SCHOOL OF COMMERCE, DAVV INDORE

SESSION (JAN. – JUNE 2020)

MBA(Foreign Trade)2 YEARS II SEM

Subject: Financial Management

Unit II- Receivable Management:

Meaning and Objectives of Receivables Management.

Receivables management is the process of making decisions relating to investment in trade debtors. If you want to increase sales turnover and profits of the firm, you have to sale goods on credit basis, which includes the risk of bad debts. The objective of receivables management is "to promote sales and profits until that point is reached where the return on investment in further funding of receivables is less than the cost of funds raised to finance that additional credit" .

Receivables represent amounts owed to the firm as a result of sale of goods or services in the ordinary course of business. These are claims of the firm against its customers and form part of its current assets. Receivables are also known as account receivables, trade receivables, or book debts. The receivables are carried for the customers. The period for credit and extent of receivables depends upon the credit policy followed by the firm. The purpose of maintaining or investing in receivables is to meet competition, and to increase the sales and profits.

Receivable management is a process of managing the account receivables within a business organization. Account receivables simply mean credit extended by the company to its customers and are treated as liquid assets. It involves taking decisions regarding the investment to be made in trade debtors by organization. Deciding the proper amount be lent by the company to its customers in the form of credit sales is quite important. It affects the overall cash availability for undertaking various operations.

Receivable management business ensures that a sufficient amount of cash is always maintained within the business so that operations can continue uninterrupted. It helps in deciding the optimum proportion of credit sales. The overall process of receivable management involves properly recording all credit sales invoices, sending notices on due date to collection department, recording all collections, calculation of outstanding interest on late payments etc.

Receivables management aims at raising the sales volumes and profit of the business by managing and providing credit facilities to customers. A proper

receivables management process aims at monitoring and avoidance of occurrence of any overdue payment and non-payment. It is an effective way of improving the financial and liquidity position of the company. Credit facilities are important for attracting and retaining customers and this makes management of credit facilities by business crucial. Objectives of receivables management are as follows:

Objectives of Receivable Management

- Monitor and Improve Cash Flow
- Minimizes bad debt losses
- Avoids invoice disputes
- Boost up sales volume
- Improve customer satisfaction
- Helps in facing competition

- **Monitor and Improve Cash Flow**:

Receivable management monitors and control all cash movements of organizations. It maintains a systematic record of all sales transactions. Receivable management helps business in deciding appropriate investment in trade debtors. It aims that a sufficient amount of cash needed for day-to-day activities is maintained at business. Credit facilities are extended by doing proper analysis and planning to ensure optimum cash flow in a business organization.

- **Minimizes bad debt losses:**

Bad debts are harmful to organizations and may lead to heavy losses. Receivable management takes all necessary steps to avoid bad debts in business transactions. It designs and implement schedules for collection of outstanding amount timely and informs the collection department on due dates. Customers are notified for amount standing against them and charges interest on delay in payments.

- **Avoids invoice disputes:**

Receivable management has an efficient role in avoiding any disputes arising in business. Disputes adversely affect the relationship between customers and business organizations. Complete and fair record of all transactions with customers are maintained on a daily basis. There is no chance of confusion and dispute arising as all sales transactions are accurately maintained. Automated receivable management systems present full evidence in a short time in case of dispute arising for resolving them.

- **Boost up sales volume**:

Receivable management increase the sales and the profitability of the organization. By extending the credit facilities to their customers business are able to boost up their sales volume. More and more customers are able to do transactions with the business by purchasing products on a credit basis. Receivable management helps business in managing and deciding their investment in credit sales. This leads to increase in the number of sales and profit level.

- **Improve customer satisfaction**:

Customer satisfaction and retention are key goals of every business. By lending credit, it supports financially weaken customers who can't purchase business products fully on a cash basis. This strengthens the relationship between customer and organization. Customers are happy with the services of their business partners. Receivable management help in organizing better credit facilities for their customers.

