INVENTORY MANAGEMENT

Inventory : Meaning

- **The assets that are:**

  - Held for sale in the ordinary course of business; or

  - In the process of production for such a sale; or

  - In the form of materials to be consumes in the

    production process; or

Types of Inventory

- **Raw Materials:** Basic inputs that are converted into finished product through the manufacturing process.
- **Work-in-Progress:** Semi-manufactured products that need some more work before they become finished goods for sale.
- **Finished goods:** Completely manufactured products ready for sale.

Inventory Management: Objectives

- To maintain an optimum size of inventory for efficient and smooth production and sales operations.

- To maintain a minimum investment in inventories to maximize the profitability

- To place an order at the right time with **right time** with **right source** to acquire the **right quantity** at the **right price** and **right quality**.

Inventory Systems:

- **Periodic Inventory System:** In this inventory is ascertained by actual physical count (weekly, monthly or yearly). Calculation is done directly by applying the method of valuation of inventories.

  Cost of goods sold = Opening inventory + Purchases

  – Closing inventory

- **Perpetual Inventory System:** In this inventory is ascertained on the basis of records (inventories are checked after every receipt and issue)

Methods of Inventory Valuation:

- **Cost Price Method:**

  - LIFO: Last in First Out

  - FIFO: First in First out

  - HIFO: Highest in First out

- **Average Price Method:**

  - Simple Average Price Method

  - Weighted Average Price Method

- **Notional Price Method:**

- Standard Price method: stock will be issued at **same**

Inventory Control Techniques:

- <u>**EOQ (Economic Order Quantity): very important (theory + numerical)**</u>

Amount of Inventory to be **ordered at one time** for purposes of **minimizing annual inventory cost**.

Inventory Control Techniques:

- **ABC Analysis:**

❖ Inventories are analyzed on **the basis of management control**.

❖ **A** Class inventory requires **closed monitoring & tight control**.

❖ **B** class inventories are of lower grade than A class and

Inventory Control Techniques:

- **VED Analysis:**

  - Inventories are analyzed on the basis of their **criticality to the production process.**

  - **V : vital items** without which the production process would come to a standstill.

  - **E : Essential items** whose stock out would adversely affect the efficiency of production

Inventory Control Techniques:

- **HML Analysis:**

❖ Inventories are analyzed on **the basis of unit cost rather than their usage value.**

❖ **H** **:** High cost inventory.

❖ **M** **:** Medium cost inventory.

❖ **L** : Low cost inventory.

Inventory Control Techniques:

- **SDE Analysis:**

  - Inventories are analyzed on the **basis availability of item.**
  - **S : Scarce items** which are in short supply.
  - **D : Difficult items** which might be available in market but cannot be procured easily.
  - **E : Easily available** items from the local markets.

Inventory Control Techniques:

- **FSN Analysis:**

  - Inventories are analyzed on the basis of **consumption pattern.**
  - **F : Fast moving items.**
  - **S : Slow moving items.**
  - **N : Non-moving items.**
  - Analysis can also be done on the basis of **FNSD:**

Inventory Control Techniques:

- **GOLF Analysis:**

❖ Inventories are analyzed on the **basis of source of material**.

❖ **G** : Transaction with **Government** (**long lead time**)= 2 months

❖ **O** : Transaction with **ordinary suppliers** (moderate delivery time) = 1 month

Formulae:

Formulae:

- **Reorder level:**

(maximum consumption rate * Maximum re-order period)

- **Maximum level:**

(Re-order level + Re-order quantity) – (Minimum consumption * Minimum re-order period)

- **Minimum level:**

Re-order level – (Normal Consumption rate * Normal re-order period).

Financial Accounting and Management

Presented by:
Dr. Yamini Negi

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INTRODUCTION TO ACCOUNTING

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After studying this chapter, you should be able to understand:

- Meaning of Accounting, Attributes or Features of Accounting.
- Accounting Process.
- Objectives and Advantages of Accounting.
- Limitations of Accounting.
- Meaning of Book-keeping , Accountancy.
- Difference between Book Keeping and Accounting.
- Difference between Book Keeping , Accounting and Accountancy.

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Meaning of Accounting

"**Accounting is the process of**

(a) Identifying,

(b) Recording,

(c) Classifying and

(d) Summarizing in a significant manner and in terms of money,

(e) Transactions and events which are, in part at least, of financial character,

(f) interpreting and communicating the results thereof".

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Features of Accounting:

- IDENTIFICATION.
- MEASURING.
- RECORDING.
- CLASSIFYING.
- SUMMARIZING.
- ANALYZING AND INTERPRETING.
- COMMUNICATING.

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Objectives of Accounting

- To keep systematic record of business transactions.
- Calculation of profit or loss of the business.
- To depict the sources of items of revenue and expenses.
- To communicate the information to the users.
- To know the solvency position.

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Advantages of Accounting

- Maintenance of records rather than memory.
- Preparation of financial statements.
- Assistance to management.
- Facilitate Comparative Study.
- Prevention of errors and Frauds.
- Information about debtors and creditors
- Facilitates Accounting Information to Users.

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BASICS OF ACCOUNTING

Dr. Yamini Negi

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After studying this chapter, you should be able to understand:

- Users of Accounting Information.
- Basic Accounting terms.
- Objectives and Advantages of Accounting.
- Difference between Book Keeping , Accounting and Accountancy.
- Limitations of Accounting.
- Meaning of Book-keeping , Accountancy.
- Difference between Book Keeping and Accounting.

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Users of Accounting Information:

- **INTERNAL USERS:**
  - (a) Proprietors or Owners.
  - (b) Management.
  - (c) Employees and Workers.

- **EXTERNAL USERS:**
  - (a) Banks and Financial Institutions.
  - (b) Investors and Potential Investors.
  - (c) Creditors.
  - (d) Government and its Authorities.
  - (e) Customers.
  - (f) Researchers.

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Basic Accounting Terms:

- **Assets:** An asset is anything which will enable the firm to get cash or a benefit in the future.

