UNIT IV& V

WORKING CAPITAL & CASH MANAGEMENT& RECEIVABLE MANAGEMENT& INVENTORY MANAGEMENT& STOCK LEVEL

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Working capital management

- Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to the best effect. The primary purpose of working capital management is to enable the company to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.
- A company's working capital is made up of its current assets minus its current liabilities.

Understanding Working Capital Management

- *Working capital management* involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash..

Objective

- The objectives of working capital management, in addition to ensuring that the company has enough cash to cover its expenses and debt, are minimizing the cost of money spent on working capital, and maximizing the return on asset investments.

- **Smooth Operating Cycle:** The key objective of working capital management is to ensure a smooth operating cycle. It means the cycle should never stop for the lack of liquidity whether it is for buying raw material, salaries, tax payments etc.
- **Lowest Working Capital:** For achieving the smooth operating cycle, it is also important to keep the requirement of working capital at the lowest. This may be achieved by favorable credit terms with accounts payable and receivables both, faster production cycle, effective inventory management etc.
- **Minimize Rate of Interest or Cost of capital:** It is important to understand that the interest cost of capital is one of the major costs in any firm. The management of the firm should negotiate well with the financial institutions, select the right mode of finance, maintain optimal structure capital etc.
- **Optimal Return on Current Asset Investment:** In many businesses, you have a liquidity crunch at one point of time and excess liquidity at another. This happens mostly with seasonal industries. At the time of excess liquidity, the management should have good short-term investment avenues to take benefit of the idle funds.

Advantages and Disadvantages

DVANTAGES OF WORKING CAPITAL MANAGEMENT

- Working capital management ensures sufficient liquidity when required.
- It evades interruptions in operations.
- Profitability maximized.
- Achieves better financial health.
- Develops competitive advantage due to streamlined operations.

DISADVANTAGES OF WORKING CAPITAL MANAGEMENT

- It only considers monetary factors. There are non-monetary factors that it ignores like customer and employee satisfaction, government policy, market trend etc.
- Difficult to accommodate sudden economic changes.
- Too high dependence on data is another downside. A smaller organization may not have such data generation.
- Too many variables to keep in mind say current ratios, quick ratios, collection periods, etc.

Benefits of Working Capital Management

- Working capital management can improve a company's earnings and profitability through efficient use of its resources. Management of working capital includes inventory management as well as management of accounts receivables and accounts payable.

Determinants Of Working Capital Requirements

- *Nature of business
- *Length of production cycle
- *Rate of stock turnover
- *Business cycle
- *Earning capacity and dividend policy
- *Operating cycle
- *Operating efficiencies

Cash Management

- Cash management, also known as treasury management, is the process that involves collecting and managing cash flows from the operating, investing, and financing activities of a company. In business, it is a key aspect of an organization's financial stability.

Cash Management

- **Definition**: Cash Management refers to the collection, handling, control and investment of the organizational cash and cash equivalents, to ensure optimum utilization of the firm's liquid resources. Money is the lifeline of the business, and therefore it is essential to maintain a sound cash flow position in the organization.

_ Prachi. M

Objective

- **Fulfill Working Capital Requirement**: The organization needs to maintain ample liquid cash to meet its routine expenses which possible only through effective cash management.
- **Planning Capital Expenditure**: It helps in planning the capital expenditure and determining the ratio of debt and equity to acquire finance for this purpose.
- **Handling Unorganized Costs**: There are times when the company encounters unexpected circumstances like the breakdown of machinery. These are unforeseen expenses to cope up with; cash surplus is a lifesaver in such conditions.

- **Initiates Investment**: The other aim of cash management is to invest the idle funds in the right opportunity and the correct proportion.
- **Better Utilization of Funds**: It ensures the optimum utilization of the available funds by creating a proper balance between the cash in hand and investment.
- **Avoiding Insolvency**: If the business does not plan for efficient cash management, the situation of insolvency may arise. It is either due to lack of liquid cash or not making a profit out of the money available.