- **Helps in facing competition**:

Receivable management helps in facing stiff competition in the market. Several competitors existing in market offers different credit options to attract more and more customers. Receivable management process analysis all information about market and helps the business in farming its credit lending policies. Customers are provided better services by extending credit at convenient rates. Appropriate amount and rates of credit transactions can be easily decided through receivable management process. All credit and payment terms are decided for every customer as per their needs.

- **Cost of Maintaining Receivables.**

The allowing of credit to customers means giving of funds for the customer's use. The concern incurs the following costs on maintaining receivables:-

1. Cost of financing receivables.
2. Cost of collection.
3. Bad debts.

- **Factors influencing the size of Receivables.**

Size of credit sales.
Credit policies.
Terms of trade.
Expansion plans.
Relation with profits.
Credit collection efforts.
Habits of customers.

- **Forecasting the Receivables.**

Credit period allowed.
Effect of cost of goods sold.
Forecasting expenses.

COSTS & BENEFITS OF RECEIVABLES

There are various costs & benefits attached with a credit policy. These may be enumerated as follows.

- **COST OF RECEIVABLES**

1. **COST OF FINANCING** :

The credit sales delays the time of sales realization & therefore the time gap between incurring the cost & the sales realization is extended. This results in blocking of funds for a longer period. The firm on the other hand, has to arrange funds to meet its own obligations towards payment to the supplier, employees etc., and these funds are to be procured at some explicit or implicit cost. This is known as cost of financing the receivables.

2. **ADMINISTRATIVE COST**:

A firm will also required to incur various costs in order to maintain the record of credit customers both before the credit sales as well as after the credit sales

3. **DELINQUENCY COST** :

The firm have to incur additional costs known as delinquency costs, if there is delay in the payment by a customer. The firm may have to incur cost on reminders , phone calls , postages, legal notices etc. There is always an opportunity cost of the funds tied up in the receivables due to delay in payment.

4. **COST OF DEFAULT BY THE CUSTOMER**:

If there is a default by the customer & the receivables becomes partly or wholly, unrealizable , then this amount is known as bad debt, also becomes cost to the firm. This cost does not appear in case of sales.

BENEFITS OF RECEIVABLES

1. **INCREASE IN SALES:**

Most of the firms sell goods on credit, either because of trade customs or other conditions. The sales can be further increased by liberalizing the credit terms. This will attract more customers to the firm resulting in higher sales & growth of the firm.

2. **INCREASE IN PROFITS**:
Increase in sales help the firm in-
a)to easily recover the fixed expenses & attaining the break-even level.
b)Increase the operating profit of the firm

3. **EXTRA PROFIT**:
Sometimes, the firm makes the credit sales higher than the usual cash selling price. This brings an opportunity to the firm to make extra profit over & above the normal profit.

OTHER BENEFITS OF RECEIVABLES MANAGEMENT

8 BENEFITS OF ACCOUNTS RECEIVABLE MANAGEMENT SOFTWARE

- IMPROVE YOUR CASH POSITION. You have bills you have to pay. ...
- INCREASE CONTROL OVER CASH AND WORKING CAPITAL. ...
- INCREASE ACCOUNTS **RECEIVABLE MANAGEMENT** EFFICIENCY. ...
- IMPROVE CUSTOMER COMMUNICATION. ...
- IMPROVE CUSTOMER SERVICE AND SATISFACTION. ...
- REDUCE ADMINISTRATIVE COSTS. ...
- SHORTEN THE SALES TO PAYMENT CYCLE. ...
- MINIMIZE CREDIT RISK.

****

Unit II- INVENTORY MANAGEMENT:

Meaning of Inventory Management

Inventory Management is a process of ordering, storing, and using inventories. This stock management includes generating the lead on raw materials, components, and finished products, along-side warehousing and processing of such items in your company. The available stock of inventories must be physically counted before it is put on the balance sheet.

Inventory Management is a technique through which stocked goods, inventories, and non-capitalized assets are kept in a proper manner according to their specific shape and placement.

An Inventory can be any item that a business holds to receive the goal of resale or repair.

