Unit 12: Receivable Management

QN1: What do you understand by the day's sales outstanding? Explain its importance in receivable management?

The meaning of day's sales outstanding (DSO) is the average length of time required to collect credit sales. The DSO is calculated by dividing the firm's accounts receivable by average daily sales.

$$DSO = \frac{Receivable \times Days\ in\ year}{Credit\ Sales}$$

For example a firm has Rs50,000 balance in account receivable and Rs360,000 of sales, DSO is 50,000×360/360,000= 50 days. The DSO is a financial indicator showing the age in term of days that implies average time firm turn the receivables into cash.

Importance of DSO in receivable management

1. It provides good understanding of company's internal collection efficiencies and requires three pieces of information for calculation: Total receivable, total credit sales, the no of days in the period analyzed.
2. The DSO is compared against DSO of the average firms in the industry in which the firm is operating. DSO lower than industry is assumed as better.
3. The DSO is also compared with firm's credit period to evaluate the efficiency of receivable management. For example, if the firm's credit period is 30 days but the receivables collection in the average of 18 days, shows that the collection efficiency is good.

QN2 Explain the usefulness of preparing aging schedule of receivables.

Aging schedules is a report showing how long accounts receivables have been outstanding; it gives the percentage of receivables currently past due, and the percentage past due by specified periods. For e.g. aging schedule of XYZ company having credit term 1.5/10, net 45 as:

Table: Aging schedule of XYZ Company

Age of Account (Days)	Value of Account(RS)	Percentage of Total Value
0-10	15,30,500	61.22%
11-30	5,30,000	21.22
31-45	4,39,500	17.56
46-60	0	0
Over 60	0	0
Total	25,00,000	100

XYZ Company's aging schedule indicates that its entire customer pays in time. 61.22% paid on discount period i.e. 10 days, 21.22% paid on 30 days and rest paid on 45 days.

Usefulness: Management should constantly monitor the aging schedule to detect trends, to see how the firm's collection experience compares with in credit terms, and to see how effectively

the credit department is operating in comparison with other firms in the industry. If the aging schedule begins to show an increasing percentage of past due accounts, then the firm's credit policy may need to be tightened.

QN3 Explain the elements of credit policy.

Accounts receivables are equal to sales per day and collection period. These two factors sales per day and collection period are influenced by a set of controllable factors called the firm's credit policy. They are:

Credit period:

Length of time from which credit is granted usually measured in days from the date of the all invoice. Lengthening the credit period stimulates sales, increases cost of receivables and increases of bad debt losses. Tightening the credit period tends to lower sales, decrease investment in receivables, and reduces the incidence of bad debt loss.

Effects of increase in length of credit period		
Variables	**Direction of change**	**Effect on profits**
Sales volume	Increase	Positive
Investment in accounts receivables	Increase	Negative
Bad debt expenses	Increase	Negative

Credit standard:

Credit standards often revolve around the "five C" s of credit

i. *Character:* Refers to the probability that customers will try to honor their obligations. Every credit transaction implies a promise to pay. It is important to assess integrity of the credit applicant.
ii. *Capacity*: Refers to the customer's ability to meet the payment terms. It is measure in part by the past records and business methods of customer.
iii. *Collateral:* It is represented by assets that customers may offer as security in order to obtain credit.
iv. *Capital*: This measure seeks to assess the credit applicant's financial strength from a debt/equity perspective. This is to ask if the applicant has sufficient equity in the firm to absorb losses or if the supplier will have to absorb the losses.
v. *Condition*: Refers both to general economic trends and to special developments in certain geographical regions or sectors of economy that might affect a customer's ability to meet obligation.

Effects of Relaxation of Credit Standards		
Variable	**Direction of change**	**Effect of profit**
Sales volume	Increase	Positive
Investment in accounts receivables	Decrease	Positive

Bad debt expenses	Decrease	Positive

Cash Discount:

Firms generally offer cash discounts to customers to make prompt payments. Increasing the size of discount will attract customers desiring to take discounts.

Effects of increase in cash discount		
Variable	**Direction of change**	**Effect of profit**
Sales volume	Increase	Positive
Investment in accounts receivables	Decrease	Positive
Bad debt expenses	Decrease	Positive

Collection policy:

Collecting accounts receivable is usually a routine task because most firms pay their bills on time. The firm can attempt to collect past due accounts receivable in several ways. For example:

i. *Letters:* After a certain number of days, the firm sends a polite letter reminding the customer of its overdue account. This letter may be followed by yet another letter, if necessary.
ii. *Telephone calls*: 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.
iii. *Personal visits*: Sending a local salesperson or a collection person to confront the customer can be very effective. Payment may ne made on the spot.
iv. *Collection agencies*: A firm can turn uncollectible accounts over to a collection agency or an attorney for collection.
v. *Legal action*: Legal action is the most stringent step in the collection process. It is an alternative to use the collection agency.

Effects of changes in collection efforts		
Variable	**Direction of change**	**Effect on profits**
Sales volume	None or Decrease	None or negative
Investment in accounts receivables	Decrease	Positive
Bad debt expenses	Decrease	Positive
Collection expenditures	Increase	Negative

QN4 What is account receivables? How account receivable can be controlled or managed?

Accounts receivable can be defined as amounts of money owed to a firm by customers who bought goods or services on credit. It represents credit sales that have not been collected. Receivable is also known as book debts.

The total amount of account receivables outstanding at any given time is determined by two factors:

1. The volume of credit sales
2. The average length of time between sales and collections

Receivables = credit sales per day*Length of collection time

=Annual sales/360 *days sales outstanding or average collection period

=S/360*DSO or ACP

Managing receivables has both direct and indirect costs. Too little investment may reduce firm's benefit from a higher sales level. Too much investment may expose the firm to excessive costs by tying up valuable cash. The issue is how much to invest in receivable in order to maximize shareholder wealth. Control of receivable can be done through:

1. **Days Sales Outstanding**: The DSO is a financial indicator showing the age in term of days that implies average time firm turn the receivables into cash. DSO is compared against DSO of the average firms in the industry in which the firm is operating. DSO lower than industry is assumed as better. The DSO is also compared with firm's credit period to evaluate the efficiency of receivable management. For example, if the firm's credit period is 30 days but the receivables collection in the average of 18 days, shows that the collection efficiency is good.
2. **Aging Schedul**e: Aging schedules is a report showing how long accounts receivables have been outstanding; it gives the percentage of receivables currently past due, and the percentage past due by specified periods. Management should constantly monitor the aging schedule to detect trends, to see how the firm's collection experience compares with in credit terms, and to see how effectively the credit department is operating in comparison with other firms in the industry.