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Heartland FURNITURE COMPANY

ADAPTING TO CHANGE

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Heartland Furniture Company[1] has been headquartered in Heartland, Ind., for the past 100 years. The company was founded in 1900 by Joseph Muller, and since then it has expanded from a wood shop that produced household furniture for the local agricultural community to a publicly owned corporation with three U.S. manufacturing locations and 1,700 employees. The Muller family still controls a majority of the company's stock, and the company has been headed by a family member since it was founded. Craig Muller has been Heartland's chairman and chief executive officer since his uncle retired four years ago. (See Sidebar 1 for a summary of the key corporate personnel.)

Heartland prides itself on using only U.S. labor and materials in creating its high-quality case goods. The product lines focus on living room and dining room furniture and include a limited bedroom line. The company recently added home and executive office furniture to its product offerings. The products are manufactured in Heartland's three production facilities located in Dairy, Wis.; Treetop, N.C.; and Heartland, Ind. Each plant employs approximately 500 individuals. Wage rates range from $8.50 to $17.00 an hour plus benefits, including health and retirement contributions, with the highest at the Treetop plant and lowest at Heartland, reflecting differences in the skill levels of the employees. At each plant there's a high level of cooperation among the employees, many of whom are related to each other. The plants promote from within, and the employees are encouraged to improve their job skills by applying for open positions in different production areas. (See Sidebar 2 for additional information about the three production facilities.)

Each plant is headed by a plant manager. Other office personnel located at each plant include the managers of human resources, quality control, purchasing, shipping, and plant accounting. All sales, marketing, and financial accounting functions are consolidated at the corporate

Sidebar 1: List of Key Personnel

NAME	AGE	POSITION	YEAR JOINED COMPANY
Craig Muller	56	Chairman and Chief Executive Officer	1971

Craig has been chairman and CEO since 1999. Prior to that time, he served as president and COO for eight years. He joined the company at the manufacturing plant level. Since 1971, he has held a variety of positions in the areas of manufacturing and marketing. He is the grandson of founder Joseph Muller.

Richard Prentice	47	President and Chief Operating Officer	1986

Richard joined the company in 1986 as director of marketing at the Treetop plant. Prior to that, he worked for approximately six years at another furniture company headquartered in North Carolina. Prior to being appointed president and COO, he was Heartland's vice president of marketing and sales.

Carey Upton	42	V.P. Finance and Chief Financial Officer	1995

Carey is the grandniece of founder Joseph Muller. She graduated from college with high honors in accounting, worked for a major public accounting firm for 10 years and a *Fortune* 1,000 company for approximately four years. She has an MBA with concentrations in accounting and finance.

John Michael	52	V.P. Marketing and Sales	1996

A great-grandson of the founder, John joined the company after working for approximately 20 years with a national carpet manufacturer. He held the position of vice president of sales in his prior position. During the 20 years he worked in the carpet industry he lived in North Carolina.

James Unger	55	V.P. Manufacturing and Design	1981

James grew up in Wisconsin and joined Heartland as the plant manager of the Dairy facility. He was appointed vice president of manufacturing in 1993 and assumed his current position in 1998.

Sidebar 2: Manufacturing Facilities

Heartland, Ind.

The original section of the Heartland plant was built in 1922. The plant was expanded many times since then and was totally renovated during the late 1970s. The plant primarily produces dining room furniture and living room tables. The manufacturing equipment was last replaced 20 years ago. The plant produces relatively large batch sizes because of the significant time required to change from one production run to another. The workforce is stable and skilled in the production of hand-carved furniture designs. Recent changes to the dining room lines have reduced the amount of carving to reduce labor time and the associated labor cost per unit. The average age of the employees is 46.

Dairy, Wis.

The Dairy plant was established in the early 1960s. The plant primarily produces pine furniture; approximately half of the pine is imported from Canada. The plant was refurbished during the 1980s, and most of the machinery is equipped for computer-assisted design (CAD). The furniture designs are simpler and require less labor than do those produced in Heartland. The products produced in the Dairy plant were finished with a hand-rubbed process up to three years ago. At that time, the process was replaced with machine finishing to lower production costs. Dairy's labor rates are approximately 10% higher than those at Heartland. Dairy's higher levels of automation result in labor time reductions of approximately 5% to 25% as compared with Heartland. The workforce was recruited from the dairy farms in the surrounding communities and trained through on-the-job experience. Workers' average age is 42.

Treetop, N.C.

The Treetop plant was acquired from another furniture company during the 1980s to provide a manufacturing presence in the "heart" of the U.S. furniture industry. Treetop produces bedroom, dining room, and home entertainment pieces. Treetop's workforce is the most highly skilled of the three locations, and its pay rates are approximately 20% higher than those at Heartland. Workers' average age is 45.

headquarters located in Heartland, Ind.

