Accounts Receivable

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WHAT'S COVERED

In this lesson, you will learn about the process for a company to set its credit policy. Specifically, this lesson will cover:

1. Defining Accounts Receivable

When businesses sell products or services to customers, the proceeds or payments for those products and services are known as accounts receivable. In other words, **accounts receivable** represents the cash owed to the business for the products or services purchased by customers, essentially on credit.

In the majority of businesses, accounts receivable is carried out by generating an invoice that is sent to the customer, either electronically or through the mail. Then, the customer is expected to pay the invoice within a predetermined amount of time, known as the credit terms or payment terms. This process is facilitated by a business's accounts receivable department using a sales ledger, which records all sales of goods and services made by the business, the amount of money received for those sales, and the amount of money owed by customers, or debtors, at the end of each month.

TERM TO KNOW

Accounts Receivables
Money owed by entities to the firm on the sale of products or services on credit.

1a. Bookkeeping

Recall that accounts receivable is the money owed to a company by external customers, as represented on the company's balance sheet. These are also known as trade receivables. If these account receivables are due to the company within one year, then they are classified as current assets. To a company's management, these current assets represent the relevant funds when management examines working capital requirements.

There are two approaches available to companies for measuring the net value of accounts receivable. Typically, this value is calculated by taking the balance of an account receivable account and subtracting the balance of an allowance account.

- *Allowance method:* With this method, a company sets up an allowance for estimated "bad debt" accounts, or bad debt provision, which results in a reduced balance for accounts receivable. The total amount of those bad debt accounts can be calculated by either examining each individual debt and determining if it is indeed a bad debt, which is a specific provision, or by providing for a fixed percentage of total debtors–

for example, 2%–which is a general provision.

- *Direct write-off method:* This method is recognized as an easier method than the allowance method because one simple entry can be used to reduce accounts receivable to its resulting net realizable value. This entry comprises the debiting of a bad debt expense account while crediting the corresponding accounts receivable in the sales ledger.

1b. Revenue Recognition

A company has a choice of when to actually recognize revenue via various accounting methods. Revenue has a big impact on bottom-line profitability, so managers may be tempted to “manage” revenue recognition.

Under accrual accounting, a firm can recognize revenue when it has:

- Delivered goods and the title is transferred to the buyer
- Performed all, or a substantial portion of, the services to be provided
- Incurred a substantial majority of the costs, and the remaining costs can be reasonably estimated
- Received either cash, a receivable, or some other asset for which a reasonably precise value can be assigned or collectibility is reasonably assured

Managers can sometimes tweak the period in which revenue is recognized to create a more attractive financial statement for a given circumstance.

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2. Setting a Credit Policy

There are three steps a company must undergo when developing a credit policy:

- Establish credit standards
- Establish credit terms
- Establish a collection policy

2a. Credit Standards

Management must decide on **credit standards**, which involves decisions on how much credit risk to assume. These decisions play a large role in determining how much money a firm ties up in its receivables. A restrictive policy will most likely result in lower sales, but the firm will have a smaller investment in receivables and incur fewer bad-debt losses. Less restrictive policies will generate higher sales as well as a higher receivables balance, but the company will most likely incur more bad-debt losses and a high opportunity cost of holding capital in accounts receivables.

Another important factor in determining credit standards involves a company evaluating the creditworthiness, or credit score, of an individual or business. This refers to the risk that the buyer will default on extended credit by failing to make payments which it is obligated to do. When ascertaining risk, possible losses include both the selling price as well as potential disruptions to cash flows and additional collection costs. Actions that can be taken by a seller to mitigate risk include performing a credit check on the buyer or requiring collateral against credit offered.

TERM TO KNOW

Credit Standards

A set of standards that involves decisions on how much credit risk to assume.

2b. Credit Terms

After establishing credit standards, the firm must decide on the**credit terms**, which include the length of the period that would be allowed before payment must be made and whether or not they will offer a discount for early payments. If they choose to offer a discount, they must also establish the amount of the discount. Reasons for discounting include moving expired stock, rewarding valuable customers, advancing a sales promotion, or promoting behaviors that ultimately benefit the firm itself.

Some common types of discounts include:

- Prompt payment discount
- Preferred payment discount (such as cash over credit card)
- Partial payment discount
- Seasonal discount (for orders placed in a slack period, for example)
- Trade discount (usually given when the buyer agrees to perform some function)
- Quantity discount

TERM TO KNOW

Credit Terms

A set of terms that decides on the length of the period before payment must be made and whether or not a firm will offer a discount for early payments.

2c. Collection Policy

The last step is to establish a **collection policy**. Collection policies vary widely among industries. Some companies do nothing when their customers don't pay. Others send out a reminder notifying customers that their payment is late. Some companies may even take legal action at the first late payment.

BIG IDEA

When setting a credit policy, the five C's of credit are considered:

- Character: Is the borrower trustworthy, with a history of meeting its debt obligations?
- Capacity: Will the borrower have enough cash flow to make its payments?
- Capital: Does the borrower have enough capital to justify the loan?
- Collateral: Does the borrower have any assets that can secure the loan?
- Conditions: How are both the borrower and the economy performing and how are they expected to perform?

TERM TO KNOW

Collection Policy

The set of rules for receiving accounts payable or debt.

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3. Terms of Trade

Often, credit terms are quoted as “net X,” where X represents a specific number of days. The number of days of the credit term includes transit time of the purchase.