Functions

- **Investing Idle Cash**: The company needs to look for various short term investment alternatives to utilize surplus funds.
- **Controlling Cash Flows**: Restricting the cash outflow and accelerating the cash inflow is an essential function of the business.
- **Planning of Cash**: Cash management is all about planning and decision making in terms of maintaining sufficient cash in hand and making wise investments.
- **Managing Cash Flows**: Maintaining the proper flow of cash in the organization through cost-cutting and profit generation from investments is necessary to attain a positive cash flow.
- **Optimizing Cash Level**: The organization should continuously function to maintain the required level of liquidity and cash for business operations.

Cash Management Strategies

- **Business Line of credit**: The organization should opt for a business line of credit at an initial stage to meet the urgent cash requirements and unexpected expenses.
- **Money Market Fund**: While carrying on a business, the surplus fund should be invested in the money market funds. These are readily convertible into cash whenever required and yield a considerable profit over the period.
- **Lockbox Account**: This facility provided by the banks enable the companies to get their payments mailed to its post office box. This lockbox is managed by the banks to avoid manual deposit of cash regularly.
- **Sweep Account**: The organizations should avail the facility of sweep accounts which is a mix of savings and fixed deposit account. Thus, the minimum balance of the savings account is automatically maintained, and the excess sum is transferred to the fixed deposit account.
- **Cash Deposits (CDs):** If the company has a sound financial position and can predict the expenses well along with availing of a lengthy period, it can invest the surplus cash in the cash deposits. These CDs yield good interest, but early withdrawals are liable to penalties.

Limitations

- Cash management is a **very time consuming** and skilful activity which is required to be performed regularly.
- As it requires financial expertise, the company may need to hire consultants or other experts to perform the task by paying **administrative and consultation charges**.
- **Small business entities** which are managed solely, **face problems** such as lack of skills, knowledge, time and risk-taking ability to practice cash management.
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Baumol's EOQ Model

- **Baumol's EOQ Model of Cash Management:**
- William J. Baumol (1952) suggested that cash may be managed in the same way as any other inventory and that the inventory model could reasonably reflect the cost – volume relationships as well as the cash flows. In this way, the economic order quantity (EOQ) model of inventory management could be applied to cash management. It provides a useful conceptual foundation for the cash management problem.
- In the model, the carrying cost of holding cash-namely the interest forgone on marketable securities is balanced against the fixed cost of transferring marketable securities to cash, or vice- versa. The Baumol model finds a correct balance by combining holding cost and transaction costs, so as to minimize the total cost of holding cash.

- C= 2AT I
- **The optimum level of cash balance is found to be:**
- Where,
- C = Optimum level of cash balance
- A = Annual cash payments estimated
- T = Cost per transaction of purchase or sale of marketable securities
- I = Interest on marketable securities p.a. (i.e., carrying cost per rupee of cash)

Determining Optimum Level of Cash Balance

* A prudent finance manger desires to maintain only that much amount of cash balance as is just only that much amount of cash balance as is just sufficient to satisfy transaction requirements as well as to meet precautionary and speculative motives.

*This task is so important that carrying of excess cash balance entails loss of interest earnings to the firm and thus causes low profitability and maintaining a small, cash balance renders the firm's liquidity position weak, although a higher profitability us ensured. Thus, determination of suitable level of cash holding involves risk-return trade-off.

* Determination of appropriate level of cash balance is not only necessary to optimize cash utilization but also to decide the level of investment in marketable securities. It is worth stressing that the optimal level cash should be larger of

(i) The transaction balances required when cash management is efficient and

(ii)The compensatory-balance requirements of commercial banks with ‘which the firm has deposit accounts.

A number of cash management models have been developed to decide the optimal level of cash balance. We shall examine here two of the more widely used models. These models are based on such tersest rate on marketable securities and cash.

Receivable Management &Inventory Management & Stock level

What does Receivable Management Mean?

*Receivable Management or Managing Accounts Receivables means collecting the payments due for Sales in a timely manner. When we sell any services, products or solutions to our clients o customers, they owe us the money. Collecting that money is called Receivables Management.

* In Accounting terms Our Customers who owe us money are called as “Sundry Debtors”. Yes, they are called Debtors, because they owe us money.

In India, Management of Receivables is also known as:

* Payment Collection.
* Collection Management.
* Accounts Receivables.