- **An asset should have the following characteristics:**

(a) It should be owned by an individual or an organisation.

(b) It may be in tangible form or in intangible form.

(c) It should have some value attached to it.

(d) It should be capable of being measured in money terms.

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Classification of Assets:

- **Fixed Assets:** These are acquired not with the purpose to resell but with the purpose to increase the **earning capacity** of the business. Example: Furniture, Car, Building, plant and machinery, Land and building.

- **Current Assets:** These are acquired with the intention of converting them into cash during the **normal business operations. Example:** Debtors, Cash, Bank, Bills Receivable, prepaid expenses, outstanding income.

Contd…

- **Intangible Assets:** These assets are those which do not have **physical existence** or which **cannot be seen** and **touched.** **Example:** Goodwill, Trademark, copyrights, patents.

- **Tangible Assets**: These are those assets which have physical existence or can be seen and touched.

- **Wasting Assets:** Wasting assets are those assets which are natural resources extracted and consumed as a raw material. Examples: mines, oil wells, etc.

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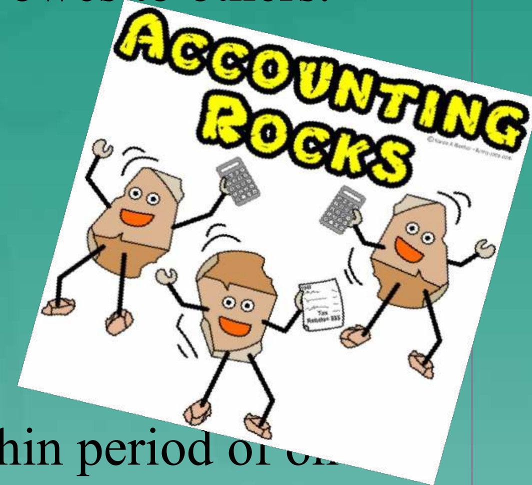
- **Liabilities:** These denote the amounts which the business owes to others.



Liabilities can be of two types:

(a) **Long-term Liabilities:** These liabilities do not become payment in one year. Example- long term loan,

(b) **Short-term Liabilities:** These liabilities are payable within period of one year. They are also known as current liabilities. Example- creditors, bills payable, short term loan, bank overdraft etc.

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- **Capital:** It is the amount invested by the owner in the business organisation. It can be in the form of cash, goods or other assets. Capital is also called as owner's equity, proprietor's net worth.

- **Business Transaction:** It includes dealing between two or more persons involving exchange of goods or services for a consideration. Transactions are of four kinds:

(a) Cash transactions

(b) Credit transactions

(c) Barter transactions

(d) Paper transactions

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- **Drawings:** It is the amount withdrawn or the goods taken by the proprietor for personal use from the business. It also includes personal expenses of the proprietor paid by the business.

- **Revenue:** All incomes earned as a result of operation of business are called revenue. Example: sale of goods and services, earnings from interest, rent and commission.

- **Expenditure:** It is the money spent or incurred for the value received in terms of purchase of assets, goods or services, etc. Expenditure are for two types:

  (a) Capital expenditure

  (b) Revenue expenditure

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- **Expense:** Expenses is the cost of the use of things or services for the purpose of generating revenue. Example: cost of sales, depreciation

- **Income:** Income is different from revenue. Surplus of revenue over expenses is called income.

Income = Revenue – Expense.

- **Gain:** It is the profit that arises from transactions which are not incidental to business. Example: winning in a lottery, appreciation in the value of land and building.

- **Stock:** It refers to goods held by a business for sale in the ordinary course of business or for consumption in the production of goods or services for sale.

- **Debtors:** The persons to whom goods are sold on credit are known as debtors. In other words, one who owes money to the company is a debtor.

- **Creditors:** Persons from whom goods have been

purchased on credit and payment has not been made to them are known as creditors.

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Accounting Principles, Conventions and Concepts

Dr. Yamini Negi

Accounting Principles

- Accounting principles are those rules of action which are adopted by accountants universally while recording accounting transactions. They are the rules which are followed in treating various items or assets, liabilities, income and expenses.

- Accounting principles are generally accepted set of principles on the basis of which transactions are recorded and financial statements are prepared. These principles are generally classified into two categories:

  (a) Accounting Concepts.

  (b) Accounting Conventions.

Accounting Concepts:

- Accounting concepts are the basic assumptions within which accounting operates. Accounting concepts conveys accounting information in a manner so that it will give same meaning to all people and make it more meaningful.

Business Entity Concept
Money Measurement Concept
Going Concern Concept
Accounting Period Concept
Historical Cost Concept
Dual Aspect Concept
Revenue Recognition Concept
Matching Concept
Accrual Concept

Business Entity Concept:

- Business is treated as separate and distinct from its members.
- Separate set of books are prepared.
- Proprietor is treated as creditor of the business.
- For other business of proprietor different books are prepared.
- It helps in ascertaining the results of each department of the enterprise.

Money Measurement Concept:

- According to money measurement concept, transactions that can be measured in money terms are recorded in the books of accounts.

- Transactions of qualitative nature, even though of great importance t o business are not considered.

Going Concern Concept:

- According to this concept, it is assumed that business shall continue for an indefinite period of time.
- As per this concept, fixed assets are recorded at their original cost and depreciation is charged on these assets.
- Because of this concept, a distinction can be made between capital expenditure or revenue expenditure.
- Because of this concept, outside parties enter into long term contracts with the business.

Accounting Period Concept:

- Accounting period means that the working life of the firm is divided into regular intervals for ascertaining profit/losses so that its performance can be measured.

- The accounting period concept is related to going concern concept whic h presumes that a business is likely to continue for an indefinite period o f time.

- Accounting period is of 2 types: Financial Year and Calender Year.

- However, accounting period is normally of one year beginning on a spec ific date and ending 12 months later.

