Receivables Management
Part I

Introduction

- The credit policy also known as receivables policy is an important aspect of overall financial management.

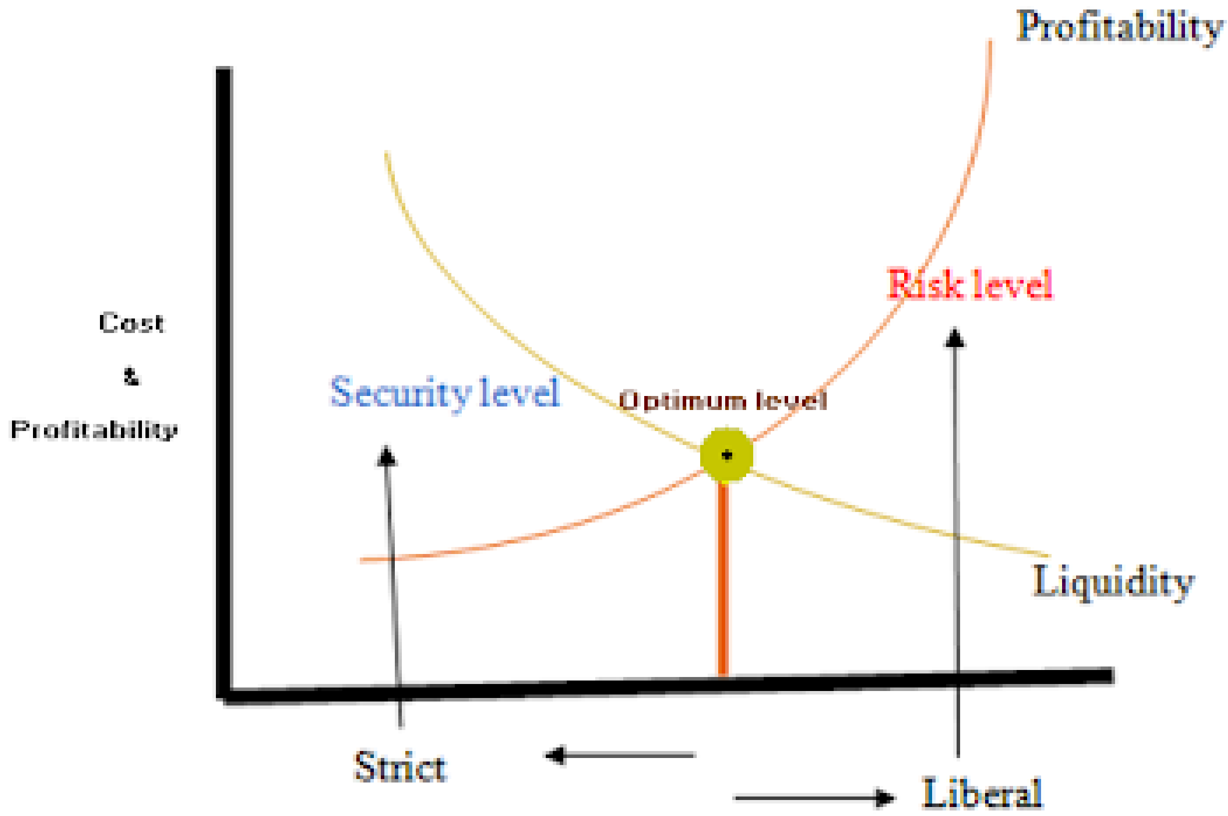
- The basic objective of credit management is to manage the receivables in such a way that sales are expanded to an extent to which risk remains within an acceptable limit.

- The management of accounts receivable is primarily concerned with the trade-off between the profit from increased sales generated by credit policies and the costs of such policies.

