Munirah Alnefaie, Imam Muhammad ibn Saud Islamic University, S.A

Bilal Makkawi, Morgan State Univeristy, U.S.A.

Storm on the desert: Strategy and Firm Profitability

Discipline Focus:

The case study in accounting will give attention to managerial accounting in a business field.

Target Audience:

The teaching case will be developed for accounting majors of undergraduate study. This case is useful for students in their junior years who take an accounting course in managerial accounting. The case will be important for graduate students who take managerial accounting in their first year.

Level of Difficulty:

This case will require students to understand the concept of cost of production and profitability. The case has a medium level of difficulty. Aside students' understanding of cost components, students have to apply their knowledge in strategic management. This is because at one point, the case requires students to decide whether to pass on the burden of tax to clients or not. The decision that students make will determine the amount of tax to be calculated and charged to clients or directly to profit. Students who are taught with this teaching case will have to have prior knowledge in financial accounting, managerial accounting and a fair knowledge of business strategy.

Learning Goals:

The study aims to expose students to the concept of cost classification and aid them to identify the components of cost to estimate product cost of a manufacturing company. The study also targets to help students to analyze qualitative factors that have implications for business strategy that impacts the short and long-term relationship between firms and their customers. Also, the case helps students to evaluate the effect of the qualitative factors on the profitability of the company.

Teaching Objectives:

The case will help students to achieve the following:

a. estimate the cost of production of a company.

b. Analyze the effect of taxation on the profitability of a company.

c. Assess how business strategy decisions affect the incidence of tax and the profitability of a company.

Learning outcome:

To help students to identify practical and contingent situations that could affect the business computation of price to clients. Also, the knowledge acquired will enable students to incorporate client relations in business strategy and the cost of such decisions in the financial statement.

Case Context/Situation:

The story presented in this case will be told from the perspective of owner of a leather products company. This manager recounts the experiences that resulted from the imposition of taxes in Saudi Arabia. The taxes were imposed on a free zone enclave, which initially were not required to pay VAT. The manager tells his story of how the sudden imposition of the VAT affected the contracts in the company entered into with its clients. This is because as at the time the company entered into the contracts with its clients, there was no VAT. The imposition of the tax happened after the contracts were signed. The manager recounts the dilemma the company faced with this sudden imposition of VAT. Should the company pass on the burden of the tax to the clients or bear the tax burden? What will be the effect of each decision on the profitability of the firm? What will be the effect on the business relationship of the firm with its clients? This case will enable students to determine the effect of each decisions on the profitability of the company. The manager decided to classify the clients into long-term and short-term customers. The long-term customers are clients who have done business with the company for several years. The short-term customers are new clients who are in the first year of doing business with the firm or customers who do business with the company occasionally. The company decided to pass on the burden of the VAT to the short-term customers through revised contract price. However, for the long-term customers, the company decided to absorb the VAT amount.

Data Requirements:

The study will consider primary data from various accounting books and systems within the company. Students need all the financial data of the firms to calculate the data. Specifically, students need the VAT rate, and the contract price to estimate the tax amount and the effect of such amount on the profitability of the company. Such effect depends on the business strategy the company adopts.

Discussion Questions:

A. Assess the implications of all the options in the case regarding the tax amount to be borne by the company and the tax amount to be borne by customers.
B. Assess the net profit implications of all the options on the company.
C. What qualitative factors should the company consider in deciding on the strategy to adopt about the VAT imposition.
D. If you were hired as a consultant, what would you recommend the company to do about the VAT imposition?
E. If you were hired as a consultant, what would you recommend the company to do about the contracts signed?

Teaching Note:

Overview:

VAT a new source of government income which will be continued to be utilized to provide high-quality public services. It will also help government move towards its vision of reducing dependence on oil and other hydrocarbons as a source of revenue. Companies will be responsible for carefully documenting their business income, costs and associated VAT charges.

