***On track or off: Should this Afro-Colombian company contract or expand?***

*This teaching note was prepared by the authors and is intended to be used as a basis for classroom discussion. The views presented here are those of the authors based upon personal knowledge about this company, business experience as well as professional judgment. While all of the principals are based in Cali, Colombia, the names of the listed firms have been disguised to preserve anonymity.*

XYZ, Inc. was created by two young, black, female, Colombian entrepreneurs. The company, headquartered in the City of Cali, Colombia, began operations in 2013 but only legally incorporated two years ago. The company created, manufactured and distributed organic hair and skin care products targeting Afro-descendent consumers within Colombia, who were frequently ignored by more traditional organic cosmetic producers both within the country and elsewhere in South America.

Over last two years, XYZ increased its sales by 20% but its costs of goods sold (COGS) had concurrently grown. The owners determined they wanted to continue to use very high-quality materials, resulting in an associated COGS of 75% of sales. This meant the firm’s gross margins would continue to have only a limited capacity to cover its overhead and related expenses.

**Table 1 – XYZ 2016 Annual Summary Profit & Loss Statement**

|  |  |  |
| --- | --- | --- |
| **Items**  | **Colombian Pesos** | **Margins** |
| Sales  | $681,250,000 | 100% |
| COGS  | 510,937,500 | 75% |
| Gross Profit | 170,312,500 | 25% |
| Aggregate Overhead Expenses  |  136,250,000 | 20% |
| Operating Profit  | 34,062,500 | 5% |
| Owners Draw | 27,250,000 | 4% |
| **Net Profit** | **$6,812,500** | **1%** |

In 2017, XYZ decided it wanted to increase its annual sales by at least 30%. The owners realized that a central factor in achieving this goal would involve assuring that the company and its products were more widely known within the Afro-Colombian consumer market. Towards that end, the two owners created an Objectives of Growth Plan (OGP). The OGP assumed the firm would need to expand its website’s capacity, develop tutorial YouTube videos, research and develop new products, obtain an export license, and increase shelving space within the company’s warehouse. The associated projected expansion costs included:

**Table 2 – XYZ 2017 Projected Expansion Cash Out Costs**

| **Research and development Items** | **Costs in Colombian Pesos** |
| --- | --- |
| Web site expansion development | $1,000,000 |
| Export license | 500,000 |
| Warehouse shelving | 2,000,000 |
| You Tube video/per video |  900,000 |
| Monthly photo costs | 100,000 |
| Monthly product R&D | 80,000 |

**Next steps?**

The young owners discovered the way they were portraying XYZ’s annualized sales figures hid the seasonality of the business as indicated on Table 3.

**Table 3 – XYZ 2015 and 2016 Monthly Sales (Figures in Colombian Pesos)**

|  |  |  |
| --- | --- | --- |
| **XYZ Monthly Sales** |  |  |
|  |  |  |
| **Month** | **2015** | **2016** |
| January | 12,051,941 | 15,064,927 |
| February | 18,498,329 | 23,122,911 |
| March | 28,027,771 | 35,034,713 |
| April | 25,084,855 | 31,356,068 |
| May | 15,695,552 | 19,619,439 |
| June | 19,619,439 | 24,524,299 |
| July | 28,027,771 | 35,034,713 |
| August | 14,013,885 | 17,517,357 |
| September | 227,024,942 | 283,781,178 |
| October | 23,543,327 | 29,429,159 |
| November | 43,723,322 | 54,654,153 |
| December | 89,688,866 | 112,111,083 |
|  |  |  |
| **ANNUAL SALES** |  **$ 545,000,000**  |  **$ 681,250,000**  |
| Average Monthly Sales | 45,416,667  | 56,770,833  |

Other than in the months of September and December, the company’s associated average monthly COGS and overhead expenses exceeded what it had managed to sell each month. As a result, the entrepreneurs had engaged in a practice of taking out revolving 120-day, short-term bank loans, incurring 25% interest payments that had to come from their already tight operating margins. The two women were clear they needed another strategy to smooth out their cash flow and allow them to expand the business.

Towards that end, they were considering an offer from one of their suppliers, AAA, that would allow them to restructure the way they made inventory payments: instead of paying the full inventory cost at the time of purchase, AAA would only require a 50% deposit with the outstanding 50% due at the time that XYZ actually sold their merchandise.

