

Management of Accounts Receivable

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Canberra ACT
23 December 1997

Dear Madam President
Dear Mr Speaker

In accordance with the authority contained in the *Audit Act 1901*, the Australian National Audit Office has undertaken a Financial and Control Administration audit of the management of accounts receivable. I present this report and the accompanying brochure to the Parliament. The report is titled *Management of Accounts Receivable*.

Yours sincerely

P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of
Representatives
Parliament House
Canberra ACT

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the Audit Act to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

Financial Control and Administration Audits

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- deal with those systems and procedures implemented to support and assist in the delivery and monitoring of the products and services provided by the public sector. They aim to identify, develop and report better practice for broader application.

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Summary and Recommendations

1. Summary and recommendations

Introduction

1.1 Receipts from the sale of goods and services are the largest component of non-taxation revenue of the Commonwealth. Sales of goods and services in the 'general government sector' (departments and Commonwealth authorities), to individuals and entities external to that sector, amounted to \$2,890 million in 1995-96 (the latest available figures).¹

1.2 A large proportion of these sales are made in advance of receipt of the money (ie. on credit). While precise figures on the proportion of sales on credit were unavailable, based on an extrapolation of the results observed in the agencies reviewed as part of this audit, it could be as high as 85 per cent. At 30 June 1996 the amount uncollected in relation to this revenue was \$385 million² (or 13 per cent

of total sales and 15.6 per cent of estimated credit sales).

Audit objectives, scope and focus

1.3 The objectives of the audit were to assess the cost-effectiveness of the management and administration of the accounts receivable function in the 'general government' sector and to identify, develop and report better practice to promote overall improvements in the management of accounts receivable.

1.4 The audit was limited in scope to agencies whose accounts receivable consist of trade debtors (normally for goods and services), levies, other charges and recoveries from staff. The audit did not examine taxation receipts, repayment of borrowings or the recovery of benefit and allowance payments. While there are some common principles in the management and administration of debt associated with these

¹ Based on the trial and unaudited Whole of Government financial statements of the Commonwealth for the year ended 30 June 1996.

² *ibid*

receipts and debt arising from the sale of goods and services, it is considered that separate management approaches are required in some areas, particularly those relating to debt recovery.

Audit conclusion

1.5 The ANAO concluded that at both the strategic and operational level improvements can be made in the management and administration of the accounts receivable function in the general government sector.

1.6 In particular, there are significant revenue gains, through reducing uncollectable debt, and process improvements to be achieved through the adoption of better practices in the management and organisational framework for the accounts receivable function and through the use of advanced information technology.

1.7 The management and organisational framework can be improved by:

- establishing a comprehensive and clear policy framework which

has been endorsed by executive management;

- identifying, analysing and assessing risks to revenue collection;
- transferring responsibility for strategic decision-making in relation to debtor management to program managers; and
- strengthening management reporting and performance measurement.

1.8 The ANAO also found scope for improving accounts receivable processes through the integration of sale and billings systems, the introduction of alternative payment options and a more structured approach to the recovery of debt.

1.9 It is important that agencies, in choosing new or replacement financial systems, consider the technology enhancements available and how they could offer efficiencies in the integration, recording and collection of Commonwealth revenue.

Summary of findings

1.10 The major findings of the audit on which the above conclusions are based were as follows:

- based on available data, the ANAO estimated that the direct labour costs associated with the accounts receivable function in the Commonwealth are significantly higher than those of the private sector (refer paragraph 2.7);
- in most agencies managers responsible for service delivery had no responsibility for management of the debt arising from the services. This was the role of Corporate Services. It is considered that improvements can be achieved in debt management by removing this separation of responsibility.
- some agencies had not developed written accounts receivable policies and those in place did not effectively address all aspects of the management of the function (refer paragraph 2.18);

- agencies had not undertaken risk assessments of either their revenue collection or accounts receivable functions. They therefore were not in a position to manage these risks (refer paragraph 2.24); and
- current management performance reporting mechanisms do not enable management to exercise ongoing control over the accounts receivable function.

