



Graves Industries Inc. (B)

Lohnes Marine Hardware Division

In January 1986, Don O'Grady, controller and financial officer of the Lohnes Marine Hardware Division of Graves Industries Inc., reviewed the financial results for 1985. It was another record year for the Lohnes division: sales were up 12% and operating profits had increased 13% (see **Exhibit 1**). Don knew that the division president, Paul Lohnes, would be very happy to see that the final figures were a couple of million dollars above budget. The company was also well positioned for a big jump on 1986's budgeted goals.

In contrast to 1984, the fourth quarter of 1985 had been relatively relaxed. Sales were strong throughout the year, and by the beginning of the last quarter the division had already achieved almost 90% of budgeted profits and sales. In 1984 the division had only 68% of budgeted goals going into October, and it had taken a large effort by all employees to make sure the division finished on budget.

The distress of last year reinforced in Don's mind the advice he had received on his first job out of school. The controller of that company had told him (when discussing the accounting policies of his new employer) that "only a fool does not have reserves salted away for rainy days." The reserves the Lohnes division built up had been very important in 1984. But now Don wondered if the division reserves went beyond the bounds of reasonableness.

The Division

Lohnes Marine Hardware was founded in 1954 by Paul Lohnes. Paul was an avid sailboat builder in the Portsmouth, N.H. area who became frustrated by the poor support existing marine hardware companies were giving sailboat builders and owners. Paul reasoned that a full-service marine hardware and tooling business that provided special services for sailboaters could be very successful. He also felt that as disposable income increased in the United States, boating would become increasingly popular, and the market would grow rapidly.

The new Lohnes Company did very well; by 1963 the company was well-established in New England, and Paul was looking at expanding into other regions. An important part of this success

Research Assistant Joseph P. Mulloy prepared this case under the supervision of Professor Kenneth Merchant as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The case is based on knowledge of actual company situations, but the facts have been disguised, and any resemblance to actual people or events is unintentional.

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was the tools and marine rigging that Paul had originally designed and built for his own use that were now marketed by his company. The boating market was still young and growing, and Paul figured that if he could expand quickly and get a toehold across the country, he would be in good position to take his share of the market. Paul had the knowledge, but lacked the financial resources to support a large expansion.

During the summer of 1963 Paul was approached by Henry Graves, executive vice president of Graves Industries Inc., a large producer and distributor of industrial and commercial hardware and tooling. Graves wanted to expand into marine hardware, but it did not have any experience in this specialized area and was looking to make an acquisition.

At first Paul rejected Graves' offers, but in the fall of 1963 he reconsidered, and a deal was quickly hammered out. For an undisclosed sum (rumored to be quite sizable), 100% interest in Lohnes Marine Hardware was transferred to Graves Industries Inc. This transfer included the name of the company, Lohnes Marine Hardware Company, and all the proprietary products manufactured by the company. As part of the agreement Paul was to remain as president of the new marine division.

One of the major reasons Paul agreed to the acquisition was the Graves' decentralized management philosophy; the company would leave him in control of the Lohnes division with almost no corporate interference as long as results were at or above the corporation's long-term growth targets of 8% in sales and profits, and budgets were consistently achieved. Lohnes' organization, personnel policies, and accounting systems would remain as they were before the acquisition. (See organization chart in **Exhibit 2**.) The only additional procedures required were a formal capital appropriation request and a monthly reporting of financial results to headquarters for consolidation. Corporate staff monitored division results (primarily sales, profits, cash and asset control), and occasionally asked the division president or controller for explanations of variances from budget.

The infusion of capital was just what the Lohnes Marine Hardware division needed, and sales grew from \$4.1 million in 1963 to \$88.4 million in 1982—a compound growth rate of 17.5%. The division almost always met its budget targets. The toughest years were during the energy crisis of 1974-75 which rocked the power boat industry. While the marine division did not make budget those years, it still remained profitable due to its strength in the sailboat segment of the market.

During his tenure with Graves Industries, Paul realized that good performance, although well-rewarded, was soon forgotten during the next fiscal year. Furthermore, because of the way the budget cycle and bonus program worked, an excellent year this year tended to make next year's goals even higher. This was not really much of a problem for the Marine division, however, as expanded production and a booming boat market caused it to be consistently among Graves' best-performing divisions.

