case four

PALMER LIMITED

Ms. Nancy Harris, the accountant for Palmer Limited (PL), a commercial and industrial mechanical building contractor in Saskatoon, received a request from Michel Palmer on January 6, 1999, to prepare monthly cash-flow projections for the next year, as well as a year-end projected income statement and balance sheet for the firm. The two Palmer brothers were to meet soon for their annual review with Mr. Bill Melnyk, the branch manager of the Confederation Bank. Mr. Melnyk had noted in a brief phone conversation that the bank faced a growing commitment to PL, currently $368,600.

In its past association with the bank, PL had negotiated its loan needs by outlining the cash requirements of specific contracts and by posting collateral as requested. A recent schedule of net worth that the brothers had completed for the bank valued their net personal assets, excluding the business, at $162,500. This amount consisted almost entirely of the brothers' homes and personal effects after deducting $200,000 in outstanding mortgage loans obtained from the Confederation Bank.

Their discussions with Mr. Melnyk now made it clear to the Palmer brothers that they would have to accurately assess financial needs to maintain the bank's continued support. As a starting point, they visited Ms. Harris to talk about preparation of the financial reports and the cash-flow projection.

COMPANY HISTORY

PL was founded by Michel and Andre Palmer in 1986. Before creating the firm, both Michel and Andre studied metal working in technical school and worked for several years as apprentices. Using their accumulated savings of $25,000, they decided to go into business for themselves. Since neither brother had any experience in running a business at the time of incorporation, they decided to undertake only small construction contract jobs.

Initially, PL specialized in sheet-metal work. As business proved profitable, they expanded activities to include contracts for the installation of plumbing and heating. PL grew rapidly along with the Saskatchewan economy. However, problems in the Saskatchewan economy were compounded by the Canada-wide recession of 1990-1991. With some belt-tightening and careful management, PL was able to survive the recession. By 1998, the firm had expanded to 32 production employees (10 in the metal shop and 22 in the field), plus two administrative personnel in addition to the brothers. This expansion necessitated a new plant, which PL leased, with a floor area of 10,000 square feet—9,500 square feet for the manufacturing operation and storage, and 500 square feet for the office. The major fixed asset investments of the company were the basic tools of the manufacturing operation (small tools, welding equipment, and an immovable metal-bending press), three trucks, and the two cars used by the Palmer brothers.

Michel Palmer, 46 years old, and Andre Palmer, 49, believed that with hard work the company would continue to be the success it had always been. Both brothers were considered workaholics by their business associates. As PL's business expanded, the Palmer brothers spent more time administering the company and less time working at their trades. In 1998, with rare exceptions, they spent all of their time in administration. Michel Palmer supervised the manufacturing operations and a small portion of the outside work, while Andre quoted on jobs and supervised the major portion of the outside work. This re-organization, a larger equity base, and an expanded workforce enabled the company to undertake larger contracts. The first major contract, begun in late 1996, and worth approximately $1.6 million, involved 18-20 months of work, on a large commercial development. Such a large contract was a substantial departure for the company, and it had been a major factor in gaining the increased financial support from the Confederation Bank.

BILLINGS AND COLLECTION PROCEDURE

Most of PL's revenue came from acting as a subcontractor on construction projects. This typically involved the submission of a bid for the plumbing, heating, and sheet metal work in a commercial or industrial construction project being undertaken by a contractor. If the PL bid was successful, PL would do the bulk of the work but would subcontract parts of the job such as the installation of control devices. In the construction trade, once a bid has been accepted, the contractor and subcontractor are expected to meet all specifications for the price quoted. If the materials, labour or overhead costs vary, the contractor or subcontractors bear the loss or enjoy the extra profit. Each subcontractor submits monthly billings to the contractor, outlining materials, labour and overhead allocated to the construction project in the past month. The general contractor in turn submits an estimate of total costs to the client. The architect, in consultation with the general contractor, approves, varies, or disapproves the billings, based on his estimate of the work done to date. The architect then submits the vetted billings to the client, who then pays the general contractor the amount of the approved monthly billings, less a statutory holdback (10 per cent in the case of all contracts undertaken by PL in 1998). The purpose of such holdbacks is to protect the client against mechanics' liens which could be applied against the job by subcontractors and trades people. Once the general contractor receives its billings (less the holdback), the subcontractors are each paid subject to the same 10 per cent holdback provision. Thus PL expected 90 per cent of each month's billings to be paid 30 days later, while the 10 per cent holdbacks were expected to be paid four months after all billings were submitted.

COMPETITIVE CONDITIONS

The city of Saskatoon acted as a transportation and servicing hub for a variety of industries in northern Saskatchewan, including government, farming, oil, potash, uranium and light manufacturing. The Saskatoon economy was closely tied to the resource sector. As a result, building activity in Saskatoon varied greatly from year to year. Residential construction in 1998 was down modestly from 1997 levels, but had shown a slight upward trend in the last quarter of 1998. Commercial construction was down as well in 1998 from 1997. However, overall the Canada economy had shown strong growth over the past year. As well, the consumer price index (CPI) inflation rate had remained low, below 1.5 per cent over the past year. The prime interest rate had increased slightly to 7.00 per cent, 0.75 per cent higher than a year earlier. On the positive side, in December, the Saskatoon area had a heavy snowfall, making farmers more optimistic about the coming farm season.

