the competition was doing it as well.

Stu Henderson also worked with Western's commercial underwriters to pay special attention to applicants who had loss histories that were less than perfect. While other insurers may not write policies for such applicants, Henderson encouraged his staff to study these applicants to determine if their losses were due to a temporary period of bad luck, rather than indicative of a long-term bad risk. Such clients could be very profitable if Western structured the premiums and coverage appropriately.

Western's GPS technology to locate insured properties was used in conjunction with software to conduct "what if" analysis for potential storm event scenarios. The technology allowed Western to make better decisions in writing new policies and setting premiums.

Credit scoring was another tool Western adopted to boost profits. Research shows that credit score is a strong predictor of an applicant's future claim risk, and by the early 2000s, many of Western's competitors had been using credit scoring for several years to screen applicants.

Western's adoption of credit scoring allowed it to more accurately gauge the loss risk of an application and set premiums accordingly.

Controlling Expenses

One of Western's strengths when Stu Henderson joined the company was its low expenses (advertising, salaries, commissions, taxes, and other operational expenses) of 22-23% of total premiums. Keeping expenses low was important to the pursuit of bringing the company back to profitability.

One-half of Western's expenses were comprised of commissions paid to independent agents. Since there are both fixed and variable costs associated with maintaining independent agent partnerships, Western conducted a review of its agents to evaluate the return on investment in each of its agent relationships. Agents were evaluated on the basis of overall profitability and total premiums generated from their policyholders. A tiered commission structure was developed to pay greater commission rates to higher performing agents, provide incentives for agents in lower tiers to boost their productivity, and reduce commissions paid to low performers who might be candidates for culling from Western's independent agent ranks. The tiered commission mechanism helped Western target rewards according to agent performance in pursuit of a higher return on agent investments.

Branding

To refresh its image and to help distinguish itself in the insurance marketplace, in 2003 Western hired an outside branding company. With the branding firm's assistance, and after conducting research and internal study, Western leaders objectively characterized the company as a "B" player in the insurance industry, selling a medium-priced and fairly generic product. The next step was to gather responses from Western employees, independent agent partners, and policy holders to the question, "Why would someone do business with us?" The answers included: "People like us." "We answer the phone." "We take care of people's problems." "We listen." A common theme emerged on which Western could build a positive market presence by projecting itself as "The Relationship Company" and by incorporating this slogan into a revamped company logo (Figures 1 and 2). Western's new marketing thrust became the branding of Western as "The Relationship Company."

Figure 1: Western's Old Logo



Figure 2: Western's New Logo



Facilities

Western's physical plant sorely needed updating. For example, the front steps and entryway were covered by worn indoor/outdoor green carpet. Inside, the building was dark and suffered from years of deferred maintenance. A fully-stocked bar in the boardroom projected an image of days past. The building lacked a training room for employee development and space for meetings with agents, regulators, and policy holders. In many other ways the building was ill-suited for supporting Western's operations and providing an aesthetically inviting work environment.

In 2005-2006, Mary Manley, Senior Vice-President of Corporate Affairs and Administration, was charged with a major renovation to Western's headquarters building. Major portions of the building were gutted, walls were removed, the bar was abolished, and a new expansive reception area was created. New offices for senior leadership were designed to facilitate easy communication and to create a bright and pleasing environment to welcome visitors. Paintings by local artists were purchased and hung in hallways, offices, and meeting rooms. A spacious training room with state of the art technology became a multi-purpose venue for employee development, agent training, and board meetings.

A key element of the building renovation was the construction of a new cafeteria. According to Manley, creating an attractive cafeteria gathering space fit well with Western

branding itself as “The Relationship Company,” noting that the culture required that not all renovations be directed to senior management spaces. New ceilings, lighting, and remodeled bathrooms were also welcomed by employees.

A significant effort was made to integrate Western’s mission into the new building design. An imposing artistic exhibit against a large wall in the entryway displayed renderings of people dealing with disaster situations, pictures of storms and tornados, objects of interest (including a melted plastic coffee pot that was salvaged from a burned-out building), newspaper clippings, and banners that communicated Western’s important role in protecting its clients from major calamities. Close by was a large engraved plaque that displayed the company’s mission statement (Figure 3) that was created as part of the remodeling strategy.

Figure 3: Western National Insurance Mission Statement

To act with integrity in the service of others.