Inventory Management is a process of ordering, storing, and using inventories. This stock management includes generating the lead on raw materials, components, and finished products, along-side warehousing and processing of such items in your company. The available stock of inventories must be physically counted before it is put on the balance sheet.

Inventory accounting is grouped into four separate categories:

- **Raw Materials** – The raw material is purchased by any company for its production purpose to transform it into a finished good.
- **Work in progress inventory** – refers to the process of transformation of raw material into a finished product.
- **Finished goods** – these are the complete goods that are now ready to be available for sale.
- **Maintenance, repair, operation (MRO) goods** – items used for support of the production of finished goods as they will be purchased from the distributor of future resale.

Principle of Inventory Management

The basic principle of inventory management is to hold costs.

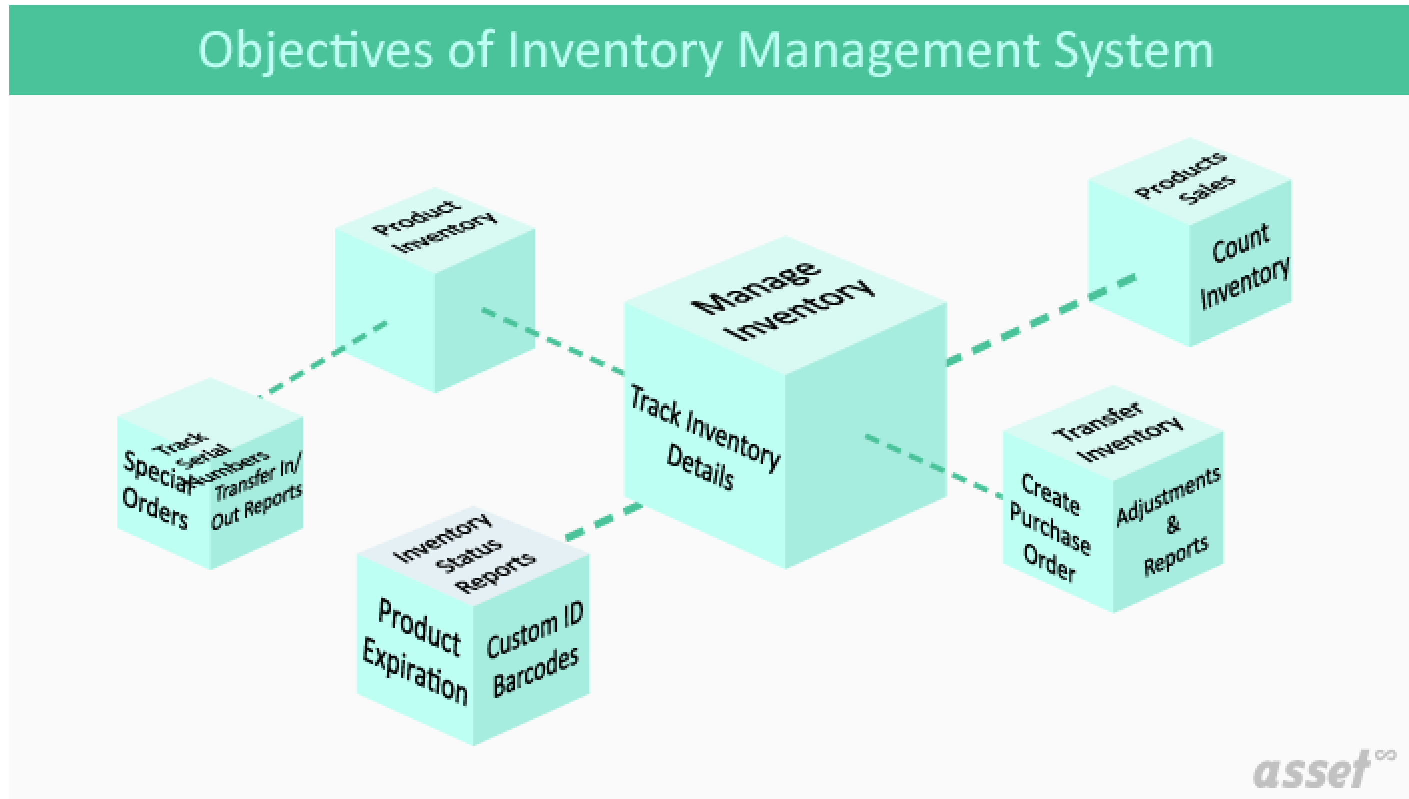
For example: The purchase of the hospital is the direct cost of materials with inclusive taxes.

