Working Capital Management, Inventory & Cash Management, Dividend Management

Subject- Financial Management & Policies

Presentation

By

Tapas Kumar Tripathy

Assistant Professor in Commerce, P. K. College, Contai

INTRODUCTION

- **Definition : Working capital management** refers to a company's managerial accounting strategy designed to monitor and utilize the two components of **working capital**, Current assets and Current liabilities, to ensure the most financially efficient operation of the company.

- Funds required for short term purposes or for meeting day to day expenses of business are called working capital.

- It is a short term finance which is used to invest in current assets.

- It is also called Revolving capital or Rotating capital or Short term capital.

COMPONENTS OF WORKING CAPITAL

Current assets:

These are those assets which converts into cash within one year.

These includes

- Inventory
- Debtors
- Bills Receivables
- Cash and Bank balances
- Prepaid expenses

Working Capital Management and the Risk-Return Tradeoff

- Working capital management encompasses the day-to-day activities of managing the firm's current assets and current liabilities. Examples of working capital decisions include:
  - How much inventory should a firm carry?
  - Should the credit be extended to?
  - Should inventories be bought on credit or cash?
  - If credit is used, when should payment be made?

COMPONENTS OF WORKING CAPITAL

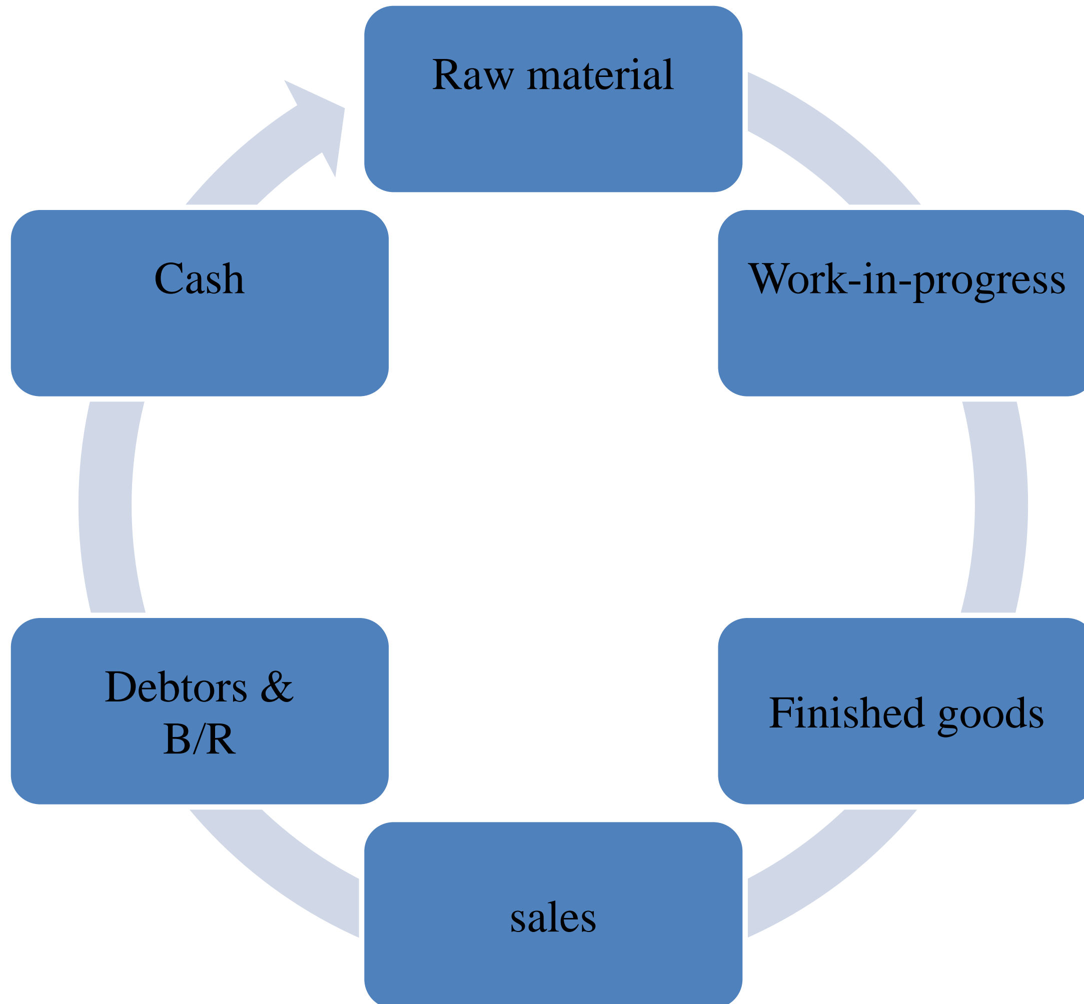
Current liabilities:

These are those liabilities which are to be paid within one year.

