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LECTURE-39

INNOVATIONS IN RECEIVABLE MANAGE- MENT

During the recent years, a number of tools, techniques, practices and measures have been invented to increase effectiveness in accounts receivable management.

Following are the major determinants for significant innovations in accounts receivable management and process efficiency.

1. **Re-engineering Receivable Process:** In some of the organizations real cost reductions and performance improvements have been achieved by re-engineering in accounts receivable process. Re-engineering is a fundamental re-think and re-design of business processes by incorporating modern business approaches. The nature of accounts receivables is such that decisions made elsewhere in the organization are likely to affect the level of resources that are expended on the management of accounts receivables.

   The following aspects provide an opportunity to improve the management of accounts receivables:

   (a) **Centralisation:** Centralisation of high nature transactions of accounts receivables and payable is one of the practice for better efficiency. This focuses attention on specialized groups for speedy recovery.

   (b) **Alternative Payment Strategies:** Alternative payment strategies in addition to traditional practices result into efficiencies in the management of accounts receivables. It is observed that payment of accounts outstanding is likely to be quicker where a number of payment alternatives are made available to customers. Besides, this convenient payment method is a marketing tool that is of benefit in attracting and retaining customers. The following alternative modes of payment may also be used alongwith traditional methods like Cheque Book etc., for making timely payment, added customer service, reducing remittance processing costs and improved cash flows and better debtor turnover.

      (i) *Direct debit:* I.e., authorization for the transfer of funds from the purchaser's bank account.

      (ii) *Integrated Voice Response*: This system uses human operators and a computer based system to allow customers to make payment over phone, generally by credit card. This system has proved to be beneficial in the orgnisations processing a large number of payments regularly.

      (iii) *Collection by a third party*: The payment can be collected by an authorized external firm. The payments can be made by cash, cheque, credit card or Electronic fund transfer. Banks may also be acting as collecting agents of their customers and directly depositing the collections in customers' bank accounts.

      (iv) *Lock Box Processing:* Under this system an outsourced partner captures cheques and invoice data and transmits the file to the client firm for processing in that firm's systems.

      (v) Payments via Internet.

   (c) **Customer Orientation:** Where individual customers or a group of customers have some strategic importance to the firm a case study approach may be followed to develop good customer relations. A critical study of this group may lead to formation of a strategy for prompt settlement of debt.

2. **Evaluation of Risk:** Risk evaluation is a major component in the establishment of an effective

control mechanism. Once risks have been properly assessed controls can be introduced to either contain the risk to an acceptable level or to eliminate them entirely. This also provides an opportunity for removing inefficient practices. This involves a re-think of processes and questioning the way that tasks are performed. This also opens the way for efficiency and effectiveness benefits in the management of accounts receivables.

3. **Use of Latest Technology:** Technological developments now-a-days provides an opportunity for improvement in accounts receivables process. The major innovations available are the integration of systems used in the management of accounts receivables, the automation and the use of e-commerce.

   (a) **E-commerce** refers to the use of computer and electronic telecommunication technologies, particularly on an inter-organisational level, to support trading in goods and services. It uses technologies such as Electronic Data Inter- change (EDI), Electronic Mail, Electronic Funds Transfer (EFT) and Electronic Catalogue Systems to allow the buyer and seller to transact business by exchange of information between computer application systems.

   (b) **Automated Accounts Receivable Management Systems:** Now-a- days all the big companies develop and maintain automated receivable management systems. Manual systems of recording the transactions and

managing receivables are not only cumbersome but ultimately costly also. These integrated systems automatically update all the accounting records affected by a transaction. For example, if a transaction of credit sale is to be recorded, the system increases the amount the customer owes to the firm, reduces the inventory for the item purchased, and records the sale. This system of a company allows the application and tracking of receivables and collections, using the automated receivables system allows the company to store important information for an unlimited number of customers and transactions, and accommodate efficient processing of customer payments and adjustments.

4. **Receivable Collection Practices:** The aim of debtors' collection should be to reduce, monitor and control the accounts receivable at the same time maintain customer goodwill. The fundamental rule of sound receivable management should be to reduce the time lag between the sale and collection. Any delays that lengthen this span causes receivables to unnecessary build up and increase the risk of bad debts. This is equally true for the delays caused by billing and collection procedures as it is for delays caused by the customer.

   The following are major receivable collection procedures and practices:

   (i) Issue of Invoice.

   (ii) pen account or open-end credit.

   (iii) Credit terms or time limits.

