CHAPTER FIVE

Impact of Debtors Management on Profitability in Iron & Steel Industry in West Bengal

5.1 Introduction

This chapter discusses on the various theoretical concepts associated with the management of accounts collection or receivables. It has also expounded the various forms of cost and benefit in holding of the receivables. A sound theoretical base relating to credit policy is necessary to frame proper policies in respect of the trade credit management for improving the profitability of the companies. Various tools or techniques of controlling the accounts receivable have been considered in this chapter for effective management of debtors which may assist the organization to collect the outstanding from their trade debtors at a faster rate or within due date and minimizing the risk of bad debts.

5.2 Meaning of Accounts Collection or Receivables

Accounts collection refers to the sum of money due from the trade debtors on account of credit sale of goods and services in the normal course of business. The term "Accounts Collection" is also called Accounts Receivables. Allowing the credit period and the amount of credit to the customers depend on the credit policy followed by the companies. The reason for sale of goods on credit is to tempt the customers, offer better quality of goods than the competitors, and increase the volume of sale and profit. According to Mihajlov (2013), accounts receivable is the significant part of working capital that includes a large investment in the assets and volume of transactions.

Selling goods and services on credit basis facilitates the debtors to enjoy the product before paying the claim, which stimulates sales; but it also includes an opportunity cost for the companies. The element of account collection includes the risk of bad debt, economic value, and futurity that calls for the need of efficient management of accounts receivables.

5.3 Cost and Benefit of Maintaining Accounts Collection

Credit sale is an essential part of the modern business system. It is a key element of operation of any commercial organization (Holysz, 2013). In fact, credit sale acts as a marketing tool for promoting sales and thereby increases the profits. However, granting credit period and the amount of credit involve the cost and risk. Therefore, the finance manager must evaluate the benefits and costs associated with maintaining the accounts receivable to achieve the aim of receivables management. The major costs incurred in extending credit and accounts receivables are as follows:

(a) **Collection Cost:** Collection costs are the additional cost incurred in collecting a promised payment from the trade debtors. It is an administrative expense incurred in the maintenance of credit department with staff, collecting credit information either by a third party or an agency or by the firm itself.

(b) **Capital Cost:** The capital cost is the cost of raising funds for financing the business obligations. There is a time gap between the sale of goods and the receiving of dues from the debtors; in between this gap, the firm needs to arrange additional funds for making the payment to the suppliers of raw-materials, employees, and distributors. Acquisition of additional funds involves a cost, which could have been used profitably elsewhere. Therefore, cost associated in raising the additional capital is the cost of extending credit and accounts receivable.

(c) **Delinquency Cost:** These costs emerge on the failure in collection of the due amount on the account of debtors. The company incurs an amount to recover the debt after the expiry of the credit period, such as, reminding the customers, giving phone calls, legal charges or any other costs incurred on interaction with the trade debtors to recover the account balances. Thus, delinquency cost arises on follow-up of the debtors for recovery of over dues failed.

(d) **Default Cost:** Credit sale does not give assurance of getting the overdue from the customers. A partial or the whole amount of credit sale may not be able to be recovered due to inability of the debtors; such irrecoverable amount is treated as doubtful or bad debt. The doubtful amount should be written off or adjusted as the amount will not be realized further. Thus, default cost is associated with the extension of credit period and the amount in credit sales.

Despite the costs involved in maintaining receivables as discussed above, it has some benefits also that may arise from the credit sale. The two major benefits are discussed below:

(a) **Sales Promotion:** One of the advantages of granting credit in sales is to increase or promote sale because of which a firm may be inclined to invest in receivables. Due to a liberal credit policy, a firm may be able to increase the volume of sales and thereby the profit may increase. Following a more liberal trade credit policy results in increasing sale to the existing customers as well as in attracting new prospective customers.The higher the number of customers, more may be the increase in the sale that leads to higher earnings and profit.

(b) **Sales Retention:** Another benefit that arises from trade credit is to safeguard the current sales from the cut-throat competition. Protecting the present debtors from the emerging competition will lead to sales retention, meaning customers retention, as a result of which the sale and the profit of the company may be stabilized, if not increased.

Thus, granting credit to customers has the effect on the sale, cost, and earnings of the companies. So, the decision relating to investment in receivables should be made after the evaluation of the cost and benefits of maintaining accounts receivables.

