

ORIOLE FURNITURE, INC. (A)

Bernard Mente, Vice President of the Rattan Furniture Division of Oriole Furniture, Inc., was faced with a difficult decision in mid-June. He was wondering what he should do in light of his division's failure to meet sales and profit goals during the first five months of the year. Despite the recession, the division had managed to meet the sales and profit budget for the first three months, but the deepening recession had severely affected the results of the following two months.

THE COMPANY

Oriole Furniture, Inc., is a 30-year old distributor of high-quality, imported furniture. Currently, the company was organized into four divisions: Teakwood, Antiques, Rosewood, and Rattan. Four centralized staff departments were organized to support the product groups: finance and control, marketing, purchasing, and engineering. Each of the four product divisions was a profit center.

THE RATTAN FURNITURE DIVISION

The division was established four years ago after the company decided to import completely knocked down (CKD) rattan furniture for assembly and sales to the mid-Atlantic states. The division had been an immediate success. Indeed, the division had had an annual sales growth of 35% for the past three years and sales were \$60 million last year. The division offered three main product lines: a living and dining room line, a bedroom line, and an outdoor patio line. Half of last year's sales came from the living and dining room line with the remainder from the other two product lines. Mr. Mente was in charge of the sales and production activities of all three lines. His performance was measured by the profits earned by the division and he had always been pleased to receive a healthy year-end bonus based on his division's performance.

THE PROFIT PLAN

Each division vice president prepared an annual profit plan, starting about six months before the beginning of the plan year. The first step in the process involved estimating sales for the next year. Two sales estimates were prepared for each division: one by the field sales force and another by the product specialists.

For the coming year, the individual product specialists estimated rattan furniture sales at \$75,130,000 and the field sales force estimated sales at \$77,010,000. After a discussion with the sales manager, Mente decided to use \$77,010,000 as his division's sales estimate even though there was a high degree of uncertainty about the direction of

the economy. He was confident, however, that sales would continue to grow, although not at the same rate as in past years.

The next step in the budget cycle had been estimating manufacturing costs. The production manager, Kay Gray, was given the rattan furniture sales estimate, and she then forecasted direct material, direct labor, variable manufacturing overhead, and fixed manufacturing overhead costs for each assembly area, or cost center. Gray organized production processes and work flow around three cost centers, one for each product line.

Most of the direct materials (e.g., CKD rattan parts) were imported from Singapore. The Singapore suppliers had informed Oriole to expect a 6% increase in price for the coming year. Gray used this information to increase the budgeted cost of production's direct materials. She had then estimated the hourly labor cost for each of her cost centers. Using the most recent productivity data she had for the factory, Gray had estimated the budget year's salaries and wages and then had reduced that figure by 5% to account for projected increased efficiencies (based on a learning curve tabulated for the division). For variable manufacturing overhead, she had assumed an historical percentage of direct production costs and reduced this by 5% to again account for planned, increased efficiencies. For fixed manufacturing overhead costs, she had used actual costs reported on the most recent monthly income statement and applied a 4% increase.

As part of the budgeting process, the sales, administration, logistics support, and quality control departments in the Rattan Furniture Division had had to also estimate their expenses for the coming year. In addition to the expenses incurred directly by the Rattan Furniture Division, the division was also allocated a share of the corporation's administrative costs. These costs were allocated to the divisions based on a division's sales as a percentage of total corporate sales. A division's own departmental fixed costs, plus the corporate allocated costs, comprised the fixed costs for the Rattan Furniture division.

Using the data described above, the accountant, George Jeffrey, had prepared the Rattan Furniture Division profit plan. The result was an estimated division operating profit of \$22,720,000 on a sales volume of \$77,010,000. This plan was submitted to Mr. Mensan, the company president, right on schedule for his review. (Generally, this review occurred three months before the start of the year being budgeted.) When Mr. Mensan reviewed the division's plan in relation to the specific sales and profit goals which he had established for the company at large, the combined plans of the four divisions had not met his profit expectations. In a heated discussion with Mr. Mensan, Mente had agreed to revise his division's sales up to \$81,060,000 and operating profit to \$23,900,000 (**Exhibit 1**). He had no real plan for reaching the new sales budget, but he realized that Mr. Mensan was not going to budge from his adamant push for continued sales growth at least equal to past levels. Thus, he had agreed to the upward revision, trusting that he had time to figure out how to get the division to that level.

