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Receivables Management

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Learning Objectives

By the end of this chapter, participants will be able to:

- Define accounts receivable and receivables management
- Explain the importance of effective credit management
- Distinguish trade and non-trade receivables
- Explain the costs and benefits of granting credit
- Develop customer credit standards
- Apply the five Cs of credit
- Establish credit limits and credit periods
- Evaluate cash-discount policies
- Calculate receivables turnover and collection periods
- Prepare and interpret receivables-aging schedules
- Estimate bad-debt provisions
- Evaluate changes in credit policy
- Design collection procedures
- Identify receivables risks and internal controls
- Recommend strategies for improving collection performance

Chapter Roadmap

This chapter covers:

1. Meaning of receivables
2. Importance of receivables management
3. Types of receivables
4. Benefits and costs of credit sales
5. Credit-policy components
6. Customer credit assessment
7. Credit limits and terms
8. Cash discounts
9. Receivables monitoring
10. Aging analysis
11. Bad debts and impairment
12. Collection management
13. Credit-policy evaluation
14. Receivables financing
15. Internal controls and fraud prevention
16. Performance-improvement strategies

SECTION 1

Introduction to Receivables

Understanding what receivables are and why they represent an investment of organizational funds.

What Are Accounts Receivable?

Accounts receivable are amounts owed to an organization by customers or other parties.

They commonly arise when:

- Goods are sold on credit
- Services are provided before payment
- Advances are issued
- Staff or partners owe money
- Claims remain unsettled

What Is Receivables Management?

Receivables management is the process of:

- Establishing credit policies
- Assessing customer creditworthiness
- Approving credit limits
- Issuing accurate invoices
- Recording receivables
- Monitoring outstanding balances
- Following up overdue accounts
- Collecting amounts due
- Managing bad-debt risk

The Central Receivables Question

Receivables management seeks to answer:

The decision should balance:

- Sales growth
- Customer relationships
- Cash flow
- Collection cost
- Bad-debt risk
- Profitability

How much credit should an organization provide, to whom, for how long and under what conditions?

Receivables as an Investment

Granting credit means investing organizational funds in customers.

Until customers pay, funds remain tied up in:

- Accounts receivable
- Collection activities
- Credit monitoring
- Financing costs
- Bad-debt exposure

Receivables and Working Capital

Accounts receivable are an important component of current assets.

An increase in receivables generally:

- Increases working-capital requirements
- Reduces immediate cash
- May increase sales
- May increase collection risk
- May require additional financing

Credit Sales and Cash Flow

A credit sale may increase:

- Revenue
- Profit
- Accounts receivable

However, it does not increase cash until payment is collected.

Receivables-Management Goal

The goal is not to eliminate credit.
The goal is to provide profitable credit while:

- Controlling default risk
- Accelerating collection
- Minimizing funds tied up
- Maintaining customer relationships
- Protecting liquidity

SECTION 2

Importance of Receivables Management

Why managing receivables is central to sales, liquidity, profitability and risk.

Supporting Sales Growth

Credit may increase sales by allowing customers to:

- Buy before cash is available
- Purchase larger quantities
- Match payment with their cash cycle
- Develop long-term supplier relationships

Improving Competitiveness

Credit terms may help an organization compete through:

- Flexible payment arrangements
- Longer settlement periods
- Customer-specific limits
- Early-payment discounts
- Structured payment plans

Maintaining Liquidity

Effective receivables management helps ensure that credit sales are converted into cash on time.

Timely collections support:

- Payroll
- Supplier payments
- Taxes
- Debt service
- Inventory purchases
- Daily operations

Protecting Profitability

Poor collection may reduce profitability through:

- Bad debts
- Collection expenses
- Legal fees
- Financing costs
- Administrative time
- Lost investment opportunities

Reducing Financial Risk

Receivables management reduces exposure to:

- Customer default
- Payment delays
- Fraud
- Disputes
- Credit concentration
- Currency losses
- Documentation weaknesses

Customer Relationships

A clear and professional credit system can improve relationships by providing:

- Transparent terms
- Accurate invoices
- Consistent follow-up
- Fair dispute resolution
- Predictable payment expectations

SECTION 3

Types of Receivables

The main categories of receivables and how they are classified.

Major Receivable Categories

Receivables may include:

- Trade receivables
- Notes receivable
- Staff receivables
- Advances
- Grant receivables
- Tax receivables
- Interest receivable
- Other receivables

Trade Receivables

Trade receivables arise from the normal sale of goods or services on credit.

Examples include:

- Customer invoices
- Service fees
- Credit sales
- Contract billings

Non-Trade Receivables

Non-trade receivables arise outside normal sales activities.

Examples include:

- Staff advances
- Loans to employees
- Tax refunds
- Insurance claims
- Interest receivable
- Supplier refunds

Notes Receivable

A note receivable is a formal written promise to pay a specified amount.

It may include:

- Principal
- Interest rate
- Maturity date
- Payment schedule
- Security or guarantee

Staff Receivables

Staff receivables may arise from:

- Salary advances
- Travel advances
- Loans
- Personal-use deductions
- Unretired activity advances

They require clear recovery and accountability procedures.

Grant and Donor Receivables

Grant receivables may arise when:

- Eligible expenses have been incurred
- Reimbursement is pending
- An approved installment has not been received
- A contractual amount remains due

They should be supported by valid agreements and documentation.

Current and Non-Current Receivables

Current Receivables

Expected to be collected within one year or the normal operating cycle.

Non-Current Receivables

Expected to be collected after more than one year.