What is receivable management?

* There are very few businesses, which have the luxury of receiving money before selling, i.e. Selling for advance payments. Most of the Companies sell their offerings on a credit. Which means that they will collect the money after selling.

Although it looks very simple on the face of it, Managing receivables from Debtors can be a very complex task depending on the nature of our business.

*As our business grows and as our offering gets complex the process of collecting the payments needs to be designed accordingly.

*So the entire process of defining the Credit Policy, Setting Payment Terms, Payment Follow ups and finally timely collection of the due payments can be defined as Receivables Management.

Definition

Receivables management is professional dunning, with the goal of avoiding payment defaults and ensuring the long-term liquidity of a company. It is part of the internal accounting department and begins with arranging, recording and organizing outstanding payments.

- **Prachi.M**

Objectives of Receivable Management

*In order to keep business running, we need cash.

*The whole purpose or objective of Receivables Management is to keep inflow of cash healthy.

*In other words, these are the objectives of Payment Collection.

*Collect receivables from our sundry debtors. Maintain a healthy cash flow for the company, so that it can pay our creditors.

*Have proper Policy for Credit management.

*A working process and mechanism for managing payment follow ups and timely collection.

Why Receivables management is so important

1.Cash flow is always considered as bloodline of any business organization. Badly managed Receivables can break the company.

2.Most of the companies that go bankrupt have Cash flow problems. Companies with lack of profit can survive, but lack of cash flow is fatal.

3.Working Capital is one the most costliest form of capital. One of the ways of calculating working capital requirement can be defined as the difference between Sales and Receivables. Bad collections can mean higher working capital requirements. Which means higher interest costs for the company.

4.A reliable and predictable Receivables will ensure steady cash flow management of the organization. Amounts receivables with no due dates are useless.

Benefits of Accounts Receivable Management

Better Cash Flow.

All our Budgets and projections depends on how much we can spend. Predictable cash flow enables us to manage our operations and expansion plans.

Lower Working Capital Requirements.

Effective receivables management ensures that our Working Capital requirements are kept at minimum.

Lowered Interest costs.

Working capital is also fixed capital, which attracts interest. Lower Debtors will reduce our Interest burden.

Better Bargaining with Sellers.

When we are buying any goods or services, we can bargain mainly on quantity or Payment terms. Having a good receivable management provides us with enough cash flow to bargain effectively with our Suppliers.

Importance of Credit Policy in Receivables Management

How do we define Credit policy depends on various factors. Some of the points for Credit Policy are listed below:

1. Market practice. In the beginning it is important to follow well established policies in the market.
2. Credit Policy as USP. Many Companies choose to provide more lenient credit policy, much better than market to get more business.
3. On boarding a new customer should have a strict emphasis on the credit check.
4. There should be proper process and policy on when to stop billing to defaulting customers.

Receivable management solutions

❖Deploying software for managing receivables is a very good alternative.

❖ A good Receivable Management solution should have the following features or capabilities.

❖Mobile App.

❖Real time information.

❖Messages templates for follow up

❖Store all contracts and related documents in one place.

❖Monitoring Due and overdue Receivables.

❖Automated Reminders

❖Rule based Escalations

❖Projected Day wise receivables.

❖Projected Sales Person wise (or person responsible for collection) receivables.

❖Area wise or any other criteria for analysis.

Inventory management

Inventory Management refers to the process of ordering, storing, and using a company's inventory. These include the management of raw materials, components, and finished products, as well as warehousing and processing such items.

Inventory Accounting

Inventory represents a current asset since a company typically intends to sell its finished goods within a short amount of time, typically a year. Inventory has to be physically counted or measured before it can be put on a balance sheet. Companies typically maintain sophisticated inventory management systems capable of tracking real-time inventory levels. Inventory is accounted for using one of three methods: first-in-first-out (FIFO) costing; last-in-first-out (LIFO) costing; or weighted-average costing

An inventory account typically consists of four separate categories:

- Raw materials
- Work in process
- Finished goods
- Merchandise

Raw materials represent various materials a company purchases for its production process. These materials must undergo significant work before a company can transform them into a finished good ready for sale.