In the early 1980s the situation in Graves changed because of the formation of the Flexible Manufacturing Systems (FMS) division within Graves Industries. The FMS division had a R&D budget of \$14 million in 1982, and this grew to \$46 million in 1985, and the corporation was trying to fund this division internally by raising growth goals for the operating divisions and by instituting cost-cutting programs. The new, more aggressive goals made management of the Lohnes division very difficult because the boating industry was hit hard by the second oil crisis in 1979 and a business downturn in 1984.

1983

In late January 1983, Paul met with his new controller/financial officer, Don O'Grady, to go over the division's financial condition and to consider plans for the future. Don pointed out that 1982 had been a relatively good year; sales had reached \$88.4 million, slightly in excess of the division's

goal of \$85 million. In addition the division had been able to maintain relatively large reserves where “a few nuts were stored away for a bad winter.”

Paul said that was all well and good, but that he was worried about future prospects, and he wanted to have more control over his reported sales and profits. He suggested a number of ways the increased control could be brought about. He told Don that when the division was having a good period he wanted to meet the assigned goals and then be very conservative in the accounting so as to have a good start on making the goals for the next period. For example, if the division was near its quarterly target, it would be good to declare a shipping moratorium for the last week or two of the quarter to shift some sales to the next quarter. He also suggested increasing the reserves taken against inventory, accounts receivable, and potential liabilities.

Paul said Don should meet with Patti Allen of Sales and Jack Nelan of Production and Purchasing to do some brainstorming for more ideas. He also told Don that the discussions should be discreet. Even though none of this was illegal, he did not want to cause waves at headquarters. Don indicated that he understood.

The year 1983 proved to be surprisingly good, and by mid-March the division had exceeded its quarterly sales goal. Patti Allen imposed a shipping moratorium for the last ten days of March, and \$3.8 million in finished goods were held until the first days of April. Even though she agreed with trying to smooth earnings, Patti did complain to Don and Paul that complete halts in shipping caused problems with workload scheduling, product damage, and delayed deliveries to customers. Paul agreed there were costs associated with this shipment policy, but he felt they could be minimized.

Patti said that she would like to be able to do some shipping to their large customers. She suggested that she could ship some large orders in the current quarter but ensure that they were not entered in the shipping log. She would date the invoices and the bills of lading for the beginning of the next quarter and hold them on her desk until the second week of the new quarter. She would then submit the invoices to the accounting department for processing as a new-quarter sale, and make the entries to the shipping log. In case any auditors asked why the invoices were out of order, she planned to tell them that the shipments had been held up for a brief time at the last minute.

In 1983 sales continued strong, and Patti's invoice-dating program allowed for smooth growth in quarterly earnings. On December 31, Patti held invoices for \$7.4 million in goods to be “shipped” in the first week of January.

Other company efforts to prepare for the unknown future included a buildup of obsolescence, liability, and bad debt reserves (a total of \$900,000) and a new marketing-expense program. This latter program, worked out between the Sales & Marketing department and the Marine division's advertising firm, allowed for the prepayment of part of the next year's marketing expenses. Rather than being booked as a prepaid expense, however, these expenses would appear on a bill from the ad agency which listed them as services for the current year; and the division would then book them as an expense of the current period. The Sales and Marketing department kept a separate ledger to keep track of these expenditures to ensure that the paid-for services were received. A total of \$600,000 of 1984 advertising expenditures was paid for in 1983.

1984

The long-anticipated downturn came in 1984; sales were very sluggish for the first two quarters. Paul and Don were somewhat worried but took no action other than maintaining their pressure on Sales and Marketing. When the third quarter continued the slow trend, Don started to liquidate some of the reserves, and by the end of 1984, reserves were reduced by \$1.8 million. The auditors questioned these changes in reserves, but Don and Paul gave them an explanation based on

an analysis of changes in inventory composition and estimates of forthcoming bad debt losses and expenses. The auditors were skeptical, but they eventually concurred with the changes.

Another big step taken by the division was the establishment of the Early Order Program for distributors and larger boat builders. Those who ordered early (e.g., the end of 1984 instead of early 1985) received large discounts. This program also provided liberal credit terms; no payments were due for 90 days, and no late-payment penalties were assessed until at least 120 days after receipt of the shipment. Some of the more aggressive salespeople told their clients to “order the stuff now and don’t worry about any payment dates; just pay us when you sell it, and you get to pocket the extra margin.” Although this was never formally sanctioned, a flurry of fourth quarter sales brought the year-end results just above the budgeted goal of \$108.0 million.