SECTION 4

Benefits and Costs of Granting Credit

Weighing the advantages of credit sales against their costs and risks.

Benefits of Credit Sales

Credit may provide:

- Increased sales
- Larger customer base
- Stronger customer loyalty
- Competitive advantage
- Higher production utilization
- Greater market share

Costs of Credit Sales

Granting credit creates:

- Financing cost
- Collection cost
- Administrative cost
- Bad-debt risk
- Delayed cash flow
- Opportunity cost
- Monitoring requirements

Financing Cost of Receivables

Funds tied up in receivables may need to be financed through:

- Bank overdraft
- Short-term loan
- Retained cash
- Supplier credit
- Equity funds

This financing has an opportunity or explicit cost.

Administrative Cost

Credit administration may require:

- Customer assessment
- Credit approval
- Invoice preparation
- Account monitoring
- Collection follow-up
- Dispute management
- Legal action

Bad-Debt Cost

Bad-debt cost arises when amounts cannot be collected.

It reduces:

- Profit
- Cash flow
- Working capital
- Asset quality
- Financial performance

Opportunity Cost

Funds invested in receivables cannot simultaneously be used for:

- Inventory
- Debt repayment
- Capital investment
- Short-term investments
- Dividends
- Emergency reserves

Credit Decision Trade-Off

A more liberal credit policy may:

- Increase sales
- Increase receivables
- Increase bad debts
- Increase collection cost
- Increase financing needs

A stricter policy may have the opposite effects.

SECTION 5

Credit Policy

The framework that governs how credit is provided and collected.

What Is a Credit Policy?

A credit policy is a formal framework governing the provision and collection of credit.

It should define:

- Credit standards
- Credit limits
- Credit periods
- Discounts
- Approval authority
- Collection procedures
- Bad-debt treatment
- Monitoring requirements

Objectives of a Credit Policy

A sound credit policy should:

- Support profitable sales
- Control bad debts
- Maintain liquidity
- Apply consistent decisions
- Clarify responsibilities
- Protect organizational resources
- Improve accountability

Main Credit-Policy Components

The four main components are:

1. **Credit standards**
2. **Credit terms**
3. **Credit limits**
4. **Collection policy**

Credit Standards

Credit standards determine the minimum conditions a customer must satisfy to receive credit.

They may consider:

- Financial capacity
- Payment history
- Business reputation
- Collateral
- Market conditions
- Customer relationship

Liberal Credit Standards

Liberal standards approve more customers.

Possible effects include:

- Increased sales
- Higher receivables
- More bad debts
- Greater collection cost
- Higher financing needs

Restrictive Credit Standards

Restrictive standards approve fewer customers.

Possible effects include:

- Lower bad-debt risk
- Faster collections
- Lower sales
- Reduced market share
- Lower receivables investment

Credit Terms

Credit terms define:

- Payment period
- Discount percentage
- Discount period
- Penalty for late payment
- Interest on overdue balances
- Required documentation

Credit Period

The credit period is the time allowed for payment.

Examples include:

- Net 15
- Net 30
- Net 60
- Net 90

Longer periods may increase sales but delay cash collection.

Credit Limit

A credit limit is the maximum unpaid balance permitted for a customer.

It should reflect:

- Creditworthiness
- Purchase history
- Payment capacity
- Risk exposure
- Collateral
- Management approval

Credit-Limit Review

Credit limits should be reviewed when:

- Sales increase significantly
- Payment behavior changes
- Customer finances weaken
- Market conditions deteriorate
- Ownership changes
- Collateral changes
- Overdue balances increase

SECTION 6

Customer Credit Assessment

Evaluating a customer's ability and willingness to repay.

Creditworthiness

Creditworthiness is the customer's ability and willingness to repay obligations.

Assessment should consider both:

- Quantitative information
- Qualitative information

The Five Cs of Credit

The five Cs are:

1. Character
2. Capacity
3. Capital
4. Collateral
5. Conditions

Character

Character evaluates the customer's willingness to pay.

Sources of evidence include:

- Payment history
- Supplier references
- Reputation
- Management integrity
- Previous defaults
- Legal history

Capacity

Capacity evaluates the customer's ability to generate cash for repayment.

Indicators include:

- Operating cash flow
- Profitability
- Debt-service coverage
- Liquidity
- Revenue stability
- Payment record

Capital

Capital evaluates the customer's financial strength.

It may be assessed through:

- Net worth
- Equity ratio
- Retained earnings
- Debt-to-equity ratio
- Asset base
- Financial statements

Collateral

Collateral represents assets pledged to support repayment.

Examples include:

- Property
- Vehicles
- Inventory
- Equipment
- Bank guarantees
- Deposits

Conditions

Conditions include external factors affecting repayment, such as:

- Economic trends
- Industry conditions
- Inflation
- Political risk
- Currency movements
- Regulatory changes
- Seasonal demand

Credit Information Sources

Credit information may be obtained from:

- Financial statements
- Bank references
- Supplier references
- Credit bureaus
- Public registries
- Customer interviews
- Historical account records
- Site visits

Financial Statement Review

Credit analysis may review:

- Revenue
- Profitability
- Cash flow
- Current ratio
- Quick ratio
- Debt levels
- Interest coverage
- Working capital

Current Ratio

FORMULA

Current Ratio = Current Assets ÷ Current Liabilities

It provides an indication of short-term payment capacity.

Quick Ratio

FORMULA

Quick Ratio = (Cash + Short-Term Investments + Receivables) ÷ Current Liabilities

It excludes inventory from liquid assets.