Case Study:

"…Alright, people, I expect to bring this issue to closure at our next meeting, so kindly work hard…see you next week." With that Mr. Naif closed the meeting with his countenance lightened than he came in.

Mr. Naif, the first son of the family, is a young man in his early forties and hails from the central region of Saudi Arabia. Custom demands that he manage the family business that his great-grandfather started. The company has grown to one that imported and sold leather during the early years of its establishment and currently manufactures leather bags. The company, Al-Dana Vision Company Limited, has two branches in Saudi Arabia and another branch in Dubai. The company operates within the free-zone enclave and therefore, enjoys some tax relief on the goods it manufactures in both Saudi Arabia and Dubai, UAE. The company employs about a total of 200 employees in both countries.

Production at Al-Dana Vision company

The company buys leather at a unit cost of US$40.00 to produce each standard bag. The cost of leather to produce intermediate and Grade A bags are US$50.00 and US$60.00 respectively. The production manager indicated to Mr. Naif that it costs the firm US$10.00 per bag to acquire other incidental materials needed to produce the bags averagely irrespective of the quality. Mr. Naif's brother-in-law owns a transport company and usually Mr. Naif contracts the company to transport the leather to the production site. Because of the family bond, the brother-in-law, Abdul, charges Mr. Naif US$500.00 to transport a truckload of leather. On his part, Abdul pays his workers US$100 to offload the leather at the premises of Al-Dana Vision company.

He, however, does not charge Mr. Naif for this amount. Salah, the production manager, notes that usually a truckload of leather is used to produce an average of 1000 bags of any grade. Based on agitations from the union workers, the company has increased the hourly wage of production workers to US$15.00. After the workers' agitation, Mr. Naif asked Salah about the working conditions of the production workers. Salah reported that usually, it takes an average of 3 hours to produce a batch of 200 bags and needs an average of 30 workers.

Depreciation and monthly expenses:

The company production machinery costs about US$50,000.00 while the building costs US$120,000.00. The company has a straight-line depreciation policy of five years for capital expenditure items. The building is depreciated at a rate of 10 percent. Monthly utility expenses at the production facility and the administrative facility average US$2,000.00 and US$500.00 respectively while the monthly selling, general, and administrative expenses average US$3,000.00.

Table 1:

	Product Quality		
	Standard Bags	Intermediate Bags	Grade A Bags
Unit Price	US$200	US$250	US$300
Monthly production	7,000	2,000	1,000

Customers and customer relationship

The company's customers can be classified into two groups namely long-term customers and short-term customers. The long-term customers are customers who have been continuously doing business with the company for more than five years.

Every lather bag one finds in these companies are produced by Al-Dana Vision company Limited. Such long-term customers usually have a strong family business bond with Al-Dana Vision that usually dates back to the founders of the companies. The company's long-term customers are Alsar Company Limited, Ansum Company Limited, and Alhaly Company Limited. Alsar Company Limited belongs to a family friend of Mr. Naif. The friendship between the two families dates back to the time of their great-grandfathers. The founder of Alsar Company Limited is the third cousin of the great-grandfather of Mr. Naif, and they both started the two companies about the same time.

Ansum company limited has been a customer for the past fifteen years. The owner of Ansum, Mr. Nager, and Mr. Naif were classmates at the University of Phoenix in the United States for their MBA degrees. They were both members of the Saudi Arabia Students Association. In their final year, Mr. Naif was the vice president of the association while Mr. Nager was the secretary. They were very close friends, and their friendship continued even after they graduated, and both took over the management of their firms.

The manager of Alhaly company Limited, Mr. Alwansar, is a childhood friend of Mr. Naif. They were both born on the same day and grew up in the same neighborhood. They used to take turns to sleep over at each other's house on weekends during their childhood and adolescent years. There was a break in communication when Mr. Naif left to attend school in the capital city of the country. However, the communication was restored when Mr. Naif met Mr. Alwansar at the golf club when he showed up for the second time. They reminisced about their childhood days and exchanged complimentary cards. Afterward, they started doing business and have continued since.

