Volume 18, Number 2

Printed ISSN: 1078-4950
PDF ISSN: 1532-5822

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

Instructors' Notes

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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 *JIACS* 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 instructors' notes contained in this volume have been double blind refereed, simultaneously with their respective cases. The cases were published in a separate issue of the *JIACS*. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies

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.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

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

The primary subject matter of this case concerns 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 gift cards and identify issues that arise in accounting for their issuance and redemption. Students also learn how accountants apply financial statement disclosure rules to new business practices as they emerge.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

A good way to begin the case discussion is to ask students if they have purchased or received a gift card in the past year. If they received a gift card, ask them how quickly they redeemed it. About one-third of retail gift cards are redeemed within 30 days. You could ask if they have lost or misplaced the card. Other questions you can use include: Did they partially use the card so that some stored value still remains on the card? Did they choose not to use it for some reason?

These questions can get many students involved in the discussion, which can lead to wider participation as the class progresses through the specific questions in the case. Students might also initiate discussion on topics not addressed specifically in the case. For example, students may have experience with incentive programs in which a customer that buys an expensive item is rewarded by the retailer with a gift card that can be redeemed on future purchases. Students might have seen bank-issued cards (the open-system cards mentioned in the case) that carry a Visa or MasterCard logo. You can make the point that this case deals with closed-system cards issued by the retailers themselves. Many students might not understand the distinction (and its importance) after reading through the case one time.

The case can be used at the undergraduate level in introductory financial accounting, early in an intermediate financial accounting sequence, or in an introductory financial accounting class for MBAs. The case can also be used in financial statement analysis courses or case courses that deal with financial reporting issues at either the undergraduate or MBA levels. This case introduces ideas about how emerging business practices are reported in financial statements, so it can be used relatively early in a course.

Students should be familiar with the accounting for accounts receivable, uncollectible accounts expense, and unearned revenue before undertaking this case. These topics are reviewed in the text of the case, but the coverage there is unlikely to be sufficient for students who have never seen these topics to gain a full understanding of them.

Instructors can proceed through the case questions in order, as some later questions build on answers to some of the earlier questions. Depending on course level, time constraints, or topic preferences, instructors can eliminate questions or re-order them. For example, instructors might want to defer discussion of breakage if they will be covering quality of earnings issues or ratio analysis later in the course. In this case, questions 1-7 and 9 could be used for discussion of gift card basics and financial statement presentation of the liability. Question 9 offers the opportunity for an extended discussion if students have obtained financial statements for a variety of different companies and it does give students a chance to use the SEC's EDGAR system. If the audience is accounting majors, greater emphasis can be placed on the journal entries in discussing questions 6 and 7. MBA students could be asked to perform additional analysis of gift card breakage and the likelihood of earnings management at Best Buy or at another selected retailer.

QUESTIONS FOR DISCUSSION (WITH SUGGESTED ANSWERS)

1. Provide a broad definition of the term "liability" as it is used in accounting. When is a liability satisfied?

A liability represents a probable future sacrifice of resources of the firm. Satisfaction of a liability could result from a payment of cash, the transfer of non-cash assets (for example, barter), or completing the performance of a service (performance of a service would consume resources). The FASB defines "liability" in its Statement on Financial Accounting Concepts No. 6 (FASB, 1985).

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?**

   A gift card becomes a liability to the firm when the firm sells the gift card. At that point, the retailer received a resource from a customer (in the form of cash or in the form of accounts receivable if the customers uses the store's own credit card to purchase the gift card) and the firm has an obligation to perform in the future by providing goods or services. There is no liability associated with unissued cards because the firm has no obligation yet. When the customer redeems the card for merchandise, then the retailer has satisfied its obligation (to the extent the card's value was exhausted), thus no further liability exists for the retailer in association with that card.

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.**

   No. The value of the gift card liability on the balance sheet is unlikely to reflect the amount of gift cards sold during the year. The amount reported as unredeemed gift card liability represents the value on the balance sheet date of the retailer's obligation to sacrifice resources in the future when customers redeem the cards for merchandise. This amount could differ day to day. Some gift cards sold this year might have been redeemed already, so they would not appear as part of this liability. Some gift cards sold last year might remain unredeemed and could be included in this liability.

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?**

   Most financial statement readers would regard this as favorable news. Although students might think of liabilities as unfavorable because they represent an obligation to sacrifice resources in the future, an increase in this unearned revenue account portends increased sales in the future as these cards are redeemed (or expire and contribute to increases in breakage revenue estimates).

5. **Why would a retailer not record revenue when it receives cash for the sale of a gift card?**

In doing so the retailer would violate one of the two revenue recognition criteria in GAAP (these are both are mentioned in the case). The retailer receives cash (and increases that asset account) when the gift card is sold, but the earnings process is not complete because the gift card has not been redeemed. In fact, the gift card might never be redeemed (or might be only partially redeemed). The company has not earned the revenue yet. Thus, the retailer would use an unearned revenue account to record the liability associated with gift cards when they are sold.

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.**

When the gift card is sold, the journal entry is a $75 debit to Cash and a $75 credit to Unearned Revenue (or Unredeemed Gift Card Liability). A liability is recorded for the value assigned to the gift card because the merchant owes the goods and services that will ultimately be "sold" to the customer who redeems the gift card.

When the gift card is partially redeemed, two journal entries should be recorded. The first is a $50 debit to Unearned Revenue and a $50 credit to Sales Revenue. The second is a $40 debit to Cost of Goods Sold and a $40 credit to Inventory.

We believe that it is important to discuss the expense side of this transaction, although many students will not think of it. The effect on net income of this transaction is different than a breakage transaction (in which there would be no cost of goods sold as an expense). Note that this treatment is similar to the journal entries presented in the case for unearned revenue. The important learning objective here is to get students thinking about the account titles and realizing that the general form journal entries they have learned (or are learning) are templates for the journal entries they will devise in practice as they record business practices that have not yet been invented. Note: This journal entry assumes that the company is using a perpetual inventory system. If your students have not seen journal entries for a perpetual system, you should substitute the appropriate entry for a periodic system here.

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.**

The expiration of an unused gift card does not involve the transfer of inventory that occurs when a gift card is redeemed. Thus, the earnings are greater on the expiration of an unused gift card (breakage). Both require the recording of an increase to revenue or other operating income, but a gift card redemption also requires that the expense (cost of goods sold) be recognized.

8. **What is gift card breakage? Why and how does it occur?**

Gift card breakage occurs when the holder of a gift card does not redeem the gift card in exchange for merchandise or services. In technical terms, the holder does not demand full performance. The card holder might have lost or misplaced the card. The card holder might have redeemed a part of the stored value on the card and the remaining value is too small to justify a trip to the retailer. The card might have expired (if the card was issued with an expiration date) or might have been consumed by dormancy fees (if the card were issued with dormancy fees). Finally, it is possible that the consumer still has the card but simply has not used it yet.

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 com**panies.

You can instruct students to search Forms 10-K of likely card issuers (retailers) for terms such as "gift," "gift card," or "shopping card." Wal-Mart, Circuit City, Target, and The Gap are all companies with which students might be familiar and they all have some information in their Forms 10-K regarding gift cards. Nieman-Marcus, which uses its cards as part of a customer loyalty program, includes a number of detailed statements regarding its accounting for gift cards. You can certainly direct students to specific companies or assign companies to teams if you wish.

Best Buy records revenue for unredeemed gift cards when "the likelihood of the gift card being redeemed by the customer is remote ("gift card breakage"), and we determine that we do not have a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions. We determine our gift card breakage rate based upon historical redemption patterns. Based on our historical information, the likelihood of a gift card remaining unredeemed can be determined 24 months after the gift card is issued.

At that time, we recognize breakage income… [which] is included in revenue in our consolidated statement of earnings." (Best Buy, 2008, 52).

Students may be curious as to why Best Buy needs to "determine that we do not have a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions" (Best Buy, 2008, 72). Many other companies do not mention this. If you have time, you can lead students into a discussion of the general operation of escheat laws. Kile and Wall (2008) provide an overview of specific provisions of escheat laws by state.

Best Buy reports the amount of breakage recognized in each fiscal year in its notes to the financial statements. Many other companies do not disclose how much they record as breakage income in any year.

There is no standard accounting treatment under current accounting standards for cards that are never redeemed. According to Schlosser (2005), there are three acceptable accounting methods of recognizing revenue (or "breakage") for gift cards that are never redeemed: (1) If the gift card has an expiration date, the seller (vendor) can recognize revenue for the unredeemed amount on the expiration date; (2) If the gift card has no expiration date, then the seller can recognize revenue when the seller determines that the likelihood of redemption has become remote; and (3) If the gift card has no expiration date, another approach permitted by the SEC is for the seller to recognize revenue in a way that represents the proportion of actual gift card redemption.

Best Buy, follows the second option stated above, as did Circuit City. Other companies will report other options. Some companies (for example, Wal-Mart) simply make a general statement in their "significant accounting policies" that they do not recognize gift card revenue until the card is redeemed and a customer purchases merchandise.

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.

The retailer is not giving up any inventory so there is no cost of goods sold in that sense. However, there may be costs related to the management of gift card transactions that are expensed to cost of goods sold. The important point is that if the firm is including breakage income with sales or revenue without having to relinquish inventory, the gross margin is overstated. If a firm records higher breakage in one year than another and includes breakages in revenue, then the gross margin is likely to be higher than a year with lower breakage. This could lead to greater volatility in gross margins and gross margin percentages across the years and hence reduce the usefulness of the ratio as a predictor of future profits. If some firms are recording breakage as revenue and others are recording breakage as elsewhere on the income statement (for example, as "other operating income"), then the comparability of gross margins across those firms is also compromised.

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.**

Most firms in the study report the unredeemed gift card liability as part of accrued expense or other liability. This effectively hides the amount unless it is disclosed separately in the footnotes. Given the information in Best Buy's (2008) balance sheet, unredeemed gift cards accounted for eight percent of total current liabilities. If the amount is significant (and Best Buy's seems significant), separate identification either in the footnotes or in a separate gift card line item would probably be preferred by users of the financial statements. It would help those users assess any trends in gift card activity that the company was experiencing. Further, gift cards may be perceived as more favorable than other sorts of liabilities on a company's books. Showing them separately would let a financial statement user adjust for that difference.

Including the liability as part of unearned revenue may work well, also. It seems likely that most or all deferred revenue for a retailer would be in the form of unredeemed gift cards.

Including the liability in accounts payable seems misleading. If unredeemed gift cards are a significant amount, including them in accounts payable could cause a user to make misleading comparisons across firms for the days' purchases number in the accounts payable ratio. Creditors and other financial statement users often want to know how long it takes a retailer to pay its suppliers for inventory. Including gift card liability in accounts payable would distort that performance measure.

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.**

Reporting breakage as other income and disclosing the amount of breakage in a footnote has the benefit of providing transparency and does not distort gross profit (or any ratios calculated using gross profit). This treatment also affords financial statement users with the opportunity to evaluate the persistence of this component of earnings separately from that of other items on the income statement.

Recording breakage as net sales (the most frequent treatment in the sample) may distort gross profit because there is no related increase in cost of goods sold. Recording breakage as a reduction of cost of goods sold similarly produces a misleading gross profit ratio if the amount of breakage is significant. If the amount of breakage changes from year to year and the breakage is reported as net sales or as a reduction to cost of goods sold, then the comparison of gross profit ratios between periods is less meaningful. The portion of the change due to breakage is not a reflection of the company's success at raising prices or at controlling its product costs (including buying costs, distribution costs, and occupancy costs that are often included in a retailers cost of goods sold).

If a company reports significant breakage amounts as a reduction in selling, general, and administrative (SG&A), investors and creditors may be more likely to assume that the company has done a better job of controlling operating expenses than it actually has. If some firms are recording breakage as a reduction in SG&A and others are recording it elsewhere, then the comparability across those firms is also compromised.

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?

Quality of earnings is the ability of a firm's income statement (and accompanying disclosures) to present the firm's true earnings. It also can be measured by how well the income statement can be used to predict future earnings. The position of items on an income statement can affect the ability of a user to predict future earnings. See discussions related to question 9 and 10 above. Separate disclosure of breakage revenue (or earnings) could enhance the quality of earnings because a user can evaluate it separately from other earnings. In terms used by Belovaray, et al. (2005), the breakage revenue could be assigned a different degree of "earnings persistence" than ordinary sales revenue would be assigned.

14. Does the breakage income that Best Buy (2008) reports, $34 million, represent a significant percentage of Best Buy's fiscal 2008 earnings?

Best Buy's reported net earnings for 2008 were $1,407 million. It is likely that the $34 million of breakage income (about 2.4% of earnings) is not material. Depending on how deeply your students understand the concept of materiality, this could lead to an extended discussion of the term and its implications. Such a discussion can be used if appropriate, but it is not necessary for this case.

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.

It was likely more than $34 million, but how much more is impossible to determine. The $34 million is just the income effect from the gift cards for which redemption was deemed remote. Some retail industry observers estimate that this income effect tends to average about 10% of annual gift card sales. But that kind of estimate would likely vary across firms and across years. If we knew the amount of gift card redemptions (which is not disclosed), we could subtract an estimate of the cost of goods sold associated with those redemptions and add the breakage of $34 million. This would yield a very rough estimate of how the gift cards impact earnings. But that would not mean that the firm's earnings would be lower by that amount if it were not to have a gift card program.

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THE DEVELOPMENT OF A STRATEGIC PLAN FOR HEALTHTRUST UTAH

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

Review Definition and Basic Principles of Strategic Planning

The instructor may wish to begin the discussion of the case by having students relate what they know about strategic planning. Very briefly, the strategic plan:

* Defines the values and mission of the corporation.
* Identifies the purpose for its existence.
* Determines where it should be in the future, and develops a roadmap to get there.

Review How the Healthcare Industry Differs from Other Industries

The next item for discussion might be how the healthcare industry differs from other industries students have encountered in case studies. The objective of this discussion would be to give students an understanding of how the unique characteristics of the healthcare industry might affect the strategic plan. As many students will have little experiences with the complexities of the health care industry, this portion of the case study may amount to a mini-lecture.
Some differences include:

1. The absence of market mechanism.
2. Inelasticity of demand and supply.
3. The impact of third party reimbursement on stakeholder behavior.
4. An excessive cost escalation curve.

The Absence of a Market Mechanism

In a free enterprise system, the allocation of resources is determined by the market—the interaction that supply and demand have on price. Ours is a market economy as compared with a controlled economy where the government determines what products are to be produced, sets their price, and allocates resources for their production. Characteristics of an efficient market include:

1. In informed consumer, who
2. makes the decision to purchase,
3. shops on the basis of quality and price, and
4. negotiates an arms-length purchase price.

These four characteristics form a market mechanism. A market mechanism is present, for example, in the automobile industry. A consumer in need of transportation makes the decision to purchase an automobile. Once this decision has been made, this individual has several sources of information on product quality. He or she can visit with neighbors who have recently purchased automobiles to determine their experience with specific brands, and can consult *Consumer Report* to learn which brands have the best safety features, highest reliability ratings, and so on.

The consumer also has one or more sources of price information. Automobile dealers typically post retail prices on vehicle windshields. Internet sites and journals such as *Consumer Report*s report prices paid by dealers.

Once the consumer selects a specific model, he or she can then visit one or more dealers, and armed with data on quality and price, negotiate an arms-length purchase price.

Now compare this with the healthcare industry—an industry that many feel lacks the characteristics necessary to create an efficient market.

An informed consumer

Healthcare consumers for the most part are uninformed. Few have the education or training to determine their diagnosis or the optimal combination of resources needed to treat their illness. There is a large disparity of information between the patient and the physician.

Who makes the decision to purchase?

Because of this disparity, it is the physician, therefore, rather than the consumer who makes the purchase decision. The physician decides what tests will be purchased to reveal the patient's diagnosis. Once a diagnosis is known, the physician selects the hospital and the clinical products and services it will provide. Physicians not only produce products and services but they decide when the patient will buy them.

For this reason, some hospital administrators believe the hospital's customer is the physician rather than the patient as it is the physician and not the patient that selects the hospital and orders its products and services.

Shops on the basis of quality and price

As mentioned above, patients lack the knowledge necessary to judge the quality of the care they receive. Even where quality metrics (morbidity and mortality data) are available, the data is often difficult for a non-professional to interpret. A surgeon with a higher than average mortality rate, for example, could either be a very poor surgeon (one who makes mistakes and therefore loses too many patients), or an exceptionally good surgeon (one so highly regarded by his peers that he is referred all of the complex or difficult cases—cases that naturally will have higher morbidity or mortality rates).

There are also reasons patients do not shop on the basis of price. One is that pricing information is not commonly available. Neither physicians nor hospitals commonly publish their charge masters. Even if they did, the data would be difficult to interpret due to the many different reimbursement systems used in health care. Almost no one pays "billed charges."

A second reason people do not shop on the basis of price is the belief that quality and price go hand in hand. How many people have you heard ask: "Where can I get a cut-rate deal on a heart operation?" or "Who gives really cheap cancer treatment?"

Negotiates an arms-length purchase price

Consumers have neither the knowledge nor bargaining power to negotiate prices. Insurance companies may negotiate with physicians and hospitals, but by the time the patient sees this data it has been aggregated into an insurance premium. Even health insurance premiums are difficult to compare due to design differences in health policies offered. Product differentiation makes price comparison almost impossible.

POSSIBLE ANSWERS TO QUESTIONS

Given the background that the students will now have on strategic planning and the health care industry, the instructor may now wish to turn to a discussion of the questions at the end of the case study. Possible responses are given below:

1. **What ethical problems do you see with the way Hospital Corporation of America chose to increase return on equity by creating HealthTrust?**

   Newsweek magazine certainly saw problems. HCA exchanged a weak asset (it poor performing hospitals) for a strong asset (the retirement plan of its employees). It is doubtful that HealthTrust employees who passively participated in this transaction had the ability to judge the risk of the proposition.

2. **What impact might the large stock options received by HealthTrust's corporate management have on the way it operated the company. Did this create incentives to optimize short-run or long-run profits?**

Goal congruence exists when managers have an incentive to act in the best interest of the owners, in this case the employee shareholders. If it were true that management desired to cash in their stock options within a five-year period, then their incentive would be to maximize the stock price in the short run. One way to do this would be to eliminate any expense that would decrease short-term profits, even if this elimination hurt the company in the long-run. There is ample evidence this occurred.
Would these actions be in the best interests of the employee stockholder? Since the employees were depending on the value of their stock to fund their retirements (which for many employees was many years in the future), maximizing short-term cash flows, or profits at the expense of long-term profitability would not be in their best interest.

3. **Why did the six administrators of HealthTrust Utah decide to exclude thedivision's vice president in the preparation of the strategic plan? What risks were there to this approach**?

They apparently viewed the division vice president as part of the problem and perhaps felt that he would oppose the study were he aware of it. It was never clear to Dr. Mallory if and when the division vice president would receive a copy of the study.

Dr. Mallory was also uncertain as to whether the six administrators saw the study as a weapon they could use to get the division vice president fired.

The risks of excluding the division vice president from the interviews performed by Dr.Mallory include:

a. Mallory was receiving only "one side of the story." It would have been helpful
to understand the division vice president's point of view.
b. The approach taken had the potential to put the division vice president on the defensive, making it less likely that he would support the study's proposals.
c. Putting the division vice president on the defensive might make it more difficult for the six administrators to work with him in the future. It might even cost them their jobs.

4. **How might Mallory address the obvious disconnect between the corporate view of how the division should be run and that of the six Utah administrators?**

Dr. Mallory did make contact with the division vice president prior to the completion of the study to discuss some of the proposals that might come from the study. His intent was to make the study as non-threatening as possible by presenting the proposals as "possible scenarios" and by assuring him that the study would be channeled through him to corporate management. A copy was also provided at the conclusion of the study.

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?

Cost Leadership

As students consider cost leadership as a possible strategy, they might identify several problems. The first is that physicians and hospitals do not commonly make cost information available. Neither physicians nor hospitals publish billed charges. In addition, even if providers did publish charge masters, this data would be marginally relevant as few patients pay billed charges. Third-party payers pay most costs under a litany of hospital payment systems.

A second problem students might identify is the common perception that low cost and low quality go hand in hand. There is some evidence that this might not be true. Providers with high infection and drug overdose rates, for example, have been shown to have longer length of hospital stays, which increases costs. The principle of total quality management would suggest that quality decreases rather than increases costs.

Assuming the perception that low cost means low quality could be overcome (perhaps through an effective advertising campaign), the students might ask if HealthTrust Utah could actually reduce its costs below that of Intermountain Healthcare which enjoys the advantages of having the largest market share, and which generates savings through (a) central planning, which reduces the duplication of facilities and equipment; (b) centralized services, and (c) horizontal and vertical integration.

<u>Central office cost savings</u>

Students who believe that cost leadership might be a viable strategy for HealthTrust Utah, might look for cost savings in areas other than labor and materials such as overhead. Dr. Mallory found that IHC's efforts to increase quality and reduce costs had led to the creation of a mammoth central office staff. As mentioned in the case study, IHC's corporate office staff occupied three floors of the expensive Beneficial Life Office Tower in downtown Salt Lake City. IHC passed these costs to 16 hospitals in the form of corporate dues. HealthTrust Utah, on the other hand, had a regional office staff of less than a dozen people.

Product Differentiation

How might HealthTrust differentiate its products from that of IHC?

a. It might try to differentiate it products on the basis of quality. Groups such as the Mayo Clinic have been successful with this strategy.

   IHC had initiated a campaign of promoting the concept that its quality of care was higher than that of competing hospital chains. To support this assertion they cited awards it received from national organizations for the quality of care. HealthTrust had received similar awards but had done little to advertise those awards. Corporate management had eliminated the advertising budget...
   Achieving higher quality in terms of morbidity and mortality would probably involve an investment in new and more innovative personnel and equipment, which would fly in the face of corporate management's policy of maximizing short term profits by not investing in new technologies, and by reducing staffing.

b. HealthTrust Utah might attempt to differentiate on the basis of hotel services—larger birthing suites, in-house chefs, etc. If patients judge hospital quality by the quality of hotel services, this might increase their perceived quality of care.

Innovation Leadership

Another strategy considered was to make HealthTrust Utah an innovation leader—a system that would be the first to offer new high tech equipment and services. The disadvantage of this strategy is that it would involve the acquisition of specialized high-tech equipment at a time that corporate management was trying to reduce cash outflow by minimizing the purchase of new equipment.

Niche Marketing

Dr. Mallory was aware of individual hospitals that had developed niche strategies, often in combination with other marketing strategies. A number of hospitals, for example, had developed centers specializing in the healthcare needs of women. Examples of other niches included cardiovascular centers of excellence, hospitals specializing in the treatment of cancer, and so on.

Copycat Strategy

Dr. Mallory had read the works of Mukti Khaire, an assistant professor in entrepreneurship at Harvard Business School. Khaire believes that it is not necessary to "recreate the wheel" in order to build a successful enterprise. Simply pick a successful firm and copy it.

If HealthTrust Utah were to adopt the copycat strategy, it had a good model in Intermountain Health Care. The corporate culture, however, was different and would be difficult to duplicate. Still, IHC had pioneered several strategies that might be reproduced if corporate management could be persuaded to let the division change its management paradigm.

6. **IHC has chosen to emphasize a corporate brand in all advertising, while HealthTrust Utah has decided to let each hospital promote its own identity. What are the strengths and weaknesses of each marketing approach?**

Students should probably note that before a marketing policy can be adopted, HealthTrust would need to restore its marketing and advertising budgets.

IHC felt that an advertising campaign that emphasized the corporation rather than its individual hospital units allowed for a unified advertising campaign—one logo, one message. The company marketed the corporation as the largest and the highest quality hospital chain in the state.

Prior to cutting the marketing and advertising budgets, the division vice president of HealthTrust Utah believed that each of his hospitals had developed a unique relationship with its community that the company should emphasize. For example, the Ogden Regional Medical Center in Ogden, Utah was the former St. Benedict's Catholic Hospital. This facility had a long history of caring which the hospital attributed to the Sisters of Benedict. The division vice president felt the goodwill created by the traditions of this hospital should be emphasized in any marketing campaign.

7. Place yourself in the position of Dr. Mallory, and propose a strategy for HealthTrust Utah. This strategy can include one or a combination of the strategies explored by Mallory or another strategy that you develop on your own. Vigorously defend your proposal.

The Actual Proposal

The instructor will probably want to report what Dr. Mallory proposed and the actual outcome of his recommendations.

