

CHAPTER FOUR

RECEIVABLES MANAGEMENT

4.1 Nature and Importance of Receivables

Firms sell goods on credit to increase the volume of sales. In the present era of intense competition, business firms, to improve their sales, offer to their customers relaxed conditions of payment. When goods are sold on credit, finished goods get converted into receivables. Trade credit is a marketing tool that functions as a bridge for the movement of goods from the firm's warehouse to its customers. When a firm sells goods on credit, receivables are created.

The receivables arising out of trade credit have three features.

1. It involves an element of risk. Therefore, before sanctioning credit, careful analysis of the risk involved needs to be done;
2. It has an element of futurity. The buyer makes payment in a future period; and
3. It is based on economic value. Buyer gets economic value in goods immediately on sale, while the seller will receive an equivalent value later on.

Amounts due from customers, when goods are sold on credit, are called trade debits or receivables. Receivables form part of current assets. They constitute a significant portion of the total current assets of the firms next to inventories. Receivables are asset account which representing amounts owing to the firm as a result of sale of goods/services in the ordinary course of business.

Objectives: The main objective of selling goods on credit is to promote sales for increasing the profits of the firm. Customers will always prefer to buy on credit to buying than on cash basis. They always go to a supplier who gives credit. All firms therefore grant credit to their customers to increase sales, profits and to meet competition.

Receivables are a direct result of credit sales are resorted to, by a firm to push up its sales which ultimately result in pushing up the profits earned by the firm. At the same time, selling goods on credit results in blocking of funds in accounts receivables.

Additional funds are, therefore, required for the operating needs of the business which involve extra costs in terms of interest. Moreover, increase in receivables also increases the chances of bad debts. Thus, creation of accounts receivables is beneficial as well as dangerous to the firm.

The decision to grant credit: Trade credit is more likely to be granted by the selling firm if;

- ☞ The selling firm has a cost advantage over other lenders.
- ☞ The selling firm can engage in price discrimination.
- ☞ The selling firm can obtain favorable tax treatment.
- ☞ The selling firm has no established reputation for quality products or services.
- ☞ The selling firm perceives a long-term strategic relationship.

4.2 Objectives and Functions of Receivables

The financial manager needs to follow a policy of using cash funds economically to the extent possible in extending receivables without adversely affecting the chances of increasing sales and making more profits. From creation of receivables, the firm gets a few advantages & it bears bad debts, administrative expenses, financing costs, etc. In the management of receivables financial manager should follow-up in the strategic way through which cash resources of the firm can be fully utilized. *Management of accounts receivables*

is defined as the process of making decision relating to the investment of funds in receivables which will result in maximizing the overall return on the investment of the firm. In other term, management of receivables is a process under which decisions to maximize returns on the investment blocked in them are taken.

Thus, the main objectives of management receivable are to maximize the returns on investment in receivables & to minimize risk of bad debts etc. Because investment in receivables affects liquidity and profitability, it is, therefore, significant to maintain proper level of receivables. In other words, the basic objectives of receivables management are to maximize the profits. Efficient credit management helps to increase the sales of the firm. Thus, following are the main objectives of receivables management:-

- i) *To optimize the amount of sales.*
- ii) *To minimize cost of credit.*
- iii) *To optimize investment in receivables.*

Therefore, the main objective of receivable management is to establish a balance between profitability and risk (cost). A business can afford to invest in its receivables unless the marginal costs and marginal profits are the same. Although the level of receivables is affected by various external factors like standards of industry, economic conditions, seasonal factors, rate of competition etc, management can control its receivables. Though credit policies, credit terms, credit standards and collection procedures.

Nature and Goal of credit policy

The total amount of accounts receivable outstanding at any given time is determined by two factors:

- i) the volume of credit sales, and
- ii) the average length of time between sales and collections.

$$\text{Accounts Receivable} = \text{Credit sales per day} \times \text{Length of collection period}$$

The investment in receivable may be expressed in terms of cost of sales instead of sale volume. The volume of credit sales is a function of the firm's total sales and the percentage of credit sales to total sales. Total sales depend on *market size, firm's market share, product quality, intensity of competition, economic conditions* etc.

There is one way in which, the financial manager can affect the volume of credit sales and collection period and consequently, investment in account receivables. That is, through the changes in credit policy.

Credit Policy

The credit seller firms may follow a **lenient** or **stringent** credit policy. The firm following a **lenient credit policy** tends to sell on credit to customers on very liberal terms and standards; credits are granted for longer periods even to those customers whose creditworthiness is not fully known or whose financial position is doubtful. In contrast, a firm following a **stringent credit policy** sells on credit on a highly selective basis only to those customers who have been proven creditworthiness and who are financially strong.

