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Customer derives pleasure in buying if he is saved the agony of paying immediately.

Customers feel that---by offering credit--- we are treating them with trust & respect.

Offering credit to customers makes our company appear more legitimate and established.

A new, unproven business usually doesn't have the financial stability to offer credit.

- **Doing so is a way of signalling to our customers & competitors that we are moving up in the ladder.**

Extending credit gives customers another reason to talk positively about us.

With more payment options, more customers will be able to buy from us.



Credit Sale--Other positive aspects are

When customers –who are given credit--pay back, they place further orders.

Such satisfied clients are a source of advertisement for us—and it enables us to get more customers. Consequently we are known to more number of clients.

Potential customers would not mind buying more if credit is granted.



Pitfalls in selling on credit

There is always a possibility that some of our customers may not pay on time.

We may have to follow up a lot

- entailing more cost and
- more importantly –investing the time and
- the consequent headache.
- Every delay beyond a point—means more expenses and/or loss of opportunities

We may have to initiate legal action thus forcing us to invest time and money

But the two worst effects are

- Cash flow tends to be slow –with undesirable effects
- it forces us to be cautious in granting credit to other deserving clients.



What if the client is not creditworthy ?—other effects

Our mind enters a negative zone & we start doubting even the existing clients

This negative feeling takes away from us the vigour to make new aggressive sales on credit basis.

If---in some cases--- recovery prospects are remote, the debt has to be categorized as bad which is a further drag on profits.

Worse still—our image as sound business gets a hit — leading to

- Doubts in the minds of the existing and would be suppliers
- And in the mind of existing clients.



Let us answer the following questions

We know that we cannot avoid selling goods on credit.

So we have to necessarily grant credit.

Questions that we need to answer

Have we laid down the guidelines ?

Who takes the decision to allow sales on credit ?

Is it you?

Is it your staff?

If it is your staff

What checks and balances are provided to ensure decisions are mostly correct ?



Credit is the norm—cash is an exception

So credit policy has to be in place

It helps to ward off any danger.

Simply put-- **policy in place is better than no policy.**

Components of credit policy are discussed on next slide.



Credit policy—what care needs to be taken ?

First and foremost requirement is

- Either the owner or some delegated authority should ok the credit decisions.
- Limit should be set by the authorized person.
- Credit days need to be decided separately for each client—initially credit days can begin with 10 days—then 20 days and finally 30 days etc. [one solution fits all should not be the case]

Below referred documents / information must be --**but tactfully**-- obtained.

- KYC type documents.
- Bank account statement for the latest three months.
- Sales and purchase figures for the latest 3 months.
- Purchase Order [PO] along with PDC covering the credit period.

Let us not
forget

The only time we
can ensure
compliance from
client is

- **before we part with the goods**



What we mean by Credit Policy ?

popular misconception

- credit policy means issues relating to sanction of credit limits and / or issues related to execution of orders on credit.

But it must be understood that credit policy means and includes

- Scanning the request received from prospective credit seekers.
- Getting all the necessary data / documents ---in a tactful manner and without making the credit seeker feel that we are doubting his intentions and capacity to honour bills on due date.
- Ensuring goods reach the desired destination on the committed date.
- Getting delivery challan duly signed by the authorized official.
- Getting an acknowledgement from the owner / authorized person—via email.
- Getting PDC covering the credit period and **ultimately the payment.**



Credit Policy

- the vital part is –
- its implementation

Though credit limit is sanctioned to a particular client, care---as under-
- --needs to be taken –as and when a particular order is received.

Owner / concerned authorized person needs to ensure / know that --

- **Original Purchase order---duly signed by the authorized person---is received**
- **Such PO is also received via email from the owner / partner / director.**
- **Goods are delivered at the desired destination and in the manner prescribed.**
- **Acknowledged delivery challan is kept on record.**
- **Email from the authorized person as regards receipt of goods is received.**



Credit Department's Role in recovery –

First & foremost --we **should not assume** that the client is a wilful defaulter

Secondly the authorized person should get in touch with the client to know **whether we erred anywhere** in meeting his expectations from us & if necessary take steps to correct ourselves.

- Client may ask for more time in which case we may have to politely inform him that there are delay charges which may accrue—assuming extra time sought is a week or more.
- Even after this , if we do not get the payment we---the owner---have to step in to have one to one talk to establish rapport with the client.
- In case it does not help, recovery measures like issuance of notice, filing of case will have to be initiated.



Why we break our own rules

It is only because we are desperate to get the orders

Because

- We are carrying excess inventory or
- We want to get rid of ageing inventory or
- We are getting good profit margin or
- We want to be in the competition or
- We want to generate enough cash—in the foreseeable future – to ward off funds shortage.



Legal Issues involved—extra care be taken in advance

Our invoices / bill should clearly state the jurisdiction—which should be place of our preference.

We may stipulate that matters be referred to Arbitration in case of dispute. [Note--details as regards place of arbitration etc need to be mentioned—those details are not quoted here]

Delivery challans be acknowledged by the authorised person of the client.

Client himself should –at the earliest---acknowledge receipt of goods as per PO placed by him.

