Competition Bikes, Inc.

Competition Bikes, Inc. makes bicycles for professional and other highly accomplished riders who compete in bike races, biathlons, and triathlons.

Sixty percent of all race winners have been victorious using a Competition Bikes, Inc. bicycle when at least ten percent of the entrants were also using a Competition Bikes, Inc. bicycle. This extraordinary success rate consistently is a topic of conversation among racers and this word of mouth advertising has been effective in promoting sales. The company also uses these statistics to promote sales, although its advertising efforts have been quite limited.

The Main Competitor

Two Wheel Racing, Inc. is the only other manufacturer that offers a competitive product in this market space. Their product weighs only a few ounces more than the bikes made by Competition Bikes, Inc. but Two Wheel Racing builds a chain driven product.

Two Wheel Racing, Inc is also a publicly traded company. Their financial ratios are provided for comparison and analysis.

THE COMPANY AND ITS CENTRAL OPERATIONS

Ownership History:

Larry Ferguson formed the company in 2001 in his garage. An avid racer, Larry often heard comments from other riders about how heavy and unreliable their bikes were. Larry identified and sought to remedy this market niche by creating a specialized product that would satisfy the needs of racers. His new company also proved to be a vehicle for financial success.

Early success prompted Larry to take the company public after three years in order to acquire sufficient capital to build the two current manufacturing facilities. His bikes enjoyed high demand and good profit margins. Larry continues to be the CEO of the Competition Bikes, Inc. and retains a 40% interest of company shares.

Standard Company Procedures for Operations

Each of the manufacturing locations for Competition Bikes, Inc. uses operating procedures based on department and function, as applicable. The following is an excerpt from the operating manual that outlines the process used to order and receive component parts.

> "The purchasing department will issue a purchase order to the supplier based on the monthly budget projections. Purchasing checks with three sources for similar quality materials and selects the low bidder from the three. The purchase order is sent to the supplier by the Purchasing Department on the first of the projected month. Upon receipt of the goods they will be brought to the production line for use during the month. Any unused parts are sent to the raw materials inventory stores on the last day of the month. Purchasing sends the supplier's invoice to accounting and accounting writes a check to pay the invoice. "

Competition Bikes, Inc. is required to conduct an annual audit since the company shares are traded on the Philadelphia Stock Exchange. The following excerpt was printed in the last annual report issued by the auditors to the shareholders.

> "A material weakness is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

Sarbanes Oxley Compliance

Management is responsible for ensuring the internal control processes prevent material misstatements from being reported in the financial statements. They also must provide a Report on Internal Control that is published in the annual report. The following excerpt from the Competition Bikes, Inc. year end report indicates no material weaknesses existed.

> "The management of Competition Bikes, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting. Competition Bikes, Inc. internal control system was designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.
>
> Competition Bikes, Inc. assessed the effectiveness of the company's internal control over financial reporting as of December 31, Year 8. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on our assessment we believe that, as of December 31, Year 8, the company's internal control over financial reporting is effective based on those criteria."

MANUFACTURING LOCATIONS, DISTRIBUTION, AND PRODUCTS

Locations

Competition Bikes, Inc. currently has facilities in two locations. Company headquarters are in San Diego, CA. There are two manufacturing facilities: one in San Diego and the other is located in an Atlanta, GA suburb. With qualified employees in each location the company has sufficient redundancy to handle a short-term increase in production if one of the locations has too many orders to adequately supply customers while maintaining high customer service standards.

Distribution Network

Competition Bikes, Inc. currently markets its bicycles through selected, pre-qualified privately owned distributorships. Each manufacturing facility services a group of authorized distributors that were selected to ensure that 95% of the U.S. population is properly served. Each distributor works directly with local specialty bicycle retailers. All product orders are checked and submitted to the factory through one of the distributors.

Product Delivery:

All bikes are conveniently delivered to the customer's ordering location by a common carrier chosen for its reliability and superior handling of the product. Competition Bikes, Inc. has a contract with the carrier. The contract includes a large financial penalty for any damages to delivered orders.

Product Line
Competition Bikes, Inc. aims to provide the most durable, reliable, light weight bike frame and component set possible. Competition Bikes, Inc. realizes that other companies make great components so their research and development department licenses these products and makes improvements where necessary to lighten the component. Care is taken to ensure that durability and reliability are maintained. The current product, CarbonLite, is a light weight, customized bike built based on the customer's unique physical attributes. CarbonLite was also the first bicycle to offer drive shaft technology.

