

Private Fitness LLC*

Private Fitness LLC is a springboard case that can be used as the basis of a discussion of management's need for information. It serves the same purpose for Part 2 of the book that the Kim Fuller case did for Part 1.

Approach

This case uses a small business as its setting so that students can visualize the business's activities, and so questions of generally accepted accounting principles will be essentially irrelevant. In fact, a shift the student needs to make as he/she begins Part 2 of the book is to think of accounting primarily in terms of its usefulness to a company's management, rather than in terms of reporting to shareholders and other outside parties. Because of the differing focus of Part 1 of the book, particularly the later chapters, some students will forget that they are dealing here with information for an apparently unsophisticated manager to help her run a small business, and not data for a NYSE company.

This case is compelling both because students understand the business—fitness-training—and because there is a real problem to discuss. A trusted employee was both stealing cash and, by not recording all sales, diverting some revenues to herself.

Discussion of this simple case helps students think about both the records needed to run the business and the challenges managers face in making sure the information put into the records is recorded accurately (i.e., the challenges faced in maintaining an effective internal control system). The case illustrates a common problem faced in many small businesses—lack of overlapping controls, or in this case, what auditors call “separation of duties.”

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Discussion

To run this simple privately-held business, Rosemary does not have to be concerned with generally accepted accounting principles. She does need to keep records that will allow the easy preparation of a tax return. But her primary concern should be in maintaining systems records that allow her to manage the business effectively. These include the following:

1. **Scheduling system.** What instructors, and other employees, should be on duty at what hours? When should classes of particular types be scheduled? What rooms should be used for what purposes at what hours? When should facility cleaning and maintenance be scheduled? What is the capacity utilization? Are more space, equipment, or instructors needed?
2. **Revenue system.** Revenue is dependent on the number of clients attending classes and private workouts.
3. **Payroll system.** What pay is due the employees? Most of the compensation is commission-based, paid as a percentage of revenue associated with the instructor's activities. But the manager, Kate Hoffman, is also paid a salary.
4. **Operating cost system.** Bills for on-going items, like rent, heat, and light, need to be paid on time. The expenses need to be recorded accurately and tracked over time so that trends can be monitored.
5. **Fixed asset system.** The costs of the facility and equipment need to be assigned to time periods.

Issues that might be raised:

1. How often should Rosemary prepare summary financial statements (e.g., monthly, quarterly, annually)? Does she need an "income" statement, or is a cash flow statement sufficient for her management purposes? Does she need to prepare a balance sheet at all?
2. How should prices be set? Should they be set only by looking at competitors' prices, or should they depend on costs (e.g., cost of the space and equipment used and required instructor expertise)? If the latter, does Rosemary need a "job costing system," or would a periodic "back of the envelope" calculation be sufficient?
3. Should Rosemary pay herself a salary and commission for the classes she ran, or should she take merely the residual profits (or cash flow) from the business?
4. Should the equipment (e.g., exercise bicycles) be "expensed" when acquired, or should the equipment costs be spread over some period of time to provide a more meaningful time-series picture of costs? If the latter, what equipment life should be used, and should the cost of equipment be spread equally to time periods over that useful life?

Addressing the Specific Problems

Students must first recognize that there are two problems to be solved—the theft of cash and the unrecorded revenue. There are a lot of internal control options, most of which involve options that go far beyond the accounting. I like to divide the options into three categories, (1) action controls—those that limit the manager’s ability to perform the specific bad actions, (2) results controls—those that improve the pay-for-performance system, and (3) personnel/cultural controls—those that encourage either more employee honesty (self-control) or encourage employees to monitor each others’ behaviors (social control).

1. Action controls—e.g., hire a supervisor (accomplish “separation of duties”), camera with videotaping capability, locked cash box, use of receipts and reconciliations with cash in the drawer/cash register.

2. Results controls—Students must recognize that providing Kate a bonus of, say, 10% of revenues or profits does little to reduce her motivation to pocket 100% of the revenue through theft of cash or direct pocketing of revenues. Revenue-based bonus systems could be effective motivators if Rosemary is sure that every client is recognized on the system, but by themselves they won’t ensure that every client is recognized.

There are some more creative and better possibilities. For example, should instructors be set up as “little entrepreneurs”? Let them keep **all** the revenue, but charge them a fixed fee for access to the facility. If this alternative is chosen, then Rosemary would have to develop a fee schedule that could be based on a cost accounting.

3. Personnel/cultural controls—stricter hiring criteria (e.g., background checks), building a strong “family” culture, group rewards (which encourage mutual monitoring).

What should Rosemary do?

To answer this question, students will have to consider the benefits (control effectiveness) and costs in this specific setting. Some alternatives, such as a camera, might be effective in tracking usage of the facility, but it is an expensive solution. A wide range of answers are possible here. Students should see that there is not just one solution to this problem.

The case also raises the question as to what Rosemary should do with Kate. Some students get emotionally involved in considering this issue, but these discussions are probably not worth much class time.

Pedagogy

This is a short case. It can be used in class even if students have not prepared the case in advance. Most students can probably read the case in 10 minutes, and the answers to the questions can developed in the ensuing class discussion. With or without advanced preparation, the discussion can consume even up to 75 minutes of class time. Or instructors can provide a lecturette/introduction and cover most of the issues in this case in half that time.