Debt-to-Equity Ratio

FORMULA

Debt-to-Equity = Total Debt ÷ Total Equity

A high ratio may indicate greater financial risk.

Interest-Coverage Ratio

FORMULA

$$\text{Interest Coverage} = \text{EBIT} \div \text{Interest Expense}$$

A higher ratio generally indicates stronger debt-payment capacity.

SECTION 7

Credit Scoring

Using structured scoring to make consistent, objective credit decisions.

What Is Credit Scoring?

KEY CONCEPT

Credit scoring assigns numerical values to customer characteristics.
The score supports consistent and objective credit decisions.

Credit-Scoring Factors

A scorecard may include:

- Years in business
- Payment history
- Liquidity
- Profitability
- Debt ratio
- Order size
- Collateral
- Industry risk

Sample Credit Score

A customer might receive points for:

Factor	Points
Strong payment history	25
Good liquidity	20
Low leverage	15
Stable industry	15
Strong references	15
Collateral	10
Total possible score	**100**

Credit-Score Decision Bands

Score Band	Decision
80–100	Approve
65–79	Approve with conditions
50–64	Limited credit or security required
Below 50	Reject or require advance payment

The thresholds should reflect organizational risk appetite.

Limitations of Credit Scoring

Credit scoring may not capture:

- Sudden business changes
- Fraudulent information
- Qualitative concerns
- Political risk
- Customer concentration
- Management integrity

Professional judgment remains necessary.

SECTION 8

Credit Approval Process

From application to approval: a controlled sequence of steps.

Credit Approval Steps

1. Receive credit application
2. Verify customer identity
3. Collect supporting documents
4. Conduct credit assessment
5. Determine credit limit
6. Approve or reject application
7. Record terms in the system
8. Monitor customer performance

Credit Application

A credit application should collect:

- Legal name
- Registration details
- Address
- Ownership
- Bank information
- Financial information
- Trade references
- Requested limit
- Authorized representatives

Approval Authority

Credit authority should be defined according to:

- Customer risk
- Credit amount
- Credit period
- Security
- Exceptions
- Management level

Higher-risk or higher-value limits should require senior approval.

Credit Agreement

A credit agreement should specify:

- Approved limit
- Payment terms
- Interest or penalty
- Dispute procedures
- Security
- Suspension conditions
- Collection rights
- Governing law

Credit Exceptions

Exceptions may include:

- Exceeding credit limits
- Extending payment periods
- Waiving penalties
- Allowing further sales despite arrears

Exceptions should be documented and approved.

SECTION 9

Cash Discounts

Using early-payment incentives to accelerate collections.

What Is a Cash Discount?

A cash discount encourages customers to pay earlier.

Example — 2/10, net 30 — means:

- 2% discount if paid within 10 days
- Full amount due within 30 days

Benefits of Cash Discounts

Cash discounts may:

- Accelerate collections
- Reduce receivables
- Reduce bad-debt risk
- Improve liquidity
- Reduce financing cost
- Encourage customer discipline

Costs of Cash Discounts

Cash discounts reduce revenue because customers pay less.

Management should compare:

- Discount cost
- Financing savings
- Collection improvement
- Bad-debt reduction
- Administrative impact

Discount Example

Invoice amount ETB 100,000

Discount 2%

Early-payment amount $100{,}000 \times (1 - 0.02)$

Early-payment amount: **ETB 98,000**

Annualized Cost of Forgoing Discount

FORMULA

$$\text{Approx. Annual Cost} = [\, d \div (1 - d) \,] \times [\, 365 \div (N - D) \,]$$

Where:

- d = discount rate
- D = discount period
- N = final payment period

Discount-Cost Example

For 2/10, net 30:

$$= (0.02 \div 0.98) \times (365 \div 20)$$

Approximate annual cost: **≈ 37.24%**

A customer forgoing the discount bears a high implied annual cost.

Evaluating a Discount Policy

A discount policy is beneficial when:

Financing and Bad-Debt Savings > Discount Cost

The analysis should also consider sales effects.

SECTION 10

Invoicing Management

Accurate, timely invoicing as the starting point of collection.

Importance of Accurate Invoicing

Collection begins with a correct and timely invoice.

Errors may lead to:

- Payment delays
- Customer disputes
- Rejected invoices
- Additional administrative work
- Cash-flow shortages

Essential Invoice Information

An invoice should include:

- Customer name
- Invoice number
- Invoice date
- Description of goods or services
- Quantity
- Price
- Taxes
- Payment terms
- Bank details
- Due date

Timely Invoicing

Invoices should be issued immediately after:

- Delivery
- Service completion
- Contract milestone
- Approved billing event

Delays in invoicing create delays in collection.

Invoice Verification

Before issuing an invoice, confirm:

- Contract terms
- Delivery evidence
- Approved price
- Correct tax
- Customer purchase-order reference
- Accurate bank details
- Correct due date

Electronic Invoicing

Electronic invoicing may improve:

- Speed
- Accuracy
- Delivery confirmation
- Document retrieval
- Automated reminders
- Customer access
- Payment tracking

SECTION 11

Receivables Monitoring

Tracking outstanding balances and measuring collection performance.

Why Monitor Receivables?

Monitoring helps management identify:

- Overdue balances
- High-risk customers
- Collection delays
- Limit violations
- Disputed invoices
- Concentration risk
- Potential bad debts

Receivables Ledger

A receivables ledger should show:

- Customer name
- Invoice number
- Invoice date
- Due date
- Amount
- Payment received
- Outstanding balance
- Aging category

Receivables Turnover

FORMULA

Receivables Turnover = Annual Credit Sales ÷ Average Accounts Receivable

It measures how frequently receivables are collected.

