
UNIT FOUR : RECEIVABLES MANAGEMENT

Nature of receivables

Accounts receivables are asset accounts representing amounts owed to the firm as result of sale of goods or services in the ordinary course of business. These are claims of the firm against its customers and form part of its assets. When a firm allows customers to pay for goods and services at a later date, it creates *accounts receivable*. By allowing customers to pay some time after they receive the goods or services, you are granting credit, which we refer to as *trade credit*. Trade credit, also referred to as *merchandise credit* or *dealer credit*, is an informal credit arrangement. Unlike other forms of credit, trade credit is not usually evidenced by notes, but rather is generated spontaneously: Trade credit is granted when a customer buys goods or services. Accounts receivable management involves the careful consideration of the following core aspects:

- ♦ *Forming a credit policy.*
- ♦ *Executing the credit policy.*
- ♦ *Formulating and executing collection policy.*

Objectives of Receivables Management

The objective of receivables management is to promote sales and profits until that point is reached where the returns that the company gets from of receivables is less than the cost that the company has to incur in order to fund these receivables. Hence, the purpose of receivables is less than the cost that the company has to incur in order to fund these receivables. Hence, the purpose of receivables is directly connected with the company's objectives of making credit sales

Objectives of credit policy

Firms extend credit to customers to help stimulate sales. Suppose you offer a product for sale at \$20, demanding cash at the time of the sale. And suppose your competitor offers the same product for sale, but allows customers 30 days to pay. Who's going to sell the product? If the product and its price are the same, your competitor, of course. So the benefit from extending credit is the profit from the increased sales.

Extending credit is both a financial and a marketing decision. When a firm extends credit to its customers, it does so to encourage sales of its goods and services. The most direct benefit is the profit on the increased sales. If the firm has a *variable cost margin* (that is, variable cost/sales) of 80%, then increasing sales by \$100,000 increases the firm's profit before taxes by \$20,000. Another way of stating this is that the *contribution margin* (funds available to cover fixed costs) is 20%: For every \$1 of sales, 20 cents is available *after* variable costs. The benefit from extending credit is:

$\text{Benefit from extending credit} = \text{Contribution Margin} \times \text{Change in sales}$

For example: If a firm liberalizes its credit it grants to customers, increasing sales by \$5 million and if its contribution margin is 25%, the benefit from liberalizing credit is 25% of \$5 million or \$1.25 million.

Costs of Credit

But like any credit, it has a cost. The firm granting the credit is forgoing the use of the funds for a period—so there is an opportunity cost associated with giving credit. In addition, there are costs of administering the accounts receivable—keeping track of what is owed. And, there is a chance that the customer may not pay what is due when it is due.

The Cost of Discounts

Do firms grant credit at no cost to the customer? No, because as we just explained, a firm has costs in granting credit. So they generally give credit with an implicit or hidden cost:

- The customer that pays cash on delivery or within a specified time thereafter—called a discount period—gets a discount from the invoice price.
- The customer that pays after this discount period pays the *full* invoice price.

Other Costs

There are a number of costs of credit in addition to the cost of the discount. These costs include:

- The carrying cost of tying-up funds in accounts receivable instead of investing them elsewhere.
- The cost of administering and collecting the accounts.
- The risk of bad debts.

Component of credit policy

The major controllable determinants of demand are sales prices, product quality, advertising, and the firm's credit policy.

Credit policy, in turn, consists of these four variables:

1. Credit period, which is the length of time buyers are given to pay for their purchases.
2. Discounts given for early payment, including the discount percentage and how rapidly payment must be made to qualify for the discount.
3. Credit standards, which refer to the required financial strength of acceptable credit customers.
4. Collection policy, which is measured by its toughness or laxity in attempting to collect on slow-paying accounts.

The credit manager is responsible for administering the firm's credit policy. However, because of the pervasive importance of credit, the credit policy itself is normally established by the executive committee, which usually consists of the president plus the vice-presidents of finance, marketing, and production. For efficient utilization of accounts receivable, a firm must adopt a credit policy.