We will achieve this mission by maintaining financial strength, and by establishing lasting relationships with people and businesses who share these attributes with us:

- *A passion for business and life*
- *A desire to serve others in need*
- *Adaptability to a changing world*
- *A strong sense of humility and humor*

Aspiring to be an “Employer of Choice”

Despite Western’s desperate situation in 2001, one of its strengths was its loyal, experienced, and customer-focused workforce. To build on this strong asset, Mary Manley and an employee relations committee met regularly to further improve Western’s work environment. Western sought to become an “employer of choice,” where high-quality applicants see the company as a highly attractive place to work. Figure 4 shows some of the policies and programs that helped Western in its pursuit to become an “employer of choice.”

Figure 4: Examples of Western's Human Resource Benefits/Programs

- High quality health care insurance
- Competitive wages
- Annual bonuses tied to company financial performance
- Friday afternoons off
- 401k retirement plan with a company match
- Cash awards for passing professional certification exams
- 100% tuition reimbursement for job-related courses
- Flexible work schedules
- Long-term care insurance
- Monetary service awards for serving 10, 20, 25 years, etc.
- One day of paid leave per year to volunteer for charitable organizations
- Charitable events for groups of Western volunteers to donate their time

Western's culture was especially focused on volunteerism and fundraising, especially for charitable organizations that served disadvantaged populations. Examples of organizations that Western supported included the Red Cross, Habitat for Humanity, nursing homes, food shelves, and homeless shelters.

In addition to giving one day of paid leave per year for employees to volunteer, Western made charitable giving fun. One program gave "Dress Down" stickers to employees who make charitable donations, allowing the employees to dress down at work for a day. Every year during National Volunteer Week, Western held special events to celebrate employees who donated their time and money to charitable causes in the past year. The company itself backed this community commitment by pledging 1% of its annual net income after tax to charitable giving to employee- and agent-suggested non-profits.

Western's new slogan, "The Relationship Company," proved to be a strong anchor for designing programs that build relationships among employees and tie them closer to their communities. Two measures of success in becoming an "Employer of Choice" indicated that the efforts were paying off. First, Western's year-to-year employee retention rate consistently averaged 97%. Second, annual employee surveys showed that nearly 100% of respondents said they would recommend Western to their friends and family as a good place to work.

Technology Upgrades

For reasons of efficiency and customer service, Western needed to upgrade its technology. One of the first major actions to move Western away from its traditional business processes was creating an agent portal for personal lines (home and auto) on its website. This occurred during 2001-2005 and required the implementation of software technology that would permit independent agents to log in to submit applications and get insurance quotes. Michael Braun, Vice-President of Information Services (hired in 2005 to lead IT), pointed to the agent portal as “putting Western on the map” as an up-to-date insurance company in the minds of its agent-customers. Braun also cited the significant savings provided to Western by the portal because agents were now doing the data entry function that Western employees used to do. Having an agent portal that worked well was also critical for building new business relationships. Attracting new agent-customers required “wowing” them with technology that provides faster service, ease, and reliability.

A second major technology project was the Imaging and Workflow Program (IWP) that was implemented in 2005-2006. IWP converted the vast majority of Western’s records into a digital format for storing and accessing. Software was implemented to permit most of Western’s incoming mail to be scanned and placed into work queues for employees to process at their work stations. IWP changed business processes by eliminating the movement of paper files, and instead moved work instantly to the right people for timely completion. Accuracy and security were also enhanced by these new systems.

Braun praised Western’s employees for smoothly adopting the new technologies and embracing new work methods. In contrast to the stories heard elsewhere about employee resistance to changes in the work environment, Western’s employees were the key to the successful implementation of IWP.

A third technology initiative dwarfed the first two in complexity and expense. This was the selection, purchase, and implementation of an end-to-end Policy Administration System (PAS) that would link all of Western’s business processes and its employees to a single system. In January 2005, the PAS package called “CSC Point In” was purchased. The Point In software provided Western with “a platform-flexible, function-rich system with broad support for all lines of businesses, including commercial lines, workers' compensation, niche and specialty lines” (CSC website: <http://www.csc.com>).