Elements of Strategic Plan Proposed:

1. It was felt essential that HealthTrust Utah develop a presence in Utah's primary market—Salt Lake City. It was the recommendation that the corporation purchase St. Mark's Hospital which was in one of the most favorable locations in the city. This recommendation was acted upon.
2. It was felt essential that a referral network be developed to capture patients presently leaving the HealthTrust system. This would include upgrading St. Mark's Hospital from a high-end secondary facility to a tertiary facility, which would allow it to capture patients presently being sent to IHC's LDS Hospital and the University of Utah Medical Center. St. Mark's has upgraded many of its services, although budget constraints prevented the facility from rapidly becoming a tertiary care facility.

   It was also recommended that HealthTrust Utah work to pull the state's non-IHC affiliated hospitals into a loose confederation that could be provided services such as central billing, central purchasing, laboratory and radiology consulting, and access to specialized personnel in exchange for a change in referral patterns to HealthTrust Utah hospitals. This recommendation was not implemented. Several years later a small hospital corporation tied several rural hospitals together through lease arrangements. Some services were provided to rural hospitals by this corporation.
3. It was recommended that HealthTrust Utah promote itself to Utah physicians as the system with a more physician-friendly model than that used by IHC in an attempt to enlarge the medical staffs of HealthTrust Hospitals and increase referrals from non-HealthTrust hospitals. No formal attempt was made by the corporation to implement this recommendation.
4. It was recommended that HealthTrust refute advertisements by IHC that its hospitals were the cost leaders in the state. Several studies showed that the answer to the question of which hospital was more cost efficient depended upon the methodology used. The best methodology, which involved dividing a particular hospital's average patient charges by that hospital's case mix index (an indicator of the complexity of the average case treated by the hospital) provided mixed results. Some IHC hospitals with comparable sizes and case-mix-indexes were more cost efficient, some were less. No advertising campaign was initiated.
5. The study recommended that HealthTrust Utah copy some parts of the IHC model such as shared services and limited vertical and horizontal integration. HealthTrust did centralize some services such as Business Office, which reduced costs. Nothing was done with regard to vertical or horizontal integration as this

would have required a change in the management paradigm (a change from focusing on individual units to focusing on the development of an integrated health delivery system) which was never accepted.

6. While the study did not feel that IHC model of developing captive insurance companies and products would be applicable to HealthTrust Utah, given the aversion of HealthTrust physicians to HMO and PPO products, and a limited budget for the development of an insurance product, the study did recommend that the Utah division work more closely with independent health insurers to help them capture a greater share of the insurance market which in turn would increase the utilization of HealthTrust Utah hospitals..

This recommendation was adopted by many HealthTrust Utah hospitals. No coordinated effort as division was made, however.

EVENTUAL OUTCOME

Subsequent legal difficulties on a corporate level undoubtedly distracted the company from focusing on the problems of the Utah division. HealthTrust, a spin off of Hospital Corporation of America, was purchased in 1995 by Columbia/HCA for $5.6 billion. Columbia Healthcare had been formed in 1988 in partnership with 120 physicians. In 1993 it merged with Galen Health Care which had been spun off from Humana, a competing hospital corporation.

In 1996 the New England Journal of Medicine published two articles by Robert Kuttner attacking Columbia/HCA's business practices. This was followed by exposure of Columbia's business practices in October 1996 by 60 Minutes.

By December of 1996 several state attorney generals began a review of Columbia/HCA corporate practices including the purchase of not-for-profit hospitals. This was followed in 1997 by Federal agents raiding Columbia/HCA's El Paso operations to investigate the company's practice of having physicians buy stock in Columbia/HCA, which Feds believed violated the Stark anti-kickback laws.

These difficulties resulted in a change in corporate and division management which did little to alleviate the lack of management continuity problems that initiated the Utah study. Resources were not allocated to implement the strategic plan, and the management paradigm was not changed, although the division's vice president was eventually fired. Within several years, the six administrators had accepted employment outside the system. Although HealthTrust no longer exists, HCA now operates several of its former hospitals in the state of Utah (along with several additional facilities) under the name of MountainStar Health Care.

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.

INSTRUCTORS' NOTES

Teaching Approaches

REA is taught in the majority of accounting information system courses (Bradford et al., 2007) and related topics take up a significant portion of accounting information systems textbook pages and course time (Badua, 2008; Bain et al., 2002). Research on accounting systems is also primarily oriented toward the REA methodology (Geerts, 2009). Similarly, educational cases related to accounting information systems are also primarily oriented toward using the REA methodology. Actual accounting systems, while having some similarities to the REA methodology, include tables that would not be concluded in an REA-compliant system. This case gives instructors of accounting information systems courses a method to relate REA as described in textbooks to the structure of an actual accounting system.

The case objectives are to help students

1. Understand REA,
2. Understand database structure of accounting systems used in practice,
3. Understand implementation compromises in implementation of accounting systems for reasons of efficiency.

Accounting education journals include many cases for creating querying accounting databases, but all of these cases use databases based on the REA methodology. By including databases that are built strictly on the REA methodology, these cases miss the opportunity to familiarize students with components of accounting system databases that are present in almost all practicing accounting systems, including general ledgers, journal entries, financial statement preparation, and decision support. This case can be used to fill the gap between the REA database methodology as taught in accounting information system textbooks and the database structure of actual accounting systems.

This case focuses on the structure of Great Plains Dynamics, which is a common accounting software product. Many practice sets are available for accounting information system classes using Great Plains (Arens & Ward, 2008; Yacht & Crosson, 2006), so using Great Plains should be convenient of accounting faculty. None of these practice sets involve investigating the actual data structure of a Great Plains implementation, although they may be written as if Great Plains is consistent with REA (Brundson et al., 2005). Although different accounting software brands are built upon a unique database structures, they should be similar to Great Plains (eg. O'Leary, 2004).

The case could be used in either a first or second semester accounting information systems course. Alternatively, the case can also be used in a database design course. Students completing the case should have been taught REA, database normalization, and entity relationship diagrams. The case should be discussed when due from the students.

Some suggested questions to ask the students include

1. List the differences between REA and Great Plains.
2. Describe why you think Great Plains is different than REA. Do the differences make for a better or a worse system?
3. Do the financial reporting requirements of Generally Accepted Accounting Principles (GAAP) influence the difference between Great Plains and REA?

SUGGESTED SOLUTION

1. List the differences between REA and Great Plains.

Great Plains retains accounting artifacts such as double-entry accounting and a general ledger. One of the primary characteristics of REA is the elimination of double-entry accounting and general ledger, as this is perceived as unnecessary categorization and summarization that reduces the value of accounting data.

Great Plains contains summary data in decision support tables in addition to detailed data included in transaction tables. REA requires that data be stored at the most basic level without summarization, which should be sufficient for decision support.

Great Plains is similar to REA in that is substantially includes the REA framework by including tables for storing transactions, resources, and parties to transactions. It merely adds structure that REA eliminates.

2. Describe why you think Great Plains is different than REA.

Two hypotheses are possible concerning the cause of the difference. Proponents of REA may say that accounting artifacts are present in Great Plains because of the inertia in changing accounting systems. Because accountants expect to see a general ledger and a chart of accounts, Great Plains includes them despite the resulting inferior system. The decision support files could be viewed as an unnecessary addition, as the same data could be gleaned from the transaction files.

An alternative position is that accounting systems include accounting artifacts and decision support tables for valid reasons. A paper about REA concluded that "…if existing systems are using the REA model or its constructs in some conceptual or compromised fashion, such implementations must have benefits that exceed their costs" (Dunn & McCarthy, 1997). The same reasoning can be applied to accounting artifacts. Benefits of using a general ledger and chart of accounts include

Summarized information for preparation of financial statements is available without a user having to create a query to generate the financial statements. Producing such a query may be beyond the expertise of many users.

Because the information is made available by the posting process, the transaction system is not slowed by processing queries to generate financial statements. In an REA system, querying data in the transaction processing tables can take computing processing resources away from transaction processing and slow transaction processing.

Financial statement format is largely determined by regulation. Including financial statements in accounting systems takes advantage of economies of scale by not requiring each user to generate a unique query to obtain the information.

The actual database underlying an accounting system like Great Plains is quite complex. By storing summarized financial information in a general ledger, Great Plains reduces the need for an end user to understand and navigate the database.

Most of the same arguments can be used in favor of the decision support tables. Storing duplicate information in summarized form eases the task of obtaining that information and reduces the strain on a transaction processing system of running decision support queries.

3. Do the financial reporting requirements of GAAP influence the difference between Great Plains and REA?

The answer to the preceding question mentions how GAAP influences the design of Great Plains. Data is stored and reports are formatted in a system that complies with GAAP. REA can be thought of as both a way to design an accounting system as well as a philosophy regarding the accounting process and financial reporting. Papers on REA primarily stress using REA to design an accounting system, but wide acceptance of REA as an accounting system design methodology probably would depend on a fundamental reexamination of the accounting model would a move away from double-entry accounting. REA research has not considered how REA would institute complex accounting situations such as accounting for business combinations and derivatives.

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ADVANCED GAME PRODUCTS, INC.

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case presents several issues covering the gamut of audit, tax, and financial reporting. As such, it has been used in an undergraduate, senior-level capstone course. However, the case can easily be used in an auditing course, a tax course, or an intermediate financial accounting course simply by requiring students to only address the issues relevant to the particular topic. Issues 1, 3, and 5 would be appropriate to assign in an intermediate financial accounting course. Issue 2 and 4 would be appropriate for a business tax course. Issues 1, 3, 5 and the internal control questions would all be appropriate for an auditing course. In addition to helping students to learn the specific topics involved in the issues, the case can be used to achieve several learning objectives. To address the issues in the case, students must research professional standards and/or tax law. This gives students practical experience in using professional databases to solve real accounting and tax issues.

In a capstone or other senior level class, this case enables students to see that transactions, such as the rebates, have financial reporting, tax, and internal control ramifications. Therefore, they are approaching the issue from a more integrated viewpoint. Instructors can also use this case to help students develop their professional writing skills and oral presentation skills. We recommend that students be asked to document their research findings in a technical workpaper memo, such as would be found in an audit file, using a format similar to that used in the assignments and solutions section. Even the better writers among the students tend to be more familiar with creative writing or term paper assignments, with little exposure to real business writing. Instructors should emphasize the need for concise, clear writing. However, an equal emphasis should be placed on having complete documentation to support the conclusions. In lieu of or in conjunction with a written report, students could be asked to present their findings to the class, thus practicing their oral presentation skills.

This case works best as a team assignment. Students benefit from brainstorming ideas, especially in the initial research phase. Sometimes, the key to success is the ability to identify the right search term to use in the databases. Students will need access to the Accounting Standards Codification to complete the financial reporting questions. They will need access to sources of tax law, such as CCH or RIA Checkpoint, to be able to research the tax questions. If students do not have access to these resources, the instructor can use the case for an in-class discussion of what the students think the answer should be, and help lead them to the proper conclusions. If students are researching the topics outside of class, the instructor should plan for an average of 2 to 3 hours per issue.

Although this case was inspired by the company UBISOFT and information about the industry was gathered from its website for background purposes (http://www.ubisoftgroup.com), the information contained in the case is fictional.

ASSIGNMENTS AND SOLUTIONS

We suggest that students be asked to assume the role of Jamie and research the following issues:

1. How should the two types of rebates be reported in the financial statements?
2. How should the two types of rebates be treated on the federal income tax return?
3. How should the advance payments and royalties under the licensing arrangements be reported on the financial statements? Also, for financial reporting purposes, what impact, if any, does the cancellation of the one athlete's game have on the treatment of the advance payment made to him?
4. How should the licensing fees be treated on AGP's tax return?
5. How should the contract with CDI be treated for financial reporting purposes? Include discussion of how the costs and revenues will be reported, as well as any required disclosures.

In addition, assume that Jamie has been asked to look into the new rebate program and the effect that it will have over the company's controls. Jamie's supervisor would like Jamie to make client inquiries about the controls that may or may not be in place. In that regard, you should address the following questions:

1. What internal control issues surround the rebate program for the retail stores?
2. What internal control issues relate to the rebate incentive program for customers that download games from the Internet?
3. Assuming that internal controls are adequate for the rebate area, construct an audit program for substantive testing over the recording of rebates.

Solutions for Research Issues

Issue One: How should the two types of rebates be reported in the financial statements?

Conclusion One: The rebates for the in-store items should be recognized by AGP when the sale is made to the retailers, at the same time the revenue is recognized. At that time, AGP must record a liability for the rebates and a corresponding reduction in the sales revenue. Since it has no experience with rebates to estimate the amount of "breakage", the conservative approach would be to recognize 100% of the potential rebate as a liability. For the Internet downloads, the rebates should be recognized as a reduction in sales price in a systematic manner for all sales based on the percentage estimate of sales that will ultimately qualify for rebates.

Analysis One: For the in-store sales, ASC 605-50-25 applies. Per ASC 605-50-25-1, this section applies if both of the following conditions are met:

- The incentive is earned from a single sales transaction (multiple purchases are not required)
- The vendor does not receive an identifiable benefit from the incentive program.

Therefore, this section applies to the sales rebates for the in-store sales, but not the internet sales.

ASC 605-50-25-3 states that if the sales incentive will not result in a loss to the vendor, the cost of the incentive should be recognized at the *later* of the following two dates:

a. The date when the vendor recognizes the related revenue on the sale

b. The date on which the sales incentive is offered (for example, a manufacturer might offer discounts on products already sold to retailers).

For AGP, these two dates are essentially the same, because at the time the products are sold to the retailers, the rebate is offered to the customer. Therefore, the rebates should be recorded at the time the sales revenue is recorded by AGP.

Per ASC 605-50-25-4, for this type of mail-in rebate, the company should recognize a liability, such as a deferred revenue account, for the estimated amount of rebates that will be requested by the customers. This liability should be recorded at the later of the date on which the vendor recognizes the revenue from the sale or the date on which the sales incentive is offered to the customer. If this amount cannot be reliably and reasonably estimated by AGP, then the liability should be for the maximum amount of rebates that could be claimed by customers, assuming no “breakage”. Breakage is the amount of rebates that go unfilled, either because the customer elects not to file the paperwork or the company rejects the rebate due to missing documentation or some other reason. ASC 605-50-25-4 further explains that the ability to make the estimates will vary from situation to situation, but that the following factors should be considered:

a. The longer the period over which a rebate can be claimed, the more difficult to estimate the amount that will be claimed.

b. A lack of historical experience for the company with similar types of incentives on similar types of products may indicate that the company does not have the ability to come up with a reasonable estimate. Or, it may be difficult to know whether that experience can be relied upon due to changing circumstances.

c. If a company does not have a large volume of similar transactions, estimating becomes more difficult.

AGP has no experience with rebates at all and, therefore, paragraph b above applies. The conservative approach would be to record a liability for the full potential rebate amount at the time of sale.

As for where to recognize rebates on the income statement, ASC 605-50-45-1 addresses whether the rebate is a reduction in revenues recognized or is an expense associated with the sale. ASC 605-50-45-2 states that a cash rebate given to a customer is normally assumed to be a sales price reduction and, therefore, would be recorded as an offset to the sales revenue account. However, if both of the following two conditions are met, then the rebate would be considered a cost incurred and should be recorded as an expense:

a. The seller receives, or will receive, a benefit, in the form of goods or services, in exchange for the rebate payment. This benefit would have to be something in addition to the revenue generated by the sale of the product.
b. The fair value of the benefit received by the seller can be reasonably estimated by the seller.

If both of the above conditions are met, then the rebate would be recognized as an expense to the extent of the value of the benefit received by the seller. Any excess of the rebate over the fair value of a benefit received would be considered a reduction in revenue. Neither of the above conditions holds true for AGP and, therefore, the rebates should be treated as a reduction in revenue rather than as an expense.

ASC 605-50-25-7 deals with the type of rebate that AGP is offering on its online downloads. These rebates are only earned by the customer after multiple purchases have been made. Per ASC 605-50-25-7, the seller (AGP) should record the rebate as a reduction of revenue using a systematic allocation method to divide the rebate over all of the sales transactions used to accumulate the rebate. As with the other rebates, the estimate of the total rebate obligation should take breakage into account. If the amount cannot be reasonably estimated, then the liability should be recorded for the total amount of potential rebates based on the amount of product sold. Under this section, the considerations as to whether or not the company can reasonably estimate the amount are the same as for the rebates for the in-store sales:

a. The longer the period over which a rebate can be claimed, the more difficult to estimate the amount that will be claimed.
b. A lack of historical experience for the company with similar types of incentives on similar types of products may indicate that the company does not have the ability to come up with a reasonable estimate. In other circumstances, it may be

difficult to know whether that experience can be relied upon due to changing circumstances.

c. If a company does not have a large volume of similar transactions, estimating becomes more difficult.

AGP has no experience with rebates, but may have experience with how many customers purchase enough to qualify for the rebates. Therefore, it should recognize 100 percent of the rebates that it estimates will be earned by the customers and this should be recognized as a reduction in sales on a systematic basis. For example, if the company estimates that 40% of its customers will accumulate enough purchases to get the rebate, then it should take 40 percent of the cost of a rebate against each sale made. (According to 605-50-45-3, credits to the customers accounts are treated the same as cash consideration.)

Issue two: How should the two types or rebates be treated on the federal income tax return?

Conclusion Two: For income tax purposes, the rebates cannot be used to reduce taxable income until they are paid to the customers.

Analysis Two: For income tax purposes, the "all events test" needs to be considered to determine the proper timing of when the rebates can be used to reduce taxable income. Under Reg §1.461-4(a), a liability cannot be considered to be incurred by an accrual basis taxpayer until economic performance has occurred. IRC Reg. 1.461-4(g)(3) specifically addresses rebates, as follows:

> "If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price."

Therefore, AGP's rebates meet the all events test when delivered in the form of a check to the customer, for rebates on the in-store sales, and when credited against the customer's account for the online sales. This will create a book to tax timing difference for AGP related to the rebate recognition.

Issue Three: How should the licensing agreements and related advance payments and royalties be reported on the financial statements? Also, for financial reporting purposes, what impact, if any, does the cancellation of the one athlete's game have on the treatment of the advance payment made to him?

Conclusion Three: For financial reporting, the advance payments are recorded initially as an asset, like a prepaid item, and then expensed as they are earned by the licensee in accordance with the agreement. For the license with the athlete who is no longer being used in the game, the entire amount can be expensed in the current year since the cost will not be recoverable through future use of the rights.

Analysis Three: AGP's licensing arrangements guarantee a minimum amount and include an advance payment. Per ASC 928-340-25-4, if guaranteed minimum amounts are paid to a licensor in advance, they should be reported as an asset on the licensee's balance sheet. According to ASC 928-340-35-3, this asset should then be expensed over time corresponding to the terms of the license agreement as to when the fees are earned by the licensor. Per ASC 928-720-25-3, if, at any time, a portion of that minimum guarantee is determined to be unrecoverable, then that portion should be expensed at that time. In AGP's case, the game with the disgraced athlete will not be produced, and, therefore, the minimum license fees already paid will never be recovered by AGP through product sales or by any other means. Therefore, it is appropriate for AGP to write off 100 percent of that amount as an expense in the current year's financial statements.

Issue Four: How should the licensing fees be treated on AGP's income tax return?

Conclusion Four: For tax purposes, the licensing fees/royalties are capitalized into inventory and then expensed as cost of goods sold when the items are sold.

Analysis Four: Per Reg. 1.263A-1(a)(3), IRC 263A applies to any tangible personal property produced, whether that property is for internal use or for sale. All direct costs and attributable indirect costs must be capitalized into inventory and then expensed as part of cost of goods sold when the product is actually sold. Reg. 1.263A-1(e)(3)(ii)(U) specifically identifies licensing fees, including initial fees and royalties, as indirect costs required to be capitalized.

Issue Five: How should the contract with CDI be treated for financial reporting purposes? Include discussion of how the costs and revenues will be reported, as well as any required disclosures.

Conclusion Five: For financial reporting, this should be treated as a collaborative arrangement. AGP should report 100 percent of any sales in its financial statements, and include the 50 percent of sales owed to the other company as part of cost of goods sold. AGP should report 100 percent of the marketing costs on its financial statements and the 50 percent it bills to the other company as "income from collaborative arrangements."

Analysis Five: This is a collaborative arrangement under ASC 808. There is no separate legal entity and, therefore, it is not a corporate joint venture. Per ASC 808-10-65-1, the equity method of accounting should not be used in these types of arrangements. Per ASC 808-10-45-2, for transactions with third parties, the member of the collaborative arrangement that is considered the "principal participant", determined on a transaction-level basis, should record the gross amount of that transaction in its financial statements. Under AGP's agreement, it is the principal participant in the sales function, while the other company is the principal participant in the game development function.

Under ASC 808-10-45-3, payments made between the collaborative arrangement's participants should be recorded according to authoritative accounting literature. According to ASC 808-10-45-4, "An entity shall evaluate the income statement classification of payments between participants pursuant to a collaborative arrangement based on the nature of the arrangement, the nature of its business operations, the contractual terms of the arrangement, and whether those payments are within the scope of other authoritative accounting literature on income statement classification. If the payments are within the scope of other authoritative accounting literature, then the entity shall apply the relevant provisions of that literature. To the extent that these payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments shall be based on an analogy to authoritative accounting literature or if there is no appropriate analogy, a reasonable, rational, and consistently applied accounting policy election. For example, if one party to an arrangement is required to make a payment to the other party to reimburse a portion of that party's research and development cost, that portion of the net payment may be classified as research and development expense in the payor's financial statements pursuant to Topic 730." There is an example illustrated in ASC 808-10-55-3 which closely resembles AGP's situation. Following this example, AGP should report 100 percent of any sales in its financial statements, because it is the "principal participant" for the sales function under the agreement. Since AGP must then pay 50 percent of the sales amount to the other company, it should include the 50 percent owed to the other company as part of cost of goods sold on its income statement. AGP is also the principal participant in the marketing function, so it should report 100 percent of the marketing costs on its financial statements. AGP then bills the other company for one half of the marketing costs incurred, and this amount to be recovered from the other company should be reported as "income from collaborative arrangements." When AGP is billed by the other company for 50 percent of the development costs, it can report those costs on its income statement as product development expenses.

ASC 808-10-50-1 describes what financial statement disclosures are required. For the current financial statements, and for all reporting period after, AGP should disclose:

a. a description of the arrangement and its purpose
b. the entity's rights and obligations under the agreement
c. the accounting policy used pertaining to the agreement, and
d. the amounts included in the financial statements as a result of transactions between the parties related to the collaborative arrangement and their income statement classification.

SOLUTIONS FOR INTERNAL CONTROL QUESTIONS

Student responses will vary in this section and will require some critical thinking and creativity. Below are suggested items for consideration.

1. What internal control issues surround the rebate program for the retail stores? Has someone sent in duplicate rebate requests for the same purchase?

The company should have a database that tracks of all rebate requests with each person's name, address, item(s) purchased, prices, and dates of purchase. Alternatively, the company could outsource this to a rebate management company.

a. How does the company prevent a customer from submitting forged or altered receipts?

The customers should be required to cut out and mail in the UPC code along with the receipt. AGP should check the name of the retailer against AGP's customer list to determine that the retailer is valid. Original receipts must be required—no photocopies. If possible, AGP should work with its retailers to request summary reports from them showing all sales of AGP products to customers. This database can then be used to verify the receipts sent in by customers requesting rebates.

b. How does the company prevent ineligible customers from receiving a rebate? These could be employees, customers who have already received the maximum rebate, or customers not making qualifying purchases.

The company should match the name on the rebate request against the company's personnel files to make sure employees are not trying to get rebates. The company should check rebate requests against the database of already paid rebates to ensure that the current rebate request does not exceed the maximum allowable cumulative rebate. An employee should verify that the product code on the receipt matches that of a product that qualifies for the rebate.

Each rebate should be checked against the database names and addresses to make sure that the same household does not receive more than one rebate. If there are duplicate names but different addresses, the company could attempt to compare the two receipts to determine if they were paid for with the same credit card.

c. How does the company control against AGP employees submitting fictitious rebate claims?

The company should have access controls over the rebate requests received from customers to ensure that an employee cannot take UPC codes and receipts that have already been used for rebates and resubmit them under their own names.

d. How does the company deal with customers who try to return a product after they have received the rebate?

Requiring the customer to send the original receipt will help limit this behavior, since most stores would require the receipt for a return. Removing the UPC code is another control—retailers should be instructed that no returns should be accepted if the UPC code is missing. The company's policy should be to not send rebate checks until after the return policy has passed, such as 60 days from the sale date.

2. What internal control issues relate to the rebate incentive program for customers that download games from the Internet?

The company will need controls to prevent the time limit from being exceeded (the sales that accumulate to the level required for the rebate must be within a 6 month period). Controls should ensure that no rebates are paid out on cumulative sales less than $100. Since these are online transactions, these controls should be built into the system.

