CHAPTER 5

INTRODUCTION TO CREDIT ASSESSMENT

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CHAPTER 5

INTRODUCTION TO CREDIT ASSESSMENT

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ❑ *list and discuss the three steps in the process of credit assessment*
- ❑ *discuss the collection of information in detail*
- ❑ *list and discuss the various sources from which information is obtained*
- ❑ *discuss the analysis of information with a view to decision-making*
- ❑ *list and explain the "seven C's" of credit*
- ❑ *discuss how a decision about granting credit is made*
- ❑ *discuss the meaning of a credit limit and the way in which it is determined and revised*
- ❑ *give a summary of the procedure of granting credit with practical examples*

5.1 INTRODUCTION

Before an enterprise grants credit to a person or another enterprise, it must first determine whether that person or enterprise's credit is acceptable. Sellers **assess** the **creditworthiness** of the buyer and base their decision to accept the buyer's credit on this. In chapter 3 we saw that assessing creditworthiness is one of the tasks of credit management. The credit department of the enterprise must decide whether it is willing to accept the risk of selling on credit to a certain person or enterprise. In the same way a financial institution must decide whether the creditworthiness of a person or enterprise is good enough for it to grant a loan or issue a credit card.

NOTE:
When we refer to the assessment of a person's or enterprise's creditworthiness, it can mean one of two types of assessment:

- ❑ *The **assessment of a new customer**, that is a person or enterprise applying for credit at the enterprise for the first time*
- ❑ *The **assessment of an existing customer**, that is a person or enterprise that is already buying on credit from the enterprise or that already has credit facilities at a financial institution*

Generally, the credit limits of existing customers are revised regularly, usually once a year (especially in the case of financial institutions). The customer can also ask for the credit limit to be increased. In both cases the customer's creditworthiness must be reassessed.

If the credit applicants (the people or enterprises applying for credit) are not assessed effectively, it will be difficult for the credit department to make a positive contribution to maximising profitability. Poor credit assessments result in great losses for the enterprise and have negative effects on the profit of the enterprise, for example by causing bad debts and a loss of income from interest. On the other hand, good credit assessments will result in a smaller number of bad debts and fewer overdue accounts.

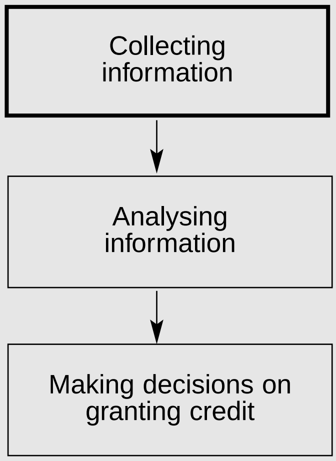
The purpose of this chapter is to provide an introduction to credit assessment. In assessing the creditworthiness of individuals, an enterprise may follow a different approach to the one it uses for assessing the creditworthiness of other enterprises. Financial institutions also have their own approach and their credit assessment is very strict, precisely because their income depends on the granting of credit (income from interest on the money that they lend). However, the ultimate aim of all the different approaches is to determine whether the credit offered by a person or enterprise is acceptable. We will give an overview of the reasons for doing a credit assessment and of exactly what is taken into account during such an assessment. We will see where the enterprise can obtain this information and how it will go about analysing the information. After the information has been analysed, a decision must be made about granting credit. We will investigate what this decision involves and how the enterprise will determine the credit limit of an applicant.

5.2 COLLECTING INFORMATION FOR CREDIT ASSESSMENT

The first step in assessing the creditworthiness of a person or enterprise is to collect **credit information** and **other information** about the person or enterprise. The next step is to analyse this information and then make a decision based on the result of the analysis.

CREDIT ASSESSMENT

- ❑ ***Collect credit information and other information***
- ❑ *Analyse the information*
- ❑ *Make a decision on granting credit*



Negative factors:
Insufficient information
Wrong interpretation
False
Out of date

Because the enterprise attempts to make decisions on granting credit as effectively as possible, it is **very important** to have **sufficient information** about the credit applicant. Insufficient information can result in poor decisions on granting credit, which will have negative results. The following factors can have a negative effect on credit decisions:

- ❑ **Insufficient information**. This means that important information was not available when it was decided whether to grant credit. For example, the applicant may not have given trade references, or may have given only the best references. It may also happen that the applicant does not fill in all the details on the application form and the credit department accepts this incomplete form. The applicant may also not know how to fill in the application form and for this reason may not give all the information requested.

- ❑ **Information is interpreted incorrectly**. The information is assessed from the viewpoint of the credit assessor, and it is possible for him or her to make incorrect conclusions. For example, if the applicant is a medical doctor, lives in a wealthy neighbourhood and drives an expensive German car, it is often taken for granted that he or she is creditworthy. This is not necessarily the case.

- **False information**. The applicant gives information that is misleading, or fails to give information that may cause the application to be rejected. For example, the person may not give the correct number of dependants, may give false information about his or her employer, or may give a false identity number.

- **Out-of-date information**. Sometimes the information on which credit decisions are based may change. In the case of trade credit, for example, the income potential (the ability to make a profit) of an enterprise may decline badly in a short time (for example, because of competition and other new products in the market). In such a case the granting of credit to this enterprise will have to be reconsidered. If the seller does not have the most recent information, it may result in poor credit decisions.

There is a large **variety of sources** from which the credit department can obtain information. We can divide these sources into the following groups:

- Information that the enterprise already has available
- Information that the enterprise has to obtain from external sources

- **Information that the enterprise already has available**

The enterprise already has some information that can be used when the creditworthiness of a credit applicant is assessed.

Examples of this are the following:

- *Information on the credit application form or order form (in the case of trade credit)*
- *Information from a credit interview. This is information that the enterprise obtains by personally interviewing the applicant. In the case of financial credit, for example, the bank interviews the person or enterprise first to determine, among other things, why the money is needed, how it will be repaid and what the obligation of the borrower will be towards the bank. In many cases the application form is filled in by the bank itself - the applicant gives the information to the interviewer during the interview*
- *Information provided by the sales staff*
- *Information known to the credit department staff (their own knowledge). This could be records of the enterprise. In the case of a financial institution, for example, the applicant may have had a loan before and repaid it in full*
- *Information that the credit department obtains from, for example, business newspapers and financial journals, such as financial statements and information about the successes or failures of the enterprise applying for credit*

Let us look more closely at a few of these examples.

❑ **Information on the credit application form/order form.**

Application Form

Tell us about yourself

TITLE (Mr, Mrs, Miss)
FIRST NAME
SURNAME
FULL RESIDENTIAL ADDRESS
CODE
HOW LONG HAVE YOU LIVED AT THIS ADDRESS? YEARS MONTHS
FULL POSTAL ADDRESS
CODE
HOME TELEPHONE NUMBER CODE No.
BUSINESS TELEPHONE NUMBER CODE No.
WHERE YOU NOW LIVE, ARE YOU OWNER TENANT LODGER LIVING WITH PARENTS
DATE OF BIRTH Y Y M M D D SEX: FEMALE MALE
IDENTITY OR PASSPORT NUMBER
NATIONALITY
MARITAL STATUS SINGLE MARRIED DIVORCED WIDOWED
MARITAL CONTRACT COMMUNITY OF PROPERTY ANTENUPTIAL CONTRACT OTHER
IF OTHER PLEASE SPECIFY
SPOUSE'S FIRST NAMES
NUMBER OF DEPENDANT CHILDREN
IF YOU ARE MARRIED, DO YOU REQUIRE YOUR SPOUSES ASSISTANCE IN ENTERING INTO THIS CONTRACT?

Kindly give us the details of a friend or relative not living with you.

TITLE (Mr, Mrs, Miss)
INITIALS
SURNAME
FULL RESIDENTIAL ADDRESS
CODE
TELEPHONE NUMBER CODE No.

Bank details

PLEASE INDICATE YOUR BANK ACCOUNT CURRENT SAVINGS BUILDING SOCIETY
BANK
BRANCH
ACCOUNT NUMBER
DO YOU HAVE A CREDIT CARD? NO VISA AMEX DINERS MASTER
YOUR CARD NUMBER

Kindly give us two credit references

IF YOU HAVE ANY ACCOUNTS WITH OTHER STORES OR HP FINANCE, PLEASE GIVE US MORE DETAILS

COMPANY
BRANCH NAME
TELEPHONE NUMBER CODE No.
ACCOUNT NUMBER
BALANCE R

COMPANY
BRANCH NAME
TELEPHONE NUMBER CODE No.
ACCOUNT NUMBER
BALANCE R

Where do you work?

IF YOU ARE A HOUSEWIFE PLEASE GIVE US YOUR HUSBAND'S DETAILS OR IF YOU ARE UNDER 21, YOUR PARENT'S DETAILS.
IF YOU ARE A PENSIONER, INSERT DETAILS BELOW OF YOUR PENSION.

EMPLOYER
BRANCH NAME
TELEPHONE NUMBER CODE No.
OCCUPATION
BALANCE R NUMBER OF YEARS AT PRESENT EMPLOYER? Yrs.

WOULD YOU LIKE TO PAY BY DEBIR ORDER? YES NO
IF YES, PLEASE STATE BANK ACCOUNT No.
BANK NAME
BRANCH
BRANCH CODE
TYPE OF ACCOUNT CHEQUE TRANSMISSION SAVINGS
DO YOU WISH TO PAY THE: FULL BALANCE INSTALMENT ONLY
APPLICANT'S SIGNATURE

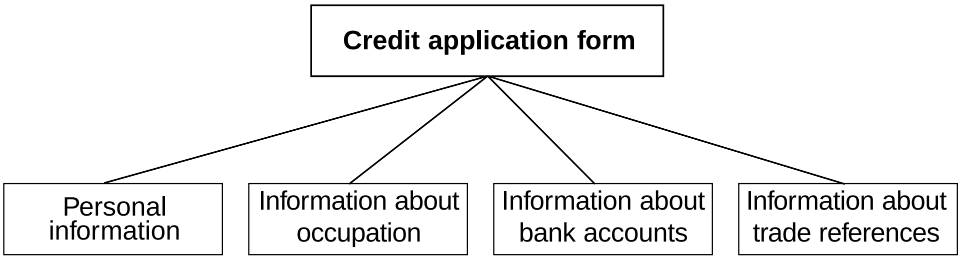
BEFORE YOU SIGN PLEASE READ THE DECLARATION OVERLEAF.
I CONFIRM THAT I HAVE READ THE DECLARATION OVERLEAF AND AGREE TO ABIDE BY THE CONDITIONS CONTAINED THEREIN

APPLICANT'S SIGNATURE
LEGAL GUARDIAN'S SIGNATURE IF APPLICANT IS UNDER 21
LEGAL GUARDIAN'S FULL NAMES
SIGNED ON THIS DAY Y Y M M D D

FOR OFFICE USE ONLY

PLASTIC NUMBER

The credit application form or order form is a primary source of information. The applicant provides information on various aspects:



i) **Personal information**

This is information such as the applicant's title (e.g. Mr, Ms or Dr), full name and surname, date of birth, identity number, marital status (married, single, divorced, widow/widower), number of dependants (number of children and adults that the person has to take care of), home and postal address, telephone numbers (home and work), and the name and address of a family member or friend who does not live at the same address.

The applicant's full name and identity number must be obtained because this ensures proper identification. The information must be one hundred per cent correct. This ensures that the right person's creditworthiness is assessed and that the account statement is given or sent to the correct person. It is essential that the **enterprise must be certain** to whom it is granting credit, in other words to whom it is lending money!

The Johannesburg telephone directory lists many people with the surname "Mann". Many of these people also have the same initials. With the help of the identity number the enterprise can ensure that it is working with the correct person.

A person's age is important in the conclusion of a contract. When a contract is concluded with a minor (a person younger than 21 years), a parent or guardian must assist the minor.

Information about the income and number of dependants is also important. It gives the credit assessor an indication of the extent to which a person's income is already "fixed". A person with a monthly income of R2 000 and six dependants have more expenses that are already "fixed" than a person with the same income but only one dependant.

Without complete information about the applicant's home and postal address and postal codes problems could arise when tracing debtors. It is also important that correspondence should reach the correct destination. Information about a previous address and how long the person stayed at this address is also of importance. A person who moves very often and thus regularly changes address will probably continue to move frequently in future - especially if he or she only rents a property or flat and does not own it. In many cases the address is also an indication of the applicant's lifestyle (and income). It is thus important to know whether a person owns property or is renting it.

