



ORIGINAL RESEARCH ARTICLE

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ENTITIES CREDIT POLICY ASSESSMENT

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ARTICLE INFO

Article History:

Received 05th November, 2017
Received in revised form
12th December, 2017
Accepted 19th January, 2018
Published online 28th February, 2018

Key Words:

Accounts Receivable,
Credit Policy,
Delay, Measurement,
Profit, Bad Debts.

ABSTRACT

Correct organization of payment operations ensures the stability of funds turnover of business entity, the strengthening of payment discipline and improvement of its financial condition. This article considers options of measurement of receivables and ways to reduce the negative effects of late payment from customers. Receivables management involves monitoring of the funds turnover in the payments. Acceleration of turnover dynamics through the several periods of time is a positive trend. The selection of potential buyers and defining terms of payment for goods provided in contracts could be an important key measure for payment deadlines reduction. The selection is carried through informal criteria: compliance with a payment discipline in the past, projected financial capabilities of buyer to pay the requested volume of goods, the level of the current paying capacity, level of financial stability, economic and financial conditions of the seller (overstocking, level of need in cash, etc.). The effect achieved by accelerating the turnover is reflected by an output increase without additional attraction of financial resources. In addition, due to the acceleration of a capital turnover there will be a profit increase. If the production and sale of products are resulted in loss-making, then the acceleration turnover funds leads to the deterioration of financial results and "eating away" of the capital. Thus, we should strive not only to accelerate the capital turnover at all stages of circulation, but also to provide its maximum potential, which is reflected in the increase of profit amount. Increasing the return of capital achieved by rational use of all resources, preventing their overspending, losses at all stages of the circulation. As a result, capital will return to its initial state to a greater amount, including a profit. The efficiency of capital is characterized by its profitability.

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Citation: Mamasdykov Abdilbaet Asanovich, Omurzakov Satybaldy Ashimovich, Torogeldieva Aktalina Begimkulovna et al. 2018. "Entities credit policy assessment", *International Journal of Development Research*, 8, (02), 18894-18896.

INTRODUCTION

Recent two decades a small private business in Kyrgyz Republic has rapidly changed.

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Development of business entity activities, stock joining, privatization of state property and as a consequence of this process, increasing a number of entities of the various legal background, deepening contacts with foreign partners (joint ventures and international investments, etc.) require the (i) new financial accounting and reporting system which is close

integrated with the relevant international systems, (ii) new methods of assessment of financial reports data, (iii) maximum of utility of the reports for decision making. «Along with the expanding the scope of users of an accounting data of financial and business activities of private companies, significantly raises an interest of participants towards the valid and real data on the financial status and business activities of the firms. All participants of the market – owners, asset holders, investors, auditors, banks, stock exchange, providers and customers, insurance companies, promoters are interested in the confidential and trustworthy information about partners.» (Arzybaev, 2011, p.16).

Activity in the market economy exposes companies to uncertainty and high level risk. The companies deal with the contracts and agreements in the internal and external market and it makes them enable to have relationship with the partners and to find out their financial state and solvency. On the other hand, the companies became more attentive to the own ability to manage liabilities, to effective use of properties, to provide investment efficiency and it obviously requires to apply relevant skills in financial analysis and this article is devoted to the credit policy as one of the important aspect of the financial analysis.

turnover of the accounts receivable. At the same time for the separate accounting of the amount of discounts it is reasonable to transform the traditional formula for turnover with the postponed payment (TPP) in the following way:

$$TPP=(GD*TD)+(SW*D)$$

Where, GD — part of goods with discounted cost out of the total volume of the good, rate;

TD— timeframe for discounts, days;

SW— part of the sales without discount out of the total volume of the good, rate.

Value of the turnover and absolute amount of accounts receivable by the formula are used for reporting actuarial profit and loss and for incremental factorial analysis of the modified credit policy. Further it is brought an example for the method is mentioned above.

Example

Small private company produces printing products and sell it by the following conditions: annual amount of sales is equal to 5320,0 thousand soms and there is a discount for the scheme «1/10 brutto 30».