3. Assuming that internal controls are adequate for the rebate area, construct an audit program for substantive testing over the recording of rebates.

The following is a sample audit program:

1. Review the company's rebate program policies to gain an understanding of the program details.
2. Examine the client's calculation of the estimated rebate payable. Evaluate the method for reasonableness and test it for clerical accuracy.
3. Verify the total debits to the liability account against the detailed rebate records and note agreement with the amount of rebates paid.
4. Review rebates paid after year end and open rebate claims to determine if the client's estimate may need revision.
5. Determine if any disclosures are required under AU Section 342.

Normally, the auditor could compare the rebate percentages and amounts with prior years, but since this is the first year AGP had rebates, that will not be possible.

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.

INSTRUCTOR'S NOTES

Questions

Task 1: **Prepare a revised Vision and Mission Statements for Community Hospital.**

The vision statement seems appropriate, while the Mission Statement can be revised to read "To provide the best healthcare for our patients and make available resources for healthy living for our communities through the use of innovative medical technologies by the efficient operations of our facilities by employing and empowering well compensated renowned physicians, nurses and other healthcare professionals."

Task 2: Prepare the External Factors Evaluation (EFE) Matrix for Community Hospital.

EFE Matrix			
Key External Factors	Weight	Rating	Weighted Score
Opportunities			
1. Median Age, population and per capita income of Monmouth County is expected to increase.	0.05	3	0.15
2. Passage of Healthcare Act by Federal Government.	0.10	2	0.20
3. Continued pressure by health insurance companies to decrease costs.	0.05	2	0.10
4. High medical malpractice costs for physicians.	0.10	2	0.20
5. Advancement in portable personal electronic equipment such as iPads and Tablets.	0.05	2	0.10
6. Societal trend towards healthy living.	0.10	4	0.40
7. Hospital consolidation and closures on rise.	0.05	4	0.20
Threats			
1. Physician owned surgery centers on rise.	0.10	3	0.30
2. Insurance Companies, government and corporations' health care reimbursements decreasing.	0.05	3	0.15
3. Medical malpractice lawsuits remain constant at a high rate.	0.05	2	0.10
4. The rate of U.S. medical graduates expected to be less than needed.	0.05	2	0.10
5. Non-paying patients likely to rise or remain the same.	0.05	2	0.10
6. Increased rate of unknown viruses and infections.	0.10	2	0.20
7. Rising cost of medicine and medical equipment.	0.10	2	0.20
TOTAL	1		2.50

Task 3: Prepare the Competitive Profile (CP) Matrix for Community Hospital.

CP Matrix							
		CMC		SUMC		UH	
Critical Success Factors	Weight	Rating	Weighted Score	Rating	Weighted Score	Rating	Weighted Score
Net of Patient Service revenue and expenses	0.15	4	0.60	3	45	2	0.30
Management/Board of Trustees	0.20	3	0.60	3	0.60	2	0.40
Specialty Care	0.10	2	0.20	3	0.30	4	0.40
Quality of Patient Care	0.20	2	0.40	4	0.80	3	0.60
Community Relations	0.07	2	0.14	2	0.14	2	0.14
Medicaid/Medicare Receivables	0.08	3	0.24	3	0.24	4	0.32
Emergency Services	0.20	4	0.80	3	0.60	3	0.60
Total	1.00		2.98		3.13		2.76

Task 4: Prepare the Internal Factor Evaluation (IFE) Matrix for Community Hospital.

IFE Matrix			
Key Internal Factors	Weight	Rating	Weighted Score
Strengths			
1. High Total Margin Ratio.	0.10	4	0.40
2. Diversified portfolio--retirement and adult living centers.	0.05	3	0.15
3. Residency in Family Medicine.	0.05	3	0.15
4. Stable Management.	0.10	4	0.40
5. New Fitness and Wellness Center.	0.05	4	0.20
6. Good mix of Medicare and insured patients.	0.05	3	0.15
7. High Utilization Ratio.	0.05	4	0.20
Weaknesses			
1. Increase in bad debt/charity care expense.	0.05	2	0.10
2. Increase in number of patients going to physician owned surgery centers.	0.15	1	0.15
3. Lack of well-known specialty care area.	0.15	1	0.15
4. Average quality of Patient Care.	0.05	2	0.10
5. Not part of a health care system.	0.15	2	0.30
TOTAL	1		2.45

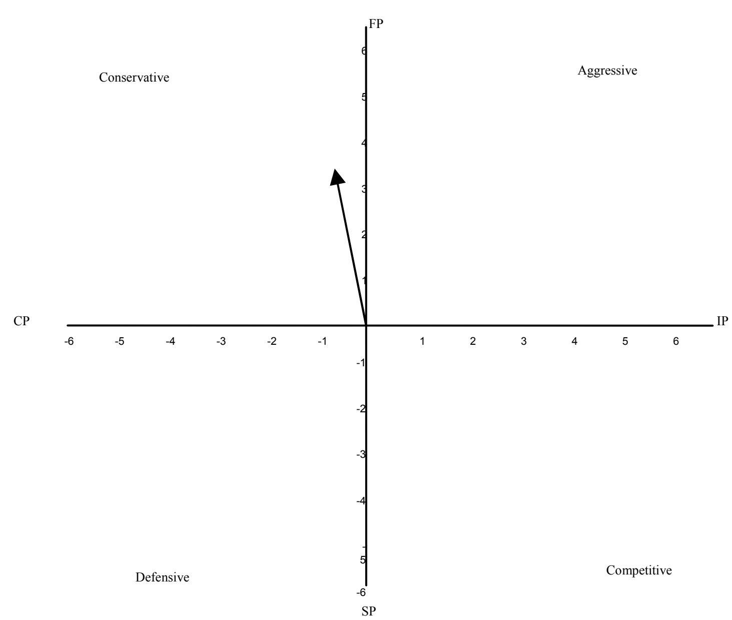
Task 5: Prepare SWOT Strategies for Community Hospital.

SWOT Strategies		
	Strengths	Weaknesses
	High Total Margin Ratio. Diversified portfolio--retirement and adult living centers. Residency in Family Medicine. Stable Management. New Fitness and Wellness Center. Good mix of Medicare and insured patients. High Utilization Ratio.	Increase in bad debt/charity care expense. Increase in number of patients going to physician owned surgery centers. Lack of well-known specialty care area. Average quality of Patient Care. Not part of health care system.
Opportunities	S-O Strategies	W-O Strategies
Median Age, population and per capita income of Monmouth County expected to increase. Passage of Healthcare Act by Federal Government. Continued pressure by health insurance companies to decrease costs. High medical malpractice costs for physicians. Advancement in portable personal electronic equipment such as iPads and Tablets. Societal trend towards healthy living. Hospital consolidation and closures on rise.	Invest in new medical equipments to treat diseases faster and with better reliability (S1, S3, S4, S7, O2, O3, O4, O5) Establish alliance with a similar hospital which has expertise in a specialty area (S1, S4, O2, O7)	Hire employees with quality care and statistics expertise (W4, O3, O4, O5,)

SWOT Strategies		
Threats	S-T Strategies	W-T Strategies
Physician owned surgery centers on rise. Insurance companies, government and corporations' health care reimbursements decreasing. Medical malpractice lawsuits remain constant at a high rate. The rate of U.S. medical graduates expected to be less than needed. Non-paying patients likely to rise or remain the same. Increased rate of unknown viruses and infections. Rising cost of medicine and medical equipment.	Provide office space at reduced rates to Physician groups (T1, S1, S3, S7) Star other residency programs (T4, T6, S3)	Form alliances with corporations for research and insurance companies (W1, T2, T3, T7)

Task 6: Prepare Strategic Position and Evaluation (SPACE) Matrix for Community Hospital.

SPACE Matrix



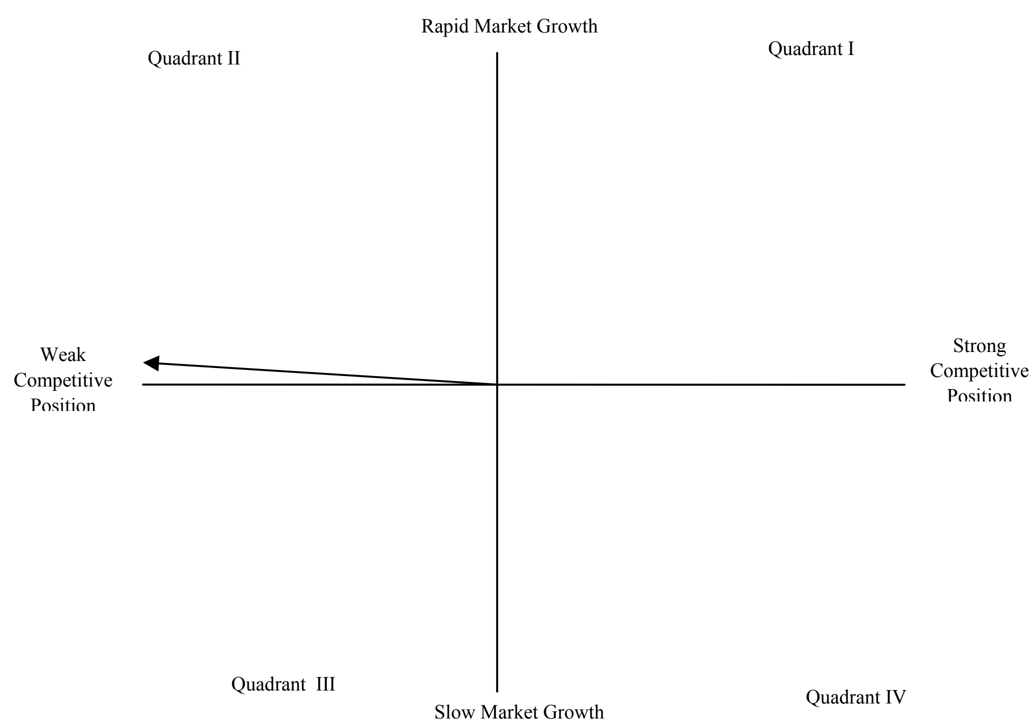
Y-axis: SP + FP = -3.0 + 5.2 = 2.2, X-axis: CP + IP = -4.2 + 3.6 = -0.6.

Financial Position (FP)		Stability Position (EP)	
Debt/Equity Ratio	4	Unemployment	-5
Current Ratio	7	Technological Changes	-2
Total Margin Ratio	3	Price Elasticity of Demand	-2
Net Patient Revenue	5	Competitive Pressure	-4
Days cash on hand	7	Barriers to Entry	-2
Financial Position (FP) Average	5.2	Stability Position (EP) Average	-3.0
Competitive Position (CP)		Industry Position (IP)	
Quality of Service	-4	Growth Potential	3
Total Income	-3	Financial Stability	5
Emergency Visits	-4	Ease of Market Entry	3
Surgeries	-6	Resource Utilization	4
Family Medicine Visits	-4	Profit Potential	3
Competitive Position (CP) Average	-4.2	Industry Position (IP) Average	3.6

Community Hospital should pursue Conservative strategies

Task 7: Prepare Grand Strategy Matrix for Community Hospital.

Grand Strategy Matrix



Market Development
Horizontal Integration
Product Development

Task 8: Prepare Internal-External Matrix for Community Hospital.

Internal-External Matrix

The IFE Total Weighted Score (2.45)

The EFE Total Weighted Score (2.5)		Strong 3.0 to 4.0	Average 2.0 to 2.99	Weak 1.0 to 1.99
	High 3.0 to 3.99	I	II	III
	Medium 2.0 to 2.99	IV	IV Community Hospital	VI
	Low 1.0 to 1.99	VII	VIII	IX

Hold and Maintain: Market Penetration, Product Development

Task 9: Prepare Quantitative Strategic Planning (QSP) Matrix for Community Hospital.

QSP Matrix					
Strategic Alternatives					
		Become part of a Health System		Open a Specialty Care Center	
Key Weight	Factors	Attractiveness Score	Total Attractiveness Score	Attractiveness Score	Total Attractiveness Score
Strengths					
High Total Margin Ratio.	0.10	2	0.20	4	0.40
Diversified in portfolio--retirement and adult living centers.	0.05	3	0.15	4	0.20
Residency in Family Medicine.	0.05	---	---	---	---
Stable Management.	0.10	2	0.20	4	0.40
New Fitness and Wellness Center	0.05	---	---	---	---
Good mix of Medicare and insured patients.	0.05	2	0.10	3	0.15
High Utilization Ratio.	0.05	1	0.05	4	0.20
Weaknesses					
Increase in bad debt/charity care expense.	0.05	2	0.10	3	0.15
Increase in number of patients going to physician owned surgery centers.	0.15	---	---	---	---
Lack of well-known specialty care area.	0.15	---	---	---	---
Average quality of Patient Care.	0.05	2	0.10	3	0.15
Not part of health care system.	0.15	4	0.60	3	0.45
SUBTOTAL	1.00		1.50		2.1
Opportunities					
1. Median Age, population and per capita income of Monmouth County expected to	0.05	---		---	

QSP Matrix					
Strategic Alternatives					
		Become part of a Health System		Open a Specialty Care Center	
Key Weight	Factors	Attractiveness Score	Total Attractiveness Score	Attractiveness Score	Total Attractiveness Score
increase.					
2. Passage of Healthcare Act by Federal Government.	0.10	2	0.20	3	0.30
3. Continued pressure by health insurance companies to decrease costs.	0.05	---	---	---	---
4. High medical malpractice costs for physicians.	0.10	---	---	---	---
5. Advancement in portable personal electronic equipment such as iPads and Tablets.	0.05	2	0.10	3	0.15
6. Societal trend towards health living.	0.10	---		---	
7. Hospital consolidation and closures on rise.	0.05	4	0.20	2	0.10
Threats					
1. Physician owned surgery centers on rise.	0.10	3	0.30	4	0.40
2. Insurance Companies, government and corporations' health care reimbursements decreasing.	0.05	3	0.15	2	0.10
3. Medical malpractice lawsuits remain constant at a high rate.	0.05	---	---	---	---
4. The rate of U.S. medical graduates expected to be less than needed.	0.05	---	---	---	---
5. Non-paying patients likely to rise or remain the same.	0.05	---	---	---	---
6. Increased rate of unknown viruses and infections.	0.10	---	---	---	---
7. Rising cost of medicine and medical equipment.	0.10	4	0.40	2	0.20
SUBTOTAL	1.00		1.35		1.25
SUM TOTAL ATTRACTIVENESS SCORE			2.85		3.35

The QSP matrix indicates that of the two choices, opening a specialty care center is more attractive for Community Hospital

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.*

INSTRUCTOR'S MANUAL

Teaching Objectives

This case has three objectives. First, it teaches the students to analyze corporate competitive strategy and analyze eHarmony's current one. Second, it teaches students about branding and marketing and leaves students with the decision of whether to expand the target market or not based on the current brand the company has created and maintained. Third, the case also asks legal and ethical questions and asks students to make the decision of when a company should be held accountable for the actions of its subscribers.

Curriculum Placement

This case would be best utilized in the following courses:

1. Corporate Competitive Strategy: this case deals with competitive strategy in a market with multiple providers. Students are asked to analyze strategy and make changes for growth and development of the company as well as for increased competition, especially from free sites.

2. Brand Management: with multiple providers and other services providing "online dating," eHarmony has created a brand based on lifelong matching instead of dating. How has this helped or hindered the company? Does the brand need to stay the same in order for eHarmony to continue achieving success?

3. Marketing: this case deals with the different types of marketing and how firms and companies choose with types to use for their products and services. Students are asked to analyze the effectiveness of the marketing strategy.

4. Business ethics: this case addresses corporate responsibility to its customers, especially for a service that its users pay for. It also addresses the discriminatory ethics of a business. Students are asked to evaluate the business ethics and make decisions accordingly.

Discussion Pastures and Timing

1. Analysis of Case Issues – 10 minutes
2. Competitive Strategy – 30 minutes
3. Brand Management and Marketing – 25 minutes
4. Business Ethics – 20 minutes
5. Conclusion – 5 minutes

Potential Pitfalls

Because of the multiple facets of this case, it could be difficult to integrate all aspects into one class discussion. Furthermore, based on the class in which the case is being used, some facets might be more important than others. The instructor should formulate the best method for teaching the case and execute that method, even if it leaves one of the issues out of the class discussion.

Also, it could be very easy for some students to focus on the ethics of the case (such as the lack of same-sex matching, lack of corporate responsibility, etc.) and not discuss the rest of the issues as some of the ethics of the case are not necessarily well known. Therefore, it is recommended that the ethics discussion be tabled until the end unless the instructor feels the need to have the ethics discussion go longer.

DISCUSSION QUESTIONS

Marketing and Branding

1. What are the strengths and weaknesses of eHarmony's traditional marketing campaign?

Strengths – eHarmony is able to market to its target audience (adult singles who wish to settle down), while still maintaining its brand identity of providing matches instead of dates. EHarmony is also still a household name due to the traditional marketing. There are few who have not heard of the company.

Weaknesses – eHarmony misses out on the younger singles, some of which would be looking for matches instead of dates. Furthermore, by not marketing online, eHarmony misses an entire market of singles that are technologically savvy and up to date with the times.

2. Should eHarmony change its marketing strategy in order to incorporate younger singles?

Answers will vary for this question. Ideally, if eHarmony wants to expand its target market and gain more subscribers, of course it will change its marketing strategy. However, if students decide that eHarmony would rather preserve its brand image, it would make sense for some to answer that eHarmony should not change its strategy for the younger generation of singles. Answers should include a careful analysis of the situation.

3. Would expanding eHarmony's target market to include younger singles be detrimental to eHarmony's brand image? If so, what should eHarmony do to expand without sacrificing its brand?

Expanding eHarmony's target market could turn out to be detrimental to eHarmony's brand image. EHarmony has built a brand based on lifelong matching instead of just being an online dating site. However, it is important that those in charge look at the cost/benefit analysis and decide if brand image is more important than the growth of a company that has already fallen and is slowly losing market share.

4. Does eHarmony's long questionnaire and intensive process help to preserve its brand or does it detract from singles that are busier in life, but still looking for a life partner? Should eHarmony change this process to make it simpler for the user?

Answers will vary for this question. As long as consumers are willing to join eHarmony and go through the intensive process, it makes sense that eHarmony would keep its original process. However, if eHarmony begins to lose subscribers, it might want to rethink its intensive questionnaire. If students believe that the branding is most important, then it is unlikely that they would have eHarmony change its questionnaire, as it is an integral part of the eHarmony brand.

Corporate Strategy

5. Does refusing to research same-sex matching hurt eHarmony as a company?

Refusing to research same-sex matching can hurt eHarmony, as it will turn people away from the company that would have been subscribers. Homosexual singles are a large market that eHarmony is ignoring. Even now, it has not provided the same service to same-sex matches that it has been told to by law and any bad publicity could harm the company overall.

6. **Has creating other sites that are country-specific helped eHarmony as a whole? Should the other sites (mainly Canada and Australia) be more focused toward demographics and sociological differences the way the UK site is?**

   Creating other country sites has helped eHarmony to better develop its corporation and brand image. Its British site has performed well, due in part to the new research into sociological differences in British society. EHarmony would benefit strongly from more research into its Canadian and Australian demographics and sociological differences. Doing so would make the site more representative of its users and would cater to the subscribers needs instead of simply having subscribers that fit into eHarmony's ideal mold.

7. **Has eHarmony's refusal to expand its target market hurt in terms of competition?**

   EHarmony's refusal to expand its target market could hurt the competition because other sites are going specifically for the young singles. Dating sites and other matching sites have marketing traditionally and non-traditionally and have done their best to attract the markets which eHarmony has shunned.

8. **How would you change eHarmony's corporate strategy? Would you focus more on company growth or on the preservation and development of the eHarmony brand?**

   Answers for this question will vary. Students should focus on theory and real-life examples to base their answers on. The answers should have evidence and analysis in order to back up the claims. If the students choose not to focus on growth, they should have a plan in order to keep the subscription count up so that the company will not flounder.

Business Ethics

9. **Should eHarmony be held responsible for verifying the authenticity of its subscribers? Would it be different if it were a free site instead of being a paid one?**

   Answers will vary for this question. Ideally, the students will focus on the fact that eHarmony is a paid site and has more responsibility to its users as such. Thus eHarmony should be held responsible to some extent for verifying the authenticity of its subscribers and their interactions. The students might see the ethics differently if eHarmony were a free site instead of a paid one and their answers might reflect that.

10. What should eHarmony do in order to better verify the authenticity of its subscribers?

Answers to this question should reflect the understanding of the material. Students should be innovative and creative in their ideas; matching the consumer need for verification with the means that eHarmony has available. Answers should be reasonable and accurately reflect the importance of the ethical guidelines.

11. Is eHarmony's decision to not delve into same-sex matching an ethical problem? Should eHarmony have been forced to include same-sex individuals?

Yes, eHarmony's decision to not delve into same-sex matching is an ethical problem as well as a corporate strategy problem. Answers for this question will vary and should include the students' understanding of the situation. Students should acknowledge the importance of companies not being discriminatory as well as the legal implications of the decisions eHarmony has made.

12. Is it ethical for eHarmony to pass off its matching system as scientific when there is no real scientific basis?

Answers for this will vary based on student opinion. There are no legal guidelines to help answer this question as there has been no legal action taken against eHarmony so it will purely be opinion mixed with the facts of the case against eHarmony in this situation.

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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 constrains 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.*

INSTRUCTOR'S NOTES

Research Methods

This is a field-based research case. The case utilizes information from a private firm's internal documents. At the request of the business the names of both firm and individuals involved have been altered to protect their privacy. Some of BodyBrace's financial information was also altered at the firm's request.

Learning Objectives

The learning objectives of this case are to place the subject of accounting information system and internal controls in perspective for accounting students, accountants and entrepreneurs and to highlight the important role the accounting function plays as the suppliers of financial information for the rest of the organization. The students will have an opportunity to synthesize and integrate the record keeping knowledge acquired in accounting principles into a business perspective. The case requires students to recognize the various types of transactions that will be processed and the basic accounting records used in an organization. This case focuses on the types of information needed to trigger events and not necessarily on the type of technology used. To that end the objectives of this case are:

1. To help students understand the importance and structure of internal controls as defined by the *Statement of Auditing Standards (SAS) No 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55.*
2. To help students gain a broader understanding of the importance of the accounting function.
3. To highlight the accountant's role as designer, user and auditor of an Accounting Information System and its importance in achieving sound internal controls for the organization.

IMPLEMENTATION GUIDELINES

The Three Stage Learning Process by Mauffette-Leenders, Erskine & Leenders, (2005) is recommended. The recommendation is that the students first prepare for the case individually, next discuss it in small groups and finally discuss the case as a class. This process would assure effective learning. When assigning the case for individual preparation, the students should be instructed to:

1. become familiar with the Statement of Auditing Standards (SAS) No.78
2. identify the modules of an accounting information systems
3. prepare data flow diagrams and
4. understand various control activities, as this information will help them justify the policies and procedures they design.

While this case is not on ethics and fraud, it would behoove the instructor to spend at least 10 to 15 minutes discussing the broad issues relating to business ethics. This should engage the students in a manner that will allow them to actively participate and appreciate the importance of their role in designing the system. Divide the class into smaller groups to allow students to discuss their own experiences with internal control issues as well as get a better understanding of the case and issues in internal control. Groups can be assigned to discuss and design the whole system or can be assigned to design different modules. The final stage is the class discussion where each group presents and justifies its own system design. Each group should be given at least 15 minutes to make their presentation. While this case discusses the sales order cycle in detail the students can also design the other business cycles.

Internal Controls

A fundamental aspect of management's stewardship responsibility is to provide the owners with reasonable assurance that the business has adequate controls in place and provide reliable financial information on a timely basis. An adequate system of internal controls is necessary to management's discharge of these obligations. With increasing number of large corporate failures there is now a greater demand for more oversight; auditors are now required to audit the internal controls established by management. This is applies to smaller companies as well. Thus if an organization's financial statements are audited by an independent certified public accountant, the accountant has to make an assessment on the adequacy of internal controls. Almost all organizations that need some form of financing from a financial institution are required to present financial statements reviewed or audited by an independent auditor. Thus a firm may not be able to secure financing for growth and expansion if it cannot present financial statements that have been audited by an independent auditor. This underscores the need for a well designed accounting information system.

