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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: MBA III SEM..

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LECTURE: 37

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LECTURE-37

APPROACHES TO EVALUATION OF CREDIT POLICIES

There are basically two methods of evaluating the credit policies to be adopted by a Company – Total Approach and Incremental Approach. The formats for the two approaches are given as under:

Statement showing the Evaluation of Credit Policies (based on Total Approach)

Particulars	**Present Policy**	**Proposed Policy I**	**Proposed Policy II**	**Proposed Policy III**
	(`)	(`)	(`)	(`)
A. Expected Profit:				
(a) Credit Sales	………	…………	………..	………
(b)TotalCostotherthanBadDebts				
(i) Variable Costs	………	…………	………	………
(ii) Fixed Costs	………	…………	………	………
	………	………	………	……..
(c) Bad Debts	………	…………	………	………
(d) Cash discount				
(e)ExpectedNetProfitbeforeTax (a-b-c-d)	……..	………..	………	………
(f) Less: Tax	……..	………..	………	………
(g) Expected Profit after Tax	………	………	………	………
B. Opportunity Cost of Investments in Receivables locked up in Collection Period	…….	………	………	………
Net Benefits (A – B)	………	………	………	………

Advise: ThePolicy…….shouldbeadoptedsincethenetbenefitsunderthispolicyare higher as compared to other policies.

Here

(i) TotalFixedCost = [AverageCostperunit – VariableCostperunit] x No. ofunits soldoncreditunderPresentPolicy

(ii) OpportunityCost

$$= \text{Total Cost of Credit Sales} \times \frac{\text{Collectionperiod(Days)}}{365\,(\text{or }360)} \times \frac{\text{RequiredRateofReturn}}{100}$$

Statement showing the Evaluation of Credit Policies (based on Incremental Approach)

Particulars	Present Policy days	Proposed Policy I days	Proposed Policy II days	Proposed Policy III days
	(`)	(`)	(`)	(`)
A. Incremental Expected Profit:				
Credit Sales	………	…………	……….	………
(a) Incremental Credit Sales	.	.	……….	.
(b) *Less:* Incremental Costs of Credit Sales	………	…………		………
(i) Variable Costs	.	.		.
(ii) Fixed Costs			……….	
(c) Incremental Bad Debt Losses			……….	
(d) Incremental Cash Discount	………	…………	……….	………
(e) Incremental Expected Profit (a-b-c-d)	.	.	……….	.
	………	…………	……….	………
(f) *Less*: Tax	.	.		.
(g) Incremental Expected Profit after Tax	………	…………	……….	………
	.	.	……….	.
	………	…………		………
B. Required Return on Incremental Investments:	.	.		.
	………	…………		………
(a) Cost of Credit Sales	.	.		.
(b) Collection Period (in days)				
(c) Investment in Receivable (a x b/365 or 360)	………	…………		………
	.	.		.
(d) Incremental Investment in Receivables	………	…………		………
	.	.		.
(e) Required Rate of Return (in %) (f) Required Return on Incremental Investments (d x e)	………	………… .	……….	………
Incremental Net Benefits (A – B)				

Advise: The Policy ……….should be adopted since net benefits under this policy are higher as compared to other policies.

Here:

(i) Total Fixed Cost = [Average Cost per unit – Variable Cost per unit] x No. of units sold on credit under Present Policy

(ii) Opportunity Cost = Total Cost of Credit Sales x

$$\frac{\text{Collection period (Days)}}{365 \text{ (or 360)}} \times \frac{\text{Required Rate of Return}}{100}$$

ILLUSTRATION 15

A trader whose current sales are in the region of ` 6 lakhs per annum and an average collection period of 30 days wants to pursue a more liberal policy to improve sales. A study made by a management consultant reveals the following information:-

Credit Policy	Increase in collection period	Increase in sales	Present default anticipated
A	*10 days*	*` 30,000*	*1.5%*
B	*20 days*	*` 48,000*	*2%*
C	*30 days*	*` 75,000*	*3%*
D	*45 days*	*` 90,000*	*4%*

The selling price per unit is ` 3. Average cost per unit is ` 2.25 and variable costs per unit are ` 2. The current bad debt loss is 1%. Required return on additional investment is 20%. Assume a 360 days year.

Which of the above policies would you recommend for adoption?

SOLUTION

A. Statement showing the Evaluation of Debtors Policies (Total Approach)

Particulars		Present Policy 30 days	Proposed Policy A 40 days	Proposed Policy B 50 days	Proposed Policy C 60 days	Proposed Policy D 75 days
		(`)	(`)	(`)	(`)	(`)
A.	**Expected Profit:**					
	(a) Credit Sales	6,00,000	6,30,000	6,48,000	6,75,000	6,90,000
	(b) Total Cost other than Bad Debts					
	(i) Variable Costs [Sales x ` 2/` 3]	4,00,000	4,20,000	4,32,000	4,50,000	4,60,000
	(ii) Fixed Costs	50,000	50,000	50,000	50,000	50,000
		4,50,000	4,70,000	4,82,000	5,00,000	5,10,000