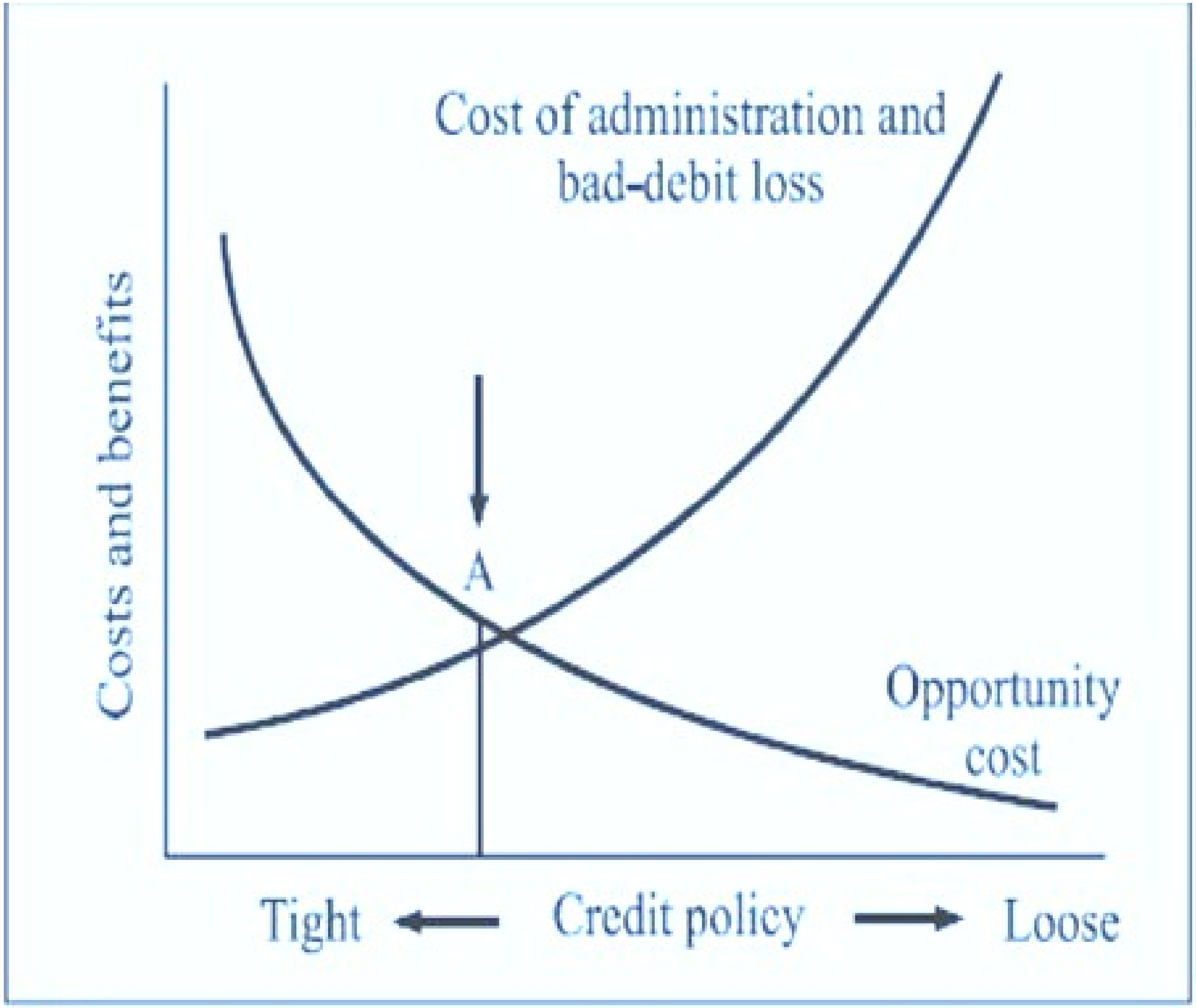
- The cost of receivables includes interest on investment in trade debtors, accounting charges in maintaining their accounts, collection charges and bad debts.

- The decision should be taken on the basis of incremental cost and incremental rise in the profitability.

Optimum level of credit



Cost behaviour



Credit Policy

- Credit standards
- Credit period
- Cash discount
- Collection effort
- A credit policy may be strict, liberal and intermediate.

Credit standards

- What rules and conditions or standard should be applied in accepting or rejecting a business partner for credit granting?
- Credit standards are like – level of credit rating, turnover, presence in the market, cash and bank balances, etc.

An illustration

- The ABC Ltd. is planning to relax its credit standards. As a result of this new credit policy, the company is expecting to an increase in sales by Rs. 10 lakh on which bad debt losses would be 10 per cent. The variable cost is 80 percent of sales. The average collection period is 30 days and the post-tax cost of capital is 10 per cent. The tax rate is 40 per cent. Should the company relax its credit norms?

Solution

S.n.	Particulars	Amount (Rs.)
1	Increase in sales	1000000
2	Less: Variable cost	800000
3	Less: Bad Debt losses	100000
4	Before tax surplus [1-(2+3)]	100000
5	Tax (4*tax rate)	40000
6	Post tax surplus (4-5)	60000
7	Less: Cost of funds (Investment) [(Sales/360)*average collection period*variable cost share*cost of capital] [(1000000/360)*30*0.80*0.10)]	6666.67
8	**Incremental gain/loss (6-7)**	**53333.33**

Credit Period

- Generally credit period ranges from 15 to 60 days.
- Higher the credit period, more is the expected sales but also higher would be the bad debt risks, administrative cost and opportunity cost.
- Shorter the credit period, the expected sales increase would not be much but also lower would be the bad debt risks, administrative cost and opportunity cost.

Additional cost of funds

$$\Delta I = (ACP_n - ACP_0)\left[\frac{S_0}{360}\right] + (V \times ACP_n)\left[\frac{\Delta S}{360}\right]$$

The NKM ltd provides 25 days of credit to its customers. Its present level of sales is Rs. 1000000. The firm's cost of capital is 10 percent and the share of variable costs to sales is 75%. The company is considering to extend its credit period to 50 days. Such an extension is likely to push sales up by Rs. 4 lakh. The expected bad debt on additional sales would be 8 percent. The tax rate is 30 percent.

Solution

S.n.	Particulars	Amount (Rs.)
1	Increase in sales	400000
2	Less: Variable cost (75%)	300000
3	Less: Bad Debt losses	32000
4	Before tax surplus [1-(2+3)]	68000
5	Less: Tax (4*tax rate)	20400
6	Post tax surplus (4-5)	47600
7	Less: cost of funds (investment) =[(50-25) * (1000000/360)) + (0.75*50*(400000/360)] *0.10	73611.11
8	**Incremental gains/loss (6-7)**	**-26011.11**

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