

EXHIBIT 2.4***Pro Forma* Income Statement for the 12-Month Period
Ended December 31, 2006**

Sales		\$1,000,000
Cost of goods sold		<u>500,000</u>
Gross margin		\$500,000
Marketing expenses		
Sales expenses	\$170,000	
Advertising expenses	90,000	
Freight or delivery expenses	<u>40,000</u>	300,000
General and administrative expenses		
Administrative salaries	\$120,000	
Depreciation on buildings and equipment	20,000	
Interest expense	5,000	
Property taxes and insurance	5,000	
Other administrative expenses	<u>5,000</u>	<u>155,000</u>
Net profit before (income) tax		<u>\$45,000</u>

A *pro forma* income statement reflects a marketing manager's expectations (sales) given certain inputs (costs). This means that a manager must think specifically about customer response to strategies and tactics and focus attention on the organization's financial objectives of profitability and growth when preparing a *pro forma* income statement.

■ SUMMARY

This chapter provides an overview of basic accounting and financial concepts. A word of caution is necessary, however. Financial analysis of marketing actions is a necessary but insufficient criterion for justifying marketing programs. A careful analysis of other variables impinging on the decision at hand is required. Thus, judgment enters the picture. "Numbers" serve only to complement general marketing analysis skills and are not an end in themselves. In this regard, it is wise to consider some words of Albert Einstein: "Not everything that counts can be counted, and not everything that can be counted counts."

EXERCISES

- ✓ 1. Executives of Studio Recordings, Inc. produced the latest compact disc by the Starshine Sisters Band, titled *Sunshine/Moonshine*. The following cost information pertains to the new CD:
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|---|-----------|
| CD package and disc (direct material and labor) | \$1.25/CD |
| Songwriters' royalties | \$0.35/CD |
| Recording artists' royalties | \$1.00/CD |
| Advertising and promotion | \$275,000 |
| Studio Recordings, Inc.'s overhead | \$250,000 |
| Selling price to CD distributor | \$9.00 |

Calculate the following:

- a. Contribution per CD unit
 - b. Break-even volume in CD units and dollars
 - c. Net profit if 1 million CDs are sold
 - d. Necessary CD unit volume to achieve a \$200,000 profit
- ✓ 2. Video Concepts, Inc. (VCI) markets video equipment and film through a variety of retail outlets. Presently, VCI is faced with a decision as to whether it should obtain the distribution rights to an unreleased film titled *Touch of Orange*. If this film is distributed by VCI directly to large retailers, VCI's investment in the project would be \$150,000. VCI estimates the total market for the film to be 100,000 units. Other data available are as follows:

Cost of distribution rights for film	\$125,000
Label design	5,000
Package design	10,000
Advertising	35,000
Reproduction of copies (per 1,000)	4,000
Manufacture of labels and packaging (per 1,000)	500
Royalties (per 1,000)	500

VCI's suggested retail price for the film is \$20 per unit. The retailer's margin is 40 percent.

- a. What is VCI's unit contribution and contribution margin?
 - b. What is the break-even point in units? In dollars?
 - c. What share of the market would the film have to achieve to earn a 20 percent return on VCI's investment the first year?
- ✓ 3. The group product manager for ointments at American Therapeutic Corporation was reviewing price and promotion alternatives for two products: Rash-Away and Red-Away. Both products were designed to reduce skin irritation, but Red-Away was primarily a cosmetic treatment whereas Rash-Away also included a compound that eliminated the rash.

The price and promotion alternatives recommended for the two products by their respective brand managers included the possibility of using additional promotion or a price reduction to stimulate sales volume. A volume, price, and cost summary for the two products follows:

	<i>Rash-Away</i>	<i>Red-Away</i>
Unit price	\$2.00	\$1.00
Unit variable costs	1.40	0.25
Unit contribution	\$0.60	\$0.75
Unit volume	1,000,000 units	1,500,000 units

Both brand managers included a recommendation to either reduce price by 10 percent or invest an incremental \$150,000 in advertising.