> ↱ EXAMPLE A common credit term is “Net 30,” which translates to the payment being due 30 days from the invoice’s issue date. If a customer purchases an item and this item take seven days to arrive, the payment is due to the seller in 23 days, because those seven days of transit time were subtracted from the Net 30 credit term.

While Net 30 is the most widely used credit term for businesses and municipalities (federal, state, and local) in the United States, other common payment terms include Net 10, Net 15, Net 45, Net 60, and 30 days end of month. It should be noted that Net 60 is less commonly used because it reflects a longer payment term.

Now, a debtor has the option of paying before the due date, and some businesses will offer a reward in the form of a discount for such early payment, stated, for example, as “2/10, Net 30.” This means the buyer would benefit from a 2% discount if they choose to pay by the 10th day instead of the 30th. Otherwise, they would simply pay the full amount in 30 days.

IN CONTEXT

Suppose an ice cream stand operator signs a franchise agreement, whereby the distributor supplies ice cream stock under Net 60 terms, offering a 10% discount on payment within 30 days, and a 20% discount on payment within 10 days.

In this scenario, the operator has the entire term of 60 days to pay the invoice in full. If the operator has a good week with robust sales, they can make a partial or full payment towards the invoice amount, making an extra 20% on the ice cream sold in the process. On the other hand, if the operator experiences a bad week of sales, contributing to a month of low cash flow, then they may opt to pay the invoice within 30 days, which garners the 10% discount, or simply wait the full 60 days to pay the invoice, which allows them use of the funds for an additional 30 days.

The ice cream distributor has similar options, because they receive trade credit from companies that supply the milk and sugar, under terms of Net 30, with a 2% discount if paid within 10 days. In this situation, it appears that they would be taking a loss in this complex network of trade credit balances. Why would the distributor do this? There are several reasons.

- They apply a considerable markup to the cost of the ingredients and other production costs associated with the ice cream sold to the operator, an amount that equates to the part of the selling price that is added to the cost of acquiring the inventory.
- It is in the best interest of the distributor for its customers to stay in business, as opposed to failing due to cash flow instabilities. In this manner, the financial terms at play in this situation strive to enable start-ups to manage their inventory investments, which essentially translates to providing them with a short-term business loan. It also allows the distributor to identify potential problems by tracking which customers pay, so they can, in turn, act accordingly to decrease or increase its amount of trade credit.

4. Collecting Receivables

Collecting upon accounts receivable is the final step in the credit extension process, and arguably the most difficult.

4a. Monitoring Tools

In dealing with collections, it is important for a firm to start by monitoring its accounts receivable in order to determine whether its policy is working to the best advantage of the company. Accounts receivable days and an aging schedule are the most common monitoring tools used.

Monitoring Tools	Description
Accounts Receivable Days	The accounts receivable days is the average number of days that it takes a firm to collect on its sales. By comparing this number to the number in the credit policy, a business can determine whether its policy is effective or not. The accounts receivable days are important because investors utilize this measure to evaluate a firm's credit management policy. This method does have its weaknesses. Seasonal sales patterns may cause accounts receivable days to change depending on when the calculation occurs. Therefore, management can potentially manipulate accounts receivable days to hide important information.
Aging Schedule	The other method commonly used is an aging schedule which categorizes accounts by the number of days they have been on the books. It can be constructed in one of two ways: using the number of accounts or using the dollar amount of the outstanding accounts receivable. If the percentages in the lower half of the schedule begin to increase, the firm needs to evaluate the effectiveness of its credit policy. Payment patterns provide information on the percentage of monthly sales that the firm collects each month after the sale. The payment pattern can be used to forecast the working capital needs for the business.
Receivable Turnover Ratio	Another way to evaluate a credit policy is to look at the receivable turnover ratio. This is a financial ratio that measures the number of times, on average, receivables are collected during a period.

4b. Collection Methods

There are several methods companies can use to collect their outstanding receivables. Some do nothing, some send out reminders notifying customers of late payment, and some take legal action–sometimes at the first late payment. If firms so choose, they can utilize a collection agency. A collection agency is a business that pursues payments of debts owed by individuals or businesses.

There are many kinds of collection agencies, the majority of which act as agents of creditors and collect debts, charging a fee or percentage of the total amount owed. One type, first-party agencies, are often a subsidiary of the company to whom the debt is obligated. Another type is third-party agencies, who are distinct companies that a business contracts on their behalf for a fee, to collect the money owed.

A company may protect against bad-debt losses by purchasing trade credit insurance. This is an insurance policy and a risk management product offered by private insurance companies and governmental export credit agencies to business entities wishing to protect their accounts receivables from loss due to credit risks like protracted default, insolvency, or bankruptcy.

SUMMARY

In this lesson, you learned about how companies manage their accounts receivable and their credit policies. **Accounts receivable are defined** as cash owed to a business when a customer purchases its products or services with credit. There are different methods that businesses can use for **bookkeeping** and for **revenue recognition** when managing accounts receivable.

You also learned that accounts receivable are directly affected by a business's credit policy. When **setting a credit policy**, a company must establish **credit standards**, **credit terms**, and a **collection policy**. Credit terms, or **terms of trade**, specify how long a customer has to make their payment and any discounts that may be available for early payment. With respect to **collecting receivables**, a business will employ one of several **monitoring tools** for their accounts receivable to determine if their credit policy and **collection method** is achieving company goals.

Best of luck in your learning!

TERMS TO KNOW

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