

An Analysis of the Construction of Total Risk Management Mechanism for Enterprises' Accounts Receivable

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Abstract

The accounts receivable that exist in enterprises' operational activities will slow down the turnover of capitals and cause risks of bad debts, what will block the normal circulation of cashes and restrain enterprises' healthy and orderly development. Therefore, it is vital for Chinese enterprises to emphasize on the risk management and risk defense of accounts receivable. By theoretical analysis, this paper makes comprehensive and systematic analysis on the problems that exist in the risk management of accounts receivable and the relevant reasons. For the problems, this paper puts forward a brand-new idea of total risk management and discusses this idea in detail. So, this paper may serve as a valuable reference for Chinese enterprises' risk management of accounts receivable.

Keywords: Accounts receivable, Credit, Risk

1. Introduction

Accounts receivable are cash that should be received but not yet at present by companies that sale products or services to others. The appearance of accounts receivable issue is a must under present modern accounting system with the accrual basis. According to the accrual basis, enterprises do not take the received cash as accounting basis. As enterprises have transferred the ownership of products or provided the services, and they have had the right of taking payments, it is the real turnover that enters that account. The essence of accounts receivable determines its difference from other cash assets. Accounts receivable is an important part in financial management (Eugene & Louis, 1999). On one hand, accounts receivable can help enterprises to expedite product sale, speed up corporate operation, grasp market, and gain profits quickly. But on the other hand, accounts receivable are not cash at all. The holding costs are inevitable and the bad debts are possible. Concerning this issue, many scholars at home and abroad have already made relatively fundamental researches. For example, Yongsheng Gan has studied the establishment of enterprises' credit policy by Satoris-Hill Credit Policy Decision Model (Yongsheng Gan, 1998). Wujun Diao and Guoqiang Xiong have researched enterprises' credit policy's increment analysis decision method (Wujun Diao, 2002). Songling Yang and Xibo Zhao have made empirical studies on credit management in medium and small-sized enterprises (Songling Yang, 2003). All these researches have served as stable foundations for studying the risk management of accounts receivable from different angles. This paper will advance several personal opinions on the total risk management of enterprises' accounts receivable.

2. Reasons for the poor risk management of accounts receivable

The existence of accounts receivable is a must in market economy. Many Chinese enterprises can not manage the accounts receivable properly. The balance of accounts receivable is high in general. And the total accounts receivable are increasing annually. As a result, enterprises' operation may confront with a shortage of capitals and a risk of bad debt. Reasons are as follow.

2.1 Lack of risk consciousness

Under the market economy condition, enterprises' products, supply, and sale are completely determined by the market. The changeable market makes enterprises face up with greater risks. As enterprises enter certain local market firstly, they may choose to sign short-term and account sale contracts with customers before they research the credit of customers and make correct risk evaluation in order to attract more customers and grasp more market shares. As a result, although enterprises can obtain high accounting profits, they neglect the problem of accounts receivable. These accounts receivable can not be taken back. After a period of time, they may become bad debts for enterprises. Moreover, some enterprises may sign contracts or agreements that are not in accord with the Law of Contract in order to extend sales. Under this condition, enterprises may suffer from economic loss, because they can not gain legal protection if there is a contract dispute.

2.2 Imperfect management system

Some enterprises that fail to manage the accounts receivable effectively do not make up relevant regulations or do not follow related rules. No strict rules to supervise the sale, the delivery, and the payment. Vouchers and receipts

are not complete. The financial branch fails to cooperate with the operational branch in time, what leads to the disjoint of operations and accounting. As a result, problems appear but not noticed in time. Some enterprises could not cope with the higher accounts receivable and leave them alone. Therefore, these accounts receivable can not be turned into cash for a long time.

2.3 Imperfect inner encouragement mechanism

Some enterprises merely associate employees' salaries with sales in order to motivate salesmen's enthusiasm. However, they neglect the possibilities of bad debts and do not take the accounts receivable into the evaluation system. Therefore, for the sake of personal interests, salesmen care for nothing but sales. Then, the accounts receivable are rising. Unfortunately, enterprises do not take effective measures to encourage their employees to solve these accounts receivable. More and more accounts receivable are appearing, what becomes a heavy burden for enterprises.

3. Results of improper risk management of accounts receivable

The results of improper risk management of accounts receivable include these conditions as follow.

3.1 Decrease enterprises' profitability

Because of the accounts receivable, the logistics can not match the flow of capitals in enterprises. Although sales are completed, enterprises do not receive payments. However, these accounts receivable may bring about excessive costs for enterprises, such as taxes. If the accounts receivable concern two accounting years, enterprises have to use flowing capitals for dividend of stockholders. As a result, amounts of flowing capitals may be occupied, what will harm the capitals' turnover in enterprises, which will correspondingly conceal the real operational situations of enterprises, affecting enterprises' production plans and sales plans. Enterprises fail to realize their supposed goals.

