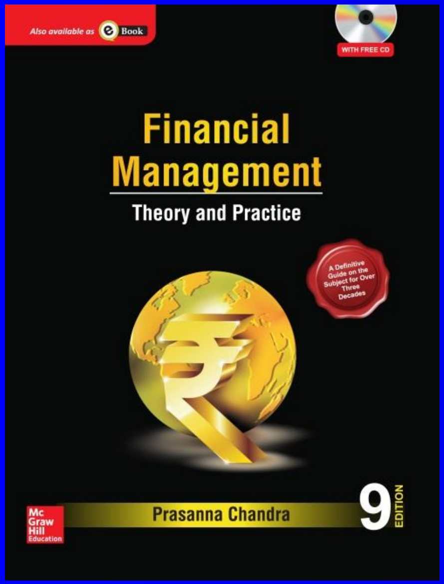

Chapter 25

CREDIT MANAGEMENT

- Meaning of receivables management
- Features of receivables management
- Objectives of receivables management
- Important dimensions of credit policy of a firm
- Obstacles for a standard policy of receivables management
- How to achieve optimum receivables standard

Features of Receivable Management:

1. Sundry Debtors and Bills Receivable
2. Credit Sale
3. Receivables
4. Credit period
5. Sale payment cycle
6. Investment in Accounts Receivable
7. Risk
8. Credit policy
9. Costs like collection cost, capital cost, delinquency cost, default cost.
10. Cost – benefit trade off

Objectives of Receivables Management:

1. Creating, presenting and collecting accounts receivables.
2. In order to establish and communicate the credit policies.
3. For evaluation of customers and setting credit limits.
4. In order to ensure prompt and accurate billing.
5. To maintain up-to –date record of accounts receivables.
6. To initiate collection procedures on overdue accounts.

CREDIT POLICY VARIABLES

The important dimensions of a firm's credit policy are:

- Credit standards
- Credit period
- Cash discount
- Collection effort

CREDIT STANDARDS

	Liberal	Stringent
• Sales	Higher	Lower
• Bad debt loss	Higher	Lower
• Investment in receivables	Larger	Smaller
• Collection costs	Higher	Lower

CREDIT PERIOD

	Longer	Shorter
• Sales	Higher	Lower
• Investment in receivables	Larger	Smaller
• Bad debts	Higher	Lower

Exercise

- Shri Krishna Ltd has current sales of ₹ 20,00,000. The firm is planning to introduce a cash discount policy of 2/10, net 30. As a result, the firm expects the average collection period to go down by 10 days and 75% of the customers opt for the cash discount facility. If the firm's required return on investment in receivable is 12% should it introduce the new discount policy? (Assume 365 days in a year)

Soln.

- Account receivable before cash discount= 2000000*30/365=164384
- Account receivable after cash discount= 2000000*20/365=109589
- Decrease in accounts receivable investment =164384-109589=54795
- Return on decreased investment in receivable =12%*54795=6576
- Discount at 2% used by 75% of sales=2000000*0.75*0.02= 30000
- As the loss due to new policy is ₹ 30000 is more than the return on receivable investment is ₹ 6576, the new policy should not be accepted.

Q. 2

- Cool Ltd is making sales of ₹ 1600000 and it extends a credit of 90 days to its customers. However in order to overcome the financial difficulties, it is considering to change the credit policy. The proposed terms of credit and expected sales are given below

Policy	Terms	Sales
A	45 days	1536000
B	60 days	1560000

- The Cool Ltd has a variable cost of 70% and fixed cost of ₹ 150000.The cost of capital is 10%.Evaluate different proposed policies and which policy should be adopted?(Assume 365 days in a year)

Soln.

- **Evaluation of Credit Period:**

Evaluation of Credit Period:			
Particulars	Present (90 days)	45 days	60 days
Sales (A)	1600000	1536000	1560000
Variable Cost (70%)	1120000	1075200	1092000
Fixed Cost	150000	150000	150000
Total Cost (B)	1270000	1225200	1242000
Profit (A-B)	330000	310800	318000
Average Receivable(at cost)			
(Total cost/365)*credit period	313151	151052	204164
Cost of receivable @ 10%	31315	15105	20416
Net profit	298685	295695	297584

Soln.

- It may be observed that the profit of the firm is going to reduce from the present level of ₹ 298685 to ₹ 295695 in case the policy of 45 days credit period is adopted and further to 297584 if 60 days credit period is adopted. **Hence, it is beneficial for the company to give 90 days credit to its customers.**

Q. 3

- XYZ Ltd has credit sales amounting to `32,00,000. The sale price per unit is `40, the variable cost is `25 per unit while the average cost per unit is `32. The average age of accounts receivable of the firm is 72 days.
- The firm is considering to tighten the credit standards. It will result in a fall in sales to `28,00,000, and the average age of accounts receivable to 45 days.
- Assume 20 per cent rate of return. Is the proposal under consideration feasible?

Soln. Q. 3

Incremental analysis (tightening credit standards or not)

	Present plan (*80,000* units)	*Proposed plan* (*70,000* units)	*Differential revenues and costs* (decrease)
Sales revenue	₹32,00,000	₹28,00,000	₹(4,00,000)
Less: variable costs @ ₹25 per unit	20,00,000	17,50,000	(2,50,000)
fixed costs	5,60,000	5,60,000	—
investment cost (working notes)	1,02,400	57,750	(44,650)
Savings (deficiency)	5,37,600	4,32,250	(1,05,350)

Recommendation: The firm should not adopt more strict credit collection policy, as it will decrease profits by ₹1,05,350.

Working Notes:

Investments in accounts receivable:

Present plan: = [(80,000 units × ₹25 (VC) + TFC (₹7 × 80,000)]/5 (360 days × 72 days) = ₹5,12,000

Proposed plan: [(70,000 units × ₹25) + ₹5,60,000]/8 (360 days × 45 days) = ₹2,88,750

Cost of investment:

Present plan : ₹5,12,000 × 0.20 = ₹1,02,400

Proposed plan : 2,88,750 × 0.20 = ₹57,750