MAZARS' INSIGHT

Best Practices for Account Receivable Management

Every organization requires adequate liquid resources to meet its day-to-day working capital requirement. Companies require cash resources to pay wages and salaries and settle immediate liabilities to ensure smooth and uninterrupted operations. Maintaining adequate cash resources is crucial in the short term to business and a necessity to safeguard the business' existence in the long term, as a profitable company may fail without the adequate cash flow to settle its liabilities as they become due.

Revenue from sales activities serves as one of the essential sources of a business working capital; therefore, the company is required to manage its accounts receivable arising from credit sales effectively.

What you need to know

For a business to well manage the amount due from customers, its account receivable management processes must encompass the following:

- Assessment of creditworthiness of customer before granting credit sales
- Formulation of credit terms and conditions
- Techniques for receivables collection
- Evaluation of account receivable management

The above key areas will be explored in more details in this article.

Assessment of the creditworthiness of customers

To mitigate the risk of bad debt, an entity is expected to assess and measure the financial worthiness of a customer before granting credit, especially when the amount involved is significant. Below are the techniques available in the creditworthiness assessment of a customer:

- The service of the credit rating agency might be employed to evaluate the credit rating of a customer before granting credit. This method is suitable when the amount of receivable is significant, and the profit margin expected to be generated from the additional sales due to granting credit will exceed the cost of the credit assessment.

- Financial statements assessment -For large corporates, publicly available financial statements can be easily obtained. While an analysis of the company's financial statements may indicate whether or not to grant the credit to a customer, it must be remembered that the financial statements available could be out of date and in some cases, subject to fraudulent financial reporting. As a result, audited and recent financial statements are expected to be used rather than unaudited accounts.

- Press comments may give information about the current situation in a company as opposed to the historical results in financial statements, which only show what the company has done in the past. For example, suppose it has been reported that a company has lost a major contract or one or more financial providers or suppliers have withdrawn from dealing with the company. In that case, this may indicate that the company has financial problems and there is a risk that credit sales granted to such company may not be recovered.

- A trade reference could be obtained from another supplier who has transacted business with the potential customer. This may be achieved by making external confirmation from the supplier that has been dealing with the customer.

- New customers may be required to provide a reference from a third party or bank before being given credit.

Formulation of credit terms and conditions

After assessing the customer's credit worthiness and granting credit to the customer, the company is expected to communicate agreed credit terms and conditions. The credit terms cover the normal credit period, any available discount within certain days of payment, and interest charged on late payments. It is expected that credit terms should vary by type of customer, the relative financial strength of the customer and the type of credit terms other competitors are offering.

Originally, suitable credit terms and limits should be established for every customer. This credit limit should only be increased as confidence in the customer grows, and all attempted breaches of the credit limit should be flagged immediately. It should also be remembered that a common trick of an unethical customer is to approach an entirely new supplier, make a small order and pay for it on time. Later make a large order and have taken delivery of this order, delays payment for a significant time.

Techniques for receivables collection

If payments become overdue, they should be tracked. Procedure for pursuing overdue debts must be established within the company and this could include:

- Sending a monthly statement to the customer – this can be produced quickly and easily by a computerized sales ledger system.
- Chasing payment by making a telephone call.
- Making a personal approach to a senior staff of the company.
- Bill-bill approach may be implemented by the company. These terms require that each prior bill must be settled before new shipments are possible.
- Early settlement discount. An early settlement discount involves a company offering a small percentage discount to customers who pay within a defined short period. For instance, a 1% discount may be offered to those who pay within 10 days from the invoice date.
- Making use of factoring. Factoring is an arrangement to have debts collected by a factor company, which advances a proportion of the money that is due to be collected. This may adversely affect customer relationship as the factor institution may want to collect amount due from the customer by all means.
- Invoice discounting. This is the purchase of selected invoices from the company (by the provider of the discounting service) at a discounted amount.

Evaluating accounts receivable management

There are numerous ways of measuring account receivable performance. Most of the techniques measure how effectively outstanding account receivable items can be converted into cash. Performance measures can be derived from general financial reports as well as more detailed internal financial records. The balance of accounts receivable can be monitored using an aged account receivable listing, credit utilization rates as well as reports on the level of bad debt.

a) Credit utilization report

The total credit offered as well as the individual customer account should be monitored to ensure that the company's policy with regards to the total credit limits are maintained. A credit utilization report assists to indicate the extent to which total limits are being utilized.

An ideal credit utilization report reveals the following:

- The number of customers usually granted credit and may request more credit. This is dependent on the utilization rate of the customer which is computed by dividing the utilization amount by the customer's credit limit.
- The extent of exposure in relation to the company receivables.
- Ensure efficient implementation of credit control policy and monitoring. When a customer exceeds its established credit limit this indicates that the credit control policy is not adequately monitored and supervised. Additionally, with the outbreak of Covid – 19 pandemic, several businesses although now at the recovery stage were affected by the lockdown restrictions which negatively impacted cashflows, and evidently would reflect on the payment pattern of these companies. This should be closely monitored, and regular follow ups made to ensure up-to-date information on business performance are obtained.

> **"The ability of a company to keep up operations and meet its obligations,, solely depends on the availability of financial resources, and this is impossible with cash tied with customers from credit sales"**

b) Accounts receivable ageing schedule

One of the key reports that should be adequately maintained by the company is the account receivable aging schedule which represents the breakdown of the accounts receivable into categories of days outstanding.

The ageing analysis provides a bird's eye view of the receivables in a Company's books of accounts and changes in behavioral pattern of these receivables could mean an extension of credit terms may have been increased as part of a special program or a change in payments plans by the company's customers.

Conclusion

The ability of a company to keep up operations and meet its obligations, solely depends on the availability of financial resources, and this is impossible with cash tied with customers from credit sales. Effective accounts receivable management will ensure the cash cycle is shorter by implementing an appropriate credit policy and cash collection techniques, this would in turn free up working capital. Effective management of accounts receivable will also reduce operational cost in terms of receivable write-off thereby increasing profitability. Proper management of accounts receivable will enable an organization to maintain an optimal balance between liquidity and profitability.

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