RECEIVABLES MANAGEMENT

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PURPOSE OF MAINTAINING RECEIVABLES

- Goods sold on credit create receivables or book debts that the firm is expected to collect in the near future.
- Purpose of maintaining receivables:

  - Helps the company in increasing sales

  - Leads to increase in profit as credit sales have higher profit margin

  - Helps in maintaining sales in a competitive environment

OBJECTIVE OF RECEIVABLES MANAGEMENT

- To analyze the cost of maintaining receivables
- To assess the probability of the receivables becoming bad debts
- To assess the creditworthiness of the clients before extending the credit
- To perform a cost-benefit analysis before extending credit to the customers

COSTS ASSOCIATED WITH RECEIVABLES

1) **Capital costs**: Cost of funds locked up in receivables
2) **Administrative costs**: Costs involved in maintaining records related to receivables
3) **Collection costs**: Costs associated with collecting the trade debts at the end of the credit period.
4) **Default costs:** Loss to be borne by the company if the customer defaults.

ASPECTS RELATED TO RECEIVABLES MANAGEMENT

- **CREDIT POLICY**: Aims at maintaining a proper balance between the variables associated with receivables, like credit period, cash discount to be offered etc.
- **CREDIT EVALUATION**: Helps in analyzing the creditworthiness of the customer.
- **CREDIT GRANTING DECISION**: Helps in performing a cost-benefit analysis before extending credit to a customer
- **MONITORING RECEIVABLES:** Aims at reviewing the extent of collections made by the firm.

CREDIT POLICY

Variables associated with credit policy

a. **Credit standards**

b. **Credit Period**

c. **Cash Discount**

d. **Collection Program**

a. Credit Standards

They are criteria set by the firm for extending credit to the clients

Implications of stringent credit standards	Implications of lenient credit standards
Benefits • Lower bad debts •Lower administrative costs •Lower investment in receivables •**Costs** • Reduced sales	**Benefits** •Increased sales **Costs** •Higher bad debts •Higher administrative costs •Higher investment in receivables

b. Credit Period

The duration for which cash payment for the goods is deferred

Implications of increasing credit period	Implications of reducing the credit period
Benefits • Increase in sales **Costs** •Higher bad debts •Higher investment in receivables	**Benefits** •Lower bad debts •Lower investment in receivables **Costs** •Decrease in sales

EFFECT OF RELAXING CREDIT STANDARDS or INCREASING THE CREDIT PERIOD

- **Incremental benefits associated with relaxing credit standards**:

  1. Increase in contribution = $\Delta S(1 - V)$

where ΔS is change in sales and V is the variable-cost to sales ratio

- **Incremental costs associated with relaxing credit standards**

1. Increase in cost of investing in receivables = $k\Delta I$,

where k is the cost of funds and ΔI is the increase in investment

2. Increase in bad debt costs $\Delta B = b_n (S_0 + \Delta S) - b_0 S_0$

where b_n and b_0 are the new and old bad debt loss ratios.

S_0 is the original sales level

Net incremental benefit $(\Delta P) = \Delta S\ (1-V) - k\Delta I - \Delta B$

Decision criterion : Relax credit standards only if ΔP is positive

c. **Cash Discount**

The discount on price of the material that is given to the customer if payment is made before the stipulated period

Implications of introducing/ increasing cash discount
Benefits • Additional sales •Reduction in amount locked up in receivables **Costs** • Loss due to cash discount offered

EFFECT OF INCREASING THE CASH DISCOUNT

- **Incremental benefits associated with increasing cash discount:**

1. Increase in contribution = $\Delta S(1\text{-}V)$

2. Decrease in cost of financing receivables: $k\ \Delta I$

where ΔI is the decreases in investment in receivables

$$= \frac{S_0}{360} \times (ACP(old) - ACP(new)) - V\frac{\Delta S}{360} \times ACP(new)$$

- **Incremental costs associated with increasing cash discount:**

1. Increase in cash discount = $p_n\ (S_n + \Delta S)\ d_n - p_0 S_0 d_0$

where p_0 and p_n are the proportions of discount sales before and after liberalizing the credit terms.

D_0 and d_n are the old and new discount rates

S_0 is the original sales level

Cash discount should be given only if incremental benefits are more than incremental costs.

d. Collection Program

The effort and policy followed by the firm in collecting receivables

Implications of a stringent collection policy	Implications of a lenient collection policy
Benefits • Lower bad debts •Lower average collection period •Lower investment in receivables **Costs** • Might adversely affect company-customer relationship and reduce sales. •Higher collection expenses	**Benefits** •Increased sales •Lower collection expenses **Costs** •Higher bad debts •Higher average collection period •Higher investment in receivables

