



# RAMA UNIVERSITY

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**FACULTY OF COMMERCE AND MANAGEMENT**

**COURSE: MBA III SEM..**

**SUBJECT: WORKING CAPITAL MANAGEMENT**

**SUBJECT CODE: MBAFM01**

**LECTURE: 19**

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## LECTURE-19



## **COST OF HOLDING INVENTORY:**

It has been highlighted above that the object of inventory management is to maintain the optimum level of inventory.

**This optimum level depends on the following costs:**

- (i) Ordering/Acquisition/Set-up Costs, and
- (ii) Carrying Costs.

**(i) Ordering/Acquisition/Set-up Costs:**

These are the variable costs of placing an order for the goods. Orders are placed by the firm with suppliers to replenish inventory of raw materials. Ordering costs include the cost of requesting, purchasing, ordering, transporting, receiving, inspecting and storing. The ordinary costs vary in proportion to the number of orders placed.

They also include clerical costs and stationery costs (That is why it is called a set-up cost). Although, these costs are almost fixed in nature, the larger the order placed, or the more frequent the acquisition of inventory made, the higher are such costs. Similarly, the fewer the orders, the lower the order cost will be for the firm. Thus, the ordering/acquisition costs are inversely related to the level of inventory.

**(ii) Carrying Cost:**

These are the expenses of storing goods, i.e., they are involved in carrying inventory.

**The cost of holding inventory may be divided into:**

- (i) Cost of Storing the Inventory and
- (ii) Opportunity Cost of Funds.

**(i) Cost of Storing the Inventory:**

**This Include:**

- (a) Storage Cost (i.e., tax, depreciation, insurance, maintenance of building etc.);
- (b) Insurance (for fire and theft);
- (c) Obsolescence and Spoilage;
- (d) Damage or Theft;
- (e) Serving Costs (i.e., clerical, accounting costs etc.).
- (f) Cost of running out of goods.

**(ii) Opportunity Cost of Funds:**

This includes the expenses in raising funds (i.e. Interest on Capital) which are used for financing the acquisition of inventory.

The level of inventory and the carrying costs are positively related and move in the same direction, i.e., if inventory level decreases, the carrying costs also decrease and vice-versa.