Learning Objectives

- What is Receivables Management
- Review of Credit Policy
- What is Factoring
- Practical Illustrations
Management of Receivables

The basic objective of management of sundry debtors is to optimise the return on investment on these assets known as receivables.

Large amounts are tied up in sundry debtors, there are chances of bad debts and there will be cost of collection of debts. On the contrary, if the investment in sundry debtors is low, the sales may be restricted, since the competitors may offer more liberal terms. Therefore, management of sundry debtors is an important issue and requires proper policies and their implementation.
Three aspects of management of sundry debtors

- Credit policy:
The credit policy is to be determined. It involves a trade off between the profits on additional sales that arise due to credit being extended on the one hand and the cost of carrying those debtors and bad debt losses on the other. This seeks to decide credit period, cash discount and other relevant matters.
Credit Analysis

- This requires the finance manager to determine as to how risky it is to advance credit to a particular party.
Control of Receivables

This requires finance manager to follow up debtors and decide about a suitable credit collection policy. It involves both laying down of credit policies and execution of such policies.
Manual systems of recording the transactions and managing receivables are cumbersome and costly. The automated receivable management systems automatically update all the accounting records affected by a transaction. This system allows the application and tracking of receivables and collections to store important information for an unlimited number of customers and transactions, and accommodate efficient processing of customer payments and adjustments.
### Ageing Schedule

An important means to get an insight into collection pattern of debtors is the preparation of their ‘Ageing Schedule’. Receivables are classified according to their age from the date of invoicing e.g. 0 – 30 days, 31 – 60 days, 61 – 90 days, 91 – 120 days and more.

This classification helps the firm in its collection efforts and enables management to have a close control over the quality of individual accounts. The ageing schedule can be compared with other firms also.
Factoring: It is a new financial service that is presently being developed in India. Factoring involves provision of specialised services relating to credit investigation, sales ledger management, purchase and collection of debts, credit protection as well as provision of finance against receivables and risk bearing. In factoring, accounts receivables are generally sold to a financial institution (a subsidiary of commercial bank-called “Factor”), who charges commission and bears the credit risks associated with the accounts receivables purchased by it.
How It Operates........

- Its operation is very simple. Clients enter into an agreement with the “factor” working out a factoring arrangement according to his requirements. The factor then takes the responsibility of monitoring, follow-up, collection and risk-taking and provision of advance. The factor generally fixes up a limit customer-wise for the client (seller).
Advantages

The firm can convert accounts receivables into cash without bothering about repayment.

Factoring ensures a definite pattern of cash inflows.

Continuous factoring virtually eliminates the need for the credit department.

Another advantage consists of relieving the borrowing firm of substantially credit and collection costs and to a degree from a considerable part of cash management.
Example (Nov 2011)

A new customer with 10% risk of non-payment desires to establish business connections with you. He would require 1.5 month of credit and is likely to increase your sales by `1,20,000 p.a. Cost of sales amounted to 85% of sales. The tax rate is 30%. Should you accept the offer if the required rate of return is 40% (after tax)?
Answer

Evaluation of Credit to New Customer
Profit on Additional Sales
Increase in Annual Sales 1,20,000
Less: Cost of Sales being 85% 1,02,000
18,000
Less: Bad Debts Loss 12,000
(10% on sales)
Profit before Tax 6,000
Less: Tax @ 30% 1,800
Net Profit after Tax 4,200
Opportunity Cost of Investment in Rec. 5,100
Net Benefit/Loss 900
Receivables Turnover = 12/1.5 = 8 times
Average Investment in Receivables
= 1,02,000/8 = 12,750
Opportunity Cost of Funds Blocked =
12,750 x 40/100 = 5,100
Decision:

Since the estimated profit after tax on additional sales ` 4200 is less than the required return on additional investment of ` 5,100 in receivables, hence the offer should not be accepted.
A Ltd. has a total sales of `3.2 crores and its average collection period is 90 days. The past experience indicates that bad-debt losses are 1.5% on sales. The expenditure incurred by the firm in administering its receivable collection efforts are `5,00,000. A factor is prepared to buy the firm’s receivables by charging 2% commission. The factor will pay advance on receivables to the firm at an interest rate of 18% p.a. after withholding 10% as reserve.

