

Cases

Case 5-1: Celtex

Celtex is a large and very successful decentralized specialty chemical producer organized into five independent investment centers. Each of the five investment centers is free to buy products either inside or outside the firm and is judged based on residual income. Most of each division's sales are to external customers. Celtex has the general reputation of being one of the top two or three companies in each of its markets.

Don Horigan, president of the synthetic chemicals (Synchem) division, and Paul Juris, president of the consumer products division, are embroiled in a dispute. It all began two years ago when

Juris asked Horigan to modify a synthetic chemical for a new household cleaner. In return, Synchem would be reimbursed for out-of-pocket costs. After Synchem spent considerable time perfecting the chemical, Juris solicited competitive bids from Horigan and some outside firms and awarded the contract to an outside firm that was the low bidder. This angered Horigan, who expected his bid to receive special consideration because he developed the new chemical at cost and the outside vendors took advantage of his R&D.

The current conflict involves Synchem's production of chemical Q47, a standard product, for consumer products. Because of an economic slowdown, all synthetic chemical producers have excess capacity. Synchem was asked to bid on supplying Q47 for the consumer products division. Consumer products is moving into a new, experimental product line, and Q47 is one of the key ingredients. While the order is small relative to Synchem's total business, the price of Q47 is very important in determining the profitability of the experimental line. Horigan bid \$3.20 per gallon. Meas Chemicals, an outside firm, bid \$3.00. Juris is angry because he knows that Horigan's bid contains a substantial amount of fixed overhead and profit. Synchem buys the base raw material, Q4, from the organic chemicals division of Celtext for \$1.00 per gallon. The organic chemical division's out-of-pocket costs (i.e., variable costs) are 80 percent of the selling price. Synchem then further processes Q4 into Q47 and incurs additional variable costs of \$1.75 per gallon. Synchem's fixed manufacturing overhead adds another \$0.30 per gallon.

Horigan argues that he has \$3.05 of cost in each gallon of Q47. If he turned around and sold the product for anything less than \$3.20, he would be undermining his recent attempts to get his salespeople to stop cutting their bids and start quoting full-cost prices. Horigan has been trying to enhance the quality of the business he is getting, and he fears that if he is forced to make Q47 for consumer products, all of his effort the last few months will be for naught. He argues that he already gave away the store once to consumer products and he won't do it again. He asks, "How can senior managers expect me to return a positive residual income if I am forced to put in bids that don't recover full cost?"

Juris, in a chance meeting at the airport with Debra Donak, senior vice president of Celtext, described the situation and asked Donak to intervene. Juris believed Horigan was trying to get even after their earlier clash. Juris argued that the success of his new product venture depended on being able to secure a stable, high-quality supply of Q47 at low cost.

Required:

- a. Calculate the incremental cash flows to Celtext if the consumer products division obtains Q47 from Synchem versus Meas Chemicals.
- b. What advice would you give Debra Donak?