Firms use credit policy as marketing tool for expanding sales and maintaining market shares. In addition companies may grant credit for several reasons such as; company's position relative to competitors, buyer's status and requirement, dealer relationships, transit delays, industrial practices etc.

Credit policy Variables (components)

The term credit policy is used to refer to the combination of four decision variables:

- i) Credit standards.
- ii) Credit period.
- iii) Cash discounts and
- iv) Collection program.

1) **Credit standards:** The term credit standards *refer to the criteria for extending credit to customers*. The bases for setting credit standards are.

- a) Credit rating.
- b) References
- c) Average payment period
- d) Ratio analysis

There is always a benefit to the company with the extension of credit to its customers but with the associated risks of delayed payments or non-payment, funds blocked in receivables etc. The firm may have light credit standards. It may sell on cash basis and extend credit only to financial strong customers. Such strict credit standards will bring down bad-debt losses and reduce the cost of credit administration. But the firm may not be able to increase its sales. The profit on lost sales may be more than the costs saved by the firm. The firm should evaluate the trade-off between cost and benefit of any credit standards.

The effect of relaxing the credit standards on profit can be estimated as under:

Change in profit = ΔP

Increase in sales = $\uparrow S$

Contribution margin = $C = (1 - V)$ or $V = 1 - C$ Where; V = Variable cost to sales

Bad-debts on new sales = $S * \text{Bad-debt ratio}$

Post-tax cost of capital = K

Increase in receivables investment = $I = ACP * S$ per day

Therefore:

Change in net Profit (ΔP) = [(Additional contribution on increase in sales - Bad-debts on new sales) (1 - tax rate)] - [cost of incremental investment (1 - tax rate)]

Change in Gross Profit (ΔP) = [(Additional contribution on increase in sales - Bad-debts on new sales) - [cost of incremental investment

2) **Credit period:** refers to the length of time allowed to its customers by a firm to make payment for the purchases made by customers of the firm. It is generally expressed in days like 15 days or 20 days. Generally, firms give cash discount if payments are made within the specified period.

If a firm follows a credit period of '**net 20**' it means that it allows to its customers 20 days of credit with no inducement for early payments. Increasing the credit period will bring in additional sales from existing customers and new sales from new customers. Reducing the credit period will lower sales, decrease investments in receivables and reduce the bad debt loss. Increasing the credit period increases sales increases investment in receivables and increases the incidence of bad debt loss.

The effects of increasing the credit period on profits of the firm are similar to that of relaxing the credit standards.

The effect of changing the credit period on profits of the firm can be computed as under:

Change in profit = (Incremental contribution - Bad debts on new sales) (1-tax rate) - cost of incremental investment in receivables.

3) Cash discount: Firms offer cash discounts to induce their customers to make prompt payments. Cash discounts have implications on *sales volume*, *average collection period*, *investment in receivables*, *incidence of bad debts* and *profits*. A cash discount of 2/10, net 20 means that a cash discount of 2% is offered if the payment is made by the tenth day, otherwise full payment will have to be made by 20th day.

For assessing the effect of cash discount the following formula can be used.

Change in profit = (Incremental contribution - cost of increase in discount) (1 - t) - opportunity cost of savings in receivables investment.

4) Collection programme: The success of a collection programme depends on the collection policy pursued by the firm. The objective of a collection policy is to achieve; Timely collection of receivables, thereby releasing funds locked in receivables and minimizes the incidence of bad debts.

The collection programmes consist of the following. (1) Monitoring the receivables (2) Reminding customers about due date of payment (3) On line interaction through electronic media to customers about the payments due around the due date. (4) Initiating legal action to recover the amount from overdue customers as the last resort to recover the dues from defaulted customers. Collection policy formulated shall not lead to bad relationship with customers.

The firm usually employs the following procedures for customers that are overdue:

- 1) Sends a delinquency letter informing the customer of the past-due status of the account.
- 2) Makes a telephone call to the customer.
- 3) Employs a collection agency.
- 4) Takes legal action against the customer.

At times, a firm may refuse to grant additional credit to customers until arrearages are paid. This may antagonize a normally good customer and points to a potential conflict of interest between the collections department and the sales department. For computation of the effect of new collection programme can be evaluated with the help of following formula.

Change in profit = (Incremental contribution - Increase in bad debts) (1 - tax rate) - cost of increase in investment in receivables.