Receivables-Turnover Example

Assume annual credit sales of ETB 60 million and average receivables of ETB 10 million:

Receivables Turnover = 60 ÷ 10

Receivables turnover: **6 times**

Average Collection Period

Average Collection Period = 365 ÷ Receivables Turnover

Using the example: 365 ÷ 6

Average collection period: **≈ 60.8 days**

Alternative Collection-Period Formula

FORMULA

$$\text{Receivables Days} = (\text{Average Receivables} \div \text{Annual Credit Sales}) \times 365$$

Interpreting Collection Period

If credit terms are net 30 but collection days are 61:

- Customers are paying late
- Collection controls may be weak
- Receivables investment is excessive
- Liquidity pressure may be increasing

Days Sales Outstanding

Days Sales Outstanding is another term commonly used for the receivables collection period.

FORMULA

$$\text{DSO} = (\text{Accounts Receivable} \div \text{Credit Sales}) \times \text{Number of Days}$$

Collection Effectiveness Index

A collection-effectiveness measure compares:

- Amount collectible during the period
- Amount actually collected

A higher index generally indicates stronger collection performance.

SECTION 12

Aging Analysis

Classifying receivables by age to reveal collection risk.

What Is an Aging Schedule?

KEY CONCEPT

An aging schedule classifies outstanding receivables according to the length of time they have remained unpaid.

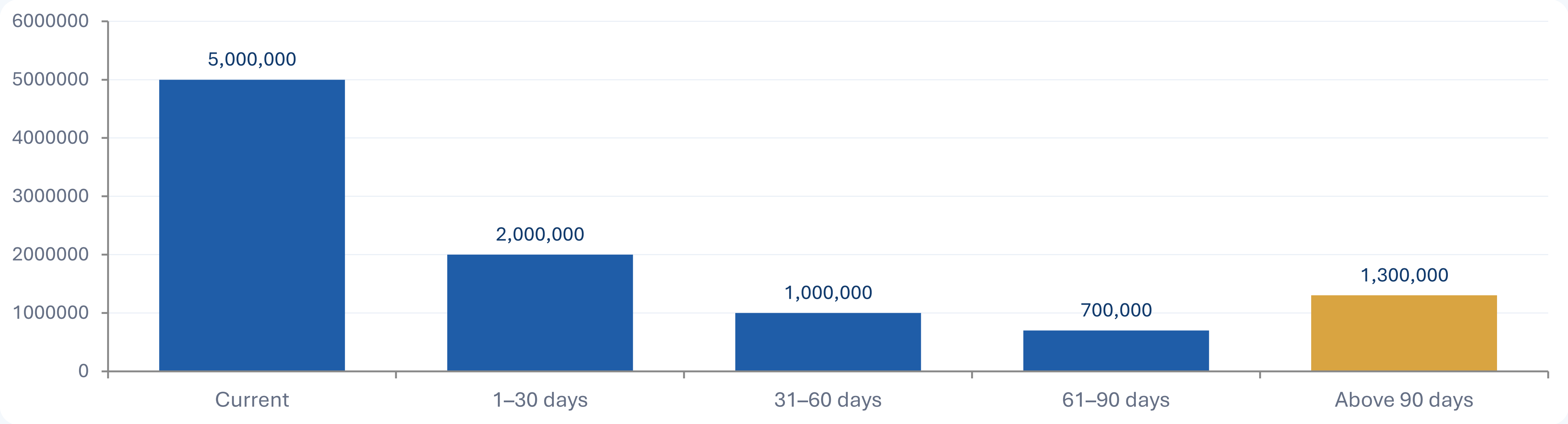
Typical Aging Categories

Receivables are commonly grouped as:

- Current
- 1–30 days overdue
- 31–60 days overdue
- 61–90 days overdue
- 91–180 days overdue
- More than 180 days overdue

Aging-Schedule Example

Outstanding receivables by age category (ETB):



Older balances warrant closer management attention.

Aging Interpretation

Older receivables generally have:

- Higher default risk
- Higher collection cost
- Lower recoverability
- Greater need for management attention
- Greater impairment requirements

Overdue Receivables Percentage

FORMULA

$$\text{Overdue Percentage} = (\text{Overdue Receivables} \div \text{Total Receivables}) \times 100$$

Aging Example

Total receivables ETB 10 million

Overdue receivables ETB 5 million

Overdue Percentage = (5 ÷ 10) × 100

Overdue percentage: **50%**

Aging-Based Actions

Age Category	Recommended Action
Current	Routine monitoring
1–30 days overdue	Reminder and customer contact
31–60 days overdue	Formal follow-up and credit review
61–90 days overdue	Management escalation and credit suspension
Above 90 days	Recovery plan, legal action or impairment review

SECTION 13

Bad Debts and Impairment

Recognizing and provisioning for amounts that may not be collected.

What Is a Bad Debt?

A bad debt is a receivable considered uncollectible.

Possible causes include:

- Customer insolvency
- Dispute
- Fraud
- Business closure
- Weak documentation
- Untraceable customer
- Legal limitation

Bad-Debt Expense

Bad-debt expense recognizes the expected loss arising from uncollectible receivables.