Calculate the effective cost of factoring to the Firm.
Answer

Average level of Receivables = 80,00,000
= 3,20,00,000 × 90/360

Factoring commission = 1,60,000
= 80,00,000 × 2/100

Factoring reserve = 8,00,000
= 80,00,000 × 10/100

Amount available for advance = ` 70,40,000
= ` 80,00,000-(1,60,000+8,00,000)

Factor will deduct his interest @ 18% :
\[ \frac{70,40,000 \times 18 \times 90}{100 \times 360} = 3,16,800 \]

Advance to be paid
= ` 70,40,000 – ` 3,16,800 = ` 67,23,200
### Annual Cost of Factoring to the Firm

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factoring commission</td>
<td>6,40,000</td>
</tr>
<tr>
<td>(( \text{$1,60,000} \times \frac{360}{90} ))</td>
<td></td>
</tr>
<tr>
<td>Interest charges</td>
<td>12,67,200</td>
</tr>
<tr>
<td>(( \text{$3,16,800} \times \frac{360}{90} ))</td>
<td></td>
</tr>
<tr>
<td></td>
<td>19,07,200</td>
</tr>
</tbody>
</table>
Firm’s Savings on taking Factoring Service

Cost of credit administration saved 5,00,000
Cost of Bad Debts 4,80,000
(\(3,20,00,000 \times 1.5/100\)) avoided 9,80,000
Answer

Net Cost to the firm  9,27,200
(19,07,200 – 9,80,000)

Effective rate of interest to the firm
= \( \frac{9,27,200 \times 100}{67,23,200} \) = 13.79%

Note: The number of days in a year has been assumed to be 360 days.
Example

A company currently has an annual turnover of ` 50 lakhs and an average collection period of 30 days. The company wants to experiment with a more liberal credit policy on the ground that increase in collection period will generate additional sales.
From the following information, kindly indicate which policy the company should adopt:

<table>
<thead>
<tr>
<th>Credit policy</th>
<th>Average collection period</th>
<th>Sales (lacs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>45</td>
<td>56</td>
</tr>
<tr>
<td>B</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>C</td>
<td>75</td>
<td>62</td>
</tr>
<tr>
<td>D</td>
<td>90</td>
<td>63</td>
</tr>
</tbody>
</table>
Costs: Variable cost: 80% of sales
Fixed cost: `6 lakhs per annum
Required (pre-tax) return on investment: 20%
A year may be taken to comprise of 360 days.

June 2009
## Answer (Evaluation of Credit Policies)

<table>
<thead>
<tr>
<th></th>
<th>Present</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average collection period (days)</td>
<td>30</td>
<td>45</td>
<td>60</td>
<td>75</td>
<td>90</td>
</tr>
<tr>
<td>Annual sales (` lakhs)</td>
<td>50</td>
<td>56</td>
<td>60</td>
<td>62</td>
<td>63</td>
</tr>
<tr>
<td>Contribution 20% on sales (` lakhs)</td>
<td>10</td>
<td>11.2</td>
<td>12</td>
<td>12.4</td>
<td>12.6</td>
</tr>
<tr>
<td>Incremental contribution (` lakhs)</td>
<td></td>
<td>1.2</td>
<td>2</td>
<td>2.4</td>
<td>2.6</td>
</tr>
</tbody>
</table>
**Answer**

<table>
<thead>
<tr>
<th></th>
<th>Present</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average debtors</strong></td>
<td>4.17</td>
<td>7</td>
<td>10</td>
<td>12.92</td>
<td>15.75</td>
</tr>
<tr>
<td><strong>Investment in debtors at</strong></td>
<td>3.34</td>
<td>5.6</td>
<td>8</td>
<td>10.34</td>
<td>12.6</td>
</tr>
<tr>
<td><strong>variable costs 80%</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(` lakhs)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Incremental investment</strong></td>
<td>2.66</td>
<td>4.66</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>in debtors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Required return on</strong></td>
<td>0.45</td>
<td>0.93</td>
<td>1.40</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>incremental debtors @ 20%</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Excess of incremental</strong></td>
<td>0.75</td>
<td>1.07</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>contribution over</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>incremental return</strong></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
Recommendation:

Since excess of incremental contribution over incremental return is maximum i.e. 1.07 lakhs, when the average collection period is 60 days, therefore, credit policy B, should be adopted.
Lesson Summary

What is Receivables Management

Evaluation of credit policy

Factoring
Thank you

All the best ........