ISSUE № 22
SIBUR for Clients

ACTION PLAN FOR MANAGING ACCOUNTS RECEIVABLE

Get the receivables under control.

Step 1. Determine the overall limit of accounts receivable

At the stage of the company's financial strategy development and revision, it is important to determine the maximum possible amount of accounts receivables (AR).

BASICALLY, A PAYMENT DEFERRAL IS A TYPE OF LENDING TO THE CUSTOMER, THIS PROCESS SHOULD ONLY BE APPROACHED PURSUANT TO THE ADOPTED AND DEVELOPED REGULATIONS

Calculation 1. Set the maximum share of AR in total assets. There is no universal formula: every company makes its own decision subject to risk assessment. For example, in the projected balance sheet, the total expected assets at the end of the year will be RUB 300 million, and AR should not exceed 30%, so the maximum possible amount of receivables is RUB 90 million.

Calculation 2. Calculate the adequacy of this share to achieve target sales. Use the formula: ((S/365)*N, where:

S is target sales;

N – average deferral period, days (for all customer groups).

Example. Expected sales for 2022 total RUB 500 million. Average deferral period is 60 calendar days: (500,000,000/365)* 60 = RUB 82.2 million

---

So, the current portfolio of deferrals offered to customers and expected sales are quite feasible with such a limit of receivables.

If calculation 2 produced a smaller required limit than calculation 1, you can try and increase the share of AR in total current assets, yet giving an objective assessment of the risks associated with such decision, for example, check the absolute liquidity ratio by the formula (C + FI) / STL, where:

C - cash;

FI – short-term financial investments;

STL – short-term liabilities.

The advisable absolute liquidity ratio limit is at least 0.2.

If a decision is made not to increase the share of AR, efforts should target the granted deferrals; for example, intensify sales to the customers who have shorter deferrals to be able to balance out the planned sales growth as well. It is also critical to sustain controls over the established AR limits. Accordingly, the stages of control should be set forth in the corresponding section of the company's credit policy.

It is also critical to sustain controls over the established AR limits. Accordingly, the stages of control should be set forth in the corresponding section of the company's credit policy.

Step 2. Calculate the credit limits

Basically, a payment deferral is a type of lending to the customer, this process should only be approached pursuant to the adopted and developed regulations.

IT IS EQUALLY IMPORTANT THAT ALL EMPLOYEES OF THE COMPANY, ESPECIALLY IN THE COMMERCIAL UNIT, UNDERSTAND THAT "RECEIVABLES ARE NOT FREE OF CHARGE". OTHERWISE, THERE IS STRONG TEMPTATION TO DELIVER THE SALES TARGETS THROUGH UNCONTROLLED GROWTH OF AR, PUSHING THE TARGET SALES GROWTH AND EXTENDING THE DEFERRAL PERIOD

The standard regulations describing the procedures for establishing and further dealing with customers' deferrals make up a credit policy. It should detail all the AR-related processes. Suggested sections are listed below:

- forms of trade credit (TC) (deferrals);
- credit terms and calculation of credit limits;
- TC security;
- procedure for changing the credit limits;

- insurance and factoring;
- monitoring of AR and overdue accounts receivables (OAR) management;
- penalties for OAR;
- collection of AR and OAR.

Each company can add/change the sections depending on their operations, pool of customers and the established market practices. But the above sections are effective and required as the backbone of the credit policy.

The customer's credit limit is easily calculated by the formula: ((S * k)/365)* N, where:

S – volumes sold to the customer in the previous year. If there are new customers with no statistics on sales as yet, the volumes are derived from the current year numbers provided by the commercial unit;

k – potential business growth factor. Set by the commercial unit, capped at 1.1. Where the threshold value is exceeded, the factor increase is subject, firstly, to the approval per the appropriate procedure (for example, by the credit committee) and, secondly, justification (for example, in the previous year, the retail network comprised 20 stores; in the next year, it is planned to open another 10, so revenue may grow +50% YOY if comparable stores are opened);

N – calendar days of deferral granted to the customer (either the current values set out in the contracts, or target values for the new year).

Example. Sales to Vasilek LLC totaled RUB 15 million in 2021.

Deferral period is 65 calendar days. The credit limit for the customer is ((15,000,000 *1.1)/365)* 65 = RUB 2,940,000.

Life may bring its own adjustments, and in certain cases a shipment can be made in excess of the established limit and without the extra security. In this situation, again, it is important that all the parties to the process equally understand the risks of such transaction.