Dairy, Treetop, and Heartland are small communities, situated in rural locations, and each town has a population of approximately 15,000. In each town, Heartland Furniture is the largest employer; the second largest employer is the public school system. Heartland provides the major tax base in each of the three communities and pays approximately $150,000 annually in real-estate and personal-property taxes to each local government. Joseph Muller firmly believed that Heartland should have a positive impact on its communities. He instilled this in the corporate culture, and, over the past 100 years, Heartland has contributed to various charities in the three towns. During the past 10 years, Heartland has contributed $100,000 annually to each location's charities and schools.

During the past five years, Heartland's management team has become increasingly concerned about the company's profitability and about changes in the furniture industry. Heartland has never imported any part of its product line. Its sole reliance on U.S.-manufactured product[5] has resulted in higher average product costs than those incurred by competitors that now outsource and import at least part of their product lines. Heartland's management team recently went on a corporate retreat to Sun Place, U.S.A., to discuss the problems facing the company.

Table 1: Heartland Furniture Company

Comparative Financial Information as of December 31

	2003	2002	2003	2002
Net sales	$130,417	$145,675	100.00%	100.00%
Cost of sales	$ 96,800	$101,200	74.22%	69.47%
Gross profit	$ 33,617	$ 44,475	25.78%	30.53%
Selling, general, and administrative expenses	$ 21,900	$ 20,300	16.79%	13.94%
Operating income	$ 11,717	$ 24,175	8.98%	16.60%
Interest expense, net	$ 2,800	$ 2,940	2.15%	2.02%
Income before income taxes	$ 8,917	$ 21,235	6.84%	14.58%
Income taxes	$ 4,000	$ 9,600	3.07%	6.59%
Net Income	$ 4,917	$ 11,635	3.77%	7.99%
Assets				
Current assets:				
Cash and cash equivalents	$ 8,720	$ 16,000	10.87%	19.76%
Accounts receivable, net	$ 27,400	$ 18,640	34.16%	23.02%
Inventories	$ 23,700	$ 18,800	29.54%	23.22%
Prepaid expenses	$ 8,400	$ 10,600	10.47%	13.09%
Total current assets	$ 68,220	$ 64,040	85.04%	79.10%
Property, plant, and equipment	$ 8,500	$ 9,500	10.60%	11.73%
Other assets	$ 3,500	$ 7,420	4.36%	9.17%
Total Assets	$ 80,220	$ 80,960	100.00%	100.00%
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	$ 8,400	$ 7,560	10.47%	9.34%
Accrued liabilities	$ 11,520	$ 14,400	14.36%	17.79%
Current portion of long-term debt	$ 6,200	$ 4,200	7.73%	5.24%
Total current liabilities	$ 26,120	$ 26,160	32.56%	32.31%
Long-term debt	$ 16,800	$ 20,200	20.94%	24.95%
Total liabilities	$ 42,920	$ 46,360	53.50%	57.26%
Stockholders' equity:				
Common stock, no par	$ 4,200	$ 4,200	5.24%	5.19%
Retained earnings	$ 33,100	$ 30,400	41.26%	37.55%
Total stockholders' equity	$ 37,300	$ 34,600	46.50%	42.74%
Total Liabilities and Stockholders' Equity	$ 80,220	$ 80,960	100.00%	100.00%

CONVERSATION AT THE CORPORATE RETREAT

James Unger, Heartland's vice president of manufacturing and design, noted that *Furniture Today* reported that during 2002 the $23.8 billion U.S. furniture industry imported $14.192 billion in furniture to the U.S. Of this total, $5.714 billion was imported from China. These numbers indicate that the U.S. furniture industry annually imports 60% of its sales.

John Michael, a great-grandson of founder Joseph Muller and Heartland's vice president of marketing and sales, noted that the increasing number of imports is significantly reducing the wholesale price of Heartland's major product lines. The imported case goods cost less

Table 2: Furniture Industry Comparative Cost Information

	IN CHINA	IN THE U.S.
Hourly Wage	$0.75	$12.50
Benefits	10% of wage cost	35% of wage cost
Overhead Rate	100% of direct labor cost	165% of direct labor cost
Worker Productivity Ratio (based on the number of workers to yield the output of one U.S. worker)	14	1
Base Lumber	$900 per 1,000 sq. ft.	$700 per 1,000 sq. ft.
Veneer	$180 per 1,000 sq. ft.	$120 per 1,000 sq. ft.
Finishing Materials	$.08 sq. ft.	$.15 sq ft
Product Lead Time	16 weeks	6 weeks
Freight (FOB USA Whse.)	10% - 15% of China Manufactured Costs	0
Packaging (as a % of manufactured costs)	4%	2%
Capacity Utilization	95%	85%

than comparable U.S. products to manufacture. Heartland's competitors that outsource at least part of their production have experienced significant costs savings and have reduced their wholesale prices to gain market share. Consequently, over the last three years, Heartland has faced increasing pressure from other furniture brands sold in the U.S. To protect its market share, Heartland has cut its wholesale prices to furniture retailers by 10% during each of these years. Profitability has suffered during this period, as market share remained at best constant and costs continued to rise. John asked Carey Upton, vice president of finance and chief financial officer, to distribute the summary financial statements she brought along to the retreat (Table 1). He emphasized that last year's results reflected continuing decreases in sales revenue, gross margin, and income before and after tax.