1985

The first quarter of 1985 was slow due to all of the Early Orders that were placed in 1984. But by the middle of the second quarter, sales had picked up and were soon roaring along. In fact, third quarter results were so good that \$4.7 million had to be “transferred” to the fourth quarter, and the Early Order Program of 1984 was suspended.

By the end of 1985 the company had not only passed all required goals, but also had a \$10.4 million start on 1986 revenues, had restored \$2.2 million in reserves, and had paid for \$0.8 million of 1986’s advertising. Once again the changing of the reserves was questioned, but the auditors accepted Don’s explanation of “wanting to be conservative.”

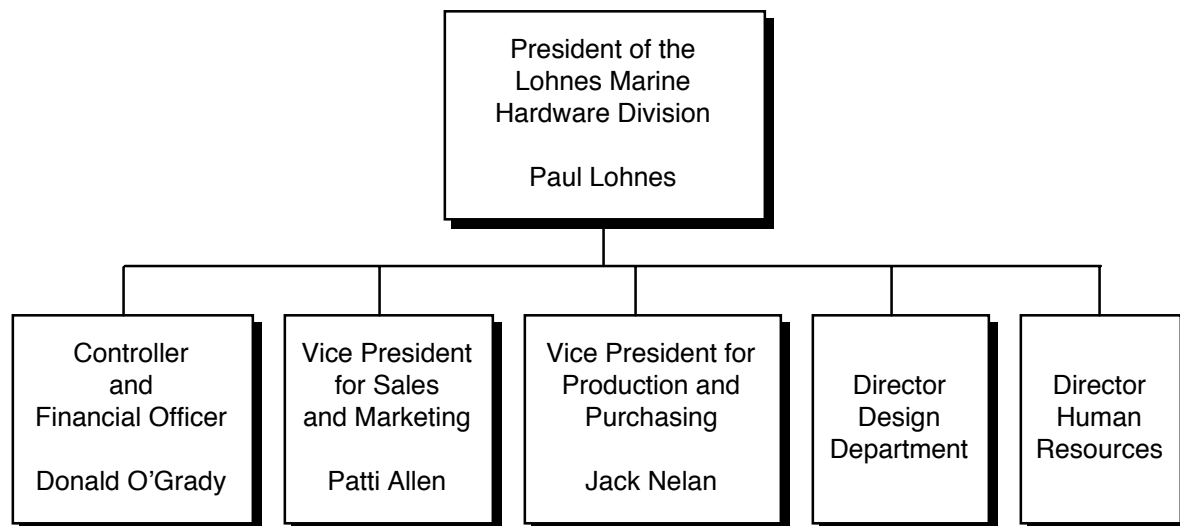
1986

Don knew the Lohnes division was well-positioned for the new year but he worried where all this management of earnings would lead. He had hoped it would not continue, but the financial drains of the FMS division were growing, and he expected the corporation to start pressing all of the other divisions even more. He also knew that Paul and Patti were already discussing new ways to smooth income, and Don wondered what he should do and whom he could speak to about this sensitive matter.

Exhibit 1 Lohnes Marine Hardware Division— Divisional Income and Budget Statements for Fiscal Years Ending 30 December (\$ millions)

	1982		1983		1984		1985	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Revenue	\$85.0	\$88.4	\$96.0	\$99.1	\$108.0	\$109.2	\$119.0	\$122.2
Cost of sales	55.7	57.5	62.4	64.4	71.8	72.9	77.4	79.4
Gross margin	\$29.3	\$30.9	\$33.6	\$34.7	\$36.2	\$36.3	\$41.6	\$42.8
R&D expense	0.6	0.6	0.8	0.8	0.8	0.8	0.8	0.8
SG&A expense	10.8	10.9	11.2	12.1	11.8	11.3	14.0	14.8
Operating profit	<u>\$17.9</u>	<u>\$19.4</u>	<u>\$21.6</u>	<u>\$21.8</u>	<u>\$23.6</u>	<u>\$24.2</u>	<u>\$26.8</u>	<u>\$27.2</u>

Source: Corporate records.

Exhibit 2 Lohnes Marine Hardware Division Organizational Chart

Source: Corporate records.