

Receivables Management in Small Enterprises: A Theoretical and Conceptual Approach

Dr. Alok Singh

Assistant Professor, Department of Commerce, S.P.M. Govt. P.G. College, University of Allahabad, Prayagraj (India)

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*Corresponding Author

Email: draloksingh@outlook.com

ABSTRACT

The problem of receivables management arises when merchandise is sold on credit. When an enterprise makes an ordinary sale of goods and services and does not receive payment, the enterprise grants credit and creates accounts receivable, which would be collected in future. Though commercial banks provide a significant part of requirements for working capital, receivables continues to be a major source of funds for small enterprises and accounts receivable that result from granting credit are major investment for the micro and small enterprises. The investment in accounts receivable is an important aspect, which requires careful management.

1. Introduction

These days it is essential to extend credit to customers in orders to boost-up sales. A firm, which only insists on cash sales, may find that sales are not adequate and credit sales, however, have the risk of bad debts. Considering this a firm must try to frame rules for ascertaining the credit worthiness of customers so that credit may be extended to them without more risk. When a firm makes an ordinary sale of goods and services and does not receive payment, the firm grants trade credit and creates accounts receivable, which would be collected in future. Receivables management is also called trade credit management (*Khan and Jain, 1994*).

The small-scale industrial (SSI) sector has acquired a place of prominence in the economy of the country. It has contributed significantly to the growth of the Gross Domestic Product (GDP), employment generation and exports. The sector is contributing significantly towards the economic growth of the country with over 1/3 of the industrial production and nearly 1/3 of direct taxes. The sector has emerged as an engine of growth in the new millennium. Consequent of the enactment of Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, the small and medium sector has been defined as micro, small and medium enterprises with effect from October, 2006 as:

1. In the case of Manufacturing Enterprises
 - (i) A micro enterprise, where the investment in plant and machinery does not exceed Rs. 25 lakh;
 - (ii) A small enterprise, where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore; and
 - (iii) A medium enterprise, where the investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs. 10 crore.
2. In the case of Service Enterprises
 - (i) A micro enterprise, where the investment in equipment does not exceed Rs. 10 lakh;
 - (ii) A small enterprise, where the investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore; and

- (iii) A medium enterprise, where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

2. Objective of the Study

The main objectives of the study are:

- To explore the theoretical and conceptual bases of receivables management.
- To discuss the ways of receivables management in small enterprises.

3. Methodology

During the course of exploration of the theoretical and conceptual bases of receivables management and discussion of the ways of receivables management in small enterprises, the analysis and interpretation of data, obtained from secondary sources, have been made. The secondary data gathered for the purpose of this study are adopted from the published records of the various books, journals, periodicals etc.

4. Discussion

The basic goal of the receivables management is to maximize the value of the firm by achieving a trade-off between liquidity (risk) and profitability. Thus the purpose of receivables management is not to maximize sales and not to minimize the risk of bad debts. If the purpose is to maximize sales, the firm would sale on credit to all and if minimization of bad debts risks is the aim, the firm would not sale on credit to anyone. In fact, the firm should manage its credit in such a way that sales are expanded to an extent to which risk remains within acceptable limit. Thus to achieve the goal of maximizing the value, the firm should manage its receivables. To study the whole gamut of the problem, four distinct aspects of the framework for the receivables management are being considered here under: (i) Credit investigation, (ii) Limits of credit, (iii) Credit policy, and (iv) Collection policy.

4.1 Credit Investigation

To see that the profitability of credit sales is maintained at a maximum level and the losses from bad debts are squeezed

down to the minimum; the management of a firm should allow credit only to those customers who constitute good credit worthiness. The classification of prospective customers according to their acceptability or non-acceptability as credit risk requires a painstaking collection and analysis of all kinds' pertinent information bearing upon each credit extension to the acceptable grade of credit risks.

The 'character, capacity, condition and capital' of credit applicants are the 4 C's of credit that form the very core of credit investigation (*Mishra, R.K., 1975*). Here the credit giver should prudently analyze and carefully calculate the liabilities of the customer and find out which of liabilities would have priority over the obligation to the selling firm. The factors that affect the extent and nature of credit investigation are (*Ramamoorthy, V.E., 1976*):

- (i) The type of customers, whether new or existing?
- (ii) The customer's business line, background and the related trade risks.
- (iii) The size of the customer's order and expected further volumes of business with him.
- (iv) Firms credit policy and practices.

Credit should, therefore, be granted to those customers who have the ability to make the payment on time. To ensure this, the firm should have credit information concerning each customer whom the credit will be granted.

Collecting credit information involves cost. The cost of collecting information should, therefore, be less than the potential profitability. In addition to the cost, the time required to collect information should also be considered. The decision to grant credit cannot be delayed for long because of the time involved in collecting the credit information. Thus, the decision to extend credit to the customer will basically depend upon the judgment of the credit analysis since a number of factors are involved.

