

INTEGRATIVE CASE PROBLEM

Working Capital Management

Anderson Furniture Company manufactures furniture and sells its products to department stores, retail furniture stores, hotels, and motels throughout the United States and Canada. The firm has nine manufacturing plants located in Virginia, North Carolina, and Georgia. The company was founded by Edward G. Anderson in 1906 and has been managed by members of the Anderson family since that time. E. G. Anderson III is currently chairman and president of the company. The treasurer and controller of the company is Claire White, who was hired away from a competing furniture company a few years ago. Anderson owns 35 percent of the common stock of the company and (along with the shares of the firm owned by relatives and employees) has effective control over all of the firm's decisions.

Financial data relating to last year's (2012) operations, along with relevant industry comparisons, are shown in Table 16C.1. The firm's overall rates of return on equity and total assets have been around the industry average over the past several years—sometimes slightly above average and sometimes slightly below average. The company is currently operating its plants near full capacity and would like to build a new plant in Georgia at a cost of approximately \$7.5 million. White has been exploring various alternative methods of financing this expansion and has been unsuccessful thus far in developing an acceptable plan. The sale of new common stock is not feasible at this time because of depressed stock market prices. Likewise, Anderson's banker has advised the firm that the use of additional long-term debt or lease financing is not possible at this time, given the firm's large amount of long-term debt currently outstanding and its relatively low times interest earned ratio. Anderson has ruled out a cut in the firm's dividend as a means of accumulating the required financing. The only other possible sources of financing available to the firm at this time, according to White, appear to be a reduction in working capital (current assets), an increase in short-term liabilities, or both.

Upon learning of these proposed financing methods, Anderson expressed concern about the effect these plans might have on the liquidity and risk of the firm. White replied that the firm currently follows a very conservative working capital policy and that these financing methods would not increase shareholder risk significantly. As evidence, she cited the firm's relatively high current and quick ratios. Anderson was unconvinced and asked White to provide additional information on the effects of these financing plans on the firm's financial status.

1. Anderson's bank requires a compensating balance of \$3 million. How much additional funds can be freed up for investment in fixed assets if the firm reduces its cash balance to the minimum required by the bank?
2. How much additional financing can be obtained from receivables if Anderson institutes more stringent credit and collection policies and is able to reduce its average collection period to the industry average? (Assume that credit sales remain constant at \$75 million.)
3. How much additional financing can be obtained for fixed-asset expansion if Anderson is able to increase its inventory turnover ratio to the industry average through

▲ TABLE 16C.1

Anderson Furniture Company's Financial Data (in Thousands of Dollars)

Balance Sheet as of December 31, 2012			Industry Average
Assets			
Cash	\$ 3,690	6.5%	5.0%
Receivables, net	15,000	26.3	21.6
Inventories	20,250	35.5	33.4
Total current assets	\$38,940	68.3%	60.0%
Net fixed assets	18,060	31.7	40.0
Total assets	\$57,000	100.0%	100.0%
Liabilities and stockholders' equity			
Accounts payable	\$ 3,000	5.3%	7.0%
Notes payable (8%)	3,750	6.6	10.0
Total current liabilities	\$ 6,750	11.8%	17.0%
Long-term debt (10%)	18,000	31.6	28.0
Stockholders' equity	32,250	56.6	55.0
Total liabilities and equity	\$57,000	100.0%	100.0%
Income Statement for the Year Ended December 31, 2012			
Net sales (all on credit)	\$75,000	100.0%	
Cost of sales	60,750	81.0	
Gross profit	\$14,250	19.0	
Selling and administrative expenses	7,500	10.0	
Earnings before interest and taxes	\$ 6,750	9.0	
Interest expense	2,100	2.8	
Earnings before taxes	\$ 4,650	6.2	
Income taxes (45.16%)	2,100	2.8	
Earnings after taxes	\$ 2,550	3.4%	
Significant ratios			
	Anderson	Industry Average	
Current	5.76	3.50	
Quick	2.77	1.60	
Average collection period (days)	73.00	58.803	
Inventory turnover (Cost of sales/inventory)	3.00	3.50	
Sales to total assets	1.30	1.60	
Debt to equity	0.80	0.90	
Times interest earned	3.20	4.70	
Earnings after tax/sales	3.40%	2.40%	
Earnings after tax/equity	7.90%	7.90%	

tighter control of its raw materials, work-in-process, and finished goods inventories? (Assume that the cost of sales remains constant at \$60.75 million.)

- Anderson's suppliers extend credit to the firm on terms of "net 30." Anderson normally pays its bills on the last day of the credit period. How much additional