1.11 The ANAO also found that cost savings from reduced debt follow-up action could be achieved, in relation to debt owed by one Commonwealth agency to another, through increased use of direct credit arrangements. The level of inter-agency debt, in the general government sector, as at 30 June 1996 was 15 per cent of the total debt outstanding (refer paragraph 2.38)³.

³ Based on the trial and unaudited Whole of Government financial statements of the Commonwealth for the year ended 30 June 1996.

Recommendations

1.12 The ANAO's recommendations are set out below.

Management control and performance measurement

1.13 The ANAO **recommends** that agencies:

- integrate their sales and billing systems and extend their business systems to decentralised operations that generate significant revenues and debtors;
- investigate the use of alternatives to managing debt arising from credit sales, including promoting payment by direct credit of bank accounts, credit card and through agents;
- adopt a structured approach to the recovery of debts, including the use of specialist debt collection staff, more timely identification of overdue debts and improved criteria against which write off or waiver of debts can be tested; and
- review functional responsibilities of managers with the aim of linking the responsibilities of program and service

delivery and accounts receivable management, where programs and services result in revenue generation.

Policy framework

1.14 The ANAO **recommends** agencies:

- review policies for the management of accounts receivable to ensure that all key elements, including modes of payment, strategies for the collection of debt, handling of customer inquiries and credit management are addressed;
- obtain approval of the accounts receivable policy by executive management prior to promulgation to staff; and
- make existing and potential credit customers aware of the key elements of the accounts receivable policy prior to any sale taking place.

Risk assessment

1.15 The ANAO **recommends** agencies with significant revenues arising from credit sales conduct a risk assessment of their revenue collection and accounts receivable functions

and of their customers and debtors.

Performance and reporting mechanisms

1.16 The ANAO **recommends** agencies:

- monitor and regularly review debt outstanding in excess of 90 days with a view to seeking, where appropriate, approval to write the debt off;
- establish credible performance indicators for measuring the effectiveness and efficiency of the accounts receivable function; and
- develop regular reporting mechanisms for monitoring actual performance against the indicators and clear procedures for actioning the related reports by executive management.

Inter-agency transactions

1.17 The ANAO **recommends**, where practicable, all inter-agency payments be made by way of direct credit, immediately following any verification process.

Better practice

1.18 The audit identified examples of better practice currently used by the agencies reviewed. Where these practices had general application, they were consolidated with applicable private sector better practices to create the companion better practice guide for the management of accounts receivable in the Commonwealth public sector.

Detailed Audit Findings

2. Detailed audit findings

Background

2.1 Commonwealth revenues from the sale of goods and services in the 'general government' sector, to individuals and entities external to that sector, for the financial year ended 30 June 1996, (the latest available figures) were \$2.9 billion. While precise figures on the proportion of sales on credit were unavailable, based on an extrapolation of the results observed in the agencies reviewed as part of this audit, it could be as high as 85 per cent. At 30 June 1996 the amount uncollected in relation to this revenue was \$385 million (or 13 per cent of total sales and 15.6 per cent of estimated credit sales).

2.2 The accounts receivable function in the Commonwealth has not been subject to a major review.

2.3 Current initiatives impacting on the Commonwealth's accounts receivable processes include:

- the introduction of the proposed financial management and accountability legislation which will impose on Chief Executives a fiduciary responsibility in relation to the management of accounts receivable in their agencies;
- the introduction of the Office of Government Information

Technology (OGIT) approved financial management information systems which present the opportunity for agencies to upgrade their systems to a standard commensurate with modern commercial practice;

- the planned introduction of accrual budgeting in Commonwealth agencies, which will focus importance on accrual information including accounts receivable; and
- the development of electronic commerce, which will change the way agencies do business in the commercial world.

2.4 The main objectives of the audit were to assess the management and administration of the accounts receivable function and to identify, develop and report better practice. Particular attention was paid to:

- establishing whether the identified policies, procedures and processes were applied in a manner consistent with the principles of sound internal control; and
- the extent of management control and better practices in both the public and private sectors.

2.5 Additional background information and details of the audit objectives, scope and approach are provided at Appendices 1 and 2 respectively.