Historical Cost Concept:

- All assets are recorded in the books of account at the acquisition price which includes purchase price, installation charges etc.
- Acquisition cost relates to the past that's why it is referred as historical cost.
- This concept is applicable only to fixed assets and not for current assets.
- If a firm does not pay anything for a fixed asset, that fixed asset would not be recorded in the books of account.
- This cost serves the basis for further accounting treatment of the asset.

Dual Aspect Concept:

- According to this concept, every transaction has a two-fold effect.
- Based on a principle, that is every **DEBIT** has a corresponding **CREDIT.**
- Each transaction will always result in equality of assets and liabilities plus capital.
- **ASSETS = CAPITAL + LIABILITIES.**

Revenue Recognition Concept:

- According to revenue recognition concept, revenue is considered to have been realized when a transaction has been entered into and the obligation to receive the amount has been established.

- Revenue is recognized at the point of sale or while rendering service s.

Matching Concept:

- Cost incurred to earn the revenue should be recognised as expense in the period when the revenue is recognized as earned.
- When an item of revenue is recognised as income i.e. is entered in th e profit & loss account, all expenses incurred should also be recognis ed as expense.
- If an expense is incurred against which the revenue will be earned in the next period, the amount will be carried forward as an expense of t he next year.
- If an amount of revenue is received during the year but against it serv ice is to be rendered in the next year, the amount received must be tre ated as revenue in the next year after the service has been rendered.

Accrual Concept:

- According to accrual concept, a transaction is recorded at the time when it takes place and not when the settlement take place.

- Profit is regarded as earned at the time the goods or services are sold to a customer, i.e. the legal title is passed to the customer.

Accounting Conventions:

- Accounting conventions are guidelines or behavior that is followed for preparing financial statements.
- These are evolved through the regular and consistent practice over the y ears to facilitate uniform recording in the books of accounts.
- They help in comparing accounting data of different business units or of the same unit for different periods.

Convention of Consistency:

- It means that same accounting principles should be used for preparing fi nancial statements year after year.
- A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time.
- If different accounting procedures and practices are used for preparing fi nancial statements of different year, then the result will not be comparabl e.

Convention of Full Disclosure:

- Convention of full disclosure requires that all material and relevant f acts concerning financial statements should be fully disclosed.

- **Full Disclosure means:**

(a) Adequate: Sufficient set of information to be disclosed.

(b) Fair: Equitable treatment of users.

(c) Full: Complete and detailed presentation of information.

Convention of Materiality:

- The convention of materiality states that, to make financial statements meaningful, only material fact, i.e. important and relevant information should be supplied to the users of accounting information.

- The materiality of a fact depends on its nature and the amount involved.

- Material facts means the information of which will influence the decision of its users.

Convention of Conservatism:

- This convention is based on the principle that “Anticipate no profit, but provide for all possible losses”.
- The main objective of this convention is to show minimum profits.
- If profit shows more than actual, it may lead to distribution of divide nd out of capital.
- This convention clearly states that profit should not be recorded unti l it is realized.

Basics of Accounting

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Limitations of Accounting

- It ignores the Qualitative Elements.
- No information about the present value of the business.
- Accounting is based on personal Judgment.
- Accounting may lead to window dressing.
- Disclosure of only material items.
- Accounting ignores the Effect of Price Level Changes.
- It is based on accounting concepts and conventions.
- It is based on historical cost.

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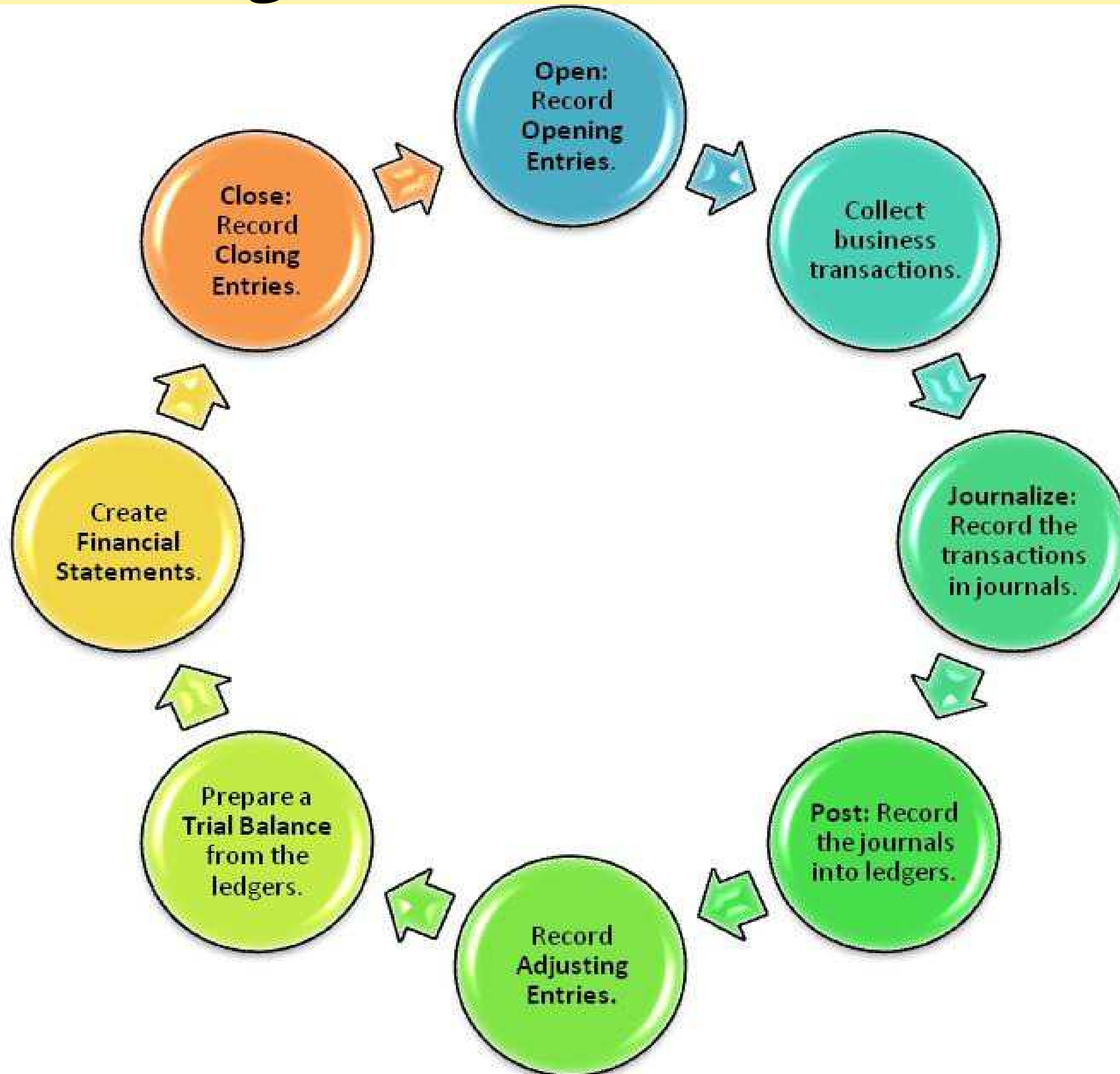
Accounting Process:



