

Credit and Collections

Last Verified: 2007-12-21

The prime objective for any business is to survive. That means a firm must have enough cash to meet its obligations. This publication shows the owner-manager how to plan for the movement of cash through the business and thus plan for future requirements.

Introduction

"Business is booming. This month alone, the sales volume has risen over 50 percent".

Many proud owner-managers equate growth in sales volume with the success of their enterprise. But, many of these so-called "successful" businesses are becoming insolvent because they do not have enough cash to meet the needs of an increasing sales volume. For, without cash, how can the business pay its bills, meet its payroll requirements, and purchase merchandise for the increased sales demand?

A business must have enough cash to meet its legal obligations and avoid becoming insolvent. This is a primary business objective that may override other objectives, such as sales volume. What good is additional sales volume if you're out of business?

Sufficient cash is one of the keys to maintaining a successful business. Thus, you must understand how cash moves or flows through the business and how planning can remove some of the uncertainties about future requirements.

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 in the acquisition of materials and services to produce the finished goods. When inventory is sold these sales generate cash and accounts receivable; that is money owed from customers. When customers pay, accounts receivable is reduced and the cash account increases. However, the cash flows are not necessarily related to the sales in that period because customers may pay in the next period.

Net working capital

Current assets are those resources of cash and those which can be converted to cash within one year or in a normal business cycle. These include cash, marketable securities, accounts receivable, inventories, etc. Current liabilities are obligations which become due within one year or a normal business cycle. These include accounts payable, notes payable, accrued expenses

payable, etc. The change in this value from period to period is called net working capital. For example:

	Year 1	Year 2
	19 x 1	19 x 2
Current assets	\$110 000	\$200 000
less current liabilities	- 70 000	- 112 000
Working capital	40 000	88 000
Net working capital increased/(decreased)		\$48 000

Net working capital increased during the year, but we don't know how. It could have been all in cash or all in inventory. Or, it may have resulted from a reduction in accounts payable.

Cash flow statement

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

The ability to forecast cash requirements is indeed a means of becoming a more efficient manager. If you can determine the cash requirements for any period, you can establish a bank loan in advance, or you can reduce other current asset accounts so that the cash will be made available. Also, when you have excess cash, you can put this cash into productive use to earn a return.

The change in the cash account can be readily determined if you know net working capital and the changes in current liabilities and current assets other than cash.

Let:

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

This relationship states that if we know net working capital (NWC), the change in current liabilities (CL), and the change in current assets less cash (CA less cash), we can calculate the change in cash. The change in cash is then added to the beginning balance of cash to determine the ending balance.

Suppose you forecast that sales will increase \$50 000 and the following will correspondingly change:

Receivables	increase by \$25 000
Inventory	increase by \$70 000
Accounts payable	increase by \$30 000
Notes payable	increase by \$10 000

Using net working capital of \$48 000, what is the projected change in cash?

$$\begin{aligned}
\text{cash} &= \text{NWC} - \text{CA} + \text{CL} \\
&= 48\,000 - 25\,000 - 70\,000 + 30\,000 + 10\,000 \\
&= -7\,000
\end{aligned}$$

Conclusion: Over this time period, under an increasing sales volume, cash decreases by \$7 000. Is there enough cash to cover this decrease? This will depend upon the beginning cash balance.

Sources and application of funds:

At any given level of sales, it is easier to forecast the required inventory, accounts payable, receivables, etc., than net working capital. To forecast this net working capital account, you must trace the sources and application of funds. Sources of funds increase working capital. The difference between the sources 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". This is total assets equal total liabilities plus stockholders' equity.

$$\text{current assets} + \text{noncurrent assets} = \text{current liabilities} + \text{long term liabilities} + \text{equity}$$

Rearranging this equation:

$$\text{current assets} - \text{current liabilities} = \text{long term liabilities} + \text{equity} - \text{non current assets}$$

Because the left-hand side of the equation is working capital, the right-hand side must also equal working capital. A change to either side is the net working capital. If long-term liabilities and equity increase or noncurrent assets decrease, net working capital increases. This change would be a source of funds. If noncurrent assets increase or long-term liabilities and equity decrease, 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 obtain the item, "funds provided by operations", subtract all expense items requiring funds from all revenue that was a source of funds. You can also obtain this result in an easier manner: add back expenses which did not result in inflows or outflows of funds to 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 much simpler than computer revenues and expenses which require funds. Again, 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.

The following is an example of how sources and applications of funds may be shown to determine net working capital.