2.6 The main issues and recommendations are set out below.

Costs

2.7 On the basis of information supplied, ANAO estimates of the

direct labour costs showed a wide variation across agencies. For those agencies able to reliably determine their direct labour costs, the average cost to manage the accounts receivable function was found to be 0.9 per cent of revenue. This compares to private sector better practice of about 0.15 per cent of revenue. Most estimates were significantly higher than those reported by private sector entities and are illustrated in Figure 1.

2.8 Figure 1 suggests the private sector is up to 6 times more efficient than the Commonwealth public sector. Given that revenue on the sale of goods and services in the 'general government' sector was \$2.9 billion this difference in processing costs translates to in excess of \$20 million.

2.9 While recognising there may be valid reasons to explain part of the cost variations in the above comparison, such as the economies of scale available to certain private sector organisations, it is clear that some cost reductions could be achieved in Commonwealth agencies through the adoption of better practices.

2.10 It is considered that implementation of the recommendations of this report and benchmarking existing practices against the better practice guide produced in conjunction with this report, should assist agencies in achieving cost savings and performance improvements in their accounts receivable functions.

Management control and performance measurement

2.11 Management's objectives for accounts receivable are to ensure that all debts are recorded and collected in an appropriate time frame and to maximise the efficiency of remittance and debt processing.

These objectives are met by establishing policy, accounting controls, organisational and processing arrangements and performance and reporting mechanisms.

Accounting controls

2.12 The audit found that 85 per cent of the revenue of the agencies reviewed resulted from credit sales. Given this reliance on credit sales, ensuring the complete, accurate and prompt recognition, recording, issue and collection of debt takes on greater significance.

2.13 The ANAO found most agencies had separated their invoicing and billing functions and, as a result, there was a sound framework for control over the completeness and accuracy of the recording of revenue and receivables.

2.14 Notwithstanding this framework, the ANAO found weaknesses in the following areas of accounts receivable processing:

- *billing processes*- significant delays between the completion of sales or the performance of services, and the generation of invoices in some agencies. Delays were typically around one month, but in one agency delays of up to three months were noted;
- *payment processes* - the collection of revenue was generally slower than the

established agency policy or 'terms of trade';

- *payment mode* - most of the agencies reviewed had not fully considered alternative payment options including, direct credit, payment by credit card and payment through an agent (eg. Australia Post);
- *customer contact* - there was little emphasis placed on customer relations. In particular there was a general lack of specific procedures dealing with how to handle and document customer inquiries and complaints;
- *collection process* - agencies had not made use of modern debt collection techniques, including automation, use of specialist debt collection staff and increased contact with debtors;
- *overdue debt* - the accounting systems in most agencies did not permit automatic referral of overdue debt for specific debt collection action; and
- *write off/waiver* - some agencies had not promulgated clear instructions on the write off and waiver of debt.

2.15 In the main these findings arise as a result of the decentralisation of the accounts receivable function in agencies, combined with the limited use of the opportunities available through computerisation and the lack of

effective integration of service delivery and invoicing activities.

2.16 In addition, the ANAO found that there continued to be a separation of responsibility for debt management between program delivery and corporate support. Traditionally, corporate support areas of agencies have been responsible for debt management while program managers have been responsible for the delivery of the goods or services. This approach, to some extent, also contributes to the above issues. In particular, linking the performance appraisal of service delivery managers to specific debt management and recovery benchmarks can provide incentive for improved management of accounts receivable.

Recommendations

2.17 It is recommended that agencies:

- integrate their sales and billing systems and extend their business systems to decentralised operations that generate significant revenue and debtors;
- investigate the use of alternatives to managing debt arising from credit sales, including promoting payment by direct credit of bank accounts, credit card and through agents;
- adopt a structured approach to the recovery of debts, including

the use of specialist debt collection staff, more timely identification of overdue debts and improved criteria against which write off or waiver of debts can be tested; and

- review functional responsibilities of managers with the aim of linking the responsibilities of program and service delivery and accounts receivable management, where programs and services result in revenue generation.

