A Change of Taste

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ABSTRACT: *This case is a disguised real world event where students break-even analysis, introduce business valuation issues, fraud, and ethics. The case is appropriate for managerial accounting courses.*

INTRODUCTION

I smiled to myself as I drove south on Interstate 95. I felt like I was joining the retiree migration to Florida. Like other retirees, I was moving back to my home town to be close to elderly relatives, long time friends and with a plan to buy a business to keep me busy and to supplement my retirement income. Many of my friends had their own businesses and were active in the local business community. One in particular, Mel Rivers, thought that he'd found a good opportunity. Mel and I grew up together and was one of my few friends who knew that I had worked for the past 20 years as a revenue agent for the Treasury Department. I generally told people that I worked for the Federal Government without mentioning that I was with the IRS.

Mel offered to introduce me to Ronald Zumbado, a business leader and respected individual within the community. Mel told me that he had met Ronald a couple of years ago at a Chamber of Commerce meeting and that Mr. Zumbado specialized in buying troubled companies, turning them around and then selling them. About a month before my official retirement date, Mel had approached Ronald to see if he knew of any businesses which might be fore sale. Ronald said "this is fabulous timing!" And went on to indicate that he was ready to sell his latest venture which was a small retail outlet selling a Spanish custard called Flan. This sweet delicacy is a favorite of local residents and tourists alike.

Mel started the meeting by saying, "Ronald, I'd like for you to meet Joe Jimenez, one of my oldest and closest friends." In our preliminary meeting Ronald told to me that he had been able to improve Tasty Flan's operations to the point that and he is ready to start something new. Ronald said that when he started the business, most of the revenue came from over the counter sales and that he had expanded sales by finding restaurants willing to put Tasty Flan on their dessert menus. He also had one Spanish market that was selling his product. He said that he felt that there was significant potential for sales growth through the commercial market for flan, but he hadn't had the chance to fully develop that potential. That was one of the reasons that he wanted to sell the business to someone who could invest the time to develop the commercial side of the business. And right now he didn't have the time because he's had to get involved in another company of his. Apparently the current owner needed some help running the business and he wanted to help the new owner make the business flourish.

Ronald exclaimed if you are interested in Tasty Flan you can have access to the business's financial statements and any other documentation necessary in order to complete your due diligence. The business leases all of its fixed assets except for a used delivery vehicle. The selling price for the business is $250,000. If you prove to be an excellent credit risk I will hold paper on the sale with a 20% down payment and the balance in a note with annual payments for 5 years at 12%. Joe, if you find these terms agreeable I will enjoy doing business with you. I assured Ronald that from what I have researched before that his terms were indeed competitive with other financial institutions in the area, but I would have to review the business's records before I would be willing to agree on the sales price. Ronald agreed in spirit, we set up a forthcoming meeting where I would have access to the business records for Tasty Flan. Ronald also wanted me to shadow him for a couple of days just to see how everything functions and to meet certain customers & vendors on the commercial side of the business.

As planned, I met with Ronald and while shadowing him for the first few days observed that he had a wonderful demeanor and that his relationships with everyone around him were positive. Further, he was approachable. He seemed to have control and managed an efficient operation. When we went into Ronald's office at Tasty Flan he said "did you notice that this business has significant cash sales?" I merely nodded while Ronald continued, "The information that I'm handing you shows sales figures which are approximately $40,000 less per year than the true amount." I said, "interesting, did you record all of the expenses?" He said "ABSOLUTELY!" And then with a smile handed me a package of financial material that consisted of the following: Copies of Profit/ (Loss) statements of Tasty Flan from Ronald's accountant. (See Exhibit 1); Copies of the Schedule C operating results along with the IRS transcripts for the tax years of 2005, 2006, & 2007 concerning the schedule C for Tasty Flan; state sales tax returns for Tasty Flan; and finally access to everything in the Tasty Flan office, including all of the paper copies of records in the file cabinets and to the office computer.

EXHIBIT 1

	Years		
Item	**2005**	**2006**	**2007**
Sales	**$225,000**	**$240,000**	**$280,000**
CGS:			
Materials	68,300	81,000	83,000
Labor (Part-Time)	55,000	58,000	60,000
Total CGS	**123,300**	**139,000**	**143,000**
Operating Expenses:			
Bank Charges	225	240	280
Delivery Truck Exp.	5,625	6,000	6,200
Equipment Rental	9,000	9,000	9,000
Insurance	3,375	4,800	4,875
Legal & Professional	2,250	2,400	2,500
Licensing	113	195	200
Office supplies	450	513	510
Payroll Expenses	4,208	4,437	4,590
Rent	15,000	16,000	16,000
Repairs	2,867	3,075	1,500
Total Operating Exp.	**43,113**	**46,660**	**45,655**
Utilities:			
Gas & Electric	8,438	9,000	10,500
Telecommunications	1,440	1,440	1,440
Waste Disposal	4,500	4,800	5,205
Water	3,375	3,600	4,200
Total Utilities	**17,753**	**18,840**	**21,345**
Total Expenses	**184,166**	**204,500**	**210,000**
Profit (Loss)	**$40,834**	**$35,500**	**$70,000**

After our meeting Ronald invited me to stay and start my analysis. The first thing that I did was to trace sales to Bank Statements, to the Transcripts of the IRS, and to the State Sales Returns. As I suspected they were a perfect match. I then turned my attention to the Profit & Loss Statements (Exhibit 1) in order to try a get a sense of what was happening.

