



Atlanta Home Loan

Teaching Note

Purpose of Case

This case was written as an example of an extreme control failure. It can be used in a class focused on management control, entrepreneurship, or management of small businesses.

Al Fiorini, the manager of a small, but reasonably successful, mortgage lending company in Atlanta hired managers to run his business while he went back to school, for his executive MBA, in California. He did his best to monitor the company's operations while 2,500 miles away. But the managers not only stole from Al, they stole his entire business! The case forces students to analyze the problems Al faced, to identify the controls that he had in place, and to suggest things he might have done to ensure that these problems would not have occurred.

Suggested Assignment Questions

1. Identify the devices (controls) that Al Fiorini used to control his business both before and after he went back to school. Classify each control as a results, action, or personnel/cultural type of control.
2. What went wrong? Did Al use the wrong types of controls? Did he use the right types of controls but fail to design or implement them properly? Or was he just unlucky?
3. What should Al do now? Why?

Professors Kenneth A. Merchant and Wim A. Van der Stede wrote this teaching note as an aid to instructors using the Private Fitness, Inc. case.

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Case Analysis

These are among the questions that the instructor can use to stimulate the in-class discussion:

1. How would you describe the Atlanta Home Loan (AHL) control system at the time Al Fiorini left for California?

Al used each of the major control types, as is shown in Table TN-1 below.

Table TN-1

Types of controls used by Al Fiorini

Results controls	Action controls	Personnel/cultural controls
Pay for performance: - loan officers - Joe's 50/50 profit sharing - Wilbur's 100% share, less a fee - telemarketers' bonus per lead produced (\$10 per lead)	Withhold authority to write checks	Personal judgments about people
	Monitoring of behaviors. Examples shown below.	Background checks
	Monitoring of emotional states by talking to employees on the phone	Trust
	Centralization of major decisions	
Performance evaluations, which could affect promotions and job retention. Bases for performance evaluations shown below.		

Examples of Al's monitoring of behaviors:

- Joe's attendance.
- He had all office mail forwarded to him in California.
- He monitored the status of loan applications submitted to lenders electronically.
- He knew what loans were approved and could calculate the amount of revenue due the company.
- He was monitoring the overhead in the office and was making sure it was in line with production. He used industry rules-of-thumb, such as one processor for every four loan officers. At one point Al sent a message to Wilbur telling him that the processor-to-loan officer ratio was too high. Wilbur countered with "Don't tell me how to run a business." At that point, Al was sure that he had a problem.

(Al did not have an electronic link to the processors' files, but he was trying to establish one.)

Examples of metrics that Al used to evaluate performance:

- Telemarketer standard measure of productivity = minimum of one lead per hour.

- Loan officers:
 - Lead-to-loan application ratio. The range was 5–20%, depending on the experience of the loan officer.
 - Number of credit reports requested.
 - Loans funded. Each processor should be up to funding 20 loans per month (one per work day), plus open two new files per day.
 - Fallout ratio (processed loan applications that do not result in a closed loan). The industry standard was 30%. AHL was doing better than this.

In the end, Al also used the ultimate control-problem “avoidance” approach—he shut the company down!

2. What caused the company's problems? Were they failures in the company's strategy or control system, or both?

Obviously this company suffered major problems. Al Fiorini lost money, and it appears he has lost his entire business. It is useful to clarify for the students that the failures were not caused by a flawed strategy. When Al Fiorini was running the company, the company was profitable, and it had significant growth potential. Thus, it is safe to conclude that the problems that arose were control problems.

3. Is it possible that Al Fiorini's control system was good but that he was just unlucky?

This can happen, as control systems are never perfect. But just being unlucky does not account for most of the problems here.

4. What did Al do wrong?

With hindsight, it is clear that Al made a number of mistakes:

- a. He trusted people who should not have been trusted. He did not know his people well enough before he left for California. (Note, loan officers are not licensed in Georgia as they are in many other states, including California.) Could he have done better background checks? Would it have helped if he had started earlier to find a manager or partner to run AHL in his absence? But can personnel controls, by themselves, ever be completely reliable? Could Al have moved major portions of the loan process with him to California?
- b. He trusted the banks to fulfill their responsibilities. Bank of America (BoFA) should not have allowed Wilbur to release the stop payments on the checks. Citizens Bank & Trust (CBT) should not have allowed Wilbur to open a new corporate bank account.
- c. The results control arrangements were too easy to evade. Joe apparently quickly discovered that if he did not pass his loan applications through the company, he could earn 100% of the fee, rather than 50%. Al had no control over Joe's loan application pipeline. He discovered the problems with Joe, but he might also have been having similar, undiscovered problems with the loan officers (i.e., diverting loan applications to other companies).

