KITCHEN SUPPLY COMPANY (KSC)

February 2007 Exam (Updated)

Ken Martin, a recent Management and Organizational Studies graduate, has just joined the controller's department of KSC. Ken had worked as a financial analyst before he returned to school.

KSC is a private company catering to customers in the restaurant business. It specializes in designing, testing and manufacturing various products in the food preparation field. It has a strong reputation for quality and dependability and is sought out by prospective customers.

KSC's largest customer is Pappa Jo's, a national fast-food franchise operation which accounts for approximately 35% of KSC's sales. KSC has worked extensively with Pappa Jo's since the latter's introduction into Canada in 1995, and an amiable and trustworthy relationship has developed between Pappa Jo's and KSC's management. KSC itself had diversified into the fast-food business in July 2000, when it opened its first "Poulet", a small restaurant specializing in chicken. This venture has proven to be quite successful, as KSC now has seven such outlets doing about six million dollars in sales each year. The future looked good in this market, as evidenced by a recent study which estimates that by 2012, 50% of all meals will be served outside the home.

On Monday, Ken met with the president to review his first assignment. The first assignment dealt with the "Poulet" side of the business. Currently there are seven outlets in various metropolitan locations. Restaurant managers are on salary for the first year of operation. After this initial period, they receive as compensation 20% of the outlet's net income after taxes.

The Poulet chain presently serves only deep-fried crispy chicken meals; however, the engineering department was recently successful in developing a new broasting cooking device which will both spit-barbeque and roast chicken. The broaster is a stand-up unit and takes less space than the deep-fryer. Each broaster can handle up to 100 chickens at a time, and provides a superior tasting, higher quality finished product than that obtained by the deep-fryer. KSC is considering whether it should install these broasters in each of its Poulet locations to replace the more bulky deep-fry equipment which has a lower-volume capacity. (see Note 1 of Exhibit 1 for the numbers of increased sa1es the broaster is estimated to generate.)

The controller, Mr. Mclntosh, told Ken that early last week he had discussed the possible changeover to broasters with Frank Sparling, the manager of Poulet Location A. This was the initial restaurant opened in July 2000 and was the first one being considered for the installation of the broaster as it was the largest outlet producing about 20% of the chain's net profit (see Exhibit 1). Mr. Sparling had been told that each new broaster would cost $160,000 installed.

Mr. Sparling was further informed that installation would take one week during which time the restaurant would have to close. The increased capacity necessitates an additional inventory in both chickens and supplies totaling $12,000 that is unlikely to be recovered. Mr. Mclntosh admitted to Mr. Sparling that the deep-fryer could be expected to last another ten years, provided that about $2,000 is spent annually on maintenance beginning this year. After ten years, KSC expects that there will be no salvage value on the deep-fryer.

Mr. Sparling, who plans to retire at the end of next year, said he would consider the matter and get back to Mr. McIntosh as soon as possible. Mr. Mclntosh then revealed to Ken that Mr. Sparling had very bluntly informed him last Friday that the management team could forget about the broaster, and that he did not care to discuss the matter anymore.

"For the life of me," Mr. McIntosh told Ken, "I don't know why he is so upset. I would like you to review the broaster proposal and give me your thoughts on it as soon as possible. We already have spent $250,000 in research and development on that project."

On Tuesday, Ken attended a sales meeting. Among others present at the meeting were Mr. Lemmon, President, Mr. Rod VanHorn, Vice President of Sales and Mr. Vito Costi, Vice President of Manufacturing. At the beginning of this meeting, Ken learned that Pappa Jo's executives had approached KSC two years ago with the proposal that KSC produce a new automated French fries 'bagger'. This bagger would automatically remove cooked French fries from the deep-fat fryer, place the appropriate amount of fries in the proper bags and stack the filled bags. This bagger would both relieve the counter personnel from the bagging duty and speed up the filling of customers' fast-food orders, especially during the peak hours. This bagger was labeled product AFS.

In order to manufacture product AFS, KSC had invested $400,000, two years ago for specialized equipment which had a useful life of 10 years and a production capacity of 1,000 units per year. Pappa Jo's had guaranteed to purchase each year for the next ten years at least 200 units at a price of $450 per unit. Mr. VanHorn had originally pressed for acceptance of this contract, not because it was financially beneficial to KSC, but rather because Pappa Jo's was such a good customer. The decision to proceed with this project was not undertaken lightly; however, KSC finally did consent, and had signed a contract with Pappa Jo's two years ago. Pappa Jo's fulfilled its commitment and purchased 400 units during the past two years. One other important feature of this contract was that, although KSC held the patent rights, it could not sell the product to anyone other than Pappa Jo's for the duration of the contract.

Last week, Mr. VanHorn had received word from the executives at Pappa Jo's that a similar product had come onto the market at a price of $350, and they wondered if KSC could reduce its price to that amount. In return, Pappa Jo's would be prepared to negate that part of the contract which disallowed KSC from selling the product to any other customer. In other words, if KSC reduced its price for product AFS to $350, it would be free to sell it to anyone. In this regard, Pappa Jo's had informed Mr. VanHorn that Burger Mac, a large hamburger chain, might be interested in the product. Mr. VanHorn had then discussed this matter with the Burger Mac executives and was confident that Burger Mac would, in fact, purchase at least 300 units per year for the next eight years; however, Burger Mac would be willing to pay only $297 per unit.

