THE AMOUNT OF CORRECTION OF RECEIVABLES VALUE
- COST OF NON-QUALITY WITH CUMULATING EFFECT

Summary

Quality costs are costs produced by non-performance of quality requests, i.e. costs caused by activities referring to error prevention, planned quality inspection and internally and externally established errors. The cost of shortcomings or non-quality cost is the essential category. Suspicious and debatable receivables, which are directly connected, are separately analysed as non-quality cost. The amount of suspicious and debatable receivables in the year of correction of values has characteristics of non-quality cost. The management of these costs, from the moment of application of norm ISO 9001:2000 is not only important for the eventual user, but for the other interested parties as well.

Key words
Non-quality cost(s), cost management, suspicious and debatable receivables, correction of values.

Introduction

“Costs present valued work, material, long-term and short-term assets, and other party’s services, with aim to achieve certain effect (product, goods or service)”.

This is one of the possible definitions of total costs.

“In the structure of total costs there is a part named quality costs. These costs are made in order to achieve certain quality. We can define them as costs caused mostly by quality requests; i.e. costs caused by activities referring to error prevention, planned quality inspection and internally and externally established errors. Quality costs are limited costs which refer to quality and are contained in various types or places of cost.”

“The term quality costs has different meanings for different subjects. Some people equal quality costs with costs for quality achievement; others equal these costs with work costs of quality section. Specialists of quality costs more and more equal them with costs of poor quality, and that opinion tends to become general.

Quality costs are usually structured into four basic categories (internal costs of shortcomings, external costs of shortcomings, evaluation costs and prevention costs), with further division into separate types, whose specifications and scope depend on the concrete situation”.

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For needs of this study, we shall divide quality costs in the following way:

![Division of quality costs](image)

**Picture 1: Division of quality costs**

Costs for quality (cost groups 1 and 2) are costs made with intention to achieve certain quality.

The reduction of these costs from the moment of beginning of application of norm ISO 9001:2000 is not important only for the eventual user, but also for other interested parties: owner, social community, partners, employees and trade unions.

Costs due to quality (cost groups 3 and 4) are costs which are made because certain quality has not been achieved. These costs occurred because something was not done properly the first time. We shall find in literature formulations like: costs due to poor quality, costs of non-quality, costs of shortcomings, costs in the shadow, and similar. 4

“Although many companies accepted such division of quality costs as useful for their own needs, at concretely defining of costs structure for a company, we have to bear in mind the following:

1. definitions of certain types of costs and their names must be *tailored* according to the situation in the subject company, and not be transferred directly from literature,
2. agreement on categories and types of costs must be reached before the beginning of their accompanying,
3. the essential category is costs of shortcomings, since in this area there are actual possibilities for their reduction, with simultaneous removal of users’ dissatisfaction. Therefore, these are the costs that should be *attacked* first”.

“The authors put the usual costs into TG 1, TG 2, TG 3 and TG 4, although to each of these cost groups one can add many other costs, whose consequences we feel daily. Some of these costs can be very important, like costs made due to: poor organisation, poor personnel politics (especially management), too large provisions, written-off suspicious and debatable

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4 For needs of this study we shall use the term “non-quality costs”.
receivables, the effect of complicated, sometimes difficultly understandable economic, political and normative impact on daily business activities, and similar."  

The scope of and the approach to the problem of recognising of non-quality costs will reveal to us enormous possibilities of locating non-quality costs in the company and of determining the cause of their appearance.

This fact directs us towards need to leave the approach of considering total costs, non-quality costs as well, in the quantitative environment only. The necessary approach is to observe the costs in qualitative environment.

“The synthesis of qualitative measures and quantitatively expressed data is characteristic for costs management in the qualitative sense. Costs in qualitative environment are observed in the context of profit making and dimension of capital use.”

The observance of costs in qualitative environment requires different approach to definition of non-quality costs. It is necessary to consider all factors from negative influence on the amount of the profit.

This study presents below a real example of possible approach to non-quality cost observance in the qualitative environment.

The amount of correction of value of suspicious and debatable receivables – non-quality costs

“In the current period it is possible to discover errors in making of financial reports for one or more previous periods. The errors can be made as a result of mathematical mistakes, errors in application of accounting politics, wrongly interpretation of facts, fraud or unintentionally. The correction of these errors is usually performed at defining of net profit or loss in the current period.