- a. What absolute increase in unit sales and dollar sales will be necessary to recoup the incremental increase in advertising expenditures for Rash-Away? For Red-Away?
- b. How many additional sales dollars must be produced to cover each \$1.00 of incremental advertising for Rash-Away? For Red-Away?
- c. What absolute increase in unit sales and dollar sales will be necessary to maintain the level of total contribution dollars if the price of each product is reduced by 10 percent?

4. After spending \$300,000 for research and development, chemists at Diversified Citrus Industries have developed a new breakfast drink. The drink, called Zap, will provide the consumer with twice the amount of vitamin C currently available in breakfast drinks. Zap will be packaged in an 8-ounce can and will be introduced to the breakfast drink market, which is estimated to be equivalent to 21 million 8-ounce cans nationally.

One major management concern is the lack of funds available for marketing. Accordingly, management has decided to use newspapers (rather than television) to promote Zap in the introductory year and distribute Zap in major metropolitan areas that account for 65 percent of U.S. breakfast drink volume. Newspaper advertising will carry a coupon that will entitle the consumer to receive \$0.20 off the price of the first can purchased. The retailer will receive the regular margin and be reimbursed for redeemed coupons by Diversified Citrus Industries. Past experience indicates that for every five cans sold during the introductory year, one coupon will be returned. The cost of the newspaper advertising campaign (excluding coupon returns) will be \$250,000. Other fixed overhead costs are expected to be \$90,000 per year.

Management has decided that the suggested retail price to the consumer for the 8-ounce can will be \$0.50. The only unit variable costs for the product are \$0.18 for materials and \$0.06 for labor. The company intends to give retailers a margin of 20 percent off the suggested retail price and wholesalers a margin of 10 percent of the retailers' cost of the item.

- At what price will Diversified Citrus Industries be selling its product to wholesalers?
 - What is the contribution per unit for Zap?
 - What is the break-even unit volume in the first year?
 - What is the first-year break-even share of market?
5. Video Concepts, Inc. (VCI) manufactures a line of DVD recorders (DVDs) that are distributed to large retailers. The line consists of three models of DVDs. The following data are available regarding the models:

<i>Model</i>	<i>DVD Selling Price per Unit</i>	<i>Variable Cost per Unit</i>	<i>Demand/Year (units)</i>
Model LX1	\$175	\$100	2,000
Model LX2	250	125	1,000
Model LX3	300	140	500

VCI is considering the addition of a fourth model to its line of DVDs. This model would be sold to retailers for \$375. The variable cost of this unit is \$225. The demand for the new Model LX4 is estimated to be 300 units per year. Sixty percent of these unit sales of the new model is expected to come from other models already being manufactured by VCI (10 percent from Model LX1, 30 percent from Model LX2, and 60 percent from Model LX3). VCI will incur a fixed cost of \$20,000 to add the new model to the line. Based on the preceding data, should VCI add the new Model LX4 to its line of VCRs? Why?

6. Max Leonard, vice president of Marketing for Disk Computer, Inc., must decide whether to introduce a midpriced version of the firm's DC6900 personal computer product line—the DC6900-X. The DC6900-X would sell for \$3,900, with unit variable costs of \$1,800. Projections made by an independent marketing research firm indicate that the DC6900-X would achieve a sales volume of 500,000 units next year, in its first year of commercialization. One-half of the first year's volume would come from competitors' personal computers and market growth. However, a consumer research study indicates

that 30 percent of the DC6900-X sales volume would come from the higher-priced DC6900-Omega personal computer, which sells for \$5,900 (with unit variable costs of \$2,200). Another 20 percent of the DC6900-X sales volume would come from the economy-priced DC6900-Alpha personal computer, priced at \$2,500 (with unit variable costs of \$1,200). The DC6900-Omega unit volume is expected to be 400,000 units next year, and the DC6900-Alpha is expected to achieve a 600,000-unit sales level. The fixed costs of launching the DC6900-X have been forecast to be \$2 million during the first year of commercialization. Should Mr. Leonard add the DC6900-X model to the line of personal computers? Why?

