Impact of Credit and Collection Policies on Recovery of Bad-Debts: A Study of Selected Micro and Small Enterprises

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Abstract

In most of the micro and small enterprises working capital management is inadequate and ineffective. This situation is often marked when the fund in accounts receivable is blocked up as bad-debts. The problem of recovery of bad-debts arises when merchandise is sold on credit. When an enterprise makes an ordinary sale of goods and services and does not receive payment, the enterprise grants credit and creates accounts receivable, which would be collected in future. The bad-debts are those receivables that a customer will not pay. The problem of collecting the accounts receivable required special attention as micro and small enterprises face collection problems as well as bad-debts problems in monitoring the accounts receivable. The investment in accounts receivable is an important aspect, which requires careful management of the problem of bad-debts. The only alternative with the seller is to have optimum credit and collection policy to restrain and control on the problem of recovery of bad-debts. It was under this background that it was felt desirable to conduct an exhaustive study of the prospects and problems of recovery of bad-debts in the micro and small enterprises and suggest the measures for overcoming the difficulties stemming from the problems.

Keywords: Accounts Receivable, Bad-Debts, Micro & Small Enterprises, Credit and Collection Policies, Chi-Square Test.

Introduction

The small-scale industrial (SSI) sector has acquired a place of prominence in the economy of the country. It has contributed significantly to the growth of the Gross Domestic Product (GDP), employment generation and exports. The sector is contributing significantly towards the economic growth of the country with over 1/3 of the industrial production and nearly 1/3 of direct taxes. The sector has emerged as an engine of growth in the new millennium. Consequent of the enactment of Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, the small and medium sector has been defined as micro, small and medium enterprises with effect from October, 2006 as:

In the case of Manufacturing Enterprises

1. A micro enterprise, where the investment in plant and machinery does not exceed Rs. 25 lakh;
2. A small enterprise, where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore; and
3. A medium enterprise, where the investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs. 10 crore.

In the case of Service Enterprises

1. A micro enterprise, where the investment in equipment does not exceed Rs. 10 lakh;
2. A small enterprise, where the investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore; and
3. A medium enterprise, where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

The problem of recovery of bad-debts arises when merchandise is sold on credit. When an enterprise makes an ordinary sale of goods and services and does not receive payment, the enterprise grants credit and creates accounts receivable, which would be collected in future. The bad-debts are those receivables that a customer will not pay. Bad-debts arise (i) when an enterprise extends too much credit to a customer that is incapable of paying back the debt, resulting in either a delayed, reduced or missing payment, and (ii) when a customer misrepresents itself in obtaining a sale

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on credit, and has no intent of ever paying the seller. The first case is caused by bad internal processes or changes in the ability of a customer to pay. The second case is caused by a customer intentionally engaging in fraud. Though commercial banks provide a significant part of requirements for working capital, receivables continues to be a major source of funds for micro and small enterprises and accounts receivable that result from granting credit are major investment for the micro and small enterprises. The investment in accounts receivable is an important aspect, which requires careful management of the bad-debts.

Review of Literature

According to BusinessDictionary.com (2015), a credit and collections policy is a document providing "clear, written guidelines that set (i) the terms and conditions for supplying goods or services on credit, (ii) customer qualification criteria, (iii) procedures for making collections and (iv) steps to be taken in case of customer delinquency". According to *Jim Franklin (2017),* "Credit and collections policies refer to guidelines that govern how an organization's credit and collections department functions. These guidelines are based on organizational goals and demands regarding risk and financial obligations". Credit and collections policies are of three types: liberal, moderate and strict. A liberal credit and collections policy means the enterprise extends favorable terms to buyers who make purchases on accounts or through short-term financing. Offering discounts for early payments or allowing lengthy repayment periods with no penalty are examples of liberal credit terms. Having a liberal policy may attract new customers and more business, but it can also impact the low cash flow. A strict credit and collections policy means enforcing tight limits on the amount of time a buyer can pay a debt. Whereas, in the case of a moderate credit and collections policy the credit terms become less extreme or violent and easier to deal with or accept.

According to Brigham (1985), credit policy is defined by the credit period, credit standards, the firms' collection policy and any discount given for early payments in an organization. Omolumo (2003), concluded that credit policy is the decision variable that influences the amount of trade credit that is invested in receivables which a firm may undertake at any given time. According to Krueger (2005), credit policy refer to guidelines that spell out how to decide which customers are sold on open account, the exact payment terms, the limits set on outstanding balances and how to deal with delinquent accounts. Several other authors of literature like Pandey (2004), Atkinson (2007), etc. have defined credit policy in like manner as the combination of such terms as credit period, credit standards, collection policy, cash discounts and credit terms.

