Case 6

James Confectioners—Part 1

Squeezed by Rising Costs, a Confectioner Struggles to Cope

Telford James and his wife, Ivey, are the second-generation owners of James Confectioners, a family-owned manufacturer of premium chocolates that was started by Telford's father, Frank, in 1964 in Eau Claire, Wisconsin. In its 50 years, James Confectioners has grown from its roots in a converted hardware store into a large, modern factory with sophisticated production and quality control equipment. In the early days, all of Frank's customers were local shops and stores, but the company now supplies customers across the United States and a few in Canada. Telford and Ivey have built on the company's reputation as an honest, reliable supplier of chocolates. The prices they charge for their chocolates are above the industry average but are not anywhere near the highest prices in the industry even though the company is known for producing quality products.

Annual sales for the company have grown to $3.9 million, and its purchases of the base chocolate used as the raw materials for their products have increased from 25,000 pounds 20 years ago to 150,000 pounds. The Jameses are concerned about the impact of the rapidly rising cost of the base chocolate, however. Bad weather in South America and Africa, where most of the world's cocoa is grown, and a workers' strike disrupted the global supply of chocolate, sending prices upward. There appears to be no relief from high chocolate prices in the near future. The International Cocoa Organization, an industry trade association, forecasts world production of cocoa, from which chocolate is made, to decline by 7.2 percent this year.[1] Escalating milk and sugar prices are squeezing the company's profit margins as well. Much to James and Ivey's dismay, James Confectioners's long-term contracts with its chocolate suppliers have run out, and the company is purchasing its raw materials under short-term, variable-price contracts. They are concerned about the impact these increases in cost will have on the company's financial statements and on its long-term health.

Ivey, who has the primary responsibility for managing James Confectioners's finances, has compiled the balance sheet and the income statement for the fiscal year that just ended. The two financial statements appear below:

[1] "Cocoa Forecasts," International Cocoa Organization, May 27, 2009, http://www.icco.org/about/press2.aspx?Id=0ji12056.

Balance Sheet, James Confectioners December 31, 20xx

	Assets
Current Assets	
Cash	$ 161,254
Accounts Receivable	$ 507,951
Inventory	$ 568,421
Supplies	$ 84,658
Prepaid Expenses	$ 32,251
Total Current Assets	$ 1,354,536
Fixed Assets	
Land	$ 104,815
Buildings, net	$ 203,583
Autos, net	$ 64,502
Equipment, net	$ 247,928
Furniture and Fixtures, net	$ 40,314
Total Fixed Assets	$ 661,142
Total Assets	$ 2,015,678
	Liabilities
Current Liabilities	
Accounts Payable	$ 241,881
Notes Payable	$ 221,725

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	Liabilities
Line of Credit Payable	$ 141,097
Accrued Wages/Salaries Payable	$ 40,314
Accrued Interest Payable	$ 20,157
Accrued Taxes Payable	$ 10,078
Total Current Liabilities	$ 675,252
Long-Term Liabilities	
Mortgage	$ 346,697
Loan	$ 217,693
Total Long-Term Liabilities	$ 564,390
Owner's Equity	
James, Capital	$ 776,036
Total Liabilities and Owner's Equity	$ 2,015,678

Income Statement, James Confectioners		
Net Sales Revenue		$3,897,564
Cost of Goods Sold		
Beginning Inventory, 1/1/xx	$ 627,853	
+ Purchases	$ 2,565,908	
Goods Available for Sale	$ 3,193,761	
− Ending Inventory, 12/31/xx	$ 568,421	
Cost of Goods Sold		$ 2,625,340
Gross Profit		$ 1,272,224
Operating Expenses		
Utilities	$ 163,698	
Advertising	$ 155,903	
Insurance	$ 74,065	
Depreciation	$ 74,043	
Salaries and Benefits	$ 381,961	
E-commerce	$ 38,976	
Repairs and Maintenance	$ 58,463	
Travel	$ 23,385	
Supplies	$ 15,590	
Total Operating Expenses		$ 986,084
Other Expenses		
Interest Expense	$ 119,658	
Miscellaneous Expense	$ 1,248	
Total Other Expenses		$ 120,906
Total Expenses		$ 1,106,990
Net Income		$ 165,234

To see how the company's financial position changes over time, Ivey calculates 12 ratios. She also compares James Confectioners's ratios to those of the typical firm in the industry. The table below shows the value of each of the 12 ratios from last year and the industry median:

Ratio Comparison

Ratio	James Confectioners Current Year	James Confectioners Last Year	Confectionery Industry Median*
Liquidity Ratios			
Current ratio		1.86	1.7
Quick ratio		1.07	0.8
Leverage Ratios			
Debt ratio		0.64	0.7
Debt-to-Net-Worth ratio		1.71	1.0
Times-Interest-Earned ratio		2.49	2.3
Operating Ratios			
Average Inventory Turnover Ratio		4.75	4.9
Average Collection Period Ratio		34.6	23.0 days
Average Payable Period Ratio		31.1	33.5 days
Net-Sales-to-Total-Assets Ratio		2.17	2.1
Profitability Ratios			
Net-Profit-on-Sales Ratio		7.40%	7.1%
Net-Profit-to-Assets Ratio		9.20%	5.6%
Net-Profit-to-Equity Ratio		29.21%	16.5%

*from Risk Management Associates Annual Statement Studies.

"How does the financial analysis look for this year, Hon?" Telford asks.

"I'm about to crunch the numbers now," says Ivey. "I'm sure that rising chocolate prices have cut into our profit margins. The question is 'How much?'"

"I think we're going to have to consider raising prices, but I'm not sure how our customers will respond if we do," says Telford. "What other options do we have?"

Questions

1. Calculate the 12 ratios for James Confectioners for this year.
2. How do the ratios that you calculated for this year compare to those that Ivey calculated for the company last year? What factors are most likely to account for those changes?
3. How do the ratios you calculated for this year compare to those of the typical company in the industry? Do you spot any areas that could cause the company problems in the future? Explain.
4. Develop a set of specific recommendations for improving the financial performance of James Confectioners using the analysis you conducted in questions 1 to 3.
5. What pricing recommendations can you make to Telford and Ivey James?