The objective of establishing and maintaining an adequate system of appropriate internal controls is to ensure the integrity and reliability of financial statements. The Sarbanes Oxley (SOX) Act of 2002 was passed by Congress in response to the public's outcry for integrity and transparency in financial reporting following the discovery of massive accounting irregularities by major corporations. Section 404 of the Act requires CEOs and CFOs of public companies to certify the adequacy of their internal control systems. Auditors of privately held companies are also making the same demands with regards to the demonstration of the adequacy of internal controls and greater disclosure. A major link between economic theory and contemporary accounting thought is the argument that a firm's commitment to greater disclosure lowers its cost of capital. By establishing adequate internal controls, BodyBrace will have greater disclosure and transparency which should enable it to obtain the necessary line of credit from a local bank at a favorable interest rate.

The Role of the Accountant

Since much of the internal control system relates directly to transaction processing, accountants are key participants in ensuring control adequacy. The need to produce reliable accounting information places the accounting function in a unique position within an organization; it does not affect the revenue generation process directly but provides all the information usually in the form of reports to support revenue generation as well as all the other functions of the organization.

Accountants are involved in information systems in three ways as system designers, system users, and system auditors. They should actively participate in the designing of accounting information systems by providing the conceptual framework. As conceptual system designers accountants must determine the information needs and sources and specify the accounting rules and procedures to be used and the internal control activities required. As end users accountants must comply with as well as enforce the company accounting policies and procedures. They must also produce the reports required by the organization. In providing attestation services, the accountant must evaluate the components of the accounting information systems to establish the degree of compliance with organizational policies and procedures and internal control standards.

The purpose of establishing and maintaining a system of appropriate internal controls is to ensure the integrity and reliability of organization data. Because much of the internal control system relates to the transaction processing, a well designed accounting information systems is central to ensuring these controls. Fundamental objectives of accounting information systems are to support the stewardship function of management, support management decision-making, and support the firm's day-to-day operations. To that end the objective of the case is for the student to develop an accounting information systems system that establishes and maintains an adequate internal control system for BodyBrace Inc.

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

ANSWERS TO DISCUSSION QUESTIONS

1. What financial statements, interim, summary, and exception reports are produced by an accounting system?

The basic financial statements produced annually by accounting system are the Income Statement, Statement of Changes in Owner's Equity, Balance Sheet and Statement of Cash Flows. For publicly traded companies these statements have to be audited once a year. The same statements are produced more frequently for internal use only, usually on a monthly or quarterly basis; they are referred to as interim statements. In addition various budgets should be prepared and used for variance analysis and control. A variety of summary reports could be produced for specific needs, e.g., inventory reports, cash report, employee report: commission reports, sales history by employee report, etc. An exception report is produced when an item requires special attention, e.g., customer orders exceed pre-approved credit limit.

2. What are the four broad objectives of an internal control system?

The internal control system comprises of policies, practices, and procedures employed by an organization to achieve four broad objectives:

Physical Controls:

1. To safeguard assets of the firm.
2. To ensure the accuracy and reliability of accounting records and information.

Operational Controls:

3. To promote efficiency in the firm's operations.
4. To measure compliance with management's prescribed policies and procedures.

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?

The five components of internal control as defined in SAS 78 are the control environment, risk assessment, information and communication, monitoring and control activities.

a. The Control Environment: The control environment sets the tone for all the other control components. Some of the elements of the control environment are the structure of the organization, the integrity and ethical values of management and the organization's policies and procedures for managing human resources. Mr. Davis's attitude towards the internal controls will set the tone for the control environment at BodyBrace Inc. A code of ethical standards should be established which will guide management and staff in their operations. The code should address, among other things, issues such as bribery, falsification of financial or performance data and confidentiality of customer and company information. It would be advisable if BodyBrace bonded all its employees. Of particular importance in designing the accounting information systems for BodyBrace is management's policy for compensation which are based on base salary plus commission on sales. All sales must be real transactions.

b. Risk Assessment: An organization must identify and manage the risks inherent to its operations especially as they relate to financial reporting. Hall (2010) identifies the following risks as relevant to financial reporting: changes in operating environment, new or reengineered operating systems or technologies that impact transaction processing, new personnel that hold different or inadequate understanding of internal control, significant and rapid company growth, introduction of new product lines with which the organization has little experience, entry into foreign markets and adoption of new accounting principles. Most of these risks are relevant to BodyBrace Inc. For BodyBrace all processes and systems are new as the organization has little experience in handling the operations. The projected rapid expansion brings its own challenges, as sales have to be processed in a timely manner; all employees will be newly hired and there is no established procedure in place right now. The company needs to establish clear policies and procedures to guide personnel. Properly structured training programs will also be key to the personnel's ability to quickly learn the system so as to achieve the desired operational results. Procedure manuals must be developed to provide workers with continuing guidance on how to carry out the day-to-day operations. Management needs an orientation on how the system works and how to use and interpret the reports. Supervisors need to understand the system, its functions, and its impact on the jobs of the people they supervise. They should also be familiar with the methods of data input, file maintenance, and troubleshooting. All the employees will need thorough training in validating the data input, maintaining files and generating output documents.

c. Information and Communication. The quality of information generated by an organization's information system impacts management's ability to make the appropriate decisions and take action for the organization in a timely manner. BodyBrace's accounting information system should consist of methods that accurately identify, analyze, classify, and record the transactions in a manner that allows the organization to prepare reliable financial statements. All types of information on sales are crucial to BodyBrace especially to the marketing department which needs this information to assess the success of its marketing strategies. BodyBrace must be able to compare projected sales with actual sales in a real time so as to adjust the marketing strategies as needed. The other information that should be captured for improved operations is the customer demographics, customer satisfaction with order processing, sales returns, inventory levels, as well as the order turnaround time.

d. Monitoring: Internal control systems must be monitored and tested for adequacy and compliance with intended policies. Rigorous evaluation of the effectiveness of the company's internal control system must be performed on a continuous basis by reviewing the activities to determine whether prescribed internal controls are being followed. Any weakness detected in the system must be reported for improvement.

e. Control activities can be grouped into two distinct categories, computer controls and physical controls.

    i. Computer Controls. Computer relates specifically to the Information Technology and falls into two broad groups: general controls and application controls. General controls pertain to entity-wide concerns such as controls at data center, organization databases, systems development, and program maintenance. Application controls ensure the integrity of specific systems such order processing, accounts payable, and payroll applications.

    ii. Physical Controls. This class of controls relates primarily to the human activities employed in accounting systems. These activities may be purely manual, such as physical custody of assets, or they may involve the use of computers to record transactions or updating accounts. Physical controls also relate to the human activities that initiate all systems, regardless of sophistication.

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 in BodyBrace's operations.

The six categories of control activities are transaction authorization, segregation of duties, supervision, accounting records, access control, and independent verification.

a. Transaction Authorization. All transactions processed by the information system are to be authorized in accordance with management's objectives. Authorizations may be general or specific. General authority is granted to operations personnel to perform day-to-day operations. Specific authorizations deal with case-by-case decisions associated with non-routine transactions like the purchase of furniture or other item over a certain amount of money.

b. Segregation of Duties. Segregation of duties is indispensable in any system of internal controls. The principle for segregation is that the work of one employee should provide a reliable basis for evaluating the work of another employee. Three objectives of segregation of duties are as follows:

   i. The segregation of duties should be such that the authorization for a transaction is separate from the processing of the transaction. For example sales representatives should not be the ones to act as credit approval managers, and the purchase department should not initiate purchases until authorized by the inventory control department. This should not be a problem for BodyBrace as all transactions are paid for by the customers with credit cards; BodyBrace employees do not have to worry about approving a customer's credit. However, an employee who does not take handle customer orders should reconcile the daily credit card transactions with the bank records to identify any discrepancies as soon as they may occur.

   ii. Responsibility for the custody of assets should be separate from the record keeping responsibility. Assets can be stolen or lost and the accounting records falsified to hide fraud when a single individual or department has responsibility for both asset custody and record keeping. For example the department that has the physical custody of the inventory (warehouse) should not keep the official inventory records. Customer data is another asset that needs to be safeguarded; both hard copies as well as computer records.

   iii. The organization should be structured so that a successful fraudulent activity requires collusion between two or more individuals with incompatible ties. No single individual should have sufficient access to records to perpetrate fraud. When employees with incompatible tasks work together in close physical spaces, familiarity may allow them to engage in collusion. BodyBrace needs to pay special attention to this aspect, as all operations will be carried out from the same warehouse. Where physical segregation is not possible organizational segregation should be implemented.

c. Supervision. Implementing adequate segregation of duties requires that a firm employ a sufficiently large number of employees. Achieving adequate segregation of duties often presents difficulties for small organizations. Initially BodyBrace may lack sufficient personnel to segregate all functions; therefore close supervision will be required.

d. Accounting Records. The accounting records of an organization consist of the source documents, journals, and ledgers that provide evidence that the transactions and events have occurred. These records provide an audit trail of the economic events of the organization. Organizations must maintain audit trails for two reasons. First the audit trail enables the auditor to trace any transaction through all the phases of its processing from the initiation of the event to the financial statements. Second, this information is needed for conducting day-to-day operations by helping employees respond to inquiries and showing the current status of transactions in process. Thus for practical expedience and legal obligation business organizations must maintain sufficient accounting records to preserve their audit trails. BodyBrace needs to employ appropriate filing systems from the beginning to efficiently maintain all its accounting records. The company can invest in a system that can scan all its documents. All documents should be prenumbered and accounted for to prevent transactions from being recorded twice or not being recorded at all. Source documents should be forwarded to the accounting department to help ensure timely recording of the transaction and event.

e. Access Control. Access controls play an important part in safeguarding assets and its purpose is to ensure that only authorized personnel have access to the firm's assets. Unauthorized access exposes assets to misappropriation, damage, and theft. Access to assets can be direct or indirect. Physical security devices, such as locks, safes, fences, and electronic and infrared alarm systems control against direct access. Indirect access to assets is achieved by gaining access to the records and documents that control the use, ownership and disposition of the asset.

f. Independent Verification. The principle of independent verification involves the review, comparison, and reconciliation of data prepared by employees to compare recorded accountability with existing assets. The objective of the independent checks is to identify errors and misrepresentations. Examples of independent verifications include:

   i. Performing physical count of assets and comparing it with accounting records.
   ii. Reconciling subsidiary accounts with control accounts.
   iii. Reviewing management reports (both computer and manually generated) that summarize business activity.
   iv. Reconciling by an independent person of the deposits to bank account per books with the bank statement, done on a daily basis.

For maximum benefit, independent verification should be done periodically and occasionally on a surprise basis. The verification must be done by someone who is independent of the personnel responsible for the information. Discrepancies and exceptions should be reported to management who should take corrective action immediately.

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.

To accomplish BodyBrace's objective with regards to a sound system of internal controls the organization needs an accounting information systems that accurately captures and records the transactions of the firm and its financial position. The system should be integrated to allow real time entry of transactions and updating of all related accounts. Integration allows sub systems to receive data as input from one system and provide information as output to another sub system. These modules support management by providing regular summary reports, exception, and ad hoc reports necessary for decision making. As with any system of internal controls however, the limitations or premises are that the costs of establishing control procedures should not exceed the expected benefit.

a. A sales order processing module – routinely records the sales orders and provides data to other systems that will fill the orders, maintain inventory and bill the customers.

Input is the customers' information including name, address, account number, as well as the type and quantity of the merchandise requested.

Output is the copy of the sales order to warehouse authorizing the release of inventory and copies to billing and shipping departments for independent verification. Update to sales journal.

The system should allow sales clerk to

i. immediately verify customer credit limit and inventory levels.
ii. accurately calculate prices, totals, discounts, and taxes on the order.
iii. track sales made by each sales representative and provides input to the payroll subsystem so that the sales representative's commissions can be calculated.

Authorization: A picking slip is delivered to the warehouse to authorize release of the inventory.

Segregation of Duties: Authorizes release of items but does not have physical custody of the inventory.

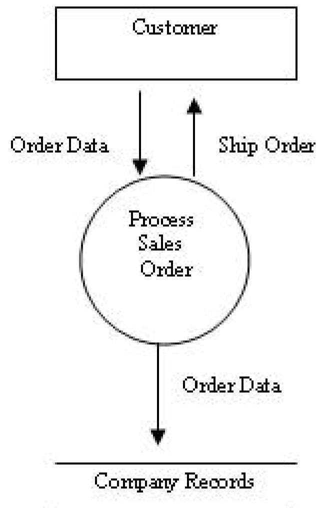
Accounting Records: When credit is approved, the sales information is sent to the warehouse, and the shipping departments.

b. Process payment. The process discussed here is an automated processing system.
Input is the credit card information received from the customers. The sales clerk collects the necessary information and processes the payment immediately which will result in the bank making a deposit into BodyBrace's account immediately.
Output is a confirmation code generated by the credit card processing company that is sent to the customer on the invoice stating payment has been received.
Segregation of duties - Clerk who collects the credit card information does not maintain the cash account and does not receive or reconcile the bank statement.
Supervision: Although credit card information is never printed on the invoice it is stored on the company's database for future transactions. This data should be encrypted and for additional safety the sales clerk who collect and process the credit card information must be bonded.
Accounting records: Credit card processing codes for each transaction provide audit trail.
Independent Verification: Bank reconciliation should be performed daily by person who does not process the sales.

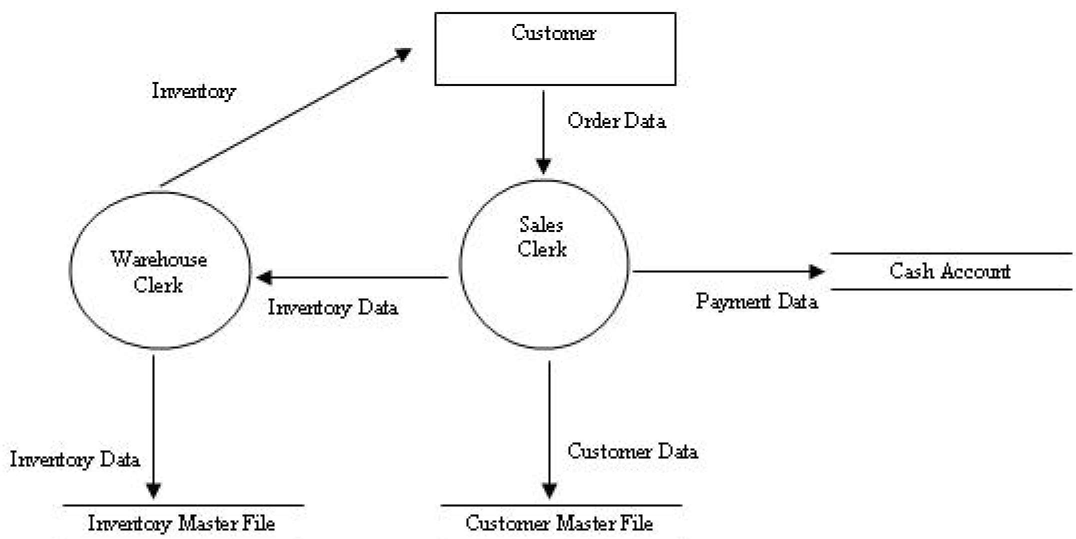
6. Draw a context, physical and logical DFD depicting the sales order process.

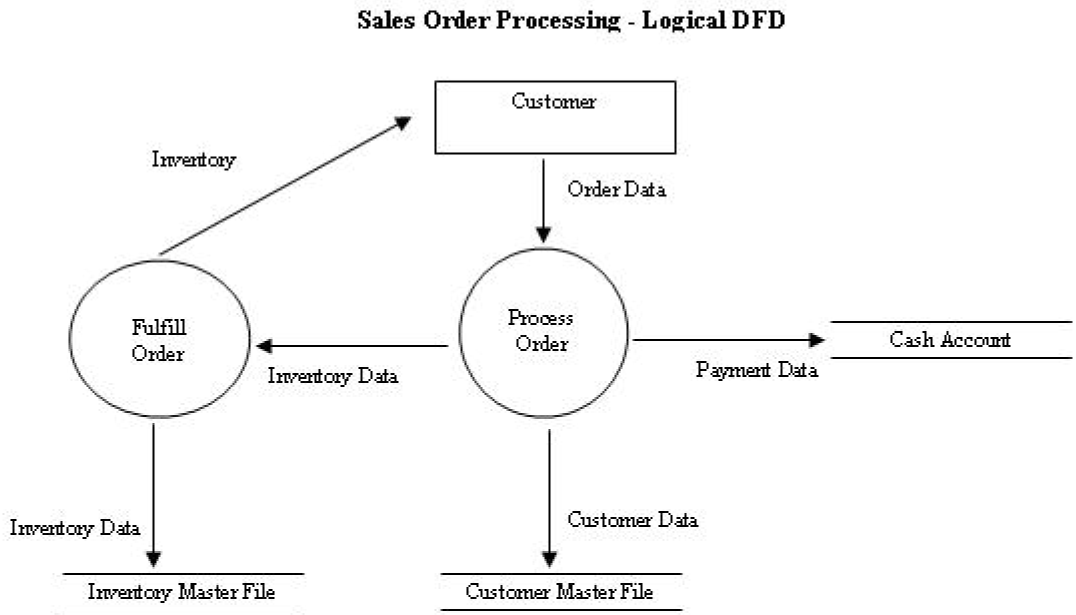
Data flow diagrams (DFDs) are used by system developers as a tool for analyzing an existing system or a planning aid for creating a new system. In the case of Body Brace Inc., DFDs will help Mr. Davis and his employees visualize the sale order process and decide on the staffing needs of the various processes. A context DFD provides an overview of the system. A physical DFD focuses on the physical entities involved in the system as well as tangible documents that flow through the system. A logical DFD focuses on the task of the physical entities identified in the physical DFD. A well designed system with the aid of DFDs efficiently allocates the resources of a business.

Sales Order Processing - Context DFD



Sales Order Processing - Physical DFD





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

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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.

INSTRUCTORS' NOTES

Objectives

The objectives of the case are to:

1. Develop an understanding of culture.
2. Become aware of cross-cultural implications in an organizational environment.

3. Understand the roles that entity and incremental theory play when dealing with conflict.
4. Develop ways to improve cross-cultural interactions in the workplace.
5. Develop approaches for dealing with discrimination as a manager.

Recommendations for Teaching Approaches

Before presenting the case, begin class by reviewing entity and incremental theory and discuss examples of each. Then have the students discuss different questions about culture in small groups. Next have the small groups share with the rest of class what they came up with. After the group discussion, break out of small groups and have students read the case individually. The case can then be run in a few different ways.

1. Run a directed question/answer discussion focusing on the conflict between Rob and Mike and their attempt to keep Tippers culturally diverse.
2. Have the students role-play the roles of Chris, Rob, and Mike, while the instructor plays the role of Brian. Role-play different ways all the characters could handle Brian's comments differently.
3. Small groups gather to brainstorm different ways for Tippers to deal with or prevent cross-cultural implications.
4. End with a review of cultural identity.

QUESTIONS FOR SMALL GROUPS BEFORE THE CASE IS PRESENTED

1. What is culture? How do you describe culture? What effects might one's culture have on them and others around them?
2. Discuss personal experiences of discrimination.
3. How might culture and discrimination be related?

QUESTIONS AFTER THE CASE IS PRESENTED

1. How do you feel about the first employee terminated in the background of the case? Do you think it was right or wrong?
2. Which stereotypical comment was the most inappropriate and why?
3. How could have Chris handled Brian's comments differently?
4. How could have Tippers prevented Brian's comments?
5. Which top manager (Rob or Mike) has the best personal theory (entity and incremental) to increase Tippers effective multicultural environment?
6. Should Brian be fired and why?

ANSWERS FOR QUESTIONS BEFORE CASE

1. **What is culture? How do you describe culture? What effects might one's culture have on them and others around them?**

   Culture consists of patterns of behaviors that are acquired and transmitted by symbols over time, which become generally shared within a group and are communicated to new members of the group in order to serve as a cognitive guide or blueprint for future interactions (Kluckhohn & Kroeberg, 1952). One's culture can give them security and belonging; can bring on actions such as discrimination and oppression; can give them privilege.

2. **Discuss personal experiences of discrimination.**

   Personal experiences.

3. **How might culture and discrimination be related?**

   Discrimination may be present because of one's culture.

ANSWERS FOR QUESTIONS AFTER THE CASE IS PRESENTED

1. **How do you feel about the first employee terminated in the background of the case? Do you think it was right or wrong?**

   Personal feelings.

2. **Which stereotypical comment was the most inappropriate and why?**

   No comment is more inappropriate than any other. They are all oppressive comments and there is no hierarchy in their oppression.

3. **How could have Chris handled Brian's comments differently?**

   Possible actions for Chris are: Don't say anything to anyone; Agree and encourage Brian's comments; Tell other Tippers employees, but not upper management; Discuss with Brian that his comments could be offensive to others and explain why.

4. **How could have Tippers prevented Brian's comments?**

Possible preventive actions by Tippers are: Engage in continuous cross-cultural training; define cultural stereotypes and biases in ethical guidelines and increase severity of punishment if they are used; Use specific past instances to guide cross-cultural training and education.

5. Which top manager (Rob or Mike) has the best personal theory (entity and incremental) to increase Tippers effective multicultural environment?

In order to have an effective multicultural environment, cross-cultural training may be important and necessary. Because Mike has an incremental theory, he believes individuals' personalities can be developed through education. Mike most likely has the best personal theory because Rob's theory states that human qualities are fixed. Rob's theory says if someone is prejudice, their prejudice can not be changed.

6. Should Brian be fired and why?

To be consistent with dealing with past discrimination, Brian should be fired. To embrace Tippers value to maintain effective cultural diversity, Brian should be educated along with every other employee through cross-cultural competence training. If training is evaluated as effective and Brian continues his comments, then termination might be appropriate.

TERMS

Culture:	Consists of patterns of behaviors that are acquired and transmitted by symbols over time, which become generally shared within a group and are communicated to new members of the group in order to serve as a cognitive guide or blueprint for future interactions (Kluckhohn & Kroeberg, 1952).
Cultural Identity:	Presumes issues of value and authority-involving issues of ethnicity, language, race, tradition, religion, and other beliefs-that are even more complicated that are more complicated than theories of conflict from a political, sociological, or economic perspective (Pedersen, 2006).
Cross-cultural Training:	Cross-cultural training enables the individual to learn both content and skills that will facilitate effective cross-cultural interaction by reducing misunderstandings and inappropriate behaviors (Black & Mendenhall, 1990).
Entity Theory:	The belief that human qualities-such as goodness or intelligence-are fixed. They are internal entities that people simply do or do not posses (Dweck & Ehrlinger, 2006).
Incremental Theory:	The belief that human qualities are malleable and can be developed. The theory does not imply that everyone will change, but rather that everyone has the ability to grow with education and effort (Dweck & Ehrlinger, 2006).

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INTERNAL CONTROL FAILURES AT THE PINE GROVE YMCA

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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 contactor. 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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case is flexible and could be used in a number of ways:

1) In an internal auditing or financial auditing course (emphasizing corporate governance including COSO and internal controls)
2) In a nonprofit accounting (emphasizing internal controls and the responsibilities of the board of directors).

Ideally the case should be used as a semester long group project at the undergraduate level, and as one of the cases in a graduate level course.

Depending on the course in which the case is used a discussion of the Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit, the fraud triangle, the COSO control framework, and corporate governance, should precede the assignment of the case to students. Students could be assigned one, a combination, or all of the questions at the end of the case (A Call for Action) and asked to develop solutions.

Learning Outcomes:

Students should be able to:

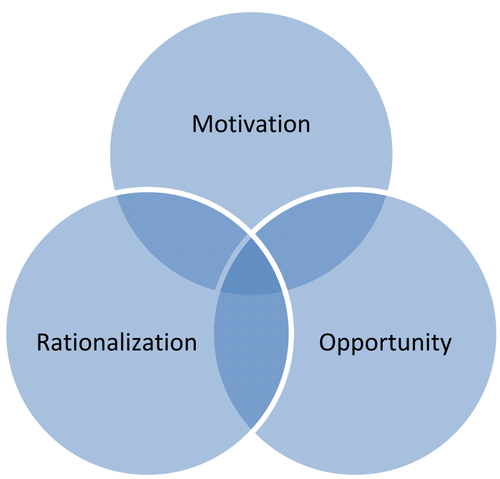
1. Identify the elements of a fraud by using the fraud triangle
2a. Identify strengths and weaknesses in internal controls and propose recommendations to address control deficiencies
2b. Report internal control weaknesses and propose recommendations to management in written form
3. Explain the differences between an ethical failure and a criminal or (illegal) act

Case Implementation and Effectiveness

The case was class tested in a graduate government and nonprofit accounting course in summer 2010. The students found the case easy to read and interesting as reflected in the assigned ratings. When asked to identify the one thing they found most interesting about the case, a student noted that "The one thing in the case I found the most interesting is that the woman was able to write payroll checks to herself over and over again. I was surprised their checks did not require more than one signature." Another student noted that "I found it very interesting that Ms. Jackson wasn't forced to take at least one vacation week in five years as the accounting manager. Most companies require their employees to take a week of vacation so they can find out if the employee is involved in some type of fraud." Finally, a student answered the question by stating that "the most interesting thing in the case to me was that the accounting manager and executive director were not charged for collusion in committing fraud. It's hard to believe that neither of them had an idea that the other person was committing fraud."