Local distributors who represent Competition Bikes, Inc. are responsible for properly measuring the rider and placing the order with the factory. Some distributors allow their bicycle shop retail outlet clients to do their own measurements but the distributor is contractually committed to the order once it is placed. The factory constructs the bike frame according to these measurements and adds the approved braking, gearing, and other miscellaneous components as specified in the order. Each bike is completely built at the factory. Quality control checks are conducted, and each new bike is test ridden to fully check all functional attributes of the product prior to shipment to the distribution network.

MANUFACTURING COSTS

CarbonLite Production Standards

Direct materials:
Each bike frame requires an average of 42 (2 as a production scrap allowance) carbon strips which cost $9/strip. The component package costs $275.

Direct Labor:
Each bike requires a total of 15 hours of direct labor. The average $20 labor costs are relatively high due to the high skill level required in manufacturing the product. Retention of the quality labor force has not been a problem.

Variable Manufacturing Overhead:
Variable manufacturing overhead is currently applied at $94.529/unit.

PRODUCT SALES AND THE MARKET

Sales Summary – last three years Company Sales in Units					
Model	**Sales Price**	**Trade Discount to Distributors**	**Current Year - 2008**	**Last Year - 2007**	**Two Years Ago - 2006**
CarbonLite	$2990	50%	3400	4000	3000

Sales Forecast:

Global Economic Impact
Competition Bikes, Inc. experienced a 15% sales decline in the most recent year based on the current economic situation. Many of the customers who place orders are sponsored professional riders. Some of the sponsors have cut back on the funding levels to their riders. Sales trends in the product mix (illustrated in the chart above) have remained consistent in spite of significant overall sales decline from professional riders who prefer the CarbonLite model. This trend is expected to continue for the next three years.

Sales Forecasts for the next three budget years:

The company expects to recover from the current year sales decline over the next 3 years. Current sales forecasts by year are:

Year	Sales in Units
9	3510
10	3660
11	3800

Working Capital and Cash Flow

Operating Cycle factors:

- Competition Bikes, Inc. sends the distributor a monthly invoice for all raw materials ordered with terms of net/30 days.
- Inventory is paid for in the month following production. All inventory ordered for the month is used during the month with ending inventory remaining at a very consistent level. The average time in inventory is 25 days.

Cash Conversion Cycle factors:

- The suppliers invoice Competition Bikes, Inc. at the end of the month for orders that month with terms of net/15. Competition Bikes, Inc. pays the invoices on the 15th of the month following the order. The checks are usually cashed on the 20th by the suppliers.

Free Cash Flow factors:

- The corporation's marginal tax rate is 25%.
- Depreciation in the data is recognized in both manufacturing overhead and as depreciation expense depending on the asset being depreciated.

FINANCIAL PERFORMANCE HISTORY AND OTHER MATTERS

Financials

The financial statements from the annual reports for the last three years have been provided for analysis on the course template in Taskstream. The company stock is traded on the Philadelphia Stock Exchange. At the end of the Year 8 fiscal year the stock is trading at $3.10/share.

THE TASKS

TASK 1 – FINANCIAL STATEMENT ANALYSIS AND CONTROLS

Requirements for Task 1:

A. Prepare a summary report in which you do the following:
   1. Evaluate the company's operational strengths and weaknesses based on the following:
      a. Review the horizontal analysis, analyze the results, and discuss operational areas of concern.
      b. Review the vertical analysis, analyze the results, and discuss operational areas of concern.
      c. Review the trend analysis, analyze the results, and discuss operational areas of concern.
      d. Review the ratio analysis, analyze the results, and discuss operational areas of concern.

2. Analyze the working capital of Competition Bikes, Inc. Consider the following in your analysis:
   - Ways to improve the working capital
   - Ways to use excess working capital to generate an increase in profits

3. Evaluate the internal controls for the Competition Bikes, Inc. purchasing system.
   a. Recommend corrective actions for any weaknesses.
   b. Identify the risks to the company.
      1. Discuss how to mitigate the risks arising from internal control weaknesses.

4. Analyze compliance with Sarbanes-Oxley requirements.
   a. Recommend corrective actions for noncompliant areas.

TASK 2 – BUDGETING

MASTER BUDGET

The student will review the budget for the coming operational year, analyze the budget, and discuss any concerns found in the budget and the budget process. Consider this additional information used in the budget process:

1. Management anticipates that the market will improve moderately during the coming year.
2. The Sales forecast is 3510 CarbonLite units.
3. No change in this pricing is expected for the coming year.
4. Factory overhead will be has been budgeted at $481,798 for the year. This figure includes $150,000 depreciation expense.
5. For accounts receivables the year-end balance have historically been 12% of the annual sales due to the increased sales in the December holiday season. All credit sales are collected in the first two months of the new accounting period.
6. For accounts payables the year-end balance has historically been 10% of purchases. All credit purchases are paid during the first month of the new accounting period.
7. Ending inventory in raw materials and work in process inventories expected to remain at the same levels as the ending balances in Year 8.
8. Selling commissions are 3% of revenue.
9. Transportation Out is $30/unit by contract with the common carrier.
10. Advertising Expense is 2% of projected Gross Margin
11. Research and Development is 6% of projected Gross Margin
12. Non-manufacturing Utilities and Services are $150,000.
13. Non-manufacturing Depreciation is $80,000.

