Harvard Business School

9-198-059
May 19, 1998

Octane Service Station

On March 15, Julio Trevino signed a lease agreement to operate a gasoline service station that was owned by the Octane Oil Company (hereafter, simply "Octane"). Trevino had contracted the regional sales manager of Octane in response to an advertisement that solicited applicants "with $25,000 to invest" to lease and operate a newly erected Octane gasoline service station. Trevino had been able to accumulate approximately $32,000 for investment purposes as a result of a $25,000 inheritance and savings on the salary of $865 per week he earned as manager of a service station operated as a separate department of a J. C. Penney store. Most of this $32,000 was held in government bonds.

The regional sales manager for Octane was impressed with Trevino's personal and financial qualifications, and after several interviews, a lease agreement was signed. During one of these meetings the sales manger informed Trevino that the new station would be ready for occupancy on May 1 at a total investment cost of $300,000. Of this amount, $100,000 had already been paid for land, and a total of $200,000 would be spent for a building that would be "good for about 40 years." In discussing profit potential, the sales manager pointed out that Octane's national advertising program and the consumer appeal generated by the attractive station "will be worth at least $30,000 a year to you in consumer goodwill."

The lease agreement stipulated that Trevino pay a rental of $1,250 per month for the station plus $0.04 for each gallon of gasoline delivered to the station by Octane.[1] A separate agreement was also signed whereby Octane agreed to sell and Trevino agreed to buy certain minimum quantities of gasoline and other automotive products for the service station operation.

As both an evidence of good faith and as a prepayment on certain obligations that he would shortly incur to Octane, Trevino was required to deposit $20,000 with Octane at the time the lease was signed. Trevino raised the cash for this deposit by liquidating government bonds. Octane used most of this money to defray certain obligations incurred by Trevino to the oil company prior to the opening of the new station. The deductions from the $20,000 deposit were applied as follows:

---

[1] The lease, which covered a period of one year beginning May 1, was automatically renewable unless notice of cancellation was given by either party at least 30 days prior to the anniversary date. The regional sales manager of the Octane Oil Company estimated that approximately 150,000 gallons of gasoline would be delivered to Trevino's Service Station during the first 12 months of operation. Subsequently, Trevino's records revealed that 27,000 gallons (including the initial inventory) were actually delivered during the first two months of operation.

Professor David Hawkins prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. This case is a rewrite of "Trevino Service Station," prepared by Professors C.A. Bliss and R.N. Anthony.

1.	Inventories of gasoline, oil, grease, tires, batteries, and accessories	$13,250
2.	Rental fee $(1,250 flat rental for the month of May and $170 figured as $0.04 per gallon for the gasoline delivered in the opening inventory	1,420
3.	Downpayment (on Trevino's behalf) on equipment costing $12,875	2,575
		$17,245

The equipment, including floor and hydraulic jacks, a battery charger, tune-up sets, and oil and grease guns, became Trevino's property. A representative of the oil company stated that this equipment would last about five years. The unpaid, noninterest-bearing balance of $10,300 Trevino owed Octane for equipment was to be paid in five semiannual instalments of $2,060 each. The first such payment was due November 1. The $2,755 remaining from the $20,000 originally deposited with Octane was returned to Trevino on April 30. He deposited this money in a special checking account he had set up for his service station venture.

Just before opening for business on May 1, Trevino converted some additional government bonds into $7,000 cash which he also placed in the service station account. Prior to May 1, he wrote the following checks: $1,650 for office furniture that had an expected life of 10 years, and $900 for a fire and casualty insurance policy providing coverage for a one-year period beginning May 1. On April 30, Trevino transferred $200 from the service station account to the cash drawer at the service station. It was Trevino's intention to deposit in the bank all but $200 of cash on hand at the close of each business day. The balance in the service station checking account at the start of business was, therefore, $7,005. In addition, Trevino had $2,700 in a savings account.

On May 1, the service station was opened for business. In his effort to build up a clientele, Trevino worked approximately 60 hours per week compared with 40 in his previous job. In addition, three other people were employed on either a full- or part-time basis. Trevino was reasonably satisfied with the patronage he was able to build up during the first two months the station was open. At the end of June, however, he felt it would be desirable to take a more careful look at how he was making out in his new business venture. Trevino felt that he should record his progress and present position in a form that would be useful not only at the present time but also for comparative purposes in the future, perhaps at six-month intervals ending on June 30 and December 31.

Trevino maintained a simple recordkeeping system in which cash receipts and cash payments were itemized daily in a loose-leaf notebook. Separate pages were reserved for specific items in this notebook. During the months of May and June, the following cash receipts and payments had been recorded:

Cash receipts (May and June):	
Sales of gasoline, motor oil, tires, batteries, and accessories and the revenue from lubrications, washing and polishing, and miscellaneous sales and services	$69,510
Rental from parking area on service station land	500
	$70,010
Cash payments (May and June):	
Purchases (including gasoline, motor oil, grease, tires, batteries, and accessories)	$44,694
Rent (does not include $1,420 deduction from $20,000 deposit)	2,018
Payroll (does not include any payments to Trevino)	9,450
Utilities	445
Advertising	690
Miscellaneous	355
Withdrawals by Trevino (June 1 and June 19)	6,750
	$64,402

The $500 listed in cash receipts as rental from parking area had been received from an adjacent business establishment that used one portion of the service station site as parking space for certain of its employees. The rental received covered a period extending from May 15 to July 15.

In addition to the record for cash receipts and payments, a detailed listing was kept of the amounts of money that were due from, or owed to, other individuals or companies. An analysis of these records revealed that $143 was due the business for gas, oil, and car servicing from a wealthy widow friend of the Trevino family who preferred to deal on a credit basis. Also, on the evening of June 30, one of the employees completed waxing a car for a regular customer who was out of town and would be unable to call for his car until July 3. Trevino had quoted a price of $56 for this job. Trevino recalled that when he once worked at an automobile agency, he had heard that setting up a reserve for bad debts equal to two percent of all outstanding accounts was a good idea. Trevino had also jotted down the fact that he and his family had used gas and oil from the service station worth $101 at retail prices, for which no payment had been made. Approximately $79 had been paid to Octane Oil Company for this merchandise.

A further summary of his record revealed the following unpaid bills resulting from operations in June:

Octane Oil Company for merchandise	$1,804
Rental payment (figured at $0.04 per gallon on most recent delivery of gasoline)	75
Utilities for the month of June	425
	$2,304

The service station's employees had last been paid on Saturday, June 28, for services rendered through Saturday evening. Wages earned on June 29 and 30 would amount to $232 in the following Saturday's payroll.

Trevino took a physical inventory on the evening of June 20, and found gasoline, motor oil, grease, tires, batteries, and accessories on hand that had cost $10,018. While Trevino was figuring his inventory position, he compared his recorded gallonage sales of gasoline on hand at the end of the period against the volume of gasoline at the beginning inventory plus deliveries. In this manner, Trevino ascertained that shrinkage due to evaporation, temperature changes, waste, and other causes amounted to 302 gallons of gasoline that he estimated had cost $360.

Late in June, Trevino's married son realized that he would be unable, because of prolonged illness, to make payment of $192 for interest expense and $800 for principal repayment on a $2,400 bank loan. Trevino, who had acted as cosigner on this note, would be obligated to meet this payment on July 1.

Questions

1. Prepare a May 1 and a June 30 balance sheet for Julio Trevino's service station and an income statement for the intervening period.

2. Has Julio Trevino's investment in the gasoline station been a good one for him? Has his return on his investment been greater or less than he would have received had he invested his funds at 15% elsewhere?