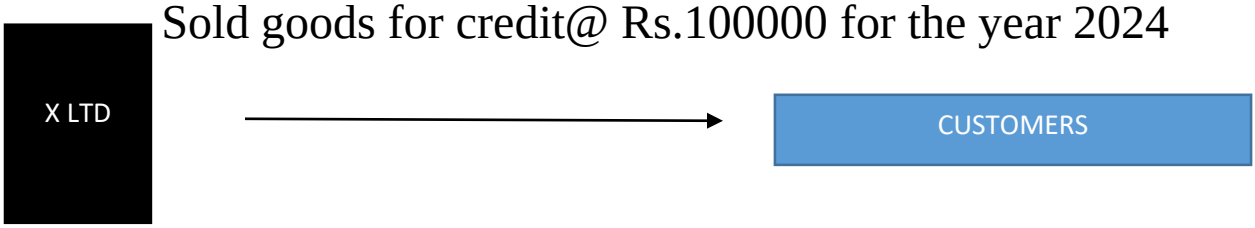
DEBTORS MANAGEMENT

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.

ANALYSE THE SCENARIO:



Credit period allowed = 30 days

Bad debts @ Rs. 10,000

Cost of sales = Rs. 90000 (variable cost & Fixed cost)

Assume 360 days in a year.

Credit period refers that,

If the goods are sold on 1.1.2024, it is collected only on 1.2.2024, it refers that, the funds are blocked in debtors for 30 days.

How much is blocked in debtors?

$= \frac{90,000}{360} \times 30 = Rs.7500$

It states that, in your 100000 sales is having Rs. 90000 cost(the actual amount you need to recover) and it is for 360 days, but your fund is blocked only for 30 days averagely. So we find for 30 days!

And Rs.7500 is nothing but , it is the amount shown as debtors in the company's balance sheet.

Now the, the customers are requested the company to increase their credit period to 45 days, and they assure to increase their purchases from the company by 20%, and there is a possibility of increase in bad debts also.