In order to gain a foothold in the mechanical contracting business, PL had bid aggressively for jobs in 1996. The net result of this aggressive bidding was that gross margins previously averaging 20 per cent were reduced. Flat business activity and a decline in house construction were causing the chartered banks to carefully review all of their construction loans.

CURRENT FINANCIAL POSITION

At their meeting, Ms. Harris and the Palmer brothers discussed business prospects and future plans for the firm. Ms. Harris presented the Palmer brothers with preliminary financial statements for the fiscal year ending December 31, 1998, as well as comparative statements for 1993 to 1997 (see Exhibits 1 and 2).

All three were especially bothered by the extraordinary expenses of $164,200. Of this amount, $44,600 arose from a 1995 investment in Blue Water Limited, a family business that retailed boats and motors. The company declared bankruptcy in the fall of 1997, and the investment was written off. Another $111,800 resulted from the bankruptcy of a major customer. And the remaining $7,800 arose from other minor bad debt losses.

FORECASTING FOR 1999

Ms. Harris noted that she had no information regarding future manufacturing overhead or selling and administrative expenses. The brothers told Ms. Harris that manufacturing overhead included shop supplies, rent, utilities, vehicle expenses, business and unemployment insurance, maintenance and fringe benefits. Their selling and administrative expenses encompassed owners' compensation, life insurance, office salaries, car expenses, legal and audit expenses, stationery, telephone, fax and courier. Over the next twelve months, they forecasted their expenses (excluding interest) as follows (to be paid within that month):

Monthly Forecasts of Manufacturing Overhead and Selling & Administrative Expenses

Month	Manufacturing Overhead	Selling/ Administrative Expenses	TOTAL
January 1999	$13,650	$19,500	$33,150
February	9,100	22,425	31,525
March	8,775	18,850	27,625
April	13,365	17,060	30,425
May	8,240	18,200	26,440
June	12,500	16,770	29,270
July	6,825	16,770	23,595
August	6,825	21,890	28,715
September	6,825	16,495	23,320
October	6,260	17,055	23,315
November	6,260	18,200	24,460
December	11,660	19,900	31,560

Ms. Harris next moved to a review of PL's current contracts (see Exhibits 3 to 5). The brothers noted that their estimates were highly speculative since there were many uncertainties in their line of business. For example, they pointed out that all the firms involved in one project had incurred costs higher than expected in meeting the original specifications, because of insufficient detail in the architect's original drawings. However, he had already incorporated such cost overruns in budgets presented in Exhibit 5. Michel Palmer estimated that $97,000 of the budgeted material expenses for January would likely be supplied by drawing down the available inventories (this was also the only expected change in inventory during the year). For current contracts, Palmer expected to pay its suppliers in 90 days (see Exhibits 4 and 5), while for any new contracts, Palmer expected to pay suppliers in 60 days.

The conversation turned to consideration of future prospects for the firm. Ms. Harris observed that their current contracts would be substantially completed by the end of March 1999 and asked about the type of business that could be expected in the coming year, especially in light of the uncertain local economy. Andre responded that the firm expected to return to smaller contracts with a greater emphasis on metal working and higher profit margins. He also anticipated substantial cuts in their workforce, probably down to a crew of 12 to 20. While the volume of such contracts was uncertain, they expected to generate $115,000 of billings per month, starting in April. It was difficult to estimate labour and material expenses for the new jobs; however, the brothers expected that material and labour costs would each be 37.5 per cent of billings (thus a total of 75 per cent). Ms. Harris asked about their billings expectations with this new business. Michel Palmer replied that future billings would be made when their part of the contract was essentially complete, and that the normal trade terms were net 30 days (i.e., with Palmer getting 90 per cent of billings in the next month). Holdbacks of 10 per cent on this new business were expected to be collected in four months. Reviewing their past experience, neither brother expected to return to the large contract field unless they could obtain a substantial gross margin, in the area of 20 per cent. They did not expect this to happen in the near future, but were interested in Ms. Harris' opinion. Although the firm expected to earn profits in the coming year, there would be no tax payments due to tax loss carry forwards from previous years.

The brothers closed the discussion by asking Ms. Harris to review their financial situation and prepare projected financial statements. They expected her to have the financial projections for the bank by the end of the week.