5.4 Elements affecting the size of Accounts Collection

Every business would like to have its entire sale on cash basis, but it is next to impossible in the present day very competitive business environment. Therefore, the business firms now-a-days tend to adopt easy trade terms and credit policy. However, the various factors which may affect the magnitude of the accounts collection have been discussed below:

Level of Sales

The size of accounts receivable depends largely on the volume of sales. The lenient credit policy increases the firm’s sales. An increase in the sales may encourage the firm to bring about a commensurate increase in the size of accounts collection. Therefore, the decision of investment in the receivables may be affected by the size of turnover.

Credit Policy

The pressure of tough competition in the market forces companies to offer better quality of products and services on credit basis. Keeping in mind that the customers may not be able to pay quickly for the sale of high end products or services, the vendor company may go for adopting a credit policy which may be either rigid or liberal. According to Michalski (2008), a change in the credit policy affects the net working capital as well as the operating costs associated with accounts receivable management. The Liberal credit policy enables the customers to pay the outstanding amount on a later period.Thereby, it may lead to increase the size of receivables, whereas a conservative or rigid credit policy tends to lose the potential customers, which may result in decrease in sales and receivables.

However, the adoption of lenient credit policy may give rise to defaults and bad debt while rigid policy involves excessive collection cost. Therefore, the firm should adopt a suitable approach by trading off between the associated costs and the benefits in establishing the credit policy

Terms of Trade

Another determinant that has impact on the volume of accounts receivable is the business terms. In order to attract and retain the customers in the business for the long run, the companies need to follow the generous business or trade terms. Such trade terms are expected to include discount rate on the sales and credit period allowed to debtors. Allowing more credit period and higher discount rate would encourage the buyers to purchase more as a result of which the sales volume of the firm increases;thereby the size of the profit and the accounts receivable may rise. Shorter credit period and lower discount rate may affect the future cash inflow as it brings down the sales of the firm. Thus, it can be said that the sale terms such as discount rate, credit period, etc. are closely associated with the volume of book debt.

Profits

The main objective of every business is to earn revenue. To maximize the earnings, the firm tries to increase the size of its sales; higher amount of sales can be achieved by maintaining sales on credit basis. Jani (2007) states that the firm follows the credit policy to increase the amount of sale. An increase in sales leads to increase the accounts receivables. As the level of receivables increases, the amount of profit will also increase. However, a rise in the magnitude of accounts receivable involves the cost of financing the additional fund blocked in it.The decision in favour of holding receivables would be opted if the additional revenue that may be generated is greater than the cost of maintaining the additional receivables. Therefore, the relation between cost and benefit of maintaining accounts collection should be properly analyzed.

Paying Capacity of Debtors

The proportion of accounts collection is influenced by the quality of the customers. A financially sound debtors would be able to clear their dues to the vendor firms on due dates, as a result of which the amount of receivables may be lesser,whereas delay in making payment by the financially weak customers may result in higher amount of receivables. Therefore, the financial position of the trade debtors should be appropriately judged before allowing the credit for the sale.

Collection Policies

The efforts in collecting dues from debtors would affect the policies in regard to receivables management. An efficient collection effort will reduce the amount of receivables where as a weak collection effort would not only raise the accounts receivable but also suffers financial cost like the amount that may need to be spent in periodical reminding to customers for outstanding clearance; failure of collecting overdues at times may result in losses.Thus, the balance of accounts collection is influenced by the approach or policy of collection.

Credit sale is the soul of any business as it assists the company to increase the turnover and profits. Survival of a company in the competitive business depends on the credit extension policy. Therefore, certain amount of additional investment in the receivables is needed for the growth and expansion of the organization.

5.5 Objectives of Accounts Collection Management

Accounts collection management refers to the set of policies and practices employed by the companies with respect to managing sales on credit. In other words, it is a technique of framing decisions in relation to investment in accounts receivables. It encompasses the evaluation of credit worthiness of the customers, risk of bad debt, and cost of financing in designing the receivables policy. Thus, the objective of accounts receivable management is to take the appropriate decision for the investment in the collection process. The key objectives of accounts receivable are presented below :

Optimum Volume of Sales

The primary goal of accounts receivable management is to increase the size of sales, which is possible by granting the credit; risk of bad debt and cost associated with maintaining accounts receivable are linked with the terms of credit sale. Therefore, a firm needs to administer the credit in a systematic manner so that it achieves the optimum level of sales within acceptable risk.