3.2 Aggrandize enterprises' business fruits

In China, enterprises adopt the accrual basis in accounting. All current account sales belong to current income. Therefore, the increase of accounting profits does not mean practical cash flow. The existence of a great number of accounts receivable contributes to the rise of accounting sales, which aggrandize enterprises' business fruits in a sense, increasing enterprises' costs of risks.

3.3 Cause financial crisis directly

Although account sales can bring about more profits for enterprises, they can not lead to a real rise of cash flow. On the contrary, enterprises have to take limited flowing cash to pay for sorts of taxes and expenses, which expedites the outflow of cash. Enterprises keep in enlarging their sales by account sales, which leads to constantly increasing accounts receivable. Once the accounts receivable appear, purchasers can employ bargainers' capitals and do not necessarily pay any interests in their credit term. Purchasers will possess more go-aheadism. If no restriction, purchasers will not repay for goods or services in advance and even not repay on time. If enterprises let accounts sales at random and do not take measures to solve these accounts, the accounts receivable will become bad debts. According to the law of taxation, no matter whether enterprises receive payments or not, only if enterprises confirm the income, they must hand in the income's turnover tax and the income tax, what will inevitably increase the outflow of cash. Because enterprises do not receive payments but have to hand in taxes, they may confront with financial crisis even if they are profitable. In China, many enterprises, including some listed companies that perform better, sometimes have to deal with the problem of capital shortage.

3.4 Mislead users of enterprises' financial statement

The existence of accounts receivable may mislead users of enterprises' financial statement, making them fail to make correct evaluation on enterprises' assets and ability of payment and repayment. The accounts receivable, especially the one that has already become bad debt but not be treated as bad debt, will increase enterprises' assets virtually. The calculation of many indicators that are used to evaluate enterprises' ability of payment and repayment, such as current ratio, quick ratio, and asset-liability ratio, takes current asset, quick asset, and total asset of accounts receivable into consideration. The untruth of assets leads to the falsehood of enterprises' ability of payment and repayment. In other words, because of the poor cash-ability of accounts receivable, users of enterprises' financial statement may overrate enterprises' assets and ability of payment and repayment.

3.5 Affect enterprises' normal business period

Business period refers to a process in which enterprises take the stock in, sale them, and take cash back. The length of business period is determined by the turnover of the stock and the turn over of accounts receivable. The business period is the sum of the two turnovers. The irrational existence of accounts receivable extends the business period and affect enterprises' capital circulation. Amounts of capitals are occupied by non-production ring. Enterprises may

confront with a shortage of capitals, what will affect the salaries of employees and the purchase of material, harming enterprises' normal production and operation.

3.6 Increase the possibility of errors in the management of accounts receivable

If an enterprise has a large number of accounts receivable, it is hard to find out errors of these accounts in time. As a result, the enterprise may lose necessary contracts, agreements, and other materials related with accounts receivable. Besides, because the enterprise can not know the real condition of purchasers exactly, it is hard to take back all accounts receivable. The enterprise may suffer from a loss of asset.

4. A new mechanism for total risk management of accounts receivable

In the risk management of accounts receivable, it is necessary to constitute a total risk management mechanism according to the characteristics of accounts receivable and the potential risks. The main points include:

4.1 Construct a scientific and effective credit evaluation mechanism

Credit evaluation is the foundation of enterprises' accounts sales. Enterprises should determine the degree of risks in accounts receivable according to the customers' credit grades, and take it as the basis for account sale decision. Constructing a scientific and effective credit evaluation mechanism should possess two processes. Firstly, it is the credit research stage. Collect and process customers' credit-related materials directly or indirectly. Enterprises can contact with customers directly and obtain needed materials by inquiry, observation, and record. Besides, enterprises can collect materials by customers' financial statements, credit evaluation agencies' materials, and materials from banks, industrial and commercial administrative branches, taxation institutions, and consumers' association. Secondly, it is the analysis and evaluation stage. The main methods are qualitative evaluation and quantitative evaluation. The qualitative evaluation can be achieved by "five C" that refers to the five aspects used to assess customers' credit, namely character, capacity, capital, collateral, and condition. Quality means customers' credit. Capacity means customers' ability of repayment. Capital means customers' financial power and situation. Collateral means customers' assets that can be used as mortgage in order to obtain sufficient transaction credit. Condition means economic environment that may affect customers' ability of payment. Quantitative evaluation is to assess customers' credit by weighing and averaging a series of financial variables. The result is the customers' integrated credit score. Suppose the five financial variables are T1, T2, T3, T4, and T5. They stand for equity ratio, asset-liability ratio, rate of return, quick ratio, and rate of capital accumulation respectively. S stands for the weight of five variables. Then:

$$W = (T1 \times S1 + T2 \times S2 + T3 \times S3 + T4 \times S4 + T5 \times S5)$$

This method must be based on a reliable statistical model. Otherwise, there are lots of limits. By means of assessing customers' credit, enterprises can establish their credit policy correspondingly.