Mr. VanHorn brought this situation to Mr. Lemmon's attention, adding that he doubted that KSC would get any additional business from Burger Mac, other than the AFS sales, during the next eight years. Mr. Lemmon was very interested in this new development, and he had requested Mr. McIntosh to prepare some cost data in order to properly evaluate the proposal (see Exhibit 2). The executives were now reviewing this data at the sales meeting.

In addition to the data in Exhibit 2, Mr. VanHorn and Mr. McIntosh have come to some general agreement on what the costs might be at the 500 and 1000 volumes. Material costs are not expected to change much but due to purchase discounts should drop by $2.00 per unit at the 1000 volume level.

In addition, plating costs should decrease by about $2.50 at the 500 level and an additiona1 $2.50 at the 1000 unit level. At the 1000 unit level an additiona1 supervisor would be hired at a cost of $25,000 per year.

After a review of the data presented, Mr. VanHorn expressed a desire to sell both Pappa Jo's and Burger Mac at the same price. Mr. Costi felt this idea was ridiculous; after all, Pappa Jo's had signed a contract calling for a price of $450. Mr. VanHorn then indicated that he had previously called upon some other current and potential customers and that, assuming the negation of the exclusive clause in Pappa Jo's contract, he was confident that KSC could sell 1,000 units per year (including sales to Pappa Jo's and Burger Mac) if the price were $270 per unit. Mr. VanHorn added, "This increased volume will give us better exposure in the market place and a chance to enter into a new growth stage. I've checked out this competitive product. I agree it does the same job as our AFS, but not nearly as efficiently or quickly. We definitely have a better product which we should get onto the market before the competition can improve theirs. However, the reputation of the competition is that they are incredibly aggressive in their pricing policies. In fact, in the past they have been known to drive competitors out of the market. There is even a rumour that the Japanese are working on a more technologically-advanced competitive product."

"It seems to me," Mr. McIntosh interjected, "that we might be losing more money each time we increase our volume. I would certainly expect our selling expenses to increase. I agree with Vito. It was a bad decision from the start, so let's take our smallest loss and sell only to Pappa Jo's at $450.

Mr. Costi agreed with Mr. Mclntosh. "Increased production means hiring more people and heaven knows there is a shortage of skilled labour in the job market."

"Yes Mac, on other than our contract sales to Pappa Jo's and Burger Mac, we would pay a 10% sales commission" replied VanHorn.

Mr. Lemmon concluded the discussion, thinking that it had gone on long enough and wanting some time to think about it. "We will make a decision at our meeting on Friday morning."

After arriving at his desk the next morning, Wednesday, Ken received an urgent message requesting him to see Mr. Lemmon immediately. He went to see Mr. Lemmon, who informed him that Mr. Mclntosh had suffered a minor heart attack the previous evening and would not be back to work for at least two to three months. After a short conversation concerning Mr. McIntosh's condition, Mr. Lemmon advised Ken that, as the only other professional member of the controller's department, he would have to assume Mr. McIntosh's duties and responsibilities.

"I appreciate the confidence you have shown in me, Mr. Lemmon," replied Ken, "and I will certainly do my best."

"Call me Jim," responded Mr. Lemmon, "Ken, I would like you to prepare a report on any items which you feel may be important to the operation of KSC. It should include at least the following:

1) The Poulet broaster project
2) The AFS Project

I would like to review your report on Thursday afternoon, as your recommendations willb e discussed at the management meeting on Friday morning.

Ken left Mr. Lemmon feeling that he was certainly getting a fast introduction to KSC in a big way! His third day on the job and he was acting controller! Back in his office, Ken reflected that he only had a few hours to prepare his report; he immediately began to organize his thoughts.

Exhibit 1

POULET LOCATION A (DATA APPLYING TO DEEP-FRYER AND BROASTER)

Current seating capacity is 150, and the average number of monthly meals served is 22,500.
(Note 1 - this is expected to increase by 15% one year after installation of the new broaster.
The delay in sales results from the need to generate public awareness.)

The average price per meal will remain at the current amount due to competitive pressures, and variable costs per meal will also remain the same:

Average price per meal	$5.00	Variable cost per meal	3.00

Other costs from last year (ending June 30, 2010): $228,000
This includes depreciation on the deep-fryer based on 10 year straight line method.
The deep fryer cost was purchased 5 years ago for $90,000 and has a current salvage value of $18,000.

Additional Information

Each new broaster will cost	$160,000	**KSC TAX RATE - 45%**
Salvage value in 10 years	3,000	**KSC AFTER TAX DISCOUNT RATE - 12%**
CCA rate for both broaster and Deep-fryer	20%	

Exhibit 2

PROJECT AFS COST DATA, Prepared by Mac McIntosh

Unit Costs, based on manufacturing volume of 200 units

Direct Costs:		
	Materials	53.25
	Labour [1] (including fringe benefits)	96.72
	Plating	25.12
Indirect Costs		
	Overhead	24.18
	Depreciation	200.00
	Total Manufacturing Costs	$399.27
Selling, general and administrative costs [4]		59.78
Total Unit Costs		$459.05

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[1] Plating is done to ensure the proper anti-corrosion property of the product, especially due to the fact that the product is constantly submerged in extremely hot cooking oils.

[2] Charged on the basis of 25% of direct labour including fringe benefits (Annual costs have been: supplies $800, allocated supervision $3,000, and other plant costs $1,036)

[3] Production basis ($400,000 / 2,000 units over 10 years)

[4] Allocated at 30% of total manufacturing, exclusive of depreciation