Credit and Collections

Last verified: 2010-10-13

The prime objective for any business is to survive - an objective that must override any other. Thus, a business must have enough cash to meet its legal obligations and avoid becoming insolvent. This publication shows you how to plan for the movement of cash through the business and plan for future needs.

Introduction
Many business owners think growth of sales equals success. But, many so-called "successful" businesses become insolvent because they do not have enough cash to meet the needs of increased sales. Without cash, how can a business pay bills, meet payroll requirements, and buy raw materials in accordance with the increased sales demand?

Cash Flow

Cash cycle
In any business there is a continual cycle of events which may increase or decrease the cash balance.

Cash is used to buy raw materials and pay for services needed to produce finished goods. The sale of finished goods generates cash and accounts receivable - that is money owed from customers. When customers pay, accounts receivable are reduced and the cash account is increased. However, cash flows are not necessarily related to sales of a given period because customers may pay in the next period.

Net working capital (NWC)
Current assets include cash and resources that can be converted to cash within one year or within a normal business cycle. (These resources include marketable securities, accounts receivable, inventories, etc.)

Current liabilities are obligations which become due within one year or within a normal business cycle. (These include accounts payable, notes payable, accrued expenses payable, etc.)

Working capital is the difference between the above mentioned assets and liabilities, and net working capital is the difference between the working capital of two periods.

Example:

	Year 1	Year 2
current assets	$110 000	$200 000
less current liabilities	(-) $70 000	(-) $112 000
equals working capital	= $40 000	= $88 000
NWC = working capital of year 2 minus working capital of year 1		$48 000

The net working capital increased during the year, but we don't know how. It could have been caused by an increase in cash or in inventory, or it may have been caused by a reduction in accounts payable.

Cash flow statement
While the net working capital shows only the changes in the current position, you can develop a "cash flow" statement to explain the changes that happened in any account during any time period. The cash flow statement is an analysis of the cash inflows and outflows.

The forecasting of cash needs is a means of becoming a more efficient manager. If you can determine the cash needs for any period, you can seek a bank loan in advance or you can reduce other current asset accounts so that the cash is available. Also, when you have excess cash, you can reinvest it into the business.

If you know the values of the net working capital (NWC), the change in current liabilities (CL), and the change in current assets less cash (CA less cash), you can calculate the change in cash.

- NWC - net working capital
- CA - the change in current assets other than cash
- CL - the change in current liabilities
- Cash - the change in cash

For example, if you use a net working capital of $48 000, what is the projected change in cash if your sales increase by $50 000 and the following changes occur?

receivables	increase by $25 000
inventory	increase by $70 000
accounts payable	increase by $30 000
notes payable	increase by $10 000

cash	=	NWC - CA + CL
	=	$48 000 - ($25 000 - $70 000) + ($30 000 + $10 000)
answer	=	- $7 000

Conclusion: Over this time period, under an increasing sales volume, cash decreased by $7 000. Is there enough cash overall to cover this decrease?

Sources and application of funds
To forecast the net working capital account, you must trace the sources and application of funds. Sources of funds increase the working capital. The difference between the sources of funds and applications of funds is the net working capital.

The following calculation is based on the fact that the balance sheet is indeed in "balance", meaning the total assets are equal to the total liabilities plus the stockholders' equity.

current assets e.g., cash, accounts receivable	+	non-current assets (not easily converted to cash) e.g., buildings, land, equipment	=	current liabilities e.g., short-term debt, accounts payable	+	long term liabilities e.g., mortgage loans	+	stockholders' equity i.e., capital owed to investors if they cash in their stocks

Rearranging this equation:

current assets	-	current liabilities	=	long term liabilities	+	stockholders' equity	-	non-current assets

Because the left-hand side of the equation is working capital, the right-hand side must equal the working capital amount. A change to either side is the net working capital.

- If long-term liabilities and equity increase or if non-current assets decrease, then net working capital increases. This change would be a source of funds.
- If non-current assets increase or long-term liabilities and equity decrease, then net working capital decreases. This change would be an application of funds.

Typical sources of funds or net working capital are:

- funds provided by operations
- disposal of fixed assets
- issuance of stock
- borrowing from a long term source

To determine the amount of "funds provided by operations", subtract all expense items needing funds from all revenue that was a source of funds. You can also get the amount by adding back expenses which did not result in inflows or outflows of funds to the reported net income.

The most common nonfund expense is depreciation: the allocation of the cost of an asset as an expense over the life of the asset against the future revenues produced. Adjusting net income with depreciation is simpler than computing revenues and expenses which require funds. Depreciation is not a source of funds.