It reduces:

- Accounting profit
- Net receivables
- Asset quality

Allowance Method

KEY CONCEPT

Under the allowance method, expected credit losses are estimated before specific accounts are confirmed as uncollectible.
This supports more timely recognition of credit risk.

Percentage-of-Sales Method

FORMULA

$$\text{Estimated Bad-Debt Expense} = \text{Credit Sales} \times \text{Expected Loss Rate}$$

Percentage-of-Sales Example

Assume credit sales of ETB 50 million and an expected loss rate of 2%:

$$\textbf{Bad-Debt Expense} = \textbf{50 million} \times \textbf{2\%}$$

Bad-debt expense: **ETB 1 million**

Percentage-of-Receivables Method

FORMULA

$$\text{Required Allowance} = \text{Ending Receivables} \times \text{Expected Loss Percentage}$$

Aging-Based Provision

Different expected-loss rates may be assigned to aging categories, for example:

Age Category	Expected Loss Rate
Current	1%
1–30 days overdue	3%
31–60 days overdue	10%
61–90 days overdue	25%
Above 90 days	60%

Provision Example

Assume the following balances by age category:

Age Category	Balance (ETB)	Loss Rate
Current	5,000,000	1%
1–30 days overdue	2,000,000	3%
31–60 days overdue	1,000,000	10%
61–90 days overdue	700,000	25%
Above 90 days	1,300,000	60%

Calculate Expected Loss

Age Category	Balance (ETB)	Rate	Expected Loss (ETB)
Current	5,000,000	1%	50,000
1–30 days overdue	2,000,000	3%	60,000
31–60 days overdue	1,000,000	10%	100,000
61–90 days overdue	700,000	25%	175,000
Above 90 days	1,300,000	60%	780,000
Total expected loss			**1,165,000**

Indicators of Impairment

Warning signs may include:

- Significant payment delay
- Customer insolvency
- Repeated broken promises
- Legal dispute
- Financial deterioration
- Business closure
- Inability to contact customer
- Breach of agreement

Receivable Write-Off

A write-off should require:

- Collection history
- Evidence of recovery efforts
- Legal review where appropriate
- Management approval
- Accounting adjustment
- Updated customer status
- Supporting documentation

Recovery after Write-Off

A receivable recovered after write-off should be:

- Recorded promptly
- Supported by documentation
- Reported transparently
- Reconciled to bank receipts
- Reviewed for control implications

SECTION 14

Collection Management

Structured, professional processes for securing payment.

Objectives of Collection Management

Collection management seeks to:

- Obtain payment promptly
- Maintain customer relationships
- Reduce bad debts
- Minimize collection costs
- Improve liquidity
- Enforce credit terms consistently

Collection Process

A structured collection process may include:

1. Invoice confirmation
2. Pre-due reminder
3. Due-date reminder
4. Overdue follow-up
5. Formal demand
6. Credit suspension
7. Negotiated repayment plan
8. Legal recovery

Pre-Due Reminder

A reminder before the due date can:

- Confirm invoice receipt
- Identify disputes early
- Reinforce payment expectations
- Reduce accidental late payment

Overdue Follow-Up

Overdue follow-up should clarify:

- Amount outstanding
- Original due date
- Reason for delay
- Promised payment date
- Required corrective action
- Consequences of continued default

Collection Communication

Collection communication should be:

- Professional
- Accurate
- Firm
- Respectful
- Documented
- Consistent with policy
- Legally compliant

Payment Plans

A payment plan may be appropriate when a customer:

- Acknowledges the debt
- Has temporary cash-flow difficulty
- Can meet structured installments
- Provides credible documentation
- Accepts formal terms

Payment-Plan Conditions

A payment plan should specify:

- Total amount
- Installment amounts
- Payment dates
- Interest or penalties
- Security
- Default consequences
- Approval authority

Credit Suspension

Further credit may be suspended when:

- Limits are exceeded
- Accounts are significantly overdue
- Payment promises are repeatedly broken
- Financial condition deteriorates
- Required documents are unavailable

Legal Recovery

Legal action may be considered when:

- The amount is material
- Documentation is strong
- Voluntary collection has failed
- Recovery prospects justify cost
- Management approves the action

SECTION 15

Evaluating Changes in Credit Policy

Assessing proposed policy changes using incremental benefits and costs.

Credit-Policy Evaluation

A proposed credit-policy change should be evaluated based on:

- Additional sales
- Contribution margin
- Additional receivables
- Financing cost
- Bad-debt cost
- Collection cost
- Discount cost
- Net profit effect

Liberal Credit-Policy Example

A company considers extending its credit period from 30 to 60 days.

Expected effects:

- Sales increase
- Receivables increase
- Bad debts increase
- Collection period lengthens
- Financing requirements increase

Incremental Contribution

FORMULA

$$\text{Incremental Contribution} = \text{Increase in Sales} \times \text{Contribution-Margin Ratio}$$

Additional Receivables Investment

A simplified estimate is:

FORMULA

$$\text{Additional Receivables} = (\text{Annual Credit Sales} \div 365) \times \text{Increase in Collection Days}$$

Financing Cost

FORMULA

$$\text{Financing Cost} = \text{Additional Receivables Investment} \times \text{Required Return}$$

Bad-Debt Cost

FORMULA

$$\text{Bad-Debt Cost} = \text{Credit Sales} \times \text{Bad-Debt Percentage}$$

The incremental change should be included in policy analysis.

Credit-Policy Decision Rule

Accept the policy change when:

Incremental Benefits > Incremental Costs

Benefits should be sustainable and risk-adjusted.

SECTION 16

Receivables Financing

Converting receivables into immediate cash.

