# Credit Policy: Supporting Sales, and Minimizing Delinquency and Bad Debts

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## Considerations for Your Credit Policy

### Goals and Objectives

What are we trying to accomplish? **The credit operation, responsible for the order-to-cash cycle or a large part of it, should have goals and objectives set by management**. Goals are accomplishments to be achieved, e.g., "We will endeavor to provide a method by which every potential customer may be able to purchase our products"; "We will maintain DSO which is better than average for our industry." Objectives are measurable, time-bound achievements that help accomplish stated goals, e.g., "We will have DSO of 40 days by yearend"; "We will reduce bad debt write-offs for the 2019 fiscal year to less than .1% of sales." The credit policy answers the question, "What will we do in our management of credit and A/R to accomplish these goals and objectives?"

The development of a credit policy begins with a clear understanding of the Company and its operations. This means an understanding of corporate goals and objectives, both for larger operations, such as production and sales and for less tangible areas such as public relations. Any statement of policy, including the credit policy, can then be tested with the question: "Will this help us achieve company and department goals and objectives?"

We establish policy to meet the goals and objectives of the company, which are determined before any other actions can be taken. **The credit policy serves as a guide in determining how to handle given kinds of credit and A/R issues . . . it does not offer definitive solutions.**

Credit policy presents a range of solutions within which the credit executive exercises judgment. In the process of decision making, we constantly interpret and apply credit policy to concrete situations with the help of specific guides or procedures, which, along with credit policy, compose the credit operations manual.

### Policy and Practice

In practice, the range of possible decisions provided under a firm's credit policy narrows for particular personnel, situations, or time periods.

Changes in practice within a policy provide flexibility in meeting changing conditions. A company's credit policy should be applicable to the great majority of credit situations over a long period of time.

Exceptions will arise, and these decisions are usually reserved for the head of the department or a credit committee. Such decisions must be consistent with overall company policy and objectives.

### Financial Considerations

1. The amount of capital commitment a company provides for its receivable investment. This concerns protection of the invested capital and the return that it will generate.

2. The type of risks acceptable to the company or the basis on which the company will exchange its products and services for the customer's credit.

### Company and Coordinate Policies

1. The relation of the credit function to the financial management of the company. Will the focus primarily be to protect the company funds invested in customer receivables, or will it endeavor to increase the turnover of these funds and consequently aid in the additional generation of profits through reduction of carrying costs?

2. What will be the relation of credit to the marketing and sales functions of the company?

3. Does the credit policy present a realistic, acceptable basis on which credit decisions can be made in an atmosphere of mature consideration?

### Legal Environment and Restraints

Credit terms are deemed by antitrust laws to be an aspect of price. Terms of sale, cash discounts, and late charges, as aspects of price, fall under the Federal Sherman and Robinson-Patman Acts. The company policy on these matters should specify credit programs "will be applied equally to all like customers or to like groups of customers purchasing like products." The failure to apply equally and consistently to all members of like groups may be interpreted as a form of price discrimination.

Also, there can be no agreement between competitors with respect to price, discount terms, and other credit programs offered to customers as such would be a violation of the Sherman Act.

### Industry Characteristics
Relative to conditions within the industry, the company's long-range ability to compete must be evaluated. Factors include its present position in the industry, financial strength, the strength of its marketing organization, and its position in product development. Most companies find it necessary to establish credit policies with one eye on the competition.

### Geographical Considerations
Widely separated markets may require modifications in credit analysis and in collection efforts.

### Market Position of the Company
The relative standing of a company will influence the course of action it sets to meet credit problems. If its position is undisputed, a company may demand more from its customers. A start-up company, on the other hand, may find it advantageous to be more lenient in its credit policy.

### Types of Merchandise or Services
This factor always affects the credit policy of the seller. If merchandise can be repossessed in good condition, without substantial loss of value, there is a tendency to sell on a more liberal basis.

### Type of Customer
Where the buyers' line of business is characteristically short of capital, the credit policy necessarily cannot be unduly restrictive and stay competitive

If an industry has many well-established customers, the company that takes additional risk must expect additional return for this added risk.

With credit risks available to provide adequate and reliable profits, there may be added incentive to make sales to fair or marginal risks.

### Financial Strength of the Company
Underfinanced companies usually need every dollar to assure themselves sufficient operating funds. Therefore, such a company might prefer to establish a more restrictive credit policy. However, the capital restriction may include a poor market position, and the company may be unable to insist on prompt payments. With fewer accounts, it cannot afford to turn away business.

