

Total working capital  
cycle =  $30+30+25-15=70$  days essay  
examples

[Business](#), [Company](#)



### - Horizontal analysis

Competition Bikers has a moderate growth rate but its profitability growth is worrying. The profitability of the company tripled from year 6 to 7, but dropped by 84% between year 7 and 8. This is explained by the economic down turn experienced in year 7, leading to a sales decline of 15% in year 8. While it is easy to say that the reduced profitability is due to poor economic conditions, a further examination of the company's income statement and balance sheet is necessary.

In the horizontal analysis, the sales decline from a growth rate of 33% to 13.33%. This is not avoidable since the economic down turn cuts across all business sectors and affects both the customer's spending ability and the source of funding for professional bikers. However, the company doesn't put in place any measures to substitute this effect to make the products attractive to customers. For instance, they could reduce the prices of Carbon Lite bicycles. The company has fixed its prices at \$1495, regardless of the customer's spending capability. Although it might be argued that this decision is dependent on the costs of the parts acquired from suppliers, it can also be argued that the cost of goods sold has only grown by 12.68% in year 8, against that of sales of 13.33%.

The company's decline in Gross profit by half its previous growth in year 7 indicates that it has inadequate planning and organization capabilities. The company should be able to take necessary mitigation approaches during economic crunches in order to minimize its losses.

One of the company's weakness is its over dependence on professional bikers. There is no indication of diversification measures because almost all

customers are professional bikers who receive funding/ sponsorship. Although it might be argued that this is the company's market niche, it cannot be ignored that it exposes the company to high risks. If the customers included armatures that do not depend on funding, or bicycles for other needs other than racing, then the economic effects could be easily mitigated to a lower level. Because of the economic downturn, the company decided to tighten its belt and reduce selling expenses. The company has a strong advertising strategy of 2% of Gross profits. While the growth of Gross profit mirrors advertising costs, this cost item must be regulated to ensure that the company does not strain its overall earnings in case of low sales. This will ensure that the shareholders can have a positive net earnings because the lower the level of sales the lower the level of expenses. Selling expenses include website maintenance whose cost for the last three periods have not changed, commissions which are directly linked to sales thus behave in the same manner as sales, distribution which decreased by 15% from year 7 to year 8. However, the company had to move its products to its distributors thus incurring the same cost in year 8 as it did in year 7. GAE increased from year 6 to 7 but due to the belt-tightening controls undertaken by the company, the GAE for year 8 were the almost the same sets of numbers used in year 7. This indicates managers willing to put the needs of the company ahead of their personal compensation needs. The company rescinded its efforts to research and develops new products, decreasing between the periods of year 7 and 8 by 16.3%. This is counter-intuitive since at a bear year, R&D should be the company's ticket back to profitability.

The company seems to be servicing its long-term debt well, given the decline in interest payments from year 6 to 8. Finally, the major decline that could be seen in the horizontal analysis is operating income, which declined from 254.56% to 78.59%. The company has a weak capability of reducing the economic risks from affecting its operating income. This major decline was reflected in the net earnings, which declined from a growth trend of 413.43% in year 7 to 76.03% in year 8.

The horizontal analysis also indicates that the company is saving up its cash. In period 6 to 7, more cash was used by the company. In the following period, this has swelled by about 348%. This means that the company is keeping its resources for a big investment. It has also reduced its short-term investments to 0% in year 8 from a very significant 10.8% in the previous period. Receivables have decreased between the two periods indicating that while the volume of receivables has increased (due to volume sales increase), the cash is managed better because collections have improved. Bottom line is that the total current assets of the company has grown proportionally smaller in period 7 to 8 than in period 6 to 7. Again this is a sign of the company saving up for future investments despite have 0% investments in the three years analyzed. The company is also paying off its short-term liabilities, with only an increase in liabilities of 28% in period year 7 to 8 compared to 122% in year 6 to 7. This means that the company is trying to get back on track with its creditors to enable it to have a better financial position when the time comes that it needs to borrow money for investments. There are no other material changes in liabilities and in stockholder equity after that, other than a decrease in the amount valued for

shareholder equity and treasury stock. This means that some of the shares of the company may have been sold back to the market as a way of raising some equity capital.