But how do you control this? Encourage whistle blowing, from someone like Leticia? Hire a company controller/auditor or another level of supervision, perhaps with two signatures required on almost anything? (The company is probably not large enough for this.) Better legal contracts?

Wilbur was clearly dishonest, and he eventually colluded with Leticia. Al relied on legal controls, which were evaded.

- d. The set of action controls was incomplete. Al should have gotten legal assistance earlier, instead of doing some things himself, probably starting with the partnership agreement. Perhaps Al needed a more elaborate set of policies and procedures, such as:
 - i. Don't take files home.
 - ii. Work at the office every day.
 - iii. Document your work.

But how can these action controls be enforced?

- e. When Al first became aware of the problems, he probably should have returned to Atlanta to straighten them out. But that would have been costly; it would have forced him to drop out of the MBA program.

5. Were Wilbur and Leticia crooks, or were they basically good people who were tempted to go bad by a weak control system?

In defense of Wilbur and Leticia, there was no evidence of prior problems. Leticia, in particular, had been loyal to Al. Maybe she was corrupted by Wilbur. But what eventually unfolded was an elaborate, clearly dishonest scheme that must have taken some planning. Therefore, one must probably conclude that Wilbur and Leticia were not totally honest people.

Can managers design control systems to protect themselves against dishonest people? Yes, it can be done, but it is hard to do when the person in charge is dishonest and the owner is 2,500 miles away.

6. What should Al do now?

Al must address two questions: (1) Should he fight for the business or just give it up? (2) Should he attempt to punish the crooks or just walk away? If a vote is taken, these questions will split the class.

The company is not worth much now, and the lawsuits are expensive to pursue. But it is tough to walk away from a business that had promise. Further, it is natural to have a revenge motive, to punish the crooks through criminal and/or civil cases. Al suffered major losses. He lost his AHL business, which he valued at \$600,000. He was unable to maintain his mortgage payments, so he lost his home in Georgia.

In reality, Al did fight back.

- He withdrew the license issued by the Georgia Department of Banking and Finance to limit the company's potential legal problems.
- He reported the crimes to the Atlanta police and the FBI, but no law enforcement agency ever showed much interest in pursuing the case. They seemingly considered it too small a case to bother with.
- He reported the bank failures to the banking regulators.

But Al never returned to run Atlanta Home Loan. There was not much left of the business. He estimated that he could reclaim about \$15,000–20,000 worth of equipment, and a phone system worth about \$10,000. But the business pipeline would have to be rebuilt, and not much company goodwill remained, if any.

Al has started a new mortgage lending business in California, and it has gotten off to a successful start. He generates many of his leads through the website www.lowerrate.com.

Pedagogy

This case is quite easy to teach. The case itself is not difficult to read and understand, and most students find the situation inherently interesting. Thus, student preparation is generally good, and it is easy to get a good discussion going. With a typical MBA class, the optimum time for discussion of the case is probably around 45 minutes. In a longer class, then, instructors should be prepared also to give a mini-lecture or to discuss something else. We have used this case in the first class of a management control course, so an introduction to the course and the general topic of control fits nicely with this case.



Armco, Inc.: Midwestern Steel Division

Teaching Note

Purpose of Case

The Armco case was designed to illustrate a performance measurement system with measures “cascading” from strategic priorities down to the lowest organization levels. The system is not tightly linked with incentive compensation, although that is being discussed. Still, the focus on measured results promises to change managerial behaviors significantly.

The case is particularly interesting because it describes a major change from an old measurement system that was primarily designed for standard financial reporting purposes and was not perceived, at least by top management, to be effective for management control purposes. The new performance measurement system eliminated most of the allocations of indirect costs and helped managers understand the critical success factors in their areas.

In this case, then, students can understand two performance measurement systems and the company’s reasons for changing from one to the other. They can evaluate the new system and decide whether the division managers have made optimal choices in designing their new system, and they can make a judgment as to whether the system should be used to increase the proportion of total compensation linked to performance.

Most of the students will conclude that the new system is a substantive change for the better. But then they will get a dose of reality as they see the problems Armco is having, getting managers to adapt to the new system.

This case is supported with a 17-minute videotape segment (on the videotape attached to this instructor’s manual). The segment provides excerpts from Bob Nenni’s (Director of Finance at the Midwestern Steel Division) visit to MBA classes. On the tape Bob provides an update as to what happened since the case was written, and he responds to students’ questions and concerns.