FLEXIBLE BUDGET

The actual number of bikes sold during year 9 was 3400 units. The CEO asks that you analyze the Flexible Budget comparing the projections in the master budget with the actual results after the end of the year. The variances have been provided.

The CEO is a strong proponent of the Management by Exception management style so you have been asked to point out areas that need further analysis and management intervention.

Requirements for Task 2:

A. Prepare a summary report in which you do the following:
   1. Discuss budgetary areas that raise concern in the budget planning.
   2. Evaluate the flexible budget and the variances.
      a. Recommend corrective actions for areas of concern based on a variance analysis.
      b. Discuss how the concept of management by exception could be applied to the variances.

TASK 3 - EXPANSION OPPORTUNITIES

CANADA MANUFACTURING

Current Canadian Business

Canadian customer orders currently comprise about 10% of the company output. The orders are shipped from the U.S. Due to the continuing increase in the Canadian business the management of Competition Bikes, Inc. is considering a location in Canada.

Expansion to Canada

Market research completed in the last month has shown that there are a sufficient number of high end bicycle shops which could carry the CarbonLite product. The current U.S. sales model would be used if the Canadian market is established. A distributor network would be established to handle all orders and to act in a sales management capacity with the retail stores.

The ability to provide cost effective, great customer service to the growing Canadian market is a primary concern. Other considerations include:

- Qualified labor force
- Cost of labor
- Land cost comparisons.
- Cost to construct a new manufacturing facility.
- Tax incentives for chosen location.
- Transportation cost and reliability for bringing in raw materials and component parts and for shipping of finished products to distributors.
- Community facilities and support that will meet employees' needs for education and health care as well as for recreational and cultural activities.
- Community business attitude

Management has reviewed the information and data from the completed market research, including the considerations listed above. After careful analysis, Competition Bikes, Inc. chose Toronto as a potential manufacturing site.

Management has been considering the decision for about a month but a complicating issue arose in the last week. A future competitor in the Canadian market, Canadian Bikes, Inc., has contacted Competition Bikes, Inc. regarding the possibility of a merger. Canadian Bikes, Inc. is also willing to discuss being acquired by Competition Bikes, Inc. Canadian Bikes, Inc. already has a facility within Canada. The CEO of Competition Bikes, Inc. has asked you to provide an analysis of the options and to provide a recommendation.

Proposed Options from the Canadian Bikes, Inc. board of directors

The board of Canadian Bikes, Inc. has proposed the following options to Competition Bikes, Inc.:

- Canadian Bikes, Inc. has offered to merge with Competition Bikes, Inc.
- Canadian Bikes, Inc. has offered to be acquired by Competition Bikes, Inc. at a 30% premium over the ending year 8 market price of $1.40. Consider if this is a reasonable offer price?
- Canadian Bikes, Inc. has also offered to license its titanium technology for $200/frame or to supply the frame for $450/frame. The U.S. facilities have sufficient capacity to build out bikes on the Titanium frames. Company management thinks the product would have appeal in the U.S. market and would provide a large increase in sales.

In your analysis of the various expansion possibilities you will consider:

- Building a new facility according to the current U.S. factory layouts.
- Building the new facility to U.S. factory layouts specifications but then selling the structure to a leasing company with a leaseback. Data supplied in the Task 3 templates.
- Finding a factory building and either lease it or buy it.
- Merging with Canadian Bikes, Inc. The company has a lower cost competition bike that is based on a Titanium frame which would complement the current bike offered by Competition Bikes, Inc.
- Acquiring Canadian Bikes, Inc.
- Buying the Titanium frames from Canadian Bikes, Inc. for $450/frame.
- Licensing the titanium technology at $200/frame

The Requirements for Task 3

In this task, you will prepare a summary report that analyzes the proposed expansion.

A. Prepare a summary report in which you do the following:
   1. Recommend a capital structure approach that maximizes shareholder return.
      a. Justify your recommendation.
   2. Discuss capital budget areas that raise concern.
   3. Discuss how working capital can be properly obtained and managed for the expansion operation.
   4. Discuss whether Competition Bikes Inc. should merge with or acquire the Canadian Biking Inc. facility.

