Accounts receivables management

Business, Management

The customer from whom receivables or book debts have to be collected in future are called Trade debtor and represent the firm's claim on assets. Receivables management, also termed credit management, deals with the formulation of credit policy, in terms of liberal or restrictive, concerning credit standard and credit period, the discount offered for early payment and the 156 collection policy Ana procedures undertaken It does so In suns a way Tanat together these policy variables determine an optimal level of investment in receivables where the return on that investment is maximum to the firm.

The credit period extended by business firm usually ranges from 15 to 60 days. When goods are sold on credit, finished goods get converted into accounts receivable (trade debtors) in the books of the seller. In the books of the rye, the obligation arising from credit purchase is represented as accounts payable (trade creditors). " Accounts receivable is the total of all credit extended by a firm to its customer. " A firm's investment in account receivable depends upon how much it sells on credit and how long it takes to collect receivable.

Accounts receivable (or sundry debtors) constitute the 3rd most important assets category for business firm after plant and equipment and inventories and also constitute the 2nd most important current assets category for business firm after inventories. Poor management of accounts receivables are: neglect of arioso overdue account, sharp rise in the bad debt expense, and the collection of debts expense and taking the discount by customers even though they pay after the discount date and even after the net date.

Since accounts receivable represent a sizable investment on the part of most firms in the case of public enterprises in India it forms 16 to 20 per cent of current assets. Efficient management of these accounts can provide considerable saving to the firm. 157 Factors involving in Receivable management: The terms of credit granted to customers deemed creditworthy. 2. The policies and practices of the firm in determining which customers are to be granted credit. 3. The paying practices of credit customers. 4. The vigor of the sellers, collection policies and practice. 5. The volume of credit sales.

Goalsof Receivable Management The basic goal of credit management is to maximize the value of the firm by achieving a trade off between the liquidity (risk and profitability). The purpose of credit management is not to maximize sales, nor to minimize the risk of bad debt. If the objective were to maximize sales, then the firm would sell on credit to all. On the contrary, if minimization of bad debt risk were the aim, then the firm old not sell on credit to anyone. In fact, the firm should manage its credit in such a way that sales are expanded to an extent to which risk remains within an acceptable limit.

Thus to achieve the goal of maximizing the value, the firm should manage its trade credit. The efficient and effective credit management does help to expand sales and can prove to be an effective tool of marketing. It helps to retain old customers and win new customers. Well administrated credit means profitable credit accounts. The objectives of receivable management is to promote sales and profits until that point is reached where the 158 turn

on investment is further funding of receivables is less than the cost of funds raised tofinancethat additional credit.

Granting of credit and its management involve costs. To maximize the value of the firm, these costs must be controlled. These thus include the credit administration expanses, b/d losses and opportunity costs of the funds tied up in receivable. The aim of credit management should be to regulate and control these costs, not to eliminate them altogether. The cost can be reduced to zero, if no credit is granted. But the profit foregone on the expected volume of sales arising due to the extension of credit. Debtors involve funds, which have an opportunity cost.

Therefore, the investment in receivables or debtors should be optimized. Extending liberal credit pushes sales and thus results in higher profitability but the increasing investment in debtors results in increasing cost. Thus a trade off should be sought between cost and benefits to bring investment in debtors at an optimum level. Of course the level of debtors, to a great extent is influenced by external factors such as industry norms, level of business activity, seasonal factors and the degree of completion. But there are a lot of internal factors include arms, standards, limits and collection procedures.

The internal factors should be well administered to optimize the investment in debtors. 159 Credit Management In order that the credit sales are properly managed it is necessary to determine following factors: Credit Policy Credit Evaluation of Individual Buyers Credit Sanction Decisions Control and Monitoring of Receivables The first stage of credit sales is to decide policy in which most important variable is whether credit sales should be made or not

and if yes to what extent I. E. What percentage of sales should be done on cash and what percentage on credit.

The discussion with cement companies marketing and finance© department clearly suggest that the credit policy is more dependent upon market forces and less on company specially in periods when there is excessive competition which has happened a number of times in the history of cement industry after decontrol and nutcrackers nave Eden Trace to prove cereal IT teeny wanted Dull utilization AT capacity. If in the market there is practice of providing credit, those companies who do not fall in line have lower sales and so lower utilization of instilled capacity.

The management has to weigh whether it would avoid risk of realization and problem of arranging funds for larger sales on credit or decide for reduced capacity utilization thereby resulting in higher cost per tone of cement produced. 160 Actually the policy should be based on cost benefit analysis of these factors but often policy is decided without detailed calculations. In actual practice when one waits to push sales the marketing department pressurize the management to provide liberal credit to buyers to realize sales targets.

Credit Rating The second virtual point of credit policy is to whom to give credit and whom it should be denied. Whether it should be given to everyone or on selective basis? As per standards one can workout impact of credit sales on profits by following formulae: AP= AS -B, AS in the above formula AP = Change in profit AS = Change in sales V = Ratio of variable cost to sales K = Cost of capital I. E. Interest cost of credit AY = Increase in receivables

investment B = Bad debts ratio on additional sales The change in profits (AP) is dependent upon ratio of variable cost and fixed cost and change in sales.

The figure is worked out by deducting variable cost from sales I. E. Sales minus variable cost is change in profits. The above formula appears to be very simple but for policy purposes it requires that policy maker should be able to estimate precisely the impact of credit on sales value, the 161 variable cost and bad debts besides the cost of capital. In practice besides the cost of capital, it is very difficult to measure extent of increase in sales as a result of credit and it is only broad estimate of sales department.