Accountancy:

"Accountancy refers to the entire body of the **theory** and **practice of accounting**."

- It tells about how to **maintain the books of accounts** and how to **summarize** the accounting information and **communicate** it to the users.

- **Accountancy can be divided into two parts:**

  (a) Book-Keeping .

  (b) Accounting.

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Book-Keeping:

Book Keeping is the art of **recording** the financial transactions of a business or an individual, **in terms of money**, in a set of books accurately and **systematically** in order to obtain **necessary information** required by others. Thus, Book-Keeping is concerned with:

(a) Identifying financial transactions and events,

(b) Measuring them in terms of money,

(c) Recording the financial transactions and events in the books of accounts.

(d) Classifying recorded transactions and events, i.e., posting them into ledger accounts.

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Difference between Book-Keeping & Accounting

BASIS	BOOK-KEEPING	ACCOUNTING
SCOPE	It is a primary stage. It is concerned with identifying, measuring, recording and classifying financial transactions.	It begins where book-keeping ends. It is concerned with summarizing, interpreting and communicating the results.
PERFORMANCE	It is performed by Junior Staff	It is performed by Senior Staff.
OBJECTIVES	Main objective is to maintain systematic records of financial transactions.	Main objective is to ascertain net results of operations and financial position and to communicate information to the users.
SPECIAL SKILLS	It can be performed by persons having limited level of knowledge	It is performed by persons having special skills and ability to analyze and interpret.
FINANCIAL STATEMENTS	It does not produce financial statements like Profit & Loss A/c and balance sheet.	It is concerned with the preparation of financial statements.

Diff. b/w Book-Keeping, Accounting & Accountancy

BOOK-KEEPING	ACCOUNTING	ACCOUNTANCY
1. It is very narrow term used to record day-to-day transactions in a set of books as per framed policy.	It is comparatively narrow as it is related to applied side of accountancy.	It is a broad term which includes theories, principles and system of accountancy.
2. It is primary stage which involves recording, classifying of transactions.	It is secondary stage which involves summarizing, interpreting and communicating the results.	It is a complete process which includes Book Keeping as well as Accounting.
3. It depends on correct recording of transactions.	It depends on Book-Keeping.	It is dependent on two helping hands- Accounting and Book Keeping.
4. It is a part of accounting and is concerned with record keeping and maintenance of accounts which is clerical in nature.	It involves finding out the profit and loss and financial position from data provided by Book-Keeping.	It includes the decision making work on the basis of information provided by Book-Keeping and Accounting.

Working Capital Management

Dr. Yamini Negi

Introduction

- Working capital is that part of the firm's capital which is required for financing

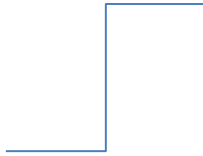
- *Capital is divided into* ***fixed capital and working capital.***

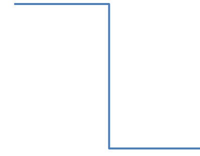
- *Fixed capital is required for* ***establishment of a business.***

- *Working capital is required to* ***utilize fixed assets****. It refers to current assets*

Classification of W.C

Working Capital can be classified in two ways:





- **Gross Working Capital**:

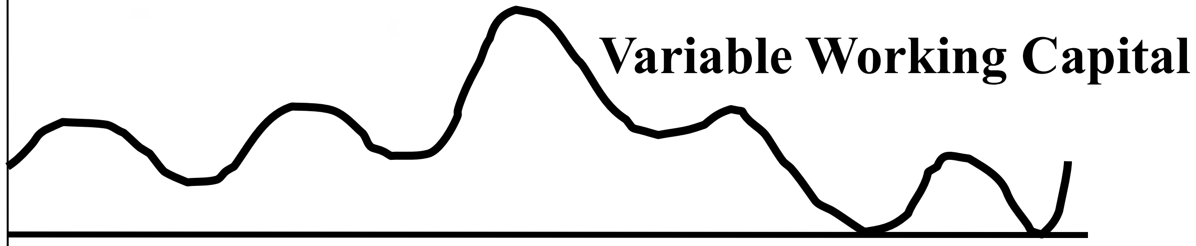
If refers to the firm's investment in **total current assets of the**

- **Permanent Working Capital**: If refers to the minimum amount which is permanently blocked in the business and that cannot be converted into cash in the normal course of business **(core current assets – Tandon committee).** This portion of working capital can be **financed through long term sources.**

- **Variable Working Capital:** It refers to the amount which is above the permanent level of working capital. **Requirement** of this working capital can be financed through short term funds. **It can be classified as Seasonal Working Capital and Specific working capital.**