There is however no particular universal credit policy that should be adopted by every organization. The credit policy of an organization should therefore be based on its particular business and cash-flow circumstances, industry standards, current economic conditions and the degree of risk involved. For a credit policy to be effective it must not be static, the policy must be reviewed from time to time regardless of how serviceable it proves to be. The review and adjustments are necessary because of dynamics in business caused by changes in its internal and external environment. According to Szabo (2005), a successful credit policy should benefit both account receivables and sales; this can be achieved by reciprocation between concerned departments viz. sales and credit. Charles (2009), concluded that the issue of credit policy zeroes down to account receivables. It is the most popular medium of managing and regulating receivables.

According to Maness & Zietlow (2005), detailed statements regarding when and how the company will carry out collection of past-due accounts make up the company's collection procedures. These policies specify how long the company will wait past the due date to initiate collection efforts, the methods of contact with delinquent customers, and whether and at what point accounts will be referred to an outside collection agency. Brigham & Daves (2007), concluded that collection policy is measured by its toughness or laxity in attempting to collect on slow-paying accounts. A tough policy may speed up collections, by it might also anger customers, causing them to take their business elsewhere.

Rationale and Objectives of the Study

In most of the micro and small enterprises, working capital management is inadequate and ineffective. This situation is often marked when the fund in accounts receivable is blocked up as bad-debts. Increase in the sales on credit results into blockade of funds in accounts receivable as bad-debts. As a consequence a considerable portion of working capital is not available in the form of cash, raw material or inventory; and thus this blockade of funds aggravates the problems of recovery of bad-debts. Therefore, for minimizing the problem, the level of accounts receivable should be reduced to a feasible extent. But complete aversion to the accounts receivable is not possible in this age of credit, because there is another side of credit sales as credit sale is a sort of invisible concession, which induces sales. These two aspects of accounts receivable, i.e., the blockade of working capital as bad-debts and the increase in sales, are to some extent contradictory. Hence, the problem of recovery of bad-debts required special attention as micro and small enterprises face many problems in monitoring the accounts receivable relating to collection problems as well as bad debts problems. The only alternative with the seller is to have optimum credit and collection policy to restrain and control on the problems of recovery of bad-debts. And thus the present study tries:

1. To explore the prospects and problems of recovery of bad-debts in micro and small enterprises, and
2. To suggest the measures for overcoming the difficulties stemming from the problems.

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Study Area–Jaunpur: The Industrial Scenario

The district of Jaunpur is situated in the North-West part of Varanasi Division in the state of Uttar Pradesh, India. It lies in eastern part of the state. Jaunpur City is situated on the bank of the Gomti River. Its attitude varies from 261 feet to 290 feet above sea level. As per official census of 2011, the district of Jaunpur recorded a population of 4,476,072 of which 2,258,437 were female and 2,217,635 male. Jaunpur district has population density of 1,113 persons per km2. Jaunpur ranks 7th in terms of population in the state and ranks 1st in terms of sex ratio (1,024).

District's main economical activity is agriculture and allied sector. Jaunpur is fastest developing area in eastern Uttar Pradesh with skill development, quality education and good infrastructure. About 29% of Jaunpur's population is employed. There is little heavy industry in Jaunpur. National highway number 56 between Lucknow and Varanasi cross from Jaunpur allows for some industrial economic development. Manufacturing Enterprises include perfume (jasmine oil and attar) and incense, furniture, carpets, chemical fertilizer, cement etc. And Service Enterprises include repair workshops, print shops, internet cafes etc. There is a special economical zone located at Allahabad road near Mungra Badshahpur - the Sathariya Industrial Area. Although all units of the Sathariya Industrial Area are not in function but maximum are doing work. Jaunpur have problem of infrastructure development. Like many other districts of eastern uttar pradesh Jaunpur have poor road quality and lack of electricity supply.

