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LUNAFRANC CAFÉ AND BENTLEY'S BOARD ROOM: A DUO OF CONNECTED MINI CASES

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Bentley Boddington, CEO and founder of Lunafranc Ltd., has grown his business from a single location hands-on operation, in which he basically did everything, to the current large scale retail business with almost 150 sites throughout Europe. With this growth has come the usual associated problems, most of which Bentley has handled proficiently, growing his skills as the business demanded. His weakness has always been on the financial side. As the operating decisions became more complex, his frustrations grew. Two immediate problems recently surfaced requiring outside financial advice, one concerning the advisability of adding new product lines, and the other in the area of performance compensation for top management. Bentley needs to know the feasibility of several new product lines under consideration, and also how to structure compensation incentives that reflect accurate operating profits among his business sectors.

LUNAFRANC CAFÉ – PART 1

COMPANY BACKGROUND

Bentley Boddington, and his wife Belinda, started the Lunafranc Café with a small coffee shop / café, located in Cheshire, England back in 1990. Hard work, good business insights, and a little luck (good market timing) contributed to strong early success. They opened several new cafés within the next few years, and later many more, most of them highly successful. Bentley and Belinda divorced in 2004, with Belinda taking half the operations, half the money, and most of Bentley's heart. He never really recovered, emotionally, he's still searching. He turned his grief into concentrating on the business and very successfully. Now with 142 cafés, the business has grown to be a very smart operation, with the help of his managers, and maybe now, Suzi his newest significant other. In the meantime, Bentley has turned away from the daily operations a bit, explaining his new interest in Caribbean vacations.

Originally, the Lunafranc café served the usual variety of coffee drinks and pastries, and that was it. They didn't sell bulk coffee, sandwiches, other drinks, coffee cups, music, clothing, ice-cream, or other items sometimes found in similar shops. Two years ago Bentley hired some consultants who suggested further growth had the most potential in wholesaling new products, capitalizing on the great Lunafranc image Bentley had built.

Since then Bentley has introduced the three wholesale product lines suggested: coffee cups, clothing, and ice-cream, with separate product management teams for each line. They sell some of these products at the regular retail cafés, but most of the new wholesale product line is with large retailers, grocery stores, discounters, like that. All the products have taken off nicely, some better than others. Many of the product costs can be directly identified with the individual products, however, some costs are not so easily traced to the individual products. The CPAs suggested allocating those costs across all divisions and product lines. They said it wasn't really that important how the costs were allocated as long as they were all accounted for because the financials would maintain their all-important GAAP status. Bentley thought it was funny, those bean counters – good with numbers, but didn't even know how to spell that popular jeans brand. Anyway, the CPAs seemed to think that allocating out unidentifiable product costs was not terribly challenging, saying that several methods might suffice, the simpler the better. They suggested allocating costs based on the proportion of sales dollars each product had. Bentley liked simple. Why get into big complicated systems if there's no real need? The higher the sales, the more they probably cost, hence charging back based on sales seemed right; CPAs ought to know – it's their business. Unlike Bentley, however, some of the product managers, and Suzi, felt otherwise. Hmm. Back to the drawing board.

LUNAFRANC CAFÉ – BENTLEY BREAKS IN BILLY

"Be a peach and grab that goo for my back won't you Suzi?" Bentley, still suffering from the long hike along the Denali mountain trail he was forced to endure yesterday, says, barely waking up yet. Bentley met her a couple of years ago at some ridiculous business retreat someone had talked him into attending. Seemed Suzi had the same ideas about the retreat as he did; they retreated out of there, and have been a couple, more or less, off and on ever since. They grew on each other; you know how it goes. She was a mysterious package, part of her attraction; lioness by day, running herd over a pack of wild accountants as the managing partner of the Deloitte & Touche practice in Prague.

Bentley had it pretty good; Suzi was part of that lately. Plus, business was very successful, kind of running itself nowadays, good health, that is if you don't count the extra 25 kilos he seemed to carry around. Hey, life was good, if not a little boring from time to time. Sometimes though, Bentley naively thought times were more interesting back when he was more involved in the business, struggling through the ups and downs of daily operations, begging for enough cash to keep things going yet a little longer.

Cash was no longer a problem. That is, unless you consider the frustrations of figuring out how to spend it. Business was good, over 150 locations now, three regions. Seems Bentley did such a good job getting the business developed and managed, that they really don't need his input much anymore.

