

Case Study on Projections

On July 17, 2017, Designs by Dezine, a building remodeling company and an existing client, requested bank financing for a new computer system that costs 10 lakhs. Designs by Dezine plans to pay 2 lakhs down and finance the balance over five years (the depreciable life of the equipment). The company requested a loan with payments on a five-year amortization.

The company's sales terms are 50 percent down at signing of the contract, and the balance upon completion of the project. Most work is done in 30 to 45 days. During FY ended July 2017, receivables were collected upon completion of all work. The company's inventory is nominal, consisting of nuts, bolts, nails, and lumber. The fixed assets consist of two company trucks.

The chart below summarizes Designs by Dezine's common-sized balance sheet and income statement for 2017. It's forecasted financial statements for FY ending July 2018, also summarized in the chart below, will be used to demonstrate pro forma analysis. A one-year forecast will be used to demonstrate pro forma analysis.

| | 2017 Actual 8 months | Common- sized % | 2018 Projections (in lakhs) | Common sized % |
|-------------------------------|----------------------------|--------------------|-----------------------------------|-------------------|
| <i>Income Statement</i> | | | | |
| Sales | 384 | 100.0% | 700 | 100.0% |
| Cost of Goods Sold | <u>330</u> | 85.9% | <u>525</u> | 75.0% |
| Gross Profit | 54 | 14.1% | 175 | 25.0% |
| S,G & A Expenses | 22 | 5.7% | 46 | 6.6% |
| Owner's salary | 43 | 11.2% | 60 | 8.6% |
| Depreciation | <u>12</u> | 3.1% | <u>14</u> | 2.0% |
| Total Operating Expenses | 77 | | <u>120</u> | 17.1% |
| Operating Profit | (23) | | 55 | 7.8% |
| Interest Expense | 3 | 0.8% | <u>10</u> | 1.4% |
| Pretax Profit | (26) | (6.7%) | 45 | 6.4% |
| Income Taxes | 0 | | <u>15</u> | 2.1% |
| Net Profit | (26) | | 30 | 6.4% |
| <i>Balance Sheet – Assets</i> | | | | |
| Cash | 6 | 9.4% | 22 | 25.3% |
| Accounts receivable | 8 | 12.5% | 18 | 30.7% |
| Inventory | 1 | 1.6% | <u>2</u> | 2.3% |
| Total current assets | 15 | 23.4% | 42 | 48.3% |
| Net fixed assets | 49 | 76.5% | <u>45</u> | 51.7% |
| Total assets | 64 | 100.0% | 87 | 100.0% |

| | | | | |
|-------------------------------|-------|---------|-----------|--------|
| <i>Liabilities and Equity</i> | | | | |
| Accounts payable | 3 | 4.7% | 7 | 16.1% |
| Shareholder Debt | 46 | 71.9% | 40 | 37.9% |
| Long-term debt | 40 | 62.5% | <u>35</u> | 40.2% |
| Total Liabilities | 89 | | 82 | 94.2% |
| Share Capital | 1 | 1.6% | 1 | 1.1% |
| Retained Earnings | 0 | 0% | <u>4</u> | 4.6% |
| Total owner's equity | (25) | (39.1%) | <u>5</u> | 5.7% |
| Total liabilities and equity | 64 | 100.0% | 87 | 100.0% |

Designs by Dezine had only eight months of sales last year, during which it generated sales of 384 lakhs. The income statement also shows that the company's gross margin was 14.1 percent. The gross profit varies, depending on the mix of products sold. For example, the company makes more money on decks and custom cabinets than it does on large additions. Selling, general and administrative (S,G&A) expenses were 5.7 percent of sales. The company had an operating loss its first year, which is not unusual.

The bank has provided various services to the Designs by Dezine's owners for several years. As part of the commercial relationship, the company provides the bank with copies of its monthly and annual financial statements. Because of these past dealings, the business banker has a good feel for the company's strengths and weaknesses and knows a number of its officers. The company's borrowings traditionally have been term loans for vehicles. To supplement the company's financial statements, the business banker also has obtained industry information from the company's trade association.