Controlling the Cost of Credit

One of the essential objectives of accounts receivable management is to determine the benefits arising from the extension of credit. In ascertaining the benefits from a sound receivables management, one must consider all the costs in connection thereof; excess of additional cost may impact the profitability and liquidity of the business. Therefore, the cost of financing could be minimized by applying the marginal concept in choosing the credit policy.

5.6 Dimensions of Credit Policy

Formulating the credit policy is in the hands of the management of business. Decision in making a credit policy involves the following variables as credit standards, credit period, cash discount, and collection efforts. According to Kontus (2013), three major problems involved in accounts receivable management are: first, to whom credit should be allowed; second, the terms of the credit; and third, the process of collecting the credit from debtors. All these issues or dimensions related to credit policy shall be taken into account before granting the credit facilities; each of these variables related to credit policy have been illustrated as follows.

5.6.1 Credit Standard

Credit standard implies the type of credit policy i.e., liberal or rigid policy being followed by the company. The volume of sales is affected by the credit policy of the business enterprise. Lower credit standard boosts the turnover, which results in increase in the income; however, an increment in the level of profit will lead to rise in the delinquency cost, risk of bad debt, etc. Increase in the magnitude of sales involves an additional cost for the firm in maintaining the records of accounts collection by the clerical department. Trade debtors may sometime take more than the standard time to make payment which could raise the additional capital in receivables.

A strict or rigid credit policy would save the collection cost, reduce the risk of losses and additional capital requirement as it extends credit only to credit-worthy debtors. As a result of this, volume of turnover declines, which further leads to lower income. Therefore, credit limits shall be liberalized to the extent where the increases in revenue is equal to or more than the additional cost.

5.6.2 Credit Period

Credit period means the time allowed to debtors for making payment by them for the credit sale of goods and services. Generally, a firm fixes the credit terms and credit period on its own. However, the competition in the market compels the firm to provide higher number of days of credit to customers. An increase in the credit period gives rise to sales volume and earnings.At the same time, however, it blocks up more funds in the accounts receivables, which could have been invested in other profitable areas to harvest income. Higher credit period will also increase the costs of debt collection and for bearing the risk for increasing possibility of doubtful debts.

While smaller number of credit days reduces the level of sales, profits, and the cost associated with the accounts receivables, the customers are likely to move away to the other vendor firm/s offering higher credit period. It results in losing the customers but at the same time it may involve lower amount of investment in the accounts receivable, releasing the additional fund that might have been tied up in accounts receivable in case of longer credit period. Thus, a firm has to decide on a credit period at the level where the additional revenue equates additional cost.

5.6.3 Cash Discount

Cash discount is a remission in the amount collectible on account of the price of products and services, allowed by the seller to debtors in order to motivate the buyers to pay the due amount at the specified time. It is also known as early payment discount. The benefit of allowing the early payment discount may improve business cash inflows and reduce the possibility of bad debt. An increase in the percentage of discount tends to raise the turnover; also offering cash discount provides the debtors an incentive to pay promptly, thereby assisting the firm to spend less time, energy, and money in the collection process, all of which result in lesser amount of investment in the accounts receivable. However, granting cash discount reduces the price of products which may unnecessarily bring down the margins of the sellers.

5.6.4 Collection Efforts

The collection effort of the company aims at collecting overdues from customers timely, which consists of the following steps as reminding customers about the payment on due date through e-mail, phone calls, etc., sending letters / notices to customers whose due date is approaching, and also informing about the legal action to be taken against unpaid overdue accounts. A certain amount of cost may be incurred in conducting the above steps. A stricter collection effort tends to decrease the level of sales, to shorten the length of credit period, and to reduce the percentage of bad debt; it may result in increase of collection expenses. On the other hand, the collection expense decreases on following of a negligent collection effort which may push up the sales and increase the average collection period, and thereby increases the chance of bad debt.

