

Key areas of accounts receivable management

There are three key areas of accounts receivable management.

- Before a company grants credit to a customer it should ensure, as far as possible, that the customer is worthy of that credit and that bad debts will not result. Checks should continue to be carried out on existing customers as a company would like to have early warning of any problems which may be developing. This is especially true for key customers of the company.
- Once the decision has been taken to grant credit, then suitable credit terms must be set and the receivables that arise must be monitored efficiently if the costs of giving credit are to be kept under control.
- A key area of the management of accounts receivable is the final collection of cash from customers. Any company must have a rigorous system to ensure that all customers pay in a timely fashion as, without this, the level of receivables and the cost of financing these receivables will inevitably rise, as will the risk and cost of bad debts.

These key areas will now be explored in more detail.

Assessing creditworthiness

The methods a company could use to assess the creditworthiness of a customer or a potential customer include:

- a bank reference – while a bank reference can be fairly easily obtained, it must be remembered that the other company is the bank's customer and so a bank reference will stick to the facts. It is most unlikely to raise any fears the bank may have about the company
- a trade reference – this is obtained from another company who has dealings with your potential customer/customer. Due to the litigious nature of society these days, it may not be so easy to obtain a written reference. However, you may be able to call contacts you have in the trade and obtain an informal oral reference
- credit rating/reference agency – these agencies' professional business is to sell information about companies and individuals. Hence, they will be keen to

give you the best possible information, so you are more likely to return and use their services again

- financial statements – financial statements of a company are publicly available information and can be quickly and easily obtained. While an analysis of the financial statements may indicate whether or not a company should be granted credit, it must be remembered that the financial statements available could be out of date and may have suffered from manipulation. For larger companies, an analysis of their accounting information can generally be found through various sources on the internet
- information from the financial media – information in the national and local press, and in suitable trade journals and on the internet, may give an indication of the current situation of a company. For example, if it has been reported that a large contract has been lost or that one or more directors has left recently, then this may indicate that the company has problems
- visit – visiting a potential new customer to discuss their exact needs is likely to impress the customer with regard to your desire to provide a good service. At the same time, it gives you the opportunity to get a feel for whether or not the business is one which you are happy to give credit to. While it is not a very scientific approach, it can often work quite well, as anyone who runs their own successful business is likely to know what a good business looks, feels and smells like!

Setting credit terms and monitoring accounts receivable

As soon as a customer is given credit, the credit terms of the company should be explained to them. For instance, the normal credit period granted and any discount for prompt payment, or interest charged on late payment, should be explicitly detailed to the customer. Very often, the credit terms a company adopts are the terms that are most common in its trade.

To use something different can cause problems as customers will be expecting, and are likely to take, what is normal in the trade. Having said that, variations within a trade do occur and, indeed, a company may well offer different terms to different customers, depending on the credit rating of each customer and their relationship with each customer.

Initially, a suitable credit limit should be set for each customer. This credit limit should only be allowed to grow slowly as your faith in the customer grows and all

attempted breaches of the credit limit should be brought to the attention of the credit controller or other responsible person. It should be remembered that a common trick of an unethical company is to find a new supplier, make a small order and pay for it promptly. A large order is then made and, having taken delivery of this order, the customer delays payment for a significant time.

The accounts receivable should be continuously monitored. In order to do this a number of reports are useful:

- Accounts receivable aged analysis – this shows the amounts outstanding from each customer and for how long they have been outstanding. This will indicate any breaches of the credit terms.
- A credit utilisation report – this shows the proportion of each customer's credit limit that is currently being utilised. Therefore, it will indicate where credit limits may need to be reviewed upwards or downwards and whether any credit limit breaches have occurred.

Taken together, these reports show how exposed a company is to its accounts receivable. In larger organisations, customers may be classified by trade and country as it is then possible to evaluate exposure by both country and trade. Larger businesses may also create their own in-house credit ratings for their customers.

Whether or not the basic credit terms offered by the company are suitable should be regularly reviewed. There is no point offering unnecessarily long periods of credit – however, equally, a company may find that extending its credit terms leads to an increase in sales. Any alteration in credit terms could be evaluated using the techniques demonstrated in the aforementioned 'Receivables collection' technical article.

Collecting cash

It may seem very obvious, but if cash is to be collected, then the customer must be invoiced. It is essential that the invoice is sent out quickly and accurately. The receipt of your invoice is the first indication a company gets of the efficiency of

your debt collection system. If the invoice takes a long time to arrive and is not accurate, then your accounts receivable department will be viewed as inefficient and customers may seek to exploit this perceived weakness and delay payment.

Furthermore, if an invoice is inaccurate some customers will take this as an opportunity to claim that there is a dispute on the account and, therefore, stop payment of all invoices until the dispute is resolved.

Having sent out the invoice quickly and accurately, the methods a company could use to ensure customers pay in a timely fashion include:

- monthly statements – these can be produced quickly and easily by any computerised sales ledger system and sent to customers. Exactly how much impact they have is however debatable
- chasing letters – these should be directed to a specific person preferably at a reasonably senior level. However, preparing and sending these letters has a cost and, like the monthly statements, their impact is often limited
- chasing phone calls – these can often have a great impact as all businesses have to answer the telephone and, hence, they have a nuisance value which can generate results. A credit controller who regularly contacts a suitably senior person at their customers with overdue amounts and politely, but firmly, demands payment can often achieve good results
- personal approach – a personal approach from a senior person in the company to a senior person at the customer can often yield results. This is quite common in trades where the personal relationship with clients is important. For instance, this often occurs in professional accountancy and legal firms
- stopping supplies – this is a cash collection tool that must be used with care. If the product being sold is built specifically to the customers design, and you are the only supplier who currently makes the product, then it is a powerful tool as, in the short term, you are the only supplier and, hence, payment is likely to be forthcoming. However, in the longer term it is always possible for the customer to train up an alternative supplier to make the product. If the product is a generic product that could be purchased from many suppliers, then quite obviously this is a weak tool that is simply likely to lead to the loss of the customer
- legal action – this is costly and is likely to lead to the customer being lost
- external debt collection agency – as with legal action this is costly and is likely to lead to the loss of the customer.

Example

A company offers its customers 30 days credit but, at present, customers are taking an average of 41 days credit. In order to speed up cash collection, the company is considering introducing a 1% discount for payment within 10 days. The company finances its working capital requirement using an overdraft at an annual cost of 9%.

Required – Calculate the annual cost of offering the discount and evaluate whether or not the discount should be offered.

Solution

Let us assume a customer has purchased goods and has been invoiced \$100. If the customer takes the discount, then the company will receive \$99 in 10 days rather than \$100 in 41 days. This is like the company borrowing \$99 from the customer for 31 days (41 – 10) and paying \$1 interest.

Discount allowed to customer	\$1.00
Balance to be collected from customer	\$99.00

Interest saving on being paid \$99.00 after 10 days rather than 41 days:

Daily rate of interest is $9\% / 365 = 0.02466\%$

So having €99 in the bank for 31 days will save interest of:

$€99 \times 0.02466\% \times 31 \text{ days} = €0.76.$

As the value of the discount exceeds the interest savings, the company should not offer the discount as long as they continue to have existing banking facilities.