Professor Kenneth A. Merchant wrote this teaching note as an aid to instructors using the Armco, Inc.: Midwestern Steel Division case.

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Suggested Assignment Questions

1. What was wrong with the Midwestern Steel Division's old system? (As part of your analysis, study Exhibit 3 carefully and figure out what the columns tell you, individually and in total.)
2. If the old system was so bad, why did the operating managers seem to like it?
3. Evaluate the new system and the way in which it was being implemented. What changes would you recommend, if any? Why?
4. What should Rob Cushman do about the two items described in the Remaining Issues section of the case?

Case Analysis and Pedagogy

- 1. What factors most determine the success or failure of the Midwestern Steel Division? In particular, how important is cost control?**

Carbon wire rod is a commodity product; so cost control is critical for this line of business.

There is some product differentiation in grinding media. Customers can measure how long the steel balls last, and they value long-lasting balls. Armco believes it has a superior manufacturing technology that causes its balls to last longer. Further manufacturing technology innovations would provide additional profits to the division.

Cost control is also important for grinding media, as Armco is the high cost producer in this market. Plant throughput (productivity) is one key to cost control. Armco can sell the entire product it makes. (The plant has been operating at capacity for 3 years straight.)

Among the cost control challenges in the plant is the fact that the plant has old equipment, generally poor preventative maintenance practices (40% of the 700 hourly workers in the plant were maintenance workers), and less than optimum worker productivity.

The people left in the plant are the most senior. They would not be hurt that much by a shutdown. They have pensions. Cost control is not that important to them. It would cost the company about \$200 million to shut down the plant (environmental clean-up, pensions, etc.).

Students might ask why Armco does not put more people or more equipment in the melt shop so it wouldn't be a bottleneck. The answer is that they would have to add a furnace, making an investment of approximately \$100 million. This would add capacity that is not needed in the industry.

- 2. How were managers controlling performance with the old system? What were the strengths and weaknesses of the old system?**

Strengths	Weaknesses
1. Managers express need for detail so they can track month-to-month trends.	1. Too much detail. Some numbers didn't change. Some very small.
2. Has value in identifying problem areas.	2. System designed for inventory costing purposes. Have to allocate costs. For performance measurement purposes, not sure if the allocations mean anything.

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| <p>3. Measured performance was based on managers' ability to control cost above. System gave managers information consistent with objective they were given.</p> | <p>3. Source of some of the data is unclear.</p> <p>4. Reports were delivered 15 days after month-end. This is too late.</p> <p>5. System too focused on cost reductions, to the exclusion of other critical success factors.</p> <p>6. Managers' performances judged on things over which they had no control. Many costs were caused by people who did not report to the managers (e.g., capital spending, salaries, maintenance). Easy-to-blame poor performance on uncontrollables.</p> <p>7. System not encouraging managers to work together. Much "local data." Contributes to suboptimization.</p> <p>8. Not graphic.</p> <p>9. Accounting accruals distort the costs. Example—annual August maintenance shutdown accruals start in January.</p> |
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It is important to walk students through Exhibit 3. Pick some representative columns and have students talk about what they mean or don't mean. Among the useful examples to discuss are nonmetallics, salaries, electricity, lubricants, and loco cranes. Students should see the types of costs that make up the total cost above. Which are the big items? Which items are variable and which are fixed? (The important ones are fixed. Costs per net ton are driven by tons produced.) Point out the distorting effect of the August maintenance shutdown.

S-orders represent extraordinary maintenance. It is accrued for. It is fixed in the short-run (a month), but it can vary over the year.

3. Why did the operating managers seem to like the old system?

- Familiarity.
- Reports were related to budget.
- Managers can't be held accountable because they always had an excuse for poor performance. (Nenni: "The traditional way we ran our operating review meetings was that the managers would find some items that didn't make sense. Then they would discredit the report and the accountants. We never got to the items the managers can and should control").
- Gives managers a false sense that they can control costs. Gives a global picture (the managers would like to have the information every week).
- Gives managers a sense that they are responsible for a large number (e.g., melt shop manager responsible for \$50 million per year).

After the students have had their crack at the analysis, if it hasn't come up, the instructor might usefully point their attention to Bob Nenni's quote about the problem with non-value-added chores under the new system and the difference between value-added and non-value-added work. (Non-value-added work includes everything customers are not willing to pay for.) One prominent example of the non-value-added work associated with the old system (which is Bob Nenni's focus) is the administrative burden required to keep it going. The old system took five accountants to operate. The new system required only three, even in start-up mode; most of the accountants' time was spent designing new reports. To what extent does Bob Nenni consider accounting to be "value-added" work?

