

DEF Co is a European company that sells goods solely within Europe. The recently-appointed financial manager of DEF Co has been investigating the working capital of the company and has gathered the following information:

Inventory Management

The current policy is to order 400,000 units when the inventory level falls to 140,000 units. Forecast demand to meet production requirements during the next year is 2,500,000 units. The cost of placing and processing an order is €1000 while the cost of holding a unit in stores is €1.00 per unit per year. Both costs are expected to be constant during the next year. Orders are received two weeks after being placed with the supplier. You should assume a 50-week year and that demand is constant throughout the year.

Accounts Receivable Management

Domestic customers are allowed 30 days' credit, but the financial statements of DEF Co show that the average accounts receivable period in the last financial year was 58 days. The financial manager also noted that bad debts as a percentage of sales, which are all on credit, increased in the last financial year from 4% to 7%.

Required

- (a) Identify the objectives of working capital management and discuss the conflict that may arise between them.
- (b) Calculate the cost of the current ordering policy and determine the saving that could be made using the economic order quantity model.
- (c) Discuss ways in which DEF Co could improve the management of domestic accounts receivable.

DEF

(a)

- DISCUSS MEANING OF TERM WORKING CAPITAL
- CONFLICT BETWEEN OBJECTIVES OF PROFITABILITY + LIQUIDITY

(AS PER CH3 OF OPEN TUTOR)

(B)

$$EOQ = \sqrt{\frac{2C_o D}{C_H}}$$

$$= \sqrt{\frac{2 \times 1000 \times 2500000}{1}}$$

$$= 70711 \text{ units}$$

$$\therefore \text{No of Orders} = \frac{2500000}{70711} = \underline{\underline{35.35}}$$

Current :

$$\frac{2500000}{400000}$$

$$\text{Ordering Cost} = 6.25 \times 1000 = 6250$$

$$\text{Holding Cost} = \frac{400000}{2} \times 1 = 200,000$$
$$\underline{\underline{206250}}$$

At EOQ :

$$\text{Ordering Cost} = 35.35 \times 1000 = 35350$$

$$\text{Holding Cost} = \frac{70711}{2} \times 1 = 35356$$

$$\underline{\underline{170706}}$$

$$\therefore \text{SAVING OF } 8351844$$

(c)

- EVALUATE PRICING STRATEGY
- CONSIDER DISCOUNTS FOR PROMPT PAYMENT
- INTEREST CHARGED FOR LATE PAYMENT
- CONSIDER COMPETITORS' COLLECTION PERIOD + PRICING STRATEGIES
- CREDIT RATING CHECKS FOR NEW CUSTOMERS
- REGULAR MONITORING OF CREDIT LIMITS
- IMPROVE EFFICIENCIES IN CREDIT CONTROL DEPARTMENT