Permanent & variable working capital - Difference

Amount of Working Capital



Permanent Working Capital

Time

Components of Working Capital

Factors determining working capital

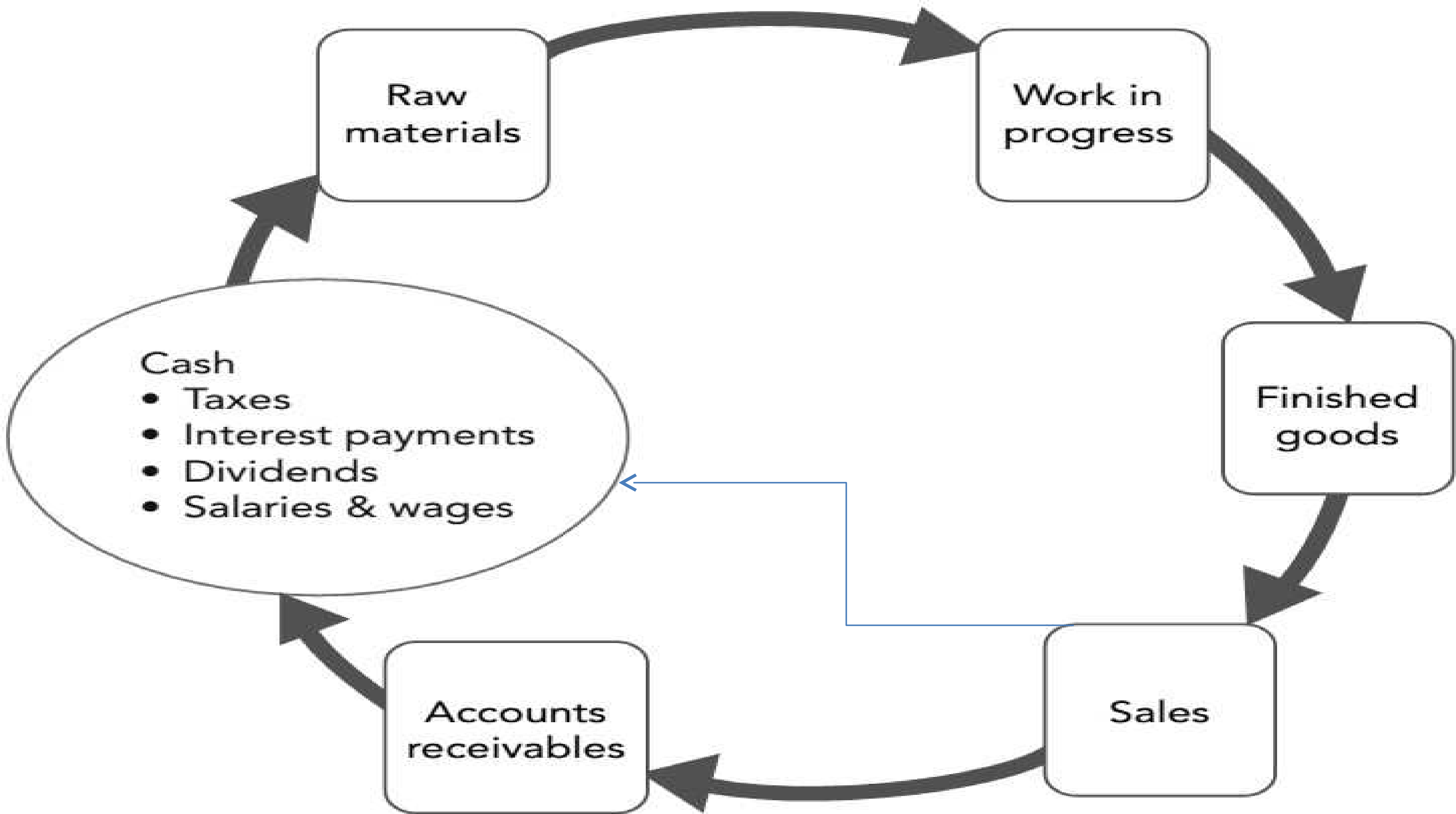
1. **Nature of Business**: The type of business, firm is involved in, is the main consideration while deciding

(4) **<u>Availability of Raw Material</u>**: If raw material is readily available then one need not maintain a

Factors determining working capital

(6) Credit Allowed (to the customers): Credit policy refers to average period for collection of

- **A company’s operating cycle typically consists of three primary activities**:
  - **Purchasing resources**,
  - **Producing the product** and
  - **Distributing (selling) the product.**
- These activities create funds flows that are both **unsynchronized** and **uncertain**.


Raw materials
Work in progress
Finished goods
Sales
Accounts receivables
Cash
• Taxes
• Interest payments
• Dividends
• Salaries & wages

Cash Conversion Cycle

Cash Conversion Cycle is the time period between the dates a firm pays its suppliers and the date it

Advantages of Adequate W.C

- Adequate working capital enables a **firm to pay its suppliers immediately**.
- It helps in increasing the productivity and **efficiency of fixed assets** in the business.
- A firm can pay its **debt in time**, hence, increases the **goodwill** of the firm.
- It helps a firm in distributing sufficient profits as **dividend**

Objectives of W. C Management

Objective 1 - To ensure the organisation has sufficient working capital resources to function and **grow Liquidity**.

- **Liquidity** refers to whether or not an organisation is in a position to meet its short term obligations as they fall due. The ultimate

Objectives of W. C Management

Objective 2 - To improve **profitability** by keeping the investment in working capital to the minimum required.

- The working capital/cash operating cycle measures the time in days that cash is tied up in working capital.

Working Capital Policy

Excessive & Inadequate W.C

- If the working capital is in excess if its requirements it **means idle funds adding to the cost of capital but which earn no profits for the firm.**

- On the contrary, if the working capital is short of its requirements, it will result in **production interruptions and reduction of sales**

Excessive W.C - Disadvantage

(1) Excessive Inventory:- Excessive working capital results

in unnecessary accumulation of large inventory. It increases the chances of misuse, waste, theft etc.

(2) Excessive Debtors:- Excessive working capital will results in liberal credit policy which, in turn, will results in higher amount tied up in debtors and higher incidence of bad debts.