Information about a friend or family member of the applicant enables the enterprise to contact someone if the debtor cannot be traced. The enterprise can contact the person to find out where it can reach the debtor or where he or she is.

ii) **Information about occupation**

This type of information refers to information about the person's work history and his or her present job. This includes the name, address and telephone number of the applicant's present employer, how long the person has been employed in the post concerned and the nature of the post (manager, supervisor or worker). The period that the person has been with the same employer can be an indication of stability. However, a short period is not necessarily negative - a person who changes jobs every now and again might also have a very successful career. On the other hand, a person who has been working for one employer for a very long time might have a poor payment record.

Information about the person's salary is important. How often does the person get paid? Is the payment, for example, a fixed monthly income, a seasonal income or an income based on commission? If income varies, it will affect the ability of the person to pay. The person may not be able to pay regularly and on time. The income of an applicant is also an indication of how high the credit limit can be, because it indicates what his or her disposable income is (the income that the person has left after all his or her necessary payments have been made). Information about disposable income is especially important when a person applies for a loan at a financial institution.

iii) **Information about bank accounts**

This is the information that a person provides about a cheque, savings or transmission account. In the case of a cheque account, information must be given about the credit limit allowed for the account (for example an overdraft facility of R5 000). The person must generally also indicate on the application form whether he or she has a credit card, and what the outstanding balance as well as the credit limit on the card is. Personal loans, instalment agreements, lease agreements, and home loans must also be mentioned on the application form. Statements (accounts or contracts) must be attached to provide proof of these obligations (especially where the applicant applies for financial credit).

iv) **Information about trade references**

Here information is given about accounts that the person has with other enterprises, such as clothing or pharmacy accounts. The enterprise can contact these references for more information about the person and the way in which he or she manages the account.

It is very important that the credit applicant must sign the application form after it has been completed, in other words after all the information set out above has been provided.

NOTE:
In the case of trade credit the enterprise granting credit requires the same type of information. The location, address, telephone numbers and owner(s) of the enterprise are important. As in the case of consumer and financial credit, these details and some additional information, such as the names of enterprises that the applicant buys from, are also needed.

i) Use the theoretical guidelines we provided in this section to design an application form for an enterprise selling clothing to final consumers.

ii) Why, in your opinion, must an enterprise collect information about the income of the credit applicant?

iii) Why do you think enterprises want to know what a credit applicant's marital status is?

- **Information provided by the sales staff**

Reasons:
Contact
Have idea
Identify problems
Exchange information

In the case of trade credit the sales staff of the enterprise can provide the credit department with valuable information. Let us look at the reasons for this:

- The sales staff have direct contact with the customers
- They have an idea of how effectively the applicant's enterprise is managed, and they know the location of the enterprise and which other enterprises trade with the applicant
- The sales staff are in a good position to identify problems at the enterprise, for example strikes and management problems
- Sales staff have contact with each other and exchange information

Type of information:
Address, tel.
Image
Nature of product/ service
Location
Local conditions
Other enterprises

The type of information that the sales staff can obtain includes information on the following:

- The address, telephone numbers and owners/managers of the enterprise
- The image and reputation of the enterprise (whether the enterprise's management follows sound business principles)
- The nature of the enterprise and the products or services that it manufactures or sells
- The location of the enterprise, in other words where it is situated (is it close to the market or in a quiet area?)
- The local conditions - the enterprise's competitive position and the demand for its products
- Other products sold by the enterprise - from which other enterprises does this enterprise buy? (What are the products of their competitors?)

Why, in your opinion, do sales staff not always want to collect information for the credit department?

- *Sales staff feel it is* ***not part of their work*** *to collect information*
- *They feel that they can* ***spend the time*** *used for collecting credit information* ***better*** *- for example by selling more and earning more commission*
- *Sales staff are* ***not necessarily good or trustworthy credit reporters***
- *Credit assessment requires complete details of the credit applicant's business, and this does not necessarily fall within the sales staff's field of expertise*

- **Information that the credit department can obtain from, for example, business newspapers and financial journals**

The annual reports and financial results of enterprises, specifically companies, are published in financial journals. The annual reports are also available at the company and are sent to all shareholders. Information about the financial results of smaller enterprises (that are not necessarily listed on the stock exchange) also appears regularly in these journals. In the case of trade credit the enterprise can request a company to provide information about, among other things, the markets, shareholders, types of products and sales figures. The financial statements (which form part of the annual report) are also available for the purpose of analysis.

- **Information that the enterprise obtains from external sources**

External sources of information are sources outside of the enterprise from which information can be obtained. Examples of such external sources are the following:

- Trade references
- Credit bureaus
- Commercial banks
- Employers
- Deeds office

- **Trade references**

We have already briefly referred to trade and bank references. Remember that the enterprise has no other information than that which the credit applicant fills in on the application form or order form. Unless the enterprise further investigates the matter itself, it only has information about the applicants' other accounts and their bank transactions. However, the information on the application form about, for example, trade references gives the enterprise the **opportunity to obtain further information**. The enterprise can now contact the trade references and obtain additional information. The type of information it can obtain is, for instance, details about the way in which a debtor manages an account. The trade references can indicate whether the debtor is a good account, a poor account or a slow account. The date on which the account was opened can also be given.

In the case of trade credit, the information that the enterprise obtains through trade references (or credit exchange services, as they are known in practice) plays an important role. Enterprises provide information to each other about other enterprises. The **type of information** made available includes the following:

Type of information: Last date Highest amount outstanding Current amount outstanding Payment pattern Credit Terms

- The last date of purchase and how long the customer has had the account
- The highest amount of credit that has been outstanding or due
- The current outstanding amount
- The customer's payment pattern
- Any specified credit terms (for example stricter credit terms, or a deposit payable with purchases)

The enterprise can obtain this information in various ways, for example through direct exchange (direct contact between enterprises), or trade group exchange (when enterprises in the same industry or market meet to exchange information).

- **Credit bureaus**

A credit bureau **collects** information, **stores** it and **sells** it to enterprises. The credit bureau provides information about the credit history of people or enterprises. The enterprise can contact the credit bureau to find out if the applicant concerned is part of a group of good credit risks (the largest group) or of the group that does not pay accounts regularly or on time.

The information available at the credit bureau is stored on computer. It can be provided immediately. The information is obtained from enterprises selling on credit. If a person's account has been handed to a collection attorney, for example, or if he or she has been convicted in court for unpaid debts, this information is stored on file at the credit bureau. Many enterprises selling on credit are linked directly with the credit bureau (by way of a computer system). This means that the enterprise does not have to wait for information from this source, but that it is immediately available when there is an enquiry.

EXAMPLES OF CREDIT BUREAUS

- ❑ *Information Trust Corporation*
- ❑ *Kreditinform*
- ❑ *Common Bank Credit Bureau*
- ❑ *Credit Guarantee*

NOTE:
The credit bureau does not provide only negative information. In 80% of the cases where enquiries are made with credit bureaus, the information provided is ***positive****. This means that, when an enterprise contacts a credit bureau about a credit applicant, positive information about the applicant is also given - in fact, there may be no negative information whatsoever about the applicant on record.*

❑ **Commercial banks**

When a person or enterprise applies for a **loan at a financial institution**, information about the applicant contained in a bank report may be provided by the applicant's commercial bank. The information is provided with the help of a bank code classification. The following bank codes are used:

- ❑ A: Undoubted for enquiry
- ❑ B: Good for amount quoted
- ❑ C: Good for amount quoted if strictly by way of business
- ❑ D: A fair trade risk
- ❑ E: Figures considered too high
- ❑ F: Financial position unknown
- ❑ G: Paper dishonoured occasionally
- ❑ H: Paper frequently dishonoured

The bank can also draw up a general, complete report with balance sheet figures and details about properties and mortgages that the person or enterprise has with the bank.

An example of a bank report is shown on the next page:

Bankverslag
Bank report

Vertroulik
Confidential

A B C BANK

Aan/To: **ABC BANK**

Van/From: ____________ Bank

____________ Tak/Branch ____________ Tak/Branch ____________ 19 ______

Hiermee inligting na aanleiding van u navraag of ondergenoemde goed geag word vir
Herewith information in reply to your enquiry as to whether the undermeNtioned can be considered good for R____________
in een bedrag/versprei oor ____________ dae/maande/jaar vir handelsdoeleindes.
in one amount /spread over ____________ days/months/years in the normal way of business.

Let wel: Dit is 'n ooreenkoms dat die verslag vertroulik en sonder enige verantwoordelikheid hoegenaamd vir die Bank, sy beamptes of meedelers aan my/ons gegee word. Ongeag van die rede wat verstrek word het die verslagdoende Bank/Tak geen verantwoordelikheid om die papier van die onderwerp van die verslag te honereer nie.

Note: It is understand that the report will be given by me/us in confidence and without any responsibility whatsoever on the part of the Bank, its officials or intermants. Irrespective of the code given there is no responsibility on the part of the reporting bank/branch to honour the paper of the subject on whom the report is given.

Naam/Name	
Beroep/Occupation	
Adres/Address	
Bank/Bankers	

Merk X teenoor betrokke klassifikasie / Mark X against applicable classification

☐	A	Ontwyfelbaar vir navraag Undoubted for enquiry	☐	E	Syfers word te hoog geag Figures considered too high
☐	B	Goed vir die bedrag genoem Good for amount quoted	☐	F	Finansiële posisie onbekend Financial position unknown
☐	C	Goed vir die bedrag streng in loop van sake Good for amount quoted if strictly by way of business	☐	G	Stukke word af en toe gedishonoreer Paper dishonoured occasionally
☐	D	'n Redelike besigheidsrisiko A fair trade risk	☐	H	Stukke dikwels gedishonoreer Paper frequently dishonoured

Bestuurder/Manager: ____________ Antwoord/Reply: ____________ ____________ 19 ______

Bankverslag
Bank report

Vertroulik
Confidential

A B C BANK

Van/From: **ABC BANK**

Aan/To: ____________ Bank

____________ Tak/Branch ____________ Tak/Branch ____________ 19 ______

Geliewe op die afskrif hiervan aan ons 'n volledige algemene verslag te verstrek (met/sonder balansstaatsyfers en besonderhede
Kindly furnish us on the copy hereof with a full general report (with/without balance sheet figures and details of property and
van eiendomme en verbande TOV ondergenoemde en of die party goed geag word vir
bonds) on the names appearing below stating whether considered good for R ____________

in een bedrag / versprei oor ________ dae/maande/jaar. In one amount/spread over ________ days/months/years

☐ As waarborggewer / As guarantor ☐ As party tot akkomodasie wissel(s) / As a party to accomodation bill(s) ☐ In gewone loop van sake / In the normal way of business

Naam/Name	
Beroep/Occupation	
Adres/Address	
Bank/Bankers	

Bestuurder/Manager: ____________

❑ Employers

In the case of consumer credit specifically, the enterprise can verify (check or confirm) the information that the applicant gave on the application form about employment (occupation, employer and income). It can be determined if the person is **indeed employed** by the enterprise concerned.

❑ **Deeds office**

The enterprise can enquire at the deeds office if the applicant does own the **property** indicated on the application form. The deeds office can also inform the enterprise if a mortgage is registered on the property (whether the applicant did borrow money to pay off the property), how large the mortgage is and in whose favour it was registered.

Sam applies for a clothing account at ABC Shoes.

i) *Give practical examples of the information that the credit department of ABC Shoes can obtain from the following external sources:*

❑ *The trade references Sam gave:*

___

___

❑ *Sam's employer:*

___

___

❑ *Kreditinform:*

___

___

ii) *Why, do you think, does ABC Shoes need this information?*

___

___

___

___

The **choice of information sources** is influenced by:

❑ the information that the enterprise already has available
❑ the type of information needed
❑ knowledge of the various sources available

- ❑ the accuracy of the information that the enterprise has available
- ❑ how detailed the information is
- ❑ the speed with which the information can be obtained
- ❑ the cost of obtaining the information

The **extent (number) of information sources** that the enterprise consults will largely depend on how detailed the information is that the applicant provided. In the case of trade credit it can also depend on the extent of the business the enterprise expects to do with the applicant. For example, is it a single purchase on credit, or could a long-term relationship develop between the seller and the buyer? Another important factor to keep in mind is the cost of obtaining the information. After all, the credit department cannot pay R200 to obtain information if the applicant wants to buy on credit for R50 only.

Let us summarise this section:

- ❑ The enterprise needs information to make decisions
- ❑ The enterprise has to verify or check the information it already has to find out if it is correct

- ❑ *The home telephone number given by the applicant can be verified with the Post Office to find out if it does belong to the person concerned*
- ❑ *The telephone number that was given for a family member or friend can also be verified*
- ❑ *The enterprise can determine if the person is indeed employed by the enterprise or institution indicated on the application form*

By verifying this information, the enterprise eliminates the possibility of fraud and can identify false information before it makes a decision about granting credit.

- ❑ The enterprise must obtain the information that it needs but does not have.