The Point In package is known as an “end to end” software product because it encompasses a broad range of functions, including claims management, document management, statistical reporting, agency management, fraud detection, business analytics, automated renewals, billing, and legal reporting, among others. Western spent millions of dollars on the purchase and implementation of Point In, but the software proved right for Western’s strategic and operational requirements.

A major contributor to the successful adoption of Point In was Western's commitment to acquiring talented people with the skill sets to work through the implementation challenges of the Point In project, and to fully exploit the system's capabilities in the post-adoption phase. For example, Western established a project office to manage on-going information technology (IT) projects, and the data analysis and testing team ramped up from 5 to 15 people as new systems were adopted. These commitments to acquiring and retaining highly skilled IT personnel helped ensure that Western's IT projects provided maximum support to the company's strategic priorities.

Point In also received top-level support from CEO Stu Henderson, who saw Point In as a critical step in Western's future success. He championed Western's IT projects and had the patience to tolerate the expense and uncertainties in adopting these complex systems.

Evolution of the Board of Directors

Between 2001 and 2009, the Board of Directors was reshaped to broaden and deepen areas of expertise. Included among the new board members was a CEO of a nation-wide pension organization, a CEO of a major Twin Cities-based logistics company, a CFO of a large health maintenance organization, a turnaround consultant with CFO experience in the restaurant industry, and a college professor with expertise in operations management. The Chairman of the Board, who had been part of the effort to bring in Stu Henderson as an outside CEO, was a principle in a Twin Cities law firm and a former Speaker of the House in the Minnesota State Legislature.

The diversity of the board changed as well, as two of the new board members were women. Western's officers attend and participate in Board meetings and have noted that the board is much stronger in asking important questions and suggesting ideas for addressing Western's challenges.

THE CHOICE FOR GROWTH: SELL EXCLUSIVELY THROUGH INDEPENDENT AGENTS OR ADD A DIRECT-TO-CONSUMER SALES MODEL?

Selling insurance products directly to consumers was one of the growth options Western was considering. Almost all insurance sold by insurance companies directly to the consumer, whether through the Internet or direct solicitation (mail, phone, etc.) is for personal lines insurance, as opposed to commercial lines. Personal lines include home, auto, umbrella, boat, recreational ATV's, and motorcycles. To date, most companies marketing directly to consumers have achieved success by selling auto insurance. Of the total U.S. pool of property casualty premiums, approximately \$170 Billion is collected for auto insurance.

In selling directly to consumers, the main competition that Western would face presently is large national carriers such as Progressive and Geico. While Progressive pursues a dual strategy of selling through both agents and directly to consumers, Geico's strategy is an exclusive one of marketing directly to consumers. In the future, Western might also face other regional carriers such as Acuity, West Bend, State Auto, and Austin, which could develop their own direct to consumer marketing strategies. At present, all regional carriers (of which Western is one) pursue a single distribution strategy of marketing through independent agents.

Selling directly to consumers via the Internet, telephone, and mail was appealing in several ways. It would give Western more control in presenting insurance products to the customer, and offered greater opportunity to control the quality of customer service. Savings on agent commissions was another major reason to sell directly. Limiting the presently dominant role of independent agencies would also reduce the technical challenges of interfacing with different IT systems. Finally, the direct sales model fit well with the well-documented societal trend toward Internet commerce.

Despite the appeal of adopting an Internet-driven sales model, the direct sales model had several drawbacks. First, Western would have to invest in recruiting, training, and rewarding permanent staff to sell its products. While sales expenses were largely variable (paid as commissions) with the independent agent model, more sales expenses under the direct sales model (salaries, benefits, and other personnel costs) would be fixed and occur regardless of sales volume.

Secondly, advertising expenses would rapidly become a significant portion of sales expense because Western would have to promote the Western brand and direct consumer traffic to the Western website. The large national brands, such as Progressive, were much better established and had greater financial resources for advertising to the public.

Finally, it was difficult to differentiate insurance products in a mass marketing environment such as the Internet, where price is often the dominant criterion in consumer purchases. If Western were forced to compete solely on price, it would struggle against its larger competitors.

Alternatively, Western could expand sales by devoting more resources toward building sales through its traditional network of independent agents. A significant advantage of this strategy, was the saving of personnel costs related to maintaining a permanent internal sales force that would be required under the direct sales model. Another advantage was that commission costs paid to independent agents are almost entirely variable and directly tied to sales volume. (The average commission paid by companies marketing through independent agents ranges from 10 to 15 percent. Western writes approximately \$60 million of personal auto premium at an average commission of 14 percent. Auto insurance is sold by Western in eight states: Minnesota, Wisconsin, Iowa, South Dakota, Washington, Utah, Oregon and Utah.)