I performed horizontal and vertical analysis. On a line by line basis, I didn't see anything significant. When I limited my analysis to the major category subtotals (Exhibit 2), some curious trends began to emerge. The vertical analysis shows that cost of goods sold as a percentage of sales dropped from 54.8% to 51.07% which is difficult to explain. All other expenses, in total, dropped as a percentage of sales which resulted in profit growing from 18.15% of sales to 25% of sales!

EXHIBIT 2

	Vertical Analysis			Horizontal Analysis		
Item	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**
Sales	100.00%	100.00%	100.00%	100.00%	106.67%	124.44%
CGS	54.80%	57.92%	51.07%	100.00%	112.73%	115.98%
Operating Exp.	19.16%	19.44%	16.31%	100.00%	108.23%	105.90%
Utilities	7.89%	7.85%	7.62%	100.00%	106.12%	120.23%
Total Expenses	81.85%	85.21%	75.00%	100.00%	111.04%	114.03%
Profit (Loss)	18.15%	14.79%	25.00%	100.00%	86.94%	171.43%

The sales increase of 24.44% over 2005 might be explained by the increase in selling price. From 2005 to 2006 profits declined and then from 2006 to 2007 profits almost doubled! For 2005 & 2006 the sales prices remained constant at $6.00 per individual unit, but in 2007 the sales price increased to $7.00 per individual unit. Basically an egg custard flan has a very short shelf life, so it wasn't surprising that total units produced equaled units sold. In 2005, '06, '07 units sold totaled 37,500, 40,000, & 40,000 respectively (Exhibit 3.)

EXHIBIT 3

	Years		
Item	**2005**	**2006**	**2007**
Sales	**$225,000**	**$240,000**	**$280,000**
Sales in units	37,500	40,000	40,000
Selling price per unit	$6	$6	$7

Many of the methods used to determine the selling price of a business are based upon business profit and expected future cash flows of the business. There was still something bothering me and that was the statement that Ronald made about undisclosed income. By Ronald disclosing to me the fact that he was skimming from the business made me skeptical of all of the information that he gave me so I decided to dig further.

When I was shadowing Ronald I had seen first hand how the product was produced and its ingredients. The process was simple enough and although the recipe was tweaked there was one ingredient that was constant in the mix and that is sweetened condensed milk. Other ingredients were increased or decreased with each batch for taste, but the condensed milk did not change. I knew now what steps had to be performed in order to calculate the total amount of product that was sold for the periods in question.

I examined Ronald's business records with respect to the purchases of condensed milk as shown in Exhibit 4. I interviewed one of the bakers and found that production was done in small batches and that each batch required one can of condensed milk. One batch created four individual flans. When I looked through the invoices for condensed milk, I called the suppliers that I met when shadowing Ronald. I also called a few others. The suppliers confirmed the number of cans of condensed milk that Ronald had purchased. So he was indeed claiming all of his business expenditures.

EXHIBIT 4 – CONDENSED MILK USAGE ANALYSIS

Number in cans:	2005	2006	2007
Beginning Inventory:	250	280	350
Quarter 1	4,000	4,220	4,300
Quarter 2	2,700	3,000	3,010
Quarter 3	1,800	1,950	1,815
Quarter 4	1,155	1,200	1,175
Total	9,905	10,650	10,650
Ending Inventory	-280	-350	-275
TOTAL CANS USED IN PRODUCTION	9,625	10,300	10,375
4 units per batch	4	4	4
Total Units Sold	38,500	41,200	41,500
Reported units sold (Exhibit 3)	37,500	40,000	40,000
Difference in cans:	1,000	1,200	1,500
Times selling price:	$6	$6	$7
Total undisclosed income:	$6,000	$7,200	$10,500

This analysis proves that Ronald was skimming money from the business, but incremental income was significantly less than $40,000 per year. Exhibit 4 shows that Ronald's skimming was approximately $6,000 for 2005, $7,200 in 2006, and $10,500 in 2007.

I decided to categorize to the best of my ability to cost components of Tasty Flan's expenses (Exhibit 5). As for the mixed costs:

- Delivery Vehicle: includes an existing note of $3,000 per year for the next 3 years. Note repayment is a cash outflow, but not a business expense. Note payments approximately equaled the truck's depreciation. I made a note to myself that I might want to change accountants or do it myself.