Post Dated Cheque [or as the case may be] be received at the time of delivery of goods or immediately thereafter.



What is your decision in the following example ?

Assume

- We have cash credit facility of Rs.20 lacs— Interest cost being 12% per annum
- Average utilization is 20 lacs--
- LY—sales 180 lacs--CY— sales trends in tune with LY results--Average monthly sales 15 lacs
- Terms of payment— vendors and clients —30 days respectively.
- We are earning gross profit margin of 4%--Our net profit margin is 1%

Assume further that we have received an order

- Rs. 15 lacs.
- Credit period 60 days.
- Profit Margin 4%---No advance



It is the evaluation of various pros & cons that leads to correct response --

- Order value--Rs.15 lacs.
- 4% profit margin translates into absolute profit of Rs.60,000/*. So this is the earnings that will accrue to us.
- Let us deduct Interest cost for 30 days that we have given extra. It comes to Rs.15000/-- [Rs.15 lacs x 1%]
- So after ---notional adjustment of ---extra interest cost, the balance left out is Rs.45,000/*
- I have to compare this with usual NP that I get—which is 1%--& in absolute terms is Rs.15K*
- So the extra profit that I am getting is Rs.30K* [Rs.60k minus Rs.15K* = 45K minus Rs-15 K]
- So I decided to execute this order.

• Is my decision correct ? See next slide



My decision could be wrong



LY Sales were 180 lacs.CY Sales were expected to be at the same level.

Average sales per month ---for both the years---were Rs.15 lacs

Sales were being realized regularly within 30 days.

So the number of sales realization cycles were 12 in an year.

Each sales realization cycle of Rs.15 lacs bought net profit of 1% i.e. 15K.



My decision could be wrong –continued

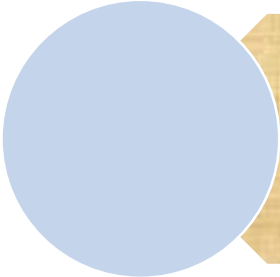
But because of extra 30 days credit, the sales realization cycles were reduced from 12 to 11. [assuming there are no other sales]

This meant notional loss of 15k. So in effect the advantage is further reduced to 15k only.

So I have to further think

- Whether to secure additional profit of 15k, should I take the risk of 60 days credit period?
- Whether I am able to manage the liquidity in the absence of one sales realization cycle of Rs.15 lacs?
- Whether—as a consequence of tightening liquidity—will I be able to pay vendors on time and / or also provide for necessary expenses ?





My decision could be wrong because

I did not think about

- **Number of sales realization cycles –before and after this particular order.**
- **Sales I have lost because I gave extra 30 days.**
- **Loss of profit because of the reduced sales realization cycles.**
- **As to why client wanted 60 days.**
- **strain on liquidity because of delayed realization of sales by another 30 days.**
- **Did not think about alternate arrangements to pay vendor and / or other expenses.**



Owner/stake
holder has no
option

but

to monitor the
receivables
himself---

- It is an area that we cannot leave in the hands of salesperson etc.
- It is in our interest to ensure that our business does not fail in recovering the receivables on due dates.
- As owner / stakeholder –
 - We need to know that
 - If we do not recover on time, we will be short of funds and thus be not able to pay our suppliers on time.
 - We will---even be not able –to provide for expenses as and when they become due.
 - We will not be able to pay our banks as per schedule.



Can we—as owner—have tools / mechanism to monitor the receivables—?

All overdue bills should necessarily be brought to your notice at least once a week with details such as

- Is the client unhappy about our services/quality/ delivery or for any other reason ?
- Is the client short on money ?
- Is there any other reason ?
- When the payment is expected ?

Clients whose dues have become sensitive from recovery point of view---

- should be handled by you or the next senior person in your business.



Monitoring Tool--A B C Analysis of Receivables

- Category A -- Represents small portion of accounts with large value
- Category B Represents moderate value
- Category C Represents a large no. of accounts with smaller value

Category	% of accounts to total accounts	% of balance Outstanding to total OS
A		
B		
C		

**Frequency of
getting data can be
at least fortnightly**



Receivables Turnover Ratio—Part I

- This is historical data.
- But none-the-less it gives an idea of what happened in the past.
- It enables us to compare it with peers in the same industry.
- The ratio also gives an idea of what need to be done henceforth.
- Formula
 - $\text{Net credit sales} / \text{average accounts receivable} [\text{Opening balance} + \text{Closing balance} / 2]$

Example next page



Receivables Turnover Ratio –Part II

Assume

- Net credit sales are 105 lacs.
- Opening Balance of Receivable Rs.20 lacs.
- Closing Balance of Receivable Rs.10 lacs

Formula

- Net credit sales / Average Receivables
- $105 / 20 + 10 / 2$
- $105 / 15 = 7$ times
- If we want no. of days, divide $365 / 7 = 52$ days.

Goes without saying = lessor the no. of days, more the realized sales cycles and more the profit and more liquidity opens up more profitable avenues.