(3) Adverse Effect on Profitability:- Excessive working capital means

Inadequate W.C- Disadvantage

(1) Difficulty in Availability of Raw-Material:- Adequacy of working capital results in non-payment of creditors on time. As a result the credit purchase of goods on favourable terms becomes increasingly difficult. Also, the firm cannot avail the cash discount.

(2) Full Utilization of Fixed Assets not Possible: Due to the frequent interruption in the supply of raw materials and scarcity of stock, the firm cannot make full utilization of its machines etc.

Inadequate W.C- Disadvantage

(4) Decrease in Credit Rating: Because of inadequacy of working capital, firm is unable to pay its short-term obligations on time. It decays the firm's relations with its bankers and it becomes difficult for the firm to borrow in case of need.

(5) Non Utilization of Favourable Opportunities: For example, a firm cannot purchase sufficient quantity of raw materials in case of sudden decrease in the prices. Similarly, if the firm receives a big order, it cannot execute it due to shortage of working capital.

CASH MANAGEMEN

Dr. Yamini

Cash - Meaning

- In **narrow sense**, it includes coins, currency, cheques, drafts held by the firm and **demand** deposits (current accounts) in its bank accounts.

- In **broader sense**, it covers **near cash assets**, i.e. marketable securities & **time** deposits in banks & other financial institution.

- Marketable securities are short-term interest earning money market instruments used by firms to obtain a return on temporarily idle funds.

1) Transaction motive,
2) Precautionary motive,
3) Speculative motive,
4) Compensating motive,
5) Statutory Motive.

- This motive refers to the holding of cash **for meeting the day-to-day transactions** of business. Ex: purchase of raw material, hiring of labour, repair and maintenance of fixed assets.

Precautionary Motive

- Precautionary motive is a motive for holding cash/near-cash as a cushion to meet unexpected contingencies/demand for cash.

- **The unexpected cash needs at short notice may be the result of:**
  - ✓ Strikes and failure of important customers;
  - ✓ Bills may be presented for settlement earlier than expected;

Speculative Motive

- It refers to holding of cash to take advantage of unexpected opportunities which may emerge suddenly.
- **Precautionary motive is defensive in nature, while the speculative motive represents positive & aggressive approach.**
- It includes taking advantage of speculative investment opportunities, exploit discounts for

Compensation Motive

- This motive refers to holding cash balance to compensate banks for providing certain free services like clearance of cheques, tranfer of funds, etc and loans.

- Clients are required to maintain a minimum balance in there accounts, which cannot be utilized for transaction motives.

- This motive is applicable particularly in case of banking industry.

- In this, as per prov. of RBI Act, 1935 and Banking Regulation Act, 1949 all commercial banks are required to maintain some minimum amount (**SLR – Statutory Liquidity Ratio**) of cash with themselves, with their branches & in a current account with RBI.

Cash Management

- Cash Management is a technique to plan and control of cash in such a way that sufficient cash is always available to meet the obligations of the firms and excess balances, if any, may invested to enhance profitability.

Objectives of Cash Management

The main objective of cash management is to **trade-off liquidity (availability of cash) and profitability (to increase the profits)** in order to maximise the firms value.

Basic Objectives are:

(1) **Meeting the cash disbursement needs**: It includes meeting of cash outflows or disbursements as and when required like invest

(2) **Minimizing funds locked up as cash balances**:

This refers to minimise the amount locked up as cash balance because whatever cash balance is maintained, the firm looses interest income on that balance.

Factors Affecting Cash Requirement

(a) **Credit Position of the Firm:** Firms with good & sound credit standing & goodwill need to maintain separate cash for unforseen situations, whereas firms with bad credit position shall have to maintain high level of cash balance.

(b) **Relation with banks:** If firm has good relation with banks, it can get the facility of cash credit resulting less requirement of cash balance.

(c) <u>Terms of Purchase & Sale:</u> If a firm has facilities to buy material on credit but sells its product on cash, it can operate with little cash, whereas, if the firm makes purchases on cash and sells its product on credit, larger cash balance is required.

(d) <u>Nature of demand of goods</u>: If there is a steady demand of product, low level of cash is required. On the contrary, firm's engaged in production of luxury items have to maintain high cash.

(f) **Production Process:** Longer the production process, higher the requirement of cash. If production process is short, low cash balance maintenance is required.

(g) **Collection Period of Receivables:** If speed of collection of debtors is quick, less cash is required. If collection period is large, high balance will have to be maintained.

(h) **Management Policy**: If management policies are towards liquidity preference, large cash

(i) **Matching of Cash Inflows and Outflows:** The extent of non-synchronization between cash inflow and outflow determines cash requirement. Higher the degree of variance between cash collection and disbursement, higher will be the requirement of cash and vice-versa.

(a) Cash Planning and Control

(b) Management of Cash Inflows and Outflows

(c) Determination of Optimum level of cash

(d) Optimum investment of surplus cash

Cash Planning and Control

Cash planning is a process of predicting cash inflows and cash outflows of the firm so as to determine surplus or shortage of cash. Cash planning can be done through:

(a) **Cash Budget:**

- Cash budget is a device to forecast the predictable discrepancies between cash inflows and outflows over a projected time period.

Cash Planning and Control

(b) Cash Flow Analysis:

☎❖➂ Cash flow statement is a statement which discloses the causes of changes in cash position between the two periods.

☎❖➂ Cash flow analysis is based on historical data while cash budget is a technique for future estimation.

Cash Planning and Control

(c) Ratio Analysis

- Ratios like cash turnover ratio (times) , cash payment ratio are important techniques in planning and controlling the cash requirement.

Management of Cash Inflows & Outflows

Management and optimizing cash availability involves accelerating collections and decelerating disbursements. This step involves the following:

(a) **Accelerating Cash Collections:**

- In order to accelerate cash inflows, the collections from customers should be prompt.

- There are three types of **float that create the difference**: mail float, Processing float and collection float.

Management of Cash Inflows & Outflows

- **In Concentration Banking**, company establishes a number of strategic collection centres in different regions instead of a single collection centre at the head office.