DISCUSSION QUESTIONS AND ANSWERS

Q1. 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.



The first element of the fraud triangle is perceived pressure or motive. Clearly the need for funds (economics) was the motivation for the fraud at the YMCA. The executive director's monetary pressure was from living extravagantly, and the accounting manager's self-imposed pressure was to provide for family.

The second element of the fraud triangle is opportunity. In the case of the Pine Grove YMCA, weak internal controls and lack of clear policies and procedures allowed the fraud to continue without prevention. Also, both the executive director and accounting manager were at a high level within the organization and thus received a high degree of trust from superiors with a low level of supervision or oversight. In addition, the person responsible for overseeing the accounting manager (i.e., the executive director) was also committing his own fraud. So perhaps he was too busy hiding his own embezzlement to focus on the actions of his subordinate. Some of the control weaknesses that provided the opportunity for the fraud to occur are identified in Q2.

The final element of the fraud triangle is the rationalization or lack of integrity to overcome a person's sense of ethical responsibility. This will vary from person to person but it's possible that both the executive director and accounting manager rationalized their behavior in a number of ways such as "No one would ever find out", or "I'm borrowing the money and will pay it back", or "I am underpaid, so this is due compensation".

Q2. 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. Write a formal report to the board of directors to discuss these weaknesses and your recommendations to address the control deficiencies.

The following are some of the control deficiencies that existed at the Pine Grove YMCA. It is not an exhaustive list and students could identify additional control weaknesses.

1. The board of directors delegated responsibilities to the executive director without adequate follow up. For instance, the executive director's expenses were not reviewed and/or approved by the board.

2. Maintenance of records was inadequate at the YMCA. For instance, the materials used at the CEO's residence renovation were bought from Y's funds and were listed as fixed asset additions on the organization's books.

3. The executive director entered into a contractual agreement with the local landscaper without the board of director's approval

4. The accounting manager had incompatible duties in that she was able to approve checks and record them in the general ledger. As a result, she wrote more than 168 checks totaling approximately $40,000 on the YMCA accounts between 1999 and

2002, disguising most of them as payroll checks. She also made personal purchases worth approximately $23,000 using corporate credit cards.

5. The accounting department did not have adequate personnel on staff to manage the organization's increasing activities.

6. The accounting manager stopped remitting both federal and state payroll taxes on behalf of about 150 YMCA employees in 1999, and continued to file false quarterly tax returns through 2002.

7. The general ledger was not reconciled to the subsidiary ledgers (or supporting records) on a monthly basis

8. The executive director was able to make large purchases without additional approval. For instance, he used corporate funds of approximately $864,000 to purchase materials for the renovation of his personal residence renovation and pay the landscaper's employees.

9. The business manager was able to create fraudulent bank statements through her computer (in order to cover up the fraud).

10. The organization did not have policies in place to address the use of purchasing cards.

11. The organization did not have a code of ethics in place

The formal audit report will vary based on instructor preference especially since there is no standard report format for reporting internal control weaknesses. However, a suggested report with the key findings and recommendations to the board of directors is provided in Appendix A.

Q3. Explain the difference between an ethical failure and a criminal or illegal act to the board of directors

A brief discussion of ethics, fraud and illegal act follows. This is not intended to serve as a formal response since students answers will vary based on their matriculation status and business knowledge. However, the information could assist instructors in leading a discussion on the question.

Ethical behavior is considered the decision which produces the greatest good or one which conforms to moral rules and principles. The accounting profession provides Codes of professional ethics to help address situations not specifically available in general ethics theories. Therefore an ethical failure is a violation of the greatest good or moral rules and principles theories, or the code of professional ethics. Fraud is knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act on it, thus suffering a loss or damage. Illegal acts are violations of laws or government regulations by the company or its management or employees that produce direct and material effects on dollar amounts in the financial statements,

EPILOGUE

The organization significantly curtailed its activities once the fraud was discovered resulting in the termination of 1/3 of its employees. Maintenance was also deferred resulting in an unclean exercise facility for members. As a result, members opted to join other, newer exercise facilities in Pine Grove that were aggressively soliciting dissatisfied YMCA members. As noted in the case, the YMCA owed back taxes to the federal government of approximately $1.4 million, with an additional $800,000 in taxes, penalties and interests owed to the State of Michigan. Therefore, facing declining memberships and eroding finances and with no reserves to pay these back taxes, the organization developed a payment plan to pay all back taxes.

The three fraudsters in the case all had jury trials and were found guilty of the various charges. The former accountant (Ms. Jackson) was convicted on all charges and sentenced to 42 months in jail, followed by three years of supervised release. She was also ordered to repay $1.5million to the YMCA. The contractor was convicted on the embezzlement charges and sentenced to 65 months in jail. He was also ordered to repay $1.5 million in restitution to the YMCA jointly with the accounting manager. Finally, the executive manager was convicted on embezzlement and misleading conduct charges and sentenced to 97 months in jail. He was ordered to repay $1.4 million to the organization.

DISCLAIMER

This case and teaching note was prepared by Raymond Elson, Susanne O'Callaghan, Phyllis Holland, and John Walker and is intended to be used for class discussion rather than either effective or ineffective handling of the situation. The names of the organization, the individuals, and location have been disguised.

REFERENCE

Louwers, T., Ramsay, R., Sinason, D., Strawser, J., and J. Thibodeau (2011). Auditing and assurance services, 4th edition. New York: McGraw Hill.

APPENDIX A– FORMAL REPORT (RECOMMENDED)

Date: November 1, 20XX
To: The Board of Directors
The Pine Grove YMCA

From: Independent Accountant

Audit Results

The recent fraud at The Pine Grove YMCA resulted primarily from inadequate oversight by the board of directors and inadequate segregation of duties. These allowed the executive director and accounting manager frauds to go undetected for approximately five years. In addition to the embezzled funds, the organization also has a tax liability of approximately $1.4 million to the federal government and an additional $800,000 to the State of Michigan.

The details of our key business issues and our proposed corrective actions are noted below.

Issues and Recommendations

1. Board Oversight

The board of directors delegated responsibilities to the executive director without adequate follow up. As a result, transactions were initiated without its implicit approval. We noted that:

- The executive director was able to make large purchases without additional approval
- The executive director entered a contractual relationship with a vendor for over $500,000 without the board's approval
- The organization does not have a code of ethics in place for employees, vendors and board members

We recommend that the YMCA establish tier authority for purchases. This will ensure that significant transactions above a pre-established threshold are approved by the board prior to purchasing. Also, the organization should develop and establish a code of ethics which should be communicated to all employees and vendors. The board of directors should monitor compliance on an annual basis.

2. Segregation of Duties

The accounting manager had incompatible duties (and little oversight) and was able to embezzlement funds without detection. The accounting manager:

- Wrote more than 168 checks totaling approximately $40000 on the YMCA accounts between 1999 and 2002, disguising most of them as payroll checks.
- Made personal purchases worth approximately $23,000 using her company issued purchasing card.
- Stopped remitting both federal and state payroll taxes on behalf of about 150 YMCA employees in 1999, and continued to file false quarterly tax returns through 2002.
- Did not reconcile the general ledger to the subsidiary ledger or supporting statements
- Created fraudulent bank statements through her computer

We recommend that the YMCA:

- Hire additional staff to ensure that functions are adequately segregated
- Reconcile the general ledger to the subsidiary ledger on a monthly and hire a controller to ensure that all material accounting transactions are reviewed and approved
- Consider the cost/benefit of engaging an accounting firm to perform annual audits of its operations.

3. Policy and Procedures

The YMCA did not have policies and procedures in place to address critical business issues. We noted lack of policies and procedures in the following areas:

- The proper use of purchasing cards and the documents required to support usage
- The lack of competitive bidding over significant renovation projects

We recommend that the YMCA develop policies and procedures to address these critical 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.

INSTRUCTOR'S NOTES

Recommendations For Teaching Approaches

This case was inspired by the desire to have an easy to follow format for a managerial budgeting problem that started with the sales budget and ended with a pro forma balance sheet. Textbooks usually include such problems but most are very time consuming and so long that the completion of them during a normal class period is nearly impossible. Our desire was to design an easier to follow problem so that the time commitment for completing it would be decreased substantially.

This problem is designed for a principles of managerial accounting class. Therefore, the focus on the case is primarily problem solving. However, as mentioned previously, the case may be slightly altered for a cost accounting or graduate level managerial accounting or budgeting course. Such alterations will be outlined following the basic questions.

We suggest that you assign the case to students as homework after covering the entire budgeting process in class. During a subsequent class period, we recommend that you then work out the entire project together. One possible method of doing so may be to break the class into groups, assign each group a budget or budgets, and then have them discuss their assigned budget(s) and any variations that members of the group arrived at in their own answers. A spokesperson may be selected for each group to work his or her group's selected budget(s) on the board. Another approach may simply be to work all of the budgets out as a class and periodically ask individual students to provide answers to assess students' understanding of the subject matter.

QUESTIONS

For Level Two

Using the provided templates, prepare the following budgets.

- Prepare a sales budget
- Prepare a schedule of expected cash collections
- Prepare a production budget
- Prepare a direct materials budget (If necessary, round up to the nearest whole number.)
- Prepare a schedule of expected cash disbursements for hulls (If necessary, round to the nearest whole dollar. If decimal is 0.5 round the first month up to the nearest whole dollar and the second month down to the nearest whole dollar.)
- Prepare a schedule of expected cash disbursements for seats (If necessary, round to the nearest whole dollar. If decimal is 0.5, round the first month up to the nearest whole dollar and the second month down to the nearest whole dollar.)
- Prepare a schedule of expected cash disbursements for drain plugs
- Prepare a direct labor budget
- Prepare a manufacturing overhead budget
- Prepare an ending finished goods inventory budget (For fixed manufacturing overhead, round to three decimal places and use in subsequent related intermediate calculations; you should round ending and beginning finished goods inventory to nearest whole dollar after using the three decimal place unit product cost to calculate those figures).
- Prepare a selling and administrative budget

- Prepare a cash budget
- Prepare a pro forma income statement
- Prepare a pro forma balance sheet

Kyle's Kayaks Budget Templates

- Prepare a sales budget

Table 1A: Sales Budget							
	Q3-Y0	Q4-Y0	Q1	Q2	Q3	Q4	Total – Y1
Budgeted Sales in Units							
x Selling Price							
= Budgeted Sales in Dollars							

- Prepare a schedule of expected cash collections

Table 2A: Schedule of Expected Cash Collections								
Accounts Receivable, beginning balance	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Collections Y1	Q1-Y2	Q2-Y2	AR Total at YE
Accounts Receivable Q3-Y0								
Accounts Receivable Q4-Y0								
First Quarter Sales								
Second Quarter Sales								
Third Quarter Sales								
Fourth Quarter Sales								
Total								

- Prepare a production budget

Table 3A: Production Budget									
	Q3-Y0	Q4-Y0	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total for Y1	Q1-Y2	Q2-Y2
Budgeted Sales in Units									
+Desired EI of FG									
= Total Needs									
-BI of FG									
=Required Production									

- repare a direct materials budget

Table 4A: Direct Materials Budget								
	Q3-Y0	Q4-Y0	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total for Y1	Q1-Y2
Required Production (kayaks)								
x Raw materials needed per kayak (hulls, seats, drain plugs))								
=Production needs								
+Desired EI of RM								
= Total Needs								
-BI of RM								
DM to be purchased								
Cost of hull								
Cost of hulls to be purchased								
DM to be purchased								
Cost of seat								
Cost of seats to be purchased								
DM to be purchased								
Cost of drain plug								
Cost of drain plugs to be purchased								

- Prepare a schedule of expected cash disbursements for hulls

Table 5A: Schedule of Expected Cash Disbursements for Hulls							
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Hulls for Year	Q1-Y2	AP on hull at YE
Accounts Payable, beginning balance							
First quarter hull purchases							
Second quarter hull purchases							
Third quarter hull purchases							
Fourth quarter hull purchases							
Total							

- Prepare a schedule of expected cash disbursements for seats

Table 6A: Schedule of Expected Cash Disbursements for Seats							
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Seats for Year	Q1-Y2	AP on seats at YE
Accounts Payable, beginning balance							
First quarter seat purchases							
Second quarter seat purchases							
Third quarter seat purchases							
Fourth quarter seat purchases							
Total							

- Prepare a schedule of expected cash disbursements for drain plugs

Table 7A: Schedule of Expected Cash Disbursements for Drain Plugs						
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Drain Plugs for Year	AP on drain plugs at YE
Accounts Payable, beginning balance						
First quarter drain plug purchases						
Second quarter drain plug purchases						
Third quarter drain plug purchases						
Fourth quarter drain plug purchases						

- Prepare a direct labor budget

Table 8A: Direct Labor Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Required production in units					
DLH required per unit					
Total DLH needed					
DL cost per hour					
Total DL cost					

- Prepare a manufacturing overhead budget

Table 9A: Manufacturing Overhead Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Budgeted DLH					
Variable manufacturing overhead rate					
Total variable manufacturing overhead					
Fixed manufacturing overhead					
Total manufacturing overhead					
Less depreciation included in fixed manufacturing overhead					
Cash disbursements for manufacturing overhead					

- Prepare an ending finished goods inventory budget

Table 10A: Ending Finished Goods Inventory Budget			
Item	Qty	Cost	Total
Production cost per kayak			
Direct Materials for 1 kayak			
hull			
seat			
drain plug			
Direct Labor for 1 kayak			
Variable Overhead			
Fixed Manufacturing Overhead			
Unit product cost			
Budgeted finished goods inventory:			
Ending finished goods inventory			
Budgeted beginning finished goods inventory:			
Beginning finished goods inventory			

- Prepare a Selling and Administrative Budget

Table 11A: Selling and Administrative Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Budgeted Sales in Units					
Variable S&A Expense per unit					
V S & A Expense					
Fixed S & A Expenses:					
Advertising					
Executive Salaries					
Insurance					
Property Taxes					
Depreciation					
Total F S & A Expenses					
Total S & A Expenses					
Less: Depreciation Expense					
CD for S & A Expenses					

- Prepare a cash budget

Table 12A: Cash Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Beginning Balance					
+ CR					
Total Cash Available					
Less - CD:					
DM – Hulls					
DM – Seats					
DM - Drain Plugs					
DL					
OH					
S & A Expenses					
Total Disbursements					
Excess (Deficiency)					
Borrow					
Pay Back					
Interest					
Ending Balance					

- Prepare a pro forma income statement

Table 13A: Pro Forma Income Statement	
Kyle's Kayaks Pro Forma Income Statement For the Year Ended 12/31/Y1	
Sales	
Less: COGS	
Gross Profit	
Less: Selling and Administrative Expenses	
Net Operating Income	
Less: Interest Expense	
Net Income	
RE, Beginning Balance	
Plus: Net Income	
Less: Dividends	
RE, Ending Balance	

- Prepare a pro forma balance sheet

Table 14A: Pro Forma Balance Sheet	
Kyle's Kayaks Pro Forma Balance Sheet As of 12/31/Y1	
Cash	
Accounts Receivable	
Inventory - RM	
Inventory - FG	
Property, Plant, and Equipment	
Less: Accumulated Depreciation	
Total Assets	
Accounts Payable	
Hulls	
Seats	
Drain Plugs	
Total Liabilities	
Retained Earnings	
Total Liabilities and Stockholders Equity	

ANSWERS TO QUESTIONS

- Prepare a sales budget

Table 1A: Sales Budget							
	Q3-Y0	Q4-Y0	Q1	Q2	Q3	Q4	Total – Y1
Budgeted Sales in Units	1,500	800	500	3,000	2,000	1,000	6,500
x Selling Price	x $800	x $800	x $800	x $800	x $800	x $800	x $800
= Budgeted Sales in Dollars	$1,200,000	$640,000	$400,000	$2,400,000	$1,600,000	$800,000	$5,200,000

- Prepare a schedule of expected cash collections

Table 2A: Schedule of Expected Cash Collections								
Accounts Receivable, beginning balance	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Collections Y1	Q1-Y2	Q1-Y2	AR Total at YE
Accounts Receivable Q3-Y0	$120,000				$120,000			
Accounts Receivable Q4-Y0	448,000	$64,000			512,000			
First Quarter Sales	80,000	280,000	$40,000		400,000			
Second Quarter Sales		480,000	1,680,000	$240,000	2,400,000			
Third Quarter Sales			320,000	1,120,000	1,440,000	$160,000		$160,000
Fourth Quarter Sales				160,000	160,000	560,000	$80,000	640,000
Total	$648,000	$824,000	$2,040,000	$1,520,000	$5,032,000	$720,000	$80,000	$800,000

- Prepare a production budget

Table 3A: Production Budget									
	Q3-Y0	Q4-Y0	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total for Y1	Q1-Y2	Q2-Y2
Budgeted Sales in Units	1,500	800	500	3,000	2,000	1,000	6,500	600	2,500
+Desired EI of FG	120	75	450	300	150	90	90	375	-
= Total Needs	1,620	875	950	3,300	2,150	1,090	6,590	975	
-BI of FG	0	(120)	(75)	(450)	(300)	(150)	(75)	(90)	
=Required Production	1,620	755	875	2,850	1,850	940	6,515	885	

- Prepare a direct materials budget

Table 4A: Direct Materials Budget								
	Q3-Y0	Q4-Y0	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total for Y1	Q1-Y2
Required Production (kayaks)	1,620	755	875	2,850	1,850	940	6,515	885
x Raw materials needed per kayak (hulls, seats, drain plugs))	1	1	1	1	1	1	1	1
=Production needs	1,620	755	875	2,850	1,850	940	6,515	885
+Desired EI of RM	76	88	285	185	94	89	89	-
= Total Needs	1,696	843	1,160	3,035	1,944	1,029	6,604	
-BI of RM		(76)	(88)	(285)	(185)	(94)	(88)	
DM to be purchased		767	1,072	2,750	1,759	935	6,516	
Cost of hull		$225	$225	$225	$225	$225	$225	
Cost of hulls to be purchased		$172,575	$241,200	$618,750	$395,775	$210,375	$1,466,100	
Cost of seat		$73	$73	$73	$73	$73	$73	
Cost of seats to be purchased		$55,991	$78,256	$200,750	$128,407	$68,255	$475,668	
Cost of drain plug		$2	$2	$2	$2	$2	$2	
Cost of drain plugs to be purchased		$1,534	$2,144	$5,500	$3,518	$1,870	$13,032	

- Prepare a schedule of expected cash disbursements for hulls

Table 5A: Schedule of Expected Cash Disbursement for Hulls							
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Hulls for Year	Q1-Y2	AP on hull at YE
Accounts Payable, beginning balance	$129,431				$129,431		
First quarter hull purchases	60,300	$180,900			241,200		
Second quarter hull purchases		154,688	$464,062		618,750		
Third quarter hull purchases			98,944	$296,831	395,775		
Fourth quarter hull purchases				52,594	52,594	$157,781	$157,781
Total	$189,731	$335,588	$563,006	$349,425	$1,437,750	$157,781	$157,781

- Prepare a schedule of expected cash disbursements for seats
-

Table 6A: Schedule of Expected Cash Disbursements for Seats							
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Seats for Year	Q1-Y2	AP on seats at YE
Accounts Payable, beginning balance	$27,996				$27,996		
First quarter seat purchases	39,128	$39,128			78,256		
Second quarter seat purchases		100,375	$100,375		200,750		
Third quarter seat purchases			64,204	$64,203	128,407		
Fourth quarter seat purchases				34,128	34,128	$34,127	$34,127
Total	$67,124	$139,503	$164,579	$98,331	$469,537	$34,127	$34,127

- Prepare a schedule of expected cash disbursements for drain plugs

Table 7A: Schedule of Expected Cash Disbursements for Drain Plugs						
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total Cash Payment on Drain Plugs for Year	AP on drain plugs at YE
Accounts Payable, beginning balance	$0				$0	
First quarter drain plug purchases	2,144				2,144	
Second quarter drain plug purchases		$5,500			5,500	
Third quarter drain plug purchases			$3,518		3,518	
Fourth quarter drain plug purchases				$1,870	1,870	
	$2,144	$5,500	$3,518	$1,870	$13,032	$0

- Prepare a direct labor budget

Table 8A: Direct Labor Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Required production in units	875	2,850	1,850	940	6,515
DLH required per unit	x2	x2	x2	x2	x2
Total DLH needed	1,750	5,700	3,700	1,880	13,030
DL cost per hour	x $10	x $ 10	x $ 10	x $10	x $10
Total DL cost	$17,500	$57,000	$37,000	$18,800	$130,300

- Prepare a manufacturing overhead budget

Table 9A: Manufacturing Overhead Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Budgeted DLH	1,750	5,700	3,700	1,880	13,030
Variable manufacturing overhead rate	$4	$4	$4	$4	$4
Total variable manufacturing overhead	$7,000	$22,800	$14,800	$7,520	$52,120
Fixed manufacturing overhead	50,000	50,000	50,000	50,000	200,000
Total manufacturing overhead	$57,000	$72,800	$64,800	$57,520	$252,120
Less depreciation included in fixed manufacturing overhead	(15,000)	(15,000)	(15,000)	(15,000)	(60,000)
Cash disbursements for manufacturing overhead	$42,000	$57,800	$49,800	$42,520	$192,120

- Prepare an ending finished goods inventory budget

Table 10A: Ending Finished Goods Inventory Budget			
Item	Qty	Cost	Total
Production cost per kayak			
Direct Materials:			
1 hull	1	$225	$225
1 seat	1	73	73
1 drain plug	1	2	2
Direct Labor	2	10	20
Variable Overhead	2	4	8
Fixed Overhead ($200,000 / 6,515)			$30.698
Unit product cost			$358.698
Budgeted finished goods inventory:			
Ending finished goods inventory	90	$358.698	$32,283
Budgeted beginning finished goods inventory:			
Beginning finished goods inventory	75	$358.698	$26,902

- Prepare a Selling and Administrative Budget

Table 11A: Selling and Administrative Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Budgeted Sales in Units	500	3,000	2,000	1,000	6,500
Variable S&A Expense per unit	$150	$150	$150	$150	$150
V S & A Expense	$75,000	$450,000	$300,000	$150,000	$975,000
Fixed S & A Expenses:					
Advertising	$5,000	$5,000	$5,000	$5,000	$20,000
Executive Salaries	250,000	250,000	250,000	250,000	1,000,000
Insurance	8,000	8,000	8,000	8,000	32,000
Property Taxes	7,000	7,000	7,000	7,000	28,000
Depreciation	5,000	5,000	5,000	5,000	20,000
Total F S & A Expenses	$275,000	$275,000	$275,000	$275,000	$1,100,000
Total S & A Expenses	$350,000	$725,000	$575,000	$425,000	$2,075,000
Less: Depreciation Expense	(5,000)	(5,000)	(5,000)	(5,000)	(20,000)
CD for S & A Expenses	$345,000	$720,000	$570,000	$420,000	$2,055,000

- Prepare a cash budget

Table 12A: Cash Budget					
	Q1-Y1	Q2-Y1	Q3-Y1	Q4-Y1	Total
Beginning Balance	$10,000	$10,000	$10,000	$142,147	$10,000
+ CR	648,000	824,000	2,040,000	1,520,000	5,032,000
Total Cash Available	$658,000	$834,000	$2,050,000	$1,662,147	$5,042,000
Less - CD:					
DM – Hulls	(189,731)	(335,588)	(563,006)	(349,425)	(1,437,750)
DM – Seats	(67,124)	(139,503)	(164,579)	(98,331)	(469,537)
DM - Drain Plugs	(2,144)	(5,500)	(3,518)	(1,870)	(13,032)
DL	(17,500)	(57,000)	(37,000)	(18,800)	(130,300)
OH	(42,000)	(57,800)	(49,800)	(42,520)	(192,120)
S & A Expenses	(345,000)	(720,000)	(570,000)	(420,000)	(2,055,000)
Total Disbursements	$(663,499)	$(1,315,391)	$(1,387,903)	$(930,946)	$(4,297,739)
Excess (Deficiency)	$(5,499)	$(481,391)	$662,097	$731,201	$744,261
Borrow	15,499	491,391			506,890
Pay Back			(506,890)		(506,890)
Interest: $15,499 * .10 * 6/12			(775)		(775)
$491,391 * .10 * 3/12			(12,285)		(12,285)
Ending Balance	$10,000	$10,000	$142,147	$731,201	$731,201

- Prepare a pro forma income statement

Table 13A: Pro Forma Income Statement	
Kyle's Kayaks Pro Forma Income Statement For the Year Ended 12/31/Y1	
Sales	$5,200,000
Less: COGS	(2,331,537)
Gross Profit	$2,868,463
Less: Selling and Administrative Expenses	(2,075,000)
Net Operating Income	$793,463
Less: Interest Expense	(13,060)
Net Income	$780,403
RE, Beginning Balance	$697,875
Plus: Net Income	780,403
Less: Dividends	0
RE, Ending Balance	$1,478,278

- Prepare a pro forma balance sheet

Table 14A: Pro Forma Balance Sheet	
Kyle's Kayaks Pro Forma Balance Sheet As of 12/31/Y1	
Cash	$731,201
Accounts Receivable	800,000
Inventory - RM ($300 x 89)	26,700
Inventory - FG	32,283
Property, Plant, and Equipment	200,000
Less: Accumulated Depreciation	(120,000)
Total Assets	$1,670,184
Accounts Payable	
Hulls	$157,781
Seats	34,127
Drain Plugs	0
Total Liabilities	$191,908
Retained Earnings	1,478,278
Total Liabilities and Stockholders Equity	*$1,670,186
*Note: Balance Sheet is off by $2 because of rounding	

QUESTIONS

For Levels Three, Four, and Five

Because students at levels three, four, and five should already have completed a managerial accounting course and now are likely enrolled in a cost accounting or graduate level managerial accounting or budgeting course, they should be at least somewhat familiar with the items that are included within each type of budget and the interrelatedness between the various statements. As a result, you may choose to ask them to complete the budgets using the information given but without providing a template for them to use. While students may choose to set up their budgets differently than we have demonstrated in our solutions, the main elements in each of the budgets should be the same as well as the final answers. For an even greater challenge for more advanced students and accounting majors, you may consider removing the titles for each of the budgets in the case narrative or possibly even mixing up the order of the data given requiring students to differentiate what information is relevant to each budget.