ACTUAL PERFORMANCE

The past eight months had flown by. As Mente was looking at his January through May results, the actual performance of the division was disappointing. A comparison of actual performance with the budget showed that sales were about 11% below plan, the backlog was down 20%, and profit was roughly 18% below plan (**Exhibit 2**). Mente knew his salespeople were working harder than ever and he believed they were doing a good job in view of the poor economic picture. Improving sales would not be easy—if it could be done at all.

Mr. Mensan had told all the division managers, as recently as two weeks ago, that he still expected to reach the profit objective set for the year. He said, “We have been successful for 20 years and I expect us to continue our growth in sales and profits. Over the years, our profit plans have helped in achieving our success. They tell us where we want to go and how we will get there. It’s tough sometimes, and that is when we have to buckle down and plow ahead.”

Mente’s relatively new division had always been fast growing and very profitable. Thus, he had no experience in managing during a slowdown in sales. He realized, however, that he must come up with a plan, one that he had not yet been able to work out, for reaching the division’s profit objective. One idea he was contemplating was to delay the purchase of some new machinery which was scheduled for delivery in September. This machinery, which cost \$500,000, would replace some existing machinery that broke down frequently and led to overtime labor and, sometimes, late delivery schedules. Another possibility he thought of was to forego hiring two new furniture designers he had been looking for all year, without any success. If he didn’t hire the designers, this would save about \$100,000 in salary for the rest of the year.

“What will I tell Mr. Mensan if he stops by today?” mumbled Mente, as he continued to ponder a new plan and wonder if his days were numbered with Oriole Furniture.

Exhibit 1

ORIOLE FURNITURE, INC. (A)

Rattan Furniture Division
This Year's Original and Revised Annual Profit Plans

	<u>Original</u>	<u>Revised</u>
Sales (Net)	\$77,010,000	\$81,060,000
Variable Costs		
Direct Material	23,100,000	24,320,000
Direct Labor	11,550,000	12,020,000
Variable Manufacturing Overheads	<u>2,310,000</u>	<u>2,430,000</u>
Total Variable Costs	<u>\$36,960,000</u>	<u>\$38,770,000</u>
Contribution	\$40,050,000	\$42,290,000
Fixed Costs		
Manufacturing Overheads	2,690,000	2,810,000
Sales and Marketing	9,050,000	9,550,000
Administration	2,350,000	2,400,000
Engineering and Purchasing	<u>3,240,000</u>	<u>3,630,000</u>
Total Fixed Costs	<u>\$17,330,000</u>	<u>\$18,390,000</u>
Operating Profits	<u>\$22,720,000</u>	<u>\$23,900,000</u>
Average Assets	\$23,000,000	\$24,000,000

Exhibit 2

ORIOLE FURNITURE, INC. (A)

Rattan Furniture Division
 Comparison of Actual Performance with Budget
 January – May

	<u>Actual</u>	<u>Budget *</u>	
Sales	\$30,060,000	\$33,780,000	-11%
Variable Costs			
Direct Material	8,990,000	10,130,000	
Direct Labor	4,470,000	5,010,000	
Variable Manufacturing Overheads	<u>900,000</u>	<u>1,010,000</u>	
Total Variable Costs	<u>\$14,360,000</u>	<u>\$16,150,000</u>	
Contribution	\$15,700,000	\$17,630,000	
Fixed Costs			
Manufacturing Overheads	1,040,000	1,170,000	
Sales and Marketing	3,920,000	3,980,000	
Administration	1,020,000	1,000,000	
Engineering and Purchasing	<u>1,520,000</u>	<u>1,510,000</u>	
Total Fixed Costs	<u>\$ 7,500,000</u>	<u>\$ 7,660,000</u>	
Operating Profits	<u>\$ 8,200,000</u>	<u>\$ 9,970,000</u>	-18%
Average Assets	\$23,000,000	\$24,000,000	
Backlog	\$28,520,000	\$35,650,000	-20%

* Amounts are rounded to equal 5/12 of the amounts of the final annual budget.

CONSUMER SERVICE COMPANY (A)

Consumer Service Company was established to take advantage of the young, professional and affluent baby-boomer population. It was apparent to Mr. John Hurdle, the founder of the company, that a major part of the economy was composed of upscale consumers, where both adults in the household were employed as professionals or where both had significant other interests that occupied their time. These two consumer segments seemed to offer great opportunity for a company that provided a variety of quality services, saving the consumers' time and enhancing the quality of their life.

