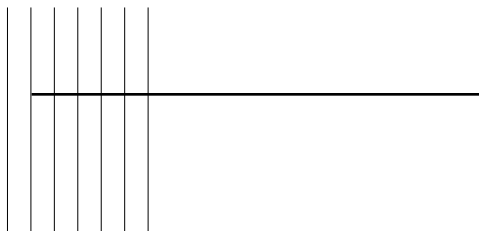


PART IV

WORKING
CAPITAL
MANAGEMENT





CASE 16

REED'S CLOTHIER, INC. WORKING CAPITAL POLICY

Jim Reed, II had just left a rather unpleasant meeting with his banker, Harold Holmes of First Virginia National Bank. Jim had banked with First Virginia for almost 30 years and his father, who had established Reed's Clothier in 1934, had only banked with First Virginia. Holmes, however, had just informed Jim that the bank would not extend their line of credit any further. In addition, the over due note payable for \$130,000 must be paid within 30 days. Jim could not believe that Holmes had the temerity to tell him he needed to drastically reduce the store's inventory and to strongly suggest an inventory reduction sale. Since its founding, Reed has only held the industry's traditional semiannual sales—in January and July. Although Jim was piqued by this young banker's demand, the note was over 45 days past due, and Jim did not know how he could make any more than a token payment on the note within the next 30 days.

BACKGROUND

Reed's Clothier was founded in 1934 by Jim Reed shortly after he had completed his military tour. He had hoped to make a career of the military but during the early 1930s the U.S. Army was reduced in size, and there seemed little chance that this trend would change in the near future. Jim Reed had loved the community near his beloved military school, and he decided to open a men's clothing shop that would cater to the numerous Virginia Military Institute (VMI) graduates who lived in and around Lexington, Virginia.

During the first six years, the store barely made enough money to provide a living income for Jim and his family. But he could see that sales were growing each year and that his primary customer base of ex-VMI graduates was

growing. Shortly after 1940, he hired his first additional salesman, Leon Hearn, a 1909 graduate of VMI who had just retired from the army after 30 years of service. After World War II, the business continued to grow and by 1976 annual sales had grown to \$800,000. Jim decided to retire in 1976 and turned the company over to his son, Jim Reed II, who had graduated from VMI in 1960 and served eight years in the U.S. Army, including a tour in Vietnam, where he had been wounded. Since 1968, the younger Reed had worked in his father's store.

In 1976, Reed's occupied the first floor of a three-story building in the heart of downtown Lexington. Reed's used the second floor of the building as the store's office and as a warehouse. The third floor, with an outside entrance and elevator access, was rented to the law firm of Bundy, Hawk, and Harrington. In 1981, Jim decided to expand the retail floor space by refurbishing the second floor as a retail shop and using the third floor as a warehouse and office. The first floor was then also modernized and the store had a very contemporary look and an \$880,00 long-term mortgage debt.

Jim Reed II had slowly increased the amount of inventory in the store with the belief that many sales were lost because an item was not in the store when a customer requested it. Sales did grow steadily each year, topping \$2 million in 1994, which bolstered Jim's belief that the increase in sales was directly related to the increase in inventory. In fact, sales had doubled in the last 10 years, but inventory had tripled over that same period of time.

CURRENT SITUATION

The increase in purchases and the interest and principal payments on the mortgage had seriously eroded Reed's positive cash flow in the past three years. The cash crunch had been met through a combination of slowly increasing the line of credit at the bank and, during the last year, not taking the cash discounts offered by the store's suppliers. Reed's purchased about 80 percent of its purchases on terms of 3/10, net 60 and until this year had always taken the cash discount, but its accounts were now almost 40 days past due, and the suppliers were demanding payment with the threat of ceasing deliveries until payment was made. This threat had pushed Jim into going to see his banker with the idea of increasing his line of credit another \$100,000.

In the past, Jim had only dealt with his VMI classmate at First Virginia National Bank, Bob Roberts, and after talking about the good old days at the military school, an increase in the line of credit had always been granted without Bob ever looking at Reed's financial statements. Today, however, had been a different story. Two months ago, Roberts had been promoted to a public relations job with the bank and Jim had been introduced to Holmes, who had asked to see an up-to-date set of financial statements at their first meeting. In today's meeting Holmes had talked about cash flow problems and even mentioned the possibility of financial distress. There had been no easy talk about the past or

how great and valued a customer Reed was, only talk about how they could get Reed's on a strong financial footing.

Holmes had strongly suggested that Jim request the help of a consultant who could help him establish a better inventory system. In addition, the condition for continuing the present line of credit was payment of the overdue note payable within 30 days. Holmes also suggested that Jim reduce his inventories and accounts receivables to the industry averages. (See Exhibits 1 and 2 for income statement and balance sheet information for the last full fiscal year. Both statements have common-size columns for Reed's and the industry.) Jim had argued that reducing inventory would reduce his sales and make it even harder to become current on his accounts. Holmes had countered this argument by saying that he thought his sales would be reduced less than 5 percent annually, and that by not reducing the inventory through an inventory reduction sale, Reed's would not be able to raise the cash required to meet its financial obligations.