Higher level courses are also designed to teach students critical thinking skills in addition to pure mathematical calculations completed at an introductory level. In regard to budgets, cost and price analysis as well as ethical considerations may be required of students. Such questions are designed to mimic situations that they may face in the real-world and encourage them to think abstractly. In addition to the basic calculation questions we provided for students at level two, we have also included some such critical thinking questions for students at those higher levels.

Basic Questions

1. Prepare a sales budget
2. Prepare a schedule of expected cash collections
3. Prepare a production budget
4. Prepare a direct materials budget (If necessary, round up to the nearest whole number.)
5. Prepare a schedule of expected cash disbursements for hulls (If necessary, round to the nearest whole dollar. If decimal is 0.5 round the first month down to the nearest whole dollar and the second month up to the nearest whole dollar.)
6. Prepare a schedule of expected cash disbursements for seats (If necessary, round to the nearest whole dollar. If decimal is 0.5, round the first month down to the nearest whole dollar and the second month up to the nearest whole dollar.)
7. Prepare a schedule of expected cash disbursements for drain plugs
8. Prepare a direct labor budget
9. Prepare a manufacturing overhead budget
10. Prepare an ending finished goods inventory budget (For fixed manufacturing overhead, round to three decimal places and use in subsequent related intermediate calculations;

you should round ending and beginning finished goods inventory to nearest whole dollar after using the three decimal place unit product cost to calculate those figures).

11. Prepare a selling and administrative budget
12. Prepare a cash budget
13. Prepare a pro forma income statement
14. Prepare a pro forma balance sheet

See the answers shown above for level two questions.

Critical Thinking Questions

15. **What, if any ethical considerations, must be made in the preparation of a budget? Why should upper level management be hesitant of numbers that are provided and what can they do to prevent making decisions based on inaccurate information?**

Some organizations may offer bonuses to their accountants or financial officers for budgets that display positive outlooks for the companies. Therefore, those individuals who are in charge of preparing the budget may have an incentive to manipulate the numbers to make the organization appear to be in stable or even excellent financial health not only currently but especially in the future. When the overall budget is falsely prepared to appear sound, it is likely that the budget preparer is looking out for his or her current financial well-being without considering the implications that the misrepresentations may have on his or her own as well as the organization's future condition. When only a portion of the budget is falsely prepared, it may be that the preparer is working in collusion with another member or members of the organization who may be in different departments. Those individuals may have provided the preparer with some type of incentive to hide their future poor operating results in hopes of being able to turn them around in the upcoming months without receiving immediate reprimand from upper management. When faced with such unethical opportunities, those in charge of preparing a company's budget must consider those stakeholders who may be affected by such false statements and make their decisions accordingly.

Upper level management should be hesitant of making decisions based on prepared budgets because of the unethical actions that the preparer may take to make the organization appear more financially sound than it really is. The longer that poor performance continues without upper management being aware of the situation, the more difficult it may be to correct the issue and direct the company back toward a positive financial direction. Aside from ethical considerations, management should also be wary of completely relying on budgets especially those prepared and updated only once a year because the numbers contained within such budgets are simply estimates. If the preparer has accurately done his or her job hopefully such estimates are based on reliable data.

However, even those preparers who conduct significant historical research and consult with all pertinent members of the organization, are liable to create budgets that accurately reflect current conditions but not future conditions especially when the economy is unstable and costs and consumer confidence are heavily fluctuating.

In order to better avoid making decisions based on inaccurate information, management can follow a number of procedures. First, upper management may offer bonuses to financial officers and budget preparers not only on the positive outlook represented by the budgets but also on how accurate they turn out to be. In such cases, expected and actual results would need to be compared and bonuses only be offered once a substantial time period had passed. Second, upper management should be well-versed in financial matters and not simply rely on the accountant or financial manager to prepare the budgets. When upper management has at least basic financial knowledge, it is more likely that discrepancies and poor estimates can be identified early. Third, upper management should review historical data especially budgets and actual operating results from the past few years with the budget preparer so that it can be determined if the current budget makes sense in light of past performance. Finally, upper management should request that budgets be periodically updated so that changes can be made during the current operating period rather than for the next operating period.

16. What are the pros and cons of budget preparation and what time frame should be covered by an organization in the preparation of its budget?

Budget preparation has a number of pros and cons. Positive organizational incentives for creating a budget include but are not limited to controlling costs across the organization, allocating funds to specific departments based on expected available money during the period, providing a framework to evaluate actual performance against expected performance, encouraging departments to work together to achieve common organizational goals, determining strategy for the period (e.g. whether any funds may be available for increased expansion whether that be into new markets or simply increasing physical capacity), and motivating employees to strive for excellent performance. Negative effects and outcomes of budget preparation include but are not limited to being a very time consuming process, requiring all departmental managers to work together which may not prove to be a very constructive use of time as a result of finger pointing and an unwillingness to work together, management requiring the organization to strictly adhere to the budget simply for the sake of adhering to the budget even though it may not be in the company's best interests, and departments choosing not to notify upper management of problems or opportunities because such conditions do not fall within the scope of the budget.

The time frame selected for a budget should be chosen based upon the goals of the organization and how upper level management expects to use the statements. For example, if the company is in the process of deciding whether or not it should expand within the next five years, a five-year outlook might be prepared to determine if and when such expansion should commence. However, normally annual budgets are prepared along with possibly quarterly or monthly reports that enable periodic updates to the annual report.

17. How can management obtain a better understanding of costs and where cost cutting may be desirable? Should lower cost raw materials and labor always be used?

Without any additional work, management can obtain a better idea of the nature of costs and where cost cutting may be beneficial by reviewing and analyzing the expense trends for each category of costs over the past three to five years while keeping in mind changes in the economy such as inflation. Where large increases are found without any logical reasoning for such increases, additional research may be necessary to see if higher costs are being paid needlessly. However, a better option for management is to consider activity based budgeting. Such an option may be particularly useful if the manufacturing process involves a number of steps or activities. By completing more in-depth and detailed budgeting, activities that contribute little to no value to the final product may be identified and measures to reduce the costs of such activities may be undertaken or the organization may be in a position to completely eliminate those activities. By engaging in such actions, costs likely can be reduced and prices charged to customers may be either kept stable or decreased which may result in a larger sales volume and more discretionary money.

No, lower cost raw materials and lower cost labor should not always be used. Lower cost raw materials may be of significantly inferior quality than those which are more expensive. Additionally, individuals who are willing to work for less may lack the knowledge and experience that those individuals who must be paid more possess. The reduction in the quality of the final product that results from the use of lower cost materials and labor must be compared to the level of cost reductions that are possible through the use of such lower cost inputs. If the quality is significantly reduced, fewer consumers may be willing to purchase the product and the company may ruin its reputation. If sales are not significantly impacted, however, the lower cost inputs may be an available option for the organization at least in some of its markets.

18. If, after preparing the budget especially the cash budget, the organization determines that it is continually facing cash shortfalls each quarter, month, etc., what attempts may be made to correct that issue? Should any other considerations be taken into account before making a final decision?

If, after preparing the budget, the organization realizes that it is continually facing cash shortfalls quarter after quarter or month after month, a number of options may be available to correct the issue. First, the organization may begin to identify unnecessary costs or items that are being obtained in larger magnitudes than necessary. For example, advertising may be an essential expense to promote the product and encourage sales. However, advertising in the local paper only once a week rather than every day or every other day may result in similar sales for a lower cost. Second, the organizational policy for paying and receiving payments on account may be altered. By extending the accounts payable cycle and decreasing the accounts receivable cycle, more cash should be on hand to pay the other day-to-day or periodic cash expenses that may arise. Third, the organization may choose to keep less finished goods and raw materials inventory on hand at the end of any given period. By reducing such inventory, the related storage and insurance expenses may be reduced but, more importantly, fewer manufacturing costs may be incurred and be required to be paid out in a period. Finally, the organization may select to borrow additional money so that it appears to be more financially solvent and has more liquid funds on hand.

All of these options require significant additional consideration before any final decision is made. First, in the case of cost reductions, it must be ensured that sales will not fall substantially as a result of such cost cuts. Second, in the case of extending the time in which accounts payable are settled, suppliers may find that such new pay policies do not align with their financial objectives, and high-quality and reliable suppliers may be lost because they are unwilling to wait for their money. In terms of reducing the time in which accounts receivable must be settled, purchasers may be unwilling to use their available funds to immediately pay for their purchases rather than using those funds in more desirable ways and they may choose to take their business elsewhere resulting in lower sales. Third, in the case of reducing ending inventory on hand, the actual costs of keeping inventory on hand must be analyzed and if they are not significant then reducing the amount on hand will have little effect on liquidity. Additional considerations revolve around obsolescence and how quickly the organization must be ready to supply finished goods to unexpected customers within a period as well as the optimal use of the organization’s manufacturing capacity. Finally, in regard to borrowing, interest costs, the amount of debt already outstanding, and current and future credit ratings must be considered and, if additional borrowing is found to be undesirable, alternative options should be selected.

19. **What besides cost cutting may be undertaken in order to increase net income? What additional research must be conducted in order to determine if such an option is available? What other departments besides accounting may be involved in such measures?**

. In order to increase net income, costs may be reduced or revenue may be increased. Revenue may come from a variety of sources but the two most common sources are sales and interest. Therefore, to increase net income, attempts may be made to increase sales or increase interest income. However, the former is likely to provide a greater effect.

Statistical research in the areas of economics and marketing may be necessary to determine the price sensitivity or elasticity of customers. Additionally, the price sensitivity of customers may vary based on geography or customer class. Therefore, research should be conducted to determine if it may be ideal for the company to offer different versions of the product if not already doing so. For instance, a basic product with a lower quality and a lower price may be suitable for some markets but a deluxe product with a slightly higher quality and possibly additional features may be desired by other markets that are willing to pay a higher price. Of course, the additional costs that may be required to alter or designate production lines for each of these types of products must be considered.

As alluded to above, marketing is likely the department that can best assist management with establishing proper price points for various classes of customers because marketing representatives have the greatest customer contact. However, other departments should also be involved including operations to determine if certain changes in production or if production variations are viable or even human resource management to determine what psychological effects such changes may have on current employees and if new employees will need to be hired to meet future organizational needs. Thus, as can be determined, budgeting truly is an organization-wide proce

MARKETING TO MUSLIMS: THE GROWING IMPORTANCE OF HALAL PRODUCTS

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approach

This case discusses the special characteristics of a potential new market that caters to the unmet needs of Muslims in the U.S. and Europe. The case focuses on the unique needs of people who desire to eat food which is prepared and served according to the tenets of Islam. It suggests that these needs are not fully met in the U.S. Part of the case examines the special way in which meat is prepared for observant Muslims. Details about the size and growth of the Muslim population in the U.S. and Europe are discussed. The case is diverse enough to be of value to courses in international business, marketing, and multicultural studies.

Teaching Objectives and Target Audience

This case has several objectives, including introducing readers to a unique cultural market segment. It raises the possibility of catering to a new or expanded market segment in the U.S. and in Europe. It discusses the complexities of this market including variations in the manner that principles of Sharia are practiced by Muslims across countries, regions, and communities. In addition, the case seeks to have readers think critically about the future of international business and how different cultural values may change global strategies.

The case is written primarily for an undergraduate audience; however, the case could have usefulness in some graduate courses as well. This case is perhaps most useful in courses covering international management, international business, international marketing, and global culture. While the primary target audience for the case is students in an introductory course in international business, it would be a good supplement to courses that touch upon multiculturalism and management in the hospitality and restaurant industries.

Teaching Approach and Strategy

This case can be used in a variety of ways. The case is appropriate for general class discussion, group project assignments, or as individual homework. While a number of approaches are appropriate for the case, it is probably most useful when students have the opportunity to discuss their analysis in an open forum. The case addresses questions which are best explored through interaction and differing viewpoints. A discussion of whether a company serving the Muslim consumer might alienate its existing domestic consumers, for example, can lead to a rich exchange of ideas. Another discussion that might result in a beneficial idea exchange might explore whether Western multinational companies are likely to experience a political backlash if they are perceived as exploiting the Muslim consumer. While the authors have provided discussion questions they feel are most important to the case, users should feel free to add any additional questions they may feel are helpful to using the case in their courses. Different courses may benefit from alternative questions, especially in courses which are more oriented to marketing or multiculturalism.

ANALYSIS

Possible answers to the discussion questions can be found below. While these are the recommendations of the case writers, they are not intended to be the definitive answers to questions.

1. How attractive are the American and European markets for halal products? Explain your answer.

The U.S. and European markets are attractive investment opportunities for companies seeking to serve Muslim consumers. It is especially underserved in the U.S. According to an AT Kearney report, "Muslims are the fastest growing consumer segment in the world…any company that is not considering how to serve them is missing a significant opportunity to offset its top and bottom line growth." Serving this community is not without costs and challenges. There are social and political pitfalls to consider, but overall, the benefits outweigh the risks and costs. While many consumer segments in the world are approaching a saturation point, the Muslim market is becoming a new outlet for companies to build a base for future growth.

Statistics on population, growth, and purchasing power provide a basis for the contention that the U.S. and European markets are attractive opportunities for halal products.

Population

Table 1 shown below provides Muslim population statistics for the U.S. and European countries.

Table 1: U.S. and European Countries with Significant Muslim Populations

Rank	Country	Estimated Muslim Population
1	Russia	27.0 million
2	U.S. *	10.0 million
3	France	5.5 million
4	Germany	3.0 million
5	U.K.	1.6 million
6	Bosnia and Herzegovina	1.5 million
7	Spain	1.0 million
8	Netherlands	0.9 million
9	Italy	0.8 million
10	Canada	0.4 million
11	Australia	0.4 million

* Includes both immigrants and African Americans

Source: http://news.bbc.co.uk

There is no accurate count of the number of Muslims in the U.S. because the U.S. Census Bureau does not collect data on religious affiliation. As such, there is debate on the true size of the Muslim population in the U.S. Organizations have compiled widely varying estimates from 1.3 million to 7 million. If immigrants and African Americans are included in the count, the estimate reaches 10 million, as reported in Table 1. A 2011 Pew Research Center report estimates the U.S. Muslim population at 2.3 million.

The Muslim population count for Europe, according to the Pew report is, 38.1 million.

Population Growth

The 2011 Pew Research Center report indicates that the Muslim population in the U.S. is predicted to double in 2030. It currently estimates the U.S. Muslim population to be 2.6 million (0.8% of the U.S. population), which will rise to 6.2 million by 2030 (1.7%).

The Pew report also predicts that the worldwide Muslim population will increase by 35% from 1.6 billion in 2010 to 2.2 billion by 2030, representing 26.4% of the world total. The Muslim population would be growing at almost twice the rate of the non-Muslim population.

By 2030, the U.S. is projected to have a larger Muslim population than any European country, except for Russia and France. Some European countries may have higher percentages of Muslims than the U.S. Muslims are expected to represent 8% of Europe's total population by 2030, which is at 6% in 2010. The continent's Muslim population is expected to increase to 58.2 million by 2030.

Purchasing Power

The highest purchasing power of the Muslim population is found in Saudi Arabia and Turkey. However, other countries rank fairly high in the list of countries with significant Muslim purchasing power. In descending rank order, they are Russia, France, the United States, and the Netherlands.

The Muslim halal food market is worth approximately $30 billion to the five major food retailers in the world and $15 billion to the top 10 food processing companies. Even as Muslims lean toward Western lifestyles and products, many make choices that assert their identity as Muslims and respect their Sharia principles. Many seek products with an Islamic brand and choose foods that are halal-certified.

On the basis of population size, growth, and purchasing power, we conclude that the American and European markets are attractive for halal products.

2. Should firms use a global or a multi-domestic strategy to market halal products?

In a global strategy a firm sells its product world-wide without altering the item or its packaging for sales in particular countries. The firm standardizes all its products and integrates operations world-wide in most or all functional areas. For this case a global strategy means that a product would be marketed throughout the world by using one halal certification mark. This strategy might work if and when the certification mark has very wide acceptance based on the strong prestige and reputation of the certifying body. Currently, most countries have their own certifying body, and occasionally several different bodies. Those countries are unlikely to accept an external halal certification.

In a multi-domestic strategy a firm has affiliates in multiple countries. This strategy implies that the firm uses a different strategy in each country in which it operates based on local (domestic) culture and preferences. Other terms used for multi-domestic strategy include national, domestic, and local or glocal. Given that most countries have their own certifying body for halal, a multi-domestic strategy would have a higher likelihood of success. This strategy would probably increase the cost of certification because there would be no economies of scale, but it would likely result in higher acceptance and sales.

In addition to the two strategies described above, a third alternative is a regional strategy. This would involve the acceptance of one country's halal certification of a product by any of its neighboring countries. In most cases this would not be a viable alternative.

3. What opportunities and threats do U.S. and European companies face in marketing halal products?

The halal market offers much potential for expansion into a niche market that has, for the most part, been overlooked by U.S. and European firms. According to a respected New Zealand trade organization, the halal market is now worth an estimated $2.3 trillion (USD) and will continue to grow. The market consists of numerous items, the majority of which are food products. It also includes cosmetics and pharmaceuticals.

The growing size of the market, coupled with a rather weak array of competitors, makes this an attractive opportunity for established Western firms. They have first mover advantages in the product groups and established brand recognition. While perhaps not known as producing halal products, these established companies and their brands can capture a large share of the halal market by expanding into properly produced products that meet Islamic standards. In addition, Western firms generally have scale economies and efficiencies that provide competitive advantages in this market.

A potential threat in marketing halal products includes a lack of trust of Western companies in some parts of the Muslim world. It should be remembered, however, that many Muslims live outside the Middle East in growing markets such as Indonesia and

Malaysia where political tensions and perceptions are not as great a problem. Another threat Western firms face is the changing and inconsistent nature of the halal certification standards. Still another is the negative public images that can spread quickly, sometimes inspired by foreign policy decisions of Western nations. False information can cause harm to companies in the halal market. Dissatisfied clerics and others have the potential to cause great harm to Western brands by spreading negative information quickly in an increasingly interconnected information world. After having established the infrastructure to produce halal products, Western companies will have to maintain the trust of Islamic consumers and counter any negative information that may surface. A final threat relates to the emergence of new competitors. While many Western brands have established advantages in general product categories, companies in other countries such as Malaysia and the Philippines are working quickly to establish their brands in the halal market. Smaller competitors can gain a strategic advantage by being closer to the market and having a greater perceived legitimacy.

It is important that Western firms closely identify with leading certifying bodies in the local market, work closely with marketing experts familiar with halal products, and maintain a good public presence in those markets if they wish to be part of this growing market opportunity.

MYTH OR REALITY: THE DYNAMICS OF THE CONTEMPORARY LEARNING ORGANIZATIONS

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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.

INSTRUCTORS' NOTES

Research Methodology

This case is based on the personal account of the secondary author's professional experience as a business editor at ABC Systems, New Delhi. It has been developed using her experiences and problems faced by her at ABC Systems.

Teaching Objectives

This case is useful in deconstructing the democratic and perfect organizational design known as the learning organization. It is appropriate to demonstrate how it can be possible to implement a subtle and hegemonic form of control system within learning organizations. It is able to portray how power can be exercised through the social technique of corporate culture laying emphasis on practices of "family and team" and "their role in corporate discipline, integration and control" (Casey, 1999: 155).

Recommended Teaching Methods

The following is a sample of teaching plan for a 50 minute session:

Discussion of case and discussion questions	7 days before class
Discussion of power and politics issues	15 minutes
Review of possible answers for the case study	20 minutes
Summarize and discuss the answers	10 minutes
Wrap up and comments	5 minutes

Suggested Readings Related To Case

Akella, D. (2003). *Unlearning the Fifth Discipline: Power, Politics and Control.* New Delhi: Sage Publications.

Akella, D. (2007). Learning Organizations: Managerial Control Systems? *Global Business Review*, 8 (1), 13-28.

Akella, D. (2008). Discipline and Negotiation: Power in Learning Organizations. *Global Business Review*, 9 (2), 219-241.

Casey, C. (1999). Come Join our Family: Discipline and Integration in Corporate Organizational Culture. *Human Relations*, 52 (2), 155-76.

Driver, M. (2002). The Learning Organization: Foucauldian Gloom or Utopian Sunshine? *Human Relations*, 55 (1), 33-53.

Snell, R. and Chak, A., M. (1998). The Learning Organization: Learning and Empowerment for Whom? *Management Learning*, 29 (3), 337-64.

Willmott, H., C. (1993). Strength is Ignorance: Slavery is Freedom: Managing Culture in Modern Organizations. *Journal of Management Studies,* 30 (4), 513-52.

DISCUSSION QUESTIONS

1. What features of Learning Organization can be found in ABC systems?

ABC Systems is a knowledge management multinational concern with headquarters in Nebraska, and branches in Canada, Europe, Japan, and India. The company is involved in business and technical writing, public relations, and website development. Its clientele include financial, pharmaceutical, fashion, agricultural, food processing, and manufacturing companies. The company employs journalists, public relations, advertising, digital media, and information technology specialists.

The company declares itself as a learning organization with a flexible, lean structure characterized by open ended communication channels. The company is designed on the format of teams with no specific hierarchical levels. In fact designations exist within the company only for logistical purposes. The entire company is divided into teams. Each team is led by a team leader. Furthermore the team leader's position is rotational thereby allowing everyone a chance to become the team leader.

The company encourages the development of an organization culture of "*democracy and equality*" where *"all employees had equal voice"*. Employees are given the autonomy to approach their superiors and "*talk openly*" on various issues and concerns. Employees are given the opportunity to criticize and disagree with managerial policies and decisions. The management endeavors to create a free and healthy working environment within the organization. The office bulletin board is adopted as a medium of official communication.

The entire ABC Systems team is relatively young i.e., ranging in ages from 25-35. The workforce is also diverse with all editors belonging to different academic backgrounds. For instance some are majors in economics, others had previously worked in banks, and others had held marketing positions in event management companies.

Moreover, the company invests in continuous training and development programs. All new editors are given orientation training. The editors are informed about the organization's policy guides, mission and vision, organizational goals, and the grading system. The performance grading system is completely merit based. Each business editor had to log in everyday and receive his/her assignments for the day. The editors then had to research on a particular company and write a brief about it. All editors, at the end of the day had to return their briefs to the senior editor for grading and editing. Next day, all briefs were returned to their authors 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 25-35 edits. All editors had to write a minimum of 12 briefs daily, and a lesser number meant earning a D grade. A "D" grade was poor performance and discouraged by the management. Apart from orientation training, employees also have to participate in intense brainstorming, discussion, and writing and editing workshops during their first week to get acclimatized to the culture and expectations of the organization.

To summarize, ABC systems at the external level, possesses, all the features of a learning organization: a learning culture, merit based rewards, participative and open decision making, and communication channels and lean, team based structures.