There were several disadvantages of the independent agent sales model. First, agents represented more than one company and Western had little control if an agent decided to present

another company's product to a customer. In other words, Western did not have the full attention or loyalty of independent agents. Second, Western did not have ultimate control over the quality of service its policyholders received from independent agents. Customer service was a critical part of policy renewals. Third, at the regulatory level, legal violations by an independent agency could present a liability risk to Western, as well as tarnish its reputation. Finally, in expanding its information technology systems to include independent agencies, Western faced the daunting task of interfacing with a myriad of different hardware and software systems at the independent agency level.

Requirements to Build a Direct-to-Consumer Capability

To begin selling personal lines (home and auto) directly to end consumers, Western would have to build from scratch a new system to enable customers to interact with the company by phone or Internet and be able to switch between those mediums easily and seamlessly. This would require a strong, user-friendly system. The critical elements for building this system are as follows:

Initial Fixed Costs:

Initial fixed costs include \$6 million for front-end software costs and interfacing with the existing financial database. This figure includes 60,000 labor hours for developing, testing, and implementing the technology at \$100 per hour (a blended rate using in-house resources and outside vendors) and \$1.2 million for additional high-end servers. Both of these fixed cost elements would be amortized over five years.

Labor Costs:

Western would have to hire permanent staff to provide customer service for a minimum of 12 hours per day. Assuming that \$15 million in premiums can be sold within 18 months of initiating operations, the following labor is required:

- Level 1 employees with skills to service existing policies for changes in address, vehicles, and usage. Eleven employees would be required at a salary and benefits cost of \$45,000 per employee.
- Level 2 employees who are licensed agents with skills to actually interact and sell insurance to prospective customers. Four employees would be required at a salary and benefits cost of \$65,000 per employee.
- A manager of the "Direct to Customer" program at a salary and benefits cost of \$90,000.

- The initial staff would be able to service up to \$25 million in premium volume. Each additional \$2.5 million of premiums would require another Level 1 employee and ¼ Level 2 employee.

Additional Estimated Expenses:

Support from human resources, legal, actuary, accounting, and all other support services (not including allocated claims handling expenses) of \$955,000 per year.

- Average claim handling expenses of \$200,000 on \$15 million of premiums.
- Annual software/hardware maintenance and upgrades of \$400,000.
- Annual advertising and other promotional expenses of \$800,000.
- Claim payments on \$15 million of premiums of \$9,300,000 (62%).
- Reinsurance costs of \$250,000.

Success Defined

If Western decided to add direct sales to its business, it would not want to disturb revenue streams being generated by the independent agents in current states of operation. Therefore, a new direct sales program, if launched, would be established in a new state where Western is not currently doing business. The venture would be deemed a success if within 18 months Western could establish a minimum premium base of \$15,000,000. Assuming the average annual premium for an auto in the new state would be \$1,428.00 (two vehicles per policy), Western would need about 10,504 policies in force at the end of 18 months.

CONCLUSION

Stu Henderson and his senior management team knew that despite the company's recovery from potential insolvency, the changing marketplace imposed rigorous competitive challenges on Western. Deciding on a future growth strategy was critical.

Staying with the proven independent agent sales approach had its merits, but Henderson knew that recognizing new opportunities and moving away from obsolete business practices was an important part of his job. He didn't want to look back at this time with regrets that he didn't make the right decision.

DISGRUNTLED EMPLOYEE RETALIATION: DOES THE EMPLOYER HAVE RESPONSIBILITY?

Robert C. Schwab, Andrews University
Susan M. Taylor, Andrews University

CASE DESCRIPTION

This short case focuses on harassment and intimidation problems faced by a manager and his family shortly after an employee has been terminated. Whether the departed employee is the intimidator, whether the employer is obligated to investigate and get involved in the matter, and which options or possible actions the manager and his family can take are the key issues in the case.

The case has a difficulty level of four, and is best-suited for use in junior or senior undergraduate-level courses in human resource management or employment law. This case can be presented and discussed in about one and a half hours, and is expected to require about two hours of outside preparation by each student.