External Assumptions

The economy is currently weak. All economic indicators are flat or down and are projected to remain so for the next year. Monetary growth and inflation appear stable for the immediate future. Industry predictions show that the value of residential real estate will increase by 5 percent in the current year.

The remodeling industry is expected to do well as individuals will likely remodel their existing homes rather than move during an economic downturn. The remodeling industry expects to grow by 15 percent next year. Government regulations have little direct effect on the remodeling industry.

The chart below shows a side-by-side comparison of the company's projected income statement to the bank's adjusted income statement.

| Designs by Dezine's Projected Income Statement | Company | | Bank | |
|---|------------------------|--------|------------------------|--------|
| | Amount In lakhs Rs. | | Amount In lakhs Rs. | |
| <i>Income Statement</i> | | | | |
| Net Sales | 700 | 100.0% | 650 | 100.0% |
| Cost of Goods Sold | <u>525</u> | 75.0% | <u>510</u> | 78.5% |
| Gross Profit | 175 | 25.0% | 140 | 21.5% |
| Selling, Gen. & Admin. Expenses | 46 | 6.6% | 58 | 8.9% |
| Owner's Salary | 60 | 8.6% | 60 | 9.2% |
| Depreciation | <u>14</u> | 2.0% | <u>14</u> | 2.1% |
| Total Operating Expenses | <u>120</u> | 17.1% | <u>132</u> | 20.3% |
| Operating Profit | 55 | 7.8% | 8 | 1.2% |
| Interest Expense | <u>10</u> | 1.4% | <u>10</u> | 1.5% |
| Pretax Profit | 45 | 6.4% | (2) | (0.3%) |
| Income Taxes | 15 | 2.1% | <u>0</u> | |
| Net Profit | 30 | 6.4% | (2) | (0.3%) |

Analysis of how the bank adjusted the income statement

After analyzing and reworking Designs by Dezine's forecasted income statement, the business banker constructs the pro forma balance sheet, as shown in the chart below. Like the income statement forecast, the chart compares the customer's to the one made by the business banker. The assumptions made and conclusions reached in projecting the various income statement accounts affect several entries on the forecasted balance sheet. Therefore, the assumptions used in composing and analyzing the forecasted balance sheet must be consistent with those used for the income statement.

The chart below shows a side-by-side comparison of the company's projected balance sheet to the bank's adjusted balance sheet forecast.

| Dezine by Disigns Projected Balance Sheet for 2018 | Company | | Bank | |
|--|-----------------------|--------|-----------------------|---|
| | Amount In lakh Rs. | % | Amount In lakh Rs. | % |
| <i>Balance Sheet – Assets</i> | | | | |
| Cash | 22 | 25.3% | 5 | |
| Accounts Receivable | 18 | 30.7% | 18 | |
| Inventory | <u>2</u> | 2.3% | <u>2</u> | |
| Total Current Assets | 42 | 48.3% | 25 | |
| Net Fixed Assets | <u>45</u> | 51.7% | <u>45</u> | |
| Total Assets | <u>87</u> | 100.0% | 70 | |
| <i>Liabilities and Owner's Equity</i> | | | | |
| Short-Term Bank Debt | 0 | 0.0% | 10 | |
| Accounts Payable | 7 | 16.1% | 12 | |
| Long-Term Debt | 35 | 37.9% | 35 | |
| Shareholder Debt | <u>40</u> | 40.2% | <u>40</u> | |
| Total Liabilities | 82 | 94.2% | 97 | |
| Share Capital | 1 | 1.1% | 1 | |
| Retained Earnings | <u>4</u> | 4.6% | <u>(28)</u> | |
| Total Owner's Equity | <u>5</u> | 5.7% | <u>(27)</u> | |
| Total Liabilities and Owners Equity | <u>87</u> | 100.0% | <u>70</u> | |