2. How was ABC's management exerting control over its employees?

According to Fox (1973, 1974), there are three frames of reference, within which the concept of an organization can be understood. To fully investigate the system of power and authority i.e., "*how different personal and group strategies are pursued*" the radical ideology is the most appropriate. The radical ideology describes organizations as social institutions where the property less are exploited at the hands of the propertied (Fox, 1974). Management sustains its power over the workers through various socialization, communication channels, and attitude formation programs. It liberally uses metaphors such as team and family to persuade employees to accept its policies and guidelines as legitimate. An impression is created by the management that the entire organization is one big happy family with no conflicts.

Lukes (1974) supports this argument by explaining a theoretical framework by which management can effectively enforce such structures of power mechanisms. Lukes analyzes "A may exercise power over B by getting him [sic] to do what he does not want to do but he also exercises power over him [sic] by influencing, shaping or determining his very wants. Indeed, is it not the supreme exercise of power to get another or others to have the desires you want them to have---that is to secure their compliance by controlling their thoughts and desires?" (Lukes, 1974: 23).

The supreme exercise of power is a process whereby the cognition, perceptions, and preferences of individuals could be shaped to promote the interests of one group over the others (Lukes, 1974). This is similar to the concept of hegemony where the beliefs and values of the dominating group are enforced, but with the active consent of the whole organization (Clegg, 1989).

Foucault (1977) uses the panopticon, examination process, and confession processes to explain how such power could be enforced insidiously within companies. The panopticon, confession, and examination techniques appear in the form of job analysis, performance appraisals, mentoring, meetings, bulletin boards, time sheets, and corporate family culture within contemporary organizations.

Learning Organizations: Hegemonic Control Systems

All the features of learning organization can be reconceptualized as insidious and subtle power nodes if the model of learning organization is screened within the theoretical framework of radical power.

For instance, corporate culture is the last frontier of control, where control is exerted over the individual's thoughts, feelings and emotions which guide his/her actions. While a softer collaborative style of management beguiles an employee into a "culture of willingness…" (Champy, 1995: 44), under the pretence of teaching, developing, facilitating, coordinating and helping them. Team based, flat, lean structures expand the horizon of control exerted. The locus of control shifts from the management to the workers. Control is now exerted by the entire team instead of one superior. Workers themselves create core values, rules and regulations within the guidelines of company's mission and vision statement which everyone had to follow. This is illustrated by a comment by a technical worker in Barker's research:

"I don't have to sit there and look for the boss to be around and if the boss is not around I can sit there and talk to my neighbor or do what I want. Now the whole team is around me and the whole team is observing what I am doing" (Barker, 1993: 408).
In other words, teams implement a more complete surveillance mechanism where there is that vigilance throughout office hours.

Similarly in ABC Systems, the management follows a concept of team based working with the leader positions being rotational. All employees are manipulated to be initiative and motivated under the belief of having equal opportunity to succeed to a managerial position if they performed. The management also hired younger and diverse workforce to encourage creativity and variety in its literary output. Moreover, a "younger" workforce is deemed to be flexible and eager to succeed, and establish themselves in their careers.

Finally, open and democratic communication is advertised through the technique of a dummy bulletin board. Extensive orientation, discussion, and training programs are used to indoctrinate the employees to the culture and environment of the organization.

3. Why was Anu fired?

Anu failed to realize the subtle concertive form of control being exercised by the management. She saw the bulletin board as a method to interact and engage in healthy dialogue with the management. Under her initiation, employees began to use the bulletin board to air their criticisms and suggestions. This was not the objective of management. Instead the management wanted to use it a mechanism to communicate about its practices and policies to reduce any future forms of resistances.

4. What options does Anu have now?

Anu Singh has limited options. Foremost, she has a viable case against the organization. ABC Systems did not follow the correct protocol in terminating her employment. She was not served any verbal, written warning about her behavior. The top management also did not draw her into a discussion about her behavior, attitude, and actions. She was not given an opportunity to mold herself into the organizational culture and recognize managerial objectives. In addition, she was neither suspended to review her own behavior and make changes accordingly. She was fired without notice.

5. 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?

The management i.e. the Managing Director and the Finance Manager did not handle the situation well. There is a proper system and format for dealing with such situations. The management should have issued a verbal warning to Anu. This would have acquainted her with the reason for management action. It would have warned her and cautioned her to rectify her code of conduct.

In case Anu had not heeded to the warning, management should have issued a written warning. This would have further urged Anu to stop her disruptive bulletin board activity. If this also had failed, management should have suspended Anu for a week or a longer duration, without pay. This would have forced Anu to reflect on the criticality of situation and if she was interested in future career prospects with ABC Systems to reform her behavior to “fit the culture” of ABC.

Firing Anu without giving her the opportunity to realize her mistake was wrong. It also goes against the image of family culture, where older members have the responsibility to punish and discipline the younger members.

6. Do you think this situation would have occurred at the US location of ABC Systems instead of the branch office in India?

According to Hofstede (2001), the entire world can be divided on the basis of five cultural dimensions:

<u>Power distance:</u> status and authority differences between a superior and a subordinate.
<u>Individualism versus collectivism:</u> the extent to which individuals define themselves as entities rather than as members of groups.
<u>Masculinity versus femininity:</u> the extent to which individuals support assertiveness and competition in comparison to quality of life and relationship oriented values in society.

Uncertainty avoidance: do individuals prefer structured and clearly defined environment or an unstructured and ambigious working environment.
Long Term orientation: are long term values such as thrift and persistence emphasized or short term values such as fulfilling social obligations.

According to the conceptual framework of Hofstede (2001) United States would be described as being high on individualism, moderate on masculinity vs. femininity and on long term orientation, and low on power distance and uncertainty avoidance. While, India would be low on individualism, uncertainty avoidance, and high on femininity, power distance and long term orientation.

In other words, if Anu had been working in USA, the probability of this incident occurring would have been less. Her actions of critically assessing the situation and demanding appropriate corrective measures would have been appreciated. While in India, where the superior is considered the ultimate authority and team success is more important than individuality and emphasis is laid on clear ranks, rules and structures within organizations. Anu's behavior seemed to be unreasonable and defiant.

EXHIBITS

FEATURES OF LEARNING ORGANIZATIONS

The basic characteristics of a learning organization lie in its emphasis on a continuous learning strategy and culture, flexible rewards and structures, participative decision making, and open communication. Yet it is possible to argue that all characteristics of a learning organization are a control mechanism adopted by the organization to develop its human resources as sustainable competitive advantages (Akella, 2007). Management in learning organizations is able to cope with continuous environmental changes by improving its quality and productivity. Management is able to attune to the needs of customers by developing an environment appropriate for generation of creativity and learning amongst its employees. To develop such an environment or culture it is essential to implement certain communication networks and structures, and reward and performance appraisal systems, and follow a specific style of management (Argyris, 1992; McGill et al., 1994; Mills and Friesen, 1992; Senge, 1990).

Organizational Culture and Learning Organizations

Culture can be defined as "a set of rules that guide the relationship between the company and its people" (Kunda, 1992, p. 7). Culture specifies the articulated rules to inculcate required thoughts and feelings, "mindsets and gut reactions" to ensure employees' dedication towards the company and identification with company goals (Kunda, 1992, p. 10). Culture can be viewed as shared meanings, values, norms, and assumptions that govern the workplace and are essential for all members to acquire to become accepted members of the organization. Management encourages the employees to become absolutely committed to the organization in feelings, thoughts, and emotions. "The governance of the employees' soul becomes a more central element in corporate strategies for gaining competitive advantage" (Willmott, 1993, p. 515).

Management control is now just not limited to enforcement of rules and procedures but also ascribing to how employees think and feel about what they produce as well. Corporate culture is able to incorporate the sentiments and emotions of the workers within the control system. Culture can be interpreted as the last frontier of control which ensnares "workers in a hegemonic system" (Ray, 1986, p. 289). Control in this case is elicited insidiously by controlling the experience, thoughts, feelings and emotions which guide the actions of individuals. Management exercises power not only over the individual's physical behaviors but also over his/her internal commitments and values (Etzioni, 1961).

In case of learning organizations, the main objective of corporate culture is to effectively control employees so as to generate learning within the organization.

Managerial Style within Learning Organizations

Managers in learning organizations are concerned with developing a strategic intent to learn, a commitment to continuous experimentation, and the ability to learn from past successes and failures (Garvin, 1993). Managers now perform new roles of coordinating, facilitating, coaching, supporting and nurturing their employees (Bridges 1994), supporting open and direct communication between employees and resolving intergroup conflicts (McGill, Slocum and Lei, 1994; Senge, 1990; Argyris, 1992).

Managers now enact the roles of a teacher, mentor, resource developer, guide and designer (Naisbitt, 1985; Senge, 1990). They are involved in "energizing people, large numbers of people to do new things…" (Peters, 1987, p. 418) to ensure "the efforts of others come to fruition" (Kiechel, 1991, p. 204). To effectively fulfill these new functions and responsibilities, managers make use of qualities like creativity, helpfulness, caring, sensitivity, attentiveness and a preference for open egalitarian and cooperative relationships (Fondas, 1997). There has been a change over to a softer, participative, and employee oriented style of management (Fondas, 1997).

This approach can be described as a form of employee control. The focus now is not on direct control i.e. giving orders, and suppressing employees through strength and aggression. Management seeks their cooperation by catering to their needs. The employees believe they are part of a company community, loved and cared for, and thus support and listen to management. It is a form of "culture of willingness…" (Champy, 1995, p. 44). Management controls the social, emotional, and mental abilities under the pretence of teaching, developing, facilitating, coordinating, and helping them. This can be considered as a supreme method of exercising power over employees (Akella, 2007).

Structures of Learning Organizations

The organizational structure of learning organizations is lean, flat, and streamlined. The organizational structure emphasizes teamwork to encourage entrepreneurial behavior, flexibility, and adaptability amongst the employees (Peters, 1987; Senge, 1990; Mills and Friesen, 1992). Flat, lean, and streamlined structures result in "demise of bureaucracy and hierarchy" (Kanter, 1989, p. 89). These flat organizational structures enable team collaboration, division of the entire company into self-managed teams. They also lead to the generation of fresh, novel ideas, strategies and information, reduce operating costs, and increase speed of operation (Nonaka, 1991; Takeuchi and Nonaka, 1986, Marquardt, 2002).

However, the above structures with their emphasis on teams can also be interpreted as a form of concertive control (Barker, 1993). The locus of control in this case has shifted from the management to the workers. Workers themselves create core values, rules and regulations within the guidelines of the company's mission and vision statement, which all team members have to follow. Control is now exerted by all the team members instead of one superior. Thus teams have a multi purpose – they help in the generation of learning and development of more creative employees and innovative products, and also effectively control employees' behavior.

Recruitment within Learning Organizations

Learning organizations, to increase generation of learning and knowledge creation within their working environments must opt for selective recruitment and selection of their staff. Management should select a diverse work force consisting of employees who are creative, entrepreneurial, willing to experiment, flexible, and are good team workers (Easterby-Smith, 1990; Garvin, 1993; Mills and Friesen, 1992; Schein, 1992). Management seeks to recruit employees not only on the basis of their technical and educational expertise, but also on their attitudinal and behavioral characteristics. Also individuals react differently to various work environments, motivations schemes and cultural norms and values. Employees' profiles must correspond to the culture of the organization (Owen and Schoenfeld, 1979). Management uses a variety of techniques to identify employees' behavioral and attitudinal characteristics (Storey, 1995). Personality tests, application forms, and interviews are helpful in predicting the overall profile of employees in learning organization.

Performance Appraisal Systems within Learning Organization

Performance appraisal systems have been identified as a form of managerial activity which is concerned with reviewing, monitoring and evaluating the overall performance of the employees (Townley, 1993). Management uses appraisal systems to gather information about an employee's performance on a variety of criteria ranging from professional expertise to behavioral code of conduct, on the basis of which s/he was promoted or terminated (Barlow, 1989).

Performance appraisal systems reinforce and recognize learning and its relevanceamongst employees. Appraisal systems evaluate learning acquired and distributed on an equal basis. Also, employees who collect and transfer knowledge from internal and external sources are recognized. Employees are appreciated and rewarded for risk taking, flexibility, team work, and continuous improvements. Failures and dissents are not punished. Instead failures are considered a source to improve overall experience and knowledge of the employees (Easterby-Smith, 1990; Garvin, 1993; McGill and Slocum Jr, 1993; Mills and Friesen, 1992). Failures are also seen as exerting a positive influence on the long term performance of the organization. They increase tolerance for risks, better search for information, recognition of problems, motivation to adapt, and processing of information (Ulrich, Jicks and Glinow, 1994).

Employees are also rewarded for their professional knowledge, performance quality, teamwork (Easterby-Smith, 1990; Mills and Friesen, 1992; Rothwell, 1993; McGill et al., 1994), versatility, technical competence, client acceptability (McGil and Slocum Jr., 1993), and contribution towards development of mission, ability to learn, and share in the overall value creation (Mills and Friesen, 1992; Senge, 1990).

Communication within Learning Organizations

Organizations have realized that open communication between all employees and management is central for managerial effectiveness (Isaacs, 1993; Schein, 1993). There has been a move from traditional forms of communication (i.e., discussions, dialectic and debates) towards dialogue where decisions are not taken on the basis of consensus or heated arguments to reach an agreement. Dialogue ensures open communication where there is a free exchange of thoughts and ideas, making it possible to change one's mental paradigms (Isaacs, 1993). "People gradually learn to suspend their defensive exchanges and further probe into the underlying reasons for why these exchanges exist. It is a sustained collective inquiry into the processes, assumptions and certainties that compose everyday experiences" (Isaacs, 1993, p. 25).

Dialogue encourages collective thinking and inquiry. It is the process of transforming the quality of conversation and a method of influencing the very thinking process which lies beneath it. Dialogue is helpful in breaking through the individual's mental paradigms and seeking a common path (Isaacs, 1993) which promotes collective thinking, and problem solving within teams. Dialogue is useful in communicating, sharing, and learning new information across different levels of hierarchy and cultural boundaries (Schein, 1993). It also provides a medium through which management is able to gain control over the individual employee's thinking process and paradigms (Akella, 2007).

To summarize, all features of a learning organization seem to place emphasis on the need to ensure an environment of fairness, mutual argument and trust, where employees and management cooperate to achieve organizational objectives. But in reality, learning organizations are interested in reducing employee resistance and exercising hegemonic control over the labor.

Issues of Power and Control

To understand the system of power and authority and how "within [it] different personal and group strategies are pursued" it is essential to differentiate between Fox's concepts of unitary, pluralist and radical frames of reference (Fox, 1973; 1974).

From a unitary perspective, "the structure of social relations within organizations is seen to embody rational efforts to develop the most efficient and effective means of achieving common interests and objectives" (Willmott, 1987, p. 254). The managers here are responsible for developing an organizational framework where all the objectives of the members are secured.

The pluralist perspective argues that an organization can be described as a coalition of individuals and groups possessing their own perceptions and needs (Ross, 1958; 1969). The term "coalition" would mean individuals and groups with widely varying priorities collaborating to achieve a consensus as regards to individual objectives. The role of management is to "make decisions within a set of constraints which include employees, consumers, suppliers, government, the law, the local community and sources of finance" (Fox, 1974, p. 260). Managers have the responsibility to balance the conflicting interests to promote the welfare of the enterprise (Donovan, 1968).

While the radical ideology describes organizations as social institutions where the property less are exploited at the hands of the propertied (Fox, 1974). The function of management is to "sustain the structure of power relations…" in the organization (Willmott, 1987, p. 255). Management seeks to sustain the power structure through socialization, communication channels, and attitude formation programs. In fact the main feature of these various methods is to condition the beliefs and values of the employees with those of the organization under the assumption that "many of the social arrangements under which they live and suppose them to are the only possible ones given the "nature of things"--- a notion which usually includes belief in an unchangeable human nature" (Fox, 1974, p. 284).

Management tries to maintain a "picture of work situation as characterized by harmony and trust" (Fox, 1974, p. 249). Management tries to create: "a family spirit in the works…to try to have one side in industry and not two…our view is that to get two sides in industry, what you might term the masters on the one side and the men on the other, to get them up like two armies is really a mistake" (Forrester, 1952, para. 70, cited in Fox, 1974).

Management makes liberal use of the metaphors such as team and family to coerce employees into accepting management objectives as legitimate. So the unitary perspective ends up as a further continuation of "master-servant conceptions" which has its origins in the historical framework of society i.e., "in the constantly asserted and enforced right of the master to demand unquestioning obedience from his [sic] servants" (Forrester, 1952, para 70, cited in Fox, 1974).

Management thus, tries to develop a unitary framework to mobilize employees consent to policies pertaining to its own interests. Management is interested in creating the impression that all is well, there is no conflict and the organization is one big family.

Framework of Power

Theoretically, Lukes (1974) discusses how latent and unobservable behavioral actions can be incorporated into power analysis. He argues that it is necessary to study: "the less visible dimensions of power, operating through collective forces and social arrangements to suppress potential issues and avert conflict by helping to shape men's [sic] beliefs and preferences and acting against their real interests" (Lukes, 1974, p. 10).

Lukes (1974) explores this concept of radical power where management can control the thoughts, feelings, and emotions of the employees. He puts forward his analysis:

> *"A may exercise power over B by getting him [sic] to do what he does not want to do but he also exercises power over him [sic] by influencing, shaping or determining his very wants. Indeed, is it not the supreme exercise of power to get another or others to have the desires you want them to have – that is to secure their compliance by controlling their thoughts and desires?"* (Lukes, 1974, p. 23).

The supreme exercise of power would be a process whereby the cognition, perceptions, and preferences of individuals could be shaped to promote the interests of one group over the others (Lukes, 1974). This is similar to Gramsci's concept of hegemony (Gramsci, 1971). Hegemony involves the enforcement of the beliefs and values of the dominating group but with the active consent of the whole organization (Clegg, 1989). Such a form of power is exercised "through the control of information through the mass media and through the process of socialization" (Dahl, 1961, p. 164). But Lukes (1974) fails to discuss the methods though which insidious power can be exercised over the individuals. Foucault's disciplinary analysis examines power and its sources (Foucault, 1977).

Foucault (1977) uses the panopticon model, examination process, and confession processes to explain how power can be enforced insidiously within companies. Foucault (1977) drawing upon the work of Bentham (1791) developed the eighteen century model of prison as a modern surveillance technique. The panopticon was basically a twelve sided polygon with a central tower through which it was possible for the superintendent to observe the behavior of prisoners. The panopticon model "draws attention to the use of techniques of surveillance which render visible or potentially visible, the most minute details of individuals' behavior" (Grey, 1994, p. 479). While the examination systems originally found in schools and hospitals was used to measure knowledge in quantitative values, and categorize individuals in terms of abilities and skills. "It [the examination] establishes over individuals a visibility through which one differentiates them and judges them" (Foucault, 1977, p. 184). Whereas confessions systems associated with the religious practices is a useful technique to gather information about their employees (Townley, 1993). Candidates are asked to acknowledge their strengths, weaknesses, successes, and disappointments during selection and interview stages, self appraisal and development appraisals, thereby opening themselves for better management control techniques. Power could be implemented by the management in contemporary organizations indirectly though techniques from Panopticon, examination and confession systems, like job analysis, performance appraisals, mentoring, meetings, bulletin boards, time sheets, corporate family culture etc.

Cross Cultural Implications in Management

Hofstede (2001) argued that there are five cultural dimensions which can be used to explain the culture across different countries. These five cultural dimensions have been explained below:

Individualism versus Collectivism

Individualism is the tendency of individuals to look after their own interests and those of their own families. A culture high on individualism would emphasize individual initiative, decision making and achievement.

Individuals in these countries are likely to value their own personal identity, personal achievement, and competition. All people, it is believed are entitled to the right of privacy and personal freedom of expression, countries which are high on individualism are United States, Canada, New Zealand, the United Kingdom, and Australia.

Collectivism is the tendency of individuals to emphasize their groups' membership to various groups. Groups would mean relatives, communities and organizations. Collectivism gives importance to "we" versus "I" and involves emotional dependence of individuals on groups, organizations and institutions. For instance individuals in China, Japan, Taiwan, and South Korea give more value to teamwork versus to individual recognition.

Power Distance

Power Distance is the extent to which individuals in a society accept status and power inequalities as a normal aspect of life. Individuals who belong to high power distance cultures are usually submissive towards their leaders and avoid disagreements with them. High power distance employees never question their leaders and take and follow orders without any questions. While in low power distance countries, employees can bypass their superiors if necessary to achieve company's objectives. Titles, status and formality are of less importance in low power distance countries. Low power countries are Finland, Israel, Norway, and Sweden. While high power countries include India, Malaysia, Mexico, Argentina, and Phillipines.

Uncertainty Avoidance

Uncertainty Avoidance is the extent to which individuals rely on procedures and organizations to avoid ambiguity, unpredictability, and risk. Societies with high uncertainty avoidance rely on orderliness, consistency, structure, laws, and formalized procedures. Individuals in such societies prefer structured lifestyles, clear specification of social expectations, and consistency. In contrast, societies with low uncertainty avoidance are tolerant towards ambiguity and uncertainty. Countries such as Japan, Sweden, and Germany are high in uncertainty avoidance. While United States, Canada, and Hong Kong are low in uncertainty avoidance.

Gender Role Orientation

Men are supposed to be assertive, tough, and focused on material success. While women are modest, tender, and concerned with quality of life. In masculine dominated societies like Japan, Austria, Italy, Mexico, and Ireland the dominant values are material success, progress and money. While female oriented societies emphasize caring for others, importance of individuals and relationships, stressing quality of work life, and resolving conflict by compromise and negotiation. Denmark, Finland, and Portugal are a few feminine oriented societies.

Long-Term Orientation

Long Term Orientation means the society prescribes to values of sustained commitment, perseverance and thrift. Societies which embrace long term orientation like China, Japan, and India possess characteristics such as respect for tradition, obligations within limits, thrift, concern with virtue and perseverance towards slow results.

A short term orientation stands for quick results, view leisure time as important, little respect for old time traditions and rewarding risk taking and adaptability. Short term orientation societies include Canada, Spain, Pakistan, and United States.

Progressive Discipline

Organizations should follow three stages of disciplinary action to convince an employee to "fit into the culture" of the company and improve his/her performance. The first step in most progressive disciplinary programs is verbal warning. Verbal warning constitutes a word of caution conveyed verbally by the manager to the employee. The manager should keep a written record of the verbal warning. Next, if unacceptable behavior still continues, the manager gives the employee a written warning. At each step, the manager is required to discuss with the employee of various ways to correct the problem. Suspension or a temporary layoff is the next step in the process. The suspension could last for a day or a few days and is usually without pay. The final step in the process is termination. At this point, the organization faces potential legal problems and violent reactions from the employee. It is a step which should be taken only after serious considerations (Denisi and Griffin, 2008).

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The case is best used to help students understand and appreciate (a) Michael Porter's competitive strategies, (b) challenges a firm faces in obtaining and sustaining competitive advantage in its industry, and (c) strategic leadership behaviors.

Porter's competitive strategies

All its life Western has followed Porter's focused-differentiation strategy. Initially, it focused on a very narrow customer group (creameries) and differentiated on the basis of superior customer responsiveness. Klouda and Henderson broadened the product and geographic niche. However, they fundamentally continued with the focus-differentiation strategy. What differs between the two is how attentive each was in the implementation of the strategy. Klouda, in his later years, seemed to become complacent. His inattention led to a crisis of survival. In contrast, Henderson shows sustained focus over a period of 8 years, using all resources in his control to regain competitive advantage by articulating and executing a coherent competitive strategy.

Obtaining and sustaining competitive advantage

The case illustrates that formulating a strategy is only part of attaining organizational success. The challenge of achieving competitive advantage lies in aligning all of a firm's activities. The case's distinctiveness is that it provides a succinct narration of the specific activities that go into achieving success in a service industry.

Strategic leadership behaviors

Leadership theories help explain how successful managers excel at understanding themselves and others, at motivating group members to excel, and at facilitating (not bossing) group members to better perform their tasks. The specific behaviors of Stu Henderson described in the case can be put to good use to help students grasp (1) what goes into being an effective leader, (2) that leadership competencies can be developed but take time, and (3) that they should start their leadership training now.

CASE OVERVIEW

Western National Insurance is a regional player in the property and casualty sector of the insurance industry. After a long period of superior performance, it entered a period of decline that culminated in being downgraded two steps at once by insurance rating firm A.M. Best. The firm brought in a new CEO Stu Henderson to arrest the decline and return Western back to financial health. The case starts by providing this background information. It then narrates in detail the various actions spearheaded by Henderson to reverse Western's decline. The case ends in the year 2009, by which time Western had regained its competitive advantage and was named for the fourth time in five years to Ward's 50 Benchmark Group of top performing property/casualty companies in the United States. Further evidence of Western's recovery was the 2009 announcement by A.M Best that it had upgraded Western to a full "A" rating, Western's third A. M. Best upgrade in eight years.

