DECOR, INC.

Decor Inc. is a producer and distributor of decorative ornaments for both business and the home. Jack and Carolyn Moss, brother and sister began the firm, headquartered in Baton Rouge, Louisiana, in 1977. In the earliest organization, Carolyn Moss was charged with production responsibilities and Jack Moss with distribution. From its beginning and until 1984, the firm sold only in Louisiana, Alabama, and Texas. Sales in 1988 were slightly in excess of $2,000,000 and the firm grew slowly.

During 2007 Jack and Carolyn retired, and Jack's daughter, Susan Moss Burke, became president. Ms. Burke was a 1997 marketing graduate of Louisiana State University. In 1999 she earned her MBA from the University of Missouri at Kansas City. Since that time she had been given increasingly responsible positions. Her last job before joining Decor was that of vice-president of marketing for a large retail firm in Kansas City, Missouri.

As president of Decor, Ms. Burke initiated a vigorous campaign to increase sales. She believed that geographical expansion into the total Southeastern market would be relatively easy; and she was right. By 2010, the firm was selling in all Southeastern states. Sales had climbed to over $16,000,000. Recent income statements and balance sheets are included as Exhibit 1 and Exhibit 2.

Ms. Burke also decided to broaden the firm's product line. The move caused sales to increase to almost $21 million by 2015. Hidden in this figure was a declining profit picture. In 2014, net profits after taxes had decreased to less than one-half of 1 percent of sales, far below the industry average. The industry had relatively flat performance during the slow economy, primarily because customers tended to spend a constant amount on Christmas decorations, and Ms. Burke expected sales to remain stable. Sales for smaller decorations proved to be relatively recession proof.

Ms. Burke knew she needed to take steps to improve profit margins by establishing a system of financial controls. To begin this process, she hired Don Woods as vice-president of accounting and finance. Mr. Woods was a CPA and had previously worked for almost 10 years as controller for a building materials firm. One of his first tasks was to prepare a cash budget for fiscal 2016 and a complete analysis of the firm's financial picture.

Mr. Woods wanted a complete cash budget, a pro forma income statement, and a year-end pro forma balance sheet for fiscal 2016 (October 1, 2015-September 30, 2016).[1] He believed that preparation of these statements was necessary to determine the firm's cash needs and surplus cash for the coming year. He knew that preparation of the cash budget and the pro forma statements would help company- wide planning by allowing the firm to establish priorities. Mr. Woods also felt that the budget was helpful in dealing with the company's major bank, First Bengal Bank (FBB) of Baton Rouge.

Until 2007 FBB was the only bank Decor used. At that time, the company established a relationship with the Second National Bank of Louisiana. FBB, however, still handled 90 percent of the firm's loan requests and kept about 80 percent of its deposits. Les Kilometer, a vice-president at FBB, had serviced the account for the last six years. He was therefore well acquainted with the financial and operational aspects of the firm.

1 In reality, you would have actual figures for some of 2016 since in May at least the first quarter information would be known. For purposes of the case, we will ignore this fact.

Decor had lines of credit with the two banks that allowed them to cover their short-term needs. Both banks required a "clean-up provision" such the loans to be reduced to zero for at least one month during the year. Decor's policy was to be short-term debt free for two months, usually during August and September.

Mr. Woods realized that an accurate sales forecast was crucial for the cash flow statement to provide a reasonable picture of its funds flow. To accomplish this goal, he first gathered information on the economy by consulting a number of government publications as well as newsletters from Southeastern banks. The consensus forecast was for a modest growth rate if any, with consumer confidence continuing at a low level as the year progressed. Given the threat of slow economic growth, Mr. Woods concluded that Decor would need to advertise and promote heavily to meet sales projections for the new year.

Consultation with the vice-president for sales, Dorothy Sands, produced a net sales forecast of $22,000,000 for fiscal 2016. All sales were on credit. Applying the firm's historical monthly pattern to the yearly sales figure developed the monthly sales forecast shown in Exhibit 3. Normally, the firm sold 40 percent of its output between June and September. This was due primarily to Christmas buying, though the effect had lessened during the last three years. The remainder of the output was sold fairly evenly throughout the rest of the year, with the first quarter of the fiscal year a bit lower than the other quarters.