Why Finance Receivables?

Organizations may convert receivables into immediate cash to:

- Improve liquidity
- Reduce collection delays
- Finance growth
- Meet working-capital needs
- Reduce dependence on overdrafts

Factoring

Factoring involves selling receivables to a financial institution or factor.

The factor may provide:

- Immediate cash
- Collection services
- Credit administration
- Credit-risk protection

Factoring: With vs Without Recourse

With Recourse

- The seller remains responsible for customer default
- Credit risk remains partly with the organization
- Financing cost may be lower

Without Recourse

- The factor assumes agreed credit risk
- The cost is generally higher
- Risk transfer is greater

Invoice Discounting

Invoice discounting uses receivables as security for financing.

The organization normally continues to:

- Manage customers
- Collect receivables
- Maintain customer relationships

Receivables Securitization

KEY CONCEPT

Receivables securitization involves pooling receivables and using them to support marketable financial securities.

It is usually used by larger organizations with substantial, predictable receivables.

Financing Evaluation

Receivables financing should be evaluated based on:

- Fees
- Interest
- Advance percentage
- Recourse
- Customer impact
- Documentation
- Credit-risk transfer
- Effective annual cost

SECTION 17

Receivables Risks

Identifying the major risks embedded in receivables.

Major Receivables Risks

Receivables risks include:

- Customer default
- Payment delay
- Credit concentration
- Fraud
- Dispute
- Currency loss
- Documentation failure
- Accounting errors
- Unauthorized write-offs

Credit-Concentration Risk

Concentration risk occurs when a large share of receivables is owed by:

- One customer
- A few customers
- One industry
- One region
- One currency

Default by a major customer may create serious liquidity pressure.

Currency Risk

Foreign-currency receivables may lose value when exchange rates change.

Management should monitor:

- Invoice currency
- Collection timing
- Currency volatility
- Hedging options
- Conversion restrictions

Dispute Risk

Payment may be delayed because of disputes involving:

- Price
- Quantity
- Quality
- Delivery
- Contract interpretation
- Documentation
- Tax treatment

Early dispute resolution is essential.

Fraud Risks

Receivables fraud may involve:

- Fictitious sales
- Unauthorized credit
- Concealed collections
- Customer-account manipulation
- False credit notes
- Unauthorized write-offs
- Lapping

What Is Lapping?

Lapping occurs when cash received from one customer is stolen and later customer payments are used to conceal the shortage.

It is reduced through:

- Segregation of duties
- Direct bank payments
- Customer statements
- Independent reconciliation
- Mandatory leave

SECTION 18

Internal Controls

Controls that reduce fraud, error and unauthorized credit.

Core Receivables Controls

Strong controls should cover:

- Customer setup
- Credit approval
- Sales authorization
- Invoicing
- Collection
- Recording
- Reconciliation
- Credit notes
- Write-offs

Segregation of Duties

Different individuals should be responsible for:

- Approving credit
- Processing sales
- Issuing invoices
- Receiving cash
- Recording collections
- Reconciling accounts
- Approving write-offs

Customer Master-Data Controls

New customers and changes should require:

- Identity verification
- Supporting documents
- Independent approval
- Duplicate checking
- System audit trail
- Periodic review

Credit-Note Controls

Credit notes should require:

- Valid reason
- Supporting documentation
- Independent approval
- Reference to original invoice
- Customer-account adjustment
- Management review

Customer Statements

Regular customer statements help:

- Confirm balances
- Identify missing invoices
- Detect unrecorded payments
- Resolve disputes
- Prevent fraud
- Strengthen collection

Receivables Reconciliation

The organization should reconcile:

- Customer subsidiary ledgers
- Receivables control account
- Bank receipts
- Sales records
- Aging reports

Differences should be investigated promptly.

Write-Off Controls

Write-offs should require:

- Evidence of collection attempts
- Reason for non-recovery
- Legal advice where appropriate
- Approval within authority
- Accounting documentation
- Periodic board or audit review

SECTION 19

Receivables Reporting

Dashboards and reports that keep receivables visible to management.

Receivables Dashboard

A dashboard may include:

- Total receivables
- Current receivables
- Overdue receivables
- Receivables days
- Collection rate
- Bad-debt provision
- Top customer exposures
- Disputed balances
- Credit-limit violations

Daily Collection Report

A daily report may show:

- Customer
- Amount received
- Invoice reference
- Payment method
- Bank account
- Receipt number
- Unapplied cash
- Collection officer

Weekly Collection Report

A weekly report may include:

- Collections achieved
- Collection target
- Overdue movements
- Major promises to pay
- Broken promises
- Disputes
- Escalations
- Expected receipts

Monthly Receivables Report

A monthly report may present:

- Opening balance
- Credit sales
- Collections
- Credit notes
- Write-offs
- Closing balance
- Aging distribution
- Provision movement

Top-Debtor Report

A top-debtor report identifies:

- Largest customers
- Outstanding balances
- Aging
- Credit limits
- Over-limit amounts
- Collection status
- Concentration risk

SECTION 20

Improving Receivables Performance

Practical strategies to collect faster and reduce risk.