XYZ had also sufficiently developed its banking relationship such that its local bank was now willing to offer a three-year, $5 million loan at 9% interest. The intent was for XYZ to immediately deal with its website, export license and shelving issues plus produce one You Tube video and leverage the same to meet its 2017 projected sales target.

In reviewing their records, XYZ’s owners discovered they were basically operating on a net 30 basis with all of their retailers and suppliers. Thus, they believed the potential financing strategy with AAA could assist in freeing up cash for XYZ to confidently plan to repay the bank loan on the projected schedule.

Or would it? And, from an operational perspective, was accepting the deal with AAA or taking out a bank loan the best strategy for XYZ’s owners to pursue?

**TEACHING NOTE**

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**Overview**

Two young Afro-Colombian entrepreneurs believe they can find a modicum of success in their country’s health and beauty industry with an infusion of capital from their local bank and the creation of a creditor relationship with a major supplier. But is their attention misdirected – should they be focused on other finance-related issues and not just strategizing about how to deal with their obvious cash flow concerns? Students are asked to place themselves in the position of the young entrepreneurs as they examine their options.

**Purpose**

This teaching case was developed to provide business students with an opportunity to apply their accounting and financial analysis skills to a common business issue facing new ventures: developing a formalized plan to assess business success or failure and modifying pre-existing operating strategies to assure the former and avoid the latter. The case allows students to review previously taught financial statement concepts including the profit and loss statement as well as the statement of free cash flows and to leverage this information to identify the profitability as well as cash flow challenges facing this company. As such, the case can be used to concurrently draw upon learners’ critical thinking and decision-making skills as part of an applied review of students’ capacities in these areas.

**Audience and placement**

This compact teaching case can be used with business undergraduate juniors and seniors to solidify their understanding of the connections between the various financial statements and their application in a real-life setting. Depending upon instructors’ preferences, it can be included as a summative assessment in the form of a post-financial statement review or quiz.

The case can also be used with business graduate students as either a formative assessment prior to reviewing financial statement concepts or as a summative evaluative, post-financial statement review, if incorporated into a post-instruction written exercise or quiz.

**Research Methods**

This compact case was developed based upon a discussion by one of the authors with a firm principal and a review of the business accounting and strategy literature.

**Learning Outcomes**

The learning outcomes for this compact case are for students to:

1. Demonstrate consolidated accounting and financial analysis knowledge by reviewing monthly and annualized profitability and cash flow financial statements and analyzing firm viability associated with the same.
2. Utilize a rational decision-making strategy and apply the same to an actual business situation.

**Discussion Questions**

1. Review the information provided on Tables 1, 2 and 3. Based upon your review, identify at least two financial challenges this business faces in trying to achieve its planned 2017 goals. Provide a rationale for the two challenges you selected. (LO1)
2. Identify the NAISCS code for businesses in the health and beauty industry. Use an appropriate on-line source to identify a typical (a) profit and loss statement; (b) statement of free cash flows; and (c) gross margin for businesses in this industry. Review this new information and identify another previously unlisted challenge that you now understand is facing this business. Provide a rationale for the additional challenge you selected. (LO1)
3. Given the challenges you identified in response to questions 1 and 2, should this business move forward with the proposed bank loan application? Cite at least two reasons why or why not? (LO2)
4. Given the challenges you identified in response to questions 1 and 2, should this business enter into a creditor relationship with their AAA supplier? Cite at least two reasons why or why not? (LO2)
5. Depending upon your complete analysis, what immediate next steps would you recommend the XYZ owners take in connection with their business? (LO2)

**Answers to the Discussion Questions**

1. Review the information provided on Tables 1, 2 and 3. Based upon your review, identify at least two financial challenges this business faces in trying to achieve its planned 2017 goals. Provide a rationale for the two challenges you selected. (LO1)

At a minimum, students should immediately focus in on the COGS and resulting gross margin. They should note that the fact that the business’s (a) COGS represents 75% of sales, resulting in a (b) gross margin of only 25% may be problematic for long-term company survival. Students should begin to hone in on the fact that the owners may need to identify ways to reduce their COGS while maintaining the high quality of their product ingredients.