Next is to control the investment amount for which there should be a balance maintained between purchase cost and carrying cost by procuring the products in optimum quantity, also known as economic order quantity.

Objectives of Inventory Management

The investment put in inventory is very high, especially for those businesses that deal in manufacturing, wholesale, and retail trade. The amount of investment might be sometimes more than the amount spent on other assets of the company. Almost 90% of the working capital of a business is invested in inventories. The management should do proper planning on how to purchase, handle, store, and account with an inventory management system. The main aim of an inventory management system is to keep the stock in such a way that it is neither overstock nor under stock. The overstock condition will reduce the other production processes and under stock will lead to stoppage of work.

The objectives of inventory management are operational and financial. In operational, materials and stock should be available in sufficient amount whereas, in functional, the minimum working capital should be locked in.



The objectives of inventory management are as follows:

1. To ensure a continuous supply of materials and stock so that production should not suffer at the time of customers demand.
2. To avoid both overstocking and under-stocking of inventory.
3. To maintain the availability of materials whenever and wherever required in enough quantity.
4. To maintain minimum working capital as required for operational and sales activities.
5. To optimize various costs indulged with inventories like purchase cost, carrying a cost, storage cost, etc.
6. To keep material cost under control as they contribute to reducing the cost of production.
7. To eliminate duplication in ordering stocks.
8. To minimize loss through deterioration, pilferage, wastages, and damages.

9. To ensure everlasting inventory control so that materials shown in stock ledgers should be physically lying in the warehouse.
10. To ensure the quality of goods at reasonable prices.
11. To facilitate furnishing of data for short and long-term planning with a controlled inventory.
12. To supply the required material continuously.
13. To maintain a systematic record of inventory.

To make stability in price. Cost of Holding Inventory

Holding costs are those associated with storing inventory that remains unsold. These costs are one component of total inventory costs, along with ordering and shortage costs. A firm's holding costs include the price of goods damaged or spoiled, as well as that of storage space, labor, and insurance.

Benefits of holding Inventory:
There are various benefits of holding inventory: Holding inventory helps in incessant supply of the products leading to a minimum or no loss of sales. Holding inventory reduces the shortage of. If it is possible to hold raw materials on a large volume, the suppliers are pleased to offer discounts.
Benefits of Holding Inventory in a firm

- Holding Inventory avoids loss of sales. ...
- Holding Inventory gains quantity discount. ...
- Holding Inventory reduces order cost. ...
- Achieve efficient production runs by holding inventory. ...
- Holding Inventory reduces risk of production shortages.

Advantages of Holding Inventory

1. Holding Inventory avoids loss of sales
In case a firm maintains adequate inventory, it can execute the customers' orders without any delay and thus avoid any possibility of losing the patronage of customers and hence sales.

2. Holding Inventory gains quantity discount
If the firm places a large order of certain materials, the suppliers of the materials will give generous quantity discounts by reducing the price. This quantity discount will reduce the cost of goods of the firm and increase profits earned on sale.

3. Holding Inventory reduces order cost

By ordering in large numbers, a firm can reduce the cost it incurs. Some of the cost involved when making an order is forms that must be completed, approvals needed to be obtained and the goods arrived must be accepted, inspected and counted. Then an invoice must be issued and payment must be made.

The cost of receiving materials may vary according to the number of orders made. By making bulk orders, the number of orders will reduce and minimize the cost involved.