CASE SYNOPSIS

This is a case about a disgruntled employee at a software development company that was being downsized. The employee became upset when he was terminated, claimed he was fired because of his Iranian background, and had to be escorted from the premises by a security guard. A few weeks later, his former manager started receiving bills for hundreds of dollars of purchases that neither he nor his wife had ordered, such as magazine subscriptions, life insurance policies, and gifts. The manager thought the terminated employee was probably doing this, but he only had a few forged signatures on some order cards as evidence. The company HR Director was informed about these harassment incidents and shown the signature cards, but didn't offer to get involved to resolve the situation. As more magazines, pornographic pictures, suggestive notes, and even a note with a veiled threat to the wife and baby arrived in the daily mail, the manager realized that his family was being intimidated and threatened in a criminal way. This was no longer just a prank. The police were called and an investigation was begun, but there still seemed to be little support from the company and the HR Director.

Does the employer have a responsibility to protect its managers and their families from work-related harassment? What should the manager do now? Should the family move to a safer place? Should they wait for the police to do something? Should the manager leave his job at the company? Should they retain a lawyer and sue the company?

DISGRUNTLED EMPLOYEE RETALIATION

Mark Sargent is a programming manager at McAlister Systems Incorporated, a software development company that produces and markets various firewall and virus-removal products. In early 2010, the company went through a modest company-wide layoff in which a number of low performing employees were terminated. Corporate reviews had determined that a software engineer in Mark's group, Mohamed Aziz, had a history of marginal productivity reviews, and he was the logical one to lay off. Mark's manager, Bob Bryan, told him that since he was the group programming manager, it was his responsibility to inform Mohamed Aziz of the termination. This was Mark's first experience in laying off anyone, and he was rather anxious about the whole process.

On the designated day, Mark called Mohamed into his office where he delivered the news. Mohamed did not take the layoff well, and started shouting at Mark, saying that he was being singled out unfairly because he was Iranian. When Mark's secretary heard the shouting (and swearing), she called security, and an officer and the Human Resources Director, Esther Coles, quickly arrived to assist. Mohamed was eventually escorted from the premises while threatening legal action. This incident left Mark a bit shaken, but thankful that Ms. Coles and the security officer had been able to intervene. Neither Mark nor the company had any direct contact or communication with Mohamed Aziz after this incident.

About four weeks later, the Sargents started receiving unexpected magazines in the mail along with bills demanding payment for the initial subscriptions. Bills also began to appear for various gifts, CDs, and even an insurance policy, most of which were supposedly ordered by Lisa Sargent, Mark's wife. In a very short time, invoices for over \$1000 of various purchases had been received (see Exhibit 1). Mark and Lisa did not have any idea who might be doing this, until they received confirmation of a gift subscription that Lisa had supposedly sent to Mark's boss, Bob Bryan. They suspected that this harassment must be work-related when they discovered that a second gift subscription had been sent to Cory Mosier, another manager at McAlister Systems. As Lisa called, pretty much on a daily basis, to cancel orders, she also asked for copies of the documents confirming these orders. While many of these were submitted as internet orders, a few were mailed-in order cards, and all had opted for the "bill me" option. After seeing the handwriting on three or four of these cards, Mark thought the large, flowery handwriting was that of Mohamed Aziz. Still, Mark and Lisa were puzzled since Mohamed had never met Lisa, so why would he focus his attention on her?

Mark sent an e-mail to Esther Coles, the Human Resources Director, asking for an appointment to discuss the situation and get some advice on how to proceed (see Exhibit 2). When Mark and Esther got together a few days later, Mark explained in more detail what had been happening over the last several weeks and his suspicions about Mohamed. In just the past few days, he and Lisa had received three more subscriptions...and some were now for

pornographic magazines like Hustler and Raunch. Mark produced some samples of Mohamed's handwriting on some old company documents, and then compared them to the signatures on the order cards that had been retrieved. He reminded Esther of the trouble they had with Mohamed's termination, and asked what should be done next about this matter. Ms. Coles made copies of the information provided by Mark, but didn't offer to intervene with Mohamed or get involved. She did say that Mark was definitely dealing with a mail fraud situation and possibly an identity theft attempt, and that perhaps the postal authorities should be notified, but the information provided wasn't sufficient to accuse Mohamed of anything. Mark left the office feeling unsatisfied with Ms. Coles lack of help, but not sure what his next move should be.

