DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES
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MBA (Financial Management)

Course Name: -WORKING CAPITAL MANAGEMENT

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Unit – IV/ Topic: RECEIVABLES AND PAYABLES MANAGEMENT

Scheme of Presentation

Receivables and Payables Management:

Credit Policy variables,

Credit Standards, Credit period,

Cash discount and collection efforts.

Credit Evaluation,

Credit Granting Decision,

Control of Receivables,

Management of Trade Credit in India,

Payables Management.

RECEIVABLE AND PAYABLE MANAGEMENT

- **Introduction**
- Receivable management refers to a business makes regarding overall credit and collection politics and the evaluation of individual credit applications.
- In formulating an optional credit policy, finance manager must analyse the marginal benefits and costs associated with changes in credit standards, credit terms, collection efforts etc.

Source : Working Capital Management – V.K. Bhalla – Seventh Revised Edition

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- Receivables management proves for a firm, both, and a problem: because of the promise of a future cash flow and a problem because of the need to obtain financing while waiting for the future cash flows.

Credit policy variables

- The important dimensions of a firm's credit policy are credit standards, credit period, cash discount and collection effort these variables are related and have a bearing on the level of sales, bad debt loss, discounts taken by customers, and collection expenses.

Source: *www.yourarticlelibrary.com.*

Credit Policy Variables

- In establishing an optimum credit policy, the financial manager must consider the important decision variables which influence the level of receivables. the major controllable decision variables include the following: Credit standards and analysis, Credit terms and Collection policy and procedures.

- Receivables management is the process of making decisions relating to investment in trade debtors. certain investment in receivables is necessary to increase the sales and the profits of a firm.
- Bolton, S.E., the objectives of receivables management is “to promote sales and profits until that point is reached where the return on investment in further funding of receivables is less than the cost of funds raised to finance that additional credit.”

Dimensions of Receivables Management

Receivables management involves the careful consideration of the following aspects:

Forming of credit policy.

Executing the credit policy.

Formulating and executing collection policy.

Forming of Credit Policy

- For efficient management of receivables, firms & must adopt a credit policy. A credit policy is related to decisions such as credit standards, length of credit period, cash discount and discount period, etc.

(a) ***Quality of Trade Accounts of Credit Standards*****:** The volume of sales will be influenced by the credit policy of a concern. By liberalising credit policy the volume of sales can be increased resulting into increased profits.

- The increased volume of sales is associated with certain risks too. It will result in enhanced costs and risks of bad debts and delayed receipts the increase in number of customers will increase the clerical wok of maintaining the additional accounts and collecting of information.

Length of Credit Period

- Credit terms or length of credit period means the period allowed to the customers for making the payment. The customers paying well in time may also be allowed certain cash discount.
- A concern fixes its own terms of credit depending upon its customers and the volume of sales the competitive pressure from other firms compels to follow similar credit terms, otherwise customers may feel inclined to purchase from a firm which allows more days for paying credit purchases.
- Sometimes more credit time is allowed to increase sales to existing customers and also to attract new customers the length of credit period and quantum of discount allowed determine the magnitude of investment in receivables.

- ***Cash Discount*:** Cash discount is allowed to expedite the collection of receivables the concern will be able to use the additional funds received from expedited collections due to cash discount.
- The discount allowed involves cost. The discount should be allowed only if its cost is less than the earnings from additional funds.

- ***Discount Period*: ** The collection of receivables is influenced by the period allowed for availing the discount.
- The additional period allowed for this facility may prompt some more customers to avail discount and make payments.
- This will mean additional funds released from receivables which may be alternatively used.
- At the same time the extending of discount period will result in late collection of funds and making payments as per earlier schedule will also delay their payments.

Executing Credit Policy

- ***Collecting Credit information*:** The first step in implementing credit policy will be to gather credit information about the customers.
- This information should be adequate enough so that proper analysis about the financial position of the customers is possible.
- This type of investigation can be undertaken only upto a certain limit because it will involve cost.

- ***Credit Analysis*:** After gathering the required information, the finance manager should analyse it to find out the credit worthiness of potential customers.
- The credit analysis will determine the degree of risk associated with the account, the capacity of the customer borrow and his ability and willingness to pay.