4.2 Limits of Credit

Once the firm has taken a decision to extend credit to the applicant, the amounts of the credit have to be decided. The decision on the magnitude of credit will depend upon the amount of contemplated sale and the consumer's financial strength. In case of the customers who are frequent buyers of the firm's goods, a credit limit can be established. This would avoid the need to investigate each order from the customers.

In general a credit limit should be a maximum amount, which a customer's ledger balance will be allowed to reach without review of his overall credit position (*Schultz and Reinhardt, 1957*). The figure set for a customer's credit limits should be based both on his expected buying needs and on the probability of his consistent prompt payment.

A credit limit is, thus, a maximum amount of credit, which the firm will extend at a point of time. It indicates the extent of risk taken by the firm by supplying goods on credit to customers. A credit limit may serve the purposes as:

- (i) It may be set as the maximum amount of credit on regular terms, which a customer will be allowed to have outstanding.

- (ii) It may be set as the maximum amount, which a customer's ledger balance will be allowed to reach without review of his general credit position.
- (iii) It may be set for a customer who is being supplied on 'must discount' terms, i.e., he expects discount but does not always comply; in such cases it acts as a penalty for his failure to discount or as an inducement to better paying habits.

The credit limit must be reviewed periodically. If the tendencies of slow paying are found, the credit can be revised downward. At times, a customer may ask for the amount of credit in excess of his credit limit. The firm may exceed to his request if the product has a high margin or if the additional sales help to use the unutilized capacity of the firm, and the cost of expected delayed payment or bad debts loss is less than expected incremental profit. Thus, "this credit limit is a '**Stop, Look, Listen**' sign for the credit managers (*Schultz and Reinhardt, 1957*).

4.3 Credit Policy

After thorough investigation of the worthiness of the credit applicant and the credit limits, the next step, of receivables management, is to consider the analysis of credit policy. "Credit is closely linked to sales and often credit policies are oriented towards achieving the sales objectives" (*Kuchhal, S.C., 1976*). For instance, if a firm wants to expand sales in order to make use of idle capacity of plant, credit policies are likely to involve a relaxation of credit terms. On the other hand, if a firm is already operating near its existing installed capacity and no expansion of facilities is contemplated, the firm's policy may involve accepting only customers with high credit ratings.

The credit policy of any firm may be classified as liberal/lenient credit policy and as tight/stringent credit policy. A liberal or lenient credit policy involves allowing of liberal credit terms, which result in increasing sales and profits (*Weide and Maier, 1985*). It also increases investment in receivables and the costs related to it; such as bad debts, supervision and collection costs, marginal costs of production and selling and opportunity costs. Such a policy will increase risk because of lower liquidity. Hence the benefits of expanded sales have to be weighed against the costs of increased receivables. So long such additional benefits exceed such costs and the firm has unutilized capacities, a lenient or liberal credit policy can be justified.

A tight or stringent credit policy will restrict sales and consequently reduce profits, because of the cautious and selective approach and the strict credit terms. Such a policy would, no doubt, be less risky; providing more liquidity with lesser fund tied-up in receivables. But such a policy will not fulfill the goals of sales and profit maximization, as some permanent less credit-worthy customers will cross over to other competing firms at the cost of the firm pursuing a tight credit policy (*Weston and Copeland, 1986*).

It may, thus, be pointed out that credit policy once formulated is not a rigid or static policy. It has to be a dynamic and flexible policy, which can suit the changed conditions. If there is any change in credit norms in the industry, extent and

nature of competition or in general economic conditions, credit policy should be suitably modified to cope with the change so as to maintain the volume of sales and profits at the desired level.

In fact, the firm should manage its credit in such a way that sales are expanded to an extent to which risk remains within acceptable limit. Thus, to achieve the goal of maximizing the value, the firm should manage its credit with the help of a trade-off between liquidity (risk) and profitability. The optimal credit policy, thus, involves a trade-off between the costs inherent in various credit policies and the profits generated by high sales (Eugene, F.B., 1976).

The firm's operating profit is maximized when total cost is minimized for a given level of revenue. But it is not necessarily the optimum credit policy. Optimum credit policy is one, which maximizes the firm's value. As we know that the value of the firm is maximized when the incremental rate of return i.e., marginal rate of return of an investment is equal to the incremental cost of funds, i.e., marginal cost of capital used to finance the investment. The incremental rate of return can be calculated as incremental operating profit divided by the incremental investment in receivables. The incremental cost of funds is the rate of return required by the suppliers of funds, given the risk investment in accounts receivable. "Note that the required rate of return is not equal to the borrowing rate" (Pandey, I.M., 1997). Higher the risk of investment, higher the required rate of return. As the firm loosens its credit policy, its investment in accounts receivable becomes more risky because of increase in slow-paying and defaulting accounts.