7. A sports nutrition company is examining whether a new high-performance sports drink should be added to its product line. A preliminary feasibility analysis indicated that the company would need to invest \$17.5 million in a new manufacturing facility to produce and package the product. A financial analysis using sales and cost data supplied by marketing and production personnel indicated that the net cash flow (cash inflows minus cash outflows) would be \$6.1 million in the first year of commercialization, \$7.4 million in year 2, \$7.0 million in year 3, and \$5.5 million in year 4.

Senior company executives were undecided whether to move forward with the development of the new product. They requested that a discounted cash flow analysis be performed using two different discount rates: 20 percent and 15 percent.

- a. Should the company proceed with development of the product if the discount rate is 20 percent? Why?
 - b. Does the decision to proceed with development of the product change if the discount rate is 15 percent? Why?
8. Net-4-You is an Internet Service Provider that charges its 1 million customers \$19.95 per month for its service. The company's variable costs are \$.50 per customer per month. In addition, the company spends \$.50 per month per customer, or \$6 million annually, on a customer loyalty program designed to retain customers. As a result, the company's monthly customer retention rate was 78.8 percent. Net-4-You has a monthly discount rate of 1 percent.
- a. What is the customer lifetime value?
 - b. Suppose the company wanted to increase its customers' monthly retention rate and decided to spend an additional \$.20 per month per customer to upgrade its loyalty program benefits. By how much must Net-4-You increase its monthly customer retention rate so as not to reduce customer lifetime value resulting from a lower customer margin?

9. The annual planning process at Century Office Systems, Inc. had been arduous but produced a number of important marketing initiatives for the next year. Most notably, company executives had decided to restructure its product-marketing team into two separate groups: (1) Corporate Office Systems and (2) Home Office Systems. Angela Blake was assigned responsibility for the Home Office Systems group, which would market the company's word-processing hardware and software for home and office-at-home use by individuals. Her marketing plan, which included a sales forecast for next year of \$25 million, was the result of a detailed market analysis and negotiations with individuals both inside and outside the company. Discussions with the sales director indicated that 40 percent of the company sales force would be dedicated to selling products of the Home Office Systems group. Sales representatives would receive a 15 percent commission on sales of home office systems. Under the new organizational structure, the Home Office Systems group would be charged with 40 percent of

the budgeted sales force expenditure. The sales director's budget for salaries and fringe benefits of the sales force and noncommission selling costs for both the Corporate and Home Office Systems groups was \$7.5 million.

The advertising and promotion budget contained three elements: trade magazine advertising, cooperative newspaper advertising with Century Office Systems, Inc. dealers, and sales promotion materials including product brochures, technical manuals, catalogs, and point-of-purchase displays. Trade magazine ads and sales promotion materials were to be developed by the company's advertising and public relations agency. Production and media placement costs were budgeted at \$300,000. Cooperative advertising copy for both newspaper and radio use had budgeted production costs of \$100,000. Century Office Systems, Inc.'s cooperative advertising allowance policy stated that the company would allocate 5 percent of company sales to dealers to promote its office systems. Dealers always used their complete cooperative advertising allowances.

Meetings with manufacturing and operations personnel indicated that the direct costs of material and labor and direct factory overhead to produce the Home Office System product line represented 50 percent of sales. The accounting department would assign \$600,000 in indirect manufacturing overhead (for example, depreciation, maintenance) to the product line and \$300,000 for administrative overhead (clerical, telephone, office space, and so forth). Freight for the product line would average 8 percent of sales.

Blake's staff consisted of two product managers and a marketing assistant. Salaries and fringe benefits for Ms. Blake and her staff were \$250,000 per year.

- a. Prepare a *pro forma* income statement for the Home Office Systems group given the information provided.
- b. Prepare a *pro forma* income statement for the Home Office Systems group given annual sales of only \$20 million.
- c. At what level of dollar sales will the Home Office Systems group break even?