Bentley was hoping to forget about that back thing. Being his clumsy self, he managed to slip on the glacier. What, he wondered, was he thinking when he agreed to a summer vacation involving ICE? Of course he slipped and fell down to the rocks, rocks and, yes, water, frigid water.

However, there was something else creating a problem on the horizon that directly involved Suzi. Suzi's son Billy had been recently hired by Lunafranc. Billy Byington was the darling of his mom's eye. She had nurtured him well in the importance of education and hard work as he grew up. He was at the point now that he really wanted to show his mom that her care and his education had some real value. He loved business and had lots of ideas for Lunafranc. He had tried to get Bentley to listen to him, but with limited success. To Bentley, Billy was kind of excess baggage that came with the Suzi package. However, some of Billy's ideas weren't so bad. Even his latest idea might be OK. Anyway, Bentley figures if Billy's idea works, Billy will go manage things and be gone. If things don't work out, Bentley always can say he gave him a chance.

Billy has an idea that Bentley's cafés should try and capture some retail trade in addition to the standard coffee and pastry service now offered. Bentley had built the business based on simplicity and service – with utmost quality in both. That combination worked well. Not messing with success is something they may not teach in management classes in fancy business schools, but it has an appealing intuitive appeal, one that Bentley had stuck with. So far. Bentley had agreed to meet with Billy to hear out the retail plan.

However, Suzi had a plan of her own. Her idea for today's Bentley and Billy meeting, the two B's in her life, was to keep things at the idea stage. Let Billy give the basics, the plan, describe the products he proposed, the marketing theme, but avoid specifics. She was onto Bentley. She figured he'd hit Billy in his weak area, which was figures, finances, analytical work. Billy was so creative, so tuned to the market and the customer that he could present that beautifully. But he didn't have a head for figures.

Anyway, once Billy got Bentley to see that the marketing made sense, right when Bentley would [predictably] start trying to frustrate Billy by demanding all kinds of financial projections, Billy would calmly (as she coached him) tell Bentley that his financial concerns and questions were very good. And that Billy would take another day or two to work up the numbers, along the lines that Bentley had [again predictably] been going. Perfect.

Suzi had met with a brilliant young group of MBA students who were required to do a consulting project for one of their courses. They were impressive, intelligent, and quick-witted. The MBA students told her that they understood Billy's plan, thought the market strategy was well developed, and were confident they could translate it to sound financial projections for Bentley. They suggested working through Billy's market plan to prepare the analyses recommended below:

SUGGESTED ANALYSIS

1. First, present a "minimum" level of sales, sales needed to at least break-even for a typical café in the first year. They hoped that this, based on very conservative market and cost projections (lower than expected prices, higher than expected costs), would show that the proposed retail market plan would easily attain sufficient sales to at least pay for itself and not suffer losses. The investment, other than some working capital for inventory, say €5,000, is minimal, requiring only €20,000 additional per café.
2. Next, prepare more realistic scenarios. Normally they would show sales needed to attain Lunafranc's usual return on investment. As the investment is so small, however, the consultants thought of simply showing the annual sales needed to make €50,000, after taxes, per café. They thought it might be interesting to do two ways: (1) repeating the conservative approach, low prices and high costs, and (2) with the actual, expected prices and costs.
3. Those (#1 & #2) shouldn't be too difficult, lots of numbers, do the first one, cut & paste the other two and you'll have all three scenarios, bingo! Now for the probabilities: Use their market studies with probabilities to prepare an overall, single projection of sales required for the €50,000 profit. Careful here, check your work – some solutions seem right, but are not!

<u>FIX IT:</u> Take on the problem. Help out Suzi with her plan. <u>Prepare the financial projections described above</u>.

Following is information about the proposed new line of retail goods Billy is proposing:

	Product P R I C E		Product C O S T		SALES
Product	**"low"**	**"expected"**	**"high"**	**"expected"**	**MIX**
Coffee, 1 Kilo	**€14**	**€18**	**€11**	**€ 9**	**70%**
Music CD's	**€10**	**€12**	**€ 6**	**€ 5**	**20%**
Cups, etc.	**€ 7**	**€10**	**€ 4**	**€ 3**	**10%**

Assume there is a 25% probability that the conservative numbers, (low prices; high costs), will occur, with 75% probability at the expected level.

Income taxes for the "typical" café should be assumed at 40%.

