

## UNIT - V

## MANAGEMENT OF PAYABLES (CREDITORS)

**10.23 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 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.

**10.24 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 favoured over the lenders with the levels of interest rates not seeming totally to redress the balance.
- (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.



## 10.25 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:

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

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:

	Refuse discount	Accept discount
	₹	₹
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.