A very large or very profitable company can afford to divert a portion of its funds to carrying customer receivables. Such a company may operate with a more liberal credit policy. At the same time, sometimes the company that can afford to carry overdue accounts may be more selective in its choice of credit customers.

### Economic Trends
When times are prosperous, the ability of debtors to pay timely their bills may be improved; however, there is a potential danger a customer may tend to overbuy. During slower business periods, debtors tend to delay payment of their bills, especially unsecured trade creditor billings, and credit requirements tend to tighten. As sales slide, selling companies tend to implement a more demanding selection of credit customers.

Consistency is important to avoid confusion on the part of customers. A sound credit policy requires enough flexibility to be compatible with the fluctuations of the economy but at the same time provide sufficient structure to avoid confusing Sales, customers, and prospects.

## Contents of Credit Policy

A credit policy should address at least the following matters:

1. **Credit information requirements**. What documents are required and who's responsible for acquiring them.

2. **Risk evaluation**. Confirming the prospect's/customer's credit history and, as required, financial well-being.

3. **Establishment of a credit limit/credit line**. Trade creditors often provide open account privileges.

4. **Terms of sale**. Credit terms should be clearly stated and enforced.

5. **Deductions and prompt resolution**. Deductions may significantly impact profitability and should be promptly addressed and resolved.

6. **Collections**. When an account becomes delinquent, what activities are pursued to collect the debt?

7. **Credit authority**. What party has authority to make decisions about credit limits and collection activities?

8. **Communication with Sales**. Keeping Sales informed is a crucial responsibility of the credit operation.

## Advantages of a Written Policy

**All companies have a credit policy**. A written one has the following advantages:

1. **Your customers know your credit policy**. Writing it down reinforces its application in a variety of situations and provides consistency in dealing with customers

2. When we write it down, we usually are **more thoughtful and deliberate**.

3. A written policy provides a **source of stability and continuity** to the operation, for the credit department, Sales, and the company as a whole.

4. Consistent decisions provide **greater reliability and profitability**.

5. A clearly stated credit policy provides a **valuable training aid** for credit and sales personnel.

## Communication of the Credit Policy

The policy should be issued by senior management, and all affected departments should be made aware of the policy. Sales representatives should be informed about what to expect in enforcement of the policy and how it may affect their responsibilities. Also, they should know what customer information will be required for prospects and for periodic reviews of existing customers.

## Customers

A credit decision based on a new application or the placement of the first order provides the ideal opportunity to provide and discuss with the new customer your company's credit policy. This starts the relationship on solid footing, demonstrates that Sales and Credit work closely together, and makes it much easier to refer to terms and policies should a future misunderstanding arise.

## Assigning Responsibility

Credit policy establishes broad limits for decisions over time. To make these limits a workable guide to decision-making, it is necessary to specify who has the authority to make specific types of decisions.

## Factors Influencing Short-term Policy Application

The short-term application of policy can be quite flexible. The firm can and should adjust procedures to meet changing conditions.

A company's current financial position may influence short-term application of policy. For example, limited operating (working) capital may require emphasis on turnover of accounts receivable and prompt collections.

Business conditions affecting the areas or industries in which the company operates also are major factors in policy application. (Note: business conditions *within a given industry* affect the interpretation of credit policy. Not all segments of the economy change at the same rate or in the same direction.)

Changes in the general level of prosperity affect the company and the credit department. The same credit policy would be in effect during all phases of the cycle, but its application may be modified.

## Review of the Credit Policy

The credit policy and its application should be reviewed periodically – at least annually. Timing depends on such factors as the difficulty of reaching objectives and changes in the competitive situation. The policy and its application are evaluated in terms of their effectiveness in reaching company-designated objectives.

## Types of Credit Policies

A credit policy has two distinct components: analysis of risk and degree of collection effort. In defining these components of a credit policy, the company has to answer the following questions. How much risk is the firm willing to take in granting credit to its customers? How much money and effort will the company invest to collect amounts owed to it? How will it treat past-due accounts? Will unearned discounts be permitted? Will the company charge late fees?

These questions can generate many different answers, depending on the company and the industry. As a result, credit and collection policies may be substantially different from company to company.

Here are the quadrants of the what's often referred to as **the Credit Matrix**:

1. **Strict analysis of risk and strict collections**
   With this type of policy, the analysis of risk will be thorough, and only highly-rated accounts will be accepted. Very little variation from terms will be allowed. Collection efforts may require a larger staff, and the selling effort may be restricted. The approach may pay sizable dividends in improved accounts receivable turnover and minimal bad debt losses. At the same time, the approach may restrict sales opportunities and impact competitiveness.