#### - Vertical analysis

The vertical analysis reveals how the company's management directives shape the cost structure of its products. The company is making an average of 26.5% of Gross profit on sales. Conversely, the cost of goods sold is at an average of 73% over the three years. This indicates that the company has maintained its operating efficiency. In addition all selling expenses appear to be constant in terms of its proportion to sales which puts down into how responsive management strategy is to changes in the competitive environment. Coupled with the dwindling of sales volume, this tells us that the company's managers have not anticipated an increased push to sell more products because the direct costs associated with selling the product has not been increased to enable the company to retain the previous periods level of profitability. In addition it appears that the company has allocated a very high percentage on administration and general expenses at 18.4% in year 8, 15.45% in year 9, and 17.12% in year 6.

The lower the sales the higher the amount allocated towards general and administrative expenses. This amount increases the level of operating expenses substantially which cuts into the company's earnings. The operating income is incomparable to operating expenses which makes the company have a low income generation capability and a low profitability. However, the items in the GAE are fixed and there is very little that the company can do to alleviate its negative effects on net margins.

The lower spending of the company is shown by way of the cash it is currently holding, swelling from 2.2% in year 7 to 9.6% to year 8. The amount of money that the company should be receiving has swollen as well to 14% in year 8 which means that the company has not been able to collect effectively from its clients. The trend analysis also shows that there is no substantial investment in PPE for the company within the relevant periods. The liabilities section shows that the company, because it has not been able to collect from its clients, also have not been able to manage its suppliers well enough with payables increasing to 6% in year 8. Other than that, the company's liabilities and shareholder equity seems to be stable.

#### - Trend Analysis

The trend analysis for net sales is shown in the figure below. The net sales of the company is mostly flat, with a spike in year 7 looking like an abnormal blip in the net sales of the company. Year on year growth indicates an increase from year 9 by 3% following a drop from year 7. Using year 6 as a basis however shows that there is very modest growth for the company's sales as well. This indicates that the company has done little to improve its growth prospects, potentially because it has not spent much on direct selling costs which are needed in pushing sales volumes.

#### Figure 1 Trend Projection

#### - Ratio Analysis

Profitability is down. Gross profit margin, operating profit margin and net profit margin have decreased from year 7 to 8. Their profitability level is very unlike to its competitor in year 7 who is operating very profitably in both years. For instance, the competitor's GMP is 32% versus the company's 27%

in year 8 and a NPM of 5% versus 0.6% for the company in the same year. The company has the same level of liquidity, with the current ratio and the acid-test ratio not changing significantly between the two years. However, its ability to cover interest payments has decreased in year 8 from 8.6% to 1.4%. This is alarming considering the level of debt that CB has taken on has not changed.

The company's collection (resource use) has not improved but its ROA and ROE have decreased significantly. This is because the revenues from the operations of CB have not risen in pace with the increase in asset base nor the increase in shareholder contribution. Surprisingly, the ROA of the competitor is similar to the company's ROA in year 7. (4.8% for Two wheel in year 8, while CB's ROA is 0.7% in year 8 and 4.6% in year 7). The ROE behaves the same (Two Wheel has 8% in year 8 while CB has 8.6% ROE in year 7 and only 1.4% in year 8). The market has reacted to this with Earnings per share dropped significantly prompting an increase in the P/E ratio. The PE ratio indicates that the company's stock is now over valued because of the quizzical cash management strategy of the company.

#### - Working Capital

Competition Bikers working capital is its current assets minus its current liabilities. Working capital shows the company's solvency level. Some company's may store a high working capital while others maintain a smaller one according to the type of the organization and its specifics. An organization whose products can be easily sold into the market, and takes a very short time to sale all stocks may maintain a low working capital while an organization that deals with slow moving goods may have to maintain a

larger working capital. Competition Biker's working capital may be determined by looking at its cash conversion cycle.

- Raw materials days 30 days
- Inventory utilization days 30 days
- Average time in inventory 25 days
- Days it takes to settle Suppliers 15 days

The company can improve its working capital by reducing this working capital cycle. Having a lower working capital may benefit the company, because it allows the company to invest most of its cash and enable high profitability. Making working capital low prevents the company from allowing money from lying around unused but instead ensures that it is invested in one of the processes of the cycle. Competition Bikers may reduce its working capital in the following ways:

- Ensuring a quicker system of collecting debts from debtors. It might require the company to put in place a system that rewards those who pay timely.
- Reducing the level of raw materials stock. This can be possible if the company's processing is smooth and efficient.
- Ensuring shorter production periods. This can only be done through improved efficiency and effectiveness.
- Requesting for an extension of the credit period. Competition bikers can do this by creating a good relationship with its suppliers in order to pay at an extended duration. It might require the company to retain one loyal but efficient supplier, for this course.
- Reducing the level of finished goods stock. This is done by increasing incentives for making high sales. It may be through aggressive



advertisements, or attractive discounts.

