Receivables Management
Part II

Credit terms

- Credit terms basically talks about the discount terms and the period of the credit.

- The discount and credit period are presented together. For example, credit terms of 1/5, net 20 mean that a discount of 1 percent is offered if the payment is made by the fifth day; otherwise the full payment is due by the twentieth day.

- The credit terms may be liberal or strict.

- Liberal credit terms mean either the discount rate is increased or the discount period is lengthened or both. The liberal credit policy expected to enhance sales, reduce the average collection period and increase the cost of discount.

An illustration

- The present credit terms of Ranjan Company are 2/10, net 25. Its sales are Rs. 50 lakh, its average collection period is 20 days, its variable costs to sales ratio is 0.75, and its cost of capital is 10 percent. The proportion of sales on which customers currently take discount is 0.5. The company is planning to relax its discount terms to 3/10, net 25 which is expected to increase sales by Rs. 10 lakhs, reduce the collection period to 14 days, and increase the proportion of discount sales to 0.8. The tax rate is 40 percent.
- Should the firm go for relaxing the discount terms?

Solution

S.n.	Particulars	Amount (Rs.)
1	Increase in sales	1000000
2	Less: Variable cost (75%)	750000
3	Less: Increase in discount cost [=((0.8*0.03*(5000000+1000000))-(0.5*5000000*0.02))]	94000
4	Before tax surplus [1-(2+3)]	156000
5	Less: Tax (4*tax rate)	62400
6	Post tax surplus (4-5)	93600
7	Add: Savings in investment =((20-14)*(5000000/360)) - (0.75*14*(1000000/360))*0.1	5417
8	**Incremental gains/loss (6-7)**	**99017**

Collection effort

- The firm also needs a solid collection policy. This policy helps in ensuring timely collection of receivables.

- Continuous reminders to customers whose due date is approaching
- Threat of legal action to overdue accounts
- Legal action against overdue accounts

- A strict collection policy tends to decrease sales,

- shorten the average collection period,

- reduce bad debt percentage,

- but increase the collection expense.

- A liberal collection policy would push sales up, lengthen the average collection period, increase the bad debt percentage, and perhaps reduce the collection expense.

An illustration

- JLA Company is considering to liberalise its collection effort. Its sales are Rs. 25 lakh, its average collection period is 25 days, its variable costs to sales ratio is 0.75,its cost of capital is 12 per cent and its bad debt ratio is 0.05.

- The relaxation in collection effort is expected to increase sales up by Rs. 4 lakh, increase the average collection period to 35 days, and raise the bad debt ratio to 0.06. The tax rate is 40 per cent.

- Should the firm relax its collection efforts?

Solution

S.n.	Particulars	Amount (Rs.)
1	Increase in sales	400000
2	Less: Variable cost (75%)	300000
3	Less: increase in bad debt loss [	49000
4	Before tax surplus [1-(2+3)]	51000
5	Less: Tax (4*tax rate)	20400
6	Post tax surplus (4-5)	30600
7	Less: cost of investment =((2500000/360)*(35-25)) + ((400000/360)*(35*0.75))*0.12	72944
8	**Incremental gains/loss (6-7)**	**-42344**

Monitoring accounts receivables

- Two commonly used methods:
  - days sales outstanding (DSO) and
  - ageing schedule.
- The days sales outstanding (DSO) is defined as the ratio of accounts receivable outstanding at that time to average daily sales figure for the given time period.

- It tells you that on an average of how many days account receivables are equal to average daily sales.

  - **DSO_t= Accounts receivables at time ‘t’/Average daily sales**

- If the DSO in a year is decreasing, it means the collection efforts are good and on an average the receivables are declining.

Aging schedule

Time period (in days)	Per cent of receivables
0-30	35
31-60	45
61-90	15
>90	5

Collection Matrix

Percentage of Receivables Collected During the	*January Sales*	*February Sales*	*March Sales*	*April Sales*	*May Sales*	*June Sales*
Month of sales	13	14	15	12	10	9
First following month	42	35	40	40	36	35
Second following month	33	40	21	24	26	26
Third following month	12	11	24	19	24	25
Fourth following month	–	–	–	5	4	5

Source: Chandra (2011)

For any query

nagendrainsearch@gmail.com