To determine the firm's collection pattern, Mr. Woods prepared an analysis of the firm's collection experience. He discovered that on the average the collection period was 60 days. Although the terms were net 45 days, he knew the firm did not plan to enforce that standard, so the 60-day average would hold. Noncollectible sales were approximately one percent of net sales. As far as bad debts were concerned, it was company policy to write off one percent of sales as bad debts at the end of the fiscal year. It was assumed that cash collections equaled 99 percent of sales at the forecasted time of collection.

Using historical data, Mr. Woods estimated the cost of goods sold to be 75 percent of sales. Exhibit 3 also details forecasts of raw materials purchases, as well as direct labor and overhead expenditures. With terms for raw materials at net 30 days, the company was committed to meeting the terms of sale. Direct labor and overhead were to be paid in the period incurred. In light of a planned increase in capital expenditures, Mr. Woods determined that yearly depreciation would amount to $600,000, spread evenly throughout the year. All depreciation costs were charged to the manufacturing operation.

Ms. Burke and Mr. Woods frequently consulted with each other regarding the purchase of new capital equipment. Both agreed that the firm must continue to acquire new equipment to improve the company's efficiency. Expected improvements would play an important part in increasing sagging profit margins. Accordingly, the firm placed an order for $540,000 of new production machinery to be delivered in January 2016. Decor planned to pay the seller one-half of the amount in January and the remainder in equal installments during April and July. The machinery vendor agreed not to charge interest during the period from January through July. In addition, Mr. Woods expected to spend $5,000 per month for small recurring capital needs.

In estimating capital requirements, Mr. Woods took a conservative stance. He felt it was unwise to operate with an extremely low cash balance since the bank would tend to regard this as poor planning. Mr. Woods knew that in fiscal 2015, Decor's cash balance had been too low during the months from June through September. During those months, cash balances were subject to greater volatility. With that in mind, the controller decided that monthly cash balances should be at least one-tenth of total projected cash outlays for raw materials, direct labor and overhead, and operating expenses in the future. Although prepaid expenses had shown a steady reduction in fiscal 2015, Mr. Woods believed this asset, along with other assets, would remain at the year-end figure.

The estimation of operating expenses, which included the approximate interest on short-term bank debt, had been proven unreliable in the past. Previously, all operating expenses had been assumed to be fixed. Upon analysis, Mr. Woods discovered a definite variable element and concluded that with increased efficiencies fixed monthly operating expenses should be budgeted at $300,000 plus 4 percent of projected net sales. The 4 percent variable cost included 1 percent for bad-debt expense. For fiscal 2016, an additional operating expense totaling $180,000, to be paid quarterly beginning in November, was budgeted for advertising and promotional expense. Although this formula would make the calculation more difficult, Mr. Woods knew it would significantly reduce the budget variance experienced by the company.

On September 30, 2012, Decor borrowed $4,000,000 for five years at 8 percent interest. The loan specified repayment in 10 equal installments on March 31 and September 30 of each year. Décor has been making the payments as agreed, and after the September 2016 payment the loan will have two payments totaling $800,000 remaining. Mr. Woods estimated that prepaids and accruals would maintain the same balances.

Federal and state income tax payments presented a difficult problem in terms of cash flow forecasting. Even though the firm's earnings were uneven during the year, Decor paid income tax based on its estimated earnings for the entire year. On October 31, 2015, the firm paid its remaining income taxes payable from fiscal 2015. On January 31, April 30, and July 31, the firm paid one-fourth of the estimated tax on the projected year's income (fiscal 2016). Income tax liability was estimated at 40 percent of net income before taxes.

Mr. Woods did not anticipate purchases for land and buildings or changes in other assets during the next year. He also did not foresee the sale or repurchase of common stock. No dividends were planned for fiscal 2016.

Mr. Woods needed to have the cash budget completed as soon as possible. To speed up the process, he decided to round off figures to the nearest thousand dollars. He also concluded that excess cash balances each month should be applied to short-term notes payable.

Selected ratios for the ornament industry are presented in Exhibit 4.