Exhibit 1

BALANCE SHEETS FOR YEARS ENDING DECEMBER 31
($000)

	1998 (prelim.)	1997	1996	1995	1994	1993
ASSETS						
Cash	$ -	$ -	$ 106.3	$ -	$ 16.3	$ 2.0
Accounts Receivable, Net	544.7	349.7	715.0	314.3	189.2	401.7
Inventory	141.7	50.7	103.4	36.7	25.1	16.9
Prepaid Expenses	58.5	87.8	40.3	14.3	20.4	6.4
Total Current Assets	744.9	488.2	965.0	365.3	251.0	427.0
Investments	22.1	65.4	54.9	48.1	35.1	29.5
Fixed Assets, Net	204.5	210.6	144.0	78.7	83.6	77.7
Other Assets	1.6	1.6	1.6	1.7	1.6	1.6
TOTAL ASSETS	$ 973.1	$ 765.8	$ 1,165.5	$ 493.8	$ 371.3	$ 535.8
LIABILITIES & EQUITY						
Bank Loan	368.6	199.3	286.0	95.6	65.0	97.5
Accounts Payable	314.6	253.5	487.2	148.2	103.9	257.4
Other Current Liabilities	89.1	81.1	113.8	60.8	59.3	50.7
Total Current Liabilities	772.3	533.9	887.0	304.6	228.2	405.6
Long Term Debt Due to Officers **	87.1	9.1	4.8	-	7.8	30.3
TOTAL LIABILITIES	859.4	543.0	891.8	304.6	236.0	435.9
Preferred Stock	39.0	39.0	39.0	39.0	39.0	39.0
Common Stock	8.1	8.1	8.1	8.1	8.1	8.1
Retained Earnings	66.6	175.7	226.6	142.1	88.2	52.8
TOTAL EQUITY	113.7	222.8	273.7	189.2	135.3	99.9
TOTAL LIABILITIES & EQUITY	$ 973.1	$ 765.8	$ 1,165.5	$ 493.8	$ 371.3	$ 535.8

*** No interest on Long Term Debt to Officers*

Exhibit 2

INCOME STATEMENTS FOR THE YEARS ENDED DECEMBER 31
($000)

	1998 (prelim.)	1997	1996	1995	1994	1993
Sales	$ 2,427.1	$ 1,822.6	$ 1,735.2	$ 1,404.4	$ 1,136.9	$ 1,211.0
Cost of Goods Sold:						
Materials	1,043.0	770.0	522.3	351.0	363.7	492.7
Labour	987.0	759.0	806.9	666.9	433.2	399.8
Depreciation	24.1	27.6	24.4	12.4	13.3	9.8
Overhead (Manufacturing)	32.5	39.0	35.8	118.3	117.7	78.7
Total Cost of Goods Sold	2,086.6	1,595.6	1,389.4	1,148.6	927.9	981.0
Gross Margin	340.5	227.0	345.8	255.8	209.0	230.0
Selling & Admin. Expenses:						
Management - Compensation	153.4	164.1	134.9	102.4	75.0	78.7
Other (including interest)	132.0	118.3	105.6	84.9	88.1	72.8
Total Selling & Admin Expenses	285.4	282.4	240.5	187.3	163.1	151.5
Net Operating Income	55.1	(55.4)	105.3	68.5	45.9	78.5
Plus: Other Income	-	-	5.2	1.7	0.4	-
Less: Other Expenses	164.2	11.1	-	-	-	44.9
Net Income Before Taxes	(109.1)	(66.5)	110.5	70.2	46.3	33.6
Taxes (see Note 1 Below)	-	(15.6)	26.0	16.3	10.9	7.8
Net Income After Taxes	$ (109.1)	$ (50.9)	$ 84.5	$ 53.9	$ 35.4	$ 25.8

Note 1: Given 1997 and 1998 losses, no taxes were expected to be paid for several years.

Exhibit 3

CURRENT CONTRACTS POSITION AS OF DECEMBER 31, 1998 AND EXPECTED BILLINGS TO MARCH 31, 1999 ($000)

Contract Position as of Dec. 31/98 (Total)	
Past Billings (Amount Billed as of Dec. 31/98)	$ 1,788.3
Expected Billings (Amount Not Billed as of Dec. 31/98)	1,022.2
Total Current Contract Positions	2,810.5
Past Billings Details	
Previously Collected During 1998	1,243.5
Holdbacks (to be received in March 1999)	178.8
December 1998 Billings (see Note 1 below)	366.0
	1,788.3
Expected Billings (for January 1999 to March 1999) Details	
January 1999	436.6
February 1999	308.5
March 1999	277.3
	$ 1,022.4

Note 1: 90 per cent of this amount to be received in January 1999; 10 per cent of this amount (holdback) to be received in April 1999.

Exhibit 4

ACCOUNTS PAYABLE AGING AS OF DECEMBER 31, 1998
($000)

Month of Purchase	Amount	% of Total Accounts Payable
December 1998	$ 69.1	22.0
November 1998	44.5	14.0
October 1998	201.0	64.0
Total Accounts Payable December 31, 1998	$ 314.6	100.0

Exhibit 5

BUDGETED MATERIALS AND LABOUR EXPENSES
FOR COMPLETION OF CURRENT CONTRACTS
($000)

	Totals
Budgeted Material Expenses	
January 1999 (see Note 1 below)	$ 252.4
February 1999	137.9
Total	390.4
Budgeted Labour Expenses	
January 1999	189.0
February 1999	104.7
March 1999	96.0
Total	$ 389.7

Note 1: $97.0 was to come from existing inventory.