Case 11

LIQUID CHEMICAL COMPANY - REVISED*

The Liquid Chemical Company manufactured and sold a range of high-grade products throughout the United States. Many of these products required careful packing, and the company had always made a feature of the special properties of the containers used. They had a special patented lining, made from a material known as GHL, and the firm operated a department especially to maintain its containers in good condition and to make new ones to replace those damaged beyond repair.

The general manager, Mr. Walsh, suspected for some time the firm might save money, and get equally good service by buying its containers from an outside source. After careful inquiries, he approached a firm specializing in container production, Packages, Ltd., and requested a quotation. At the same time he asked Mr. Dyer, his chief accountant, to provide him with an up-to-date statement of the cost of operating the container department.

The quotation from Packages, Ltd., arrived within a few days. The firm was prepared to supply all the new containers required—at that time running at the rate of 3,000 a year—for $250,000 a year, the contract to run for a guaranteed term of four years and thereafter to be renewable from year to year. If the required number of containers increased, the contract price would be increased proportionally. Additionally, and irrespective of whether the above contract was concluded or not, Packages, Ltd., undertook to carry out purely maintenance work on containers, short of replacement, for a sum of $75,000 a year, on the same contract terms.

Mr. Walsh compared these figures with the cost figures prepared by Mr. Dyer, covering a year's operations of the container department of the Liquid Chemical Company, which were as follows:

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*This case was prepared at the Colgate Darden Graduate School of Business Administration, University of Virginia, based on a case written by Professor David Solomons.

Cost of Operating the Container Department: Mr. Dyer's Figures

Materials		$140,000
Labor		100,000
Department overhead:		
Manager's salary	$16,000	
Allocated cost of plant space	9,000	
Depreciation of machinery	30,000	
Maintenance of machinery	7,200	
Other expenses	31,500	
		93,700
		$333,700
Proportion of general administrative overhead	45,000	
Total cost of Department for year		$378,700

Walsh concluded no time should be lost in closing the container department and in entering into the contracts offered by Packages, Ltd. However, he felt bound to give the manager of the department, Mr. Duffy, an opportunity to question this conclusion before acting on it. Therefore, he called Mr Duffy in and put the facts before him, at the same time making it clear that Duffy's own position was not in jeopardy; for even if his department were closed, there was another managerial position becoming vacant shortly to which Mr. Duffy could be moved without loss of pay or prospects.

Mr. Duffy looked thoughtful and asked for time to think the matter over. The next morning, he asked to speak to Mr. Walsh again, and said he thought there were a number of considerations that ought to be borne in mind before his department was closed. "For instance," he said, "what will you do with the machinery? It cost $240,000 four years ago, but you'd be lucky if you got $40,000 for it now, even though it's good for at least another four years. And then there's the stock of GHL (a special chemical) we bought a year ago for $200,000. At the rate we're using it now, it'll last us another four years or so. We used up about one-fifth of it last year. Dyer's figure of $140,000 for materials probably includes about $40,000 for GHL. But it'll be tricky stuff to handle if we don't use it up. We bought it for $1,000 a ton, and you couldn't buy it today for less than $1,200. But you wouldn't have more than $800 a ton left if you sold it, after you'd covered all the handling expenses."

Walsh thought Dyer ought to be present during this discussion. He called him in and put Duffy's points to him. "I don't much like all this conjecture," Dyer said. "I think my figures are pretty conclusive. Besides, if we are going to have all this talk about 'what will happen if,' don't forget the problem of space we're faced with. We're paying $17,000 a year in rent for a warehouse a couple of miles away. If we closed Duffy's department, we could use some of that space and we'd have all the warehouse space we need without renting."

"That's a good point," said Walsh. "Though I must say I'm a bit worried about the men if we close the department. I don't think we can find room for any of them elsewhere in the firm. I could see whether Packages can take any of them. But some of them are getting on. There's Walters and Hines, for example. They've been with us since they left school 40 years ago, and I think the contract requires us to give them a small pension of about $3,000 a year each."

Duffy showed some relief at this. "But I still don't like Dyer's figures," he said. "What about this $45,000 for general administrative overhead. You surely don't expect to sack anyone in the general office if I'm closed, do you?"

"Probably not," said Dyer, "but someone has to pay for these costs. We can't ignore them when we look at an individual department, because if we do that with each department in turn, we shall finish up by convincing ourselves that directors, accountants, typists, stationery, and the like don't have to be paid for. And they do, believe me."

"Well, I think we've thrashed this out pretty fully," said Walsh, "but I've been turning over in my mind the possibility of perhaps keeping on the maintenance work ourselves. What are your views on that, Duffy?"

"I don't know," said Duffy, "but it's worth looking into. We shouldn't need any machinery for that, and I could hand the supervision over to a foreman. You'd save $6,000 a year there, say. You'd only need about one-fifth of the men, but you could keep on the oldest. You wouldn't save any space, so I suppose the rent would be the same. I shouldn't think the other expenses would be more than $13,000 a year."

"What about materials?" asked Walsh. "We use about 10 percent of the total on maintenance," Duffy replied.

"Well, I've told Packages, Ltd., that I'd let them know my decision within a week," said Walsh. "I'll let you know what I decide to do before I write to them."

QUESTIONS

1. Assuming no additional information can be readily obtained, what action should be taken?

2. What, if any, additional information do you think is necessary for a sound decision?

EXHIBIT 11-1

LIQUID CHEMICAL COMPANY - REVISED

Worksheet

	Dyer's Figures	*Total Cost Mfg. and Maintain. Inside*	*Total Cost Contract with Packages, Ltd.*	*Savings (Higher Cost) When Contracting All Outside*
Material GHL	$ 40,000			
Other	100,000			
Labor—Wages	100,000			
Pensions				
Overhead				
Mgr's salary	16,000			
Rent: Plant	9,000			
Warehouse				
Depreciation 30,000				
Maintenance 7,200				
Other expense	31,500			
Part of G&A	45,000			
Total	$378,700			
Sub Contract				
Contract—New	$250,000			
Contr.—Maint.	75,000			
Total	$325,000			
Net Difference				