The short-term customers are customers who have done business with the company for less than five years. Such customers buy products from Al-Dana Vision occasionally. They are either customers who buy or order products from the company for the first time or customers who have bought goods from the Al- Elan before. Rashed Company Limited has been a customer for one year. Talkum Company Limited has been a customer for the past four years. Within the four years, Talkum Company Limited has ordered goods only once. Musik Company Limited has been a customer for the past two years.

Al-Dana Vision signed separate contracts with each of the customers at the beginning of the month within two weeks. The company signed the first contract on the third day of the month and signed the last contract on the seventeenth day of the month. As at the time of signing the contracts, the government had chosen not to impose taxes on goods produced by companies that operate in the free zone enclave. The tables below show the schedule of sales of each category of leather bags produced and the quantity of the leather bags that customers ordered.

Table 2

Name of customer	Product ordered	Quantity Ordered	Unit price	Amount
Alsar Company Limited	Standard Bags	1000	US$200	US$200,000
Alsar Company Limited	Intermediate Bags	500	US$250	US$125,000
Alsar Company Limited	Grade A Bags	200	US$300	US$60,000
Ansum Company Limited	Grade A Bags	500	US$300	US$150,000
Ansum Company Limited	Intermediate Bags	200	US$250	US$50,000
Alhaly Company Limited	Grade A Bags	600	US$300	US$180,000
Alhaly Company Limited	Standard Bags	700	US$200	US$140,000

Rashed Company Limited	Standard Bags	200	US$200	US$40,000
Talkum Company Limited	Intermediate Bags	300	US$250	US$75,000

Talkum Company Limited	Standard Bags	500	US$200	US$100,000
Musik Company Limited	Intermediate Bags	600	US$250	US$150,000
Musik Company Limited	Grade A Bags	400	US$300	US$120,000

One week after Al-Dana Vision signed the last contracts with its customers, the Saudi government suddenly imposed VAT of five percent on all manufacturing companies including companies that operated in the free zone enclave, retroactive the beginning of the month of the announcement. The governments of Saudi Arabia and UAE have a bilateral agreement about the imposition of the five percent VAT rates on goods produced in both countries. Mr. Naif called for an emergency meeting with his management team a day after the announcement in the evening to discuss the new development. The management team members comprise the vice presidents in charge of sales and administration(Khalid, Ibrahim), production manager(Salah), marketing manager(Hasan), general manager(Osman), procurement manager, and finance director. Mr. Naif walked into the meeting looking so distressed. The stress of the new tax imposition had already worn him out. The other management members noted his frustration and anger, and they were all tensed up. There was a deafening silence in the room for a period such that one could hear the sound from the drop. Finally, Mr. Naif asked in a distress tone: “What are we going to do about this new VAT? What is the way forward? The following conversation ensued among the management team members and Mr. Naif:

Marketing Manager: "I suggest that we schedule a meeting with the customers to discuss the way forward."

Vice President [in charge of sales]: "Hasan, I agree with you."

Vice President [in charge of Administration]: "I also agree."

General Manager: "I think we need to be careful with our customers. Some of the customers have done business with us over the years. They have been very loyal even in the face of stiff competition from both within the country and outside. I think it will not be prudent on our part to pass on the VAT rate of five percent to such customers. I suggest that the business bears such cost. It will reduce our profits, but I do not think it will lead to losses. We can pass on the VAT to the short-term customers."

While he was talking, the secretary walked in with some files and distributed it to all the management team members. The files contained information about the contracts signed with the customers.

Marketing Manager: "Osman, I do not agree with your proposal. What if the short-term customers get wind of it? What will they do? Will they not agitate to be treated the same way?"

Production Manager: "Osman, what kind of business decision is that? Why should we treat some customers more equal than others?