   (iv) Periodic statements.

   (v) Use of payment incentives and penalties.

   (vi) Record keeping and Continuous Audit.

   (vii) Export Factoring: Factors provide comprehensive credit management, loss protection collection services and provision of working capital to the firms exporting internationally.

   (viii) Business Process Outsourcing: This refers to a strategic business tool whereby an outside agency takes over the entire responsibility for managing a business process.

5. **Use of Financial tools/techniques:** The finance manager while managing accounts receivables uses a number of financial tools and techniques. Some of them have been described hereby as follows:

(i) Credit analysis: While determining the credit terms, the firm has to evaluate individual customers in respect of their credit worthiness and the possibility of bad debts. For this purpose, the firm has to ascertain credit rating of prospective customers.

Credit rating: An important task for the finance manager is to rate the various debtors who seek credit facility. This involves decisions regarding individual parties so as to ascertain how much credit can be extended and for how long. In foreign countries specialized agencies are engaged in the task of providing rating information regarding individual parties. Dun and Broadstreet is one such source.

The finance manager has to look into the credit-worthiness of a party and sanction credit limit only after he is convinced that the party is sound. This would involve an analysis of the financial status of the party, its reputation and previous record of meeting commitments.

The credit manager here has to employ a number of sources to obtain credit information. The following are the important sources:

Trade references; Bank references; Credit bureau reports; Past experience;

Published financial statements; and Salesman's interview and reports.

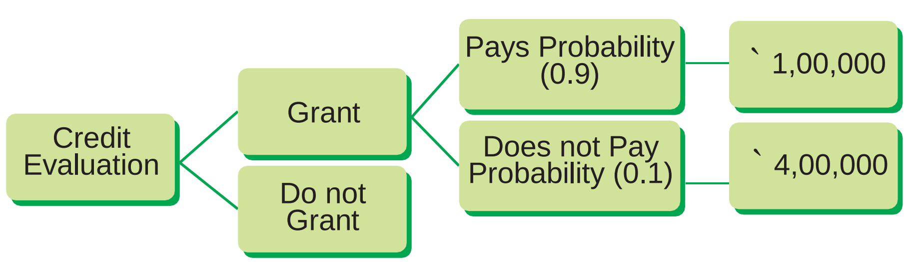
Once the credit-worthiness of a client is ascertained, the next question is to set a limit of the credit. In all such enquiries, the credit manager must be discreet and should always have the interest of high sales in view.

(ii) Decision tree analysis of granting credit: The decision whether to grant credit or not is a decision involving costs and benefits. When a customer pays, the seller makes profit but when he fails to pay the amount of cost going into the product is also gone. If the relative chances of recovering the dues can be decided it can form a probability distribution of payment or non-payment. If the chances of recovery are 9 out of 10 then probability of recovery is 0.9 and that of default is 0.1.

Credit evaluation of a customer shows that the probability of recovery is 0.9 and that of default is 0.1. the revenue from the order is ` 5 lakhs and cost is

` 4 lakhs. The decision is whether credit should be granted or not.

The analysis is presented in the following diagram.



The weighted net benefit is ` [1,00,000 × 0.9 i.e. 90,000 – 0.1 × 4,00,000 i.e. 40,000]

= 50,000. So credit should be granted.

(iii) Control of receivables: Another aspect of management of debtors is the control of receivables. Merely setting of standards and framing a credit policy is not sufficient; it is, equally important to control receivables.

(iv) Collection policy: Efficient and timely collection of debtors ensures that the bad debt losses are reduced to the minimum and the average collection period is shorter. If a firm spends more resources on collection of debts, it is likely to have smaller bad debts. Thus, a firm must work out the optimum amount that it should spend on collection of debtors. This involves a trade- off between the level of expenditure on the one hand and decrease in bad debt losses and investment in debtors on the other.

The collection cell of a firm has to work in a manner that it does not create too much resentment amongst the customers. On the other hand, it has to keep the amount of the outstanding in check. Hence, it has to work in a very smoothen manner and diplomatically.

It is important that clear-cut procedures regarding credit collection are set up. Such procedures must answer questions like the following:

(a) How long should a debtor balance be allowed to exist before collection process is started?

(b) What should be the procedure of follow up with defaulting customer? How reminders are to be sent and how should each successive reminder be drafted?

(c) Should there be collection machinery whereby personal calls by company's representatives are made?

(d) What should be the procedure for dealing with doubtful accounts? Is legal action to be instituted? How should account be handled?