These includes

- Creditors
- Bills payable
- Bank overdraft
- Proposed dividend
- Provision for taxation

WORKING CAPITAL CYCLE



CALCULATION OF DURATION OF OPERATING CYCLE

DURATION OF **R**AW MATERIAL STORAGE

+

DURATION OF **W**ORK IN PROGRESS

+

DURATION OF **F**INISHED GOODS

+

DURATION OF RECEIVABLES FROM **D**EBTORS

-

DURATION OF **C**REDIT PERIOD ALLOWED BY THE SUPPLIERS

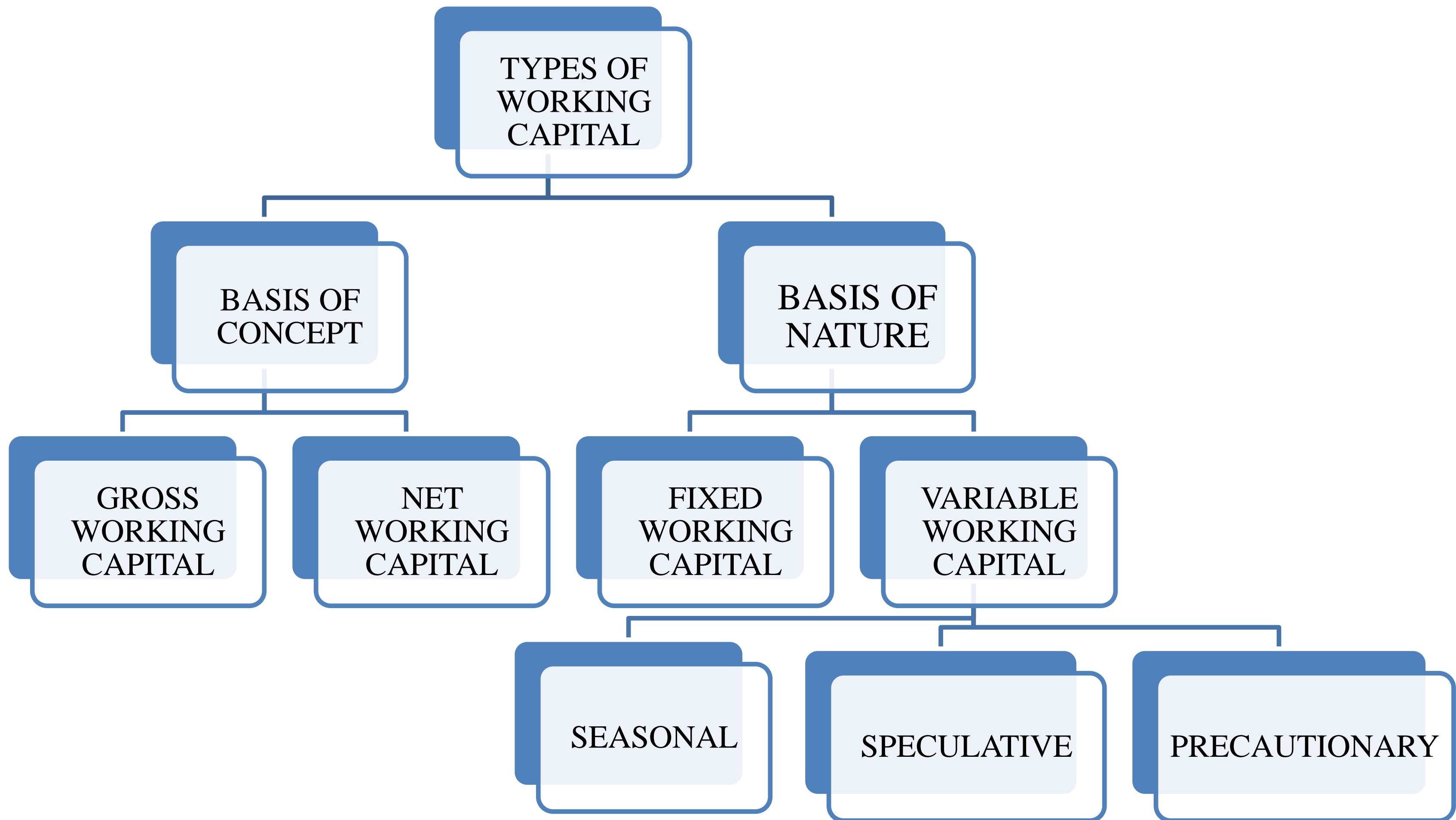
$$O = R + W + F + D - C$$

TECHNIQUES OF ANALYSING WORKING CAPITAL

The analysis can be conducted through using following tools.

- Fund flow analysis
- Working capital budgeting
- Ratio analysis

TYPES OF WORKING CAPITAL



Importance of Inventory

- Balance the advantages and disadvantages of small and large inventories

- Pressures for small inventories
  - Inventory holding cost
  - Cost of capital
  - Storage and handling costs
  - Taxes, insurance, and shrinkage