A credit policy is a set of decisions that include a firm's;

- *credit standards,*
- *credit terms,*
- *collection procedures and*
- *Discount offered.*

Credit standards

Credit standards refer to the financial strength and credit worthiness a customer must exhibit in order to qualify for credit. If a customer does not qualify for the regular credit terms, it can still purchase from the firm, but under more restrictive terms. The firm's credit standards would be applied to determine which customers qualified for the regular credit terms and how much credit each should receive. The major factors considered when setting credit standards relate to the likelihood that a given customer will pay slowly or perhaps end up as a bad debt loss.

Credit terms

Credit terms specify the length of time over which credit is extended to a customer and a discount given for early payment. For example, one firm's credit terms might be expressed as "2/10, net 30." The term "2/10" means that a 2 percent cash discount is given if the bill is paid within 10 days of the invoice date. Thus cash discount period is 10 days. It is the period of time during which a cash discount can be taken for early payment. Cash discount is (a 2 percent reduction in sales or purchases price) allowed for early payment of invoices. It is an incentive for credit customers to pay invoices in a timely fashion. The term "net 30" implies that if a discount is not taken, the full payment is due by the 30th day beginning from invoice date. Thus the credit period is 30 days. It is the total length of time over which credit is extended to a customer to pay a bill. There is no binding rule on fixing the terms of credit. Credit terms vary and even within the same industries. Differences are linked to product characteristics as well as market competition.

Executing Credit Policy

After formulating the credit policy, its proper execution is very important. Having established the terms of sale to be offered, the firm must evaluate individual credit applicants and determine the applicant's credit worthiness. The credit evaluation procedure involves three related steps:

- ♦ *Collecting information on the credit applicant*
- ♦ *Analyzing the credit information*
- ♦ *Making the credit decision.*

Collecting Credit Information

The first step in implementing credit policy will be to gather credit information about the credit applicant /customers/. When a customer desiring credit terms approaches a business firm, the credit department typically begins the evaluation process by requiring the applicant to fill out various forms that request financial and credit information and references.

Analyzing Credit Information

After gathering the required information, the finance manger should analyze it to find out the credit worthiness of potential credit customers and also to see whether they satisfy the credit standards of the firm or not. The credit analysis will determine the degree of risk associated with the account, the capacity of the credit customer to get goods and /or services and its ability and willingness to repay. Often the selling firm not only must determine the creditworthiness of a customer, but also must estimate the maximum amount of credit the customer is capable of supporting

It is the credit analyst's job to synthesize and analyze all information that has been collected and reach a judgment regarding the applicant's credit worthiness. To perform this synthesis and

analysis, it is useful to have some mechanism for organizing the information that has been collected. One traditional way of organizing this information is by characterizing the applicant along five dimensions. These dimensions are called the Five Cs of Credit - capital, character, collateral, capacity and conditions.

A firm's credit analysts often use these five Cs of credit to focus their analysis on the key dimensions of an applicant's creditworthiness. Each of these five dimensions is briefly described in the following list.

Character: It is the applicant's record of meeting past obligations - financial, contractual, and moral. Past payment history as well as any pending or resolved legal judgments against the applicant would be used to evaluate its character. In assessing character, the credit analyst considers all the information that relates to willingness to pay debts.

Capacity: It is related to the applicant's ability to repay the requested credit. This dimension has two aspects: management's capacity to run the business and the applicant's plant capacity. Management's capacity to run the business relates to the competency (ability) of the management personnel in the applicant's operations. Physical capacity refers to the value and technology of the applicant's production or service facilities. Financial statement analysis with particular emphasis on liquidity and debt ratios is typically used to assess the applicant's capacity. The applicant's ability to generate cash to meet obligations is assessed.

Capital: It is the financial strength of the applicant as reflected by its ownership position. To assess the capital dimension, analysis of the applicant's debt relative to equity and its profitability ratios are frequently used. The credit analyst considers the data obtained from the applicant's financial statements. The usual procedure is to perform extensive ratio analysis, comparing the applicant's financial ratios to ratios for the applicant's industry and performing trend analysis of the applicant's ratios over time.

Collateral: The amount of assets the applicant has available for use in securing the credit is called collateral. The larger the amount of available assets, the greater the chance that a trade creditor will recover its funds if the applicant defaults.