Background Section

After a short narration of the firm's long history, the section focuses on Western's decline. It provides two types of facts: the performance metrics and the reasons for decline. This helps students note that the indicators used for assessing an insurance firm's health are quite different from those of manufacturing firms (and from other types of service firms for that matter). A few short sentences direct the reader's attention to reasons for the decline – a business-level growth strategy that went awry because appropriate (and supporting) actions were not instituted in the firm's functional departments.

Turnaround Section

Section headings succinctly capture the various fronts on which Henderson acted. Thus, the case is not a chronological narration of facts. Rather, facts have been gathered into meaningful categories with appropriate section titles – *Independent Agent Relationships, Reinsurance, Mitigating Risk, Entry into Commercial Lines, Tiered Commissions, Branding, Facilities, and Technology Upgrades*. This helps students consider how the organization must align tactical measures and functional strategies to achieve the organization's strategic goals.

By presenting a section titled *Initial Actions,* the case directs students to recognize the need for immediate actions, and to see how those actions signaled to external and internal stakeholders two positive aspects of Henderson: (1) his competence and drive, and (2) how he would manage the company back to health by using his social capital with external agencies (e.g. A.M. Best and independent agents) and an internal decision-making style that includes employee participation and systematic analysis of Western's strengths and weaknesses. The case has been written so that statements of actions taken in various areas and by various departments are preceded or followed by a rationale for those actions.

Growth Strategy Section

This section lays out the pros and cons for evaluating the two main growth options. Of course, there are other options for growing the company (expansion into other lines of business, mergers and acquisitions, etc.), but the case focuses on whether or not to use technology to reach consumers directly. Both qualitative and quantitative information is included to add depth to the discussion, as well as permit a preliminary financial analysis of the direct-to-consumer model.

TEACHING PLAN

An 80-minute class using three boards will effectively bring out the case's three central issues: (1) (re)gaining competitive advantage requires not just formulating a business-level strategy but also orchestrating activities of the functional departments to help achieve that strategy (40-45 minutes); (2) challenges of sustaining competitive advantage, and of growing the business – not an easy call as both require changing a successful business model that took Henderson about six years to develop and execute (15-20 minutes); and (3) strategic leadership (15-20 minutes).

Main Board: Competitive Advantage Requires Alignment of the Activities of All Functional Departments of the Firm (40-45 Minutes)

Being the central issue, this discussion should be in the middle board. The main objective is to help students see that the many actions taken by Western over eight years had logic; they were mutually reinforcing and led to successful firm performance. A Value Chain analysis is the best way to schematically demonstrate this to students. The Value Chain model can be found in many strategy textbooks. Two with clear expositions are *Fundamentals of Strategic Management* by R. Parthasarthy, Cengage, (Chapter 4); and *Strategic Management*, by Charles Hill & Gareth Jones, Cengage, (Chapter 3).

It helps to start the class with some preliminary remarks about business strategies, competitive advantage, superior performance, their sustainability, and comparisons of manufacturing and service industries. This sets up issues and themes that students should focus on during discussion.

Follow up with Discussion Question 2. Let it be free flow. It gives the instructor a good idea of the student's level of information and understanding. Allocate about 5 minutes for this phase, and end it by saying that you would like to formally organize the discussion. Introduce the following performance logic:

- Profitability (or competitive advantage) = Margin (i.e., Price – Cost)
- Price can be increased if value is added to the product. Thus,
- Margin = Function of [Creating/enhancing product's value to customer - Cost of creating/enhancing value]
- Thus, each activity should help at creating value or at lowering the cost of creating value.
- Service industry cases are not as commonly used as manufacturing. It is, therefore, useful to spend a few minutes to see that students understand clearly what makes up an insurance company's revenue and expense statement.
- Revenues are comprised of two sources:

- Net premiums earned (in contrast to premiums written) +
- Investment income (derived from investing loss reserves, surplus, and unearned premiums)
- Expenses derive from four major categories:
- Underwriting expenses (e.g., commissions to agents) + Reinsurance expenses + Claims (or loss risk) payments + Operating expenses
- Introduce the Value Chain concept, and draw the value chain outline on the board. Moderate class discussion to get students to help fill the table. In about 25 minutes, the main board should look similar to Figure 1 (next page).

Board 2 (To Right of Main Board): Challenges of Sustaining Competitive Advantage, and of Growing the Business (15-20 Minutes)

Taking stock (5 minutes). Start this discussion segment by saying "Let us take stock of Western as of 2009 by listing its strengths." If "Resource-Based View" and the concept of distinctive competencies have been covered prior to this case discussion, then the best approach is to get students to help summarize Western's "resources and capabilities."

Exploration of options (about 15 minutes). The discussion of the independent agent model versus the direct sales channel model should indicate that neither option guarantees future success. Therefore, enumerating the advantages and disadvantages of each option should foster debate and perhaps a middle-ground strategy. Urge students to be creative and come up with scenarios where both channels can be used simultaneously without creating channel conflict.

It is important to bring out the point that *Western's success was possible only because of near-perfect alignment of strategy, structure and the various activities of each and every functional department*. Any one element cannot be changed without drastically affecting the other elements. Thus, while a well formulated and executed focused–differentiation strategy resulted in superior performance, it has also resulted in lowering the firm's strategic flexibility.

Board 3 (To Left of Main Board): Strategic Leadership Behaviors (About 15 Minutes)

Fundamentally, leadership is the ability to inspire and influence others to work independently and collaboratively to achieve a common end. The model chosen to expand upon depends on the textbook that the instructor uses. Most models emphasize, in one shape or form, the need for multiple competencies – especially competencies beyond technical skills. Facts given in the case about Stu Henderson's behaviors show us he has depth of industry experience, is open-minded, and is confident enough in himself to solicit and consider ideas from others.

Figure 1. Main Board: Value Chain Analysis of Western

Sup-port Activities	**Company Infrastructure**	+ Board of Directors: effective stewards + Top mgmt: skilled strategic planners; ability to motivate + Structure: decentralized; cross-function integration + Building: aesthetic design; form & function + Relationship with regulatory agencies	**Each** → **Activity** → **Contributes**→ **To** →	Creating Value Or Lowering Cost of Creating Value
	Human Resource Mgmt	+ Selection: competence-based + Training - rigorous + Bonus - profit-based + Personal growth: encourage/facilitate volunteering		
	Finance	+ Investment portfolio mgmt: emphasis on safety & yields		
	Information Technology	+ ERP: Point In + IWP + Agent portal + Increased cross-functional integration, accuracy, security. + Flexible systems – scale-up with size & product diversity + Project office; data analysis & testing teams		

R&D	**Marketing & Sales**	**After-sales service**
• Actuarial research • Risk analysis • Identify & screen for perfect applicants	• Logo: conveyed firm's mission & uniqueness • Agent management ○ Evaluate: loss/premium ○ Encourage: tiered commission	• Claim staff ○ Prompt handling ○ Accurate & fair ○ Legitimate claims always honored

Primary Activities

Two models seem appropriate to bring out those characteristics: *emotional intelligence* model of Daniel Goleman ("What Makes a Leader," Harvard Business Review, January 2004), and the *Servant Leadership* concept espoused by Robert Greenleaf (http://www.greenleaf.org/).

Both emphasize that technical (cognitive) competence is necessary but not sufficient for effective leadership. Thus, according to Goleman an effective leader scores highly on:

- Self-awareness: recognizes and understands own mood, emotions, and the effects they have on others.
- Self-regulation: is able to suspend judgment – i.e., think before acting.
- Motivation: has a high passion for work, beyond money and status reasons.
- Empathy: skilled at treating others based on their emotional state.
- Social skill: proficient at managing relationships and building networks; ability to find common ground & build rapport.

(Source: Goleman, HBR 2004)

The case provides facts to easily conclude that Stu Henderson possessed high degrees of motivation and social skills – e.g., his visit to A.M. Best even before moving to Minneapolis. The remaining attributes can be presented by updating students on the Goleman and Greenleaf leadership models.

Role of the Board of Directors (Optional, About 5 minutes)

Role of boards is an important research topic. But there is a dearth of cases that address the important role boards can play in helping the CEO with her/his strategic planning responsibilities. Also, most textbooks emphasize a negative view by emphasizing that directors are needed to keep an eye on the management team. Top management cannot be trusted as it is interested in lining its pockets at the expense of shareholder interests. This is true to some degree. But governance literature also points to the facilitating or stewardship role that directors can play.

By providing some information on the boards that served during the tenures of Klouda and Henderson, Western is one of the few cases that includes the dimension of corporate governance. As the case indicates, the board's composition changed after Henderson's arrival. It is more diverse, composed of members with expertise in different fields, and experiences in politics or higher education or industry. Thus it can reasonably be concluded that Henderson does not look at the board as an entity that will just rubber-stamp his actions. Instead of looking at the board as a controlling body, Henderson is viewing it as a body whose members would help him with Western's important stakeholders. He also seems to be asking the board to emphasize their stewardship role.

STUDENT ASSIGNMENT

The case is rich in details. To make good use of classroom time, we recommend that students/teams/groups be assigned sections of the case, asked to make notes on their assigned section, and bring them to class. This will help increase student involvement, and quickly expose the whole class to all relevant case information. Thus, the majority of class time can be used for integrating the details into a coherent whole. Students will better understand the importance of aligning a firm's activities and the challenges of achieving that alignment.

Students should be warned that the operation of an insurance firm is quite different from that of a manufacturing firm, and that during discussion they will be asked to describe industry-specific technical terms. Thus, it should be told how to go about preparing their notes: as they read the case they should (a) pay attention to section headings and see that they understand what the headings' words/labels mean, (b) make a list of the specific actions described in their assigned section.

DISCUSSION QUESTIONS

1. **Which competitive (or business-level) strategy (of Michael Porter) did Stu Henderson use to turn Western National around? Provide appropriate facts from the case to support your answer.**

   Henderson used a **focused-differentiation** strategy to regain Western's competitive advantage.

   Focus: narrow (a) geographic (eight states in the U.S.), and (b) product (property & casualty segment) of the insurance industry.

   Differentiation: (a) superior customer service – speed of response, long-term partner; (b) pricing policy – 'no surcharge' during the term of the contract.

2. **What actions did Henderson take as CEO to move from A.M. Best's "B+" grade in 1999 to a full "A" grade in 2009? Do not just repeat facts as given in the case. Organize them into meaningful categories.**

   Henderson actions fall into two categories: immediate actions and long-term actions.

   - **Immediate actions**. These were of three types: external relations; information gathering and morale boosting.
     - **Strengthening external relations**: met with A.M. Best official to apprise them of Western's positive aspects and to give him time to rectify the situation before further downgrades.
     - **Information gathering**: meeting with managers and departments to take stock of Western's strengths and weaknesses.
     - **Morale boosting**: style of talking with employees of Western; lowering their anxiety about him taking drastic actions; soliciting ideas from them and asking for their rational appraisal of Western's situation.
   - **Actions for long-term improvements**
     - **Revenue enhancing**: broadened product lines; expanded commercial segment; product bundling; setting premiums based on actuarial research.
     - **Cost reducing**: enhanced IT dept; investing in state-of-the-art software programs - ERP; IWP, and agent portals.
     - **Quality enhancing**: IT also helped in speed of response, improved security and accuracy, all of which helped achieve superior customer responsiveness.

- o **Building human capital**: recruitment of skilled and motivated personnel; establishing meaningful recognition & reward systems; renovations to enhance the workplace environment and climate.

3. **What are the strengths of Western National as of September 2009? (If the case is scheduled for discussion after the instructor has covered the resource-based view's concept of "distinctive competencies," the question can be posed as: What are the distinctive competencies of Western National as of September 2009? Take care to distinguish capabilities from resources.)**

<u>Resources – Tangible</u>

- Company head office: bright entryway; artwork; meeting rooms; state-of-the-art training rooms.
- State-of-the-art IT equipment.
- Employees: motivated and skilled.
- Agent network.
- Product variety and bundling.

<u>Resources – Intangible</u>

- Company logo & motto: the relationship company.
- Reputation: customer service/orientation.
- Strong and positive relationship with independent agents.
- Positive relationship with A.M. Best and state regulators.
- Technological knowhow. Internally developed software: (i) agent portal for personal lines; (ii)
- IWP (Imaging & Workflow Program); (iii) adaptation and full-scale implementation of CSC's Point In ERP software.

<u>Capabilities</u>

- Organizational structure: decentralized; cross-functional integration.
- Decision-making style: thorough, analytical and data-driven; regular meetings – e.g., employee relations committee.
- Communication style: both top-down and bottom-up.
- Human Resource Management: procedures and processes for selection, retention and reward.
- Top management leadership abilities as illustrated by Stu Henderson (CEO), Mary Manley (Senior VP, Corp Affairs & Administration) & Mike Braun (VP,

Information Services): ability to (i) develop and communicate a clear vision, (ii) motivate employees through empowerment, (iii) make employees comfortable so they would provide ideas.

4. **What are the two main strategic alternatives presented in the case for growing Western? Identify the pros and cons of each alternative.**

The case's concluding section, clearly lays out the two options that Western's top management team was looking into.

Option 1: Status quo, using existing independent agent model.

Pro
- No need for hiring and training of in-house sales personnel.
- Thus, costs remain variable.

Con
- Divided loyalty, as agents sell products of competing firms.
- Decreased ability to exercise quality control.
- Western is legally responsible for regulatory violations of agents.
- Challenges of integrating Western's IT systems with 'myriad different' hardware and software systems of the independent agencies.

Option 2: Direct-to-consumer selling model.

Pro
- Increased control over the sales function.
- More effectively present (new) products and bundles developed by marketing dept.
- Decreased costs as no need to pay agent commissions.
- Decreased IT systems integration costs.

Con
- Hiring and training expenses.
- Increased advertising expenses.
- Inability to realize differentiation strategy because of decreased ability to convey through the Internet the unique features of Western's products/services.

5. **Using the financial information provided in the case, conduct a financial analysis of the "Direct to Customer" sales model.**

The case defines success as achieving $15 million in premiums 18 months after launching the "Direct to Customer" program. At that point, the project is expected to generate a profit of about $806,000 (5.4%), based on the following analysis:

- Annual Expenses for $15 million in premiums
- $1,444,000 in hardware and software depreciation (5-year amortization of initial investment, as noted in the case)
- $400,000 for software/hardware maintenance and upgrades
- $845,000 direct labor costs
- $955,000 home office support
- $200,000 claim handling costs
- $9,300,000 claim payments or reserves to pay expected claims
- $800,000 advertising and other promotion expenses
- $250,000 reinsurance costs

Total Annual Expenses: $14,194,552

$15,000,000 Annual Premiums
-14,194,552 Annual Expenses
$ 806,000 Profit

As new sales increase, direct labor costs should not increase until premiums reach $25 million, after which an additional Level 1 employee and ¼ Level 2 employee will be needed for every $2.5 million premium. With the infrastructure in place, expenses will decrease as a percentage of premiums as sales increase beyond $15,000,000. Western could also be expected to benefit from word of mouth advertising as satisfied customers talk to their family, friends, neighbors, and co-workers.

6. You have been asked by your boss to develop a list of competencies required of an effective leader. Develop a list using Stu Henderson as your guide.

Note: the question asks that Henderson be used as the model.

- Needs to have varied and deep experience.
- Needs to be highly motivated and driven.
- Should be high on analytical skills.
- Should seek information and data before deciding.
- Should withhold judgment until clarity is achieved.
- Lack of arrogance: solicit ideas from subordinates.

EPILOGUE

Stu Henderson and his top management team have not yet made a decision about replacing or complementing their independent agent distribution model. They continue with their existing business model, concentrating on strengthening their resources and capabilities, and growing through geographic product line expansion, and seeking opportunities for growth through mergers and acquisitions.

In January 2008 they completed their merger with Farmers Home Mutual Insurance Company. The company's December 30, 2009 press release said:

> Western…today announced that it had completed its purchase of Titan Property & Casualty Insurance Company of Monee, Ill. ….(President and CEO Stuart Henderson said) "Between the greater geographic diversification and the addition of Titan's book of business, our newly expanded group of companies is well positioned to increase profit and enhance stability for our mutual policyholders."

Western National Insurance Group, headquartered in Edina, Minn., is a super-regional property-and-casualty insurance group writing over $240 million in Direct Premium in ten states. The group now consists of four active companies (Western National Mutual Insurance Company, Western National Assurance Company, Pioneer Specialty Insurance Company, and Titan Property & Casualty Insurance Company) serving personal and commercial customers in Minnesota, Nevada, Oregon, South Dakota, Utah, Washington, and Wisconsin, as well as commercial customers in Iowa, Illinois, and North Dakota. All of the group's products are sold exclusively through professional independent agents.

The February 2008 press release announced that

> Jeffrey Couchman was hired as "Senior Vice President & General Manager" of the group's west coast operation…(Couchman's) role will initially be focused on portfolio risk management (particularly property concentration of risk) and business development through mergers, acquisitions and affiliations.

Western's June 2008 press release announced that

> Kevin J. Christy was promoted to Vice President – Chief Actuary,…in which position he has overall management responsibility for ratemaking and policy form duties.

A September 2009 press release informs that the company

> …had been named a recipient of the 2009 Alfred P. Sloan Award for Business Excellence in Workplace Flexibility. (CEO Henderson commented) "Finding ways to properly balance the needs of our customers and with those of our employees and their families is an ongoing goal of our company."…The Alfred P. Sloan Awards are part of the *When Work Works* project, an ongoing initiative of the Families and Work Institute, the Institute for a Competitive Workforce (an affiliate of the U.S. Chamber of Commerce), and the Twiga Foundation. Through *When Work Works*, these partner organizations provide research, resources, and recognition to employers nationwide. …..
>
> Ellen Galinksy, president of the Families and Work Institute, explained: "From new forms of flexible work arrangements that minimize lay-offs, to creative cost-cutting that retains core medical benefits, to providing financial information and support to employees, these employers are braving the economic storm through innovative policies that prevent undue shock to their workplaces and their employees."

DISGRUNTLED EMPLOYEE RETALIATION: DOES THE EMPLOYER HAVE RESPONSIBILITY?

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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?

INSTRUCTORS' NOTES

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. Ask your students to read the case carefully and prepare answers to the discussion questions, or assign them to small groups and ask each group to report their recommendations to the class. As you discuss the case, try to keep the class focused on both the legal and ethical issues that arise. Expect lively class debates and differences of opinion.

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?**

   Normally, employees expect the company to provide a safe, "harassment-free" workplace. However the Sargent's intimidation did not occur on company premises and was focused mostly on the family rather than the manager. Furthermore, the alleged harasser is not an employee and it is not at all clear whether Mr. Aziz is the perpetrator. Has the company ever obtained any information that implies that Mohamed has engaged in intimidating or harassing activities like those described by Mark Sargent? If so, then the company would seem to be liable (the negligent hiring or negligent retention argument), and should take some responsibility for resolving the issue. If there is no previous or current evidence of unacceptable behavior, the company is probably not legally obligated to get involved, since Mr. Aziz is no longer an employee. However, most would say that ethically, it would be good if McAlister Systems did all it could to alleviate the stressful situation the Sargents are currently facing.

2. **Is there any proof that Mohamed Aziz is the perpetrator of this harassment?**

   Just because Mark thinks Mohamed is retaliating against his wife Lisa doesn't mean it is true. The only evidence has been the flowery handwriting on a couple of order cards, which Mark thinks bears some resemblance to Mohamed's signature. Esther Coles didn't appear to be convinced that the cards were signed by Mr. Aziz, and without expert corroboration, there really is no proof. However, Mark is very suspicious, given the explosive departure of Mohamed from the company, and the "gifts" sent to two mid-level managers at the company. It seems that further investigation is necessary to find better evidence before accusing Mohamed of anything.

3. What actions can Mark and Lisa take to stop this intimidation? What are their options?

Here is a partial listing of possible options for Mark and Lisa. Obviously, the strengths and weaknesses of each of these options can be explored by the class.

- Hire a security company to protect Lisa at home.
- Hire an independent investigator to watch Mr. Aziz.
- Get a handwriting expert to evaluate the cards and notes received... is it Mohamed's signature?
- Relocate Lisa and the baby to a different location (move the family).
- Leave McAlister Systems and seek work elsewhere (quit to escape the harassment).
- Call the police again and ask for advice on what to do.
- Ask the police to question and monitor Mohamed Aziz.
- Contact the postal authorities and report the forged subscriptions.
- Ask Esther Coles to help the police immediately with this investigation.
- File a grievance at the company against Esther Coles.
- Hire a lawyer and sue the company for constructive discharge or failure to protect.

4. Given your responses above, what would you recommend that Mark and Lisa do? Justify your recommendation.

Many suggestions are plausible. The most obvious ones are to call the police again and ask for advice on what to do now. Also ask Esther Coles to cooperate immediately with the police investigation (see Exhibit 3). Hopefully, the police will have a handwriting expert look at the notes and cards and determine whether Mohamed is really the culprit in this case. If the investigation is still going to take some time, perhaps Lisa and the baby should leave town temporarily, and go visit relatives to get away from the stress and fear that comes with each day's mail. Once the police have concluded their investigation, they can deal with Mr. Aziz if indeed he is the perpetrator of these incidents.

5. What do you think the company could have done or should have done to protect Mark and Lisa Sargent from these harassing incidents? Are these legal or ethical responsibilities?

Even though the company may not feel that there is a legal obligation to get involved, they are somewhat responsible because they failed to train and advise their manager in how to handle Mohamed's termination properly. Mark was ordered to terminate Mohamed, a task for which he was unprepared. He was very nervous and probably didn't know which procedures to follow, or how to use tact and a sympathetic approach. The result was that Mohamed clearly took offense, made some threats, and now Mark suspects that the intimidation and harassment are payback. In retrospect, managers like Mark should have received training in how to properly discipline and terminate employees. The Human Resources Director should also have been more involved by providing coaching and advice to Mark, as well as making sure that proper procedures were followed and appropriate notices were given. If these things had been done, Mark would have felt more confident, and perhaps Mr. Aziz would not have become so upset.

Why has McAlister Systems been so slow in responding to the request for information from the police? Is the company afraid that Mr. Aziz will target them if they cooperate with the police, or is Esther Coles preoccupied with other company matters? Perhaps she is always very slow to respond to information requests. All the police need is background and support information about Mohamed, so why the delay? Is the information not available? Has the company "lost" the documents supporting Mr. Aziz's termination? At the very least Esther Coles should contact Officer Park immediately and provide whatever information she can. This is a possible criminal investigation, so the lack of company cooperation is unacceptable.

Finally, the company needs to be very supportive of Mark. Mark is a valuable employee, he did what was asked of him, and now he's suffering the consequences of following those orders and firing Mohamed Aziz. Even if Mohamed is not involved, the harassment and intimidation that Mark and Lisa have experiences is very disruptive. They are feeling abandoned because of the apparent indifference of the company to their situation. Mark's loyalty and commitment to the company will be damaged if this feeling isn't rectified soon. If Esther Coles had been more supportive and promptly asked how she could be helpful in assisting Mark and Lisa with this problem, I suspect Mark's morale would be much higher than it is right now. It always makes good sense to show concern and support for a highly-valued employee. Esther Coles (or someone else at the company) needs to reassure Mark and Lisa that the company is behind them, and will do all that they can to end the harassment and restore a sense of well-being in their lives. To ignore their plight and act as though this is a private matter of no concern to the company seems callous and unethical.

POSTSCRIPT

Two days later on May 12, Ms. Coles did respond to Lisa's request and provided Officer Park with the information that he had requested.

On the following day, Officer Park contacted Mohamed Aziz and told him that the police were investigating a serious fraud and harassment complaint filed by the Sargent family. The fraudulently ordered items were reviewed, as well as the photos and threatening notes that had been sent. The handwriting and e-mail addresses involved in these incidents were currently being analyzed. Officer Park warned that if these harassing incidents did not stop immediately, he (Mohamed) would be arrested and charged with several violations. After several minutes of denying repeatedly that he had done anything wrong, Mohamed assured Officer Park that if these incidents continued, he would certainly not be involved in any way, and that he had no intention to harass the Sargents or anyone else at McAlister Systems.

Fortunately, this warning seemed to be enough. Lisa and Mark stopped receiving unordered subscriptions, gifts, and threatening letters. From Lisa's perspective, the crisis was over and she was satisfied with the outcome. However, Lisa and Mark have always felt that McAlister Systems should have done more to protect them and to assist in resolving their situation.