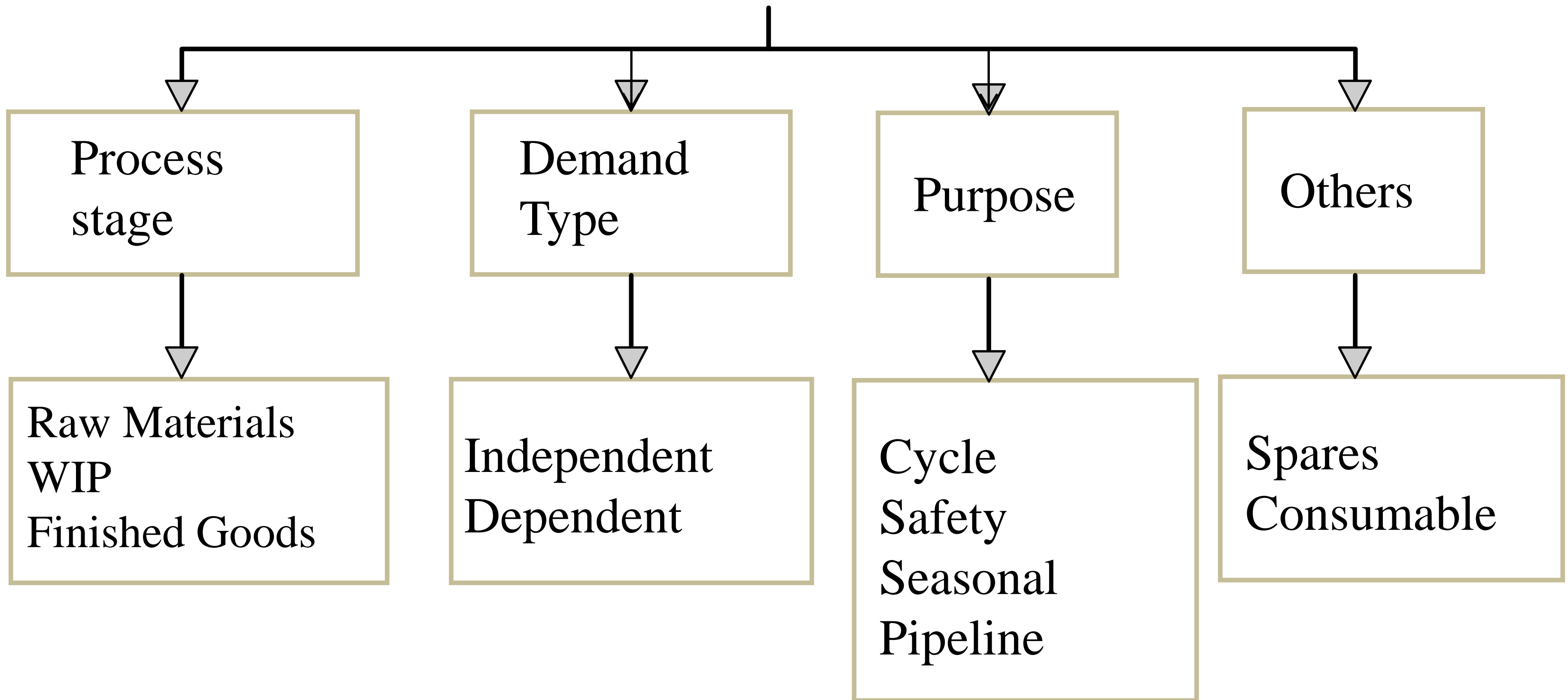
Importance of Inventory

- Pressures for large inventories
  - Customer service
  - Ordering cost
  - Setup cost
  - Labor and equipment utilization
  - Transportation cost
  - Payments to suppliers

Reasons for Holding Inventory

- To meet anticipated customer demand
- To protect against stock outs
- To take advantage of economic order cycles
- To maintain independence of operations
- To allow for smooth and flexible production operations
- To guard against price increases