Improvement Strategies

Receivables performance can be improved through:

- Stronger credit screening
- Clear payment terms
- Timely invoicing
- Electronic payment
- Early reminders
- Automated collection alerts
- Aging reviews
- Credit suspension
- Staff accountability

Reduce Invoice Errors

Organizations should:

- Standardize invoice templates
- Verify contract details
- Use correct customer references
- Confirm tax calculations
- Validate bank details
- Review invoices before issuance

Accelerate Billing

Billing can be accelerated by:

- Invoicing immediately
- Using milestone billing
- Automating recurring invoices
- Reducing approval delays
- Integrating delivery and invoicing systems

Improve Customer Payment Options

Payment may be accelerated through:

- Bank transfer
- Mobile payment
- Online portal
- Direct debit
- Standing order
- Card payment
- Digital wallets

Strengthen Collection Accountability

Each overdue account should have:

- Assigned owner
- Next action
- Follow-up date
- Promised payment date
- Escalation status
- Management visibility

Link Sales and Credit Teams

Sales and credit teams should coordinate because:

- Sales staff understand customers
- Credit staff understand risk
- Collection affects future sales
- Incentives should reward profitable, collectible sales

Avoid Sales-Only Incentives

Sales incentives based only on invoiced revenue may encourage:

- Weak customer selection
- Excessive credit
- Uncollectible sales
- Credit-limit overrides

Incentives should consider collection quality.

PRACTICAL EXERCISE

Practical Exercise

Apply the chapter's tools to a full receivables and credit-policy evaluation.

Practical Exercise

ACTIVITY

Evaluate Receivables Performance and Credit Policy

Participants will:

- Calculate receivables turnover
- Calculate collection period
- Prepare aging analysis
- Estimate bad-debt provision
- Evaluate a proposed policy change
- Identify collection risks
- Recommend corrective actions

Exercise Scenario

ACTIVITY

A company reports:

- Annual credit sales: ETB 72 million
- Opening receivables: ETB 10 million
- Closing receivables: ETB 14 million
- Credit terms: net 30
- Required return: 15%

Step 1 — Calculate Average Receivables

Average Receivables = (10 + 14) ÷ 2

Average receivables: **ETB 12 million**

Step 2 — Calculate Receivables Turnover

Receivables Turnover = 72 ÷ 12

Receivables turnover: **6 times**

Step 3 — Calculate Collection Period

$$\text{Collection Period} = 365 \div 6$$

Collection period: **≈ 60.8 days**

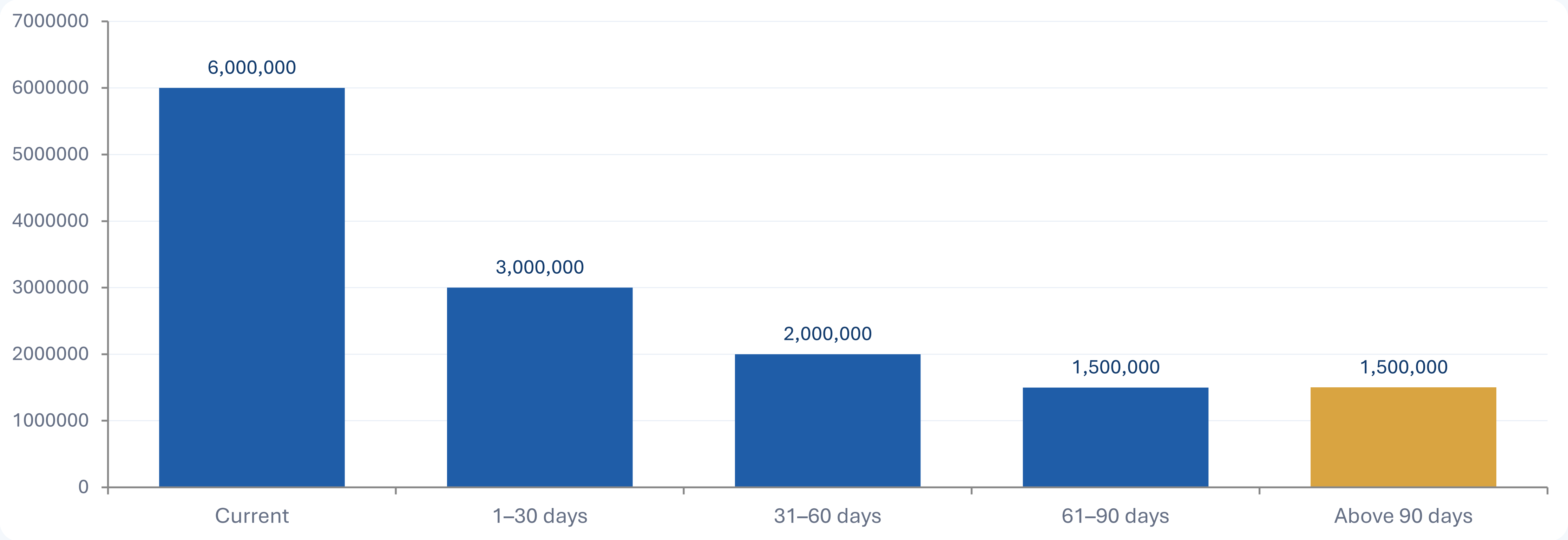
Collection Interpretation

The company allows 30 days but collects in approximately 61 days. This suggests:

- Significant payment delays
- Weak collection procedures
- Excessive receivables investment
- Increased financing costs

Exercise Aging Schedule

Outstanding receivables by age category (ETB):



Expected-Loss Rates

Apply the following expected-loss rates:

Age Category	Expected Loss Rate
Current	1%
1–30 days overdue	3%
31–60 days overdue	10%
61–90 days overdue	25%
Above 90 days	60%

Step 4 — Calculate Provision

Age Category	Balance (ETB)	Rate	Expected Loss (ETB)
Current	6,000,000	1%	60,000
1–30 days overdue	3,000,000	3%	90,000
31–60 days overdue	2,000,000	10%	200,000
61–90 days overdue	1,500,000	25%	375,000
Above 90 days	1,500,000	60%	900,000
Total provision			**1,625,000**

Provision Interpretation

The estimated loss represents:

$$(1{,}625{,}000 \div 14{,}000{,}000) \times 100$$

Provision as % of receivables: **≈ 11.61%**

This indicates significant collection risk.