So, the company's credit policy, in the "Credit Terms and Limit Calculation" section, should determine the following:

1. Calculation of limits for each specific customer/region/Financial Accountability Center;

2. It is advisable to formalize the amount of the established limit and sales targets for the period in the addendums signed with the

IF THE CASE IS A GROUP OF COMPANIES AND THERE ARE NO CONSOLIDATED FINANCIAL STATEMENTS, IT WILL NOT BE IMPOSSIBLE TO OBTAIN RELIABLE INFORMATION ON THE CUSTOMER'S FINANCIAL POSITION SIMPLY BY ADDING UP ALL THE NUMBERS FROM THE STATEMENTS OF THE ORGANIZATIONS WITHIN THE GROUP

customers, so that everyone has the same understanding of the sales vs debt ratio;

3. The limit is recorded in the software that the company uses to generate shipping documents. So, when a shipment is posted, the system will automatically account for both the current AR and the new shipment value, reconcile their total against the limit set for this customer, and where the limit is exceeded, the shipment will be blocked automatically.

From there, either a collegial decision is made to ship in excess of the limit (for example, the limit is redistributed among other customers or extra security is provided (pledge, guarantee, surety), or the shipment volume is adjusted downwards until the approved limit is reached.

Of course, life may bring its own adjustments, and in certain cases a shipment can be made in excess of the established limit and without the extra security. In this situation, again, it is important that all the parties to the process equally understand the risks of such transaction.

Step 3. Valuate the cost of accounts receivable

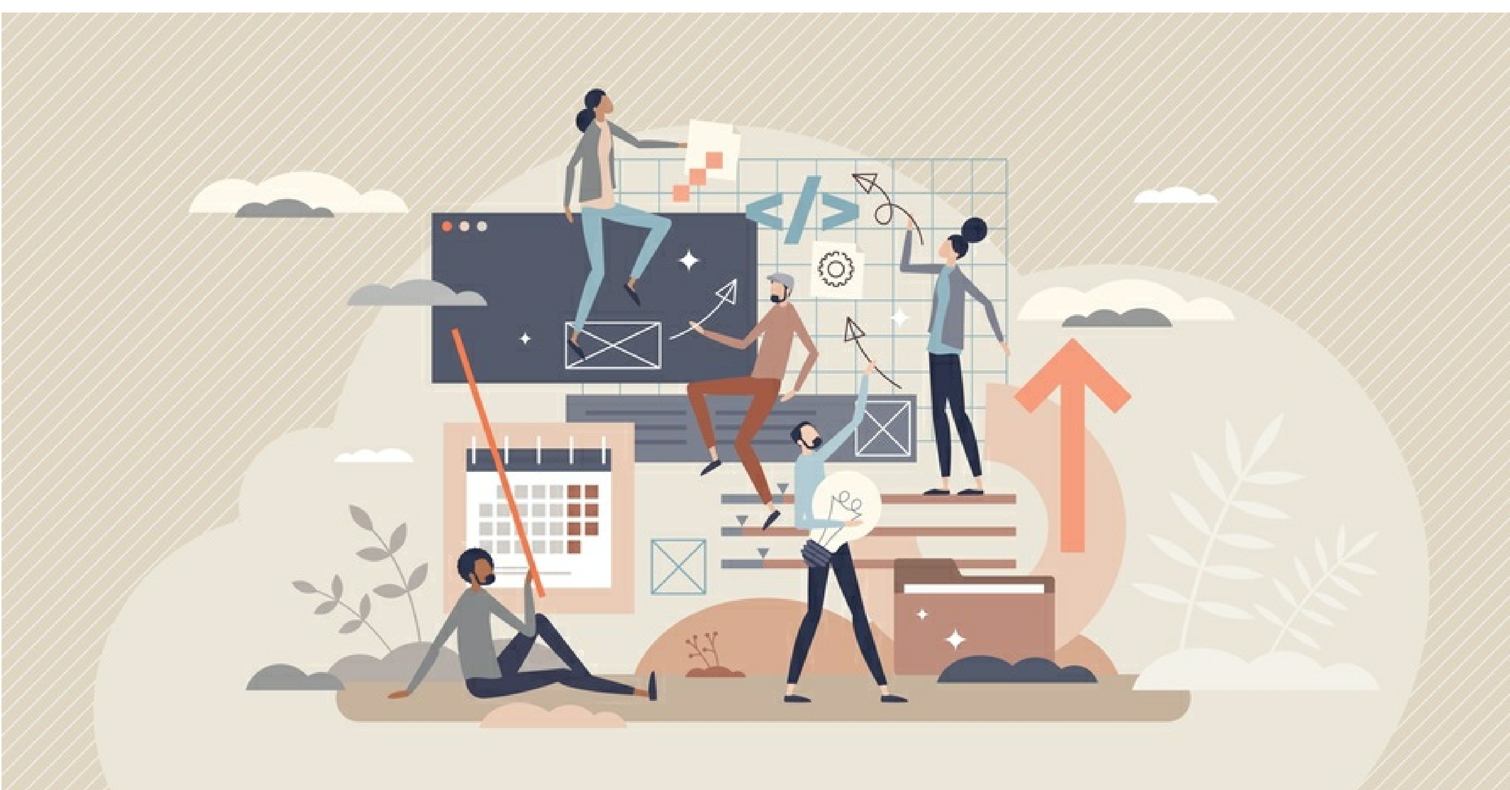
It is equally important that all employees of the company, especially in the commercial unit, understand that "receivables are not free of charge". Otherwise, there is strong temptation to deliver the sales targets through uncontrolled growth of AR, pushing the target sales growth and extending the deferral period.