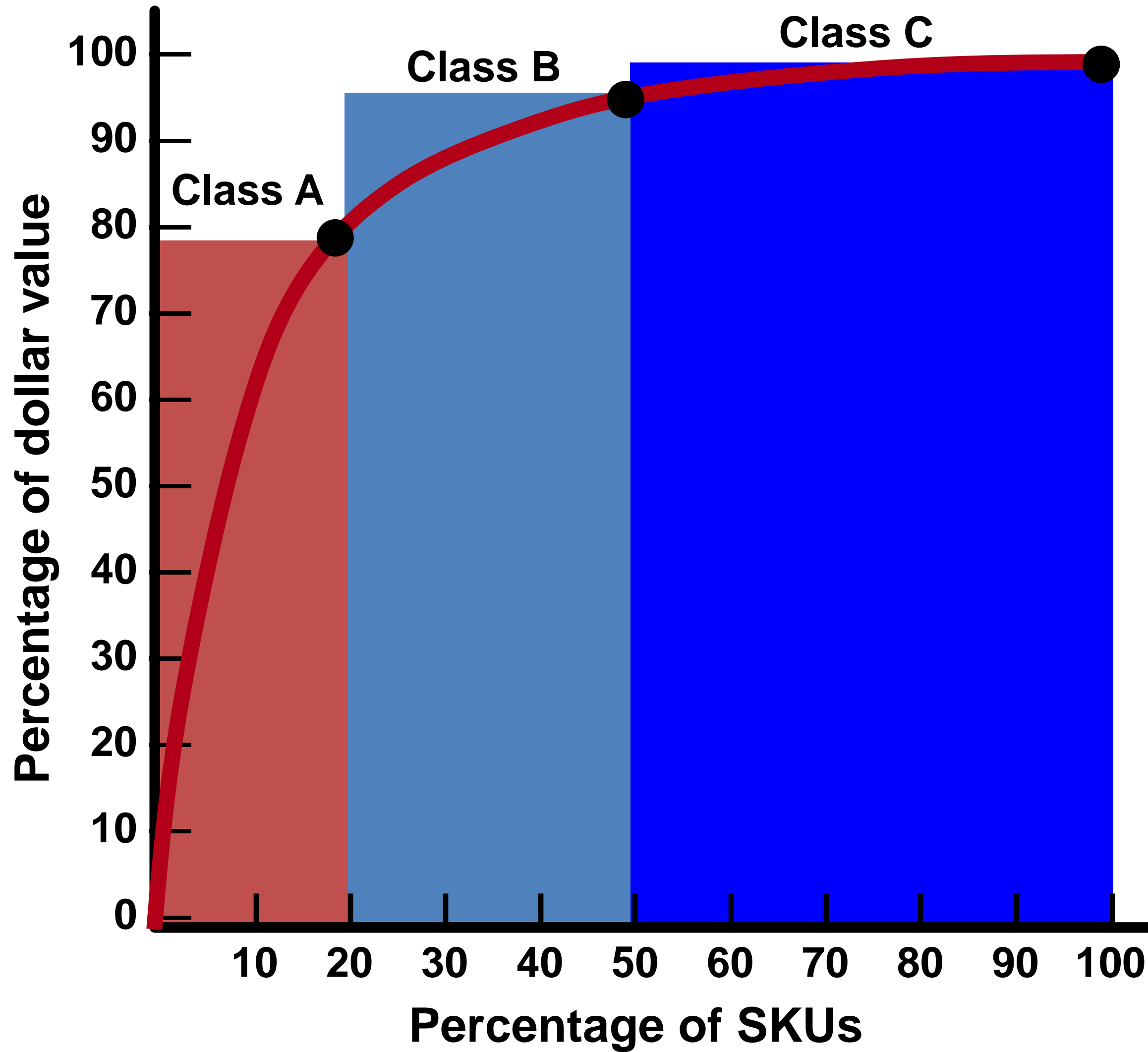
Type of Inventory



ABC Analysis

- Stock-keeping units (SKU)
- Identify the classes so management can control inventory levels
- A *Pareto chart*

ABC Analysis



Inventory Cost

- Holding costs - associated with holding or "carrying" inventory over time
- Ordering costs - associated with costs of placing order and receiving goods
- Setup costs - cost to prepare a machine or process for manufacturing an order
- Shortage cost

Factors Determining Cash Needs

Following factors are to be considered before determining the amount of cash requirements. 1]

Synchronization of cash flows

2Consideration of short costs

3Position of accounts receivables 4] Operating and cash

cycle

5] Control of cash disbursements 6] Nature of Product /

Business

7] Management's attitude towards procurement

9] Availability of other sources of funds

Advantages of Adequate Cash

When a firm manages to keep adequate cash balance, following benefits obtained.

1Higher Productivity and Liquidity

2Firm can avail cash as well as trade discounts

3It helps to improves credit worthiness, good will 4] It provides regular flows of cash

5] Firm can enjoy new business opportunities 6] It helps to overcome short term crises

7] It creates good confidence among the investors 8] It ensure timely procurement of raw material

Issues in Cash Management

The main aim of cash management is to match the inflow and outflow of cash. It is very essential for a business to maintain adequate cash balance. Many times a concern operates profitability and yet finding it difficult to predict cash flows accurately.

Cash management is important since it is very difficult to correct prediction of cash flows. To gain control on company's cash flows, a firm or finance manager should develop some strategies for cash management with the help of following points.