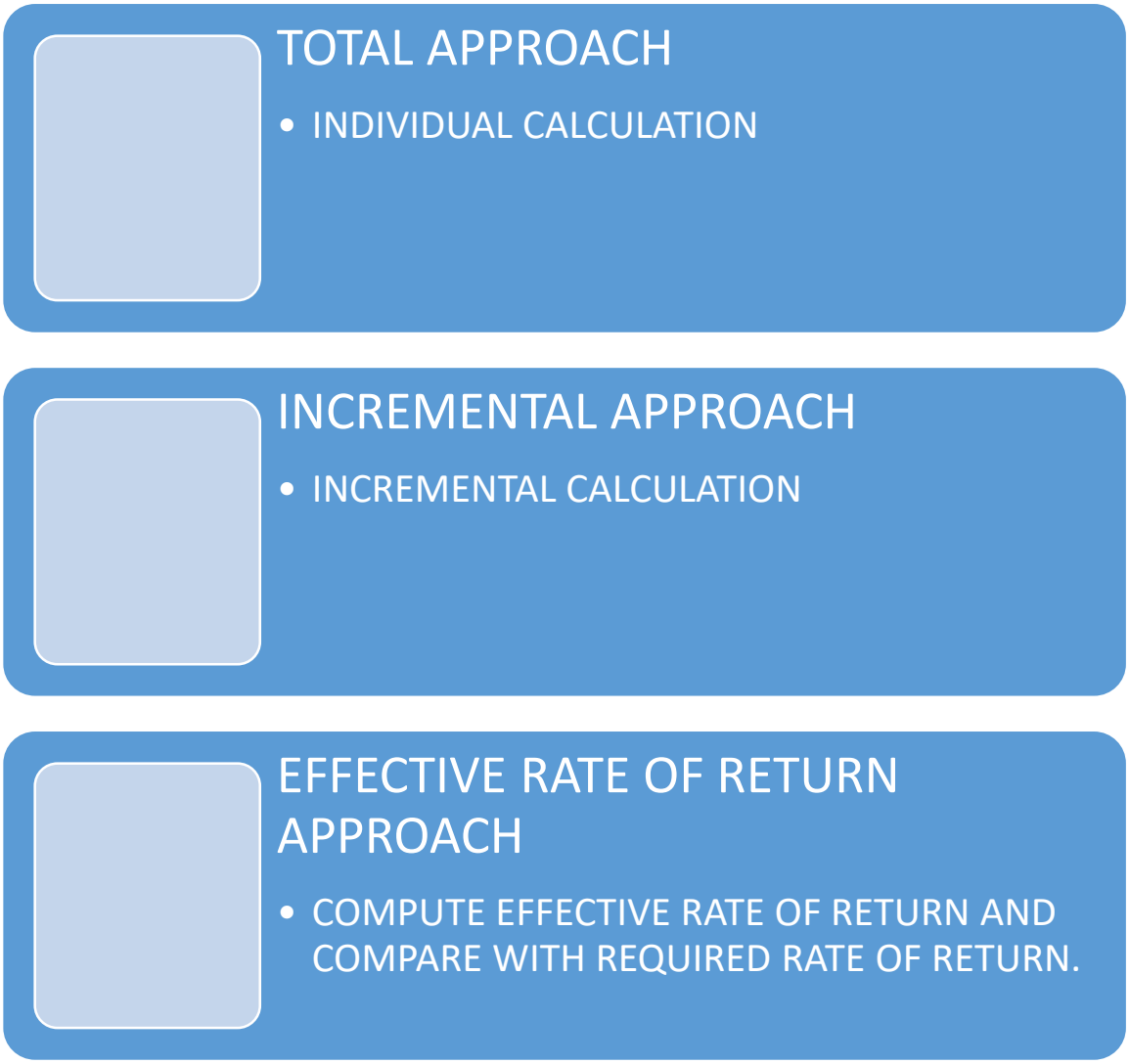
It effects that,

1. The sales of the company is increased to Rs.1,20,000.
2. At the same time, the amount blocked in debtors also increases for the increased credit period days (i.e.15 days)
3. The company estimates that bad debts increased to Rs.20,000

Now the company is in the situation, to decide whether to increase the credit period by establishing the **new credit policy or to continue with the existing credit policy** based on their net benefits!

THE ABOVE ANALYSIS IS KNOWN AS EVALUATION OF CREDIT POLICY !

HOW TO EVALUATE THE CREDIT POLITY?



1.UNDER TOTAL APPROACH (Individual calculation)

PARTICULARS	PRESENT POLICY	PROPOSED POLICY I	PROPOSED POLICY II
SALES			
(-) Cost other than Bad debts and cash discount			
Variable cost			
Fixed cost			
Other costs: Bad debts			
Cash discount			
PROFIT BEFORE TAX			
(-) Tax			
PROFIT AFTER TAX (A)			
Opportunity cost of investment in receivables (W.N) (B)			
NET BENEFIT / LOSS (A – B)			

WORKING NOTE (W.N.)1:

Computation of opportunity cost:

In our above example, the amount invested/blocked in debtors is Rs.7500.

If the amount of Rs.7500 is invested in any banks rather than investing in debtors, the bank provides interest for such investment! Assume that interest rate provided by bank is 10%.

So the company loses the opportunity to earn **Rs. 750** (7500 x 10%), because the fund are locked up in receivables for 30 days!

DERIVATION FOR THE OPPORTUNITY COST:

$= \frac{90{,}000}{360} \times 30 = Rs.7500 \times 10\% = Rs.750$

Here, Rs.90,000(Cost of sales) is for 360 days, but our amount blocked in debtors for 30 days averagely(Collection period), gives Rs.7500 (Receivables of the company) and it is multiplied with bank rate of interest 10% to find opportunity cost **i.e. Rs.750**

$$\text{Opportunity cost} = \frac{\text{Cost of sales (VC+FC)}}{\text{365days/12months/52weeks}} \times \text{collection period} \times \text{Rate of return}$$

