

CREDIT POLICY

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Credit – necessary for business growth, but carrying both risk and cost

The granting of trade credit is a powerful selling aid, and is a fundamental foundation upon which all trading relationships are built. Both seller and buyer gain advantage from credit facilities, but the risk of slow or non payment is borne by the seller – risk in the form of non payment, and cost in the form of the interest expense incurred from the date of the sale to receipt of the funds.

The demand for trade credit requires:

- a sound operating procedure to cope with continuous sales volumes;
- capital to fund the waiting time (between sale and cash receipt) with a worthwhile return on the investment; and
- regulation and enforcement, informally or by law, of credit agreements.

In effect, this means having a Credit Policy.

Why is a credit policy needed?

Every function of a business plays a part in the life of a sale and equally in the death of a sale, and therefore the debtors' asset. It is created when a customer is prospected for business, or when products or services are advertised, since expense begins then. This expense has to be recouped by a sale, which, by definition, must be fully paid on time. Anything less reduces the intended margin. Thus:

- the selling operation;
- the order processing system;
- the manufacturing or procurement action;
- the costing and pricing basis;
- the conditions of sale; and
- the customer service efficiency,

all contribute together with the company's credit control, sales ledger and cash collection departments.

A credit policy is necessary to show the company's intended way of doing business and avoids confusion and potential misunderstanding. The need for company policies in respect of health and safety, smoking, employment etc., are well founded and accepted as both normal and necessary, and this should apply equally to the credit operation. Successful companies have long set down their preferred operational approaches to the credit function and how it fits into the organisation:

- involve all relevant functional heads in shaping the business for the future;
- clarify 'best practice' and iron out inconsistencies in procedures;
- define job responsibilities and objectives;
- avoid internecine disputes and save valuable management time;
- plug any 'profit leaks' caused by chaotic attitudes and procedures;
- ensure that all operations comply with the corporate focus on net profit; and
- ensure that all operations comply with the law of the land.

All businesses can benefit from the experience of well-established firms by taking a look at how they do things and by developing their own operating policies.

Instigating a credit policy

A credit policy should start at the highest level, be agreed at all levels, and be inclusive of all those areas of the business operation which leads to satisfying customer requirements. Every employee in the business should know:

- what the credit terms are;
- how and why they have been arrived at; and
- how, why and when they are implemented.

A director or senior manager is delegated by the Board of Directors to produce a brief outline of collective policy, process and procedures required to manage the debtors' asset efficiently. Producing and/or updating the policy document motivates and requires functional heads in sales, production and customer service, etc. to involve all staff and delegate responsibility. It invariably clarifies areas where staff may have been unclear about authority, responsibility and seniority in certain situations. When a credit policy has been decided, it should be signed by the Board of Directors and issued to all departments to show its importance to the cash flow and profitability of the company.

The production and implementation of a credit policy document is an excellent opportunity for sales and credit to get together to decide and define responsibility for solving customer problems. The credit manager should bring sales staff together and explain key points such as:

- credit approval of new customers;
- observance of credit ratings and credit terms;

- joint visits to major customers; and
- action to recover seriously at risk debts, etc.

The credit manager and the sales manager may still have fundamental differences of opinion from time to time in respect of the rights or wrongs of credit facilities for an individual customer. There may be good marketing reasons for trading with a customer, not always in accord with credit best practice as seen by the credit manager. For this reason, an important feature of a credit policy is the establishment of an arbitrator, usually the Managing Director or CEO. When two sides cannot agree, the arbitrator decides and has the final authoritative say. The decision can be accepted by both sides and no blame (or reward) is attached to the consequences. In such circumstances, the policy would require such decisions to be officially recorded.

Considerations when developing a credit policy

The credit policy cannot be produced in isolation, without any reference to outside influences or circumstances. Much has to be taken into account when developing a credit policy, including:

- the seller's strength in the market;
- the capital needed to finance seller's sales;
- the credit terms which the seller gets from his own suppliers;
- the range of customers (types and sizes);
- available net profit margins;
- any special arrangements, including longer terms and/or instalments;
- competitive pressures – i.e. 'what the others are doing';
- the type and nature of the goods supplied – for example, the shorter the life of the goods, the shorter the credit period should be (a buyer may lose interest in paying if the goods or services are long gone);
- the customer's creditworthiness;
- the buyer's own cash cycle – if a buyer is retailing for cash, a seller's terms can be short but if his business process last for a long time, credit may be much longer;
- seasonal sales may be greater at specific times of the year;
- incentives to boost sales may include extra credit facilities; and
- the existence of any security for the credit exposure.

