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UNIT – 5 INVENTORY MANAGEMENT

**MEANING OF INVENTORY:** The inventory means and includes the goods and services being sold by the firm and the raw material or other components being used in the manufacturing of such goods and services. A retail shopkeeper keeps an inventory of finished goods to be offered to customers whenever demanded by them. The term inventory refers to stock of goods kept for sale by the firm. In case of trading concers, it only includes only finished goods. However, in case of manufacturing concerns, inventory may include:

1. **Inventory** **of** **raw** **materials**: The raw material include the materials which are used in the production process and every manufacturing firm has to carry certain stock of raw materials in stores. These units of raw material regularly issued or transferred to production department. The amount of raw materials to be kept by a firm depends on a number of factors, including the speed with which raw material can be ordered and procured and the uncertainity in the supply of these raw material.
2. **Inventory** **of** **work**- **in**- **progress** (semi-finished goods): It refers to the raw material engaged in various phases of production schedule. The degree of completion may be vary from different units. The work-in-progress refers to patially produced goods. The value of work-in-progress includes the raw material costs, the direct wages, and expenses already incurred and the overheads, if any. The quantity and the value of work-in-progress depends on the length of production cycle. In case of shorter production cycle, the work-in-progress may be small but if the production cycle is lengthy, the firm will be having a large work-in-progress.
3. **Inventory** **of** **finished** **goods**: These are the goods which are either being purchased by the firm or are being produced or processed in the firm. These are just ready for sale to customers. Inventories of finished goods arise because of the time involved in production process and the need to meet customer’s demand promptly. If the firms do not maintain a sufficient finished goods inventory, they run the risk of losing sales, as the customers who are unwilling to wait may turn to competitors. The purpose of finished goods inventory is to uncouple the production and sales function so that it is not necessary to produce the goods before a sales can occur and therefore sales can be made directly out of inventory.

**MOTIVES OF HOLDING INVENTORY**

Business firms keep inventories for different purposes. Every firm, big or small, trading or manufacturing has to maintain some minimum level of inventories. There are different motives of holding or maintaining inventories, and these are as follows:

1. **TRANSACTIONARY MOTIVE :** Every business has to maintain some level of inventoryto meet the day to day requirementsof sales, production process, customer demand etc. this motive makes the firm to keep the inventory of finished goods as well as raw materials. The inventory level will provide a smoothness to the operations of the firm. A business firm exists for business transactions which require stock of goods and raw materials.
2. **PRECAUTIONARY MOTIVE :** A firm should keep some inventories for unforeseen circumstances also. For example, the fresh supply of raw material may not reach the factory due to strike by the transporters or due to natural calamities in a particular area. There may be labour problems in the factory and the production process may halt. So, the firm must have inventories of raw materials as well as finished goods for meeting such emergencies.
3. **SPECULATIVE MOTIVE :** The firm may be tempted to keep some inventory in order to capitalize an opportunity to make profit e.g, sufficient level of inventory may help the firm to earn profit in case of expected shortage in the market.

**BENEFITS OR REASONS OF HOLDING INVENTORIES**

1. **TIMING OF DEMAND AND SUPPLY :** Need to hold inventory of raw material arises because it is not possible for a firm to procure raw material whenever it is needed. If the firm is assured of supply of raw material without delay, at the rate it is used in it’s manufacturing process, it is need not to hold stock of raw materials. But in actual practice, there is a time lag between demand of raw material in manufacturing process and its supply due to the factors like strike, transport disruption, short supply etc. therefore, the firm should maintain adequate inventory.
2. **QUANTITY DISCOUNTS:**  Raw materials are required as and when production process is run. But instead of procuring raw materials in small quantities at the time of each production run, firm may purchase large quantities of raw material in advance to obtain ‘ quantity discounts’ of bulk purchasing. This results in a significant saving in cost.
3. **ANTICIPATION OF PRICE RISE:** Anticipation of price rise may also necessitate purchasing and holding of raw material inventories.
4. **REDUCING ORDERING COSTS:** These costs include the cost of preparing purchase orders, transporting orders, receiving costs, inspecting costs etc. these costs increase in proportion to number of orders placed. This also results in accumulation of raw material inventory.

**OBJETIVES OF INVENTORY MANAGEMENT**

Inventory of finished goods should be maintained at sufficient high level so that demand of customers may be fully satisfied. Similarly, inventory of raw material should also be sufficient so that manufacturing process can be run smoothly. In case of inadequate inventory of finished goods, there is always a risk of being out-of-stock and in case of inadequate inventory of raw materials, there is always a risk of manufacturing process being halted. Therefore, the major responsibility of inventory management is to determine the sufficient level of inventory required in the business.

On the other hand, since inventory is a major assets and it involves a lot of funds, inventory level should not be excessive. Excessive inventory increases costs because extra funds are involved in it. Therefore, inventory management also tries to minimise the sufficient level of inventory.

Thus, both excessive and inadequate quantity of inventory is undesirable in the business. Therefore, the term inventory management includes two conflicting tasks:

1. **To maintain a sufficient large size of inventory:**  To meet the demand of finished goods and to meet the demand of raw material by production department.
2. **To keep the investment in inventories at minimum level:** By efficiently organsing the purchase and swales department.

Accordingly, the detailed **objectives** **of** **inventory** **management** can be expressed as under :

1. To ensure a continuous supply of raw material to facilitate uninterrupted productions.
2. To maintain sufficient inventory of raw materials in periods of short supply.
3. To maintain sufficient inventory of finished goods so that demands of customers are duly met.
4. To minimise the carrying costs of inventory namely cost of godown, insurance expenses, cost of funds involved in inventory.
5. To control investment in inventory and keep it at an optimum level.

**RISK AND COST OF EXCESSIVE INVENTORY**

1. **Excessive carrying cost:** The carrying costs such as storage costs, holding cash, insurance expenses etc. also increase in proportion of inventory. Excessive inventory results in unnecessary tie-up of the firm’s fund and loss of profit due to high carrying cost.
2. **Risk of loss of liquidity:** Excessive inventory also increases risk of losse of liquidity. If excessive funds are invested in inventories, it may not be able to sell inventories at full value whenever funds are required.
3. **Risk of price decline:** The price decline in the market may cause finished goods to be sold at low prices. In case of excess inventory, the risk of loss due to price decline is more.
4. **Risk of deterioration of goods :** Normally, there is always deterioration of some goods with the passage of time and due to improper storage facilities. Risk of deterioration of goods is more in case of excessive inventory because inventory remains in stores for longer period.
5. **Risk of obsolescene:** Goods may become obsolete due to change in technique, change in design, change in consumer’s choice etc. obsolete goods have to be sold at lower price. Risk of loss due to obsolescence is more in case of excessive inventory.

**RISK OF INADEQUATE INVENTORY**

1. **Risk of break-down in manufacturing process:** In case of inadequate inventory of raw material, there is always a risk of break-down in manufacturing process due to lack of raw material supply. Therefore, the firm will not be able to utilise its anufacturing capacity in full. It also increases cost of manufacturing per unit because fixed cost of manufacturing do not reduce even if there are frequent interruptions in production.
2. **Risk of not meeting demand of customers:** in case of inadequate inventory of finished goods, demand of customers may not be met and they may shift to competitors. It will result in permanent loss to firm.