General Manager: "They are customers who have done business with us for a long time. Khalid, do you remember that we introduced this concept during the promotional sales? Anyway, if you do not agree on this, what do you propose that we do?"

> Mr. Naif called the secretary to serve them with Arabian coffee. Hadija walked I with the coffee and dates and some cookies for the gentlemen. Hasan jokingly asked her if they can get lamb with rice after the meeting since he will get home late. Hadija looked in Mr. Naif's direction for an answer to the question but Mr. Naif asked her not to pay attention to Hasan.

Vice President [in charge of sales]: "Osman, I remember. We classified the customers according to the number of years they have done business with us. At that meeting, we agreed that customers who have done business consistently with us for at least five years are considered long-term customers, and we gave them a higher discount."

Marketing Manager: "Really!"

Vice President [in charge of sales]: "Yes Hasan. You had not joined our company then. However, that was what we agreed on unless we want to revisit it."

Marketing Manager: "Khalid, I suggest we talk later in your office to thrush out this matter."

Production Manager: "I think we should pass on the entire VAT to the customers. After all, they also heard the announcement about the imposition of the VAT. We have to review the contract and increase the price to account for the tax."

General Manager: "Salah, that is too radical and might hurt our business."

Vice President [in charge of sales]: "will we not be in breach of contract if we decide to ask the customers to pay more because of the tax? We have already signed the contract with them."

Production Manager: "I have no idea about that. I think we should inquire from the legal counsel."

> Hadija walked in with packed bags of food and placed it on the table at the far end of the room. The members are distracted, and Mr. Naif angrily asks why she brought in the food at this time? Osman pleads on her behalf and walks her to the door. Mohammed and Hasan express their joy at the sight of the food and ask if they could take a 15 minutes break to eat the food before it gets cold. Mr. Niaf grants permission and the meeting continued after 15 minutes with the ensuing dialogue.

Vice President [in charge of Administration]: "I have a different view on what on what Salah said before the break. Instead of classifying the customers by how long they have done business with us, I suggest we consider case by case situation. The profit margin on the standard products is low. I propose that for contracts that involve standard products, we should pass the VAT to the customers while we bear the VAT for contracts on grade A products?"

Mr. Naif: "Ibrahim, what do we do about the VAT for intermediate products if we are to consider your suggestion?"

Vice President [in charge of Administration]: "In my view, we should pass on half of the VAT amount to the customers who buy the intermediate grade of bags while the company bears the other half."

Production Manager: "Sounds very good."

General Manager: "Very good idea. I agree."

Finance Director: "Have we thought about our suppliers. Will they also not consider charging us VAT?

Procurement Manager: "the materials needed to produce the units under the current contracts have already been supplied and paid for before the imposition of the VAT. We paid for the products last month."

Mr. Naif: "Ibrahim, your task is to schedule a meeting with the company's legal counsel to find out about the legal consequences of the various suggestions made. Find out from him if it is possible to review the contract price upwards with the customers, without breaching the contract terms."

Vice President [in charge of Administration]: "Alright Mr. Naif. I will call and arrange for the meeting as soon as we close from this meeting."

Mr. Naif: "While we wait for the outcome of the meeting with the legal counsel, I want all of you to think about whether we should pass on the VAT to customers or not. Also, Osman, Salah, and Mohammed should meet and decide on the basis to pass on the VAT to customers based on the two suggestions that came up; long-term customer relationship or product classification, while we await the outcome of the meeting with the legal counsel. I am done with this meeting."

Suggested Questions

1. Assess the implications of all the options in the case regarding the tax amount to be borne by the company and the tax amount to be borne by customers.
2. Assess the net profit implications of all the options on the company.
3. What qualitative factors should the company consider in deciding on the strategy to adopt about the VAT imposition.
4. If you were hired as a consultant, what would you recommend the company to do about the VAT imposition?

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