Proposed Credit-Policy Change

Management proposes increasing the credit period from 30 to 45 days.

Expected results:

- Sales increase by ETB 6 million
- Contribution-margin ratio: 35%
- Bad debts increase by ETB 180,000
- Collection and administration cost increase by ETB 100,000

Step 5 — Calculate Incremental Contribution

Incremental Contribution = 6,000,000 × 35%

Incremental contribution: **ETB 2,100,000**

Step 6 — Additional Receivables

$$\text{Increase in collection period} = 45 - 30 = 15 \text{ days}$$

$$\text{Additional Receivables} = (78{,}000{,}000 \div 365) \times 15$$

Additional receivables: **≈ ETB 3,205,479**

Step 7 — Financing Cost

Financing Cost = 3,205,479 × 15%

Financing cost: **≈ ETB 480,822**

Step 8 — Total Incremental Cost

480,822 + 180,000 + 100,000

Total incremental cost: **ETB 760,822**

Step 9 — Net Incremental Benefit

2,100,000 − 760,822

Net incremental benefit: **≈ ETB 1,339,178**

The proposed change may be financially beneficial under the assumptions.

Risk Interpretation

Before approval, management should also assess:

- Customer quality
- Cash-flow pressure
- Credit concentration
- Collection capacity
- Economic conditions
- Sensitivity to higher bad debts
- Impact on existing customers

Sensitivity Exercise

ACTIVITY

Recalculate the decision if:

- Sales increase by only ETB 3 million
- Bad debts increase by ETB 600,000
- Collection days rise to 75
- Required return increases to 20%
- Administrative cost doubles

Group Recommendation

Each group should present:

1. Receivables turnover
2. Collection period
3. Aging interpretation
4. Required bad-debt provision
5. Credit-policy benefit
6. Credit-policy cost
7. Main collection risks
8. Final recommendation

CHAPTER REVIEW

Chapter Review

Consolidating the chapter's key lessons, checks and takeaways.

Common Receivables-Management Mistakes

- Granting credit without assessment
- Allowing undocumented credit limits
- Delaying invoice issuance
- Ignoring disputed invoices
- Failing to review aging reports
- Allowing sales staff to override credit controls
- Weak follow-up of overdue balances
- Writing off debts without approval
- Failing to reconcile customer accounts
- Concentrating credit in a few customers

Receivables-Management Checklist

Management should regularly review:

- Credit applications
- Customer limits
- Payment terms
- Receivables turnover
- Collection days
- Aging schedule
- Overdue percentage
- Credit-limit violations
- Bad-debt provision
- Disputed balances
- Collection promises
- Customer concentration
- Write-offs
- Receivables controls

Knowledge Check

1. What are accounts receivable?
2. What is receivables management?
3. Why do organizations grant credit?
4. What are the five Cs of credit?
5. What is a credit limit?

1. How is receivables turnover calculated?
2. What does the collection period measure?
3. What is an aging schedule?
4. Why is a bad-debt provision required?
5. How can collections be accelerated?

Knowledge Check Answers

1. Amounts owed by customers or other parties
2. Planning, controlling and collecting outstanding balances
3. To increase sales and support customer relationships
4. Character, capacity, capital, collateral and conditions
5. Maximum unpaid balance approved for a customer

1. Credit sales divided by average receivables
2. Average time required to collect customer balances
3. Classification of receivables by age
4. To recognize expected credit losses
5. Timely invoicing, reminders, electronic payment and firm follow-up

Action Plan

Evaluate one organization's receivables system and identify:

- Annual credit sales
- Total receivables
- Average receivables
- Receivables turnover
- Collection period
- Credit terms
- Overdue percentage
- Largest customer exposure
- Bad-debt provision
- Main control weakness
- Immediate corrective action
- Long-term improvement

Chapter Summary

- Receivables arise when goods or services are provided before payment.
- Receivables management balances sales growth, liquidity and credit risk.
- Credit policies should define standards, terms, limits and collection procedures.
- The five Cs provide a structured credit-assessment framework.
- Timely and accurate invoicing supports faster collection.
- Receivables turnover measures collection frequency.
- Collection days should be compared with approved credit terms.
- Aging analysis identifies overdue and high-risk accounts.
- Expected losses should be recognized through appropriate provisions.
- Collection procedures should be consistent, professional and documented.
- Credit-policy changes should be evaluated using incremental benefits and costs.
- Strong controls reduce fraud, error and unauthorized credit.
- Effective receivables management converts sales into cash and protects financial sustainability.

KEY MESSAGE

A sale is not financially complete until the cash is collected.

Effective receivables management connects every stage of the credit-to-cash cycle:

Customer Assessment → Credit Approval → Accurate Invoicing → Monitoring → Collection → Risk Control → Cash Flow → Financial Sustainability

THANK YOU

Questions and Discussion

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Effective receivables management transforms credit sales into reliable cash flow — supporting growth by extending credit responsibly, monitoring exposure, collecting promptly and protecting the organization against avoidable default, fraud and liquidity risk.

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