Scope of the Study

As observed in the foregoing paragraphs that the recovery of bad-debts in micro and small enterprises need be enquired into so that the problems faced by this sector in recovery of bad-debts may be analysed and investigated and remedial measures may be suggested, the present study has the following scope:

1. The study relates to the problem of recovery of bad-debts in micro and small enterprises situated in the District of Jaunpur.
2. The present study is restricted to the micro and small enterprises, which are registered with District Industries Centre (D.I.C.), Jaunpur, up to March 2016.
3. The problem of recovery of bad-debts in micro and small enterprises is observed and analysed for three years (2013-2016), in particular.

Hypothesis for the Study

The hypothesis formulated for the purpose of this study is that the "strict credit and collection policy is essential for the recovery of bad-debts in micro and small enterprises." In other words, the large-scale failure of micro and small enterprises in recovery of bad-debts is pre-dominantly due to the employment of ineffective and inefficient credit and collection policies.

Methodology for the Study

For the purpose of studying the problem of recovery of bad-debts in the micro and small enterprises the stratified random sample method has been adopted. One hundred enterprises coming under micro and small-scale sector have been selected out of a universe of 7,269 enterprises registered, up to March 2016, as micro and small enterprises at District Industries Centre (D.I.C.),J aunpur, in as much as the various categories of micro and small enterprises have been selected on the basis of their nature as manufacturing enterprises, which include perfume (jasmine oil and attar) and incense, furniture, carpets, chemical fertilizer, cement etc. And service enterprises which include repair workshops, print shops, internet cafes etc.

The study is design to look forward to the prospects of such enterprises based on their historical performance restricted to their positions obtained during the three years. Since a period of three financial years (i.e., from 2013-14 to 2015-16) has been decided for the comparative evaluation of recovery of bad-debts, the universe has been remodeled accordingly. The micro and small enterprises, which were either abandoned at any time during this period or started after the financial year 1913-14, have ceased to form the part of the universe.

During the course of this study, sophisticated statistical tools of analysis and interpretation have been used for the data collected through primary sources and also obtained from secondary sources. To obtain the primary data a structured questionnaire has been circulated to the suppliers of credit. The secondary data gathered for the purpose of this study are from the published records of the District Industries Centre (D.I.C.), Jaunpur. However, the analysis and interpretation of the present study seeks to focus mainly on the primary data.

Data Analysis and Observation of the Study

The problem of recovery of bad-debts is studied with the help of growth pattern and trend of credit sales, and bad debts' analysis.

Table 1				
Growth Pattern and Trend of Credit Sales (Approximate)				
	2013-14	2014-15	2015-16	Average
(a) Total Sales (Lakh Rs.)	5,666	6,878	8,018	6,854
(b) Credit Sales (Lakh Rs.)	4,300	5,421	6,328	5,350
Rate of Annual Growth of 'a'	---	21%	17%	19%
Rate of Annual Growth of 'b'	---	26%	17%	21%
Credit Sales as % of Total Sales	75%	78%	79%	78%

Appraising the overall performance of micro and small enterprises in the sample as revealed by Table 1, it has been observed that a substantial part of the total sales available with the sample enterprises is blocked in the credit sales during the whole period (2013-16). It is revealed that the credit sales

constitute as much as about 78 percent of the total sales. The credit sales have caused the problems of

collection as well as bad debts.

Table 2 Trend of Bad-debts (Approximate)				
	2013-14	2014-15	2015-16	Average
Bad Debts (Lakh Rs.)	72	81	91	81
Bad Debts as % of Credit Sales	1.67%	1.49%	1.43%	1.51%

An analysis of bad-debts as a percentage of total credit sales over time as per Table 2, shows that it is about 1.67 percent in first year. This percentage went down to about 1.49 percent and 1.43 percent in second year and in third year respectively. It seems that bad-debts as percentage of total credit sales are declining. On an average the incidence of bad-debts is to the tune of about 1.51 percent of the total credit sales.

Table 3 Bad-debts in different types of Credit and Collection Policies				
Credit and Collection Policies	Bad-debts as % of total Bad-debts of the year (Approximate)			
	2013-14	**2014-15**	**2015-16**	**Average**
Liberal	44	45	48	46
Moderate	33	31	29	31
Strict	23	24	23	23

On perusal of table 3, it reveals that the bad-debts in micro and small enterprises in the sample, is 46 percent under liberal credit and collection policies, 31 percent under moderate credit and collection policies and 23 percent under strict credit and collection policies. Thus Strict Credit and Collection Policies in comparison to two other policies have lowest bad-debts percentage and hence, the strict policies have been more effective in realisation of overdues as bad-debts than the other two policies.