4.3 Costs associated with maintaining receivables (Changes in Credit Policy)

i) Capital costs: A firm when sells goods on credit achieves higher sales. Selling goods on credit has consequences of blocking the firm's resources in receivables as there is a time lag between a credit sale and cash receipt from customers. To the extent the funds are held up in receivables, the firm has to arrange for additional funds to meet its own obligation of monthly as well as daily recurring expenditure. Additional funds may have to be raised either out of profits or from outside. In both the cases, the firm incurs a cost. In the former case there is the opportunity cost of the income the firm could have earned had the same been invested in some other profitable avenue. In the latter case of obtaining funds from outside, the firm has to pay interest on the loan taken. Therefore, sanctioning credit to customers on sale of goods on credit has a capital cost.

ii) Administration cost: When a firm sells goods on credit it has to incur two types of administration cost:

- a) Credit investigation and supervision costs, and
- b) Collection Costs.

Before sanctioning credit to any customer the firm has to investigate the credit rating of the customer to ensure that credit given will be recovered on time. Therefore, administration costs have to be incurred in this process.

Costs incurred in collecting receivables are administrative in nature. These include additional expenses on staff for administering the process of collection of receivables from customers.

iii) Delinquency Costs: The firm incurs this cost when the customer fails to pay the amount to it on the expiry of credit period. These costs take the form of sending reminders and legal charges.

iv) Bad-debts or Default cost: When the firm is unable to recover the amount due from its customers, it results in bad debts. When a firm relaxes its credit policy, selling to customers with relatively low credit rating occurs. In this process a firm may make credit sales to its customers who do not pay at all.

Therefore, the assessing the effect of a change in credit policy of a firm involves examination of: (a) *opportunity cost of lost contribution* (b) *credit administration cost* (c) *collection costs* (d) *delinquency costs*.

Credit analysis

When granting credit, a firm tries to distinguish between customers that will pay and customers that will not pay. There are a number of sources of information for determining creditworthiness.

Credit Information: The commonly used sources of information to assess creditworthiness of the customer/buyer include the following:

- a) *Financial Statements.* A firm/credit seller can ask a customer/buyer to supply financial statements. Rules of thumb based on financial ratios can be calculated.
- b) *Credit reports on customer's payment history with other firms.* Many organizations sell information on the credit strength of business firms.
- c) *Banks.* Banks will generally provide some assistance to their business customers in acquiring information on the creditworthiness of the customer, but only by the customer's intention/interest.
- d) *Customer's payment history with the firm.* The most obvious way to obtain an estimate of a customer's probability of nonpayment is whether he or she has paid previous bills.

Credit Scoring: Once information has been gathered, the firm faces the hard choice of either granting or refusing credit. Many firms use the traditional and subjective guidelines referred to as the "five Cs of credit":

- a) *Character.* The customer's willingness to meet credit obligations.
- b) *Capacity.* The customer's ability to meet credit obligations out of operating cash flows.
- c) *Capital.* The customer's financial reserves.
- d) *Collateral.* A pledged asset in the case of default.
- e) *Conditions.* General economic conditions.

Optimal credit policy

Optimal credit policy is a policy that maximizes the firm's value. The value of the firm is maximized when; the incremental or marginal rate of return of an investment is equal to the

incremental or marginal cost of funds used to finance the investment. The incremental rate of return can be calculated as incremental operating profit divided by the incremental investment in receivable. The incremental cost of funds is the rate of return required by suppliers of funds given the risk of investment in accounts receivables.

In other words, optimal credit policy is a policy which equalizes the carrying cost and opportunity costs. *Carrying costs* are the costs associated with granting credit and making an investment in receivables. Carrying costs include the delay in receiving cash, the losses from bad-debts, and the costs of managing credit. And *Opportunity costs* are the lost sales from refusing to offer credit. These costs drop as credit is granted.

Factoring

A firm can sale its account receivables. Factoring is the selling of accounts receivable or invoices in order to secure immediate, working capital (cash). The institution which purchases the receivables is called factor and the seller is called client. Factoring has been used by businesses around the world for more than four centuries to manage cash flow.

A factor company purchases receivables by giving an advance payment up front. This advanced payment is usually 70 - 90% of the total value of the receivables. After charging a small fee (2% and up) the remaining balance is released upon full receipt of payment for all the receivables/invoices. This allows a business to be able to make those larger sales and still have the working capital to continue operations and further growth.

Reasons to Factor: to obtain a source of working capital, to relief from responsibility for collection of no-pay and slow-pay clients, to fill more orders, to flexible funding program that increases as you increase your sales, to have ability to take advantage of vendor discounts, to have funds for payroll and taxes, to extend credit to customers on large orders, and buy equipment or inventory on demand (*read more about factoring*).