For the utility costs I plotted the bill by month and the associated units sold for the same month. I then estimated the formula for the line: $Y = a + bX$. Where the answer that I calculated for "a" the fixed cost and the amount of "b" is variable costs per unit. The amount in the table is "b" multiplied by the unit sales for 2007.

EXHIBIT 5 – ANALYSIS OF COST BEHAVIOR

	Mixed, Fixed, or Variable	2007	
		Fixed	Variable
Materials	v		$ 83,000.00
Labor	v		55,000.00
Bank Charges	f	$ 280.00	
Delivery Truck Exp.	m	3,000.00	3,200.00
Equipment Rental	f	9,000.00	
Insurance	f	4,875.00	
Legal & Professional	f	2,500.00	
Licensing	f	200.00	
Office supplies	f	510.00	
Payroll Expenses	f	4,590.00	
Rent	f	16,000.00	
Repairs	v		1,500.00
Gas & Electric	m	1,540.00	8,960.00
Telephone	f	1,440.00	
Waste Disposal	m	600.00	4,605.00
Water/Sewer	m	465.00	3,735.00
TOTALS		$ 45,000.00	$ 160,000.00

Before our next scheduled meeting I emailed him a number of questions regarding production capabilities, the timing of the sale of the business, my credit standing with him, and the amortization of the note. I also mentioned that, based upon my analysis, I wasn't confident that a price of $250,000 could be justified. I thought that Ronald stated that by the following week he will have all of my answers and that hopefully all will go according to plan.

The day arrived and we commenced our meeting. Ronald's answers to my key questions were as follows:

1. As long as we have a signed sales contract, I could keep Tasty Flan until the end of the year. This way you'll be launching the business at the start of the tourist season.
2. The business price was based upon his estimate of the discounted future potential income of the business, including the $40,000 of revenue, which he said was how he had determined the selling price of previous businesses and that method had always worked in the past.
3. Joe you have checked out with excellent credit, if you decide to purchase the business I will need a down payment of $50,000 on 12/31/08 and you will make annual payments of $55,482 to me for the next 5 years. Since the tourist season just ended, we could postpone the formal transfer of ownership until December 31, 2008 and the first note payment would be due on December 31, 2009.
4. With respect to Tasty Flan's productive capacity, given the size of the rental unit the business's production is capped at 42,000 individual units per year. (And that's pushing it to the outer limits!)

At the conclusion of the meeting I said, "Ronald, given this information I only have a couple of things that I have to accomplish via my due diligence and I will be able to give you an offer in two business days. If we agree upon a purchase price, I will have my attorney draft a purchase agreement." Ronald agreed and said that he was looking forward to my answer.

Later that day my friend Mel called to find out how things were progressing with Ronald and the Tasty Flan investigation. I told him that things were moving forward and that Ronald seemed to be very open with sharing his business information and allowed me to meet customers and suppliers, etc. And then I said "Mel, do you happen to know any of the people who have purchased a business from Ronald?" Mel said, "not really, but I heard that Ronald recently had an owner default on their note and that he took back the business and found another buyer. Why do you ask?" I responded, "Well, like most sellers, Ronald is presenting Tasty Flan in the best possible light. I thought that it might be interesting to talk to other people who had purchased businesses from him." I then added, "Ronald has been so open I don't anticipate any problems. Don't worry about it."

I thought to myself that Tasty Flan looked exactly like the business of my retirement dreams. I particularly liked the idea of working the counter and getting reacquainted with people in the neighborhood. Right now the retail sales were just carryout. I thought it might be worthwhile to put in a couple of small tables and encourage customers to stay and have some flan and coffee before taking their order home for their family. And then there was the possibility of expanding wholesale sales to other grocery stores and restaurants. Ronald appeared to be very open, cooperative, and willing to work with me. The terms of the note were competitive for a first time business owners. However, the repossession and resale of one of his other businesses bothered me. And of course, as a former IRS agent, not reporting all of the Tasty Flan's income concerned me. Of course I would report all of the income.

I decided that I needed net profit from the business of at least $45,000. The net amount, after paying Social Security taxes and income taxes would be a nice supplement to my government pension.

INSTRUCTIONS

Joe is faced with a business decision that can affect the rest of his life. Assume that the business will continue to operate as show in 2007. Finish Joe's due diligence by calculating the following:

1. a. Tasty Flan's unit variable costs for 2007 using the Joe's estimate of sales volume.
   b. The number of units that Joe Jimenez would need to sell in order to achieve his objectives.
   c. What are the dollar sales required to achieve this objective.
   d. Prepare a contribution margin income statement for 2009.

2. Based upon the findings in question #1, should Joe purchase the business from Ronald? (Please explain your answer.)

3. What are the ethical issues that are found in this case? Explain what should be done and the consequences of the actions that you have taken.

Teaching Note/Instructor Manual available from the Journal of Business Cases and Applications