United Bank: Master Budgets to Support a Credit Decision

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Early one morning in March, Jordan Buford was preparing his daily work when his boss, Olivia Anton, approached him and announced, "Little Annin Flagmakers (LAF) has submitted an application for a line of credit (LOC) for April through June. I want you to prepare budgeted financial statements similar to the ones you prepared for our last LOC applicant. I need this by 3 PM today for the 4 PM credit committee meeting. Be prepared to make a loan recommendation and to address questions from the credit committee. I have cleared your schedule. Let me know if you need anything."

United Bank is a state bank with multiple branches that offers a variety of services for personal and commercial needs. The bank has been serving the local community for over 110 years and prides itself on its personalized approach to provide financial services, local management, long-term stability and a full range of deposit and lending products and services. Commercial credit decisions at United Bank are made by the Commercial Credit Committee, which consists of the senior commercial credit analyst and two vice presidents.

Jordan was recently hired by United Bank as a commercial credit analyst, to provide analysis for commercial loan applications. During his undergraduate studies, he studied accounting and finance and shortly after graduation passed the CMA® exam. Jordan reports directly to Olivia Anton, the senior commercial credit analyst who has been with United Bank for ten years.

As Jordan began the work, he recalled his last line of credit (LOC) analysis and how well received it was. He had taken the information provided by the company and developed master budgets in Excel that used an input section with numbers that could be changed for assessing different scenarios. The committee had specifically asked about the effect on the applicant's cash needs would be if sales were reduced by 2%, 5%, and 10%. He wanted to be prepared for these types of questions.

LITTLE ANNIN FLAGMAKERS BACKGROUND

Little Annin Flagmakers (LAF) manufactures one product, a large durable 8’ x 12’ American flag, which it sells for US$120. Because of the large size of the flag, this product is not sold in stores; rather, it is sold through a relatively small number of on-line retailers. Each quarter, retailers estimate sales for the upcoming five months, revising proximate sales as necessary. In general, the retailers are reasonably good at estimating their sales needs; however, some variation in demand does occur and the retailers expect to be able to adjust orders as needed. LAF allows retailers to adjust each month’s purchases to 80-120 percent of the estimated sales levels. Flags are shipped to retail customers using JIT distribution so that the on-line retailers do not have to store inventory.

Typical sales for the flag are 1,800 units per month with seasonal increases April through August. Sales estimates are April 2,500 units, May 6,000 units, June 3,000 units, July 2,500 units, and August 2,000 units. Customers historically have paid 40 percent of their purchases in the month of the sale, 55 percent in the following month, and the remaining five percent is uncollectible.

MANUFACTURING AND SG&A COSTS

The flags are made in one plant which has a capacity of 6,200 units per month. LAF budgets to have 20 percent of next month’s sales in finished goods inventory at the end of each month. There is plenty of storage space for finished goods.

Fabric is the only direct material and each flag requires five pounds of fabric at US$7 per pound. LAF plans to have 40 percent of next month's fabric needs on hand at the end of the month. Fabric is purchased on credit with 40 percent paid in the month of purchase and 60 percent the next month. The standard direct labor hours to manufacture one flag is 0.50 hours at US$40 per hour. For simplicity, direct labor costs are budgeted as if they were paid when incurred. Manufacturing overhead rates are computed quarterly and applied based on direct labor hours. Fixed manufacturing overhead costs are estimated to be US$57,950 per month, of which US$20,000 is PPE depreciation. Variable manufacturing overhead, including indirect materials, indirect labor, and other costs, is estimated at US$10 per direct labor hour.

The selling and administrative expenses include variable selling costs (primarily shipping) of US$1.25 per unit, and fixed costs of US$63,000 per month of which US$10,000 is deprecation of the administrative office building and equipment.

FINANCIAL STATEMENT DETAILS AND CASH PLANNING

Little Annin Flagmakers uses FIFO inventory valuation. As of March 31, the expected finished goods inventory is 410 units, valued at US$75 per unit. The company expects to have 4,600 pounds of fabric on hand, valued at US$7 per pound. Other expected account balances include: accounts payable at US$55,000, accounts receivable at 132,000, cash at US$37,745, land at US$520,000, and building and equipment at US$1,800,000 with accumulated depreciation of US$750,000. LAF has no long-term debt; common stock is valued at US$500,000 and is not expected to change during the quarter; expected retained earnings as of March 31 are US$1,247,695.