4.2 Construct a selective mechanism for credit line

Accounts receivable occupy lots of capitals. It is necessary to establish the risk degree of accounts receivable and make it possible to assess the risk. As an enterprise invests in accounts receivable, it has to consider whether invest or not and how much the investment is. The former can be determined by credit research and assessment. The later should be determined by analyzing the credit and relevant favorable conditions and profits.

The investment in accounts receivable = the average accounts sales everyday * the average deadline of accounts receivable

4.3 Construct reasonable credit policies

Customers' credit and the risk degree of accounts receivable serve as basic standards for enterprises in making decisions on whether permit account sales or not. In order to guarantee the exactness of credit decision, it is a must to make up rational and effective credit policy. An enterprise should have relevant policies that suit for it. Once an enterprise provides customers commercial credit, it has to consider specific conditions for customers' payment, including credit term, discount term, and cash discount.

4.4 Construct an approval mechanism for account sale

Enterprises should set up limitations respectively for salesmen approving account sales. If surpassing limitations, they should apply for higher managers. By this kind of leveled management system, employees at different levels are completely in charge of their acts. As salesmen sign sales contracts with customers, enterprises should arrange professional experts and sales managers to examine the contracts and the signing process. After the examination and the approval, enterprises can deliver goods according to contracts. No goods can be delivered if no contract.

4.5 Construct a risk warning mechanism for accounts receivable

In order to ensure a timely take-back of accounts receivable, enterprises should construct a risk supervising and warning mechanism for accounts receivable that can supervise and examine the accounts receivable. Its main contents include:

4.5.1 Check and analyze periodically

Enterprises should construct a check system for accounts receivable, by which enterprises can check every item of accounts receivable with customers, ensuring the trueness and exactness of accounts receivable. Insist on a periodical audit on accounts receivable. Enhance the inner control over the generation of accounts receivable and its check, management, and take-back. Find out errors and correct them timely. Avoid problems of appropriation, corruption, and outer circulation of capitals caused by loose management. Decrease risks and escape from bad debts. Analyze on the ages of accounts receivable. Compose an analysis table for the ages of accounts receivable and sort them according to the ages. Estimate the potential risk loss and evaluate the value of accounts receivable correctly.

4.5.2 Enhance a settlement system for accounts receivable

Considering the different ages of accounts receivable and the different credits of customers, enterprises can adopt different measures to solve the accounts receivable, such as informing by mails, asking by calls, negotiating by face to face, and legal action. For customers who have the capability of repayment but delay the repayment purposely, enterprises can choose rational measures to solve the accounts receivable, such as persuading by rational explanations, gaining commiserations, and many other useful ways. Enterprises should set up a settlement responsibility system. The salesmen who have contributed to the generation of accounts receivable must shoulder the responsibility of taking them back. Enterprises can constitute assessment methods and indicators for the settlement of accounts receivable and make up specific encouragement-and-punishment rules to inspire salesmen to promote goods and take back capitals. Assess the expenses of taking accounts receivable back and the rate of successfully solving accounts receivable. Evaluate the difference between the increase of expenses of taking accounts receivable back and the decrease of loss of reducing accounts receivable and bad debts. The evaluation methods can take reference from the evaluation of credit standards and credit conditions.

5. Conclusion

In order to pursue high profits, enterprises usually enlarge sales by account sales that can help to increase income and profits. However, the more the accounts receivable, the higher the risks for enterprises are. The risk management of accounts receivable aims at achieving an optimal unity of the risks and profits of accounts receivable, realizing the maximization of total effect. To construct a risk management mechanism for accounts receivable and apply total risk management to accounts receivable can help enterprises decrease risks, guarantee the safety of business, expedite the turnover of capitals, improve the utility efficiency of capitals, and realize the benefit goals, with the precondition of ensuring certain profits. In a word, enterprises should take the management of accounts receivable as a long-term and systematic task. Enterprises must set up a modern marketing concept, enhance the construction, management, and supervision of credit system, and carry out all measures thoroughly, by which enterprises can control the accounts receivable under a rational level and gaining more profits.

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