Case Study

Private Fitness, Inc.

"I don't know how much money I might have lost because of Kate. She is a long-time friend whom I thought I could trust, but I guess that trust was misplaced. Now I've got to decide whether or not to fire her. And then I've got to figure out a way to make my business work effectively without my having to step in and do everything myself."

This case was prepared by Professor Kenneth A. Merchant.

Rosemary Worth was talking about the consequences of a theft that had recently occurred at the business she owned, Private Fitness, Inc. Private Fitness was a small health club located in Rancho Palos Verdes, California, an upscale community located in the Los Angeles area. The club offered personal fitness training and fitness classes of various types, including aerobics, spinning, body sculpting, air boxing, kickboxing, hip hop, step and pump, dynamic stretch, pilates, and yoga. Personal training clients paid $50 per hour for their instructor and use of the club during prime time. During slower times (between 9:00 a.m. and 4:00 p.m.) the price was $35 per hour. The price per student for each hour-long fitness class was $12. Some quantity discounts were offered to clients who prepaid. Unlike the large health clubs, Private Fitness did not offer memberships for open access to fitness equipment and classes.

Prior to starting Private Fitness Rosemary had been working as an aerobics instructor and fitness model. She had won many local fitness competitions and was a former finalist in the Ms. Fitness USA competition. She wanted to go into business for herself to increase her standard of living by capitalizing on her reputation and knowledge in the growing fitness field and to have more time to spend with her two young children. Private Fitness had been operating for six months.

To open the club, Rosemary had to use almost all of her personal savings, plus she had to take out a bank loan. The building Rosemary rented, located in a convenient strip mall with ample parking, had formerly been operated as a fresh food market. Rosemary spent about $150,000 to renovate the facility and to buy the necessary fitness equipment. The club was comprised of five areas: an exercise room, a room containing aerobic equipment (e.g. treadmills, stair climbers, stationary bicycles, cross-country ski machines), a room containing weight machines and free weights, men's and ladies' locker rooms, and an office.

Rosemary contracted with five instructors she knew to run the classes and training sessions. The instructors were all capable of running personal training sessions, but they each tended to specialize in teaching one or two types of fitness class. Rosemary herself ran most of the spinning classes and some of the aerobics classes. The instructors were paid on commission. The commission, which ranged between 20% and 50% of revenue, varied depending on the instructor's experience and on whether the instructor brought the particular client to Private Fitness.

As manager of the business, Rosemary hired Kate Hoffman, one of the instructors and a long-time friend. Kate's primary tasks included marketing, facility up-keep, scheduling of appointments, and record keeping. Kate was paid a salary plus a commission based on gross revenues. During normal business hours when Kate was teaching a class one of the other instructors, or sometimes a part-time clerical employee, was asked to staff the front desk in return for an hourly wage. Private Fitness was open from 5:30 a.m.–9:00 p.m., Monday through Friday. It was also open from 6:00 a.m.–noon on Saturday and noon–3:00 p.m. on Sunday.

Rosemary was still in the process of building the volume necessary to operate at a profit. Typically one or two private fitness clients were in the facility during the prime early morning and early evening hours. A few clients came in at other times. Classes were scheduled throughout the times the club was open. Some of these classes were quite popular, but many of them had only one or two students, and some classes were cancelled for lack of any clients. However, Kate's marketing efforts were proving effective. The number of clients was growing, and Rosemary hoped that by the end of the year the business would be earning a profit.

As the quote cited above indicates, however, Rosemary gradually realized that Kate Hoffman was stealing from the club. On one occasion when Rosemary came to the club she noticed $60 in the cash drawer, but she noticed when she was leaving that the drawer contained only $20. She asked Kate about it, and Kate denied that there had been $60 in the drawer. Rosemary wondered if other cash amounts had disappeared before they had been deposited at the bank. While some clients paid by credit card or check others, particularly those attending fitness classes, often paid cash.

Rosemary became very alarmed when, during a casual conversation with one of the other instructors, the instructor happened to mention to Rosemary some surprising "good news." The good news was that Kate had brought in a new private fitness client who was working out in the 1:00–2:00 p.m. time period on Monday, Wednesday, and Friday. Kate was doing the training herself. However, Rosemary checked the records and found no new revenues recorded because of this new client. She decided

to come to the club during the period to see if this client was indeed working out. Since the client was there and no revenue entry had been made, she confronted Kate. After first explaining that she had not yet got around to making the bookkeeping entry, Kate finally admitted that this client had been writing her checks out to Kate directly, in exchange for a discount. Kate said that she was very sorry and that she would never be dishonest again.

Rosemary realized she had two major problems. First, she had to decide what to do with Kate. Kate was a valuable instructor and a long-time friend, but her honesty was now in question. Should she forgive Kate or fire her? Second, Rosemary also realized that she had an operating problem. She did not want to step in and assume the managerial role herself because she had significant family responsibilities to which she wanted to be able to continue to attend. But how could she ensure that her business received all the revenues to which it was entitled without being on-site at all times herself? Should she leave Kate, who promised not to steal again, in the manager position? Or should she hire one of the other instructors, or perhaps a non-instructor, to become the manager? And in either case, were there some procedures or controls that she could use to protect her business's assets?