- ❑ *Contact the credit bureau*
- ❑ *Contact the trade references*

5.3 THE CREDIT STANDARD

The reason why the enterprise collects all this information is to obtain a **profile** ("picture") of the person or enterprise applying for credit. When all the information is put together, what is the picture that the seller gets of the potential buyer? Does this picture correspond to the risk that the enterprise is willing to accept? The information in itself does not mean much - the enterprise has to **analyse** and **assess** it. Only then can it make a decision about granting credit. The information is used to draw conclusions about the creditworthiness of the person or enterprise. For example, if a person constantly fails to pay his or her other accounts on time, the enterprise can conclude that there is a good chance that the person will also be late in paying the enterprise's accounts.

However, it is important that the information about a person or enterprise must be assessed according to **specific norms (guidelines)**. The credit department must have guidelines that it can use to decide whether a credit risk is good or poor. The **credit standard** gives the enterprise these guidelines. With the help of the credit standard the enterprise can assess its information and decide if the applicant concerned meets the requirements to be granted credit.

*When creditworthiness is assessed according to these norms, the credit assessor must still use common sense. **Common sense** cannot be completely disregarded.*

The credit standard is the **minimum requirements** that the person or enterprise must meet to qualify for credit. It gives an indication of the **credit risk** that the enterprise is willing to accept.

The credit risk refers to the possibility that a debtor will take a long time to pay an account, or will not pay the account at all. With a good credit risk, the possibility of late payment or non-payment is smaller than in the case of a poor credit risk.

The enterprise can use various ways to limit the risk of credit sales. These include the following:

- ❑ **Increase the profit margin** of the enterprise to provide for possible bad debts (with a higher profit the enterprise can cover the losses caused by bad debts)

Limit risk:
Increase profit margin
Reserve
Insurance
Deposit
Follow-up system
Bills of exchange
Low credit limit
Short credit period

- ❑ Provide for bad debts by budgeting a certain amount for it - in this way a **reserve** for bad debts is created
- ❑ **Credit insurance**
- ❑ In the case of durable goods especially, the enterprise can request a **deposit** when a new account is opened - the larger the deposit, the smaller the possibility that the customer will fail to pay the account. In the case of trade credit, the enterprise can also request a deposit with the first order, especially if the customer has applied for a large credit amount (even if the account must be paid within 30 days)
- ❑ Implement an **effective follow-up system** if the customer does not pay before or on the date of payment (this reduces the risk of late payments and bad debts)
- ❑ Use **bills of exchange** as a means of payment - the enterprise draws a bill of exchange on the debtor, which the debtor has to sign
- ❑ Grant **lower credit limits**
- ❑ **Reduce the credit period** (for example, reduce the credit period from 12 months to 6 months)

The enterprise must give a great deal of consideration to its **decisions about the credit standard**. If it has a very strict credit standard, its sales could decline and the income from sales could therefore also be low. The enterprise can lose customers because they might go to other enterprises that do accept their creditworthiness. On the other hand, a very liberal (free) credit standard can result in high collection costs and increased bad debts. The credit department should therefore attempt to create a situation where it has maximum sales, on the one hand, and a minimum of bad debts, on the other hand. The enterprise tries to attain a **balance** between maximum sales and a minimum of bad debts. If the enterprise has a good collection system, it is possible to implement a lower credit standard. In this case credit can be granted to average credit risks, because the enterprise counteracts bad debts with a strict collection policy and the effective implementation of this policy.

The credit standard enables the enterprise to maintain a certain quality of credit extension and debtors. Once the credit standard has been determined, however, it does not mean that it can never be changed. The credit standard can be **adjusted**. For example, the enterprise can decide to lower the credit standard in order to ensure higher credit sales. Remember, though, that lowering the credit standard does not have advantages only. It also has disadvantages: there is a greater possibility of bad debts, and the cost of extending credit increases (because there are higher administration and finance costs). We could say, therefore, that if there is a **change in the enterprise's credit standard**, the following corresponding changes will take place:

- ❑ **A change in the volume of sales**. For example, if the credit standard is made stricter, there is a strong possibility that sales will decrease, because fewer applicants will qualify for credit.
- ❑ **A change in the level of debtors**. If credit sales decline, the investment in debtors will also decrease. Lower credit sales means there are fewer debtors.
- ❑ **A change in the possibility of late payments and bad debts**. The stricter the credit standard, the smaller the likelihood of bad debts. Why? The higher the quality of the credit risk, the smaller the possibility that the debtor will not pay the account.

i) *What do you think will happen if the enterprise totally disregards a credit standard? Try to give at least three practical examples.*

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ii) *Suppose you are the owner of an enterprise selling textbooks and stationery to students on credit. How will you limit the risk of credit sales? Give reasons for each of your answers:*

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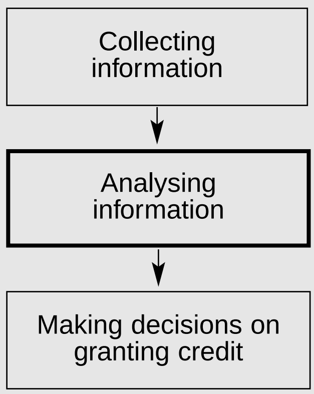
5.4 ANALYSING INFORMATION WITH A VIEW TO GRANTING CREDIT

We have already seen that the enterprise uses the information about the credit applicant to make decisions. If the enterprise does not analyse and assess the information, it cannot make a decision.

CREDIT ASSESSMENT

- ❑ Collect credit information and other information
- ❑ **Analyse the information**
- ❑ Make a decision on granting credit



C's:
Character
Capacity
Capital
Collateral
Climate
Credit history
Common sense

When the enterprise analyses the information that a credit applicant has provided and that the enterprise itself has collected, it usually looks at the **seven C's of credit**. The seven C's of credit give an indication of what is analysed during the credit assessment.

CHARACTER	**C**APACITY	**C**APITAL	**C**OLLATERAL
CLIMATE	**C**REDIT HISTORY	**C**OMMON SENSE	

The seven C's of credit is a **summary** of all the factors influencing the **quality** of the credit risk. For example, if the capacity of a credit applicant (the ability of the person or enterprise to pay) is very high, the possibility of late payment or non-payment will be small.

Let us have a closer look at the seven C's of credit.

- ❑ **CHARACTER.** This is the **willingness** of the person or enterprise to pay as agreed. In other words, it refers to the integrity (honesty) of the applicant. To investigate this, the enterprise looks at the applicant's personal information and other information such as home address, employer's address, period in the employer's service, occupation, marital status and details about other accounts, bank accounts and credit cards, and it also looks at how **regularly** the applicant pays his or her accounts. For example, the enterprise determines when an account was opened, what the outstanding amount is on the account and what the payment pattern is for the account - is it always paid on time or is it overdue? If an applicant does not pay his or her Edgars account or telephone account regularly and on time, he or she will probably also fail to pay this account on time. The applicant's **attitude** towards credit is an important indication of his or her willingness to pay.

- ❑ **CAPACITY**. This refers to the applicant's **ability to pay**. Does the applicant have the financial ability or means to pay by the due date? If the applicant earns R500 per month, can credit be granted? The ability to pay is also influenced by the applicant's other obligations. For example, in the case of consumer credit the applicant's ability to pay can be influenced by a home loan, study loan, clothing account and also by the number of dependants that the person is responsible for (has to support financially). Other factors such as unemployment also influence the ability to pay.

When a person applies for a loan at a financial institution, for example, the institution requests a complete cash flow statement. This is a statement on which all income and expenditure are shown. Before any decision is made about granting credit, the applicant's cash flow is first assessed to determine if he or she will have the necessary money to make the required payments. If this is not the case, it is unlikely that credit will be granted.

A cash flow statement (based on income and expenditure) is shown on the next page:

Inkomste en Uitgawes / Income and expenditure

Inkomste- en Uitgawestaat / Income and expenditure statement

Maandelikse inkomste/Monthly income:

Basiese salaris (self) Basic salary (self)	Bedrag/Amount
Basiese salaris (gade) Basic salary (spouse)	

Plus:
Plus:

Oortyd Overtime	
Behuisingsubsidie Housing subsidy	
Ander toelaes (spesifiseer) Other allowances (specify)	

Subtotaal
Subtotal

Minus:
Less:

* Salarisaftrekkings (self) * Salary deductions (self)	
* Salarisaftrekkings (gade) * Salary deductions (spouse)	

* Versekeringspremies en verbandpaaiement ingesluit, indien deur werkgewer afgetrek
* Insurance premium and bond repayment included, if deducted by employer

Netto salaris
Nett salary

Plus:
Plus:
Ander inkomste:
Other income:

Rente op beleggings Interest on investment	
Ander (spesifiseer) Other (specify)	

Totale inkomste
Total income

Maandelikse uitgawes/Monthly expenditure

Vaste paaiemente:
Fixed instalments:

Motor Car	
Karavaan/sleepwa Caravan/trailer	
Swembad Swimming pool	
M-net M-net	
Television/video-opnemer Television/video recorder	
Meubels Furniture	
Persoonlike lening Personal loan	
Huishuur/verband (indien nie by aftrekkings ingesluit) Rent/bond (if not included in deduction)	
Kredietkaart Credit card	
Ander (spesifiseer) Other (specify)	

Water en ligte, erfbelasting Water and lights, rates and taxes	
Tuindienste Gardening service	
Sekuriteitdiens/alarmstelsel Security service/alarm system	

	Bedrag/Amount
Kruideniersware Groceries	
Melk, groente, brood Milk, vegetables, bread	
Vleis Meat	
Apteek Pharmacy	
Huishulp Domestic help	
Telefoon Telephone	
Klere, skoolklere, klererekeninge Clothing, school uniforms, clothing accounts	
Skoolfonds/kleuterskoolfooie School fees/Nursery school fees	
Brandstof Pertol	

Rente op oortrokke fasiliteit Interest on overdraft facility	
Uitstaande belasting (maandelikse afbetaling) Outstanding tax (monthly repayment)	
Onderhoud Maintenance	
Versekering (korttermyn) Insurance (short term)	
Versekering (uitkeer, lewens) assurance (endowment, life)	
Ander uitgawes (spesifiseer) Other expenses (specify)	

Totale uitgawes
Total expenditure

Totale inkomste minus totale uitgawes = Surplus/Tekort
Total income less total expenditure = Surplus/Shortfall

Slegs vir kantoorgebruik/For office use only

Besonderhede van rekeninge wat gekonsolideer moet word
Details of accounts to be consolidated

Ander uitgawes (spesifiseer) Other expenses (specify)	Saldo verskuldig Balance owing	Paaiement Instalment
Totaal Total		

In the case of trade credit the enterprise's ability to pay plays an important role. For this reason the financial statements of the enterprise are analysed to determine whether it will have the ability to pay regularly and on time.

- **CAPITAL**. This is the **financial strength** of the credit applicant. Here we are actually referring to the "value" of the applicant - what does the balance sheet of the applicant's assets and liabilities look like? In times of financial crisis, will he or she have a reserve that will make it possible to continue paying regularly and on time? The assets of a person or enterprise indicate the financial strength. The assets can be tangible (touchable), for example a person's house or savings account or an enterprise's premises or buildings. However, the assets can also be intangible. For example, how easily will a person be able to find a job if he or she becomes unemployed? The ease with which a new job can be found is also an asset because it will help a person to continue payment even if he or she loses a job.

- **COLLATERAL**. This is the **security** that an applicant can offer in case he or she cannot continue payment. The enterprise granting credit is not willing to bear the risk alone. As a **precautionary (safety) measure** it asks for security in case the debtor cannot pay. Security is any asset that cannot simply disappear, such as life insurance, property, or a fixed deposit or investment at a bank. If the debtor cannot pay, these assets are converted into money to pay the debt. For example, if a person buys a car and cannot pay cash for it, it can be stated in the contract that the car is collateral. This means that the enterprise can take the car back if the debtor does not make the payments regularly and on time. When financial credit such as a bank loan is granted, the financial institution always asks for security.

- **CLIMATE (CONDITION)**. This refers to the **circumstances or conditions** in which the enterprise is running its business. It includes economic, political and international circumstances. For example, how will the current economic circumstances influence the credit applicant's ability and willingness to pay? If interest rates rise, home loan instalments will increase, and in that case will the person still be able to afford the payments? Is the person still ensured of an income at present, or could he or she possibly be retrenched? Do enterprises have the opportunity to extend their markets and so improve their income potential?

- **CREDIT HISTORY**. In investigating the credit history of an applicant the credit department looks at the way the person or enterprise managed accounts **in the past**. Have all the payments been done? The department also finds out whether there has been any legal action against the person or enterprise in the past (in other words, if the person or enterprise had to appear in court because of unpaid debts). The department further establishes if the applicant has ever been declared bankrupt in the past.