Support your projections with the usual prestigious consultant p's "patter & pictures." That is to say, beef up the financials with elegant presentation formats, graphs, pictures, narratives on assumptions, and other explanations. Support the plan, but offer other relevant comments on potential market or other issues that may confound things. Remember you're doing this for Suzi too; she could end up being a lucrative, and certainly entertaining, client for years to come.

You could play with the mix assumptions as well, always looking for ways to garner more consulting work (and fees). For this meeting, however, <u>stick with the given mix assumptions</u>. Remember the client, serve the customer's needs. Stay with an approach that isn't too complex – after all, these are simply initial projections. Show that the sales levels to breakeven and make €50,000 are completely reasonable and attainable (are they?). Everybody's happy, Billy, Suzi, and Bentley; as are the well-paid, intelligent, engaging, eager, attractive, and articulate MBA consultants!

<u>Remember</u>: You're the Hot-Shot, MBA students. Earn your keep, put on a good business show!

LUNAFRANC CAFÉ – PART 2

BENTLEY'S BOARD ROOM

Business used to be kind of fun, Bentley was reminiscing now, back when we were smaller – just the little daily hassles, paying the bills, worrying about the help showing up, dealing with nutty customers. Now, in addition to the regional managers, and store managers, as if they weren't enough of a headache, we've got product managers. Manager this, manager that… And what exactly do these 'managers' do? Complain. And they want to get paid more! For what? And what do I get? Headaches. Nothing but headaches.

Why can't we find managers that care about what they are doing instead of what they are making, Bentley wondered? If those managers would put their heart into the cafes and products they manage, like we did back in the old days, sales and profits would go up and costs would be under control. And Bentley would even be happy to pass on some of those nice extra profits to his lazy managers. Then he could take it easy, buy the boat he was eyeing, and sit on the beach sipping his favorite beverage.

Monte called the other day. Bentley remembered. Monte used to be our best regional manager, before he got 'promoted' to manage the new ice-cream product line. Monte's telling me how unfair I treat him. Says he does more than any of our product managers, says I don't recognize that, don't pay him enough. He's complaining that he only makes a little more than Sophie, and her product (cups and kitchenware) has much lower sales. So I say to him – "Ah, Monte, how about profits, sales are nice, but we're really after profits. You remember the money we actually get to keep. Last time I checked you and Sophie had about the same profits, right Monte – boy?"

Bentley realized maybe that was a mistake, treating Monte like that. Monte gets all in a huff about accounting overhead allocations being unfairly slanted against him and in favor of Sophie and Tiffany. Since when did that big oaf know anything about accounting? The CPAs do all that financial costing junk, and do it perfectly I'd think. That's what they get all that money for, right: to AUDIT the books, make sure they're done right! So what's with him and his 'unfair cost allocation' speech?

Bentley is furious, thinking about how nobody is pulling their weight, especially Monte. He can't understand why Monte is talking about a big raise, big bonus, or whatever. To make it worse, other senior managers are floating other big ideas about replacing some old equipment, opening more cafes, adding product lines, and changing the company image. These are new ideas, but this is my money they are playing with. And spending that money spells MORE OVERHEAD. And that spells LESS profit.

"Listen to you Mister Sad-face," chimes in Suzi, between sips of her banana and fruit loops daiquiri. "Problems, problems, problems. Why don't you concentrate on the decisions you're good at, like, should you have another drink before your massage? Listen, maybe if you gave your managers a little more accountability, they'd have more incentive to work harder, smarter, and follow through better. Are your accounting systems really separating out product line profitability properly? Do you really know how much each of your products really contributes to the business? Is that how you got to build this little empire of yours, by taking everyone at their word", Suzi continues? Whatever they say goes? Think about it Bentley. Some of the biggest costs on the product side are overhead. Do you think it makes sense to spread all that overhead around to the products based on their sales, and only sales? So the more they sell, the more overhead they get charged, right? Even if that overhead cost, such as utility and equipment costs to store ice cream, has absolutely nothing to do with a product like clothing. Clothing sales go up, overhead cost allocations go up, no matter what the overhead is actually for. Sales go down, overhead cost allocations go down even though overhead for that product may actually be going up. Come on Bentley, time to put your thinking cap on."

Suzi is wondering if she really wants to get Bentley going like this. She knows him, if he gets rolling on a subject, that's it, bye bye vacation. She wonders if she should be following up with this cost stuff or following others to the bar and Jacuzzi. She hesitates, Bentley is a terrific businessman, but can be a real blockhead too. And that wasn't what this cruise was supposed to be about.