Little Annin Flagmakers budgets for US$30,000 ending cash balance each month and is requesting a line of credit that will allow it to adjust for its cash needs. The dividends of

US$15,000 are paid each month. During the quarter, LAF planned to purchase equipment in May and June for US$47,820 and US$154,600 respectively. This equipment is being purchased to increase capacity and is not expected to come on-line until after the quarter, thus not affecting the manufacturing overhead costs.

LOAN DETAILS

Little Annin Flagmakers has requested a line of credit of US$60,000 to cover production costs during the seasonal increase in business. United Bank uses the following terms on its lines of credit. All borrowing is done at the beginning of the month, in whole dollar increments. All repayments are made at the end of the month, in whole dollar increments. The full line of credit is expected to be paid off by the end of the quarter with all of the interest repaid at the end of the quarter. The interest rate on this loan is 16 percent per year.

REQUIRED

1. Using the data input provided (Exhibit 1), prepare LAF's master budgets in Excel. Do not hard-code numbers into the spreadsheet, except in the financing section of the cash budget.
2. Conduct a sensitivity analysis, decreasing sales 2%, 5%, and 10% for April through August. New sales levels are provided in Exhibit 2. Adjust the financing and cash needs at these new sales levels.
3. Determine a credit recommendation for United Bank, to lend or not. Be prepared to justify your credit decision.
4. Explain why the cash budget is more important than the accounting net income, to a bank when determining a credit decision.
5. Explain why decreases in sales is examined in a sensitivity analysis for a credit decision.

Exhibit 1: Excel Data Input Section

	A	B
1	**Input Data** (USD)	
2		
3	**Budgeted sales**	**Expected**
4	April (units)	2,500
5	May (units)	6,000
6	June (units)	3,000
7	July (units)	2,500
8	August (units)	2,000
9		
10	Selling Price/unit	US$120.00
11		
12	**Cash collection pattern**	
13	Month of sale	40%
14	Following month	55%
15	Uncollectible	5%
16		
17	**Cash payments for materials**	
18	Month of purchase	40%
19	Following month	60%
20		
21	**Production requirements**	
22	Raw material per unit (lb)	5
23	Raw mat. cost per lb	US$7.00
24	Direct labor hours per unit	0.5
25	Direct labor rate per hour	US$40.00
26	Variable MOHD per DL hour	US$10
27	Fixed MOHD per month	US$57,950
28	Depreciation in Fixed MOHD	US$20,000
29		
30	**Selling & administrative costs**	
31	Variable S&A cost per unit sold	US$1.25
32	Fixed S&A cost per month	US$63,000
33	Depreciation in Fixed S&A cost	US$10,000
34		

	A	B
35	**Other cash outflows**	
36	Cash dividends paid each month	US$15,000
37	Equipment purchases May	US$47,820
38	Equipment purchases June	US$154,600
39		
40	**Desired ending inventory**	
41	Finished Goods	20%
42	Raw Materials	40%
43	Cash (US$)	US$30,000
44		
45	**Beginning account balances-Mar. 31**	
46	Cash (US$)	US$37,745
47	Accounts Receivable (US$)	US$132,000
48	FG inventory (@US$75/unit)	US$30,750
49	FG cost per unit	US$75.00
50	FG inventory (units)	410
51	Raw Materials (@US$7.00/lb)	US$32,200
52	Raw Materials (lb)	4,600
53	Accounts Payable (US$)	US$55,000
54		
55	Land	US$520,000
56	Buildings and equipment	US$1,800,000
57	Accumulated Depreciation	(US$750,000)
58	Common stock	US$500,000
59	Retained earnings	US$1,247,695

Exhibit 2: Sales at different levels

		Decreased by		
Budgeted sales	**Expected**	**2%**	**5%**	**10%**
April (units)	2,500	2,450	2,375	2,250
May (units)	6,000	5,880	5,700	5,400
June (units)	3,000	2,940	2,850	2,700
July (units)	2,500	2,450	2,375	2,250
August (units)	2,000	1,960	1,900	1,800