- **COMMON SENSE**. Common sense is really nothing other than **good judgement** - a "gut feeling" or intuition. The credit assessor forms an opinion based on **experience** and **observation**. For example, the credit assessor can make certain observations during a credit interview - how does the applicant react, what does his or her "body language" say? It can happen that the applicant's creditworthiness looks very good on paper, but that the credit assessor intuitively knows that credit should not be granted.

Refer back to the example of Sam who applies for credit at ABC Stores. Give practical examples of the seven C's of credit as they apply to Sam. You can make your own assumptions.

Credit to enterprise: Integrity Risk Income potential Security Financial statements Auditor's report Cash flow Competition Cost

When an enterprise has to decide whether to grant **credit to another enterprise** (trade credit), and also in the case of **financial credit**, the following factors are taken into account to determine the quality of the credit risk. Some of these factors overlap with the seven C's of credit and are in fact the C's phrased in a different way. However, it is very important that the enterprise granting credit should investigate the following factors specifically:

- **The integrity of the enterprise and its management**. When an enterprise's creditworthiness is assessed, the competence of this enterprise's management is regarded as especially important. The enterprise may have great potential (to make a profit and grow), but if its management is not capable of managing it in an effective way, the growth and survival of the enterprise could be threatened. This has a negative influence on the enterprise's creditworthiness. The **positive attitude** of the managers (or one manager-owner in the case of a small business or one-man business) is clearly reflected in sound business principles.

- **The business risk** (the chances of success and survival) of the enterprise. If the enterprise's activities involve a high risk, the enterprise granting the credit will have to be very cautious. The **market** in which the applicant functions, the **type of product or service** it sells and the extent of its **competition** all influence the credit risk. For example, a wholesaler granting credit to retailers will bear a much greater credit risk if a retailer is located in a quiet shopping centre with a high turnover of shops than if the retailer is in a busy and prosperous suburban shopping centre. In the same way a financial institution will not easily grant a loan to a prospective entrepreneur if there is doubt about the survival of the enterprise.

- **The profit or income potential of the enterprise**. To make all payments regularly and on time, an enterprise must be ensured of an **income**. It cannot rely on extensive credit facilities if it does not have a good prospective income. This aspect must be thoroughly assessed in the case of new accounts especially. For example, if a retailer applying for credit has had a very low income over the past five years (in comparison with similar enterprises), the wholesaler must first do a thorough analysis of the causes of this, and also of the enterprise's future income potential.

- **The security that the enterprise can offer**. Here it is determined what fixed property the enterprise has, and in many cases where the enterprise is capital intensive, the value of machinery and equipment can also be taken into account. In some cases it is also possible to transfer the total value, or a part of the value, of the enterprise's debtors to the enterprise granting the credit.

- **The enterprise's financial statements**. Analysing the enterprise's financial statements allows the credit assessor to determine the following:

  - The income potential of the enterprise (profitability)
  - The enterprise's ability to pay (liquidity)
  - Whether the enterprise will be able to pay back all its debts at any time (solvability)
  - Whether the enterprise uses its available assets in the best possible way to generate an income (management of assets)

From these aspects the credit assessor can draw conclusions about the credit applicant's financial position.

- **The auditor’s report**. In this report, the auditor confirms that he or she has examined the enterprise’s financial statements and that, in his or her opinion, the statements are a true reflection of the enterprise’s financial position. It is useful for the credit assessor to look at the auditor’s report. The auditors can issue one of the following two types of report after auditing the enterprise’s statements:

  - **An unqualified report**. The auditor states that the financial statements are a fair reflection of the enterprise’s financial position and financial results (of the enterprise’s activities). The auditor has audited the financial statements and is satisfied that they have been compiled in accordance with generally accepted accounting principles.

  - **A qualified report**. An auditor gives this type of report if there is too much uncertainty to give an opinion, or if the auditor can give an opinion, but it would contradict the content of the financial statements.

- **The enterprise’s cash flow**. The cash flow position of the enterprise is investigated to determine if the enterprise does have the necessary cash flow to pay accounts regularly and on time. The enterprise’s liquidity position is of importance for the credit assessor. If the enterprise has cash flow problems, the reasons for this must be established, and it must be determined what the enterprise does to supplement shortages of cash, for example whether it uses a bank overdraft facility.

- **Competition**. How great is the enterprise’s competition in the market? Strong competition can threaten a small or new enterprise’s growth and survival. The enterprise granting credit is also interested in the applicant’s **strategy** with regard to competition.

- **Cost**. How **cost-effective** is the enterprise in carrying out all its activities? This has a direct influence on the enterprise’s income position. The enterprise should therefore aim at keeping costs as low as possible and implementing measures to control costs. In this regard we can refer to the break-even point of the enterprise.

The break-even point gives an indication of the number of products that an enterprise must sell to cover its costs. At the break-even point the total costs of the enterprise are equal to its total income. The enterprise thus does not make a profit or a loss if it manufactures (or purchases) and sells the number of products specified by the break-even point. If the enterprise sells more products than the number given by the break-even point, it begins to make a profit.

The break-even point is important from the credit assessor's point of view because it indicates what the costs of the enterprise are and the number of products it will have to sell to make a profit. The break-even point has a direct influence on the enterprise's income. If an enterprise must sell many products to break even and the market for that product is not very large, enterprises granting credit may be unwilling to extend large amounts of credit. (The reason for this is that they are not sure if the enterprise will be able to generate enough income to meet its financial obligations.) In the case of a new enterprise especially the break-even point can give an indication of the viability (potential for succeeding) and income potential of that enterprise.

i) *Why should a credit assessor investigate the income potential of a credit applicant?*

ii) *Is it really necessary to examine the integrity of an enterprise's management during a credit assessment? Give reasons for your answer.*

iii) *Do you agree with the following statement?*
"An enterprise's cash flow is very important during a credit assessment."
If you agree, why?

It is clear that the quality of a credit risk is influenced by a variety of factors. When assessing a credit application the credit assessor must specifically try to identify **possible danger signs** that may influence the quality of the credit risk (and to find innovative solutions for these problems, if at all possible). In the case of consumer credit, an applicant may show the following danger signs (of being a poor credit risk):

- ❑ Lives in a boarding house, hotel, with a friend, or in a caravan park
- ❑ Limited financial circumstances with a large number of dependants
- ❑ Impossible to obtain the applicant's history
- ❑ Various new accounts have been opened with an average or low income
- ❑ Very keen to obtain loans at a time when it is difficult to get credit information
- ❑ Tries to impress the enterprise granting credit with his or her exceptional qualities as a credit user
- ❑ Alleges to have a certain income which cannot be verified, and also does not have bank accounts
- ❑ Works for employers who are known to be suspect or unreliable
- ❑ Works only on a commission basis
- ❑ Works for him- or herself at home, and has no bank references or proof of the extent of the enterprise (for example the names of suppliers and customers)

In the case of trade credit the credit assessor should also look out for certain aspects that could be an indication of a poor credit risk. Enterprises could be a poor risk if:

- ❑ they do not provide a physical address
- ❑ they have no permanent postal address (and have their mail sent to "poste restante")
- ❑ they cannot provide any trade or bank references
- ❑ they are not willing to provide financial information
- ❑ they offer to pay with a post-dated cheque
- ❑ they are listed with a consumer institution or credit bureau
- ❑ they cannot give any security
- ❑ their owners have been listed at a credit bureau or have been bankrupt
- ❑ the owners of the enterprise refuse to sign a guarantee for their own enterprise (a guarantee that debt will be paid)

The actual analysis of credit information can be done in a number of different ways. We will not study this in depth in this course (it will be dealt with in the second year), but below we list some of the methods used:

- ❑ **Credit grading**. A grading form is used to evaluate the applicant on a scale that ranges from excellent to poor. The various characteristics of the applicant are assessed individually.

- ❑ **Credit scoring**. Points are allocated (by hand or a computer) to various characteristics or factors, such as the type of employment, whether the applicant owns a home, and the monthly income. The total score is compared with the minimum score required by the enterprise to make a decision on granting credit.

- ❑ **Financial statements**. The financial statements of an enterprise are analysed to determine its financial position. The information obtained from the analysis is assessed together with other information, such as the location of the enterprise, the management of the enterprise, the market and competition and the product or service sold by the enterprise before a decision is made.

5.5 MAKING A CREDIT DECISION

The credit assessment leads to a credit decision. There are three possibilities:

- ❑ The decision to accept the application
- ❑ The decision to reject the application
- ❑ Postponing the decision (to obtain more information)

CREDIT ASSESSMENT

- ❑ *Collect credit information and other information*
- ❑ *Analyse the information*
- ❑ ***Make a decision on granting credit***

Collecting information

Analysing information

Making decisions on granting credit

IMPORTANT:
The credit decision is made taking into account the enterprise's credit standard.

Let us assume that the enterprise has decided to accept the credit application. Now it has to decide how much the applicant can buy on credit. It must thus decide on a **credit limit**. This is the maximum amount that the enterprise will grant. The credit limit can be adjusted at a particular time. It is not always increased; it can also be decreased.

The credit limit is determined after the credit assessment has been completely finalised and the enterprise has decided to grant credit. Credit limits eliminate **continuous decision-making**. In the case of trade credit the credit manager cannot personally approve every order. The credit limit therefore serves as a guideline for approving orders. If the order exceeds this limit, the account must be further investigated and it must be decided if the order should be approved or not. The enterprise can also decide to decrease the credit limit if a person or enterprise finds it difficult to pay.

Credit limits enable the credit manager to **delegate**. Subordinates can deal with orders and sales transactions. Credit limits also **protect** the credit department against excessive bad debts because it prevents customers from buying on credit in an unrestricted way.

A general **guideline** for determining a credit limit is the following: make the limit low at first, and consider increasing it later. However, it should meet the needs of the customer. The enterprise should not grant more or less than is needed. The limit must be set in such a way that it prevents overspending, ensures fairness among customers and is affordable for the customers.

The enterprise can use the following guidelines for **determining credit limits**:

❑ Ask the consumer how much credit he or she wants. Grant as much credit as the consumer wants - as long as he or she can pay on time as agreed (it must be within the customer's ability to pay).
❑ Grant as much credit as the other creditors.
❑ Give a small amount of credit at first, for example the value of the order received (in the case of trade credit). Gradually increase the limit as the customer proves him- or herself to be a good credit risk.
❑ Grant an amount that is equal to the average purchases during a week or month.
❑ In the case of trade credit, grant for example 10% of the value of the working capital.
❑ Base the limit on experience. For example, teachers are paid a salary falling between two margins. Use the margin as a starting point to determine the credit limit of a teacher.
❑ The credit limit can be determined according to the number of points the applicant received during his or her credit assessment. For example, suppose the minimum number of points an applicant has to receive is 500. A person with a score of 550 and a monthly income of R2 000 could then qualify for a credit limit of R500.

Credit limits can be **revised** if the person pays the accounts slowly. The enterprise can then consider decreasing the limit. If product prices are constantly rising, credit limits will also have to be adjusted, because people's credit limits may then be too low for them to buy what they need. If a credit limit no longer satisfies the needs of a customer, it can also be adjusted if the customer pays regularly and on time, has a good payment record and asks for an adjustment in the credit limit. Credit limits have to be revised from time to time as a result of inflation.

With reference to CREDIT LIMITS, what are the first thoughts you have when you see the following words? Write them down below:

i) Overspending

ii) Determining

iii) Adjustments

iv) Revise

The enterprise must **inform** the customer in **writing** about the results of a credit application. The person or enterprise must be notified, for example, that the application has been **approved**. The applicant must also be informed which **credit limit** has been granted. It is also important that the enterprise informs the customer about its **credit terms**.

The credit terms are usually set out in the enterprise's credit and collection policy. In the case of trade credit and financial credit it is also possible to agree on special terms with a certain customer. The enterprise's credit terms determine the following:

- ❑ *The form in which credit is granted, for example a revolving credit account or an open-book account*
- ❑ *The credit period - for how long credit is granted, for example 30 days*
- ❑ *The method of payment - for example by cheque, bills of exchange or electronic transfers*
- ❑ *Cash discounts and the discount period - for example 5% discount if the account is paid within 10 days after the date of the account statement*
- ❑ *Interest charges if the account becomes overdue, at 3% above the prime bank rate*
- ❑ *Seasonal offers (how the credit terms can be adjusted to provide for non-seasonal sales, for example clothing purchases for the next season)*

The written notice to the customer can be in the form of a personal letter, a form letter or a printed card. The tone of the letter should be friendly. The applicant should be welcomed as a new customer. The letter must be phrased in such a way that it creates goodwill for the enterprise (the customer must want to buy from the enterprise).

