**Accounting Capstone**

**Scenario:**

The ABC Company manufactures and markets commercial grade fitness equipment. The senior management team is meeting for its second annual strategic planning session. While strategic plans usually encompass 3-5 years of the planning horizon, the CEO has asked that, for now, everyone concentrate only on years 1-3.

At the conclusion of the session, staff members will begin working on their individual plans and budgets for the coming year. The accounting manager will end up compiling all the budgets for incorporation into the strategic plan book.

**ABC Background and Current Situation**

**Company:**

* ABC develops, domestically manufactures, markets, and sells commercial-grade, strength-training fitness equipment, like that found in a health club.
* It has created a patented, revolutionary line of strength training equipment, which has clearly allowed the company to be positioned as the “innovative leader” in the market place, addressing the fitness trend of “core training.”
* The company is considering adding a line of cardiovascular (CV) training equipment including treadmills and exercise bikes.
* Its entire staff is well respected in the industry.
* Although its sales are exclusively in the United States it has, from time to time, considered expanding into international sales. International market growth has historically been at a rate 5-8% faster than domestic sales.

**Products:**

* The industry breaks its product group into cardiovascular and strength-training products. The profitability/piece overall is greatest on the strength-training equipment although the dollar value of total industry sales is 2:1 in favor of the CV equipment. However, from a COGS perspective CV COGS is equal to strength COGS + 15%.
* While ABC has in fact developed a revolutionary line of strength equipment addressing core training, duplicating this innovation in the CV line has proven to be beyond the reach of any manufacturer in the industry in the last 10-15 years, primarily due to the very high cost of developing something truly revolutionary for a product line of relatively low-margin and high-warranty costs.

**Industry:**

* As the health and fitness craze continues in America and around the world, the overall market is expected to grow 5-8% a year.
* The overseas, international fitness equipment market is growing 5-8% faster than the domestic growth rate.
* There are currently seven bonafide manufacturers of this fitness equipment: the two largest offer “one stop shop” product offerings (CV and strength products) and garner the highest market share; the other five specialize only in either strength or CV over equipment. There is talk of one or more of the CV manufacturers merging with one or more of the strength manufacturers.
* The customers-primarily health clubs-are always seeking innovative products to help market their club as different than the one down the street and attract more new members.
* Most of the larger health clubs prefer to buy all fitness equipment from one manufacturer: both strength training and cardiovascular training products.

**Current situation**

While ABC fully expects its innovative products to continue to sell well, it feels the addition of a CV line will only make the company garner greater sales due to the “one stop shop” preference of many of the larger customers. It is considering whether to add a line of CV products, sourced from a well-respected, domestic contract manufacturer.

At the same time, it is considering opening its market internationally. It has already developed personal relationships with several dealers in various countries. These dealers would act as middlemen for the sale of these U.S. products and generally face the same challenges as ABC’s domestic sales people, except for one significant issue: shipping timeliness. Because this equipment weighs a considerable amount, air freight is unrealistic. Ocean freight timing adds over a month to lead times, which would put a U.S. firm at a lead time disadvantage to internationally based competitors.

Therefore, If ABC chooses to begin international sales and marketing effort, it plans to license small manufacturing companies in each country to manufacture the product, effectively making the shipping lead time difference go away. Unfortunately with the dealer and the contract manufacturer markups there is a net difference in the COGS, amounting to a 25% cost premium for sales in the overseas markets (cogs on international sales is 25% higher than on domestic sales).

The two major, independent, strategic decisions ABC is facing as it creates its strategic plan are as follows:

1. Should they expand their product lines to include “generic” CV products, which outsell strength products 2:1 in sales $ (albeit at a lower margin) **Note:** ABC is very concerned about how customers of its revolutionary, innovatively designed strength line will view the company as a whole if it begins to also include generic treadmills and exercise bikes just like everyone else. Will the company lose its valuable position in the marketplace as the innovative leader?

2. Should the company expand into international sales knowing COGS is higher.

**Income Statement**

Last year’s income statement results below will serve as the starting point or base year for the next 3-year plan.

**Income Statement ($000’s)**

|  |  |
| --- | --- |
| Sales (domestic only, strength line only) | 10,000 |
| COGS at 65% | 6500 |
| Gross margin | 3500 |
| Less SG&A | - |
| Marketing | 970 |
| Sales | 1210 |
| New product development | 465 |
| Total SG&A | 2645 |
| Net income | 855 |

**Budget Impacts**

The members of the senior staff have agreed on the following expected departmental budget impacts regarding some of the strategic decisions they may make:

**Marketing:** The expense budget consists of depreciation expense, salary expense, advertising, trade show expense and possible international marketing expense and/or CV marketing expenses. If they choose to enter any of five viable international markets, they expect to spend $120,000/market in each budget year (net of inflation), spread out evenly through each year. If they choose to launch the CV product line, they expect to spend an additional $240,000 annually (net of inflation) on advertising, whether they sell just domestically or internationally as well; these added costs would also be spread evenly through each year.

**Selling:** The expense budget consists of depreciation, fixed-salary expense for the manager, depreciation, commission (10% on domestic sales), and warranty costs (estimated at 1% of strength sales and 15% of CV sales). If they choose to open international markets, internationally based non-commissionable dealers would be used, so no added selling expenses are expected.

**New product development:** The expense budget consists of salaries, patent fees, depreciation, and an expected one-time charge (fees for design/tooling of this product line) of $1 million I they choose to enter the CV marketplace. These costs would be a one-time, upfront fee, whenever they decide to launch that line.

Overall inflation in SG&A expense budgets is expected to be 4% but due to competition cannot be passed on in terms of price increase.

Management also recognizes that with COGS at a noncompetitive 65% of sales, there is a great need for improvement.

The expected inflation rate of 4% is assumed on all expenses except for depreciation and COGS.

**Forecasting I**

**Deliverable Length**: 500-600 words

**A.** If you had only 1 of the 4 main financial statements available to study to assess the financial health of the company, which would you prefer to have:

* Income statement
* Balance sheet
* Cash flow statement
* Statement of changes in owner’s equity

State which one you would prefer and why you choose that one specifically.

**B.** Out of the 20 or more popular ratios:

* List 4 key financial ratios that could be calculated from these 4 statements.
* For each ratio listed, describe what it tells about the financial health of a company (while it is acceptable to include the ratios’ formula, this is not where your answers should be focused).