1. Cash Planning 2. Managing Cash flows

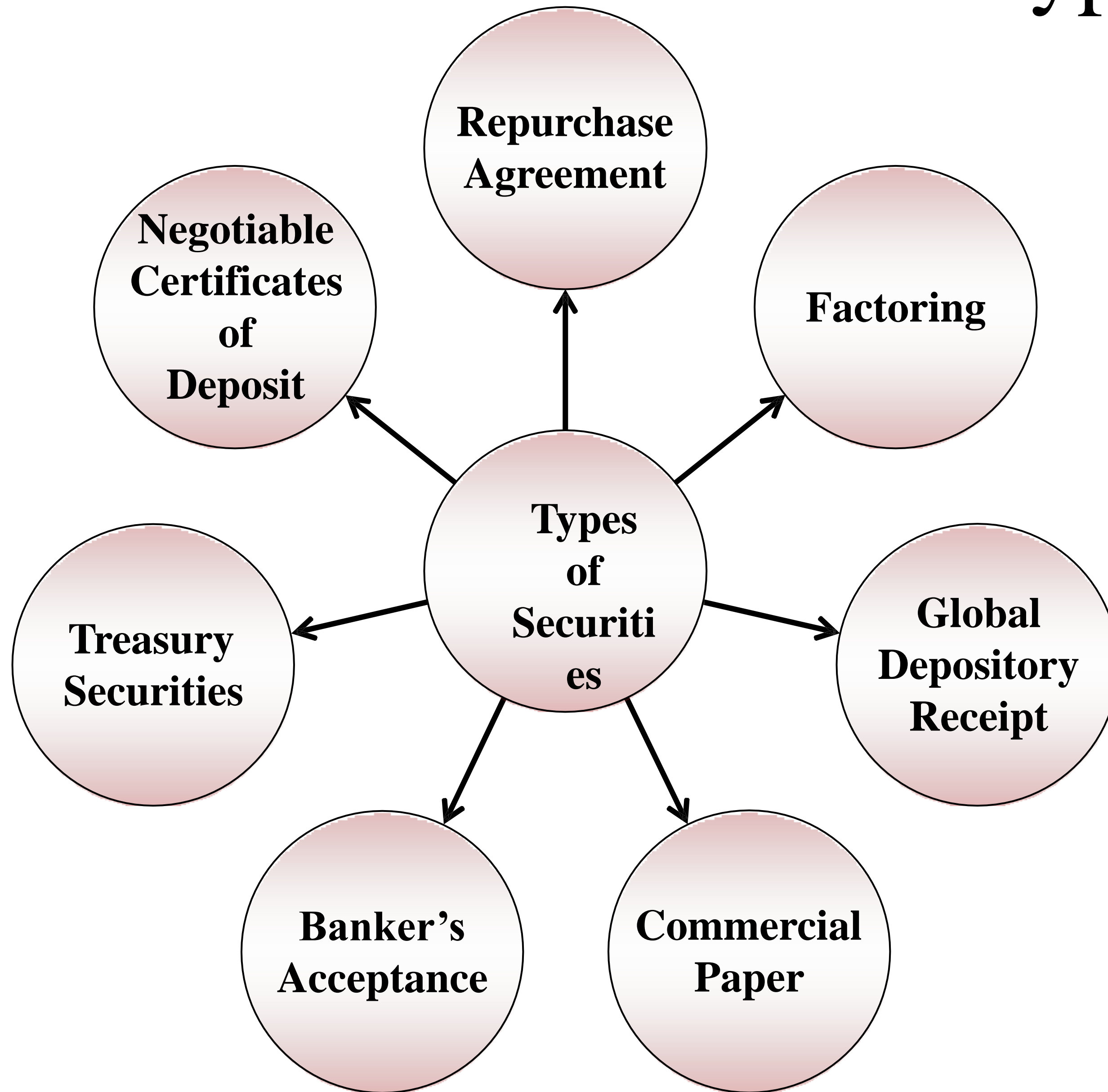
3. Optimum Cash level 4. Investing Idle Cash

Avoiding Cash Deficit or Cash Insolvency

While managing cash flows, if company gets in to position from where it is difficult to meet its operating expenses, following stapes should be taken;

1. Utilise unavailed credit limits.
2. Sell marketable securities
3. Accelerates collection from debtors
4. Negotiates for short term loans from banks
5. Sell redundant assets
6. Accounts receivables may be discounted with banks
7. Put control over expenditures
8. Defer payments may be extent to the possible

Marketable Securities and its Types



Functions of Cash Management

Following are the basic functions of Cash Management;

1. Controlling inflow of cash or sources of cash
   - (a) Accelerating Collection
   - (b) Concentration Banking
   - (c) Lock-box System
