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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: MBA III SEM..

SUBJECT: WORKING CAPITAL MANAGEMENT

SUBJECT CODE: MBAFM02

LECTURE: 36

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LECTURE-36

RECEIVABLES MANAGEMENT

MEANING AND OBJECTIVE

Management of receivables refers to planning and controlling of 'debt' owed to the firm from customer on account of credit sales. It is also known as trade credit management. The basic objective of management of receivables (debtors) is to optimise the return on investment on these assets.

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

ASPECTS OF MANAGEMENT OF DEBTORS

There are basically three aspects of management of receivables:

1. *Credit Policy:* The credit policy is to be determined. Decision of Credit standards, Credit terms and collection efforts is included in Credit policy. 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. The credit period is generally stated in terms of net days. For example if the firm's credit terms are "net 50". It is expected that customers will repay credit obligations not later than 50 days.

   Further, the cash discount policy of the firm specifies:

   (a) The rate of cash discount.

   (b) The cash discount period; and

   (c) The net credit period.

   For example, the credit terms may be expressed as "3/15 net 60". This means that a 3% discount will be granted if the customer pays within 15 days; if he does not avail the offer he must make payment within 60 days.

2. *Credit Analysis:* This requires the finance manager to determine as to how risky it is to advance credit to a particular party.

3. *Control of Receivable:* 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.

There is always cost of maintaining receivables which comprises of following costs:

(i) The company requires additional funds as resources are blocked in receivables which involves a cost in the form of interest (loan funds) or opportunity cost (own funds)

(ii) Administrative costs which include record keeping, investigation of credit worthiness etc.

(iii) Collection costs.

(iv) Defaulting costs.

FACTORS DETERMINING CREDIT POLICY

The credit policy is an important factor determining both the quantity and the quality of accounts receivables. Various factors determine the size of the investment a company makes in accounts receivables. They are, for instance:

(i) The effect of credit on the volume of sales;

(ii) Credit terms;

(iii) Cash discount;

(iv) Policies and practices of the firm for selecting credit customers;

(v) Paying practices and habits of the customers;

(vi) The firm's policy and practice of collection; and

(vii) The degree of operating efficiency in the billing, record keeping and adjustment function, other costs such as interest, collection costs and bad debts etc., would also have an impact on the size of the investment in receivables. The rising trend in these costs would depress the size of investment in receivables.

The firm may follow a lenient or a stringent credit policy. The firm which follows a lenient credit policy sells on credit to customers on very liberal terms and standards. On the contrary a firm following a stringent credit policy sells on credit on a highly selective basis only to those customers who have proper credit worthiness and who are financially sound.

Any increase in accounts receivables that is, additional extension of trade credit not only results in higher sales but also requires additional financing to support the increased investment in accounts receivables. The costs of credit investigations and collection efforts and the chances of bad debts are also increased.