Hypothesis Testing

As the hypothesis formulated for the purpose of this study is that the "strict credit and collection policy is essential for the recovery of bad-debts in micro and small enterprises", Chi-Square test have been applied for the purpose of testing the hypothesis. The null hypothesis, H_0, taken for the testing is that the two attributes, strict credit and collection policy and recovery of bad-debts, are independent.

On an average the minimum bad-debts as percentage of total bad debts which are not recovered in the case of strict credit and collection policies is about 23 percent. Therefore, here, we assume that the micro and small enterprises, which are showing bad debts of 23 percent or less, are with strict credit and collection policy. Hence, those micro and small enterprises, which have average bad debts of more than 23 percent, are the enterprises with non-effective credit and collection policy. In the same way, the average bad-debts of all micro and small enterprises collectively are about 1.51 percent of the credit sales. So, the micro and small enterprises with average bad-debts of about 1.51 percent or less are having better recovery of bad-debts and other than these enterprises, are having poor recovery of bad-debts.

The Critical Value of Chi-Square for one degree of freedom at 5% level of significance is 3.841. It has been observed that the Calculated Value of Chi-Square being 11.312 is more than the tabular value; hence the difference is significant. The observed frequencies and the expected frequencies do differ significantly. The null hypothesis is rejected. The strict credit and collection policy and recovery of bad-debts are not independent. Thus, strict credit and collection policy is essential for the recovery of bad-debts in micro and small enterprises

Conclusion and Suggestions

The foregoing observations' regarding the Impact of Credit and Collection Policies on Recovery of Bad-Debts in micro and small enterprises reveals that very few micro and small enterprises have attempted a systematic articulation and formalization of their credit and collection policies. Generally credit and collection policies have emerged as unstated conventions. Thus, strict credit and collection policy is essential for the recovery of bad-debts in micro and small enterprises. To make the role of strict credit and collection policy in the recovery of bad-debts in micro and small enterprises more meaningful, action on the line of following suggestions should be initiated:

1. There should be better co-ordination between sales and finance departments of the enterprises.
2. Credit and collection policies need to be articulated in explicit terms and revised periodically in the light of present situation.
3. As far as possible sales should be on documents against payment. Sales against demand and issuance bills may be encouraged because these documents can be used as security for borrowings. However, the documents related with the goods sold should be properly and quickly handed over to the customers.
4. Debtors should be divided according to their payment habits and should be approached accordingly.
5. The firm should implement strict credit and collection policies as it has been observed that

strict credit and collection policies have lessened the problems.

6. Micro and small enterprises granting credit should examine the published statements of prospective Attempts should be made to have strong and sound set-up and management of credit and collection functions. A well defined collection programme, aimed at timely collection of receivables, must be developed, may consist of the following:

a. Monitoring the state of receivables.
b. Dispatch of letters to customers whose due date is approaching.
c. Telegraphic and telephonic advice to customers around the due date.
d. Threat of legal action to overdue accounts.
e. Legal action against overdue accounts.

Limitations of the Study

The present study has been conducted subject to the following limitations:

1. The present study is limited to a substantial portion of accounts receivable, i.e., recovery of bad-debts only.
2. The micro and small enterprises operating in the District of Jaunpur but are not registered with the District Industries Centre (D.I.C.), Jaunpur has ceased to form the part of the universe.
3. The present study is limited because of another factor also, i.e., it is mainly based on the primary data. As it is a sample-based study its findings suffer from the limitations inherent in any sample based study.

Groundwork for Future Researches

Notwithstanding the fact that the current study is subject to the above limitations, the importance of the study just cannot diminish or be wished away, because this is an attempt to highlight, though in a limited way, the impact of credit and collection policies on recovery of bad-debts keeping in view the study of micro and small enterprises; and as such our hypothesis is that the "strict credit and collection policy is essential for the recovery of bad-debts in micro and small enterprises". The present study may be used as a groundwork for future researches based on the present hypothesis. The future researchers may look into the following specific problems relating to the recovery of bad-debts in micro and small enterprises:

1. Inter-district or inter-state comparative studies may be conducted.
2. The problem of recovery of bad-debts in the micro and small enterprises may be investigated with reference to a particular industry group according to the size of capital employed, forms of organisation, sales volume, number of persons employed, etc.
3. The testing of hypothesis of the study has been conducted by taking all the micro and small enterprises collectively. Hence, the hypothesis may be tested according to the nature of the micro and small enterprises for each industry group and may be compared.

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