Receivables Turnover Ratio— other interpretations / limitations

Efficient
turnover
ratio---

Is not welcome if we are sacrificing credit sales & try to be too much on the safer side.

is not welcome if we do not aggressively place ourselves in the market because of the fear of non recovery.

Is **welcome only if** it meets both the goals--more sales & timely realization

Does not correctly represent the picture if we do not take the data spread over throughout the year –taking only opening & closing balances could give us wrong data.



Let us understand the credit period economics

Supposing we have two clients---order value is Rs.1 lac

- One seeking to pay immediately but insisting on cash discount—how much we can give ?
- Other one seeking credit period of 60 days without interest. –how much we will be losing ?

What should be our response? [Assuming we pay interest of 12% P.A]

Formula --- to decide cash discount

- Load interest rate on amount of credit sale along with credit period that we will be granting & divide by 360
- Resultant figure is the cash discount we can give to avoid credit sale
- $12\% \times 1,00,000 \times 60 / 360 = 2,000 / *$

Formula to decide credit period

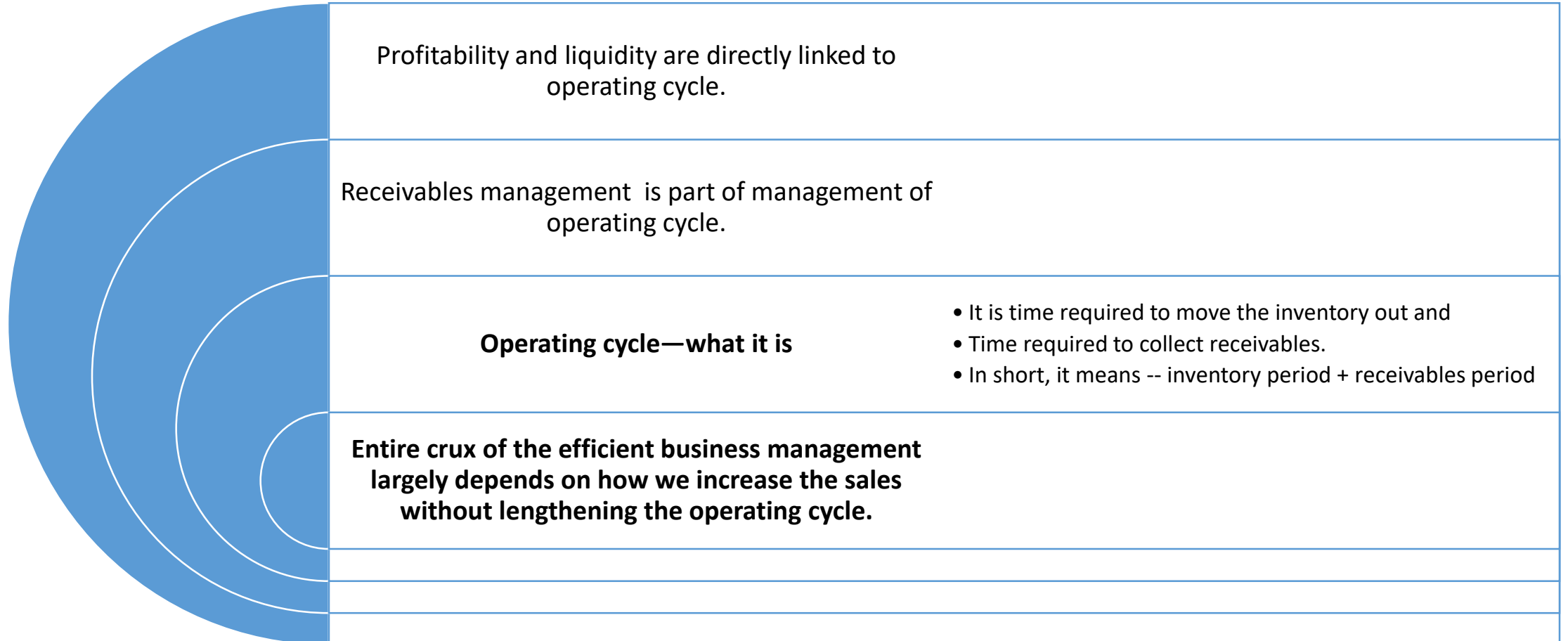
- Rate of interest applicable to credit period asked.
- Multiply by credit amount
- Add this amount to credit sought
- $2\% \times 1,00,000 = 2,000 + 1,00,000 = 1,02,000$

Of course, there could be other considerations –such as liquidity—need to spend immediately etc



Efficient Receivables Management

helps us to survive and grow



Cash & Credit Sales— What should be the ideal mix ?

We cannot forget the importance of having sufficient cash available to us for

- Meeting day to day expenses.
- Paying statutory dues on time.
- Satisfying obligations to suppliers on due dates.
- In some cases, we may desire to give advance payment to suppliers to secure some benefits or even to get preferential treatment.
- To meet unforeseen expenses.

There is no fixed formula as such but **decision can be taken on the basis of cash flow statement** that we need to draw for each month.

The projected funds shortfall should be bridged by cash sales and one way to achieve this is to offer discount equivalent to bank interest.