2. INCREMENTAL APPROACH (Incremental calculation)

PARTICULARS	PRESENT POLICY	INCREMENTAL PROPOSED POLICY I	INCREMENTAL PROPOSED POLICY II
INCREMENTAL SALES			
(-)Incremental Cost other than Bad debts and cash discount			
Incremental Variable cost			
Incremental Fixed cost			
Other costs: Incremental Bad debts			
Incremental Cash discount			
INCREMENTAL PROFIT BEFORE TAX			
(-) Tax			
INCREMENTAL PROFIT AFTER TAX (A)			

Incremental Opportunity cost of investment in receivables (W.N) (B)			
NET BENEFIT / LOSS (A – B)			

Here, we comparing the new policy with existing policy and record only the amount which is increased from the existing!

NOTE: same working note applied here!

3. EFFECTIVE RATE OF RETURN APPROACH.

Here, we evaluate by comparing company's expected rate of return with the required rate of return.

Expected rate of return: how much profit you are making from extending credit to customers.

Required rate of return: it is like a benchmark – it tells you the minimum profit you need to make.

HOW TO CALCULATE EFFECTIVE RATE OF RETURN:
General formula for rate of return is based on your investments so formula is,

Expected profit ÷ Investment x 100

Here our investment is in Trade receivables, so the formula is,

$$\text{Expected Rate of Return} = \frac{\text{Incremental Expected Profit}}{\text{Incremental Investment in Receivables}} \times 100$$

Note: we use the word “incremental” because the incremental values helps to determine if the new credit terms will be profitable, instead of looking at your entire business performance.

DECISION:

If expected rate of return are higher than your required rate of return, choose the policy