The enterprise can also use this letter to inform the customer of the credit terms. For example, with the letter it can include a brochure explaining how the account should be used, when it must be paid, where it must be paid and whether interest is charged. The brochure can also contain information about the various credit services provided by the enterprise. If the enterprise issues a plastic card to the customer, this can also be included with the letter. In many cases, however, the customer has to collect the card from the enterprise personally.

The following is an example of a letter to a customer who has successfully applied for consumer credit:

"We are pleased to inform you that your application for a revolving credit account has been approved. To collect your pink card, you can visit our credit office on the eighth floor at your convenience. You have to use this card when making purchases on the revolving credit account.

The credit limit on your account is R3 000.

We will do everything possible to make your shopping with us convenient and pleasant. We look forward to being of service to you and gladly welcome you as one of our customers."

It is also important that the enterprise should contact those applicants whose credit applications were not successful. A poor credit risk today may be a good credit risk tomorrow. The enterprise must inform the applicant that the application has been received, but that it has not been approved. A reason for rejecting the application must be given, for example that a credit bureau has a previous conviction against the person on record. If the person does not meet the enterprise's credit standard at present, but may qualify for credit in the future, he or she should be informed of this:

"Thank you very much for your application. Unfortunately you do not qualify for credit at present, but you are welcome to contact us again in a few months' time."

5.6 SUMMARY

In this chapter we looked at the three steps in the process of granting credit to a person or enterprise. These basic steps apply to consumer, trade and financial credit. We saw what each step involves. We gave an introduction to the meaning of credit assessment. We also saw that credit assessment cannot be done without a credit standard.

In the second-year course we will examine assessment methods in more detail and specifically study the assessment of an enterprise with the help of its financial statements. In this chapter we **established a starting point** for the assessment of creditworthiness.

We can summarise the procedure followed during credit assessment as follows:

- Obtain a detailed credit application with all the relevant facts
- Check the information and ensure that it is correct by, for example, verifying telephone numbers and employment
- Contact the bank and trade references and the credit bureau. Keep a record of the information obtained from these sources
- Analyse the information in terms of the seven C's of credit
- Assess the application on the basis of the enterprise's credit standard
- Decide whether to:
  - approve the application
  - reject the application
  - request additional information from the applicant or other external sources before making the final decision
- Set a credit limit
- Inform the credit applicant about the decision as soon as possible
- Inform the credit applicant of the credit terms and state the consequences of late or no payment. The credit applicant must **know** what his or her **obligations** are towards the enterprise granting credit

IMPORTANT:
Be positive and innovative in your approach to credit assessment. Always try to find ways to approve an application (and not to reject it) by using ***common sense****, and always be* ***aware of the risks*** *of granting credit!*

5.7 SELF-EVALUATION

1. CASE STUDY

Pam decides to apply for an account at Fashion Stores. During her lunch hour she fills in the credit application form and hands it in at the store's credit department. The next morning Fashion Stores informs Pam that her application has been approved. Later that day Pam collects her Fashion Card from the store and makes her first purchases. Pam's credit limit is R1 200.

i) List the sources from which Fashion Stores could obtain information about Pam.

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ii) Discuss how Fashion Stores would have determined whether Pam was a good or a poor credit risk. (HINT: Use the C's of credit as a starting point. Make your own assumptions about Pam.)

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iii) Explain the role of the credit bureau as an aid to assess Pam's credit application at Fashion Stores.

iv) What does it mean to say that Pam's credit limit is R1 200?

v) What principles should Fashion Stores follow when determining a credit limit?

2. Clothing Fashions is a clothing manufacturer that sells on credit to retailers like Fashion Stores.

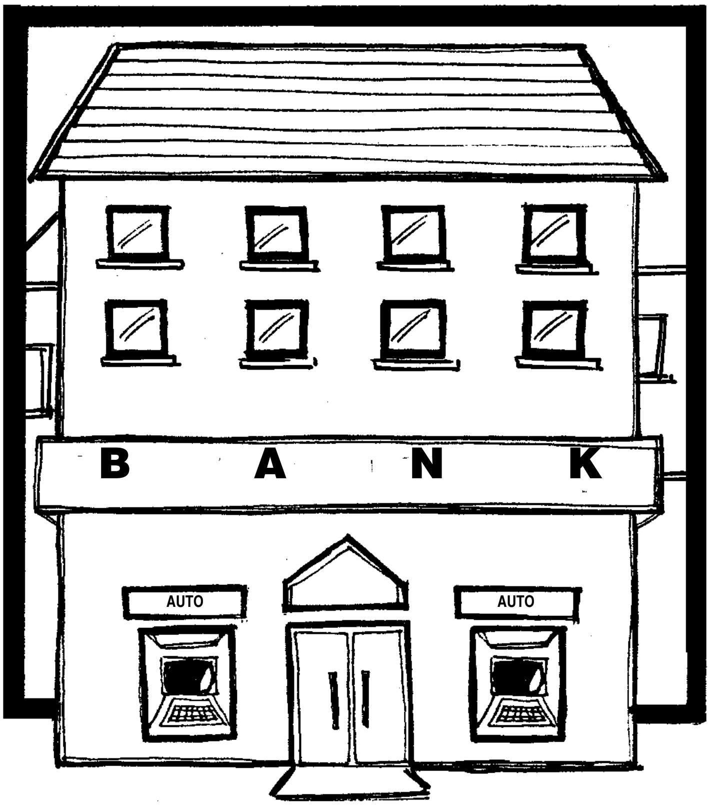
i) Discuss the information that the sales representatives of Clothing Fashions can obtain about Fashion Stores.

ii) What are the advantages and disadvantages of using the sales representatives as a source of information for Clothing Fashions?

iii) List and briefly discuss the factors that Clothing Fashions has to take into account when deciding whether to grant credit to a retailer.

iv) Which possible danger signs should Clothing Fashions look out for during the credit assessment?

3. James Modise would like to do certain home improvements. He would like to install kitchen cupboards, replace his wall-to-wall carpets and paint his house inside and outside. However, he does not have enough money to do all this. After considering the matter, James decides to apply for a loan at his commercial bank.



Discuss, in detail, the procedure that the bank will follow in making a decision about James's application. Give practical examples that apply to James. (HINT: Discuss the three steps in the assessment of creditworthiness.)

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CHAPTER 6

CREDIT TERMS

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CHAPTER 6

CREDIT TERMS

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- *explain the importance of credit terms*
- *describe the different components of credit terms in detail*
- *discuss the factors influencing the enterprise's credit terms and credit period*
- *explain the different methods of payment*
- *discuss cheques, bills of exchange and promissory notes as negotiable instruments*
- *give reasons why it is essential to provide information about credit terms*

6.1 INTRODUCTION

Once an enterprise has decided to grant credit to a person or another enterprise, it must inform the credit applicant of the credit terms and the conditions of sale. Conditions of sale include aspects such as delivery, the acceptance of goods and notification of errors or defects. The credit terms, on the other hand, are determined by the enterprise's credit policy. The policy gives clear guidelines about, for example, the form in which credit is granted and the period for which credit is granted.

In the case of consumer credit enterprises usually have standard credit terms that apply to all consumers. With trade credit, however, enterprises may decide to apply special terms to certain of their debtors over and above the standard credit terms.

The purpose of this chapter is to discuss the importance of credit terms and the various aspects of these terms. In examining the method of payment (one of the aspects of credit terms), we will also investigate the most common instruments of payment. Here we will specifically look at cheques, bills of exchange and promissory notes (negotiable instruments). We will conclude this chapter by discussing why it is essential to give information about the credit terms to buyers (and to borrowers of money).

6.2 CREDIT TERMS

Credit terms are the "rules" according to which the enterprise grants credit to a person or another enterprise.

List the different components of an enterprise's credit terms (we mentioned these terms in chapter 3):

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You already know that the enterprise cannot grant credit to simply anyone. The applicant's creditworthiness must first be assessed. In the same way, once the enterprise has decided to grant credit, it cannot simply give this credit for an indefinite period and without any conditions. This will cause the disadvantages of credit to completely eliminate the advantages. The cost of granting credit and the fact that the enterprise will have to wait for its money for a very long time will cancel out the profits made from credit sales. For this reason it is extremely important that the enterprise should have **clear guidelines** for credit terms. These guidelines are determined by the **credit policy**.

The enterprise cannot make random decisions about its credit terms. The decisions must be well considered, because poor credit terms (just like the absence of credit terms) will create many problems for the enterprise. **Poor credit terms** such as very long credit periods can result in, among other things:

Poor credit terms result in:
Cash flow problems
Bad debts
Poor credit-worthiness
High financing costs
Unsuccessful transactions
Liquidation

- ❑ **cash flow problems -** the enterprise has to wait for a long time before debtors can be converted into cash (and in the meantime it has to meet its own obligations and make its payments on time)

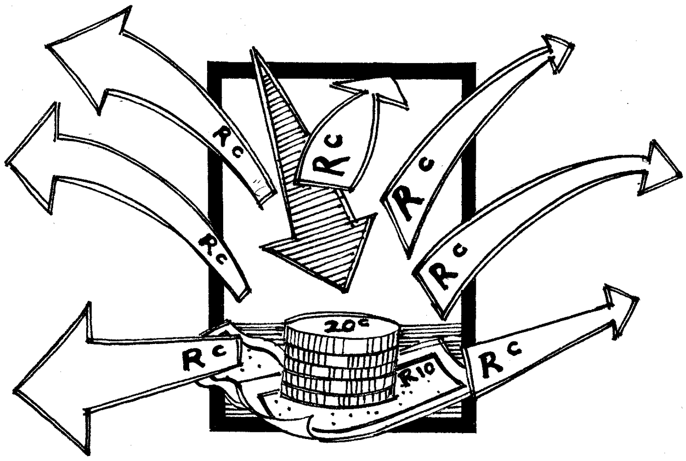
- ❑ **losses in terms of bad debts -** the longer the enterprise has to wait for the payment, the greater the risk that the debtors will not pay at all

- a **negative effect** on the enterprise's **image of creditworthiness** - the enterprise may find itself in a situation where it can no longer meet its own obligations

- **additional finance costs** of debtors - the enterprise has to use capital to finance the debtors and so loses this money. The longer it has to finance the debtors, the higher the cost

- **sales transactions that are not successfully concluded** - transactions may be delayed, and this may have a negative effect on the relationship between the seller and the buyer

- **liquidation** - in some cases poor credit terms can cause the enterprise's cash flow position to become so poor that it cannot meet its obligations (especially in the case of small businesses). This will lead to the closure of the enterprise (bankruptcy)



Factors influencing credit terms:
Industry
Economic conditions
Capital
Competition

There are **various factors** that may influence decisions about the credit terms. For example, the enterprise has to establish what other enterprises in the **same** industry are doing.

An industry refers to all the enterprises in the market that offer more or less the same products and services. For example, all enterprises that manufacture and sell clothing are part of the clothing industry.

EXAMPLE
The fact that enterprises' credit terms are influenced by those of other enterprises in the same industry can be seen when examining, for example, the similarities between the credit terms of retail clothing stores such as Edgars, Sales House, Truworths and Markhams. All these shops have the following terms:

- ❑ *Revolving credit over a period of six months*
- ❑ *Interest on overdue instalments*
- ❑ *No discounts if the account is paid earlier*
- ❑ *Cheques and cash as common methods of payment*

Another factor influencing the credit terms is the **current economic conditions**. In poor economic conditions enterprises will agree to introduce "more relaxed" credit terms. Enterprises would obviously like to continue selling their products and services. However, if economic conditions make it impossible for people or other enterprises to buy these products or services (because the demand for the product is poor, or because the buyers do not have the money to buy or do not have the money to pay over such a short credit period), enterprises may have to consider longer credit periods. (In poor economic conditions the enterprise therefore actually bears a "double risk" in granting credit, that is the normal risk of late or no payment and the risk of late or no payment because of the poor economic conditions.)

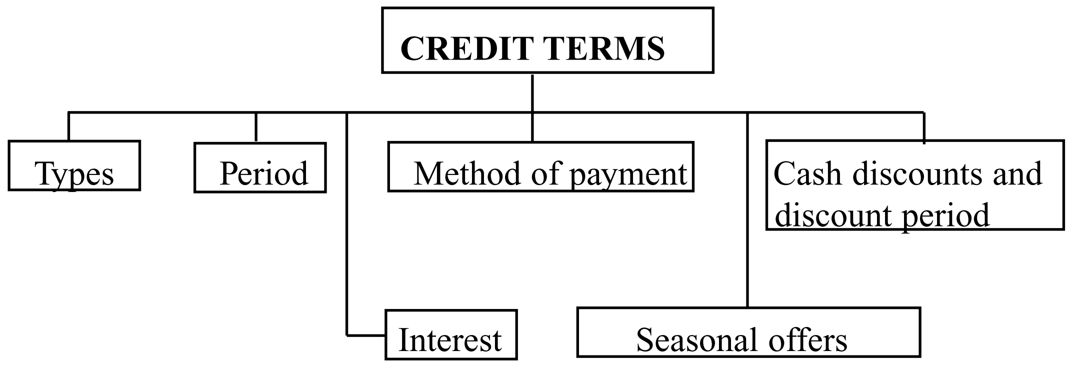
Another important factor that should be taken into account is the **amount of capital** the enterprise has available for financing the debtors. In the case of a small business especially, a shortage of capital may force the enterprise to have very strict credit terms (for example, a short credit period and high interest charges on overdue accounts).