The typical applications of funds or net working capital are:

- purchase of fixed assets
- payment of dividends
- retirement of long-term liabilities
- repurchase of equity

Example of how sources and applications of funds may be shown to determine the net working capital:

From operation		
net income		$10 000
add back depreciation (non cash item)		+ $15 000
		$25 000
issuance of debt		$175 000
issuance of stock		+ $3 000
		$203 000
Application of funds		
purchase of plant		$140 000
cash dividends		+ $15 000
		$155 000
net working capital increase (decrease)		$48 000

You could place low credit risk accounts on a preferred list for automatic approval within certain dollar limits. It is usually sufficient to only review these accounts periodically.

Accounts classified as fair risks will require closer checking, particularly on larger amounts or if payments become slow.

The weak accounts represent acceptable credit risks. However, you must watch these accounts closely. You will spend most of your time watching these weak accounts. Such risky accounts are usually with businesses that are well managed and have good sales ability, but that have limited working capital.

A business whose credit risk is judged as marginal (possibly high) by one company may not be viewed as such by another. You should define the standard for accepting business of this type in your credit policy.

As an aid to credit approval, it is helpful to establish a credit line for each customer. The credit line will act as a guide for approval of orders and is based on the customer's normal needs and debt paying ability.

The credit line represents the maximum amount of credit to be extended to the customer based on the customer's balance sheet and financial capacity. Both the credit line and the credit limit will need periodic review based on changes in the customer's financial status and credit experience gained with the account.

If your business has its accounts receivable and its order entry function on a computer, it is relatively easy to program the credit limits into the system and create exception lists that show the orders that are over the established limits. Such a system eliminates the need to review each and every order and can be expanded to show orders placed on past-due accounts.

Credit Investigation

A major cause for bad debt loss is a credit decision based on an inadequate credit investigation. But, since prompt shipment of orders is essential, your credit checking method should be fast and efficient.

The extent to which you investigate each customer's credit will vary with each case. You will want to consider:

- the size of the order and the potential for future orders
- the length of time the customer has been in business
- the status of their account
- whether the product is seasonal and how it relates to those offered by competition
- the amount of time until delivery
- the effect of the order on the total credit exposure of the customer
- where the credit risk falls within your credit policy
- if it is a special order, whether a deposit is required or if it should be COD

You will base your credit investigation mainly on the past experience of the customer, both with yourself and with other suppliers. Your own customer file is the first place to look; it will give you payment history, the maximum credit given to date, and the frequency of purchases.

The management background and experience of a business is an important factor in its ability to remain profitable. This can be a deciding factor when financial strength is somewhat light, often making the difference between a marginal and an unacceptable credit risk.

Information concerning your client's bank dealings is helpful, as is trade experience from other suppliers. You can get this information in a number of ways:

- For new accounts, you can ask the client to complete a credit application - an effective way to get the name of their bank and trade references.
- Your salespeople are also a valuable source of information.
- Most suppliers and banks are co-operative in exchanging credit information as long as you can assure them that the information obtained will be treated in the strictest confidence.
- Whenever possible, you should obtain a financial statement, usually directly from the customer, although such statements are available from the company prospectus if they issue one or are publicly held.

Outside Sources of Information
You can get valuable credit information from sources such as credit bureaus and Dun & Bradstreet.

Collection Procedures
The collection of outstanding receivables is as important as the investigation, evaluation, and approval of the customer's credit. The collection effort should include a systematic and regular follow-up. This is vital to establishing credibility with the customer concerning your credit terms.

Time is the essence of credit and collections. You should follow-up on a timely basis in order to be effective. A timely, accurate, monthly-aged trial balance of the company's accounts receivable is a valuable method of reviewing and controlling the collections and can be used for reference when granting further credit.

Holding customers' orders when an account is past due is an effective collection tool. Prompt contact with the customer in a tactful and courteous manner will generally produce results. It is important, however, to respond rapidly when the customer clears the account to avoid unnecessary delays in shipping.

Reports
You should perform a periodic review of the working capital and sales goals. Simple reports can be made for a month-to-month review and comparison to establish trends for evaluation.

- *Monthly collection index* - This is a percentage of collections made during the month of the receivables from the beginning of the month.

- *Accounts receivable turnover period* - This is normally expressed as "Days sales outstanding" or DSO, and is calculated as: Total Outstanding Receivables at the end of the period analyzed divided by Total Credit Sales for the period analyzed (typically 30, 90 or 365 days), times the number of days in the period analyzed. That is,

days sales outstanding	=	(accounts receivable/credit sales) x days

When computed monthly, along with aging data, "days sales outstanding" is a means for watching collection trends.

The aged trial balance and percentages of past due accounts also provide a measure of effectiveness, along with the bad debt loss experience for the fiscal period compared to previous years and other similar businesses in industry.

Analysis of Results

It is not enough to simply compare the results of various reports. The overall results of the credit function and collection efficiency must be judged in accordance with the sales and credit policy of the business, as well as with industry trends and economic conditions for the period.

Accurate records and conscientious reports will help you evaluate your credit and collection activities. If you observe trends and make adjustments when needed, your credit and collection activities will help increase your sales and profits.