James reported that Heartland's three manufacturing facilities were operating at levels of less than 55% of capacity. Recent industry estimates indicate that levels of 85% of capacity are desirable, and levels of 70% of capacity are required to achieve acceptable returns. Craig, John, and Carey grew up in a family tradition that fostered strong ties to the communities in which the plants are located. The three were born in or near Heartland and graduated from Heartland High School. They, in particular, feel responsible for the welfare of the workers and their families at each location. Significantly reducing the size of the workforce through layoffs or, worse yet, a plant closure, has kept them awake at night. Craig reminded the group that the workers had accepted a reduction to a 30-hour work week to keep everyone on the payroll. He believes that accepting these personal hardships should be rewarded in the future.

John interjected an additional concern about disturbing trends in the furniture retail industry. Each week, the sales staff reported that at least one more traditional furniture retailer had gone out of business. National furniture retail chains are growing rapidly, but at least one has indicated it may cut back on Heartland's products if the company doesn't expand its bedroom line to complement more of the living room and dining room styles. The sales staff are concerned that they frequently have to negotiate on price and product. John wants Heartland to consider establishing its own retail outlets in the cities in which its products have been most successful. He believes these stores would sell more furniture per square foot than is currently being sold through national, multi-brand retail stores. James would rather see Heartland develop the bedroom line if retailers consider it important. He pointed out that the company has plenty of production space and that its traditional designs could be easily adapted to additional bedroom offerings.

Both Craig and Richard Prentice, the company's president and chief operating officer, believe that a move to the retail level is outside Heartland's expertise. They built their reputation on the production of traditionally designed, high-quality furniture. The company has no experience in retail, except for the outlet stores it operates at each of its manufacturing locations. These outlets sell discontinued and damaged items at reduced prices in a warehouse-like environment, mainly to employees and their friends and relatives. This retail environment is very different from the upscale design of single-brand furniture stores. Both Craig and Richard believe the company could more readily add to the bedroom line.

Carey reminded the group that the company's gross profit fell from 31% in 2002 to 26% in 2003. During the same period, its operating margin fell from 17% to 9%. During the weekly meetings of the management team, she has consistently emphasized that current-year results are projected to be lower than those of 2003.

The management team decided that the changes in the U.S. furniture industry make 2004 a turning point in the company's history. Either Heartland can continue as it has in the past, hoping that things will turn around in the future, or it can find ways to adapt and succeed in the current U.S. furniture environment.

The management team asked Carey if she would head Heartland's Strategic Task Assessment Review (STAR). The four men believed that her financial orientation was necessary to collect and appropriately analyze all of the available data. Carey agreed to head the review, but only under the condition that STAR would include a team of accountants who act as strategic business partners to the group.[2] Craig and Richard were quick to agree and suggested she work with a team of approximately four individuals from across the company.

The management group developed a charge for the STAR team. The charge indicated they should specifically analyze Heartland's:

- Cost structure,
- Products,
- Distribution channels, and
- Future opportunities.

Table 3: **Comparative Product Cost and Profit Information**

Products Delivered to U.S. Warehouse Based upon Heartland, Ind., Plant Production

	DRESSER		ENTERTAINMENT CENTER OR DINING ROOM HUTCH	
MANUFACTURED IN:	CHINA	U.S.	CHINA	U.S.
Labor and Benefits	$ 75.00	$109.48	$ 65.00	$ 89.59
Overhead	$ 75.00	$180.65	$ 65.00	$147.82
Material:				
Lumber	$ 66.06	$ 51.61	$141.34	$110.42
Veneer/Plywood	$ 56.42	$ 37.61	$171.65	$114.43
Other Materials and Hardware	$ 53.67	$ 71.57	$ 63.10	$ 78.89
Material Total	$176.15	$160.79	$376.09	$303.74
Manufacturing Cost	$326.15	$450.92	$506.09	$541.15
Packaging	$ 13.05	$ 9.02	$ 20.24	$ 10.82
Freight from China to U.S.	$ 40.00	$ 0.00	$ 40.00	$ 0.00
Total Warehouse Cost	$379.20	$459.94	$566.33	$551.97
Total Warehouse Cost	$379.20	$459.94	$566.33	$551.97
Add: Allocated Selling and Admin.	$ 91.01	$110.39	$135.92	$132.47
Total Product Cost	$470.20	$570.32	$702.25	$684.45
Wholesale Selling Price	$599.00	$599.00	$749.00	$749.00
Profit	$128.80	$ 28.68	$ 46.75	$ 64.55
Number of units produced per U.S. employee during 2003		160		130

