CREDIT POLICY
A LOGICAL APPROACH IS KEY

Candidates seem to struggle with calculations that involve a change in receivables collection policy or payables payment policy. Study session 26 (f) requires candidates to 'evaluate and demonstrate the issues involved with early payment and settlement discounts' while study session 30 (e) requires candidates to 'calculate the cost of factoring arrangements, invoice discounting and changes in credit policy'.

When these areas have been examined in the past, the standard of answers has been low. I commented in my examiner's report for the December 2009 paper that a substantial minority of candidates scored zero or did not attempt the question. The previous examiner also commented in her report for the December 2007 exam, that there were 'few correct answers' and few candidates adopted 'any kind of logical approach at all'.

Many candidates seem to completely ignore questions of this type, leaving their answer script blank, and so do not put themselves in the best position to pass the paper overall.

There is not a proforma that can be learnt for this type of question. Scenarios can have different costs, eg there may or may not be credit insurance within a factoring question. In addition, there can be some trickier elements to these questions, as with any calculation question, but if candidates take a logical approach and attempt the question, marks can be gained.

This article aims to demonstrate to candidates how with a logical approach, they can answer these questions well.

Invoice factoring

Let us look at an example and see the benefits of a logical approach:

C Co's receivables currently take 80 days to collect, and the receivables ledger stands at $20,000. Irrecoverable debts are 2% of sales, and working capital is financed by an overdraft on which interest of 8% is paid. A credit controller is employed, the cost of whom is $10,000 per year.

C Co has approached a factoring company, whose terms are:

- *75% of amounts receivable will be advanced for a fee of 7%*
- *Credit insurance of 1.5% of sales will be charged*

The receivable days are expected to reduce to 60 days if the factoring company is used.

Assume 365 days in a year.

I believe that the easiest/most logical way to approach this style of question is to set up two calculations. The first will look at the current situation, whilst the second will look at the position if the factoring company is used. The two positions can then be compared and the best option recommended to C Co.

Step 1
The first step candidates should take is to go through the information given, deciding which parts of the information relate to calculation one, and which parts of the information to calculation 2. For this example:

Calculation 1: current situation
The relevant information is:

1. *Receivables balance and current receivable days*
2. *Irrecoverable debts*
3. *Interest on the overdraft*
4. *The cost of the credit controller*

Calculation 2: the factoring company is used
The relevant information is:

1. *Fee for amounts advanced (7%). This relates to 75% of the receivables*
2. *Credit insurance*
3. *Proposed receivable days*

Step 2
Candidates now need to do a quick check. Do all of the receivables have an interest cost allocated to them under the factoring arrangements?
The answer is no. Only 75% of the amounts advanced have an interest cost allocated to them so far. The remaining 25% will still be financed by C Co and the cost of these will be the overdraft rate of 8%. This element of the calculation is often missed by candidates.

Step 3
Candidates can now set up the two calculations and should start 'filling in the figures' starting with the easiest figures first.
I shall do this below, and the figures are listed in the order I would prepare the calculation (ie the easiest figures first).
Calculation 1: current situation

	$
Credit controller	*10,000*
Interest cost of financing receivables (8% x $20,000)	*1,600*
Irrecoverable debts (w1)	*1,825*
	13,425

Working 1
This calculation is not quite so straightforward. The irrecoverable debts are 2% of sales, but there is no sales figure given. However, the information on receivables allows the sales figure to be calculated:
20,000 x 365/80 = $91,250

Therefore, the irrecoverable debts can be calculated as
2% x $91,250 = $1,825

Calculation 2: factoring company is used

	$
Credit insurance (1.5% x $91,250)	*1,369*
Fee for the amounts advanced (w2)	*788*
Cost of financing the remaining receivables (w3)	*300*
	2,457

Working 2
The fee for the amount advanced is going to be equal to 7% multiplied by 75% of the new receivables figure.
We need to calculate the new receivables figure
= 60/365 x $91,250 = $15,000
The fee for the amount advanced is, therefore, 7% x 75% x $15,000 = $788

Working 3
The cost of financing the remaining receivables is going to be equal to the short-term cost of borrowing for C Co (8%) multiplied by 25% of the new receivables figure.
This cost is therefore 8% x 25% x $15,000 = $300

Step 4
Finally comparing the results for each calculation we can see that the factoring company should be used as a saving will be made.
The example above is an illustration of an approach that can be used. Although questions involving factoring can have other complications, for example, sales levels can change as occurred in the question set in December 2007, as long as a logical approach is taken and workings clearly shown, many marks can be gained from these questions, and they should certainly never be left unanswered.

Change in payables policy
At the beginning of this article, I mentioned that a question could involve a change in the policy for payables. This was the case in December 2009 when candidates were asked to calculate the net gain or benefit from accepting the discount on offer from a supplier, ie a monetary answer was required. Let us take the question and approach it as above. Extracts from the question are detailed below:

1. *Choc Co pays $0.75 per kg of sugar and purchases 100,000 kg*
2. *Choc Co takes the 60 days credit provided by their suppliers*
3. *The suppliers have offered Choc Co a discount of 2% for payment within 14 days*
4. *Choc Co has a short-term cost of finance of 10% per annum*

Step 1
Go through the information given and allocate it to either the current position or the proposed situation:

Calculation 1: current position
The relevant aspects of the question:

1. *The interest saved on the short term borrowing by not paying the supplier straight away.*

Calculation 2: discount is taken
The relevant aspects of the question:

1. *The discount received*
2. *The revised interest saved on the short-term borrowing by not paying the supplier straight away*

Step 2
Now for the quick check – are all the payables covered by the discount?
In this case the answer is yes.

Step 3
We can now set up the two calculations, and I shall again fill in the figures dealing with those that I consider to be the easiest first.
Calculation 1: current situation

	$
Interest saved (w1)	*1,233*

Working 1
The interest saved is going to be equal to the payables multiplied by the cost of short-term borrowing (10%).

Payables = 60/365xpurchases = 60/365 x $0.75 x 100,000 = $12,329
Interest saved =10% x $12,329 = $1,233

Calculation 2: discount is taken

	$
Discount gained (2%x$0.75x100,000)	*1,500*
Interest saved w2	*288*
	1,788

Working 2
The interest saved is going to be equal to the new payables multiplied by the cost of short-term borrowing (10%).

New payables = 14/365xpurchases = 14/365 x $0.75 x 100,000 = $2,877
Interest saved = 10% x $2,877 = $288

Step 4
Comparing the results we can see that the discount should be taken as a saving of $555 can be made.

Summary
There are different approaches that candidates can take when answering questions involving changes in payables policy or receivables policy.

I hope that this article gives candidates a logical approach that will help them answer the questions on these areas of the syllabus – areas of the syllabus that have been poorly answered by candidates in recent sittings.

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