The cost of receivables is calculated by the formula: CostAR = AR * %% of the cost of capital, where:

AR – average AR for the period: (opening AR + closing AR)/2;

%% – cost of capital (valuation method is up to the company: WACC or cost of credit).

This calculation applies to both the total amount of AR and the debt of a particular customer.



In the current situation, such an assessment becomes crucial in the event of an explosive increase in the key rate and the resulting increase in the cost of credit.

Example: Vasilek LLC (numbers derived from the budget).

CL (credit limit) = RUB 2,940,000

AR as of 01 January 2022 = RUB 2,000,000

AR as of 01 January 2023 = RUB 2,900,000

%% on the credits (average rate) = 25% p.a.

CostAR = ((2,000,000 + 2,900,000)/2) * 25% = 2,450,000 * 25% = 612,500.

So, in addition to direct costs associated with contract execution (discounts, delivery, advertising, etc.), customers must subtract another 612,500 (RA costs) from the operating profit.

In the current situation, such an assessment becomes crucial in the event of an explosive increase in the key rate and the resulting increase in the cost of credit.

THE SURETY OPTION IS ONLY REASONABLE WHERE THE GUARANTOR HOLDS ANY LIQUID ASSETS. THE LLC OPTION WITH NEAR-ZERO TOTAL ASSETS BARELY HAS ANY PRACTICAL VALUE

Step 4. Measure the customers' financial stability

The methodology for calculating the possible limit of customer receivables was described above. This calculation is based solely on the estimated sales volumes, and does not account for the risks of the customer itself. Because, as mentioned above, from a financial security perspective, it not rational to set a RUB 50 million limit for a limited liability company with the least possible authorized capital (even with substantial sales in the previous year) and a retail network with long-term presence on the market but perhaps a slower development pace, yet growing steadily year-on-year.

For example, to measure the buyer's financial stability, the Altman's four-ratio model could be effective (offers an easier calculation and enables analysis based on accounting data alone).

Z = 6.56 * WC/TA + 3.26*RWC + 6.72 * EBIT/TA + 1.05 *E/D, where:

WC – Working Capital (current assets);

TA – Total Assets;

RWC – Return on Working Capital calculated as Net Profit/Total Assets ratio;

NP – Net Profit;

EBIT - Earnings Before Interest and Tax;

E – Equity;

D – Debt.

Score interpretation:

Z = 0 – 1.1: high probability of bankruptcy;

Z = 1.1 – 2.6: 50% chance of bankruptcy;

Z = 2.6 and above: strong financial position and stability.

Once again, this score is calculated on the basis of the customer's financial statements, namely forms 1 and 2.

If the financial statement analysis reveals rather high risks of delay/non-repayment of AR, but dealings with the customer need to continue, risk mitigation tools may be used.

However, if the case is a group of companies and there are no consolidated financial statements, it will not be impossible to obtain reliable information on the customer's financial position simply by adding up all the numbers from the statements of the organizations within the group.

You will not be able to split the intercompany turnovers, so the data, for example, on revenue and assets will be incorrect.

In practice, another simple and very effective way to assess the financial strength of the debtors may be recommended: ask the insurance company whether they are ready to insure the AR of a given customer. If insurers agree to include the debt in their portfolio, it means that their underwriters have not just evaluated the customer's financial statements, but also collected inputs from other sources and found no negative aspects.

If the financial statement analysis reveals rather high risks of delay/non-repayment of AR, but dealings with the customer need to continue, risk mitigation tools may be used, in particular:

- pledge;
- surety;
- insurance;
- non-recourse factoring.

However, note that the last two are fee-based and their cost must be factored in the profitability calculation for the transaction/customer.

The surety option is only reasonable where the guarantor holds any liquid assets. The LLC option with near-zero total assets barely has any practical value.

Step 5. Encourage faster AR repayment

The credit policy should outline:

- incentives for the customers to shorten the AR period;
- penalties for overdue accounts receivable.