Conditions: It includes current economic and business climate as well as any unique circumstances affecting either party to the credit transaction. For example, if the firm has excess inventory of the items the applicant wishes to purchase on credit, the firm may be willing to sell on more favorable terms or to less creditworthy applicants. Analysis of general economic and business conditions as well as special circumstances that may affect the applicant or firm is performed to assess conditions.

The Credit analyst typically gives primary attention the first **two Cs** - character and capacity- because they represent the most basic requirements for extending credit to an applicant. Consideration of the last **three Cs** capital, collateral, and conditions-is important in structuring the

credit arrangement and making the final credit decision, which is affected by the credit analyst's experience and judgment.

Making Credit Decisions

After analyzing the credit worthiness of the customer, decisions should be made whether the credit is to be extended to the credit applicant customer. If the analyst decides to extend credit to the applicant, what amount of credit to extend will be the next issue to decide. To do this, it is necessary to match the creditworthiness of the customer already determined based on the credit analysis with the credit standards of the credit granting firm. If the customer's credit worthiness is above the credit standards then there is no problem in taking a decision. In cases where the customer's credit worthiness is below the firm's credit standards then they should not be outright refused. Rather they should be offered to pay on delivery of goods or some third party guarantee may be insisted.

Formulating and Executing Collection Policy

The collection policy refers to the procedures the firm follows to collect past due accounts. A number of collection procedures are employed. For example, a letter might be sent to customers when a bill is 10 days past due; a more severe letter, followed by telephone call, would be sent if payment is not received within 30 days, and the account would be turned over to a collection agency after 90 days. As an account receivable becomes more and more overdue, the collection effort becomes more personal and more intense. The popular procedures are briefly described in **Table 3.1** listed in the order typically followed in the collection process.

Table 3.1 Popular Collection Techniques

Techniques*	Brief Description
<i>Letter</i>	After an account receivable becomes overdue a certain number of days, the firm normally sends a polite letter reminding the customer of its obligation. If the account is not paid within a certain period after the letter has been sent, a second, more demanding letter is sent. Yet another letter may follow this letter, if necessary. Collection letters are the first step in the collection process for overdue accounts.
<i>Telephone calls</i>	If letters prove unsuccessful, a telephone call may be made to the customer to personally request immediate payment. Such a call is typically directed to the customer's accounts payable department where the responding employee acts on instructions of his or her boss. If the customer has a reasonable excuse, arrangements may be made to extend the payment period. A call from the seller's attorney may be used if all other discussions seem to fail.

Personal visits	This technique is much more common at the consumer credit level, but it may also be effectively employed by industrial suppliers. Sending a local salesperson or a collection person to confront the customer can be a very effective collection procedure. Payment may be made on the spot.
Collection agencies	A firm can turn uncollectible accounts over to a collection agency or an attorney for collection. The fees for this service are typically quite high; the firm may receive less than 50 cents on the dollar from accounts collected in this way.
Legal action	Legal action is the most stringent step in the collection process. It is an alternative to the use of a collection agency. Not only is direct legal action expensive, but also it may force the debtor into bankruptcy, thereby reducing the possibility of future business without guaranteeing the ultimate receipt of the overdue amount.

* Techniques are listed in the order typically followed in the collection process.

Monitoring Credit and Collection Policies

Accounts receivable management does not stop with the establishment of a credit terms, collection policy and credit standards, for the individual customer or for the entire firm. Credit and collection policies must be monitored continually, not only for indications of deterioration in the individual customer's ability to pay, but also for signs of overextended credit to all customers. The financial officer must also troubleshoot for mechanical and procedural failures on the part of the credit department's equipment and personnel. The effectiveness of credit and collection policies can be partly evaluated by looking at the level of bad debts expenses. This level depends not only on collection policy, but also on the policy on which the extension of credit is based. If one assumes that the level of bad debts attributable to credit policy is relatively constant, increasing collection expenditures can be expected to reduce bad debts. Popular approaches used to evaluate credit and collection policies include:

- ♦ *Average collection period and*
- ♦ *Aging accounts receivable.*

Average collection period

The average collection period or average age of accounts receivable is useful in evaluating credit and collection policies. It is arrived at by dividing the accounts receivable balance by the average daily sales:

$$\text{Average collection period} = \frac{\text{Accounts receivable}}{\text{Average Credit Sales per day}}$$

$$= \frac{\text{Accounts receivable}}{\text{Annual Credit sales / 360 days}}$$

For example, assume Ethio-Food Company's ending accounts receivable balance and its annual credit sales are Br. 503, 000 and Br. 3,074,000 respectively, its average collection period will be:

$$= \frac{\text{Br. 503,000}}{\text{Br. 3,074,000 / 360 days}} = 59 \text{ days}$$

This means that on average it takes the firm's 59 days to collect an accounts receivable. The average collection period is meaningful only in relation to the firm's credit terms. If, for instance, Ethio- Food Company extends 30-day credit terms to customers, an average collection period of 59 days may indicate a poorly managed credit or collection department or both. Of course, the lengthened collection period could be an intentional relaxation of credit term enforcement by the firm in response to competitive pressures from other suppliers of the product. If the firm had extended 60- day credit terms, the 59-day average collection would be quite acceptable. Clearly, comparison of the firm's average collection period and credit terms (credit period provided) would help to draw definitive conclusions about the effectiveness of the firm's credit and collection policies. However, a major weakness of average collection period for this purpose is that it is quite sensitive to seasonal variations in sales. Consequently, unless sales are quite stable overtime, the collection period can mask fundamental changes in collection experience.

Aging Accounts Receivable

Aging Accounts receivable is a technique that indicates the proportion of the accounts receivable balance that has been outstanding for a specified period of time. By highlighting irregularities, it allows the analyst to pinpoint the cause of credit or collection problems. Aging requires that the firm's accounts receivable be broken down into groups based on the time of origin. This breakdown is typically made on a month-by-month basis, going back 3 or 4 months. Let us look at an example.

Assume that Ethio- Food Company extends 30-day EOM credit terms to its customers. The firm's December 31, 1997, balance sheet shows Br. 200,000 of accounts receivable. An evaluation of the Br. 200,000 of accounts receivable results in the following breakdown:

Day	Current	0-30	31-60	61-90	Over 90	
Month	Dec.	Nov.	Oct.	Sept.	Aug.	Total

Accounts Receivable	Br.60,000	Br.40,000	Br.66,000	Br.26,000	Br.8,000	Br.200,000
Percentage of total	30	20	33	13	4	100

Because it is assumed that Ethio- Food gives its customers 30 days after the end of the month in which the sale is made to payoff their accounts, any December receivables that are still on the firm's books are considered current. November receivables are between zero and 30 days overdue, October receivables still unpaid are 31 to 60 days overdue, and so on.

The above breakdown shows that 30 percent of the firm's receivables are current, 20 percent are 1 month late, 33 percent are 2 months late, 13 percent are 3 months late, and 4 percent are more than 3 months late. Although payment seems generally slow, a noticeable irregularity in these data is the high percentage represented by October receivables. This indicates that some problem may have occurred in October. Investigation may find that the problem can be attributed to the hiring of a new credit manager, the acceptance of a new account that has made a large credit purchase it has not yet paid for, or ineffective collection policy. When accounts are aged and such a discrepancy is found, the analyst should determine its cause.

By comparing aging schedules for different periods, the credit manager can get some idea of any changes in collection experience; additionally, he/she can identify those individual accounts requiring attention. Like the collection period, however, a weakness of the aging schedule is that it is influenced by changes in sales.

Change in credit policy

Once a credit policy is set, it doesn't mean it is not subject for change. Since market environment is not static, there is a need to assess the credit policy and make adjustments accordingly. The change might be made on:

- Credit period
- Discount rate
- Discount period
- Credit limit, etc.

Optimal Credit policy

The amount of trade credit that is affected by the variables in the decision is known as Optimal Credit Policy, for example the receivables in an investment. Assignment help shows that many factors such as the internal factors in an organization, the present situation in the economy and the competition that is faced by the firm in the market are some of the external factors that affect the credit policy of the firm. It's the credit policy which helps the firm to get its level of credit. One should work on the credit policy costs and variables In order to understand both jointly and individually it's the maximization profit and the goals and its varied impacts.