Policy framework

2.18 A key component of the management of accounts receivable is the establishment of a comprehensive and clear policy framework which is disseminated to all areas of the agency involved in their management.

2.19 The ANAO found that several of the agencies reviewed had not developed written policies for the management of accounts receivable and that policies in place did not effectively address all aspects of the management of accounts receivable. In particular it was noted that policies did not address:

- alternative modes of payment;
- strategies for the collection of debt; and
- procedures for handling customer inquiries and complaints.

2.20 Where policies existed the ANAO found that they had not been formally adopted by management, resulting in a lack of authoritative guidance to staff on the operational procedures to be put in place and a consequential weakening of the control over the raising and collection of debt.

2.21 In addition, most agencies had not developed a credit management policy, resulting in decisions on the credit worthiness of customers being made on the basis of poor information.

Recommendations

2.22 It is recommended that agencies:

- review policies for management of accounts receivable to ensure all key elements, including modes of payment, strategies for the collection of debt, handling of customer inquiries and credit management are addressed;
- obtain approval of the accounts receivable policy by executive management prior to it being promulgated to staff; and
- make existing and potential credit customers aware of the key elements of the accounts receivable policy prior to any sale taking place.

Risk assessment

2.23 Risk assessment involves the identification, analysis and

assessment of risks and the treatment of these risks through the application of appropriate control processes.

2.24 The ANAO found the majority of agencies reviewed had not completed risk assessments of either their revenue collection or accounts receivable functions. As a result they were not in a position to make informed decisions about the processes required to manage identified risks nor to determine whether existing processes were cost-effective.

2.25 In addition, it was found that agencies had not undertaken any risk assessment of their debtors and their existing and potential customers. They tended to treat debtors and customers as a homogeneous group.

2.26 One advantage arising from conducting a risk assessment of customers and debtors is improved collection performance. An analysis of customer and debtor populations can result in revised credit policies and the focus of debt collection activities on high risk debtors.

Recommendation

2.27 It is recommended agencies with significant revenues arising from credit sales conduct a risk assessment of their revenue collection and accounts receivable functions and of their customers and debtors.

Performance and reporting mechanisms

2.28 Two key aspects of the performance of the debt collection function are the days to collect debts and the age of debts. The results of the ANAO's assessment of the performance of the agencies reviewed are set out below.

2.29 For those agencies who were able to supply these figures, the ANAO calculated that the majority of agencies were not collecting their debts in accordance with their terms of trade. Figure 2 shows this result.

2.30 Figure 2 shows that the average time to collect receivables (39 days) among these agencies was greater than the expected time, given their terms of trade (30 days). Several agencies had collection times well in excess of their terms of trade. However, this result was better than that achieved in the whole general government sector where average days to collect receivables on sales of goods and services during 1995-96 was approximately 57.⁴ This result was likely to have been influenced, to some extent, by the existence of the following factors:

- irregular billing by agencies; and
- individually large debts which were the subject of legal action.

⁴ Determined by the following formula: Total Days in Year x (Average Accounts Receivable/Annual Credit Sales)

2.31 However, it indicates scope for improvement in management of accounts receivable.

2.32 Of the total debt outstanding in the agencies reviewed (\$95.8 million) the ANAO noted that 24 per cent (\$23 million) of this debt was outstanding more than 60 days from the date of the invoice and over half of this was outstanding for in excess of 90 days, notwithstanding each of the agencies 'terms of trade' were 'payment within 30 days'. Industry experience indicates that the majority of debts outstanding in excess of 90 days are either unlikely to be collected or are relatively expensive to collect. The collectability of aged debt is a matter of particular concern in relation to outstanding debt in the general government sector.

2.33 Most agencies were also unable to provide details of their collection success rates against various outstanding debt categories. On the basis of information available, the ANAO calculated that, of the debt collected, 87 per cent of collections were from debtors outstanding for less than 60 days. The balance of 13 per cent was from debts older than 60 days.

2.34 These results indicate that there is significant scope for improvement in the management of accounts receivable, particularly at the strategic level.

