

## UNIT - V

### MANAGEMENT OF PAYABLES (CREDITORS)



#### 23. INTRODUCTION

There is an old age saying in business that if you can buy well then you can sell well. Management of your creditors and suppliers is just as important as the management of your debtors.

Trade creditor is a spontaneous / short term source of finance in the sense that it arises from ordinary business transaction. But it is also important to look after your creditors - slow payment by you may create ill-feeling and your supplies could be disrupted and also create a bad image for your company.

Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.



#### 24. COST AND BENEFITS OF TRADE CREDIT

##### (a) Cost of Availing Trade Credit

Normally it is considered that the trade credit does not carry any cost. However, it carries the following costs:

- (i) **Price:** There is often a discount on the price that the firm undergoes when it uses trade credit, since it can take advantage of the discount only if it pays immediately. This discount can translate into a high implicit cost.
- (ii) **Loss of goodwill:** If the credit is overstepped, suppliers may discriminate against delinquent customers if supplies become short. As with the effect of any loss of goodwill, it depends very much on the relative market strengths of the parties involved.
- (iii) **Cost of managing:** Management of creditors involves administrative and accounting costs that would otherwise be incurred.
- (iv) **Conditions:** Sometimes most of the suppliers insist that for availing the credit facility the order should be of some minimum size or even on regular basis.

### (b) Cost of Not Taking Trade Credit

On the other hand, the costs of not availing credit facilities are as under:

- (i) **Impact of Inflation:** If inflation persists then the borrowers are favored over the lenders as they were better off to pay the fixed outstanding amount later than sooner. Also, the subsequent transactions shall be at higher prices.
- (ii) **Interest:** Trade credit is a type of interest free loan, therefore failure to avail this facility has an interest cost. This cost is further increased if interest rates are higher.
- (iii) **Inconvenience:** Sometimes it may also cause inconvenience to the supplier if the supplier is geared to the deferred payment.



## 25. COMPUTATION OF COST OF PAYABLES

By using the trade credit judiciously, a firm can reduce the effect of growth or burden on investments in Working Capital.

Now question arises how to calculate the cost of not taking the discount.

The following equation can be used to calculate nominal cost, on an annual basis of not taking the discount:

$$\frac{d}{100-d} \times \frac{365}{t}$$

However, the above formula does not take into account the compounding effect and therefore, the cost of credit shall be even higher. The cost of lost cash discount can be estimated by the formula:

$$\left( \frac{100}{100-d} \right)^{\frac{365}{t}} - 1$$

Where,

$d$  = Size of discount i.e. for 6% discount,  $d = 6$

$t$  = The reduction in the payment period in days, necessary to obtain the early discount or Days Credit Outstanding – Discount Period.

**ILLUSTRATION 20**

Suppose ABC Ltd. has been offered credit terms from its major supplier of 2/10, net 45. Hence the company has the choice of paying ₹ 10 per ₹ 100 or to invest ₹ 98 for an additional 35 days and eventually pay the supplier ₹ 100 per ₹ 100. The decision as to whether the discount should be accepted depends on the opportunity cost of investing ₹ 98 for 35 days. ANALYSE what should the company do?

**SOLUTION**

If the company does not avail the cash discount and pays the amount after 45 days, the implied cost of interest per annum would be approximately:

$$\left( \frac{100}{100 - 2} \right)^{\frac{365}{35}} - 1 = 23.5\%$$

Now let us assume that ABC Ltd. can invest the additional cash and can obtain an annual return of 25% and if the amount of invoice is ₹ 10,000. The alternatives are as follows:

	<b>Refuse discount</b>	<b>Accept discount</b>
	₹	₹
Payment to supplier	10,000	9,800
Return from investing ₹ 9,800 between day 10 and day 45: $\frac{35}{365} \times ₹ 9,800 \times 25\%$	(235)	
Net Cost	9,765	9,800

**Advise:** Thus, it is better for the company to refuse the discount, as return on cash retained is more than the saving on account of discount.

**ILLUSTRATION 21**

The Dolce Company purchases raw materials on terms of 2/10, net 30. A review of the company's records by the owner, Mr. Gautam, revealed that payments are usually made 15 days after purchases are made. When asked why the firm did not take advantage of its discounts, the accountant, Mr. Rohit, replied that it cost only 2 per cent for these funds, whereas a bank loan would cost the company 12 per cent.

- (a) ANALYSE what mistake is Rohit making?
- (b) If the firm could not borrow from the bank and was forced to resort to the use of trade credit funds, what suggestion might be made to Rohit that would reduce the annual interest cost? IDENTIFY.

**SOLUTION**

- (a) Rohit's argument of comparing 2% discount with 12% bank loan rate is not rational as 2% discount can be earned by making payment 5 days in advance i.e. within 10 days rather 15 days as payments are made presently. Whereas 12% bank loan rate is for a year.

Assume that the purchase value is ₹100, the discount can be earned by making payment within 10 days is ₹2, therefore, net payment would be ₹98 only. Annualized benefit

$$= \frac{₹2}{₹98} \times \frac{365 \text{ days}}{5 \text{ days}} \times 100 = 149\%$$

This means cost of not taking cash discount is 149%.

- (b) If the bank loan facility could not be available, then in this case the company should resort to utilise maximum credit period as possible.

Therefore, payment should be made in 30 days to reduce the interest cost.