2. **Strict analysis of risk and liberal collections**
   This type of policy concentrates on the selection of good credit risks but will be more liberal in its

collection procedures. It does involve aggressive payment demands. This type of policy may lead to turnover problems, resulting in higher carrying costs, especially if orders involve substantial amounts. This approach focuses on relationships and long-term customers.

3. **Liberal analysis of risk and vigorous collection effort**
This policy emphasizes sales and collections. With liberal credit review, nearly every prospect will be accepted. Collections will be emphasized. This type of policy may be followed in selling high markup, low unit priced goods. This approach has low credit review costs, but collection costs may be very high. Also, depending on the market, this approach may tend to have higher customer turnover.

4. **Liberal analysis of risk and liberal collections**
This policy aims to maximize sales volume; however, the costs of bad debts and of carrying receivables for long periods of time offset the profits. Profit margins must be set so high that the bad debt losses are balanced effectively. This tends to be a short-term approach, and we sometimes see this in a transient company that's building sales with the intent of selling the company in the near term.

## Credit Policies—Some Examples

This policy was written for a small company with a one-person credit department and very specific needs. Note the minimum order level for credit checking and special terms of sale for onetime or bulk orders.

**SAMPLE CREDIT POLICY #1** **[written for a smaller company, one person responsible for credit and receivables , ~$3mm in Sales, formerly without a written policy]**

1. New customers placing orders with a value exceeding $300 will have a credit check performed and credit approval prior to shipment.

2. All customer accounts will have a set credit limit. Purchases which exceed the established credit limit or which will result in the account balance exceeding the limit will have approval of the credit manager before shipment.

3. Terms of sale:
   a. The standard terms of sale are Net 10 EOM. The company will issue a statement on the last day of each month, which summarizes the purchases during the previous month. The balance is due and payable on the 10th of the month. For example, purchases during the month of June are summarized on a statement as of June 30 and are due on July 10.

   b. Special terms of sale for office setups and other onetime bulk sales of more than $3,000 may be granted terms of 1/3 10 EOM, 1/3 10 EOSM, and 1/3 10 EOTM, i.e., one-third due on the tenth of the first month, one-third due on the tenth of the second month, and one-third due on the tenth of the third month. Special terms will be pre-approved by the credit manager.

4. Accounts sixty (60) days or more past due will be placed on credit hold. Additional shipments will have the approval of the credit manager or will be shipped only on a CWO or COD basis.

5. The credit manager has the responsibility for all credit and collection functions. The credit manager will keep the sales department informed of all actions involving customers.

**SAMPLE CREDIT POLICY #2** **[written for a mid-sized company, ten people working in Credit and A/R, $150mm+ in Sales]**

The credit department shall function under the supervision of the Director of Credit, who shall report Chief Financial Officer of the Company.

Credit Department activities shall be coordinated with overall Company policy and the activities of the Sales Department and other departments participating in the order-to-cash cycle.

The Credit Department shall be responsible to help build a broad and durable customer relationship for the Company. In the performance of this responsibility, the Credit Department shall maintain a positive and constructive attitude toward the Company's customers. Discrimination in customer relationships is to be avoided. The Credit and Sales Departments shall maintain a cooperative attitude, with an aim to promote sales and the customer relationship.

Within the bounds of sound credit practices, the Credit Department shall endeavor to find a suitable credit basis on which to deal with every customer the Sales Department desires to have purchase our products. The decision as to what constitutes a suitable credit basis shall rest with the Credit Department. From the standpoint of Credit, no customer shall be denied the right to purchase our products until every means of selling that customer on a safe and sound basis has been exhausted.

Standards by which credit risks are accepted or rejected shall be flexible enough to permit the maximum of profitable sales by the Company. Marginal credit risks are to be dealt with when they are needed to complete operating schedules, provided they constitute a source of added net profit to the Company.

Customer contacts are to be kept on a dignified and friendly basis, conducted so as to promote a wholesome respect for the Company, its business practices, and its relationship with its customers.

Credit Department practices shall be designed to permit the maximum number of orders to flow without interruption through the Sales Department. At the same time, these practices will provide for interception when necessary as a means of safeguarding credit extensions.

The Credit Department shall keep the Sales Department fully informed regarding the status of a customer's account when the free flow of orders from that customer is in jeopardy.

The Credit Department has the responsibility for collection of all accounts. Sales Department advice or direct assistance may be sought in exceptional cases. All credit decisions shall be made independently and shall strive to maximize return on investment in receivables while achieving the lowest possible days sales outstanding and bad debt loss.

*cf Credit Executives Handbook, Christie & Bracuti (1986)*