- **Lock-Box** is a post office box maintained by a firm's bank that is used as a receiving point for customer remittance. In this, firm hires a post-office box & instructs its customers to mail their remittances to the box.

- In **minimum no. of bank accounts**, companies can close their super flous accounts and release funds for investment in profitable channels.

(b) Slowing Disbursement:

- In this cash requirement is managed by slow disbursement of **accounts payables. (creditors)**
- Accounts Payable payment can be delayed with the help of centralised disbursement centre, avoidance of early payments, and playing the float.
- In centralised disbrusement centre, all payments are made from a single control account resulting in delay in presentation of cheques for payment.
- In avoidance of early payments, all payments should be made on due dates, neither before nor after.
- Playing the float is a technical process by which a firm can make

Determination of optimum level of cash

- The optimum level of cash is determined by the trade-off between transaction cost and opportunity cost.

- If firm runs **out of cash** or it has low liquidity, it will have to either sell its securities or borrow cash.

Optimum Investment of surplus cash

- Due to changing working capital needs, the finance manager is required to consider the minimum cash balance that the firm should keep to avoid the cost of running out of funds. This minimum level may be termed as ‘ Safety level of cash’.

- Surplus which is not required for any specific purpose like general reserve, can be invested in securities with long term maturity and thus firm can earn more return.

- Finance manager while deciding the channels of investment should

(a) **<u>Baumol’s Model (EOQ Model, 1952):</u>**

- Baumol’s model considers cash management similar to an inventory management problem.

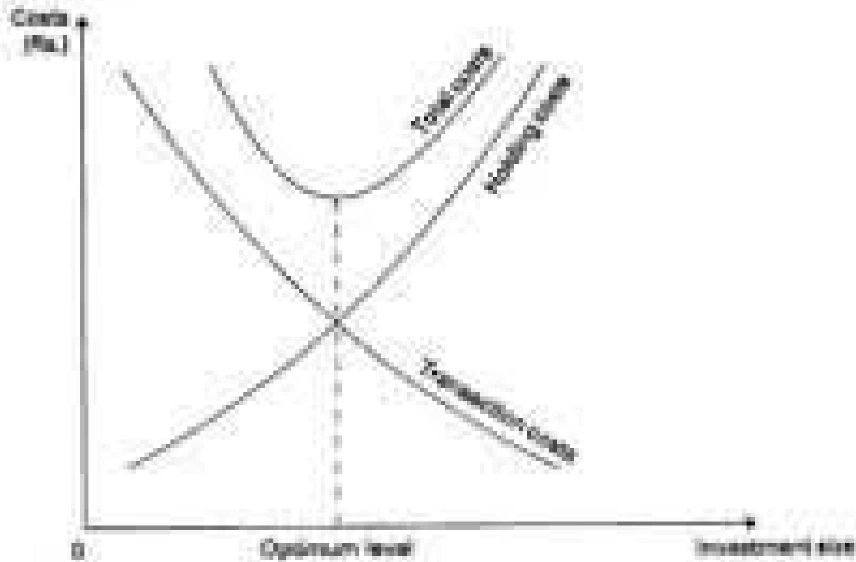
- According to this model, optimum cash level is that level of cash

- The firm can forecast its cash requirement with certainty.

- Cash disbursement will be steady during a given period.

- Whenever the firm converts its securities into cash, its transaction

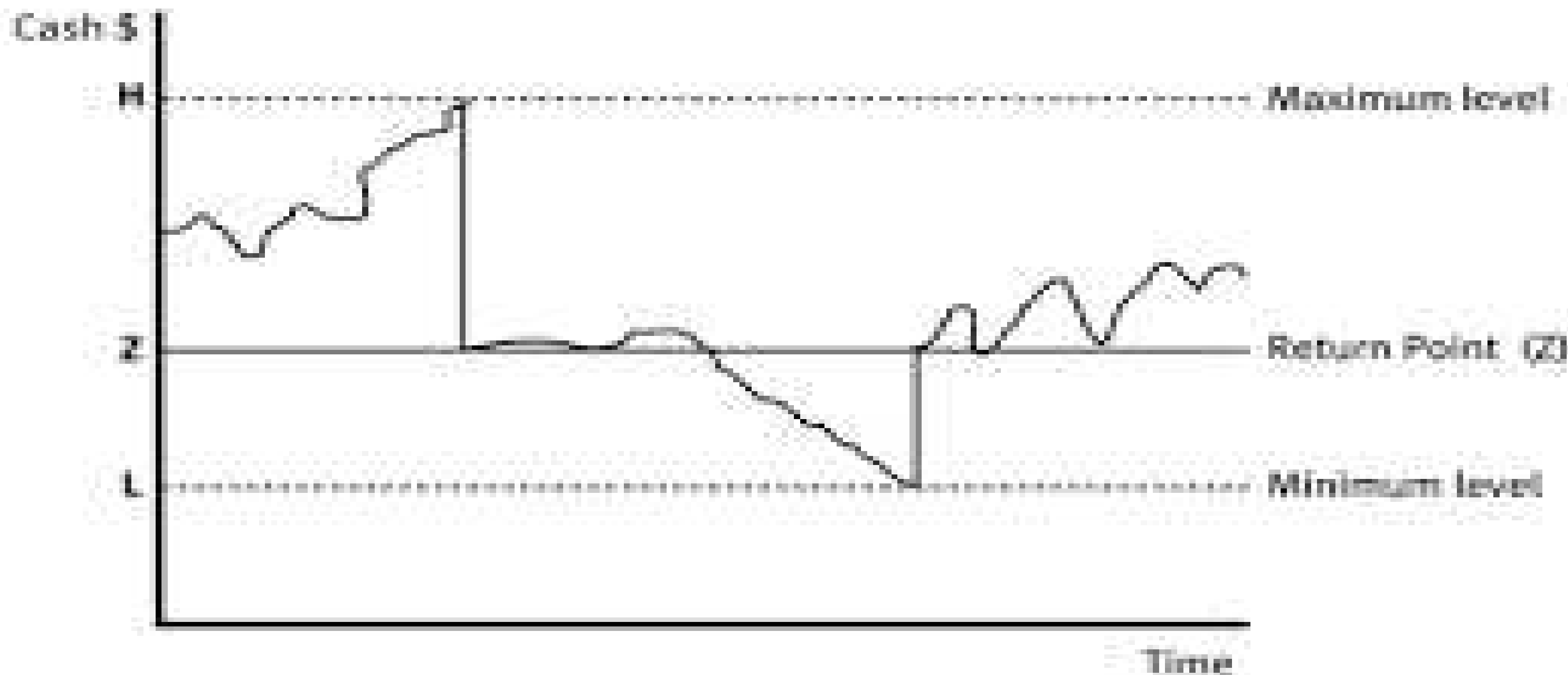
Baumol's Model:



- This model helps in determining the optimum level of cash when the demand for cash is not steady and cannot be known in advance.