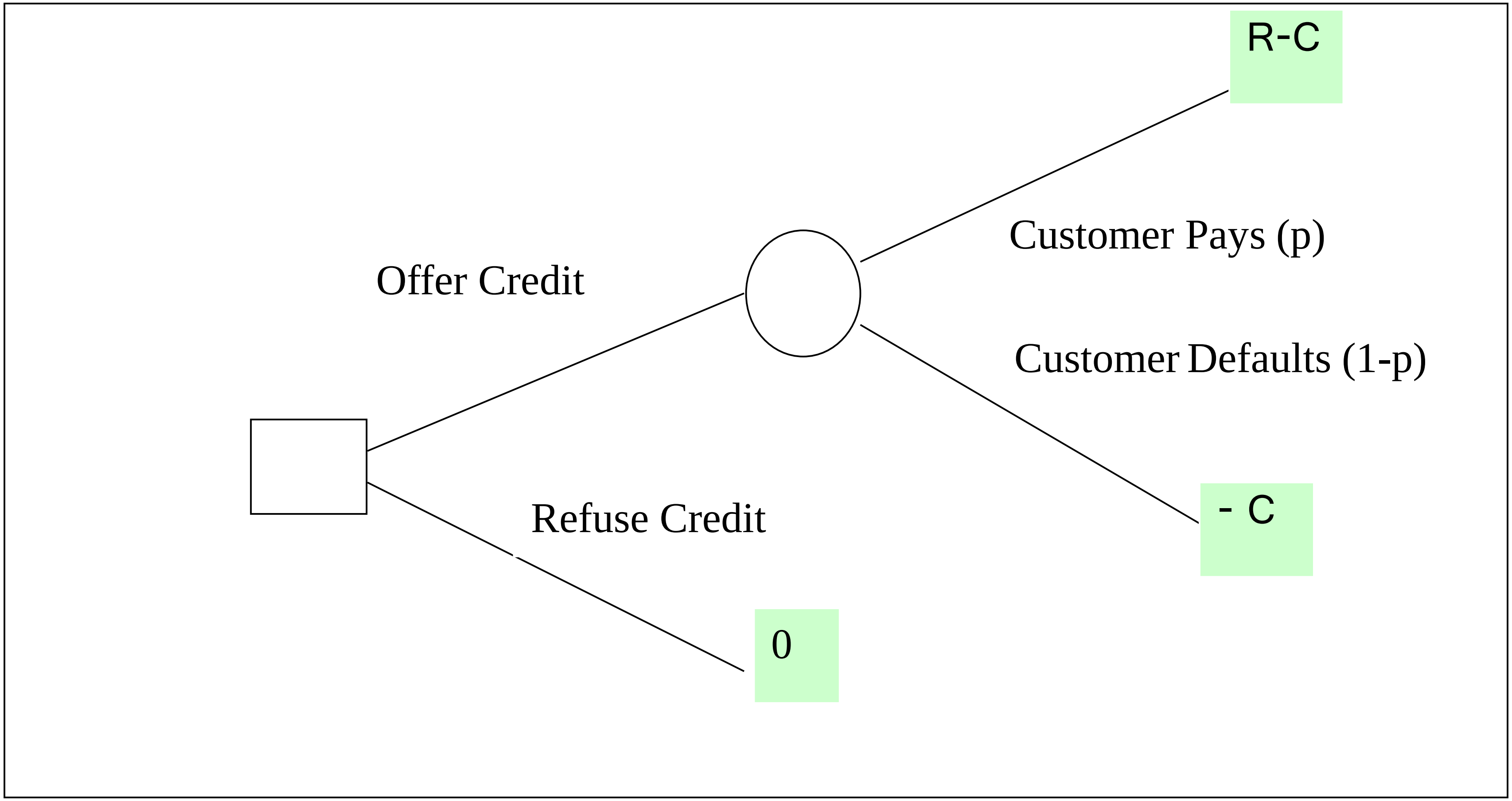
CREDIT EVALUATION

Techniques/ Sources for evaluating creditworthiness of the customers

- Financial statements of the customer
- Bank references
- Firm's Experience
- Numerical Credit Scoring

CREDIT GRANTING DECISION

- **DECISION-TREE APPROACH**



MONITORING RECEIVABLES

Techniques For Monitoring Receivables

- **Days Sales Outstanding** :
- **Ageing Schedule**:
- **Collection Matrix**:

Days Sales Outstanding

Indicates the average number of days' sales outstanding at a particular time.

It is computed as:

$$\frac{\text{Accounts receivable at the time chosen}}{\text{Average daily sales}}$$

Ageing Schedule:

It reflects the age-wise distribution of accounts receivable at a given time.

Example: Following is the ageing schedule for IQ Ltd. which has Rs. 1,00,000 in receivables:

Age of account	Amount (in Rs.)	Percent of total value of outstanding accounts receivables
0-10 days	50,000	50%
11-60 days	25,000	25%
61-80 days	20,000	20%
Over 80 days	5,000	5%
	Total: 1,00,000	

If a particular firm has a credit period of 60 days then as per the above ageing schedule, 25% of the firm's accounts are yet to be collected.

Collection Matrix

Indicates the extent to which collections associated with the credit sales are made.

Example, Following is the collection matrix for Venus Ltd.

Percentage of receivables collected during	January	February
The month of sales	30%	40%
First Month after the sales	48%	35%
Second month after the sales	22%	25%

In case of Venus Ltd., in the month of January, 30% of the sales were collected in the same month, 48% were collected in the next month, 22% were collected in march (i.e. the second month after the sales). Similarly, 40% of February's sales were collected in that month itself, 35% were collected in march and 25% were collected in the month of April.

END OF SESSION

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