Topics to be covered:

- Evolution of credit policy
- Cash Discount Policy
- Factoring

Format

Sale
Variable _____
Contribution
Fixed Cost _____
Gross Profit
Bad Debts ( )
Collection Cost ( )

Opportunity Cost ( )

Extension of credit results in an increase in sales leading to increase in contribution

However it results in chances of Bad Debts, incurrence of Collection Cost and Opportunity Cost in terms of interest foregone.

Self Note: It is used only when credit sales are there
- we do not consider Cash Sales in it.

If Percentage of Bad Debts are given then we should always apply it on Credit Sales.

Formula for finding opportunity cost:

$$\text{Total Cost} \times \text{Interest Rate} \times \frac{\text{Credit Period}}{365/52/12}$$

↓

[Fixed cost + variable cost]

- If information relating to Fixed cost is not given then we will find out opportunity cost only on the Basis of variable cost.
- If information regarding Both [Fixed & variable] cost is not given then we'll consider opportunity cost on Sales Basis.

Other Formula's:

1) Sale value: Sale units/volume × SP/unit

2) Variable Cost:

Variable cost Percentage on Sale will always remain constant.

Variable Cost % + PV Ratio = 100%

Variable Cost per Unit will always Remain Constant

(Reason: As the Total variable cost also increases as per the same Rate of output units)

3) Fixed Cost:

Fixed Cost in Total will always remain constant.

Total Fixed Cost = (Total cost/unit − Variable cost/unit) × Current No. of Units

=> Payment by installment:

when customers made Payment in installments we made calculated adjustments

=> weighted average credit Period

example =	installments in	% of Payment	Days considered
	30 days	20%	6
	60 days	30%	18
	90 days	40%	36
	120 days	10%	12
			72

Formula will be

$$\text{opportunity cost} = \text{Total cost} \times \text{int Rate} \times \frac{72}{365}$$

Cash Discount Policy:

Company may offer cash discount in case of profit / payment by customer:

Payment terms → 3/45 net 180

this is how it will be mentioned in Ques

3/45 net 180 → 180 Days are normal Period of credit.

- 3 → Cash Discount
- 45 → an offer for first 45 days

If Payment made in 45 days then he will receive a 3% Cash Discount.

Format will be:

Sales	x
variable cost	(x)
contribution	x
Fixed cost	(x)
Gross Profit	x
Bad Debts	(x)
Collection Cost	(x)
opportunity cost	(x)
Cash Discount	(x)
	xx

This will be added in Format

Effect of Taxation:

Interest is a Pre-tax Nature of expense hence int rate should also be on pre-tax basis.

If interest rate is post tax basis, we will convert it into pre-tax as per following formula:

$$\frac{\text{Interest Rate} \rightarrow \text{(Post tax)}}{1 - \text{tax Rate}}$$

We can do such sums in two different ways where Post interest is present.

Case 1) where we should convert such Post interest Rate to Pre tax interest Rate then use it Normally.

Case 2) we can use the Post tax interest Rate after the Tax deduction.

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Factoring:

Factoring is the arrangement B/w the company (seller) & the Factor where company sells it's Debtors to the Factor against a consideration

Procedure of Factoring

1) Customer places an order to Company.

2) Company approaches Factor for credit report of the customer.

3) After proper Analysis & research factor will submit credit report along with rating to the company.

4) Company will sell goods on credit to customer.

5) Company will sell it's debtors to the factor in case of short-term requirement of fund.

6) Factor will pay the amount due from debtor after deducting fees, commission, Reserves & Interest

7) After expiry of credit period, customer will pay the amount due to the factor. Simultaneously factor will pay the amount of Reserves to the Company.

Amount Payable By factor		₹
Amount Due from Customer		@ xx
(-) Fees / Commission	(% of @)	(xx)
(-) Reserves	(% of @)	(xx)
		(b) xx
(-) Interest	(% of (b))	(xx)
Amount Payable by factor		xx

Effective Cost of Factoring:

$$100 \times \frac{\text{Fees/Commission} + \text{Interest}}{\text{Amount Payable by Factor}}$$

Cost Benefit Analysis:

	₹
Benefit	
Savings in Bad Debts	xx
Savings in collection cost	xx
Savings in opportunity cost	xx
Savings in Cash Discount	xx
A	xx

Cost

Factor Fees / Commission	xx
Interest	xx
B	xx