# Kings Mountain Distillery, Inc.

In early August 1996, Ralph Harmon, president and chief operating officer(COO) of Kings Mountain Distillery, Inc. (KMD) of Bessemer City, North Carolina, sat in his office pondering the previous day's meeting of the board of directors and wondering if he should submit the 1996 financial statements (**Exhibits 1** and 2) to the GastoniaBanc of Gastonia, North Carolina. KMD had requested a new loan of $4 million from the bank in July, and the bank was waiting for the new financial statements before making a decision on the new KMD loan.

At the board meeting the day before, there had been considerable discussion about the 1996 reported loss of almost $1.2 million and the manner in which it had been determined. A great deal of controversy had arisen about the accounting treatment of various expenses and costs and the manner in which they were reported in the 1996 financial statements. Harmon felt that the issues raised had to be resolved quickly because the company had reached a point where additional working capital was needed immediately to maintain KMD's solvency.

## Company History

Robert Lee Hager, known as "Lee," began distilling whiskey in 1921 on the lower slopes of Kings Mountain, which is between Gastonia and Bessemer City. The previous year, the 18th Amendment to the Constitution of the United States had banned the export, import, manufacture, sale, and transportation of alcoholic beverages in the United States and its territories. In a small, heavily wooded valley surrounded by high knolls, Hager began to distill bourbon whiskey using the pure water from a local stream. Although the business was very risky due to its illegality, demand grew steadily. Remarkably, the distilling operation was never shut down by local authorities.

When the 21st Amendment to the U.S. Constitution repealed prohibition in the United States, Hager moved his distilling equipment to Bessemer City and into a barn beside his home. There he began to produce a high quality, distinctive bourbon whiskey which he marketed as "Hager's Own." Sales grew from $100 thousand in 1935 to nearly $5 million in 1941. During that time, the distillery was moved into more extensive and suitable facilities in downtown Bessemer City. Lee Hager emphasized quality, and the distillery was one of the first in the state to have its own chemical testing laboratory. The quality of the ingredients and product was constantly monitored from 1939. In addition, only the finest fire-charred white oak barrels, made locally by the Harmon family, were used in the aging process.

Production of "Hager's Own" was restricted during World War II, when more than half of the plant capacity was converted to the production of commercial alcohol for military purposes in the defense effort.

In 1985, Ralph Harmon, son-in-law of Lee Hager, took over as COO of the company. During the next 10 years, sales revenues nearly doubled. Harmon felt that the company had grown because of the stress it placed on marketing a distinctive, high-quality product and because of its concentration on only one brand of fine bourbon whiskey—Hager's Own. The company's advertising stressed the quality of its ingredients, processes, and its use of the Harmon family produced "specially prepared and cured fire-charred white oak barrels." Promotions had been very effective in establishing a brand image of Hager's Own in the consumer's mind that connoted a family produced product from rural North Carolina where people still worked hard to make a living and still cared about quality.

In 1995, the company produced less than 1% of the whiskey distilled in the United States and thus was one of the smaller distillers in the industry. Since the mid-1980s, the company's production had been stable; the financial statements for 1995 (**Exhibits 1** and **2**) were typical of the results of the preceding several years. After a surge in demand in the 1980s, no special effort had been made to gain a larger share of the market, but at a board meeting in December 1995, a decision had been made to expand production to try to capture a larger proportionate share of the increase in whiskey consumption that industry research had forecast.

This market research forecast that consumption of straight bourbon whiskey would increase as the baby boom generation matured and Generation X became more regular liquor consumers. Based on this report and other industry data, Harmon expected a doubling of straight whiskey consumption from 1995 to 2003. In view of this assumption, and because bourbon whiskey had to be aged at least four years, the board had decided to increase the production of whiskey in 1996 by 50% of the 1995 volume (see **Exhibit 2**) in order to meet the anticipated increase in consumer demand for straight bourbon whiskey in general, and for Hager's Own in particular.

## The Manufacturing Process

Hager's Own was a straight bourbon whiskey and thus, by law, had to be made from a mixture of grains containing at least 51% corn and be aged in new (not reused) charred white oak barrels. The process began when the ground corn was mixed with pure water in a large vat. To this mixture was added a certain amount of ground barley malt and rye. It was then heated slowly until the starches were converted to sugars, thus completing the "mashing" process. This mash was then pumped into a cypress fermenting vat where yeast and certain other ingredients were added. This mixture was allowed to ferment for several days until the yeast had converted the sugars into alcohol, at which time the fermenting process was complete and the mash was pumped into a distillation tower (or still) where the alcohol was separated from the "slurry," or spent mash, through a series of distillation tanks and condensers. The distilled liquor was then mixed with pure water to obtain the desired proof (percent alcohol by volume where one degree of proof equals .5% alcohol).

At this point, the whiskey was a clear liquid with a sharp, biting taste and had to be mellowed before consumption. For this process, it was pumped into 50-gallon barrels and moved to an aging warehouse. The cost accumulated in the product prior to its entry into barrels, including all direct and indirect materials and labor consumed in the production process, was approximately $1.50 per gallon (see **Exhibit 2**). The volume of production had been the same for each of the years 1991 to 1995, and all costs during this period had been substantially the same as the 1995 costs shown in **Exhibit 2**.