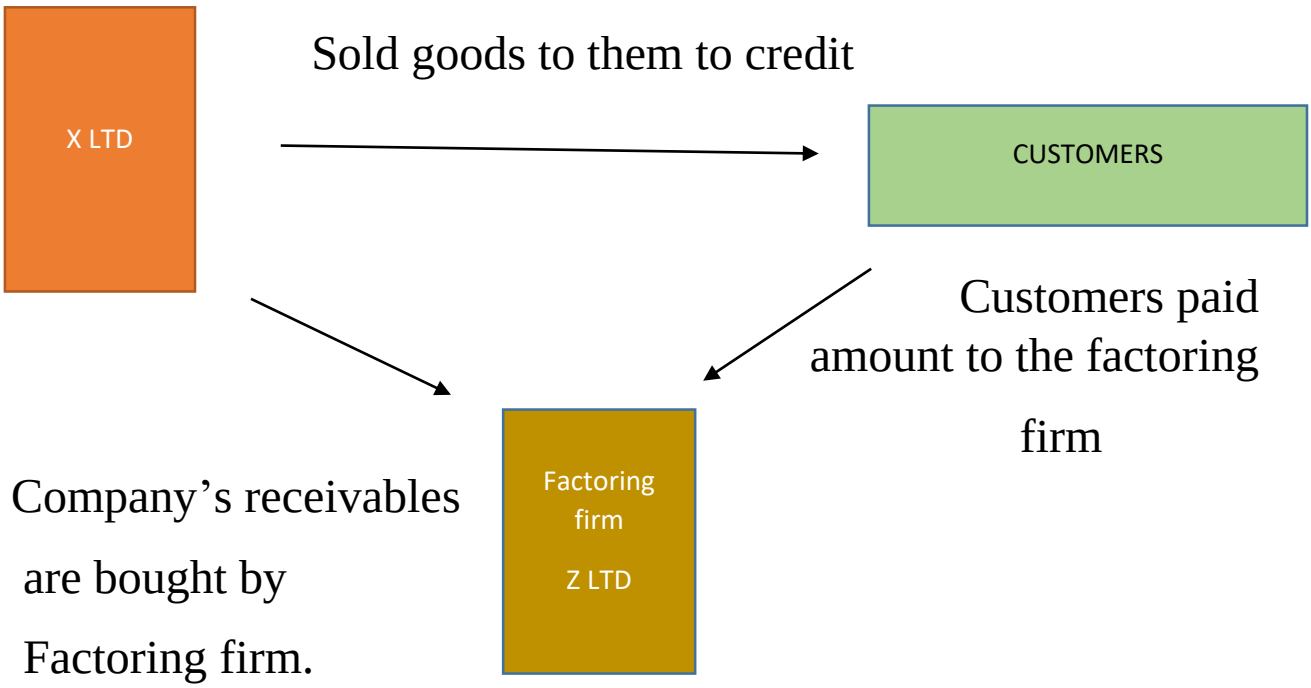
EROR >RROR = choose

If the expected rate of return are lower than your required rate of return, reject the policy.

EROR<RROR = reject

FACTORING

Factoring: Factoring is a relatively new concept in financing of accounts receivables. This refers to outright sale of accounts receivables to a factor or a financial agency. A factor is a firm that acquires the receivables of other firms.



Firm's expenses before go for factoring	Firms expenses after go for factoring
Bad debts Administration expenses Cash discount (for early payment) Opportunity cost	Commission to factoring firm Interest on advance from factors Opportunity cost (if any)

Note: if the company accepts factoring proposal, their current expenses are turned into savings of their company.

Who suffers loss of bad debts?

If it is recourse agreement: the company bears the bad debt loss

If it is non- recourse agreement: the factor bears the bad debt loss

Note: Generally, most of the agreements are non-recourse in nature.

Services provided by Factoring firm

If they provide
Only collection services

If they provide
both collection and
Lending advances

Collection services:

Assume that **A ltd** sold its receivables collection services to **B & co.,** it states that, if the company has existing collection period of 30 days, factoring firm takes collection period of 20 days only. Now the receivables amount are available to **A ltd** by 10 days earlier.

For that B & co. charge commission only.

Providing advances and collection services :

Same example, here **A ltd** received their Receivables amount as advances immediately, and they no need to wait for 20 or 30 days.

For that, B & co. charge, interest for such advances and commission .

The company can decide whether they go for factoring services or collection made by themselves. They analyze the cost involving in both and choose which is beneficial to them.

Statement showing evaluation of factoring proposal.

PARTICULARS	**Rs.**
A. Savings to the company:	
Cost of credit administration	
Bad debts	
Interest saved due to reduction in collection period (opportunities cost)	
	xxx
B. Factoring cost	
Commission paid to factoring firm (on sales)	
Interest on advances (W. N)	
	xxx

WORKING NOTE:

The factoring firm provides you the receivables as advances immediately, so that they charge interest @ certain percentage.

How to compute the advances,

particulars	**Rs.**
Amount of receivables (same calculation done in evaluation of credit policy, but here calculated on credit sales, instead of cost of credit sales)	
(-) Reserve held by factoring firm, if any	
(-) Commission included in such advances (advance amount x percentage of commission)	
Total	**xxx**
Interest on advances (Total x rate of interest)	**xxx**
Advances to be paid (these amount used only to find effective cost of factoring)	**xxx**

Note: Reason for receivables calculation done in credit sales instead of cost of credit sales, because here, factoring firm involves and they don't have any relationship with cost of sales, so, for the fair comparison we take credit sales.

Another method: (by computing effective cost of factoring)

First we have to know why the company go for factoring,

The reason is, the blocked amounts are received as advances, so they can meet their short term liquidity needs by this funds. For that advance fund factor charge interest on such fund, and it is known as effective cost of factoring (incl. commission).

The company has other option to get their short term funds, i.e, the company approach the bank to get their short term funds and banks also charge interest for such services.

Now, if decision will be,

The company's effective cost of factoring is always less than the banks borrowing rate.

If it is more, the company should reject their factoring proposal and go for bank to get their short term liquidity funds.

How to calculate effective cost of factoring?

$$\text{Effective cost of factoring} = \frac{\text{net annual cost of factoring}}{\text{Net amount of advances}} \times 100$$

Net amount of advances, means the W.N calculation calculated above.