Contents of a credit policy

Credit policy documents can be one-page statements of intent or major volumes in a bound set of corporate guidelines. Whatever the format, **it should ALWAYS be issued by top management** and show a date for review with interim updates as circumstances dictate. Useful contents would be:

- a simple statement of the company's business aims;

- a list of the company's types of customers, and their business sectors;
- the full conditions of sale, as issued to customers;
- the conditions of sale which affect credit management, for example;
 - the range of payment terms;
 - cash discount rules;
 - scope for special terms, prepayments, instalments, extensions, etc
 - penalty interest, and
 - reservation of title;
- bad debt levels and method of reserves or provisions;
- DSO (days sales outstanding) calculation and uses;
- methods of assessing customers, explaining credit ratings and risk codes;
- order referrals and stop list, actions and circulation;
- follow-up methods for various kinds of accounts;
- legal action and use of other third parties to collect;
- use of external services, e.g. credit reference agencies and credit insurance;
- staff responsibilities and authority levels;
- interaction with other departments and their responsibilities to achieve objectives; and
- the arbitration process.

Where the company is engaged in international business, there should be a separate part of the policy document devoted to export processes and policies.

Practical stages in operating a credit policy

The elements of a well-structured approach to credit management include:

- the credit policy;
- objectives;
- procedures; and
- an organisation chart, which clearly indicates authority and responsibility, levels.

It also lays out the financial measurement process from the initial budget to monthly reports of actual results compared to that budget, as follows;

- a credit policy statement, including:
 - the part that credit plays in overall sales and financial objectives, and
 - the responsibilities of various job-holders
- annual and monthly objectives showing:

- criteria (e.g. DSO, overdues, bad debts, etc.), and
 - ratios and percentages:
- annual budgets for monthly debtors and credit department costs;
 - organisation chart to show credit jobs and their connections to other functions;
 - procedures for credit assessment and collections; and
 - credit manager's monthly report showing:
 - debtors results and variance from budget, with reasons, and
 - credit department costs and explanation of variances from budget.

Additional notes

The policy should be adaptable to changes in circumstances, both internal and external. Credit terms remain the heart of the contract between seller and buyer and establish the moment in time when the transaction will be completed. The nature of both business and product dictates that from time to time variations from standard terms will take place – such variations from normal terms are carefully negotiated, documented and enforced.

All business is done on the *seller's* conditions of sale, and the payment terms must be integral to those conditions. As one of the legally binding sales conditions, credit terms, once established, must not be regarded by the buyer as flexible. It is important that the credit terms are clearly stated at the order taking stage and subsequently enforced, just as other contract details are. Standard credit terms are not inviolate at all times, but *agreed* terms are part of the negotiated and enforceable contract.

Monthly, or weekly, reporting illustrates the effectiveness of the credit policy and its adherents. Trade credit terms are invariably expressed in days, so the reporting of outstandings in terms of days is the usual key performance indicator. The credit policy should stipulate how reporting should take place, but it should always incorporate the four key elements of:

- days sales outstanding (DSO);
- overdues as a percentage of total debtors;
- age of overdues within the total overdue; and
- disputed debts.

Summary and conclusion

All companies extending and managing trade credit should establish a credit policy which provides the framework for making consistent and well informed credit and collection decisions which are compatible with the company's strategic objectives and the goals of the credit function. The credit policy is a document that specifies the course of action for

granting credit and recurring credit activities. The credit policy has to be understood by, and communicated to, all relevant parties, particularly credit staff, sales staff and customers.

Credit policies need to be reviewed and monitored on a regular basis to take account of changing market conditions, company strategy, competition, and financial needs. A carefully documented credit policy is a fundamental requirement of sound credit management practice, and should serve at least the following purpose:

- to define the objectives of credit extension in the context of corporate strategy and organisation structure
- to define the authority and responsibilities for credit granting, establishing and varying terms and the timing of collection actions
- to provide documented procedures in relation to the above that can be communicated to all staff
- to specify training policy for credit staff
- to specify performance targets and monitoring activities for credit staff
- to reinforce “one company – one customer” culture throughout the organisation

The credit policy of a company should be developed in accord with the strategic, marketing, financial and organisational context of the business and be designed to contribute to the achievement of corporate objectives. The corporate strategy can include trade credit management not just in terms of its contribution to collection and cash flow but as a means of generating sales and profits, and of investing in customers by building relationships.

The management of trade credit can help build stable and long term relationships with customers, generate information about the customer and their requirements and facilitate different customer strategies in terms of credit granting, credit terms and customer service. The objective is to generate growing but profitable sales.