Statement of sources and applications of funds

Sources of funds:

From operation

Net income	\$ 10 000
Add back depreciation (noncash item)	<u>+ 15 000</u>
	\$ 25 000

Issuance of debt	\$175 000
Issuance of stock	<u>+ 3 000</u>
	\$203 000

Application of funds

Purchase of plant	\$140 000
Cash dividends	<u>+15 000</u>
	\$155 000

Net working capital increase (decrease)	\$ 48 000
---	-----------

Good credit risks may be placed on a preferred list for automatic approval within certain dollar limits. Periodic review of these accounts is usually sufficient.

Accounts classified as fair risks will require closer checking, particularly on larger amounts or if some slowness in payment is developing.

The weak accounts will represent acceptable credit risks. However, you must closely watch these accounts. Here is where the credit manager will spend most of his or her time. Such risks are usually those with good management and sales ability but with limited working capital. A business that may be considered marginal by one company might not be viewed as such by another. The standard for accepting business of this type should be defined and set forth in your credit policy.

As an aid to credit approval, it is extremely 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 requirements and debt paying ability.

The credit line should serve the customer's normal requirements.

The credit line represents the maximum amount of credits 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 order entry function on a computer, it is a relatively easy matter to program the limits into the system and create exception lists showing orders over the established limits. This eliminates the necessity of reviewing each and every order and can be expanded to list orders placed on accounts that have past-due balances also.

Credit Investigation

A primary cause for bad debt loss is a credit decision based on an inadequate credit investigation. Yet, prompt shipment of orders is essential. Your credit checking method should be geared for speed and efficiency to enhance the order flow.

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 the present account;
- whether the present product is seasonal and how it relates to the products offered by competition;
- amount of time until delivery;
- relationship of the order to the total credit exposure of the customer;
- where the credit risk falls within the firm's credit policy; and
- if it is a special order, whether a deposit should be required or if it should be COD.

You will base your credit investigation primarily on past experience of the customer, both yours and the experience of other suppliers as well. Your own customer ledger file is the first place to look. This will give you payment history, high credit, and frequency of purchase.

The management background and experience of the firm is a very important factor in its ability to maintain a profitable business. 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 bank dealings is always helpful as is trade experience from other suppliers. You can get this information in a number of ways. For new accounts, a complete credit application may be desired. Direct credit inquiry is a very effective way to gain the name of the customer's bank and trade references. Your salespeople are also a valuable source of information. Most suppliers and banks are very cooperative in exchanging credit information and they should be assured that the information obtained will be treated in the strictest confidence. Whenever possible, a financial statement should be obtained, 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

Valuable credit information is available from several sources. You should have a thorough knowledge of where to find these facts. Some of the sources are:

- Credit Bureau;
- Dun & Bradstreet Reports.

Collection Procedures

The collection of outstanding receivables is as much a responsibility of the credit department 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 establish credibility with the customer concerning the company's credit terms.

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

Holding customers' orders when an account is past due is an extremely effective collection tool. Prompt contact with the customer, tactfully and courteously made, will generally produce results. It is important to respond rapidly in the event that the customer does clear the account so that unnecessary delays in shipping are avoided. It is essential, therefore, that the credit department and accounts receivable bookkeeper have close communication with each other.

Since the credit department is responsible for the protection of working capital along with the promotion of profitable sales, periodic review of these goals should be made. Simple reports can be made for review and a comparison on a month-to-month basis to establish trends for evaluation.

One such report is the monthly collection index. This is a percentage of collection during the month to receivables at the beginning of the month.

Another is the accounts receivable turnover period. This is normally expressed as Days sales outstanding and is computed as follows:

Days sales outstanding = Average A/R balance last 3 month-end x 90/sales for last 3 months

When computed monthly, along with aging data, Days sales outstanding proves an excellent 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 these 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 reports will facilitate your evaluation of your credit and collection activities. If reports are prepared conscientiously and accurately, and if trends are observed and adjustments made when needed, your credit department will make a valuable contribution toward increased sales and profits for your company.

Source: U.S. Small Business Administration

For further information regarding starting a business, contact the

Canada-Saskatchewan Business Service Centre
#2 - 345 3rd Avenue South
Saskatoon, Sask. S7K 1M6
Phone: **306-956-2323** Toll-Free: **1-800-667-4374**

E-mail: saskatchewan@canadabusiness.sk.ca
Web site: <http://www.canadabusiness.ca/sask/>

DISCLAIMER

Information contained in this document is of a general nature only and is not intended to constitute advice for any specific fact situation. Users concerned about the reliability of the information should consult directly with the source, or seek legal counsel.

business infosource is a proud partnership between:



Western Economic
Diversification Canada

Diversification de l'économie
de l'Ouest Canada

Canada