2.35 The ANAO concluded that current management performance

and reporting mechanisms required improvement to enable management to exercise suitable ongoing control over the accounts receivable function. Findings included:

- a general absence of established performance targets for the accounts receivable function. Where targets had been set, they were generally limited to performance against 30, 60 and 90 day 'terms of trade' and were seldom met or followed up;
- most agencies had information systems capable of capturing and processing large quantities of data, however, there was considerable variance in the level of reporting and the level of management to which the reporting was directed; and
- some agencies had no formal management reporting processes.

2.36 The development of performance targets, such as standard time between the provision of the goods or service and issue of the invoice, average cost per collection, numbers of invoices and reminders processed, percentage of 30, 60 and 90 day debts, and number of customer contacts/queries would provide suitable signposts allowing managers to identify, and react to, problem areas.

Recommendations

2.37 It is recommended agencies:

- monitor and regularly review debt outstanding in excess of 90 days with a view to seeking, where appropriate, approval to write the debt off;
- establish credible performance indicators for measuring the effectiveness and efficiency of the accounts receivable function; and
- develop regular reporting mechanisms for monitoring actual performance against the indicators and clear procedures for actioning the related reports by executive management.

Inter-agency revenue

2.38 Unaudited figures available for 1995-96 indicate that, within the General Government sector, as at 30 June 1996, inter agency accounts receivable from the sale of goods and services was around 15 per cent. This figure for inter agency transactions excludes transactions between agencies in the general government sector and other government agencies not in this sector. The actual level of inter agency transactions is therefore understated by the transactions between agencies in the general government sector and agencies in the other government sectors.

2.39 The ANAO, in Audit Report No. 16 of 1995-96, suggested that, in the case of transactions within the Commonwealth Public Account, where there is no interest benefit to the Commonwealth from either early or late payment, payment should be made by direct credit as soon as possible. The Department of Finance in response to Audit Report No. 16, while recognising the practical difficulties for agencies in differentiating inter-agency payments for preferential processing, supported the suggestion that all inter-agency payments be made by way of direct credit, immediately following any verification process.

2.40 The implementation of this suggestion would result in both cost savings from reduced cheque production and handling, and, in the context of this audit, from reduced follow-up action by revenue receiving agencies.

Recommendation

2.41 The ANAO recommends, where practicable, all inter-agency payments be made by way of direct credit, immediately following any verification process

Canberra ACT
23 December 1997

P. J. Barrett
Auditor-General

Appendices

Appendix 1

Background

FCA audits

Financial Control and Administration (FCA) audits are aimed at improving the quality of public sector administration by assisting and encouraging agencies to achieve better practices. FCA audits are undertaken across a selection of agencies and involve the identification of better practices from both within and outside the public sector. The main output at the end of the audit is the publication of a better practice guide. The approach provides a benchmark against which each agency, service-wide, will be able to compare its respective performance and to implement improvements, where necessary.

Definition of accounts receivable

Accounts Receivable was defined, for the purpose of the audit, as including credit approval, invoicing procedures, the recording of transactions, debt recovery processes, and management reporting.

Accounts receivable, for the purposes of the audit, are confined to the following types:

- trade debtors (normally goods and services);
- levies;
- other charges; and
- recoveries from staff.

In normal circumstances an invoice or debit advice note would be issued for these debts. The audit excludes loans, taxation revenues, recoveries of benefit and allowance payments, and payments made in advance.

Previous reviews and audits

Relevant audits of the management of the accounts receivable function undertaken by the ANAO in recent years are:

- Department of Administrative Services - Debt Management (Audit Report No.42, 1991-92);
- Across agencies - Debt management and collection (pages 7-10 of Volume 2, Audit Report No.1, 1993-94);
- Australian Taxation Office - Collection of taxation debt (pages 12-36 of Volume 7, Audit Report No.1, 1993-94);

- Cash Management in Commonwealth Government Departments (Audit Report No.10, 1994-95); and
- Tax Debt Collection - Australian Taxation Office (Audit Report No.13, 1996-97).