Credit Decision

- After analyzing the credit worthiness of the customer, the finance manager has to take a decision whether the credit is to be extended and if yes then upto what level.
- He will match the creditworthiness of the customer with the credit standards of the company.
- If customer's creditworthiness is above the credit standards then there is no problem in taking a decision.

- In case the customers are below the company credit standards then they should not be out rightly refused. Rather they should be offered some alternative facilities.

Executing Collection Policy

- The collection o f amounts due from the customers is very important. The collection policy the termed as strict and lenient.
- A strict policy of collection will involve more efforts on collection. Such a policy has both positive and negative effects.
- This policy will enable early collection of dues and will reduce bad debt losses the money collected will be used for other purposes and the profits of the concern will go up.
- On the other hand a rigorous collection policy will involve increased collection costs. It may also reduce the volume of sales.

PAYABLES MANAGEMENT

- Account Payables Management refers to the set of policies, procedures, and practices employed by a company with respect to managing its trade credit purchases.
- It consist of seeking trade credit lines, acquiring favorable terms of purchase, and managing the flow and timing of purchases.
- The account payables of a company can be found in the short-term liabilities section of its balance sheet, and they mostly consist of the short-term financings of inventory purchases, accrued expenses, and other critical short-term operations.

Credit Evaluation

- Credit evaluation and approval is the process a business or an individual must go through to become eligible for a loan or to pay for goods and services over an extended period.
- It also refers to the process businesses or lenders undertake when evaluating a request for credit.

Accounts receivable controls

Require credit approval prior to shipment. ...

Verify contract terms. ...

Proofread invoices. ...

Authorize credit memos. ...

Restrict access to the billing software. ...

Segregate duties. ...

Review accounts receivable journal entries. ...

Audit invoice packets.

What is the accounts receivable control?

- A control account is a summary account in the general ledger the details that support the balance in the summary account are contained in a subsidiary ledger—a ledger outside of the general ledger. Rather, these details of the accounts receivable activity will be in the Accounts Receivable Subsidiary Ledger.

Trade Credit

- Trade credit. Trade credit is the credit extended by one trader to another for the purchase of goods and services.
- Trade credit facilitates the purchase of supplies without immediate payment. Trade credit is commonly used by business organizations as a source of short-term financing.

Management of Trade Credit:

- The firm should exploit the possibilities of trade credit to the full extent, because it is an important source of financing working capital needs of the firm. But before opting for taking trade credit, the firm should negotiate with suppliers for maximum credit period without causing embarrassment to the supplier.

OPTIMUM CREDIT POLICY

A firm should establish receivables policies after carefully considering both benefits and

costs of different policies. These policies relate to:

(i) Credit Standards,

(ii) Credit Terms, and

(iii) Collection Procedures.

Credit standards - The term credit standards represent the basic criteria for extension of credit

The levels of sales and receivables are likely to be high if the credit standards are relatively loose, as compared to a situation when they are relatively tight. The firm's credit standards are generally determined by the five "C's". Character, Capacity, Capital, Collateral and Conditions. Character denotes the integrity of the customer, i.e. his willingness to pay for the goods purchased. Capacity denotes his ability to manage the business. Capital denotes his financial soundness.

- Collateral refers to the assets which the customer can offer by way of security.
- Conditions refer to the impact of general economic trends on the firm or to special developments in
- certain areas of economy that may affect the customer's ability to meet his obligations.
- Information about the five C's can be collected both from internal as well as external
- sources. Internal sources include the firm's previous experience with the customer supplemented by its own well developed information system.

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Credit terms - It refers to the terms under which a firm sells goods on credit to its customers.

As stated earlier, the two components of the credit terms are

(a) Credit Period and

(b) Cash Discount.

The approach to be adopted by the firm in respect of each of these components is discussed below:

Credit Period:

It is the period of time for which trade credit is made available to the company by the suppliers. Like the amount of credit, credit period too is determined by various of factors.

Cash Discount:

It is a discount or reduction in debt allowed by creditors to their debtors to encourage them to pay their dues before the expiry of the credit period.

iii. **Collection procedures - A stringent collection procedure is expensive for the firm because of** high out-of-pocket costs and loss of goodwill of the firm among its customers however, it minimizes the loss on account of bad debts as well as increases savings in terms of lower capital

- costs on account of reduction in the size of receivables. A balance has therefore to be stuck between the costs and benefits of different collection procedures or policies.

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