Credit Policy

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Cash Conversion Cycle

The cash conversion cycle focuses on the time between payments made for materials and labor and payments received from sales:

Cash conversion cycle	=	Inventory conversion period	+	Receivables collection period	-	payables deferral period

CCC can help us see the real components of working capital

Cash Management

- To have sufficient cash on hand to meet the needs listed on the previous slide.
- However, since cash is a non-earning asset, to have not one dollar more.
- Cash Budget is an effective tool to help better manage cash

Accounts Receivable Management

- Evaluation of existing A/R policy
- credit policy
- Effect of change in credit policy

Accounts Receivable Management

- AAA's days' sales outstanding (DSO)of 45 days is well above the industry average (32 days).
- AAA's customers are paying less promptly.
- AAA should consider tightening its credit policy to reduce its DSO
- A tighter credit policy may discourage sales. Some customers may choose to go elsewhere if they are pressured to pay their bills sooner.

Four Components of credit Policy

Cash discounts

Credit period

Credit standards

Collection policy

Credit Policy

- Cash Discounts: Lowers price. Attracts new customers and reduces DSO.
- Credit Period: How long to pay? Shorter period reduces DSO and average A/R,but it may discourage sales.
- Credit Standards: Tighter standards reduce bad debt losses, but may reduce sales. Fewer bad debts reduces DSO.
- Collection Policy: Tougher policy will reduce DSO, but may damage customer relationships.

Example

Current credit policy:

- Credit terms = Net 30
- Gross sales = $1,000,000
- 80% (of paying customers)pay on Day 30
- 20% pay on Day 40
- Bad debt losses = 2% of gross sales

Operating cost ratio = 75%

Cost of carrying receivables = 12%

Effect of Change in Credit Policy

New credit policy:

- Credit terms = 2/10,net 20.
- Gross sales = $1,100,000.
- 60% (of paying customers) pay on Day 10
- 30% pay on Day 20.
- 10% pay on Day 30.
- Bad debt losses= 1% of gross sales.

DSO

Current:

$DSO_o = 0.8(30) + 0.2(40)$

$= 32$ days.

New:

$DSO_N = 0.6(10) + 0.3(20) + 0.1(30)$

$= 15$ days.

Bad Debt Losses

Current:

BDL_O $=0.02\ (\$1{,}000{,}000)$

$= \$20{,}000.$

New:

BDL_N $= 0.01(\$1{,}100{,}000)$

$= \$11{,}000.$

Cost of Discount

$$\text{Discount}_o = \$0.$$

$$\text{Discount}_N = 0.6(0.02)(0.99)(\$1{,}100{,}000)$$
$$= \$13{,}068.$$

Carrying Cost of Accounts Receivable

- Costs of carrying receivables$_o$

  =($1,000,000/360)(0.75)(32)(0.12)

  =$8,000.

- Costs of carrying receivables$_N$

  =($1,100,000/360)(0.75)(15)(0.12)

  =$4,125.

Incremental After-Tax profit associated with the change in credit terms

	New	Old	Difference
Gross sales	$1,100,000	$1,000,000	$100,000
Less: Disc.	13,068	0	13,068
Net sales	$1,086,932	$1,000,000	$ 86,932
Prod. costs	825,000	750,000	75,000
Profit before credit costs and taxes	$ 261,932	$ 250,000	$ 11,932

Incremental After-Tax profit associated with the change in credit terms

	New	old	Difference
Profit before credit costs and taxes	$261,932	$250,000	$11,932
Credit-related costs:			
Carrying costs	4,125	8,000	(3,875)
Bad debts	11,000	20,000	(9,000)
profit before taxes	$246,807	$222,000	$24,807
Taxes(40%)	98,723	88,800	9,923
Net income	$148,084	$133,200	$14,884

Should the company make the change?

Change in Credit Policy

Assume the firm makes the policy change, but Its competitors react by making similar changes. As a result, gross sales remain at $1,000,000. How does this impact the firm's after-tax profitability?

Change in credit Policy

Gross sales		$1,000,000
Less: discounts	11,880	
Net sales		$ 988,120
Production costs	750,000	
Profit before credit costs and taxes		$ 238,120
Credit costs:		
Carrying costs		3,750
Bad debt losses		10,000
Profit before taxes		$ 224,370
Taxes		89,748
Net Income		$ 134,622

Change in Credit Policy

Before the new policy change, the firm's net income totaled $133,200.

The change would result in slight gain of $ 134,622-$133,200 = $ 1,422.