Current initiatives

Current initiatives impacting on the Commonwealth's management of accounts receivable include:

- the introduction of the legislation to replace the Audit Act 1901;
- the selection of a suite of suitable financial management information systems by the Office of Government Information Technology (OGIT); and
- the continued scope for increased use of electronic facilities and systems in payment of accounts receivable.

The new Commonwealth financial legislation will require Chief Executives of Commonwealth departments and agencies to promulgate Instructions for the financial management of their organisations. Model Chief Executive's Instructions produced by the Department of Finance specify the obligations of organisations in respect of the management of accounts receivable.

Specifically the Model Instructions require Chief Executive Officers to:

- maintain proper records of debtors,
- promptly bring all debtors to account in their accounting records,
- promptly forward a letter of demand to debtors seeking payment of amounts outstanding, and
- delegate authority for the write off or waiver of debt in appropriate circumstances.

Department of Finance activity

In February 1996 the then Department of Finance issued Finance Circular 1996/2 titled 'Management and Recovery of Outstanding Debts' to departments and agencies operating under the Audit Act. The purposes of the circular were:

- to bring together better practices reported and observed through consultation commonwealth bodies and commercial debt collection agencies; and
- to encourage agencies to develop procedures that best meet their own particular circumstances.

The key best practices outlined in the circular are:

- clear and coherent procedures for debt identification and recovery;
- debt needs to be identified quickly and acted on immediately;
- agencies should be aware that, where collection agents are used, the Privacy Commissioner should be advised; and

- payment by instalments should only be allowed after a reasonable investigation of each case, and consistent and efficient application of debt recovery procedures.

Appendix 2

Objectives, Scope and Approach

Objectives

The main objectives of the audit across the Commonwealth were to assess the management and administration of the accounts receivable function and to publish a consolidated better practice guide for the use of all public sector agencies. These objectives require analysis of information at each of the agencies selected for audit, as well as the Department of Finance and other central agencies, and in the private sector.

The first objective of assurance is addressed in this report through the expression of an overall opinion which is supported by detailed conclusions, findings and recommendations in Part One.

The second objective of better practice is addressed through the preparation of a Better Practice Guide issued separately but in conjunction with this report.

The Agencies

The main objectives of the audit within each agency were to identify good practices in the accounts receivable function, to assess the management and administration of the function and to recommend improvements as necessary. Specifically the objectives were to:

- to ascertain the policies, practices and processes in place for the management of the accounts receivable / debt management function;
- to determine whether the identified policies, procedures and processes are applied in a manner consistent with the existence of a sound control structure;
- to identify any best practice in operation or development, and to establish any further opportunities for improving the management of the accounts receivable / debt management function; and
- to report on the administration of the management of the accounts receivable / debt management function.

Audit methodology

The audit was undertaken in accordance with ANAO Auditing Standards which are consistent with Australian Auditing Standards.

Audit evidence was obtained primarily by means of discussion with staff of the agencies audited, inspection of reports, policies and procedures manuals and the testing of accounts receivable related transactions.

Findings and recommendations were reported to individual agencies for their review and comment. A report was provided to each Minister on the results of the audits on agencies within their portfolios.

Scope and focus

The scope of the audit was restricted to the function of accounts receivable. It involved an examination of the controls and processes in place for the management of receivables, an assessment as to whether the identified controls and processes were applied in accordance with legislative requirements and good management practice, and the identification of better practices operating outside the public sector.

The main focus of the audit was on the identification of better practices and included an emphasis on:

- organization, staffing and costs;
- policy, procedures and performance measures;
- providing credit;
- invoicing;
- customer relations;
- promoting payment;
- recording of transactions on the accounting system;
- identification of overdue amounts;
- recovery of overdue amounts;
- difficult accounts; and
- write-offs and waivers.

Audit approach

The audit approach comprised the following main elements:

- research of reference information;
- conduct of fieldwork at fifteen agencies, including regional offices;
- liaison with the Department of Finance and review and analysis of relevant data and processes;
- an emphasis on information gathering on the instructions, processes, organisations, cost and technologies applying to the process of receivables; and
- analysis of the information with a view to reporting better practices and developing relevant performance indicators.