   - (d) Efficient Inventory Production Management
2. Control Over Cash Outflow or Application of Cash
   - (a) Efficient System of Cash Disbursement
   - (b) Billing Float
   - (c) Mail Float
   - (d) Check Processing Float
   - (e) Bank Processing Float
3. Optimum Investment of Surplus Cash
4. Controlling Level of Cash
   - (a) Preparing Cash of Cash
   - (b) Providing unpredictable discrepancies
   - (c) Consideration of Short Cost
   - (d) Exploring other sources of finance.

Cash Management models

It may be necessary for a cash management to know what should be the optimum cash balance must be maintain. There are number of cash management models developed to determine the optimum level of cash balances. Below mentioned are two important cash models;

1William J. Baumol Model

2Merton Miller and Daniel Orr Model

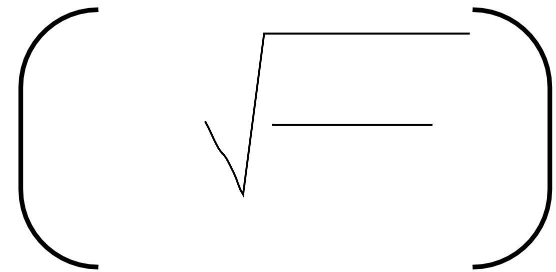
We shall look each one of them in brief.