## Maturing or Aging Process

In order to mellow the whiskey, improve its taste, and give it a rich amber color, the new bourbon whiskey had to be matured or aged for a period of time of not less than four years under controlled temperature and humidity conditions. The new whiskey reacted with the charred oak and assimilated some of the flavor and color of the fire-charred oak during the period of aging.

Since the quality of the aging barrel was an important factor in determining the ultimate taste and character of the final product, KMD had its barrels manufactured under a unique patented process at a cost of $89 per barrel. The barrels could not be reused for aging future batches of bourbon whiskey, but the barrels could be sold to used barrel dealers for about $1.50 each at the end of the aging period.

The filled barrels were next placed in open "ricks" in an aging warehouse rented by KMD or in part of the factory building that was available for warehouse space. The increased production in 1996 necessitated the leasing of an additional warehouse at an annual cost of $280,000. The temperature and humidity of the warehouse space had to be controlled, since the quality of the whiskey could be impaired by aging too rapidly or too slowly, a process determined in part by temperature and humidity conditions.

Every six months the barrels had to be rotated from a high rick to a lower rick or vice versa or between warehouses (because of uneven temperatures at different locations in the warehouses) and sampled for quality and character up to that point in the aging process. A small amount of liquid was removed from representative barrels at this time and sent to the sampling laboratory for quality inspection (some of which was performed by skilled tasters). If the quality of the whiskey was not up to standard, certain measures were taken to adjust the aging process to bring the whiskey up to standard. At this time, each barrel was also checked for leaks or seepage, and the required repairs were made.

At the end of the four-year aging period, the barrels were removed from the ricks and dumped into regauging tanks where the charred oak residue was filtered out and volume was measured. On the average, the volume of liquid in a barrel declined by 30% during the aging process because of evaporation and leakage. Thus, a barrel originally filled with 50 gallons of raw bourbon would usually produce about 35 gallons of aged bourbon. The regauging operation was supervised by a government liquor tax agent, since it was at this point that the excise taxes of $29.50 per gallon were levied on the whiskey removed from the warehouse. Once the bourbon had been removed from the aging warehouse, it was bottled and shipped to wholesalers with the greatest speed possible because of the large amount of cash tied up in taxes on the finished product. During both 1995 and 1996, the company sold 30,000 regauged barrels of whiskey, equivalent to about 43,000 barrels of original production.

## Excerpts from the Board of Directors' Meeting—August 5, 1996

**Ralph Harmon (President and COO)** "I'm quite concerned over the prospect of obtaining the $4 million loan we need in light of our 1996 loss of $1.2 million. We have shown annual profits every year since 1980, and our net sales of $59 million this year are the same as last year, and yet we incurred a net loss for the year. I think I understand the reason for this, but I am afraid that the loan officers at GastoniaBanc will hesitate in granting KMD a new loan on the basis of our most recent performance. It looks like we are becoming less efficient in our production operation."

**Mac Hager (Production Manager)** "That is not true Ralph. You know as well as I do that we increased production by 50% this year, and with this increased production our costs were bound to increase. We cannot produce something for nothing."

**Claudette Morgan (Controller)** "Yes, but that should not necessarily reduce our income. Granted that our production costs must rise when production increases, but our inventory account takes care of the increased costs of deferring these product costs until a future period when the product is actually sold. As you can see by looking at our 1995 income statement, our cost of goods sold did not increase in 1996, since the volume of sales was the same in 1996 as in 1995. The largest share of the increase in production costs has been deferred until future periods, as you can see by looking at the increase in our inventory account of almost $1.5 million. I believe that the real reason for our loss this year was the large increase in other costs, composed chiefly of warehousing costs. The 'Occupancy costs' category in our income statement is really the summation of a group of expense accounts, including building depreciation or rent, heat, light, power, building maintenance, labor and supplies, real estate taxes, and insurance. In addition, warehouse labor cost also rose substantially in 1996. Administrative and general expenses went up, due primarily to higher interest expense on the additional money needed to finance our increase in inventory. Selling, distribution, and advertising expenses increased because we incurred costs to restructure relationships with all our distributors. Also, our smaller distributors ordered more frequently than they did previously."

**Ralph Harmon** "Well, what's our explanation for the large increase in warehousing costs, Mac?"

**Mac Hager** "As I said before, Ralph, we increased production, and this also means an increase in warehousing costs, since the increased production has to be aged for several years. You just can't age 50% more whiskey for the same amount of money."

**Ralph Harmon** "But I thought Claudette said that increased production costs were taken care of in the inventory account. Isn't that so, Claudette?"

**Claudette Morgan** "Well, yes and no, Ralph. The inventory account can only be charged with those costs associated with the direct production of whiskey, and our warehousing costs are handling or carrying costs, certainly not production costs."