Competition between enterprises is also important. If an enterprise's competitors all grant long credit periods, it will be very difficult for that enterprise not to adjust its credit period as well.

In our discussion of the credit period in paragraph 6.2.2 we list various factors that influence the length of the credit period. Keep in mind that these same factors play a role when credit terms in general are determined.

The different aspects of **credit terms** discussed below are:

- ❑ the type of credit
- ❑ the credit period
- ❑ the method of payment
- ❑ cash discounts and the discount period
- ❑ interest charges
- ❑ seasonal offers



6.2.1 Type of credit

A certain **type** of credit must be granted to the person or enterprise applying for credit. For example, in the case of consumer credit the enterprise must decide whether to grant credit in the form of an open-book account or a revolving credit scheme. With trade credit the open-book account is a commonly used practice. The types of credit granted by financial institutions are, for example, personal loans, mortgage loans or credit cards.

You may want to refer back to chapter 2, where we discussed the various types of consumer, trade and financial credit.

6.2.2 Credit period

The credit period refers to the **time** for which credit is granted. In the case of an open-book account, for example, it could be 30 days after the purchase or 30 days after the date of the account statement. The account holder **must pay** the account at the end of the period.

A revolving credit scheme over a period of six months means that the account holder has the opportunity of paying off the account over six months, but must pay a certain instalment every month. If a bank grants a loan over twelve months, the credit period is actually twelve months. The borrower has twelve months to pay back the money by paying an instalment every month. It is thus clear that the credit period is often directly influenced by the form in which credit is granted.

In the case of trade credit, enterprises may also have a **standard credit period** (a fixed credit period that apply to all buyers). For example, in the case of an enterprise granting credit according to an open-book account system, the credit period for all buyers may be determined as 30 days after the date on the account statement. With trade credit it is possible, however, to make decisions about the credit period on an individual basis. In other words, when the sales contract is concluded, the enterprise (seller) and the individual buyer could decide about the credit period together.

If an enterprise does not have standard credit terms, the decision about the credit period can be left to the sales manager (in the case of trade credit). The reason for such a decision is that the credit period is regarded as part of the total sales package that is given to the customer. In such a case, however, it is very important that the credit department and the sales department should liaise with each other. The credit department should provide the sales department with **information** about the cost of the credit granted, because this should have a **direct influence on the selling price** of the goods.

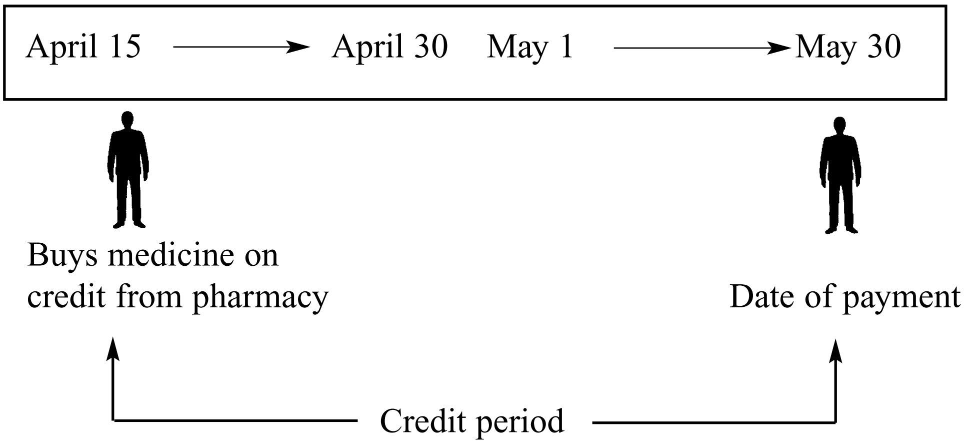
EXAMPLE
Products for R5 000 are sold with a credit period of two months. The cost of granting credit is 18% per year. This means that it will cost the enterprise R150 to grant credit to the buyer (18% of R5 000 for two months). If credit were granted over a period of one month, the cost would be R75.

Can you see how the length of the credit period directly influences the cost of credit? (Among other things, it influences the cost of financing debtors - the longer the debtors are financed, the higher the cost, while at the same time the enterprise loses income from interest on this capital - in other words, the opportunity cost of capital.)

The cost of credit must be taken into account when the selling price of the product is determined. Why? The cost of credit reduces the income that can be obtained from the sales. The profits from credit sales can be changed into a loss if the credit period and the cost of granting credit over, for example, 60 days instead of 30 days are not taken into account.

Another factor that should be considered is that, before determining credit terms, these terms should first be **discussed with the sales department**. Not doing this can be risky, because it could result in the enterprise losing profitable sales transactions.

It is therefore clear that decisions on the credit period should be thoroughly considered. In the case of trade credit where enterprises can make different decisions about the credit period for individual debtors, a number of factors should be taken into account.



NOTE:
Some of the factors influencing decisions about the credit period for trade credit also play a role in decisions about the credit period for consumer credit. For example, the amount of capital that the enterprise has available for financing the debtors will have a direct influence on the length of the credit period. Perhaps you still remember us mentioning, in chapter 2, that the enterprise granting revolving credit or instalment credit needs more capital to finance the debtors. Such an enterprise also has to wait longer before the capital becomes available again.

In actual fact, the factors influencing the length of the credit period also influence credit terms in general.

Factors influencing credit period:
Current practice
Available capital
Financial position
Competition
Profitability
Demand
Location
Type of product
Risk
Trade volume

Let us look at the most important of these factors:

- **Current industry practice**. If it is a standard credit term in the industry to which the enterprise belongs that, for example, the credit period is 60 days, the enterprise would use this as a guideline.

- **Capital available for financing the debtors**. If the enterprise has limited capital for financing the debtors, it will set a shorter credit period. The enterprise will attempt to make the capital invested in the debtors available as soon as possible so that it can be used for another purpose. Frequently enterprises, especially new and small businesses, make the final decision about granting credit on the basis of whether they have enough capital to finance the debtors.

- **Financial position of the seller**. If business is slow for the enterprise (the seller), in other words if it does not have many sales, or if it is in a difficult financial position, it may be willing to grant more favourable credit periods. This is done to increase the volume of sales transactions - a favourable credit period can stimulate the volume of sales. **However, it is important that the enterprise must still have enough capital to finance the credit sales!**

- **Degree of competition**. If the enterprise has very strong competition, the credit period can be a key factor when an important order has to be obtained or allocated. In such a case an enterprise may grant a longer credit period, because this will give it a competitive advantage above other enterprises. Remember, however, that if the enterprise grants a longer credit period, it must make provision for the longer waiting period in some way. The enterprise "builds in" this longer waiting period in its product prices by setting higher prices for products.

- **Degree of profitability**. Enterprises earning a large percentage of profit on the products or services it sells can grant a longer credit period. The longer waiting period as well as the risk relating to this period is covered by the higher profit margin. On the other hand, an enterprise with a low profit margin will set a shorter credit period.

- **Demand for the product/service**. If there is no great demand for a product, the enterprise could consider a longer credit period. This will create a competitive advantage for the enterprise. Why? Buyers might choose to buy from the enterprise with the most favourable credit period.

- **Location of the customer**. With some sales transactions there may be a long period from the time the seller sends the products to the buyer, to the time when the buyer receives them. Exactly how long is this period? It may have a direct influence on the payment of the account. Suppose that the credit period is based on the date the goods are sent, and it takes a long time before the buyer receives the goods (because he or she lives in a distant area). The buyer will then only have a short period before the account has to be paid.

- **Type of product**. The length of the credit period is directly influenced by the type of product. In the case of products that are sold quickly or that are perishable (non-durable products) the credit period should not be very long. For example, a short credit period will usually be determined for customers paying for bread, fresh fruit and vegetables, and dairy products. The credit period for durable products such as cars and furniture is then usually longer.

Study the following examples and then answer the question below:

- ❑ *When someone buys a car on credit, the credit period (the period over which the car is paid off) could be, for example 36, 48 or 60 months.*
- ❑ *When someone buys clothes on credit from a shop, the credit period can be six months.*
- ❑ *When someone buys medicine from a pharmacy on credit, the credit period is normally 30 days.*

Based on these examples, what conclusion can you draw about the credit period?

- ❑ **Degree of risk.** The greater the risk of the credit transaction, the shorter should the credit period be. If the credit risk is already high and the enterprise then has to wait for its money for a long time, the risk becomes higher or even too high. This may eliminate the advantages of credit. If there is doubt about the financial position of buyers or their ability to pay, the seller should set a shorter credit period.

- ❑ **Trade volume per customer**. This refers to the number of sales or transactions that the seller expects to conclude with the buyer. If the seller regularly sells large quantities to the buyer, it will be possible to grant more favourable credit periods. If the enterprise expects that there will be only a single transaction, however, it can use the standard credit period.

i) Why do you think it is necessary for the enterprise to make a decision about the credit period?

ii) Give at least three advantages of determining a credit period.

iii) *XYZ is an enterprise that manufactures toys and sells its products to retailers on credit. Which factors will influence the length of XYZ's credit period? Use practical examples to illustrate your answer.*

6.2.3 Method of payment

In practice there are a number of different methods of paying an account. Below we list some of these methods.

Methods of payment:
Cash
Cheque
Debit order
Postal order
Electronic transfer
Bills of exchange
Contra accounts
Post-dated cheque

- **Cash**. In the case of consumer credit, many account holders pay their accounts with cash, in other words notes and coins. For example, they might draw the money from their savings account at an automatic teller machine and personally go to pay the account at the enterprise (for instance a clothes account at Edgars or Sales House).

- **Cheques**. Cheques are a common form of payment for consumer credit as well as trade credit. Because cheques are so widely used, we will look at this method of payment in more detail in paragraph 6.3.

- **Debit orders**. A person or enterprise with a cheque account at a bank can use a debit order system. A debit order system means that the cheque account holder gives the bank permission to draw a certain amount from the account every month and to pay it over to a creditor. For example, the monthly payment on an instalment contract with a vehicle financing company can be paid by debit order.

- **Postal orders**. Postal orders are issued by the post office and guarantee the payment of a certain amount to the receiver at another place. The debtor "buys" a postal order to the value of his or her debt at the post office and sends it to the enterprise. The enterprise, in turn, takes the postal order to the post office and in exchange receives an amount in rands and cents that is equal to the value of the postal order. This is a common method of payment in retailing when, for instance, debtors do not have cheque accounts (because it is unsafe to send actual money, rands and cents, by post).

- **Electronic transfer of funds**. The account holder pays the account at an automatic teller machine. The funds are immediately transferred from the debtor's bank account to the creditor's bank account. In other words, the funds are electronically paid into the seller's bank account. The seller does not have to wait for the money, and the risk of, for example, a cheque that cannot be paid out by the bank is eliminated. This also means that the enterprise's cash flow position improves. This system needs less administration because nobody in the enterprise needs to deal with actual money that is paid over.

- **Bills of exchange**. Bills of exchange are commonly used for trade credit especially. They will be discussed in more detail in paragraph 6.3.

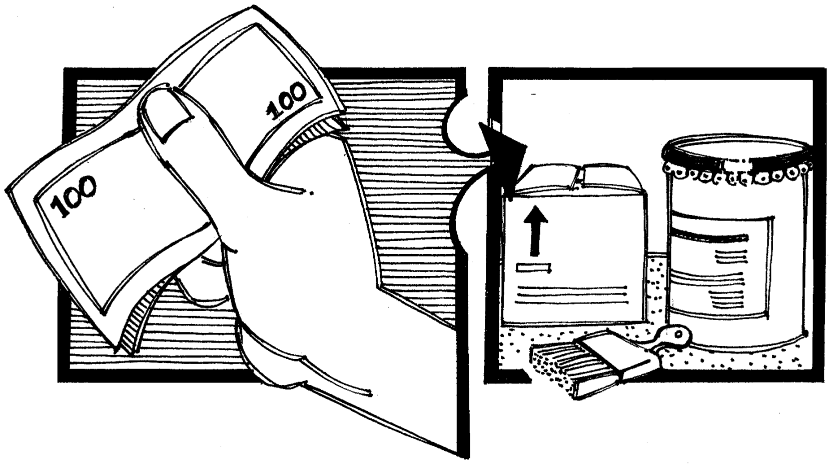
- **Contra accounts**. This method of payment is used when two enterprises sell products or services to each other. Enterprise A sells fabric to enterprise B, and enterprise B in turn sells the clothing it manufactures to enterprise A. The two enterprises agree about the way in which differences in amounts owing will be paid. Information about the state of the accounts must be exchanged monthly to ensure that there is complete agreement about the outstanding amounts owed by both parties.

