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ESTABLISHING A CREDIT POLICY

Because the availability of credit has a direct relation to the business's sales and profits, establishment of a credit policy is a central concern in business planning.

A credit policy essentially establishes three criteria:
1. Credit availability - Will credit be freely available or will it be restricted?
2. Credit limits - How much credit will customers be granted?
3. Repayment terms - When is payment required?

Positive Effects of Credit

The availability of credit will directly affect the firm's sales volume. Since credit makes it easier for potential customers to buy goods and services, sales volume will increase.

The availability of credit also builds customer loyalty, because customers tend to return for follow-up purchases. The availability of credit also decreases price resistance, which also adds up more sales and higher profits.

If credit is too freely available, however, too many marginal risks may be accepted. A marginal risk is a credit customer who may not have the ability to repay. Acceptance of too many marginal risks will, in turn depress profits despite the added sales volume.

Management's Role in Setting the Credit Policy

Establishing a credit policy requires management to analyze its market and to design a policy that will enhance the company's operation and profitability. Management should estimate the degree of credit availability that will generate the most sales and profits while minimizing problem accounts.

Marketing Factors - Managers must consider other factors in establishing credit availability. The availability of credit also contributes to a company's marketing efforts. For example, if the company's attraction is based at least in part on exclusivity, the company's credit policy should reflect the marketing decision to aim for the top of the market by reserving credit account only to select customers.

Credit Limits - A company's credit policy should also determine appropriate credit limits. Management must consider not only the ability of individual customers to repay their debts, but also the aggregate of unpaid accounts.

Coordinating with Collections Policy - Finally, the credit policy should also address the company's billing and collection procedures, which affect the timing of cash receipts and the business's ability to pay it's own debts. Businesses should coordinate their billing and collection plans with their credit planning to ensure that income will meet anticipated cash needs.

Why Have a Written Policy?
Although it is possible to operate without a written credit policy, there are distinct advantages to having your policy set down in writing.

There are at least four major advantages of having a written credit policy:
1. Assures consistency in granting credit
2. Provides uniformity of treatment to customers
3. Allows better decisions by having predetermined criteria
4. Speeds decision making

Establishing the Policy
A written credit policy can be long or short. It may provide specific guidance for granting credit and setting limits or it can just state general goals. Any credit policy should, however, address the following eight questions:
1. Who is responsible for deciding who get credit?
2. Who is responsible for establishing credit limits?
3. What factors control the initial decisions to grant credit?
4. What factors determine the customer's credit limit?
5. What are normal payment terms?
6. What are normal interest terms?
7. What discount terms are available?
8. How will delinquent customers be dealt with?

In a smaller company one person-usually the owner or manager with responsibility over financial matters-will determine who gets credit and will also set the credit limit. In larger companies, this responsibility may be divided among several employees.

Who should Get Credit? Tight vs. Loose Credit
Credit policies can be either conservative or liberal. When a company adopt's a conservative credit policy, credit will be extended only to customers who are deemed very likely to repay their debts. At the opposite extreme are company's with liberal credit

policies who extend credit to literally anyone. Obviously, most companies position themselves between these two extremes.

In most cases a liberal credit policy produces greater profits than a conservative policy, depending, of course, on market conditions. The key here is volume. By restricting credit to the most credit worthy only, a company greatly restricts sales volume and profits. The better goal is to increase sales volume so that the profit generated by the volume more than offsets the expected bad debt losses.

Setting Credit Limits

Setting the credit limit is a matter of using professional judgement after weighing the evidence. Normally the decision maker will be looking at the customer's credit application and supporting documents, along with reports furnished by consumer credit bureaus.

Once a business has established a basic credit policy, management must formulate and implement procedures to answer four questions:

1. Which customers will receive credit?
2. How much credit will they receive?
3. When will payment be made?
4. What will be payment terms?

Cash and Trade Discounts

Although the cash discount may look advantageous only to the customer, it actually benefits both parties. The customer obviously gets a good bargain by promptly paying the bill and receiving a price reduction. The company is able to convert the accounts receivable into cash in a short time. This is especially important for small and startup businesses that may have trouble meeting payroll, tax, and loan obligations.

Even if a company has a line of credit with a bank that lets it borrow funds on short notice, a line of credit may not be as efficient in raising cash as the cash discount.

Need to Reevaluate Credit Policies

Once a credit system is in place it must be closely monitored to serve two purposes: first, to observe if the system is functioning efficiently, and second, to determine if the company's credit policy is sound.

On the other hand, a credit policy that has functioned well for years may need to be reevaluated and amended.

A key indicator of the success of the credit policy is the size and age of your accounts receivable. Similarly, both the number and dollar amount of bad debt write-offs are critical in determining if the current credit policy is realistic. Armed with this information managers can carefully evaluate the current credit policy and implement changes that will enhance profitability.

Summary & Prospective

Establishing a credit policy is an essential step in operating a successful credit system. The credit policy will set goals and will suggest strategies and techniques for achieving those goals.

In short, although large and small companies differ in how they manage the credit operation, all companies can benefit from the skillful use of credit and cash discounts to encourage prompt payment. Call us today at (661) 810-2446 or visit us on-line at www.azarandassociates.com