The elements of a good credit policy, implications of increased receivables, the ...

Finance

The paper " Accounts Receivables Management" is a wonderful example of an assignment on finance and accounting.

What are the elements of a good credit policy? Evaluate Modern Farm Equipment's credit policy.

A good credit policy should, therefore, have the following elements considered and ingrained:

i) The mission statement that indicates the primary purpose of the credit department as well as the companies appetite for risk and how the department should aim to get maximum sales by balancing both areas;

ii) Goal statement that acts as drivers to ensure the improvement of receivable balances. It also includes industry benchmarking statistics as well as various metrics i. e. days the sales are outstanding, collection effectiveness index, aging performance, bad debt write-offs, etc.

iii) A credit evaluation and approval process;

iv) Credit continuation procedures to support continuous monitoring of receivables portfolio and overall appropriate risk;

v) Collection procedures Modern Farm Equipment's credit policy

i) The board memo indicates ' they cannot continue holding their customers as long as they have been'- this indicates that the receivables aging performance has not been done well as there are a great number of customers who have not paid within the stipulated time periods assigned.

ii) The firm was hard-pressed to offer terms of net 60 to the clients due to industry competition – This means that there is a weakness in the company's goal statement as instead of formulating a goal/payment terms in line with their own risk appetite, they have undertaken the industry's payment period of 60 days which is hurting their business.

2. Why is the increase in accounts receivables of concern to the board of directors? Are they justified in their demand for a tighter credit policy? Why?

Increase in accounts receivables is of concern to the board because it shows that the company is having trouble collecting money from customers, therefore, meaning that the company's cash flow is affected negatively i. e. there are no funds available to pay for other expenses.

The board is justified to demand a tighter credit policy in order to improve on the company's reported net income. This is because as company's accrue profits, they can book revenue (and receivables for customers) in the income statement and if these receivables are essentially bad debts, the company will be misrepresenting their accounts (Gallagher, 2010).

By holding the customers for long, the business is indirectly extending interest-free loans to their clients, therefore, a tighter credit policy also ensures a high receivables turnover which is also a means of knowing how a company is using its assets efficiently.

3. What is the amount of annual expense to the firm as a result of the delay in collections? What other risks do such delays entail?

40% of credit sales are being collected 10 days late. Due to this, bad debts have increased to 2% of sales. Therefore the bad debt expense incurred by the company (assuming all sales are credit sales) is :

2% * 30, 000 = 600.

Increase in delays creates a risk of increasing bad debts incurred by the company which then reduces the net income received and the overall performance of the business.

5. What are some other ways in which the company could speed up collections and reduce the receivables?

Ways to speed up collections include:

i) Track accounts receivables balance thoroughly – An up to date aging schedule should be maintained, either manual or automated. Some accounting packages can trigger alerts thus making this process easier and this enables the company to be aware of late payments soonest and thus take action (Salek, 2005).

ii) Offer small discounts for earlier payment – this will act as an incentive for customers to pay early and eliminate the problem of long outstanding receivables and the risk of incurring bad debts (Schaeffer, 2002).

iii) Clearly, state the terms of payment and ensure no deviations to it by the customer.

iv) The company can call the customers after sending the invoice. This improves the customer relationship as well as providing an avenue to solve any arising problems early.

v) The company can set billing/collection goals each month for the accounts receivables staff thus ensuring early collection of debts.

vi) An audit of current practices can be done regularly to check the policies are being adhered to.

6. Why has this slow build-up in accounts receivables occurred? Could it have been avoided? How? Please explain.

The build-up in accounts receivables occurred due to the lack of follow-ups or audits to check collection procedures over the past couple of years. The company has also bowed to industry pressure by offering terms of net 60 to its clients while this may not have been in line with their own risk appetite.

The company did not have a policy for charging interest or late fees

The financial manager had been recruited to manage the company's working capital six months ago, with the emphasis being placed on the management of cash and inventory, thus the accounts receivables issue has still not been addressed.

This issue could have been avoided by first having credit policy terms that were manageable for the company, ensuring clients are screened for payment potential before credit is offered to them (through use of credit bureaus) as well as keeping track of the receivables balances and following up with the clients to pay on time (Funsten, 1993).