The company began with a home cleaning service. Initially, its regional offices were headquartered in the larger East coast suburbs and each had staffs of well-trained janitorial people who were available to perform inside home cleaning on a weekly, bi-weekly, or monthly contract basis. Recent additions to the service portfolio included exterior home maintenance, vehicle maintenance, and landscape maintenance. The concept was powerful and the business grew explosively.

ORGANIZATIONAL STRUCTURE

The basic concept was demonstrably sound, and was the root of the company's success. Part of the company's success could also be traced to its organization structure (see Exhibit 1). All four services were performed from regional offices located in a number of cities across the United States. Regional offices were staffed with a manager for each one of the four service lines and it was that manager's responsibility to hire and train the staff, supervise the day-to-day work, and conduct the local marketing. The local office administrators managed the offices, but were not involved in the functional operations. Each of the four service lines was managed as a division, by a national director. The national directors were responsible for the supervision of their respective field-service managers and for the national marketing of their service lines. Mr. Hurdle had rightly understood that the four services the company offered involved different consumer decisions, and his decision to orient the company's marketing and service directly to the interests of the buyer had fueled a large part of the company's growth.

The four product-service directors had small marketing and administrative staffs, working out of the company's headquarters in Morristown, N. J. The corporate office provided accounting, computing, legal, and administrative assistance to the divisions and the regions. Each of the four service-line directors (and an administrative vice president) reported to Mr. Hurdle, the chief executive officer. He was the model of an entrepreneur. In addition to being the founder of the company and the developer of the consumer-services idea, Mr. Hurdle had put all of his personal capital at risk in the venture. Consumer Service's stock was owned by several institutions and by about 300 individuals. Mr. Hurdle remained a 30% stockholder and his stock holdings made him a wealthy man. Of late, he had begun thinking about opening a European operation

modeled on the successful U. S. operations. After all, he could finance the start-up himself, the challenge was intriguing, and his two sons could head it up.

THE PLAN PROCESS

Each year in the fall, the division directors developed a profit plan for their divisions, committing their group to a deliverable level of sales and profits before taxes. Sales were billed to customers based on time spent on the job by the Consumer Service employee, multiplied by a standard hourly rate. Because employees were paid only for time they actually worked on jobs, and because fixed costs were relatively small, profit levels for the company were fundamentally a factor of sales levels. Indeed, division directors primarily focused their efforts on hours sold and average rates charged.

To help develop the sales plan, each division director asked their field-service managers to provide an estimate of the sales level they expected during the next year. In addition, each division's marketing staff was asked for their projections as to what the division's sales would be. In previous years, the division directors had met with Mr. Hurdle during the first week in October in a seaside resort to establish the profit plan for the divisions and for the company as a whole. Together, they reviewed the prior years' results for each division, and in a collegial discussion established their coming year's sales and profit plans. Mr. Hurdle always made an inspirational speech at the start of the proceedings and he challenged any division director who seemed to be proposing a lazy plan. But he also believed the directors were to be treated as managers of their own businesses and so he did not pry too deeply into the details of the division plans.

The profit plans were used to keep things on track during the year—if a division was falling behind plan, the director would investigate, and if necessary, change marketing programs, increase field training, or take some other action deemed necessary. The division plans were also used to forecast demand for accounting and computer services from the headquarters group. In fact, once the division plans were established, the headquarters budget was crafted and each division profit plan was allocated a share of the corporate costs. This allocation was not changed during the year regardless of the division's actual sales results.

The division plans were important to the company and to the division directors. The division directors' annual compensation was based on the following formula:

$$\begin{array}{rccccccc} \text{Base Pay} & + & 2.5\% \text{ of Planned} & + & .5\% \text{ of Sales} & - & 7.5\% \text{ of Sales} \\ \$25,000 & & \text{Sales for the Year} & & \text{over Plan} & & \text{under Plan} \end{array}$$

The time for establishing the profit plan for the coming year was fast approaching and Mr. Hurdle suggested a modification to the previous years' procedure. He suggested that the company would save time and money if each of the division directors met with him in his office to finalize plans for their individual divisions. He asked Ms. Fortright to meet with him at 2 o'clock next Thursday, October 17. She was relieved because that appointment would give her a week to study the data from her field managers and division marketing staff. However, as the week passed she became

anxious. She learned from the grapevine that she was the last of the four directors to meet with Mr. Hurdle. The other three had found the meetings to be quite unpleasant and each had left their meeting committed to a plan they thought would be difficult to meet.

(Additional facts available only to Ms. Forthright and to Mr. Hurdle are available separately from your professor.)