Additional Data to consider in your analysis and decision:

There are various options to consider in this decision. The following data are used in the analysis.

Canadian Bikes, Inc. Financial Forecasts

The board of directors of Canadian Bikes, Inc. provided a net income and cash flow forecast of the next five years of its operations. These forecasts have been converted to U.S. dollars.

Capital Structure

Competition Bikes, Inc. has different capital acquisition methods it can select to fund the Canadian expansion if the decision is made to go forward with the expansion. Complete an analysis of the alternative capital sources available to optimize the company capital structure after obtaining the funds necessary for expansion. Total needs are expected to be $600,000.

Computes the optimal capital structure based on obtaining the required funds by issuing only bonds.

- Obtain the required funds by issuing 9% bonds for 100% of the financing needs.
- Obtain the required funds by issuing common stock for 50% and preferred stock for 50%.
- Obtain the required funds by issuing 5 year, 9% bonds for 20% and common stock for 80%.
- Obtain the required funds by issuing 5 year, 9% bonds for 40% and common stock for 60%.
- Obtain the required funds by issuing 5 year, 9% bonds for 60% and common stock for 40%.

Choose the best option after considering the risks inherent in the options available. What indication is best used in this analysis to indicate the best option? Use that measure for your choice.

CAPITAL BUDGETING
A capital budgeting analysis based on the next five years of projected cash flows from the Canadian Sales and Cash Flow Forecast has been provided.

The following data support this capital budgeting analysis:

- Management has decided that the most reliable data for a capital budgeting analysis is to estimate the number of product sales using the U.S. pricing and cost data. It is anticipated that costs will be consistent in the new Canadian location.
- The cost to build the manufacturing facility is expected to be $400,000. (All figures are in US$) Working capital of $200,000 will also be necessary to support the operation. These two items have been considered as the total investment in the capital structure analysis.
- The depreciation on the new asset will be based on a 10 year life. The building is expected to have $200,000 value at the end of the ten years.
- The selling and administrative expenses for the Canadian operation are expected to be approximately $200,000 for the first year due to higher levels of advertising expense. The anticipates reducing the ad expense by $10,000 each year for three years before stabilizing thereafter as word of mouth advertising becomes the primary advertising.

Competition Bikes, Inc. requires a 10% return on capital (hurdle rate) to pursue a capital investment.

LEASE VS. PURCHASE ANALYSIS
Competition Bikes, Inc. found a suitable existing facility it could buy outright for $400,000 using one of the options from the capital structure analysis. The lenders require a $50,000 down payment. The working capital requirements and down payment must be internally funded.

However, 5 year lease financing has been offered at 6%. No down payment is required with this option but the $200,000 working capital must still be internally funded. The leasing company would buy the building outright and then accept five $90,000 lease payments over 5 years. A $50,000 buyout option would be included so Competition Bikes, Inc. could choose to keep the location at the end of the five year lease.

MERGER vs. ACQUISITION.
Competition Bikes, Inc. Is considering the following additional information related to the potential merger of the two companies.

Additional data:

a. The Canadian Biking, Inc. shares were trading for $1.40/share (US$) at the end of Year 8.
b. In a merged company the Canadian Bikes, Inc. shares will be exchanged for Competition Bikes, Inc. shares on a 3:1 basis.
c. Competition Bikes, Inc. has the option to acquire Canadian Bikes, Inc. at an offer price 30% above the Year 8 ending share price.

Consider the advantages and disadvantages after completing the financial analysis necessary for each of these options. Consider the risk and reward from each option.

Task 4

(For Task 4 it is assumed that Competition Bikes, Inc. has acquired the Titanium technology of Canadian Biking. Your decision might not agree with this assumption.)

Competition Bikes, Inc. has retooled and is making both the CarbonLite and the Titanium frame bikes for a number of years. The company vice president has directed that a cost study be conducted and an activity-based costing analysis has been undertaken in one of the company plants. After this study was completed there was a breakeven analysis completed along with target profit projections.

The Excel workbook for the Competition Bikes, Inc. tasks includes the overhead analysis and costing information.

The Requirements for Task 4

1. Recommend whether the company should change its costing method to activity-based costing.

2. Based on an evaluation of cost-volume-profit, complete the following:
   a. Analyze the breakeven point for Competition Bikes Inc. with regard to sales units and sales dollars for both CarbonLite and Titanium bikes.
   b. Describe what would happen to the breakeven analysis if company management needed to add $50,000 in fixed costs to the production facility and the direct materials had a 10% cost increase.