In sum, we may state that the goal of the firm's credit policy is to maximize the value of the firm, and "the firm will obtain the maximum value for the credit policy when the incremental rate of return of investment in receivables is equal to the opportunity cost of capital i.e., the incremental costs of funds" (Solomon and Pringle, 1977). As the investment in accounts receivable is increased, marginal expected rate of return falls and risk increases, so the required rate of return increases.

4.4 Collection Policy

At the next step of the management of receivables, analysis of collection policy is needed because all customers do not pay the firm's bills in time. Some customers are slow payers while some are non-payers. The collection efforts should, therefore, aim at accelerating collection from slow payers and reducing bad-debt losses.

Thus, a collection policy refers to the procedures followed to collect accounts receivable when, after the expiry of the credit period, they become due (Khan and Jain, 1994). A collection policy should ensure prompt and regular collection. Prompt collection is needed for fast turnover of working capital, keeping collection costs and bad debts within limits and maintaining collection efficiency. Regularity in collection keeps debtors alert, and they tend to pay their dues promptly.

The aim of the collection policy is to increase profitability and liquidity (Brandt, L.E., 1965). Profit is positively related with sales, which in turn gets impetus from credit sales (Bradley,

J.F., 1969). But mere grant of credit does not increase profitability unless it is followed by the effective collections. In the absence of such collections not only the profitability but also the liquidity of the firm is adversely affected because a larger part of the working capital remains standstill in the form of accounts receivable. There a proper collection policy is necessary.

The collection policy of any firm may be classified as strict/tight and lenient/liberal. In view of above necessity the business units neither follow a very strict nor a very lenient collection policy. The former reduces the sale while the latter increases the financial costs of the concern as in the latter case the firm will have to borrow money from other sources to meet the requirement of the working capital and will have to pay sufficient interest for such borrowings.

Thus, the combined effect of strict and liberal collection policies should be assessed before ascertaining any proper policy. It is also important to note that when poor collection policy is followed, it is practically impossible to have effective collections. So, in following an '**Optimum Collection Policy**' the firm should compare the costs and benefits. The optimum collection policy (trade-off between costs and benefits) will maximize the profitability and will be consistent with the objective of maximizing the value of the firm.

In collections, one of the principal policy variables is the amount extended on collection procedures. Within a range, the greater the relative amount expended, the lower the proportion of bad-debts losses and shorter the average collection period...(Van Horne, J.C., 2000). The relationships are not linear. Initial collection expenditures begin to have a significant effect up to a point; then they tend to have little effect in further reducing these losses. A well established collection policy should have clear-cut guidelines as to the sequence of collection efforts (Khan and Jain, 1994). After the credit period is over and payment remains due, the firm should initiate measures to collect them. The effort should in the beginning be polite, but with the passage of time it should become gradually stricter. The steps usually taken are:

- (i) Letters, including reminders, to expedite payment,
- (ii) Telephone calls for personal contacts,
- (iii) Personal visits,
- (iv) Help of collection agencies, and finally,
- (v) Legal action.

The firm should take resource to very stringent/ tight measures, like legal action, only after all other avenues have been fully exhausted. They not only involve a cost but also affect the relationship with the customers. The aim should not be collect as early as possible; genuine difficulties of the customers should be given due consideration. For example, "some customers are honest but are financially weak. In order to make payment they borrow the others. So, the credit period of such customers should be extended; and liberal attitude with slight-strictness in collection procedures may be adopted. There may be some sort of indirect restrictions on credit sale to them" (Hunt, William and Donaldson, 1966). In practice, firms may take certain precautions vis-à-vis collections (Pandey,

I.M., 1997). Some firms require their customers to give pre-signed cheques. Bills discounting is another practice in India. Some firms provide for penal rate of interest for debtors who fail to pay in time.

5. Conclusion

In most of the industrial units working capital management is inadequate and ineffective. This situation is often marked when the fund in accounts receivable is blocked up. The problem of receivables management arises when merchandise is sold on credit. Increase in the sales on credit results into blockade of funds in accounts receivable. As a consequence a considerable portion of working capital is not available in the form of cash, raw material or inventory; and thus this blockade of funds aggravates the problems of working capital employed.

Therefore, for minimizing the problem, the level of accounts receivable should be reduced to a feasible extent. But complete aversion to the accounts receivable is not possible in this age of credit, because there is another side of credit sales as credit sale is a sort of invisible concession, which induces sales. These two aspects of accounts receivable, i.e., the blockade of working capital and the increase in sales, are to some extent contradictory. Hence the problem of receivables management required special attention. The only alternative with the seller is to have restrain and control on the problems of accounts receivable through proper credit planning, credit investigation, credit limits and effective credit and collection policies. Management of the industrial unit would also be required to consider general economic conditions while making such adjustments.

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