To get the STAR members off to a good start, the management group gathered key information. For example, Carey and James pulled together some basic cost information they thought would be useful to the STAR members. James had been active in the furniture manufacturer's association for many years, and he was able to obtain cost information on outsourcing key products from various organization members (Tables 2 and 3). James also obtained information about the average restructuring costs incurred by furniture companies that closed domestic manufacturing facilities (Table 4). John provided Carey with a list of retailers and their sales figures (Table 5) he obtained from *Furniture Today*, and he suggested the team obtain more information from its industry database. Richard provided a list of U.S. furniture companies and their annual sales figures. He thought the STAR team would find this helpful if they wanted to benchmark operations against competitors (Table 6). He asked Carey to remind the STAR team that Heartland is unique for its size, as it only produces case goods and has never manufactured upholstered furniture. The team needed to evaluate Heartland against similar, not dissimilar, companies. The financial information included in Table 1 was passed on to the STAR team as well.

ASSIGNMENT

Carey asked you to be part of the STAR team. She needs your assistance as STAR assesses alternative ways in which Heartland can best adapt and succeed in the current U.S. furniture industry environment. Specifically, she asked that you develop the basis for a strategic plan. She expects you will need to use capital budgeting, benchmarking, and other appropriate analyses. Because of Heartland's long association with and concern for its communities, the strategic plan must include the impact of changes on the local community or communities, if any. She provid-

Table 4: Estimated Plant Closing Costs

Estimated employment-related costs per employee:	
Severance pay	$3,300
Bonus	750
COBRA	1,000
Unemployment compensation, per week	225
Estimated asset values and environmental cost:	
Book value, plant and equipment, per plant	$2,500,000
Estimated fair value, plant and equipment, per plant	1,000,000
Anticipated environmental monitoring, per plant	50,000

Table 6: Top U.S. Furniture Manufacturers per *Furniture Today*

MANUFACTURER	2002 SALES IN MILLIONS
Furniture Brands International*	$2,302
La-Z-Boy	2,060
Ashley Furniture	1,267
Klausner	860
Ethan Allen	757
Sauder	621
Berkline	456
Lacquercraft	400
Hooker Furniture Corporation	248

* Brands include Broyhill, Lane, Thomasville, Drexel Heritage, Henredon, and HDM.

ed you with access to the *Furniture Today* database to help with your industry analysis.[3] She suggested you get to work, collect as much information as you can, begin to analyze the data, and then meet with the management group to resolve any issues or questions it has before completing your proposed strategic plan.[4] ■

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Table 5: Major Furniture Retailers per *Furniture Today*

RETAILER	2002 SALES IN MILLIONS
Wal-Mart	$1,240
Rooms to Go	1,235
Ethan Allen	1,006
Levitz	950
La-Z-Boy Galleries	896
Office Depot	868
Sam's Club	850
Federated Department Stores	843
Nebraska Furniture Mart	836
Costco	750
Staples	702
Havertys	683
Value City	674
IKEA	670
Pier I	641

Endnotes:

1 Heartland Furniture Company is a hypothetical company developed for this case. It is based on a composite of mid-size U.S. furniture manufacturers facing similar competitive decisions in an increasingly outsourced environment.

2 For more information about the accountant's role as a strategic business partner, see G. Siegel, J. E. Sorensen, and S. B. Richtermeyer, "Becoming a Business Partner," *Strategic Finance*, October 2003, pp. 37-41; G. Siegel and J. E. Sorensen, *Counting More, Counting Less: Transformations in the Management Accounting Profession*, the Institute of Management Accountants; Montvale, N.J., 1999: G. Siegel, *The Practice Analysis of Management Accounting*, the Institute of Management Accountants; Montvale, N.J., 1996: and "2003 Best Practices in Financial Analysis, Planning & Reporting," *IONA's Report on Financial Analysis, Planning & Reporting*, March 2003.

3 Case participants may access, without charge, propriety *Furniture Today* databases at www.furnituretodayonline.com/taylor from November 1, 2004, through January 31, 2005.

4 Each case team may query furniture industry experts by submitting one e-mail of no more than 10 questions to IMACASE@butler.edu. The e-mail should clearly identify the team's institutional affiliation and clearly identify the return e-mail address. Each team will receive an e-mail reply. The e-mail account will be available from November 1, 2004, through January 31, 2005. Teams may not submit a second e-mail request.