The Cost of Extending Credit

Credit, like the honour of a female, is of too delicate a nature to be treated with laxity – the slightest hint may inflict an injury which no subsequent effort can repair (The Morning Chronicle, 1825)

When your business allows goods and services to be sold on credit terms, there is a cost attached which directly effects profit and liquidity.

If cash-on-delivery was the only option, industry as we know it would come to a halt.

Nothing is free! The result of giving credit to customers is that a large amount of cash is tied up in your sales ledger. If this is not collected, your business will not have enough cash to meet its commitments. This cost may be included into your prices, charged in late payment interest (with similar discounts for up front payment) or simply 'taken on the chin' but there is always a cost that must be counted.

Every £1000 of credit, which remains unpaid for 4 months will cost £26.60 assuming the bank lending rate is 8%pa.

Example 1 - 8% / 12 = 0.66 x 4 months = 2.66%

Therefore: £1000 x 2.66% = **£26.6**

Example 2 - If the bank lending rate was say 12% per annum, then one month is 12% divided by 12 months = 1%.

	Company 1 **(30 days)**	Company 2 **(60 days)**	Company 3 **(90 days)**
Annual Sales	12,000	12,000	12,000
Debtors	1,000	2,000	3,000
Net Profit= (5% before cost of credit)	600	600	600
Cost of credit	(120)	(240)	(360)
Net Profit	**480 (1%)**	**360 (2%)**	**240 (3%)**

If cost / price inflation is added to this example the above companies would have to include this to the monthly cost of bank interest.

Example 3 – If annual inflation = 6% (this equates to 0.5% per month) Company 3 above on 90 day terms would have to add 1.5% onto the 3% cost of bank interest. **TOTAL = 4.5%.**

You therefore reduce interest when you reduce debtors.

Example 4 -

Year 1

Sales per annum	1,200,000
Debtors	300,000 = 3 months sales
Cost of credit 9% pa	27,000

Year 2

Sales per annum	1,320,000
Debtors	220,000 = 2 months sales
Cost of credit 9% pa	19,800

Interest Saved = £9,900 pa

It is therefore relatively easy to measure the cost of credit in terms of bank interest but there are other elements which are equally affected - **Profits / Liquidity & Bad Debts**

The ICMOS Benchmarking Analysis makes it easier to identify the cost of credit impact on net profits. By simply typing in your profit margin, cost of borrowing and credit days overdue, the software will calculate the impact of profit erosion over time. You can then analyse variable targets until a realistic view is achieved.