On two successive days in the following week, Lisa received two unsigned hand-written letters in the mail that each contained an explicit pornographic photo, along with some suggestive sexual comments. This was no longer just a case of fraudulent charges for unwanted goods; Lisa was clearly being harassed! The Sargents immediately called the police. Officer Park soon arrived at their home, listened to their complaint, gathered the evidence they had accumulated, and told them to be patient as he moved forward with the investigation. One of the things Officer Park wanted to do was talk to McAlister Systems about Mohamed's background and work performance. Unfortunately, after several days of attempting to set up an appointment with Ms. Coles at McAlister Systems, Officer Park had still not received a reply. Since the police did not have the background information they needed, no attempt had yet been made to approach Mr. Aziz. It seemed to the Sargents that McAlister Systems was responsible for the harassment they were experiencing from Mohamed, and yet the company, and specifically the HR Director, Esther Coles, were reluctant to get involved with this investigation. Why?

A third unsigned hand-written note was received in the mail a few days later that said simply, "I'm watching you, and I know where your babysitter lives!" Lisa and Mark were feeling quite intimidated at this point and started considering what they should do. Would Lisa and the baby feel safer if they left town? Should they hire a private security firm to monitor their home? Would the harassment stop if Mark quit his job at the company? Why wasn't Esther Coles cooperating with the police on this investigation? They called Officer Park, and he again came to their house, gathered the new evidence, and encouraged them to be patient. Lisa wrote an impassioned e-mail to Esther Coles, the HR Director, pleading with her to cooperate with the legal investigation that Officer Park was trying to conduct (see Exhibit 3). Mark and Lisa want the nightmare to stop right now! What else can they do?

DISCUSSION QUESTIONS

1. Does McAlister Systems have an obligation to protect its employees and their families from harassment, particularly if it stems from a work-related incident?
2. Is there any proof that Mohamed Aziz is the perpetrator of this harassment?
3. What actions can Mark and Lisa take to stop this intimidation? What are their options?

4. Given your responses above, what would you recommend that Mark and Lisa do? Justify your recommendation.
5. What do you think the company could have done or should have done to protect Mark and Lisa Sargent from incidents like this? Are these legal or ethical responsibilities?

EXHIBIT 1: APRIL INVOICES FOR GOODS CHARGED TO THE SARGENTS				
<u>Date</u>	<u>Item Ordered</u>	<u>Description</u>	<u>Amount</u>	<u>Ordered by</u>
4-12	Business Week	51 issue subscr	\$45.97	Mark Sargent
4-13	Psychology Today	18 issue subscr	34.97	Lisa Sargent
4-14	PC Magazine	22 issue subscr	39.97	Lisa Sargent *
4-14	Bicycling	11 issue subscr	19.94	Lisa Sargent
4-14	American Baby	12 issue subscr	13.97	Lisa Sargent
4-14	Parents Magazine	24 issue subscr	15.98	Lisa Sargent
4-16	Hamilton Authenticated	Elvis '68 special	45.90	Lisa Sargent
4-16	Hamilton Authenticated	End of a Perfect Day	66.85	Lisa Sargent
4-18	Lenox Collections	Song of Friendship	44.88	Lisa Sargent
4-18	Lenox Collections	Kinkade Beach/S&P	34.88	Lisa Sargent
4-18	Lenox Collections	Jewels of Christmas	30.98	Lisa Sargent
4-19	Good Housekeeping	12 issue subscr	13.03	Lisa Sargent
4-19	Redbook	12 issue subscr	8.91	Lisa Sargent
4-20	Bicycling	11 issue subscr	19.94	Mark Sargent
4-20	China Imports	8 pc Tea Set	95.40	Lisa Sargent *
4-21	Sunset - 12 issue subscr	Gift to Cory Mosier	29.00	Lisa Sargent
4-21	Outside Magazine-24 issues	Gift to Bob Bryan	60.00	Lisa Sargent
4-22	Gerber Life Insurance Co	1 yr Term insurance	299.90	Lisa A. Sargent *
4-23	The Bradford Exchange	Three Kings	55.94	Lisa A. Sargent *
4-25	People Magazine	52 issue subscr	49.91	Lisa Sargent
4-26	Vegetarian Times	24 issue subscr	37.95	Lisa Sargent
4-26	Stock Car Racing	12 issue subscr	18.00	Lisa Sargent
4-27	ESPN	26 issue subscr	26.00	Mark Sargent
4-27	Better Homes & Gardens	12 issue subscr	14.97	Lisa Sargent
4-27	Playboy – 12 issue subscr	Gift to Mark Sargent	28.00	Lisa Sargent
4-28	Hustler Magazine	24 issue subscr	36.00	Lisa Sargent
4-29	AdultWorld – sex toys	Gift to Mark Sargent	45.00	Lisa Sargent
4-30	Raunch Magazine	12 issue subscr	39.95	Lisa Sargent
TOTAL CHARGES FOR APRIL 2010			<u>\$.1272.19</u>	
* Obtained a copy of the order card from the company. In each case the signature was forged, and seemed to be the same “flowery” signature				