Rarely an error has such a large effect on financial reports for one or more previous periods that those financial reports cannot be considered reliable any longer on the date of their issuance. Such errors are called basic errors.”

Suspicious and debatable receivables are defined as: "... part of receivables whose collection is uncertain. They are run on the accounts where (regular) receivables are run until defined period. After the collection period for the receivables has expired, the receivables are written-off as irregular expense. Subsequent collection of such receivables is shown as increase of irregular income.”

The correction of value, or “... value adjustment of receivables from buyers and other receivables is carried out in accordance with adopted accounting politics and evaluations based on the appropriate business information on status and movement of financial and business situation of the debtor. Such value adjustment is entered on the debit side of income, and on the credit side to the account of correction of value receivables from buyers and to the account of correction of value of other receivables. As well as with other value adjustments, the point is in reserving of collection risks of receivables from buyers and other receivables, which had already been entered on the credit side of income. In such way the amount of income is corrected.”

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8 The example is real, but the author does not name the company. The amounts of money are also real, but rounded for easier following.
Example:

The company from our example presented in its financial reports, in the period from 1995 to 2000, the results of business activities as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PROFIT / LOSS</td>
<td>6.000.000,00</td>
<td>1.000.000,00</td>
<td>6.000.000,00</td>
<td>1.000.000,00</td>
<td>46.000.000,00</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Presentation of financial results per years

This table shows that the company presents loss in financial reports for years 1995 and 2000. Other years present positive financial result, i.e. profit.

By audit of financial reports it was determined that the correction of values of suspicious and debatable receivables for the observed period (receivables were settled more than 180 after due date), was made only in 1995 and 2000.

During make-out of financial reports for 2000, the company administration/management brought a decision on write-off of all suspicious and debatable receivables from previous periods. The amount of correction of value of suspicious and debatable receivables carried out in 2000 is the sum of all suspicious and debatable receivables for the period from 1995 to 2000. It caused cumulating negative effect on total financial result of the company for business year 2000 with negative consequences for a long time.

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
<th>The amount in HRK</th>
<th>The year of occurrence of suspicious and debatable receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/ Receivables per given credits to other legal subjects</td>
<td>4.000.000,00</td>
<td>1995</td>
</tr>
<tr>
<td></td>
<td>9.000.000,00</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>18.000.000,00</td>
<td>2000</td>
</tr>
<tr>
<td></td>
<td>3.000.000,00</td>
<td>1996</td>
</tr>
<tr>
<td>TOTAL A</td>
<td>34.000.000,00</td>
<td></td>
</tr>
<tr>
<td>B/ Receivables for given advance payments</td>
<td>2.000.000,00</td>
<td>2000</td>
</tr>
<tr>
<td></td>
<td>2.000.000,00</td>
<td>1995</td>
</tr>
<tr>
<td>TOTAL A+B</td>
<td>38.000.000,00</td>
<td></td>
</tr>
<tr>
<td>C/ Not collected receivables from buyers</td>
<td>5.000.000,00</td>
<td>2000</td>
</tr>
<tr>
<td>TOTAL A+B+C</td>
<td>43.000.000,00</td>
<td></td>
</tr>
<tr>
<td>D/ Subsequently determined expenses from previous years (not collected receivables from buyers)</td>
<td>15.000.000,00</td>
<td>1997</td>
</tr>
<tr>
<td></td>
<td>2.000.000,00</td>
<td>1999</td>
</tr>
<tr>
<td></td>
<td>500.000,00</td>
<td>2000</td>
</tr>
<tr>
<td>ALL TOTALLY:</td>
<td>60.500.00,00</td>
<td></td>
</tr>
</tbody>
</table>

Table 2: Occurrence of negative cumulative effect of correction of value of suspicious and debatable receivables.