One of the ways to incentivize a shorter AR cycle is an early repayment discount. Such discount could be linked to the key rate, for example:

- the deferral period set for the customer is 60 calendar days;
- for example, the key rate is currently 20%;
- the customer repays the AR in 30 days;
- discount amount: (20% : 365) = 0.0547% * 30 calendar days = 1.64% p.a. from the payment amount.

Monitoring of accounts receivable is the responsibility of the financial function, in close cooperation with the commercial unit, since deferral terms (and the price) contribute towards the competitive advantage of the company's offer.

In contrast, a restrictive penalty for the OAR to show the customer that even in the current situation it is more cost-effective to borrow from a bank (of course, if this option is accessible) than to delay the payment to the supplier. So, the penalty may be set as equal to the doubled key rate:

- the deferral period set for the customer is 90 calendar days;
- for example, the key rate is currently 20%;
- the customer repays the AR in 120 days;
- penalty amount: (40% : 365) = 0.1095% * 30 calendar days = 3.28% p.a. from the payment amount.

It is essential to carry out these AR management activities on a regular basis: depending on the market conditions, revise the total AR limit and cost, measure the customers' financial stability, encourage timely repayment, and prevent debt accumulation. Monitoring of accounts receivable is the responsibility of the financial function, in close cooperation with the commercial unit, since deferral terms (and the price) contribute towards the competitive advantage of the company's offer.

Written by: Elena Ageeva, CFO at Golden Electronics. Over 25 years of experience in financial management. Credentials: implementation of budget management and management reporting framework, finance function reorganization.

Irina Safina,
Credit Manager, SIBUR LLC:

"The process of managing the receivables proposed by the article writer is a good description of all stages of customer relationship: from financial position assessment to AR monitoring. SIBUR has extensive experience in dealing with customers, underpinned by a

IRINA SAFINA

Credit Manager, SIBUR LLC

thoroughly designed credit policy and solid connection with the business functions.

A credit limit provision is initiated by the business function. The grounds for the request may be different: for example, a customer has reached a qualitatively new level of operations and is now rapidly increasing purchase volumes, or is it a totally new, but rather ambitious customer. In any case, in the beginning, all the available trade finance tools are studied: insurance, factoring, bank guarantees, letters of credit. If for some reason security cannot be guaranteed, the credit department analyzes the financial statements and produces an opinion, including the calculated rating, permitted credit limit, and the level of management to approve the limit.

Our in-house methodology considers financial and non-financial metrics, as well as the current situation, for example, lawsuits, change of registered address or management. Where possible, we add inputs from public sources, e.g., the SPARK system. Following the review, we deliver an opinion outlining the identified risks and their levels (low, medium, high). And while the positive factors are already known (from the full track record of partnering with the customer), our job is to ‘highlight’ the possible negative aspects. For example, the customer has set up a legal entity just recently, there are complications associated with payment discipline, or accounts have been frozen for tax reasons, etc. We will be sure to show the current receivables and, of course, overdue receivables (if any).

Note that provision of a credit limit is subject to enhanced customer due diligence on our part. It undergoes approval at different levels of management, depending on the amount of the credit limit and the requested deferral period. At the same time, the business functions themselves already have a rather considerable expertise and bring forward the applications that have passed a quality review, meaning there is no such thing as ‘our goal is to sell, we don’t care about the risks’. In my experience, there have been no ‘toxic’ applications for opening a credit limit.

After a decision is made to provide a trade credit, we calculate the limit. We do not have such a well-specified scoring formula as suggested in the article, as each case is different: some might need a delay for 10 days, others ask for a month. We rely on specific parameters (requested period, required amount), factor in the growth percentage to arrive at the optimal limit so that, on the one hand, we do not have to recalculate the limit upon every transaction, and on the other hand, the customer is not overburdened with an excessive debt.

We are all on the verge of a new economic reality that, among other things, affects the issue of receivables. First of all, we are tightening the requirements, i.e., a new customer is unlikely to get a credit limit approval. We strongly recommend to start working on a prepayment basis. Secondly, we are revaluating our entire credit portfolio. For a group of customers with high risk and those rejected coverage by a bank/insurance company, the credit limits have been recalculated or cancelled. On the contrary, we raise the limits for reliable customers due to higher prices.

The main focus now is to monitor overdue receivables. In the current situation, the risk of AR formation increases. Consequently, we are developing a set of actions aimed at minimizing the losses of our company.

Design and programming: LudiPeople www.vashagazeta.com (www.vashagazeta.com)
e-mail: dearcustomer@sibur.ru (mailto: dearcustomer@sibur.ru)
+16