- **Post-dated cheques**. This method of payment can be used in the case of a relatively unknown buyer who cannot pay for the goods in advance. Enterprises granting consumer credit usually also accept post-dated cheques. The cheques are filed until they have to be paid in at the bank. This method can be risky because the enterprise cannot be absolutely certain whether the bank will pay out the cheque (and whether the buyer will indeed have the ability to pay at this later date).

  Sometimes debtors pay with post-dated cheques because they do not want their accounts to become overdue, for example when they are going on holiday. This situation should not be confused with the receipt of post-dated cheques some time **after the goods have been received -** it may be a sign of liquidity problems (that is, a sign that the person or enterprise is unable to pay).

Another method of payment is **advance payment**. This means that the buyer must pay the account **before** the products or services are provided. This arrangement is often made if:

- ❑ there is doubt about the buyer's ability to pay
- ❑ the enterprise is unwilling to accept any risk with regard to late payment or no payment
- ❑ the customer has just started trading (a new enterprise)



Terms of advance payment include the following types of arrangement:

Terms of advance payment:
Cash with order
Cash before delivery
Cash on delivery
Load-over-load
Sight draft with bill of lading
Single payment

- ❑ **Cash with order or cash in advance**. This means that the customer must send the payment (for example a cheque or postal order) together with the order. In this case the seller bears no risk whatsoever. An example is when a person orders products from a mail-order service and sends a cheque together with the order.

- ❑ **Cash before delivery**. This arrangement is slightly less strict than cash with order. Here the seller may prepare and package the goods, but the goods are not delivered before payment has been received. Examples are a small business buying and paying for a computer at a certain enterprise, after which the enterprise delivers it to the small business's premises; or someone buying a television set from Dions after which it is delivered to his home.

- ❑ **Cash on delivery (COD)**. With cash on delivery the goods are transported but not handed over to the buyer until the transporter has received payment for the full amount on the invoice.

It is of course possible that the buyer may refuse to pay cash on delivery. With this system the seller thus bears the risk of:

- transport costs in both directions (from the enterprise and back to the enterprise)
- preparation of the products
- packaging costs
- possible damage of the goods

- **Load-over-load terms**. These terms are often used when there is a very fast turnover rate of stock (when the stock is sold very quickly, for example bread and milk), or where there are regular weekly deliveries. With each delivery the invoice for the products delivered the previous time is paid. Petrol is often sold to service stations according to these terms.

- **Sight draft with a negotiable bill of lading**. A sight draft is a bill of exchange that is payable “at sight”, in other words when it is presented to the buyer. A bill of lading is a document listing the goods transported and various other details, and the buyer uses the bill of lading to prove his or her right to take possession of the goods. A bill of lading can be “negotiable”, which means that it can be transferred from one person to another.

  When these terms are used, the seller sends a negotiable bill of lading to the buyer’s bank, together with the invoice and a sight draft drawn on the buyer. The bank makes the bill of lading available to the buyer after the buyer has paid the sight draft. The buyer can now take receipt of the goods (this cannot happen without the bill of lading - the buyer must pay first, and then receives the goods). As with cash on delivery, the seller’s risk is limited to packaging and transport costs if the buyer cannot pay the sight draft.

- **Single payment**. In this case the seller allows the buyers to build up their obligations over a period. For example, purchases during the course of a month are recorded and then a single payment is made at the end of the period (the period can be from the beginning to the end of a calendar month, or even from the middle of one month to the middle of the next month).

i) Give your own practical example for each of the following methods of payment:

- ❑ *Electronic transfer of funds:*

- ❑ *Post-dated cheque:*

- ❑ *Cash on delivery:*

- ❑ *Single payment:*

- ❑ *Load-over-load terms:*

ii) In which cases will an enterprise probably use cash before delivery or cash with order?

6.2.4 Cash discounts and the discount period

A cash discount refers to the **reduced payment** that an enterprise grants to debtors if the debtors pay their accounts **before or on a certain date**. The main purpose of discounts is directly related to the fact that the enterprise wants to make capital invested in debtors available as soon as possible. If debtors can get a cash discount - in other words, if they can pay less than the total amount outstanding - they may pay **sooner**. A cash discount can thus **speed up** the collection of debtors.

Cash discounts are thus offered in the hope that debtors will pay sooner and that cash will so become available sooner. If debtors are collected quickly, this will have a positive effect on the enterprise's liquidity position.

Granting cash discounts therefore has certain **advantages** for the enterprise:

- ❑ The debtors are converted into cash more quickly
- ❑ Improved cash flow
- ❑ Reduced need for working capital
- ❑ Lower credit costs (for example financing costs)
- ❑ Lower bank interest costs (if the enterprise finances debtors with a bank overdraft facility)
- ❑ Lower collection costs
- ❑ Reduced losses as a result of accounts that are overdue for a long time (for example loss of income from interest)
- ❑ Lower levels of bad debt

NOTE:
Granting cash discounts, however, is not a way to limit bad debts. If a debtor does not have enough money to pay his or her account, the possibility of a discount for early payment will not make it easier to collect that debtor. On the contrary, there is an even greater possibility that the debtor will disregard the credit period.

The enterprise must **decide on the discount period**. This is the **period in which the discount is granted**. For example, the enterprise can decide that if payment is done within 14 days after purchases, or within seven days after the date of the account statement, or sooner, the debtor is entitled to a cash discount of 5%.

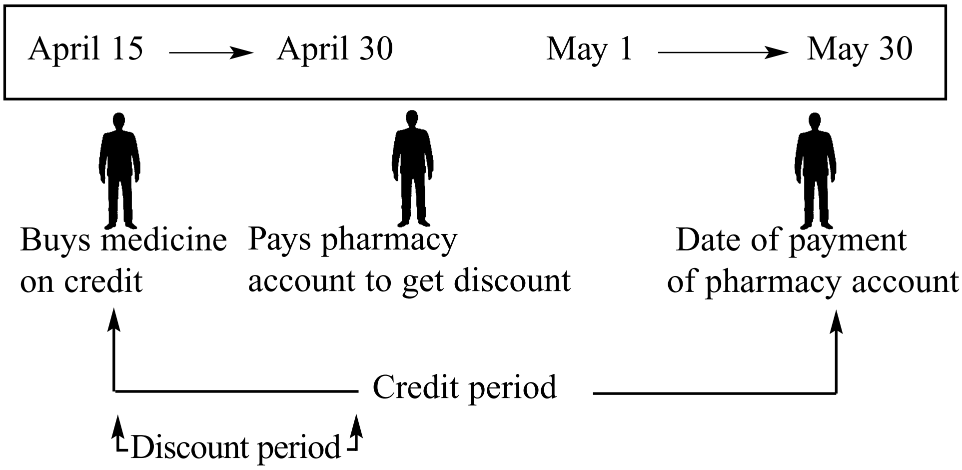
In practice it often happens that debtors **still claim** the cash discount after the discount period has expired. This means that the debtor deducts the discount from the outstanding balance to determine the amount payable. The enterprise then receives a payment from the debtor that is equal to the outstanding amount minus the cash discount, even if the debtor no longer qualifies for this discount. The discount is granted only if the account is settled within a certain period.

The enterprise must **decide** what it will do in such a case. If the enterprise receives the payment after the credit period has expired, it can, for example, inform the debtor by letter that the debtor:

- ❑ has not qualified for the discount
- ❑ must pay the outstanding amount

The outstanding amount is shown on the debtor's account. The enterprise expects the debtor to pay this amount as well. The enterprise can also decide that all orders by or sales to the debtor will be suspended (stopped) until the overdue amount (the cash discount that was not earned) is paid.

To eliminate the problem of unearned cash discounts, the enterprise must clearly show the credit terms on the account. In respect of the cash discount, the enterprise may, for example, state the following: "This account must be paid before or on 30 June. A discount of R20 will be deducted if the account is **paid in full before or on this date**. No discounts will be granted if the account is paid after the due date."



i) *Fill in the missing words:*

- ❑ *A cash discount is a* ______________ *granted by the* ______________ *to the debtor if* ______________
- ❑ *The discount period is* ______________

ii) *Can cash discounts result in debtors paying their accounts more quickly? Give reasons for your answer.*

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iii) *Why, do you think, do enterprises grant cash discounts?*

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6.2.5 Interest charges

When the credit policy is formulated, the enterprise must decide whether it will charge interest on overdue accounts. Every day after the expiry date that the enterprise has to wait for the debtor to pay the account, the enterprise loses income.

Overdue accounts slow down the turnover rate of debtors. If this happens, the enterprise must use alternative sources of capital for financing the requirement for working capital. The slow turnover rate of debtors means that the enterprise cannot use the capital that should have become available from the debtors in other ways. For example, debtors are converted into cash when the accounts are paid, and this cash can be used for paying the enterprise's creditors. If the debtors do not pay their accounts on time, the enterprise must find funds from alternative sources to pay its creditors. For instance, it may have to use a bank overdraft facility.

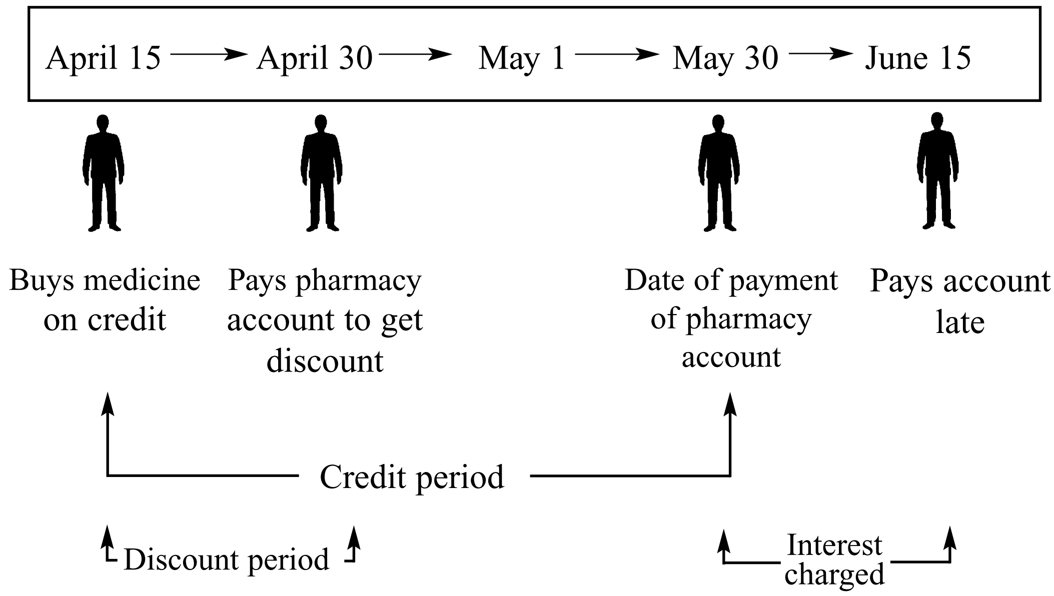
The enterprise also loses an alternative return on the capital (opportunity costs). The cash becoming available from the debtors could have given the enterprise an income from interest. For example, the enterprise could have invested the funds in a 32-day notice account at a bank and could have earned interest in this way.

If debtors do not pay their accounts before the expiry date, it actually means that they are borrowing money from the enterprise. If the enterprise does not charge interest on overdue accounts, the debtor is in fact borrowing the money from the enterprise free of charge. Nobody lends money free of charge. When a person takes out a personal loan at a bank, interest has to be paid on that loan. The same applies to an enterprise that borrows money from a bank.

The enterprise can thus provide for the losses mentioned above by charging interest on overdue accounts. This means that the enterprise compensates itself for the "loss of income" it suffers when debtors pay their accounts late. Charging interest on overdue accounts also prevents the enterprise from indirectly discriminating against those debtors who do pay their accounts on time.

However, there is also another opinion on the question of interest on overdue accounts. Many enterprises are not in favour of charging interest on overdue accounts. These enterprises are afraid that they will offend their debtors and perhaps lose them. In other words, the enterprises are afraid of losing customers. Many enterprises also believe that interest charges in fact encourage debtors to pay their accounts late. They are of the opinion that there is always a group of debtors that will not mind paying the interest, as long as they can pay their accounts at a later date.

