INTRODUCTION

- Trade credit happens when a firm sells its products or services on credit and does not receive cash immediately.
- **A credit sale has three characteristics:**
  - First, it involves an element of risk that should be carefully analyzed.
  - Second, it is based on economic value.
  - Third, it implies futurity.

Benefits of Credit sale

1. Increase in sales
2. Increase in profits
3. Extra profits

Cost of receivables

1. Cost of financing
2. Administrative costs (maintaining records)
3. Delinquency costs (follow up)
4. Cost of default by customers (bad debts)

Determinants of Receivables

1. Percentage of credit sales to total sales
2. Nature of business and conventions of trade
3. Level of sales
4. Credit and collection policies
5. Quality of customers

Scope of Receivables Management

1. Credit Policy
2. Credit Evaluation
3. Credit Control

Credit Policy

Defined as the set of parameters and principles that govern the extension of credit to the customers.

It includes determination of

i) Credit standards (selecting customers)

ii) Credit terms: Credit Period, Discount Terms and Annual percentage of Cash discounts

Annualised Financing Cost

= (% discount / 100 - % discount) X

(365/ credit period – discount period) X 100

Annualised Financing Cost

ABC Ltd. is offering a cash discount under the term 3/15, 2/30 net 50. In order to reduce the average collection period, it has 2 alternative policies before it.

i) 3.5/12, 2/30 net 50

ii) 3/15, 2.5/25 net 50

Evaluate the alternatives.

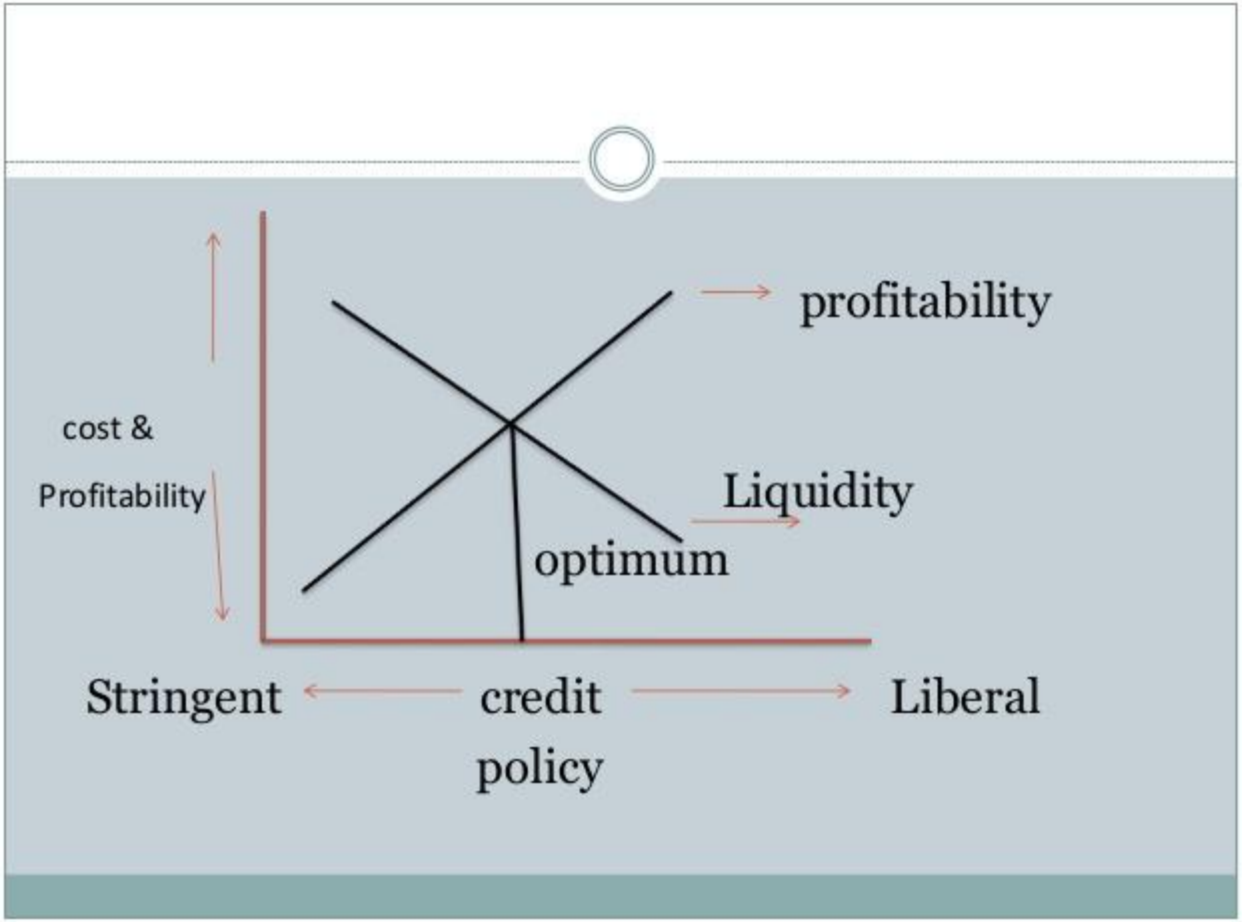
Goals of Credit Policy

- **Marketing tool**
- **Maximisation of sales**
- **Maximisation of incremental profit**

Optimum Credit Policy

Trade-off between

i) sales and costs
ii) Profitability and liquidity



CREDIT EVALUATION OF INDIVIDUAL ACCOUNTS

- Factors of Creditworthiness

1) Willingness and practice of the customer to honor his obligations
2) ability to pay
3) Collateral

Steps in evaluation of creditworthiness

1) Collection of information
2) Analysis of information

Collection of Information

1. Bank reference
2. Credit Agency report (not a common practice in India)
3. Published financial statements
4. Credit scoring (objective assessment of each customer)

Credit Control

1. **The collection procedures (to speed up the slow paying customer and reduce bad debts)**
2. **Monitoring of receivables**
3. **Lines of credit**
4. **Accounting ratios**

Evaluation of Credit Policies

i) Total profit Approach

ii) Incremental profit approach