4. **Achieve efficient production runs by holding inventory**

Start up cost is incurred when a firm sets up its lab our/man power and machines to produce goods. The cost will then be absorbed when production begins. The cost will come down when the process of production runs longer.

When the firm frequently sets up its production line, it will increase its startup cost. Holding an inventory to make sure the production line will never run out of raw materials will ensure longer run in production line, hence lower the startup cost.

5**. Holding Inventory reduces risk of production shortages**

An inventory is needed to store large amount of raw materials and unprocessed components. If one single component run out of stock, the-entire production line could be halted.

To avoid the risk of shortage of essential components during a big production process, the firm should maintain inventory management. This will prevent the shortage of vital raw materials and components needed to produce goods. The system will manage and notify any shortage before it is materialized.

The inventory management systems are suitable to maintaining large quantities of stocks and always keep firm's inventory on check.

Credit Policy in Receivable Management

Concept of Credit Policy

The discharge of the credit function in a company embraces a number of activities for which the policies have to be clearly laid down. Such a step will ensure consistency in credit decisions and actions. A credit policy thus, establishes guidelines that govern grant or reject credit to a customer, what should be the level

of credit granted to a customer etc. A credit policy can be said to have a direct effect on the volume of investment a company desires to make in receivables.

A company falls prey of many factors pertaining to its credit policy. In addition to specific industrial attributes like the trend of industry, pattern of demand, pace of technology changes, factors like financial strength of a company, marketing organization, growth of its product etc. also influence the credit policy of an enterprise. Certain considerations demand greater attention while formulating the credit policy like a product of lower price should be sold to customer bearing greater credit risk. Credit of smaller amounts results, in greater turnover of credit collection. New customers should be least favored for large credit sales. The profit margin of a company has direct relationship with the degree or risk. They are said to be inter-woven. Since, every increase in profit margin would be counterbalanced by increase in the element of risk.

Credit policy of every company is at large influenced by two conflicting objectives irrespective of the native and type of company. They are liquidity and profitability. Liquidity can be directly linked to book debts. Liquidity position of a firm can be easily improved without affecting profitability by reducing the duration of the period for which the credit is granted and further by collecting the realized value of receivables as soon as they fails due. To improve profitability one can resort to lenient credit policy as a booster of sales, but the implications are:

- Changes of extending credit to those with week credit rating.
- Unduly long credit terms.
- Tendency to expand credit to suit customer's needs; and
- Lack of attention to over dues accounts.

Setting a Credit Policy

To establish a credit policy, a company must establish credit terms, credit standards and a collection policy.

1. Credit Terms

Credit terms refer to the stipulations recognized by the firms for making credit sale of the goods to its buyers. In other words, credit terms literally mean the terms of payments of the receivables. A firm is required to consider various aspects of

credit customers, approval of credit period, acceptance of sales discounts, provisions regarding the instruments of security for credit to be accepted are a few considerations which need due care and attention like the selection of credit customers can be made on the basis of firms, capacity to absorb the bad debt losses during a given period of time. However, a firm may opt for determining the credit terms in accordance with the established practices in the light of its needs. The amount of funds tied up in the receivables is directly related to the limits of credit granted to customers. These limits should never be ascertained on the basis of the subjects own requirements, they should be based upon the debt paying power of customers and his ledger record of the orders and payments. There are two important components of credit terms which are detailed below:

1. **Credit period**:

The credit period lays its multi-faced effect on many aspects the volume of investment in receivables; its indirect influence can be seen on the net worth of the company. A long period credit term may boost sales but it‘s also increase investment in receivables and lowers the quality of trade credit. While determining a credit period a company is bound to take into consideration various factors like buyer's rate of stock turnover, competitors approach, the nature of commodity, margin of profit and availability of funds etc. The period of credit diners form industry to industry. In practice, the firms of same industry grant varied credit period to different individuals. as most of such firms decide upon the period of credit to be allowed to a customer on the basis of his financial position in addition to the nature of commodity, quality involved in transaction, the difference in the economic status of customer that may considerably influence the credit period. The general way of expressing credit period of a firm is to coin it in terms of net date that is, if a firm's credit terms are "Net 30", it means that the customer is expected to repay his credit obligation within 30 days. Generally, a free credit period granted, to pay for the goods purchased on accounts tends to be tailored in relation to the period required for the business and in turn, to resale the goods and to collect payments for them. A firm may tighten its credit period if it confronts fault cases too often and fears occurrence of bad debt losses. On the other side, it may lengthen the credit period for enhancing operating profit through sales expansion. Anyhow, the net operating profit would increase only if the cost of extending credit period will be less than the incremental operating profit. But the increase in sales alone with extended credit period would increase the investment in

receivables too because of the following two reasons: (i) Incremental sales result into incremental receivables, and (ii) The average collection period will get extended, as the customers will be granted more time to repay credit obligation.

2. **Cash Discount Terms**:

The cash discount is granted by the firm to its debtors, in order to induce them to make the payment earlier than the expiry of credit period allowed to them. Granting discount means reduction in prices entitled to the debtors so as to encourage them for early payment before the time stipulated to the i.e. the credit period. Grant of cash discount beneficial to the debtor is profitable to the creditor as well. A customer of the firm i.e. debtor would be realized from his obligation to pay Soon that too at discounted prices. On the other hand, it increases the turnover rate of working capital and enables the creditor firm to operate a greater volume of working capital. It also prevents debtors from using trade credit as a source of working capital. Cash discount is expressed is a percentage of sales. A cash discount term is accompanied by (a) the rate of cash discount, (b) the cash discount period, and (c) the net credit period. For instance, a credit term may be given as "1/10 Net 30" that mean a debtor is granted 1 percent discount if settles his accounts with the creditor before the tenth day starting from a day after the date of invoice. But in case the debtor does not opt for discount he is bound to terminate his obligation within the credit period of thirty days. Change in cash discount can either have positive or negative implication and at times both. Any increase in cash discount would directly increase the volume of credits sale. As the cash discount reduces the price of commodity for sale. So, the demand for the product ultimately increase leading to more sales. On the other hand, cash discount lures the debtors for prompt payment so that they can relish the discount facility available to them. This in turn reduces the average collection period and bad debt expenses thereby, bringing about a decline in the level of investment in receivables. Ultimately the profits would increase. Increase in discount rate can negatively affect the profit margin per unit of sale due to reduction of prices. A situation exactly reverse of the one stated above will occur in case of decline in cash discount. Yet, the management of business enterprises should always take note of the point that cash discount, as a percentage of invoice prices, must not be high as to have an uneconomic bearing on the financial position of the concern. It should be seen in this connection that terms of sales include net credit period so that cash discount may continue to retain its significance and might be prevented from being treated

by the buyers just like quantity discount. To make cash discount an effective tool of credit control, a business enterprise should also see that is allowed to only those customers who make payments at due date. And finally, the credit terms of an enterprise on the receipt of securities while granting credit to its customers. Credit sales may be got secured by being furnished with instruments such as trade acceptance, promissory notes or bank guarantees.

2. **Credit Standards**

Credit standards refers to the minimum criteria adopted by a firm for the purpose of short listing its customers for extension of credit during a period of time. The nature of credit standard followed by a firm can be directly linked to changes in sales and receivables. A liberal credit standard always tends to push up the sales by luring customers into dealings. The firm, as a consequence would have to expand receivables investment along with sustaining costs of administering credit and bad-debt losses. As a more liberal extension of credit may cause certain customers to the less conscientious in paying their bills on time. Contrary, to these strict credit standards would mean extending credit to financially sound customers only. This saves the firm from bad debt losses and the firm has to spend lesser by a way of administrative credit cost. But, this reduces investment in receivables besides depressing sales. In this way profit sacrificed by the firm on account of losing sales amounts more than the cost saved by the firm. Prudently, a firm should opt for lowering its credit standard only up to that level where profitability arising through expansion in sales exceeds the various costs associated with it. That way, optimum credit standards can be determined and maintained by inducing trade-off between incremental returns and incremental costs.