Table 1. Change of credit policy and its impact to the amount of income, thousand

No.	Indicator	Value of the indicator according to the current credit policy	Effect of the credit policy change	Value of the indicator according to the new credit policy
1	Credit sales	5 320,0	+1 180,0	6 500,0
2	Trade discounts	26,6	+51,4	78,0
3	Net sales	5293,4	+1128,6	6422,0
4	Expenditures, including indirect expenses (0,75 × line 1)	3990,0	+885,0	4875,0
5	Brutto income (with interests and taxes)	1330,0	+295,0	1625,0
6	Accounts receivable	310,3	+123,0	433,3
7	Expenses for maintenance of the debts	23,2	+9,3	32,5
8	Expenses for analysis of potential customers and for collecting arrears	10,6	+15,4	26,0
9	Loss from bad debts	159,6	+165,4	325,0
10	Income before taxes	1136,6	+104,9	1241,5
11	Income tax (25%)	284,15	+26,2	310,4
12	Net income	852,4	+78,7	931,1

Efficiently managed credit policy helps to speed up payment procedures and reduces the risks of non-payments. In theory and practice there are the following two kinds of credit policy which may affect to a coefficient of debts turnover:

- Companies where the credit policy is conducted by the named “data gathering system” by using severe methods for unfair debtors (forced collection of debts, cease the goods shipment, impose fines, etc.). In this case goods are sold without any discounts and the arrears of the debts turnover are calculated by using the classical formula (S. B. Barngol'c., 1984. p.216).
- Entities with soft credit policy where it is applied the selling price discounts to motivate customers to speed up payment for purchases. The method is profitable to customers as well as to sellers. The customer has low prices whereas the seller has more shorter period of materials and goods turnover.

Analysis and assessment of the impact of the changed credit policy to the financial results of entity are determined gradually in several stages. Initially, based on the loan conditions, credit standards and levels of discounts are figured out the rate of

Within the current credit policy 50% of customers make payments on 10th day and gain profit by the discounts, 40% of customers make payments on 30th day and 10% delay payment up to the 40th day. By using the mentioned formula it is calculated the turnover of the accounts receivable (TPP), and it resulted in 21 days [(0,5 × 10) + (0,4 × 30) + (0,1 × 40)], and its average remaining balance is equal to 310,3 thousand soms [(5 320,0 : 360) × 21]. Total expenditures related to discounts are equal to 26,6 thousand soms (5 320,0 × 0,01 × 0,5). Expenses for maintaining the accounts receivable are defined by multiplying its average remaining balance (BAR) by the rate of the expenditures variables in the volume of sale (V) and by the cost of the capital (C), invested into the accounts receivable.

For the sample entity it is equal to 75 и 10% accordingly and expenses for maintaining of the accounts receivable are equal to 23,3 thousand soms (310,3 × 0,75 × 0,1). Average yearly amount of bad debts are equal to 3%, and expenses for analysis of potential customers and for collecting arrears are equal to 0,2% of the total volume of sale. Entity is planning to soften these standards understanding that it leads to slowing down of the turnover of the accounts receivable and, in turn,

raising up the doubtful debts. The conditions of the new credit policy are the scheme «2/10 brutto 40» instead of the mentioned «1/10 brutto 30». As a result, it is planned to increase the volume sales up to the 1 180 000 soms, by maximizing the annual sale up to the 6500,0 thousand soms. At the same time, the more number of discounts the more customers with the payments on 10th day of the operation (up to the 60% of 10th day payments). In turn the expenses for maintaining the discount are increasing up to the 78,0 thousands som ($6500,0 \times 0,02 \times 0,6$). Half of the remaining customers pay the contract on 40th day and the rest delay it till 50th day. Finally, the new value of the TPP is equal to 24 days $[(0,6 \times 10) + (0,2 \times 40) + (0,2 \times 50)]$, and its average remaining balance is 433,3 thousand soms $[(6500,0 : 360) \times 24]$. Besides, expenses for supporting the accounts receivable is increased up to 32,5 thousand soms ($433,3 \times 0,75 \times 0,1$). Based on these conditions the rate of the bad debts increases up to 5%, and expenses for the credit analysis and for the collecting arrears up to the 0,4% out of the total sale. Using these data it may be designed actuarial report of the profit and loss and defined impact of each item of the credit policy (change of accounts receivable, rate of bad debts in the debts and level discounts) for the alteration of the amount of a net income. In accordance to the table, change of conditions and standards of credit policy of an entity made a positive impact to the amount of net income and increases it by 78,7 thousand soms or 9,2%. Multiple factors which influence to the amount and behavior of receivables turnover shows the necessity of

systematic monitoring and supervising based on the detailed analysis of its following components:

- Evaluation of the status of the accounts receivable by the date of emergence, its composition and structure ;
- Actuarial prognosis of amounts of accounts receivable;
- Defining the real amount of accounts receivable by taking into account the process of the currency devaluation;
- Conducting comparative analysis and monitoring of conditions of customers and commercial credits.

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