Cash Management models

1] William J. Baumol Model: This model is based on combination of inventory theory with monetary theory. To determine optimum level of cash balance for company, Economic Order Quantity Model is used in the standard inventory situations. According to this model, the optimum cash level is that level, where the carrying cost and transaction cost are the minimum. Symbolically this method can be presented as below;

2 UP

C = S



Where,

C = Optimum Cash Balance

U = Annual (monthly) Cash disbursement P = Fixed Cost Per Transaction

S = Opportunity Cost of one Re. p.a.

Cash Management models

2] Merton Miller and Daniel Orr Model: The main objective of this model is to maximize earning by investing in securities. Symbolically it is presented as below;

$$\left(Z = \sqrt{\frac{3\, b\, \sigma^2}{4i}} \right)$$

Where,

b = Fixed Cost Associated with Security Transactions

σ = Variance of Daily net Cash Flows

i = Interest Rate per day on Securities

DIVIDEND POLICIES

- Dividends refer to that portion of a firm’s net earnings which are paid out to the shareholders
- Since dividends are distributed out of the profits, alternative to the payment of dividends is the retention of the earnings/profits
- The retained earnings constitute an easily accessible important source of financing the investment requirement of the firm.
- There is, thus a type of inverse relationship between retained earnings and cash dividends i.e. larger retentions, lesser dividends and vice versa
- Dividends decision is a major corporate decision in the sense that the firm has to chose between distributing the profits to the shareholders and ploughing them back into the business and the choice depends on the effect of the decision on the firm’s value.

PAY-OUT RATIO

- It refers to the percentage of net income to be paid out as cash dividend.
- It should be based in large part on investors preferences for dividends vs capital gains i.e. do investors prefer

a. To have the firm distribute income as cash dividends
b. To have it either repurchase stock or else plough the earnings back into the business, both of which should result in capital gains

PAY-OUT RATIO

- Recall the constant growth stock valuation model
- $P_0 = D_1/K_s - g$
- If the company increases the pay-out ratio this raises D1 which would cause the stock price to rise
- If D1 is raised, then less funds will be available for growth therefore g will decline, thus the stock price also declines
- Therefore dividends policy have two opposing effects.
- Optimal dividend policy is that policy which strikes a balance between current dividends and future growth and maximizes the firm's stock price

DIVIDEND THEORIES

- **DIVIDEND IRRELEVANCE THEORY**
- This is the theory that a firm's policy has no effect in either its value or its cost of capital
- MM argued that a firm's value is determined only by its basic earnings power and its business risk
- They argued that the value of the firm depends only on its income produced by its assets not on how this income is split between dividends and retained earnings

DIVIDEND IRRELEVANCE THEORY

- MM noted that any shareholder can in theory construct his/her own dividend policy.
- If a firm does not pay dividends a shareholder who wants a 5% dividend can create it by selling 5% of his/her stock or
- If a company pays a higher dividend than an investor desires , the investor can use the unwanted dividends to buy additional shares of the company’s stock.
- Therefore investors could buy and sell shares, they can create their own dividend policy without incurring cost, the firm’s policy would therfore be irrelevant

DIVIDEND POLICIES

- STABLE DIVIDEND POLICY
- This is where the dividend growth rate is predictable
- The shareholders can also be certain that the current dividend will not be reduced.
- It may not grow at a stable rate but management will probably be able to avoid reducing the dividend

DIVIDEND POLICIES

- RESIDUAL DIVIDEND MODEL
- Dividend paid is equal to net income minus the amount of retained earnings necessary to finance the firm's optimal capital budget

1. The determines the optimal budget
2. Determines the amount of equity needed to finance that budget given its target capital structure
3. It uses retained earnings to meet equity requirements to the extent possible
4. It pays dividends only if more earnings are available than are needed

FACTORS AFFECTING DIVIDEND POLICY

- They may be grouped into four broad categories:

1. Constraints on dividends
2. Investment opportunities
3. Availability and cost of alternative sources of capital
4. Effects of dividend policy on cost of capital

4. EFFECTS OF DIVIDEND POLICY ON COST OF CAPITAL

- It may be considered in terms of four factors

1. Shareholders desire for current versus future income
2. Perceived riskiness of dividends versus capital gains
3. The tax advantage of capital gains over dividends
4. The information content of dividends

- The important of each factor in terms of its effect on cost of capital varies from firm to firm depending on the make-up of its current and possible future stockholders