**Mac Hager** "Now just a minute, Claudette, I think that some of those costs are just as valid production costs as are direct labor and materials going into the distillation of the new bourbon. The manufacturing process doesn't stop with the newly produced bourbon; why it isn't even marketable in that form. Aging is an absolutely essential part of the manufacturing process, and I think the cost of barrels and part of the warehouse labor should be treated as direct costs of the product."

**Ralph Harmon** "Great, Mac! I agree with you that warehousing and aging costs are an absolutely essential ingredient of our final product. We certainly couldn't market the bourbon before it had been aged. I think that all the costs associated with aging the product should be charged to the inventory account. I think that most of the "other costs" should be considered a cost of the product. Don't you agree, Claudette?"

**Claudette Morgan** "Sure, Ralph! Let's capitalize depreciation, interest expenses, your salary, the shareholders' dividends, our advertising costs, your secretary's salary—why, let's capitalize all our costs! That way we can show a huge inventory balance and small expenses! I'm sure GastoniaBanc and the income tax authorities would be happy to cooperate with us on it! Why, we'll revolutionize the accounting profession!"

**Ralph Harmon** "I think you're being facetious, Claudette. Be reasonable about this. I'm afraid I really don't see why we couldn't charge some of those costs you mentioned to the inventory account, since it seems to me that they are all necessary ingredients in producing our final product. What distinction do you draw between these so-called "direct" costs you mentioned and the aging costs?"

**Claudette Morgan** "By direct costs, I mean those costs that are necessary to convert raw materials into the whiskey that goes into the aging barrels. This is our cost of approximately $1.50 per gallon and includes the cost of raw materials going into the product such as grain, yeast, and malt; the direct labor necessary to convert these materials into whiskey; and the cost of any other overhead items that are needed to permit the workers to convert grain into whiskey. I don't see how aging costs can be included under the generally accepted accounting definition of the inventory cost of the product."

**Ralph Harmon** "I think we'd better defer further discussion of this entire subject until our meeting next month. In the meantime, I am going to try to get this thing squared away in my own mind. I have never really thought that financial statements had much meaning, but now I am not at all sure that they aren't truly misleading documents!

"Let's move on to selling, distribution and advertising expenses. I can't understand why these costs have increased as much as they have in 1996 since sales to each of our distributors are exactly the same as in 1995. The only change I was expecting here was the increase in advertising costs of $149,000, from $385,000 to $534,000, because of higher advertising rates."

**Sally Shields (Sales and Distribution Manager)** "We have 40 distributors. Based on the market research forecasts, I began to restructure relationships with our distributors. I had consultants prepare files on distributor characteristics, visited our distributors for discussions, drew up new legal contracts, and designed a system to evaluate distributor performance over time. I also had to give them promotional allowances and new point-of-sales material including our very popular antique neon signs. I gather from the information Claudette sent me that we spent $6,000 per distributor. In 1995 these costs were $500 per distributor.

"Of our 40 distributors, 10 are large distributors while 30 are small specialty distributors. In 1995 and 1996 we sold the equivalent of 1,200 barrels of regauged whiskey to each of our large distributors and 600 barrels to each of our small distributors. During 1995, both our large and our small distributors placed five orders each. In 1996, each of our large distributors continued to place five orders but each of our small distributors placed 10 orders rather than five. Each time an order is placed, we incur costs to confirm and input the order into the order-entry system, set aside the correct number of gallons, organize shipment and delivery, verify that the order is correctly packed, ensure that the delivery is made, send invoices and follow-up for payments. Claudette's department calculated costs of $400 for performing the activities pertaining to each order.

"In addition to the above costs, we continue to incur selling and distribution costs of $57 per barrel sold (for sales commissions and freight)."

**Ralph Harmon** "I see what you are trying to get at but I am still confused. For all these years now the selling and distribution costs per barrel have been essentially unchanged. I would like all of us to think through the implications of these higher selling and distribution costs."

"Well, let's turn briefly to the question of our developing needs for a more formal set of management controls as we grow and prepare to turn the business over to the next generation. Because we have always been essentially a family business, we really have never had much in the way of formal controls or a formal planning and control system. Now, Mac and I are thinking about retiring or at least cutting back on the time we spend in Bessemer City, and most of the family members who might have been suitable replacements have moved to Charlotte, Atlanta, and beyond and seem to have little interest in returning here.

"Several things are very different than when Lee invited me to come into the Distillery. We are much larger, and if we have evaluated the future potential of the business correctly, we will grow even larger in the next decade. As we grow, I expect that we will have to add additional facilities, just as we had to do this year as we needed more aging space. We are out of land here in the center of Bessemer City, so these new locations are likely to be physically removed from our traditional locations. Finally, the businesses of liquor production and distribution are changing to favor larger distribution organizations than we have developed, and I think that in the long run we may find that we should grow into distributors and take on other distillers' products to let us grow into a larger and more efficient distributing organization.

"Because these problems are relatively new to me, I really need some help in thinking about how we might go about assessing our management control environment, developing a management control strategy, and implementing some new management control systems that will help us and our successors to control KMD successfully.

"We have to adjourn now, but I would really appreciate your spending some time thinking about this problem and getting your ideas back to me before our next board of directors meeting."