EXHIBIT 1
Decor Inc.
Balance Sheets as of September 30 (In Thousands)

	2014	2015
Assets:		
Cash	$ 250	$ 197
Accounts Receivable, Net	3,960	4,356
Inventory	1,651	1,590
Prepaid Expenses	348	302
Total Current Assets	$6,209	$6,445
Fixed Assets		
Land	$ 50	$ 100
Buildings	950	1,200
Machinery and Equipment	3,692	3,775
Less: Accumulated Depreciation	(1,441)	(1,981)
Total Fixed Assets	$3,251	$3,094
Other Assets	260	147
Total Assets	$9,720	$9,686
Liabilities and Stockholders' Equity:		
Accounts Payable	$ 550	$ 750
Accruals, Including Interest Payable	145	230
Notes Payable to Banks	1,420	1,477
Current Maturities, Long-Term Debt	800	800
Income Taxes Payable	10	86
Total Current Liabilities	$2,925	$3,343
Long-Term Liabilities	$1,600	$ 800
Total Liabilities	$4,525	$4,143
Stockholders' Equity		
Common Stock	$ 213	$ 213
Paid-in Capital	1,143	1,143
Retained Earnings	3,839	4,187
Total Stockholders' Equity	$5,195	$5,543
Total Liabilities and Stockholders' Equity	$9,720	$9,686

EXHIBIT 2
Decor Inc.
Income Statements for Fiscal Years Ending September 30
(In Thousands)

	2014	2015
Net Sales	$20,476	$20,925
Cost of Goods Sold	15,451	15,648
Gross Profit	$ 5,025	$ 5,277
Operating Expenses	4,691	4,539
Operating Profit	$ 334	$ 738
Interest	224	160
Net Income Before Taxes	$ 110	$ 578
Federal and State Income Taxes	22	230
Net Income After Taxes	$ 88	$ 348
Depreciation Expense	$ 500	$ 540

EXHIBIT 3
Decor Inc.

Projections of Monthly Sales, Raw Materials Purchases, and
Direct Labor and Overhead for August and September 2015
and for Fiscal 2016 (October 1, 2015--September 30, 2016)
(In Thousands)

	Sales	Raw Materials Purchases	Direct Labor Overhead[1]
August **(fiscal year 2015)**	$2,400	$900	$900
September **(fiscal year 2015)**	2,000	750	750
Fiscal Year 2016:			
October 2015	1,800	675	675
November 2015	1,400	525	525
December 2015	1,400	525	525
January 2016	1,400	525	525
February	1,600	600	600
March	1,800	675	675
April	1,800	675	675
May	2,000	750	750
June	2,000	750	750
July	2,200	825	825
August	2,600	975	975
September 2016	2,000	750	750

[1]Includes depreciation of $50,000 per month.

EXHIBIT 4
Peer Ratios for Decor Inc.

Selected Ratios for the Ornaments Industry for the Following Years

	2012	2013	2014	2015
Liquidity:				
1. Current Ratio	2.06	2.04	2.70	1.97
2. Acid Test	1.39	1.38	1.31	1.20
3. Current Assets/Total Assets (%)	64.97	65.21	63.08	62.67
Activity:				
4. Receivables Turnover	5.34	5.44	5.52	5.41
5. Cost of Goods Sold/Inventory	9.47	9.21	9.39	9.56
6. Net Sales/Net Working Capital	6.77	6.42	6.16	6.27
7. Net Sales/Total Assets	2.02	2.02	2.00	1.98
Leverage:				
8. Total Debt/Total Assets (%)	44.36	43.21	45.06	44.78
9. Debt/Net Worth	0.83	0.80	0.81	0.84
10. EBIT/Interest	3.16	3.29	2.87	3.04
Profitability:				
11. COGS/Net Sales (%)	75.36	76.02	75.87	75.47
12. Operating Profit/Net Sales (%)	5.21	4.98	4.96	5.11
13. Profit Before Taxes/Net Sales (%)	3.06	3.09	2.99	3.04
14. Profit Before Taxes/Total Assets (%)	6.12	6.34	6.43	6.29
15. Profit Before Taxes/Net Worth (%)	12.87	13.42	14.04	13.77