1. Identify the NAISCS code for businesses in the health and beauty industry. Use an appropriate on-line source to identify a typical (a) profit and loss statement; (b) statement of free cash flows; and (c) gross margin for businesses in this industry. Review this new information and identify another previously unlisted challenge that you now understand is facing this business. Provide a rationale for the additional challenge you selected. (LO1)

Students should be referred to the North American Industry Classification System (NAICS) code for this type of business (<https://www.naics.com/search/>). With a NAICS code in hand, they should then identify appropriate industry standard financials for this type of business via BizStat.com (<http://www.bizstats.com/industry-financials.php>) or another appropriate source. Learners should compare the financial data and ratios found through these resources to those provided in the case and identify areas of similarity and difference in relation to the added challenge they identified.

1. Given the challenges you identified in response to questions 1 and 2, should this business move forward with the proposed bank loan application? Cite at least two reasons why or why not? (LO2)

Even without extensive financial calculations, students might offer cogent arguments as to why a capital investment in various promotional activities – an expanded website, You Tube videos, etc. – might or might not make sense if the firm is to achieve its projected 2017 sales goals. More complete responses might include some very preliminary market research to identify the potential size of the Afro-Colombian population and associated health and beauty care spending; more sophisticated learners may chose to project potential company sales results, based upon corresponding market size and spending within the US African American population. Some learners may also calculate anticipated 3-year loan payment costs and consider the impact on the company’s cash flow and profitability.

No matter if marketing or financial rationales are offered, they should be carefully linked with a recommendation to either move forward or not with the offered bank loan.

1. Given the challenges you identified in response to questions 1 and 2, should this business enter into a creditor relationship with their AAA supplier? Cite at least two reasons why or why not? (LO2)

Most students should recognize that creating a creditor relationship with a major supplier does not assist the firm in resolving either its profitability or cash flow challenges. Rather, a new creditor relationship complicates an already complex cash flow situation by creating another payable for the firm that it can ill afford, given its existing financial problems.

1. Depending upon your complete analysis, what immediate next steps would you recommend the XYZ owners take in connection with their business? (LO2)

Here, students can move in various directions. A common theme might include a recommendation that XYZ reduce its inventory/COGS costs to more closely align with industry averages. This would have the affect of increasing the company’s gross margins and, holding all other expenses even, would result in greater firm profitability and, correspondingly, an improved cash flow.

Students might also suggest that, if the firm wishes to move forward with any of the listed cash out expansion efforts, they ask to restructure the loan from a 3-year to a 5-year period, even if this results in an increase in bank’s proposed interest charges. Reducing cash out loan payments as the company attempts to reach its higher sales targets can only assist it in surviving, assuming the planned expenses do result in higher sales.

**Teaching strategy**

If the class session for this case instruction is 60 minutes or less, instructors may wish to have students preview the case prior to coming to class. Under these circumstances, learners should be directed to closely examine the Table 1 Summary Profit and Loss Statement and identify points of concern. They should also be asked to locate (1) the most appropriate North American Industry Classification System (NAICS) code for this type of business (<https://www.naics.com/search/>) and (2) identify appropriate industry standard financials for this type of business via BizStat.com (<http://www.bizstats.com/industry-financials.php>) or another appropriate source. Students should be asked to bring this information for use in the scheduled class discussion.

Instructors should initially set aside about 15 minutes for students to share business challenge results they identified through their pre-class research as well as the standard industry financials they may have discovered during their pre-class research. Following this initial conversation, students can be walked through each of the discussion questions.

Depending upon planned use of the exercise, the instructor can follow-up the in-class conversation with a written assignment related to any of the listed discussion questions. This allows for further consolidation of the linkages between the financial statements and strategic decisions that business owners routinely are required to make.

If the scheduled class is longer than 60 minutes, Instructors can vary this teaching strategy and have the listed pre-class preparation completed as part of a longer collective in-class discussion session.

**References**

Block, S.B., Hirt, G.A. and Danielsen, B.R. (2014), *Foundations of Financial Management* (15th ed.), McGraw-Hill Education.

Bodie, Z., Kane, A., & Marcus, A.J. (2016). *Essentials of Investments, 11th Edition*. New York: NY, Mc-Graw Hill Education. Instructors may want to focus on Chapter 14, Financial Statement Analysis.

Harrison, Jr., W.T., Horngren, C.T. and Thomas, C.W. (2014), *Financial Accounting* (10th ed.), Pearson Education.