

# Xtreme toys case study



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Imagine the excitement of the management team at Xtreme Toys at their recent board meeting when told about the company's increased sales statistics. However, joy soon turned to bewilderment when confronted by the company's shrinking cash flow situation. Convinced that the figures must have been misstated, the board members appointed a team from the finance accounting department to investigate. The following paper details the team's findings, including their recommendations on what actions the company should adopt to reduce its cash gap predicament.

**The Situation**Xtreme Toys is a small manufacturing company in Southern California that has experienced rapid expansion in sales over the past year. The expanding sales have caused intense pressure for increased inventory production, combined with a receivables buildup that is now draining the company of its cash resources. With management focused on increasing sales as the best way for the company to prosper, insufficient resources were dedicated to working capital management. The substantial growth in sales has increased the company's current assets such as accounts receivables and inventory, and now requires financing beyond internal funds and retained earnings.

**The Figures**By studying the company balance sheet, the investigatory team soon found reasons for concern. The current inventory conversion period is running at 113 days. Taking almost four months to turn inventory into a sale puts an increased strain on the company's cash position. One possible explanation for this could be that as the company has expanded its sales, so the inventory has turned from self-liquidating assets i. e.

inventory that is produced and immediately sold, to the “ permanent” current asset inventory, such as the floor displays and non-seasonal items. Added to the inventory turnover situation is the 62 days receivables conversion period. Once the inventory sells, it then takes a further two months before the company sees the cash from its customers. Conversely, the payables deferral period, or the time between the company receiving goods from suppliers to payment to the same suppliers is only 40 days. Therefore, the cash conversion cycle, or the time it takes to convert sales into inflowing cash, is now 135 days. The Solution Following the review of data, the investigatory team focused on three areas for improvement:\*

Accounts Receivables\* Accounts Payables\* Inventory

Management Fundamental to the solution is the need for management to understand that accounts receivable is an asset that should be thought of as an investment, just as any other current asset of the company.

Rather than look to historical data to set perceived desirable levels, the decisive test should be one of receiving the best return for outlay. The current 62 days it is taking for customers to pay is simply too long. One solution that presented itself is to encourage customers to pay earlier by offering an incentive of a cash discount for early payment. However, even offering a 2% discount for payment within 30 days would equate to an annualized discount far greater than the company’s current 8% cost of financing.

Consequently, after analysis we would not recommend that course of action. However, customer accounts that remain delinquent beyond 30 days could have a penalty of 8% imposed on them. The 8% is a means by which the

company's financing costs are passed directly to the late paying customers. Alternatively, to circumvent the delay entirely, the company could factor receivables to a finance company.

Factoring would transfer any risks of possible customer defaults and high administrative costs, and would enable quick transfer of cash into the company accounts. Another area for improvement is the company's current policy of paying its suppliers within 40 days. As the company's purchasing power increases, there will be more suppliers eager to provide goods that are, in turn, more likely to extend lines of credit beyond 40 days. Trade credit is normally between 30 to 60 days and companies can often stretch the payment period to receive additional short-term financing, as long as the extension is not taken to the extreme.

Consequently, the team's immediate recommendation would be to extend all lines of credit an additional 20 days. The third area for consideration is inventory management. Together with the manufacturing department, a review of inventory production levels should be undertaken to determine if a seasonal production schedule should be adopted, rather than the current level production. Although level production has the advantage of maximum efficiency in the use of the work force and machinery, it may produce unnecessary inventory buildups in a seasonal business. However, the team feels that further research is necessary in this area to ensure that movement to seasonal production does not result in unused capacity during the slack periods and increased labor costs due to overtime wages.

Alongside this research, the team also feels that further analysis of the economic ordering quantity (EOQ) should also be undertaken to ensure that it is up to date with the firm's current sales growth. Conclusion When initially reviewing the company's financial data, the team identified as a goal a minimum reduction of 20 days in the cash conversion cycle. After a more detailed review, the investigatory team believes that the 20-day reduction target is a highly modest goal. As identified in the commentary and analysis in the body of this paper, if the company:

- \* Stretches accounts payable from an average of 40 to 50 days, this will immediately achieve half of the cycle day target. Of course, the team proposes that any supplier concerns are addressed through consultation and communication to ensure continued good terms with key suppliers.
- \* Secondly, a 5 to 10 day reduction in the average time accounts payable remain outstanding should be achieved by providing an incentive for customers to pay early.

A key objective will be to reduce accounts receivable delays to something less than accounts payable.\* Finally, by looking closely at production options, the team believes the most worrying 113-day average inventory carrying time could be significantly reduced. The project team calculates that by implementing the recommended changes, at least to the extent of a 20-day improvement, will save the company \$29, 778 annually in financing charges. Additionally, as if the finance charges were not sufficient, the cash conversion cycle time reduction will also free up nearly \$400, 000 in lines of existing credit that can potentially be deployed to improve production and/or increase sales.