4. What were the key features of the new system and what improvements did it promise?

Hit the key design choices and discuss them; for example:

- Strategic (not just financial) focus—10 key measures.
 - Priorities must come from the general manager and his direct reports. Priorities must cascade from above so that everybody is working on the right things.
 - Everybody agrees with the top four priorities—safety, productivity, quality, and up-time.
 - Safety is the #1 priority because managers do not want people to get hurt. It is not #1 because it is the largest cost.
- Elimination of cost above measure.
- New system does not do a trend analysis (e.g., performance vs. a year ago or vs. last rolling 12 months). What is key is whether the manager did, in January, what he said he would do (vs. agreed-to benchmark).
- Focuses attention on important categories and provides more detail on those.
- Focuses on controllables. For example, melt shop manager controls KWH/T, not electricity dollars/T. Purchasing negotiates the price.
- Focuses more on productivity than costs.
- Standardizes everything. Everything is not driven by tons.
- Apparent reduction in the manufacturing managers' financial responsibility. (The new system reported only what the employees reporting to each manager spent. Those are the dollars that can be controlled.)

5. What are the weaknesses of the new system?

- It is not a cost system. Company still needs a cost system. The company does still not have a handle on what costs are controllable, what are fixed and variable, and so on.
- Should show consumption, not purchases. (There is still a problem with the source of the data.)
- The performance standards are not benchmarked with the best in the industry. (Firms in the steel industry do not share much operating performance information.)
- Seasonal factors are ignored.

- Uncontrollables still not handled well. For example, what happens if the plant shuts down for a few hours? Should this be segregated from the managers' performance reports?
- The system is not complete. Three measures—maintenance, on-time delivery, and inspection—are not yet implemented.
- Should the system focus on exception reporting, rather than provide all the details?

6. The implementation process.

- Division managers decided to discontinue the old system immediately? What are the advantages and disadvantages of that decision?

Managers would never adapt to new system if old system was still running. After the switch to the new system, they were frequently in Rob Cushman's office "begging" for their old reports. (Actually the old system is still being run, for inventory valuation and product costing purposes. But the operating managers have not been told that the old system is still running.)

The risk of the immediate switch-over is that uninformed decisions will be made: managers don't have their old information, and they don't yet understand the new information. But the new system seemed to work. The periods after the switch-over to the new system were the best in the history of the plant.

- Department managers had no input into the design of the new system? Was that wise?

Ideally it should be the operating managers, not the accountants, who identify what is critical to their areas. But the operating managers were consulted, and they only said, "We want the old system." Only three managers in the division wanted the new system—the general manager, the director of finance, and the manager of cost accounting. The other 997 people in the plant were "indifferent to overtly combative."

What can be done to get operating managers to take the lead? Training? Hiring? Should accountants have a role in measuring quality, on-time delivery, and so on?

- Why did Bob Nenni devote so much energy to the performance measurement system instead of working on, for example, an activity-based costing system, which Armco does not yet have?

He thought that the performance measurement system, with its link to strategic priorities, was much more important than an accurate costing system.

7. Remaining issues:

- When should something be considered "uncontrollable"?

Under the new system at Armco, the handling of uncontrollables is at the discretion of the individual superior. The lines between controllables and uncontrollables are tough to define. The company has a culture of making excuses.

- Should larger bonuses be linked to the new system measures?

The answer to this question is complex. Among other things, it depends on the trust people have in the measures and the company's compensation strategy (e.g., compensation competitiveness, amount of risk they want managers to bear).

8. What has happened since the case was written?

Many things happened since the case was written. There was significant management turnover. First, the manufacturing cost manager (Scott Molaro) resigned. The operating managers' resistance to change frustrated him. Then there was significant turnover among the operating managers. The works manager (Charlie Bradshaw) was asked to retire. The maintenance manager (Ed Graves) was fired. The rolling/finishing manager (Paul Phillips) retired.

In April 1992, Armco Inc. acquired Cyclops Industries, Inc., another specialty steel manufacturer. The combined company needed capital, so they spun off the Midwestern Steel Division. It is now a privately held, freestanding business.

As of March 1993, the new performance measurement system was still operating. The three missing measures were still not implemented. Rob Cushman was not sure that the on-time delivery measures would be worth the cost of developing them. Managers were not sure how best to develop the maintenance measures. And they had not gotten around to developing the inspection measures.