Negative cumulating effect occurred due to:
- not respecting the principles of value significance at evaluation of positions, balance (sheet), profit and loss statement, as well as
basic accounting preconditions for elaboration of financial reports, and these are: consistency and recognition of business changes in the current moment.\(^\text{12}\)

Adhering to the principles that the correction of value of suspicious and debatable receivables was done for suspicious and debatable receivables which were settled later than 180 days of their due date, it was necessary to perform the correction of value of suspicious and debatable receivables per years, as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (HRK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>6,000,000.00</td>
</tr>
<tr>
<td>1996</td>
<td>3,000,000.00</td>
</tr>
<tr>
<td>1997</td>
<td>15,000,000.00</td>
</tr>
<tr>
<td>1999</td>
<td>11,000,000.00</td>
</tr>
<tr>
<td>2000</td>
<td>25,500,000.00</td>
</tr>
<tr>
<td><strong>TOTAL:</strong></td>
<td><strong>60,500,000.00 HRK</strong></td>
</tr>
</tbody>
</table>

Since it was not done per years, but cumulatively in financial report for year 2000, the mistake was made with large effect on financial reports for more previous periods, so that those financial reports cannot be regarded reliable on the date of their issuance. The basic accounting error was done. \(^\text{13}\)

The easiest way to notice it is if we present the comparative survey of presented financial result per years, and result which approximately had to be presented if the accounting principles were respected.

Graphically it can be shown in the following way:

\(^{12}\) “Law on Accounting” N.N. 90/92, p. 2141.

The causes of occurrence of suspicious and debatable receivables in the example are:

1. Not collected receivables per given credits to other legal subjects. It is in practice to give credits and loans to other legal subjects with appropriate interest and payment guarantees, when there is a surplus of liquid assets.
   In our case (example), the system of security management in the financial area was neglected. The risk management, especially credit risk, was missing.

2. Not collected receivables for given advance payments are also consequence of inappropriate evaluation of risk. All circumstances at giving advance payments were not considered, and estimation of partner's credit ability was not performed qualitatively.

3. Not collected receivables from buyers which occurred as result of arrogant behaviour towards buyers, wrong estimation of own position in the market, on the principle "they cannot do without us", dealing business with buyers at inertia, without precisely contracted mutual rights and liabilities for every business year. The consequence of such work and behaviour over a number of years is non-acknowledgement of part of company's receivables, by the buyer, and, further, impossibility to settle that part of receivables.

4. Subsequently determined expenses from previous years (other not collected receivables from buyers) occurred in the same way and from the same reasons as explained in item 3. Therefore, we can conclude that the causes of occurrence of so large items of suspicious and debatable receivables from our example are the following:

   a) non-existence of security management system in the area of credit risk management,
   b) inappropriate way of resource management, especially financial,
   c) neglecting of marketing function, and as a result of that, wrong estimation of own position on the market,
   d) belittling of real and anticipated need of the buyer, and arrogant behaviour towards them,
   e) non-observance of laws and international accounting standards,
   f) years-long not arranged business system.

   These causes, in our example, have consequence of HRK 60.500.000,00 of not needed costs wrote-off in 2000, which led the company to a loss.

Since the correction of value of suspicious and debatable receivables was not carried out in accordance with accounting principles and international accounting standards for each business year, in 2000 occurred cumulative effect of these costs, which would burden business operations of the company for a long period.
These costs have, undoubtedly, occurred from the reason that appropriate quality of business system was not achieved. Also, these costs have certain characteristics of non-quality costs, and as such they should be treated. In the situation from our example, this type of non-quality costs has an additional characteristic, which is a cumulating effect, with all the negative consequences for business operations of the company.

Conclusion:

Despite the slight probability that in the future period some of these suspicious and debatable receivables, wrote-off in year 2000, will be collected, this cumulating cost burdens business year 2000. In 2000, only this non-quality cost makes 33% of total income realised in that year.

Previously to future explorations of quality costs, within its structure and non-quality costs, agreements and consensus about categories and types of non-quality costs must be reached among explorers.

Non-quality cost, which is the subject of this study, has direct and exact influence on profit of the company, and eventual business result accordingly.

This type of non-quality cost is almost impossible to reduce by partial and ad hoc measures. One of the middle-term measures with long-term positive effects would probably be the arrangement of business system. The point is, in fact, on some sort of restructuring of the whole company, in the frame of which the implementation of the quality system in compliance with norm ISO 9001:2000 would permanently eliminate most part of the amount of suspicious and debatable receivables as non-quality costs, especially its cumulative effect.

Literature:

8. “Law on Accounting” N.N. (Official Gazette) 90/92.