5.7 Techniques of Monitoring Accounts Collection

Accounts receivable is a significant part of current assets and represents,on an average,a large amount of investment after inventory. Accounts receivable constitutes a huge amount of investment in the firm's assets which are like capital budgeting projects measured in terms of Net Present Value (Mbula, S.F., and A.,2016). It involves a major portion of fund that needs attention of the management on it; failure of collecting the overdue amount may lead to affecting the liquidity and profitability of the company. The aim of exercising control over the current asset i.e., account receivable is to eliminate bad debt and it is executed by applying a proper debt collection method (Dorota, 2013). It is, therefore, vital for the company to adopt the methods for controlling the accounts receivable. The three major techniques of monitoring the accounts collection have been discussed below:

Days Sales Outstanding (DSO)

Days sales outstanding is a widely used method to determine the average number of days that a firm takes to recover its outstanding from debtors after credit sale. DSO is also known as the Average Collection Period (ACP). The average collection period may be defined as the ratio of average accounts receivable by total credit sales. The DSO assists the firm to judge the collection efficiency by comparing the DSO with the standard credit period. A higher number of accounts collection days in comparison with predetermined credit means the company follows a lax system of collection which results in delay in receiving cash flow, weakens the liquidity position, and increases the chance of bad debt. Whereas lower value of DSO indicates that the firm is efficient in collecting dues; quick payment enables the firm to depend less on the borrowed fund in financing its working capital. As a consequence, the cost of holding receivable is reduced and thereby the profitability improves. As it measures, the quality of account receivable suffers from certain limitations; it provides an average picture of collection which is based on aggregate data. Thus, to control account collection effectively, the business needs a set of information about the age of outstanding account receivable.

Ageing Schedule

Ageing schedule is an important technique employed in the context of accounts receivable to find out the pattern or style of collecting invoice amount and estimating doubtful debt. The report or schedule that contains the name of customers with their accounts receivable to be paid within the time or credit period allowed by the firm. It acts as a collection tool which assists the management to know whether the outstanding amount is received from debtors in time or not. If not, then the slow-paying customers are sent reminder for payment by the collection department or personnel. Drawing up the ageing schedule report helps the firm in many ways. One way is to identify customers and the cash inflows behind the due date for payment. Other benefit of doing the ageing report is to prohibit the sale of goods and service to those customers who make late payment instead of consistently writing off as bad debt. Chalking out the schedule builds a regular contact with customers suggesting them that late payment is not acceptable from them. Thus, it can be concluded that the aging schedule is a vital liquidity management tool that assists in anticipating the cash flow pattern and doubtful debt.

However, the major limitation of drawing up the schedule is that they solely depend upon the aggregate data; it needs specific information for classifying as well as it fails to relate receivables to sales of the same period.

Collection Experience Matrix

Collection experience matrix is a modern approach or a different method from the other two i.e., DSO and Ageing Schedule of monitoring accounts receivable that point out the manner in which the firm collects the amount of credit sales over a period of time. Under this method, a matrix is formed when the sales over a period and the associated accounts collection are presented in horizontal and vertical way respectively. Therefore, the name of this method is developed as collection matrix. Through this matrix a company could ascertain how much of the credit sales in terms of percentage have been collected in the month of sale occurred and what percentage is to be collected in future or later. One of the major benefits of interpreting collection matrix is to assess the debtor's payment behavior. The percentages of accounts collection related to credit sale increases denotes the firm collects its outstanding account receivable faster. An improving collection pattern may strengthen the liquidity and profitability condition of the business and vice-versa. As it keeps past records of the collection in terms of percentage that could be helpful for the companies to forecast the future pattern of collection from the next sale.

5.8 Conclusion

As specified that the aim of the study is to examine the impact of debtors management or Accounts Collection Period on the profitability in the selected public steel companies, this chapter discusses in detail the various theoretical concepts that affect the credit allowance management. The chapter starts discussion by defining the accounts receivable along with explaining the cost and benefits of holding accounts receivable. The cost and benefit of maintaining accounts collection justify the need for analyzing the receivables as assisting a company in decision making relates to investment in accounts receivable including meeting competition and sales promotion. Determinants affecting the magnitude of accounts collection advocate the demand for a suitable credit policy to boost up the turnover of the company and to sustain in the competitive market. The aspect of credit policy consisting of credit standard, credit period, cash discount, and collection efforts explain why companies allow credit. It clarifies that companies adopt a suitable credit policy as it assists them to collect the due amount promptly,to reduce the possibility of bad debt losses, and to keep the cost of maintaining debtors at a minimum level. At last, the three well known techniques (DSO, Aging Schedule, and Collection Experience Matrix) of monitoring the receivables have expounded which supports the need for controlling accounts receivable to improve the company's cash cycle and the pattern of cash inflows through the business which helps in making the business organization sound in respect of liquidity and profitability.