"Listen Bentley, here's the deal", charges Suzi. "You're charging out overhead to products based on their sales volume. What kind of sense does that make? You do product research for coffee branding and it gets allocated across all product lines, desserts, delicatessen goods, even our clothing and music product lines. What's with that Mr. Big Brains? Yeah, yeah, I know, your darling little CPAs told you it was ok. Those CPAs, they're the same ones that told you to expense all research costs, right? Why would you even do research if it had no future value? It's not like paying rent, or insurance, or your electric bill. Those you pay for as, or right after, you use them; you get the service, you pay, and finito, done. But research, you do that for the future, not for the present. But oh no, your sweet little CPA pals tell you to expense it all now. Think Bentley, maybe the CPAs have different objectives in their little world than you do. You want to know which products and product managers are performing best. You need accurate products cost allocations, costs that make sense. Does spreading overhead, regardless of what it is, based on sales volume make sense to you? Think Bentley. You're a successful business person because you did what you felt was right, not what a bunch of introverted number-obsessed nemesis's told you to do. Come on Bent, get back!"

Suzi's on a roll: "Why don't you get some kind of entrepreneurial thing going? See if you can't find the real overhead costs for your products, not some tangential CPA overhead allocation, but the real costs, charged to the right product. This will give you a better picture of true product profitability. Maybe Monte's right, maybe his products are contributing much more than our financials are showing. The point is, we don't know."

"Here's what I'm thinking, cut the product managers' regular salaries in half, but give them some kind of pay for performance deal. Bonuses based on real product profitability contributions. For sure Monte knows enough to know the overhead allocations are at best pretty simplistic." Suzi continues, "if they increase profits by 10% say, you give them half the additional income. Something like that." Suzi knew what she was talking about, being a partner in one of the world's largest accounting firms. She was beginning to think, however, she might have pushed Bentley a little beyond his limit.

"Hey Suzi, do me a big favor, stick to your shell collecting and sun worshiping," Bentley chuckled. Bentley likes to act the big shot, but he's beginning to think maybe Suzi's got something, especially knowing her background. Right now he pays his product managers a fixed salary, a good salary, he thinks – but they're all pretty equal. However, they get paid the same, no matter if their product sales are good or bad. Sure, if product sales and profits jump up, the product manager gets a nice raise and all, but maybe that's not enough incentive. And she might be right, how accurate is his product accounting system? Bentley is thinking more about Suzi's idea, although the fruity drinks are beginning to muddle things a bit; plus he hates it when she goes off like that, especially when she's right.

He's thinking two things: (1) is a massage better before the Jacuzzi or after?, and (2) maybe Monte (and Suzi) have a point. Hmm, if he was product manager, he wouldn't have any real incentive to do much, just come in, do the job, go home. No real reason to work harder, or smarter. Is that Suzi's point? A manager is supposed to evaluate markets and operations, come up with ideas to improve things, and then do it. Now they get paid the same no matter what happens. He remembers that idea one of his managers had a few years back. He suggested giving away lottery tickets with each purchase. Maybe that was crazy, but the point was to come up with something different that might work.

Here's what those darned "unidentifiable" product costs look like:

- Wholesale Products Division Management: Product manager and staff salaries, including office expenses – technology, phones, rent, supplies.
- Wholesale Sales Operations: There is a separate sales department for the new wholesale products. It includes a sales staff, sales order and customer service department, plus a technology person to make sure the computer ordering, sales and delivery systems are functioning properly.
- Wholesale Office Costs: The Wholesale Sales department takes up space in the corporate offices. Rent, depreciation of equipment, utilities, insurance, and other allocations are passed on to them. Retail management is done at the individual store basis, and centrally through regional management offices. These offices are located at selected stores within the region.
- Wholesale Warehousing and Packaging: Rented a separate warehouse to receive goods from suppliers, store, package, and ready for delivery.
- Wholesale Delivery: A fleet of trucks delivers the wholesale products to customers.
- Purchasing: Purchasing is done by the corporate purchasing department, which services the entire company, the café purchasing, and now the additional wholesale products.
- Corporate Allocations: Human resources, finance, market research department, and other corporate overhead is charged back to divisions and products. Product liability insurance is contracted by the corporate office for the entire company and included in the allocation for all company products.