Finally, Holmes suggested that accounts receivable be reduced by aggressively collecting its past-due accounts. (See Exhibit 3.) This was a particularly sore point with Jim, for he knew he had allowed his collections efforts to lapse in his efforts to increase sales. Jim was afraid that if he aggressively attempted to collect his past-due accounts, these customers might become angry and take their business elsewhere. Reed's sold about 75 percent of its sales on terms of net 30, which were the same terms offered by all its major competitors. As he slowly walked the two blocks between the bank and his store, Reed finally realized that his store was in serious financial trouble and wondered what he needed to do to regain control.

QUESTIONS

1. Calculate a few ratios and compare Reed's results with industry averages. (Some industry averages are shown in Exhibit 4.) What do these ratios indicate?
2. Why does Holmes want Reed's to have an inventory reduction sale, and what does he think will be accomplished by it?
3. Jim Reed had adopted a very loose working capital policy with higher current assets than industry averages. If he merely tightens his working capital policy to the averages, should this affect his sales?
4. Assuming that Reed's can improve its operations to be in line with the industry averages, construct a 1995 pro forma income statement. Assume that net sales will be reduced 5 percent to \$1,938,000 but that depreciation and amortization will not change but remain at \$32,000.
5. What type of inventory control system would you suggest to Jim Reed?
6. What type of accounts receivable control would you suggest to Jim Reed?
7. Is the increase in sales related to the increase in inventory? (See Exhibit 5.)
8. What is Reed's cost of not taking the suppliers' discounts?

EXHIBIT 1
Reed's Clothiers Income Statement (in 000s)

		<i>Common Size</i>	
		<i>Reed's</i>	<i>Industry</i>
Net Sales	\$2,035	100%	100%
Cost of goods	1,428	70.2	67.0
Gross profit	<u>\$607</u>	<u>29.8</u>	<u>33.0</u>
General & administrative expenses	374	18.4	18.2
Depreciation & amortization	32	1.6	0.9
Interest expense	63	3.1	1.2
Earnings before taxes	138	6.7	12.7
Income Taxes	53	2.6	4.9
Net income	<u>\$85</u>	<u>4.1%</u>	<u>7.8%</u>

EXHIBIT 2
Reed's Clothiers Balance Sheet (in 000s)

		<i>Common Size</i>	
		<i>Reed's</i>	<i>Industry</i>
Cash	\$17	1.0%	1.5%
Inventories	491	30.9	20.0
Accounts receivable	<u>413</u>	<u>26.0</u>	<u>20.1</u>
Total current assets	\$921	57.9	41.6
Fixed assets	<u>670</u>	<u>42.1</u>	<u>58.4</u>
Total assets	\$1,591	100.0%	100.0%
Accounts payable	\$205	12.9%	9.3%
Notes payable	234	14.7	6.4
Other current liabilities	<u>18</u>	<u>1.1</u>	<u>0.2</u>
Total current liabilities	\$457	28.7	15.9
Long-term debt	<u>604</u>	<u>38.0</u>	<u>30.4</u>
Total liabilities	\$1,061	66.7	46.3
Stockholders' equity	<u>530</u>	<u>33.3</u>	<u>53.7</u>
Total liabilities and stockholders' equity	\$1,591	100.0%	100.0%

EXHIBIT 3
Reed's Clothiers Aging Schedule

<i>Days Past Due</i>	<i>Amount (000s)</i>	<i>Percent</i>
0-29	132	32.0
30-59	90	21.8
60-89	89	21.5
Over 90	<u>102</u>	<u>24.7</u>
	\$413	100.0

EXHIBIT 4
Reed's Clothiers Selected Ratios*

<i>Liquidity Ratios</i>	<i>Industry</i>
Current ratio	2.7
Quick ratio	1.6
Receivables turnover	7.7
Average collection period	47.4
 <i>Efficiency Ratios</i>	
Total asset turnover	1.9
Inventory turnover	7.0
Payable turnover	15.1
 <i>Profitability Ratios</i>	
Gross profit margin	33.0
Net profit margin	7.8
Return on common equity	25.9

*Since many ratios may have different meanings the following definitions were used in the above calculations:
 Receivable turnover = sales/accounts receivable
 Average collection period = 365/receivable turnover
 Total asset turnover = cost of sales/total assets
 Inventory turnover = cost of sales/inventories
 Payable turnover = cost of sales/ accounts payable

EXHIBIT 5
Reed's Clothiers

<i>Year</i>	<i>Inventories</i>	<i>Net Sales</i>
1991	\$378	1,812
1992	411	1,886
1993	452	1,954
1994	491	2,035