Excess working capital can be invested in short-term highly liquid investments, which is something that company has been doing since it is receiving interest earnings. The ultimate result of a suitable capital structure should be one that maximizes the shareholders' wealth creation objective.

Fixed Assets are very important for carrying out operations in any organization. Many organizations would prefer to purchase them, but the access to sufficient finances is always a limitation. The closest alternative is to lease these assets. Leasing is a contractual arrangement in which the business will have access to the fixed assets but doesn't take over their ownership. In the venture in the U. S. Competition Bikers needs to build a factory but also compete against the rivals their by investing in the products that have titanium frames. This could become costly and cut deep into the company's net earnings. Moreover, building a new facility in a foreign base could be marred by numerous complexities which could take a very long time to complete before operations begin.

- Internal Controls

The purchasing orders depend on the budget projections for the month. Purchasing department selects the suppliers and sends them the purchasing order. The segregation of duties prevents fraud, since the purchasing department, and the accounting department is involved in the purchase. Purchases order is made on a monthly basis. The purchasing department then sends the accounting department an invoice to pay suppliers. The standard internal controls may be flawed however. For instance, the bidding process uses three bidders, selecting the lowest cost among the three. It

may be more advantageous for the company to enter into long-term supply contracts instead to reduce the cost of administration for purchasing and instead work on more competitively priced materials than take on the hassle of purchasing everything monthly.

#### - Corrective actions

The budget projections must be constructed by the production department with specifications and specific volumes of materials required in order to prevent any quality issues and running out of stock. The purchasing department could only prioritize cost over quality. The Just in Time system could be implemented in order to increase the economic quantity order. This could reduce the increased costs involved in the monthly purchase of stock to only when it is required. The suppliers invoice should go directly to the accounting department, which should verify with the goods received document in the production department. The JIT system improves inventory turnover as well and frees up cash that can be used for other parts of operation or to generate revenues from short-term investments.

A long-term supply contract for the year could be established by the company with its suppliers (through a bidding process) so that the company does not have to depend on always getting quotes from suppliers every time. This would curb the incidence of fraud if any.

#### - Sarbanes Oxley Compliance

It ensures that there are no misstatements in the company's financial statements. Competition Biker's has an adequate internal control as per the SOX requirements, which reports to the management and board of directors. The company has a problem in its internal controls, which could lead to

misstatement. This means that the internal controls of the company are wanting and that the actions that Competition Bikes is taking indicate that they are non-compliant with SOX.

- Corrective action
- The company should synchronize its operations in the two manufacturing facilities. This would enable the company to manage its internal controls and be SOX compliant.
- It should explore long-term but more competitive contracts for supply of its raw materials. This would enable the company to buy cheap and produce cheap.
- It should enhance its documentation policies to ensure incidents of fraud. This would enable the company to control its transactions.
- It should increase the separation of powers and responsibilities to add accountability to its managers and link performance to manager compensation
- Risks and Risk Mitigation

### **The following risks are identified:**

- Not finding optimum ways of doing business puts the entire viability of the company at risk. To mitigate this risk, the company should establish more rigid internal controls for the company.
- It is risky not to fully involve the production department in the purchasing of materials. This means that at least three departments must be involved in the procurement to ensure that there is adequate check-and-balance involved.

- There is still a threat of collusion since the segregation of duties is thin, with only two departments being involved in the purchasing process. Internal controls such as long-term procurement/supply contracts would enable the company to make sure that the cheapest raw materials are sourced thereby reducing the threat of collusion.
- The monthly purchase of materials may be too routinary to attract planned fraudulent activity. Projections should be made and adequate reporting instilled to ensure that fraud is negated.
- The Purchasing department is the center of the purchasing process and may act fraudulently by requesting the accounting department to pay a ghost supplier. Again, a supply contract would mitigate this problem.