Current Costing System:

The present system, designed on advice of the CPAs, accumulates all the above costs and then charges them to products based on a proration of its sales. While some costs such as delivery are exclusively for the new Wholesale Product Division, allocating costs to retail stores is considered appropriate because the retail stores also sell the wholesale products, although it is a small portion of their sales – and the majority of wholesale sales are with larger outside retailers. Well, that's what the CPA's said anyway.

TABLE 1 – PRODUCT COSTS & COST DRIVERS

Lunafranca Café
Costing Issues // Activity-Based Costing & Performance Incentive Systems

To design an effective costing system do the following:

1. Determine the cost pools to be charged out.
   >>> First for those that direct casual relationships, identify the cost driver.
   >>> For the rest, consider them general costs, settle on a cost allocation method
2. Calculate the Rates, based on the cost drivers determined in step one.
3. Multiply the rates time the activity, per cost driver: yeilds the allocated cost.

Step #1 is Done, Below
>> You Do Steps 2 & 3 <<

Cost Pools:	ALLOCATION NOTES	COSTS 2007 *annual*	COST DRIVING ACTIVITY — ACTIVITY		Explanations
Wholesale Products Division Management:					
Product Managers & Staffs	Identifiable by product	n/a (1)			*>>> Each staff is separate, works*
Technology	Need to be allocated	$240,000	12,000	Hours	Computer time can be traced to produ
Phones	Identifiable by product	n/a (1)			*>>> Can accumulate costs per pe*
Rent	Need to be allocated	$500,000	50,000	Sq. Feet.	Space used is easily identifiable.
Supplies	Identifiable by product	n/a (1)			*>>> Can accumulate costs per pe*
Wholesale Sales Operations					
Sales Staff	Need to be allocated	$320,000	32,000	Sales Orders	Can accumulate number of sales orders
Orders & Customer Service	Need to be allocated	$200,000	10,000	Hours	Computer usage can be traced to prod
Technology Person	Need to be allocated	$100,000	$20,000,000	Sales $*	Costs cannot be traced to products // a
					** Sales of the wholesale products o*
Wholesale Sales Office Costs					
Rent, Office Equip. Depr, Utilities, Insurance, other costs...	Need to be allocated	$240,000	20,000	Sq. Feet	Space used is easily identifiable.
Wholesale Warehousing and Packaging					
Wharehouse Rental	Need to be allocated	$160,000	40,000	Sq. Feet	Products take up separate wareshouse
Packaging	Need to be allocated	$60,000	4,000	Hours	Packaging labor times can be tracked b
Wholesale Delivery					
Trucks deliver products comingled in common shipments	Need to be allocated	$200,000	1,000,000	Miles**	Products can be tracked by invoice & s
					*** Miles per item. One shipment with 100 item*
Purchasing					
Done by corp. purchasing	Need to be allocated	$150,000	3,000	P.O.'s	Purchase Orders are identifiable by pro
Corporate Allocations					
General Management, Human Resources, Finance	Need to be allocated	$1,600,000	$80,000,000	Sales$***	Corp. overhead cannot be traced to pr
Market Research	Identifiable by product	n/a (1)			*>>> Can accumulate costs by market re*
					**** Total Company Sales Wholesale*

TABLE 2 – ACTUAL OPERATING STATISTICS

	Actual Activities: Individual Wholesale Product Areas			
	Ice Cream	Clothing	Cups, Kitchenware	
Wholesale Products Division Management:				
Technology	3,000	5,000	4,000	Hours
Rent	20,000	15,000	15,000	Sq. Feet.
Wholesale Sales Operations				
Sales Staff	3,000	8,000	21,000	Sales Orders
Ordering & Customer Service	5,000	3,000	2,000	Hours
Technology Person	$12,000,000	$6,000,000	$2,000,000	Sales $*
Wholesale Sales Office Costs				
Rent, Office Equip. Depr, Utilities…	5,000	5,000	10,000	Sq. Feet
Wholesale Warehousing and Packaging				
Wharehouse Rental	14,000	18,000	8,000	Sq. Feet
Packaging	2,000	500	1,500	Hours
Wholesale Delivery	800,000	150,000	50,000	Miles*
Purchasing	100	400	300	P.O.'s (rest are for retail cafes)
Corporate Allocations	$12,000,000	$6,000,000	$2,000,000	Sales $** (rest are retail café