3. **Collection Policy**

Collection policy refers to the procedures adopted by a firm (creditor) collect the amount of from its debtors when such amount becomes due after the expiry of credit period. The requirements of collection policy arise on account of the defaulters i.e. the customers not making the payments of receivables in time. As a few turn outs to be slow payers and some other non-payers. A collection policy shall be formulated with a whole and sole aim of accelerating collection from bad-debt losses by ensuring prompt and regular collections. Regular collection on one hand indicates collection efficiency through control of bad debts and collection costs as well as by inducing velocity to working capital turnover. On the other

hand it keeps debtors alert in respect of prompt payments of their dues. A credit policy is needed to be framed in context of various considerations like short-term operations, determinations of level of authority, control procedures etc. Credit policy of an enterprise shall be reviewed and evaluated periodically and if necessary amendments shall be made to suit the changing requirements of the business. It should be designed in such a way that it co-ordinates activities of concerns departments to achieve the overall objective of the business enterprises. Finally, poor implementation of good credit policy will not produce optimal results.

To conclude, the credit policy of a company should be developed in accord with the strategic, marketing, financial and organizational context of the business and be designed to contribute to the achievement of corporate objectives. The corporate strategy can include trade credit management not just in terms of its contribution to collection and cash flow but as a means of generating sales and profits, and of investing in customers by building relationships. The management of trade credit can help build stable and long term relationships with customers, generate information about the customer and their requirements and facilitate different customer strategies in terms of credit granting, credit terms and customer service. The objective is to generate growing but profitable sales.

A credit policy thus, establishes guidelines that govern grant or reject credit to a customer, what should be the level of credit granted to a customer etc. A credit policy can be said to have a direct effect on the volume of investment a company desires to make in receivables.

Techniques of the Inventory Management System

Many businesses select one inventory management technique, and some prefer a unique blend of techniques, that best suits their particular needs.

However, what implements an integrated inventory management software to your business is Asset Infinity.

Nevertheless, the technique your business chooses to employ, it if does not have the ability to track, trace and account your inventory in real-time, anyhow it will run into trouble.

There are several inventory management techniques that you can use to manage, track, and analyze your production and sales system.

The three most common Inventory Management techniques are:

1. Just-in-Time (JIT) Delivery –

Just-in-Time technique is a strategy to increase efficiency and decrease waste by receiving goods in the quantity as needed for the production process, thereby decreasing inventory costs.

JIT delivery leads to reductions in costs and improves efficiency and profit margins in the following ways:

- Decreased inventory levels
- Reduced labour costs
- Fewer factory spaces
- Stock reduction
- Increased productivity
- Improved quality
- Reduced throughput times

2. ABC Inventory Analysis –

ABC Analysis allows you to characterize your product according to their requirement. A few of the product require more attention than others. In this add your product to each category as per their requirement list.

- Category A — This includes the product of high quality with a low frequency of sales.
- Category B — This includes the product of moderate quality with a moderate frequency of sales.
- Category C — This includes the product of low quality with a high frequency of sales.

3. Drop-Shipping –

Drop shipping technique is a retail fulfillment method where a store does not keep the finished products to sells in its stock. Instead, when a store had to sell a product, it purchases the item from the third party, and it is shipped directly to the customer. As a result, the merchant never sees or handles the product.

Conclusion:

A proper Inventory Management System must be used to manage stocks. All inventory management has to do is to keep accurate records of items that are ready for shipment.

asset

Inventory management is also important for keeping costs down while meeting regulation. Supply and demand are a delicate balance, and inventory management promises to ensure that the balance is undisturbed.

Economic Order Quantity

Economic Order Quantity is an inventory management tool, which shows quantity to be ordered each time that inventory cost. Normally, the ordering cost and carrying cost are equal at the point of economic order quantity. Thus, the economic order quantity is the quantity that minimizes the total inventory cost.

ALL THE BEST

******