EXHIBIT 2

E-MAIL TO ESTHER COLES, HR DIRECTOR AT MCALISTER SYSTEMS INC.

April 27, 2010

To: Esther Coles, HR Director, McAlister System Inc.

Cc: Bob Bryan, VP Program Development

Subject: Mail Fraud

Hello,

My wife and I have been the victims of mail fraud harassment since about April 10 of this year. Many magazine subscriptions, collectibles and even some life insurance forms have been ordered in our name and with our address - including some with forged signatures. We did not order any of them. We have been busy calling each vendor and telling them to cancel our order, take our name off their mailing list, don't sell our address and yes, please send us a copy of the order submission card for evidence. We have received several samples of the guilty party's handwriting. We really didn't have any suspects until last Friday when we received a bill for a gift subscription from my wife to Bob Bryan. We are now quite sure that Mohamed Aziz is the person behind these unauthorized purchases.

As you all know, mail fraud is a federal offense and forging my wife's signature is a crime as well. In any case, our company is definitely involved in this and I wanted to consult with you before we contact the post office and finger Mohamed as a prime suspect. Also, I have some safety concerns since he seems to be quite obsessive about all this, he has my home address, knows my wife's name and middle initial, as well as Bob Bryan's home address. Finally, remember the threats and the ugly scene Mohamed made when we terminated him two months ago. My wife and I are both very concerned about what he might do next.

I've attached a list of the merchandise that has been ordered in our name thus far, and I'd like to meet with you to get your advice on all of this.

Thanks in advance,

Mark Sargent
Development Programming Manager

EXHIBIT 3

SECOND E-MAIL TO ESTHER COLES, HR DIRECTOR AT MCALISTER SYSTEMS

May 10, 2010

To: Esther Coles, HR Director, McAlister System Inc.

Subject: Personal Harassment and Fraud by Mohamed Aziz

Hi Esther:

I'm not sure that Mark has communicated to you exactly how far this situation with Mohamed Aziz has escalated, so I thought I'd lay it out for you. As you know, he has been fraudulently using my name to order magazines, memorabilia, life insurance, etc. To date he has spent over \$1200 in my name.

About a week ago, we received direct correspondence from Mohamed. The letters were addressed to me and contained explicit pornographic images along with sexual threats. We immediately called the police. I believe this is far more serious than a prank - it is direct communication of a threat from a third party. We have provided our police contact (Officer Park) with all the requested information that we can, but there is some additional information that he needs from the company before he can proceed. Just today we received another threatening letter. I want this to stop and I want him to be arrested this week! I have never met this individual and I have no idea what he is capable of. I don't want to wait around to find out. I believe that as a woman, you can appreciate the urgency of this situation. It needs to stop!

Officer Park really needs to make contact with you. He works Wednesday through Sunday. Please call him today and provide him with the information that he needs to proceed with this criminal case. He says he needs verification of birth date, home address, and work permits, and he'd like copies of Mohamed's performance reviews, disciplinary record, and all documentation related to the termination. Officer Park cannot proceed until he has this information. I would like this to be resolved as quickly as possible and would prefer that we not wait until next week or even longer to move forward. This is no longer just a case of Mohamed just irritating us. This is a criminal investigation where we will be pressing charges against someone who is breaking the law.

Please let Mark or me know if you have any questions. I'd like to get this resolved as quickly as possible.

Many thanks!

Lisa Sargent