Similarly, it is very difficult if not impossible to workout likely bad debts. The variable cost can be worked out with great precision if proper costing system is maintained. Because of difficulties in notifying various variables in the formulae often credit policy is decided without working details on prevailing market conditions and the need of the company to push sales at a point of time. It has been by various companies that no details are worked. The credit period is the time length for which seller agrees to provide credit to the buyers.

It varies according to the practice of trade and varies between 15 to 60 days. In some cases for an early payment pre-agreed discount is given to induce buyer make an early payment. For late payment in the agreement there is provision for interest payment by buyer. If credit is given for longer period it induces to push up sales but this is true only when one provides longer period credit than competitors. The customer-distributor, dealer, consumers is attracted to a firm who provides longer period credit.

The impact of credit on profits and sales can be worked out from the following formula: AS AS The various components are as under : 162 A Change in profit A S= Change in sales A Change in investments receivables V= Ratio of variable cost to sales K= Cost of giving credit b= bad debits ratio to increased credit The discussion with the industry suggests that they rarely take decision on period of credit based on formula. It is market conditions and practices in the trade, which decides the period of credit and hardly any calculations of cost are done. In practice it is marketing department whose advice plays an important and deciding role.

In the period when sales have to be pushed up more credit is provided and there is no uniform policy overtime. During rainy season Oily- Seep.) when demand is generally slack more liberal credit is granted than rest of the year. Further, when stocks accumulate due to sluggish sales, producers accept the terms of their customers and traders bout the period of credit but when market conditions are tight, the seller becomes more strict in providing credit. Optimum Credit Policy Credit policy refers to those decision variables that influence the amount of trade credit I. . The investment in receivables. The firm's investment in receivable are affected by general economic conditions, industry norms, pace of technological change, competition etc. Though the firm has no control on these factors, yet they have a great impact on it and it can certainly influence the level of trade credit through its 163 cereal policy Walton toner constraints Imposed externally. I en purpose AT any commercial enterprise is the earning of profit. Credit itself is utilized to increase sales, but sales must return a profit.

Further, whenever some external factors change, the firm can accordingly adopt its credit policy. R. J. Chambers says, " Theresponsibilityto administer credit and collection policies may be assigned to a financial executive or marketing executive or both of them Jointly depending upon the original structure and the objectives of the firm. " Different types of credit policy are: Loose or Expansive Credit Policy- Firms following this policy tend to sell on credit to customers very liberally. Credits are granted even to those whose credit worthiness is not proved, not known and are doubtful.

Advantages of Loose or Expansive Credit Policy: Increase in Sales (higher sales), Increase in profit (higher profit), Disadvantages of Loose or Expansive Credit Policy: Heavy bad/debts. Problem of liquidity Increase in cost of credit management. Tight or Restrictive Credit Policy- Firms following this policy are very selective in extending credit. They sell on credit, only to those customers who had proved credit worthiness. Advantages of Tight of Restrictive Credit Policy: Minimize cost. Minimize chances of bad debts. 64 Higher sales in long run. Higher profit in long run.

Do not pose the serious problem of liquidity. Disadvantages of Tight or Restrictive Credit Policy: Restrict Sales. Restrict Profit Margin. Benefits of Credit Extension: Increases the sales of the firm. Makes the credit policy liberal. Increase the profits of the firm I en market value AT ten Tells snare would roles Cost of Credit Extension: Bad debt losses Production and selling cost. Administrative expenses. Cash discounts and opportunity cost. Cost Benefit Trade off Profitability 165 Aspects of Credit Policy: Credit terms

Credit Period Cash Discounts Credit Standard Collection policy or collection efforts.

Credit terms - The stipulations under which the Tall sells on cereal to Its customers are called alt terms. (a) Credit Period - The time duration for which credit is extended to the customers is referred to as credit period. It is the length of time for customers under which they are allowed to pay for their purchases. It is generally varies between 15-60 days. When a firm does not extend any credit the credit period would obviously be zero. It is generally stated in terms of a net date, for example, if firm allows 30 days of credit with no account to induce early payments credit then its credit terms are stated at 'net 30'.

Usually the credit period of the firm is governed by industry norms, but firms can extend credit for longer duration to stimulate sales. If the firm's bad debts build up, it may tighten up its credit policy as against the industry norms. According to Martin H. Swished, " Credit period is the duration of time for which trade credit is extended. During this period the overdue amount must be paid by the customer. The length of credit period directly affects the volume of investment in receivables and indirectly the net worth of the company.

A long credit period may blast sales but it also 166 increase investment in receivables and lowers the quality of trade credit. " Cash Discounts - It is the another aspect of credit terms. Many firms offer to grant cash discount to their customers in order to induce them to pay their bill early. The cash discount terms indicate the rate of discount and the period for which

discount has been offered. If a customer does not avail this offer, he is expected to make the payment by the net date. In the words of Martin H. Sudden " Cash Discount prevents debtors from using trade credit as a source of Working

Capital. " Liberalizing the cash discount policy may mean that the discount percentage is increased and or the discount period is lengthened. Such an action tends to enhance sales (because the discount is regarded as price reduction), reduce the average collection period (as customers pay promptly). Cash Discount is a premium on payment of debts before due date and not a compensation for the so - called prompt payment. Credit Standard - The credit standard followed by the firm has an impact of sales and receivables. The sales and receivables level are likely to be high, if the credit