- This model deals with cash management problem by laying down control limits for cash

Miller-Orr Model:



Receivables Management

Dr.

Receivables Management-Meaning

- Accounts receivable management is an important aspect of working capital management.
- Receivables management is the process of making decisions relating to investment in

Scope of Receivables Management

- **Determining Credit Policy:**

❖ In developing an optimum credit policy, the benefits of **credit extension** should be compared with the **cost of credit**.

❖ Major considerations in cost are liquidity and opportunity costs

Profitability

Risk level

Cost

&

Profitability

Security level

Optimum level

Liquidity

Strict

Liberal

Scope of Receivables Management

- **Determining Credit Terms:**

  ❖ Credit terms include the decisions like credit period, quantum of cash discount and period of cash discount.

Scope of Receivables Management

- **Evaluating the credit applicants:**

❖ This step involves laying down clear-cut guidelines and procedures for granting credit to individual customers.

❖ While taking decision, five C's

Scope of Receivables Management

- **Determining Collection Policies and Methods:**

  ❖ The collection policy should aim at accelerating collections from slow payers and reducing bad debt losses.

  ❖ Company can follow various

Scope of Receivables Management

- **<u>Control and Analysis of Receivables:</u>**

❖ This step involves analysing the size of investment in this current asset from time to time.

❖ Various ratios like Debtors turnover ratio, Average collection

Factors Affecting the size of Receivables

(a) **Volume of credit sales:** If the proportion of credit sales is relatively higher, then the amount of receivables will also be higher.

(b) **Credit Policies:** How liberal (stringent policy)) or conservative the credit policy is, will also affect the amount of receivables. A tight credit policy will imply a low size of receivables. If collections are prompt, then even if the firm has a liberal credit policy, the size of receivables will remain under control.

(c) **Trade Terms:** The most important credit terms affecting the level of receivables are the credit period and the cash discount. For instance, cash discount reduces the investment in receivables because it encourages earl

Factors Affecting the size of Receivables

(d) Credit Collection policies: An efficient collection policy will considerably reduce the amount of investment in receivables.

(e) Business Expansion Plans: In the early stages of expansion of business, more credit facilities may be necessary to attract customers in new markets. Of course, the period of credit can be gradually reduced when the firm is able to get permanent customers.

(f) Competitors' polices: The credit policies of the competitors also influence the credit policy of the firm. Sometimes, the trade policies of the competitors have to be kept in mind otherwise, it may be difficult.

(g) Other factors: Several other factors such as level of business activity, seasonal factors, industry norms etc. affect the level of investment in receivables.

Analysis of Terms of Credit

- Firm's credit terms specify the repayment terms required for all credit customers.

- Changes in credit terms affect the firm's sales, profits, average collection period and bad debts expenses.

- Credit terms have three components: **Cash discount, Cash discount period and the credit period.**

- **The cash discount** indicate the rate of discount offered to the customers to induce them to pay their bills early. It results in increas in sales and decrease in average collection period, bad debt expense

Analysis of Terms of Credit

- **Credit Period** is the time duration for which credit is extended to the customers is called credit period. Generally stated in terms of a **net date. Ex: “net 30”.**

- Credit period of the firm is governed by **industry norms** but can be extended to stimulate sales. Increasing the credit period should increase sales but both the average collection period and bad debts expenses are likely to increase.

- **Cash discount period** affects the firm’s collection period and profits. When the cash discount period is increased, it has both positive and negative effect on profits.

Analysis of Terms of Credit

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Credit Evaluation Procedure

- Once the firm has established its credit standards, procedures are developed to evaluated the credit-worthiness of prospective customers.

- **Line of Credit** must be stated which shows the maximum amount of credit the customer is capable of supporting.

- **Credit Evaluation Procedure involves** Obtaining credit information about customers, credit investigation, credit analysis, fixing credit limits and establishing collection procedure.

Credit Evaluation Procedure

(a) <u>Obtaining Credit Information</u>:

- When a firm is approached by a customer desiring supply of goods on credit, the firm's credit department begins the credit evaluation procedure by obtaining credit information.

- Major sources of credit information are **financial statements of the customer, bank reference, credit information associations, Credit Bureau Reports.**

Credit Evaluation Procedure

(b) Credit Investigation:

- After obtaining the credit information, the firm collect information regarding various other aspects.

- These aspects are: type of customer (new or existing), Customer’s business line and background, Nature of product (Perishable or seasonal), Size of customer’s order and expected future volumes of business with him.

Credit Evaluation Procedure

(C) **<u>Credit Analysis</u>:**

- A credit applicant's financial statements and accounts payable ledger can be used to calculate its "**Average age of accounts payable"** and compared with the credit terms currently being extended by the firm.

Credit Evaluation Procedure

(d) Credit Limit:

- In this, the amount and duration of credit is determined.

- **Line of credit** involves the fixation of maximum amount of trade credit and duration of credit to be allowed to a particular customer.

Credit Evaluation Procedure

(e) <u>Collection Procedure:</u>

- In this step, firm decide about the collection procedure to speed up the collection of dues.

- Firm may take various steps such as letters, telephone calls, personal visits, using collection agencies, etc.