Works-in-process represent raw materials in the process of being transformed into a finished product.

Finished goods are completed products readily available for sale to a company's customers.

Merchandise represents finished goods a company buys from a supplier for future resale

Economic Order Quantity

The economic order quantity (EOQ) model is used in inventory management by calculating the number of units a company should add to its inventory with each batch order to reduce the total costs of its inventory while assuming constant consumer demand. The costs of inventory in the model include holding and setup costs.

The EOQ model seeks to ensure that the right amount of inventory is ordered per batch so a company does not have to make orders too frequently and there is not an excess of inventory sitting on hand. It assumes that there is a trade-off between inventory holding costs and inventory setup costs, and total inventory costs are minimized when both setup costs and holding costs are minimized.

stock level

stock level in British English
(stɒk ˈlɛvəl) business. the quantity or number of goods or raw materials kept on the premises of a shop or business.

Stock Level:

Reordering level
Maximum stock levels
Minimum stock level

Reorder level

** The reorder level formula is that inventory level at which an entity should issue a purchase order to replenish the amount on hand. When calculated correctly, the reorder level should result in replenishment inventory arriving just as the existing inventory quantity has declined to zero.

** To calculate the reorder level, multiply the average daily usage rate by the lead time in days for an inventory item

Re-order Level = Maximum consumption per day/per week etc. x Maximum delivery time.

Example

Following example is given to understand the calculation of reorder level of Stock:

Maximum consumption = 15,000 units per week

Maximum delivery time = 10 weeks

Re-order Level = Maximum per day/per week etc. x Maximum delivery time

solution

= 15,000 units x 10 weeks

= 1,50,000 units.

Maximum level

The maximum level of inventory could be described as the maximum capacity of a business to stock goods (inventory or raw material) in its store, which may be due to reasons like demand limitation of goods (in production or sales), the storage capacity of business, rationed funds etc

Formula:

The formula to calculate maximum level of stock is given below:

Maximum Level = Re-order level + Re-order quantity – (Minimum usage × Minimum lead time)

Example 1

The Maya Cutlery Outlet sells dinner sets.
It provides you the following information:
Maximum demand: 200 per week
Average demand: 160 per week
Minimum demand: 145 per week
Maximum lead time: 2 weeks
Average lead time: 1.5 weeks
Minimum lead time: 1.35 weeks
Re-order quantity per order: 500 dinner sets
Safety stock: 184 dinner sets
Required: Compute maximum level of stock of Maya Cutlery Outlet using above information.

Solution

Maximum Level of Stock = Reorder level+ Reorder quantity – (Minimum usage × Minimum lead time)
= Reorder quantity – (Minimum usage × Minimum lead time)
= *584 units + 500 units – (145 units × 1.35 days)
= 584 units + 500 units – 196 units = 1,084 units – 196 units
= 888 units
*Reorder level = (Maximum usage × Maximum lead time) + Safety stock
= (200 units × 2 days) + 184 units
= 400 units + 184 units
= 584 units

Minimum Stock level

The **Minimum level of stock** is a certain predetermined minimum quantity of raw materials or merchandise inventory which should always be available in stock in the normal course of business.

The formulas used to calculate the minimum level of stock are given below:

Minimum Level of Inventory = (Maximum usage × Maximum lead time) – (Average usage × Average lead time)

Example 1

The Noor Clothing House sells T-shirts. Each shirt costs $15 and is sold for $20 to customers. The maximum demand is 20,000 shirts per year and the average demand is 18,570 shirts per year. The average lead time is 57 days and the maximum lead time is 64 days.

Required: Compute the reorder level and the minimum level of stock of T-shirts for Noor Clothing House.

Solution

Maximum demand per day: 20,000 shirts/365 days = 55 shirts

Average demand per day: 18,570 shirts/365 days = 51 shirts

Reorder level = (Maximum demand × Maximum lead time)

= (55 units × 64 days)

= 3,520 units

Minimum level of stock = Reorder level – (Average demand × average lead time)

= 3,520 units – (51 units × 57 days)

= 3,520 units – 2,907 units

= 613 units