If an enterprise decides to charge interest on overdue accounts, it is important that this policy should be applied consistently. Notifying the customers that, for example, "2% interest per month will be charged unless the account is paid before or on 30 June" has little value unless the enterprise implements this policy.



Examples of enterprises ***charging interest on overdue accounts*** *are the following:*

- ❑ *Commercial banks where individuals or enterprises can apply for loans*
- ❑ *The credit card division of a bank, when people do not pay their accounts in full or when the payment reaches the bank after the due date*
- ❑ *Telkom. If a person or enterprise does not pay a telephone account before or on the due date, interest is added*
- ❑ *Any enterprise offering hire-purchase facilities, for example Russells and OK Bazaars. If account holders do not pay their instalments before the due date, interest is added. In most cases the interest rate is the same as that at which the hire-purchase financing was made available*
- ❑ *Bankfin. If a person or enterprise that bought a car or a delivery vehicle in terms of a hire-purchase transaction or a lease agreement does not pay the instalment in time, interest is charged*

- *Clothing chain stores such as Edgars or Truworths. However, some of these stores do not immediately charge interest on overdue accounts, but only after payment has not been received after, for example, three months*

6.2.6 Seasonal offers

When the demand for a product is seasonal, sellers encourage buyers to make **purchases out of season**. They do this by **adjusting** the credit terms in such a way that payment is postponed to correspond to the buyer's selling season. The **payment period** is thus **extended**. This is called **seasonal dating**.

Seasonal dating is usually done by the seller dating the invoice with a date at the beginning of the new active season. The standard credit terms of the seller, or the terms agreed by the seller and buyer, apply to this invoice. For example, summer clothing may be purchased in June, July and August, but the invoice is dated for September or October (depending on the agreement). Purchases during the buyer's active selling season are invoiced (recorded and indicated on the buyer's account) according to the normal standard terms or the terms as agreed.

Advantages of seasonal dating: Constant sales Constant manufacturing Storing stock Lower costs

The **advantages of seasonal dating** for the seller are that:

- sales continue to take place - it results in credit sales that may otherwise not have been made
- the enterprise can continue manufacturing its products (the factory can be in operation throughout the year)
- for the manufacturer, it eliminates problems of storing stock - it is not necessary to store all the stock until the beginning of the next season
- the cost of storing the stock is lower for the seller

Seasonal dating also means, of course, that the seller has to finance the credit sales for a much longer period. As a result **more capital** must be **invested** in the debtors, which leads to **additional costs**. The seller waits much longer for the money than would have been the case with a normal credit transaction (and thus has higher financing costs and a loss of income from interest). It is thus important that the advantages of seasonal dating should always be greater than the cost it incurs.

In your opinion, which advantages does seasonal dating have for the ***buyer****?*

6.3 NEGOTIABLE INSTRUMENTS

In the previous section we already saw that people and enterprises use, among other things, cheques and bills of exchange to pay their accounts. Let us look at these methods of payment in more detail.

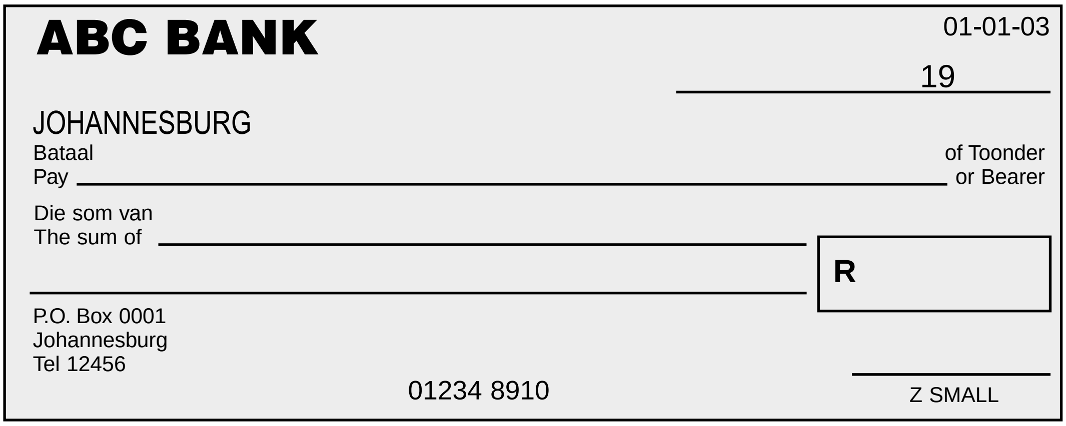
Cheques, bills of exchange and promissory notes (promises to pay) are negotiable instruments. This means that they can be **transferred** from one person to another. It also means that the person who receives the negotiable instrument becomes the **legal owner** of it - even if the document (for example a cheque or bill of exchange) was stolen and then given to the person. However, in such a case the owner must not know about the theft and must also have given something (such as products or services) in return for the money received.

The three negotiable instruments we will examine are:

- ❑ cheques
- ❑ bills of exchange
- ❑ promissory notes

❑ **Cheques**

A cheque is a written order that a person or enterprise with a cheque account gives to his or her bank, instructing the bank to pay a certain amount on demand to a specific person or enterprise, or to a bearer (someone who has the cheque in his or her possession and has the right to possess it).



There are three parties involved in a cheque transaction:

- ❑ **The drawer**. This is the person or enterprise instructing the bank to pay out an amount.
- ❑ **The drawee**. This is the bank that receives the instruction to pay out the amount. The bank receives this instruction from the drawer.
- ❑ **The payee**. This is the person or enterprise to which the cheque is originally made out.

Identify the three parties involved in the ***cheque*** *transaction in the example below:*
Simon writes out a cheque to pay his study fees to Technikon SA.

i) ________________________ *is the drawer*
ii) ________________________ *is the drawee*
iii) ________________________ *is the payee*

We can distinguish between an **order cheque** and a **bearer cheque**.

- ❑ **Order cheque**. If a cheque reads: "Pay M Smith or order", it means that the cheque must be endorsed by M Smith. This means that the payee must sign on the reverse side (the back) of the cheque before the bank will pay out the money.
- ❑ **Bearer cheque**. If the cheque reads: "Pay M Smith or bearer", M Smith does not have to endorse the cheque.

*When the payee of an order cheque signs his or her name on the reverse side of the cheque, the cheque is **endorsed**.*

We can distinguish between the following types of endorsement:

- **Blank endorsement**. The payee of an order cheque signs his or her name on the reverse of the cheque. This changes the order cheque into a bearer cheque, and the person who has the cheque in his or her possession has the right to receive the payment from the bank.

- **Special endorsement**. When the payee endorses the cheque and instructs the bank to pay another person, this is known as a special endorsement.

- **Restrictive endorsement**. If the payee endorses the cheque and makes it payable only to a certain person, no other person may receive the payment. This is a restrictive endorsement.

It is also common practice to **cross** cheques. A cheque is crossed when two parallel lines are made across the face (front) of the cheque - with or without adding certain words. When a cheque is crossed, the words "or bearer" must also be crossed out. (If this is not done, there will be two different instructions to the bank and it will not be clear which of them is the valid one.) As soon as a cheque is crossed, the person who has the cheque can no longer go to the bank concerned and receive the money across the counter. The cheque must now be deposited into (paid into) a bank account, for example into a cheque or savings account. If a cheque that is made out to a person is deposited into his or her own bank account, it does not need to be endorsed.

However, if the payee transfers the cheque to another person, it must be endorsed before it is deposited.

A cheque can be crossed in a number of different ways.

- **General crossing**

    - Two parallel lines with no additional words are drawn across the face of the cheque

    - Two parallel lines are drawn and the words "and Co" are written between the lines

The effect of these two methods of crossing is the same: the cheque must be deposited into a bank account. However, the crossing has no effect on the negotiability of the cheque (in other words, it can still be transferred to another person).

- ❍ Two parallel lines are drawn and the words “not negotiable” are written between the lines. If a cheque is crossed in this way, it is still transferable, but if the cheque is stolen, the real owner can recover the money from any person who has the cheque.

- ❑ **Special crossing**
  If the name of a certain bank is written between the parallel lines, the cheque can be deposited in any person’s valid bank account **at that bank only**.

- ❑ **Restrictive crossing**
  If the words “not negotiable, account payee only” are written between the parallel lines, the cheque may only be deposited into the payee’s account. A restrictive crossing thus makes a cheque a **non-transferable cheque**.

The crossing of a cheque is regarded as a precautionary (safety) measure, and for this reason the drawer should cross a cheque whenever possible. If a person receives an uncrossed cheque, he or she has the right to cross it as he or she prefers. The person who has the cheque may change a general crossing to a special crossing.

If the bank refuses to pay out a cheque, we say the cheque is **dishonoured**. In everyday language we say the cheque has “bounced”. If the bank dishonours a cheque, the cheque is marked by the bank and it is shown why the cheque was not paid out. The following table shows the reasons why cheques may be dishonoured, the actions that must be taken and the way in which the bank marks the cheque:

Reason for dishonouring	*Action marked*	*Cheque*
❑ Special written instruction by the drawer to stop the cheque	Communicate with drawer	P/S - payment stopped
❑ No funds or insufficient funds in account	Communicate with drawer	R/D - refer to drawer
❑ Account closed before cheque was presented	Communicate with drawer	Account closed
❑ The words and figures are different	Communicate with drawer	Words/ figures
❑ Cheque post-dated (for example, a cheque is paid in on the third of the month but the date on the cheque is the 15th)	The date on the cheque must be changed, or the cheque must be kept until the 15th	Post-dated
❑ The drawer died before the cheque was presented	Contact the deceased's (the dead person's) executor (the person who is handling the estate)	Drawer deceased
❑ Cheque stale (old, when it is more than three months after the date on the cheque)	Drawer must change date	Stale
❑ Cheque not signed	Communicate with drawer	Not signed

With regard to the general reasons why cheques are dishonoured by banks, we would like to emphasise the following important points about writing out cheques:

- Make sure that the **date** on the cheque is correct
- Make sure that the cheque is **signed**
- Check that the **words** and **figures** on the cheque **are the same**
- If there are any **changes** to the cheque, for example if the date or the name of the payee is changed, the drawer must **sign** his or her full name next to the change

Cheques should be written out in such a way that the possibility of fraud is kept to a minimum. For example, do not leave empty (blank) spaces before the amount so that extra words or figures can be filled in. The amount in figures must be written as close as possible to the R sign.

Cheques may only be signed by the drawer or any other person authorised by the drawer. For example, in an enterprise there are only certain people in the financial department who are authorised to sign cheques on behalf of the enterprise. The people who sign cheques on behalf of an enterprise are not personally responsible for the payment. In the same way, for example, a husband with a cheque account can grant his wife signing rights on the cheques. This means that she has authorisation (permission) to write out cheques on his account.

When a cheque account is opened, the bank obtains a **specimen signature**. This is an example of the signature(s) of the person or persons authorised to sign the cheques. The purpose of this is to prevent that someone else signs the cheques and has them paid out. It is a measure to prevent fraud.

Many enterprises accept **bank-guaranteed cheques** only. This means that the cheque is "certified" or guaranteed by the bank **before** the cheque is written out and given to the payee. The bank guarantees that the cheque will be paid out (honoured). To have a cheque guaranteed, it must be taken to the drawer's bank **before** it is handed to the payee. If the **drawer has sufficient funds**, the bank also signs the cheque ("countersigns" the cheque).

Match the words in column A with the best definition in column B. All the words and definitions relate to cheques.

A	*B*
❑ *Drawer*	❑ *Receives an instruction to pay*
❑ *Endorse*	❑ *Drawing two parallel lines on the front of the cheque*
❑ *Drawee*	❑ *Gives an instruction to pay*
❑ *Crossing*	❑ *Payee writes name on the back of the* cheque
❑ *Dishonoured*	❑ *Bank countersigns the cheque*
❑ *Guaranteed*	❑ *Bank refuses to pay out the cheque*

- **Bills of exchange**

A bill of exchange is an unconditional order in writing from one person to another that requires the person to whom the bill is addressed (the addressee) to pay, in exchange for goods or services received, a certain amount of money:

- *on demand, or*
- *by a certain date, or*
- *by a date still to be determined.*

The amount mentioned in the bill of exchange must be paid to the sender of the bill of exchange, or to a person who is specifically mentioned, or to the bearer of the bill of exchange. The person giving the order must sign the bill of exchange.

Due 25 March 1996	No. 2564 21 February 1996
R2 000	34 days after date
Pay to the order of GL Rose LTD (Payee) The sum of two thousand rand for value received	
To J Smith & Co P.O. Box 1234 Johannesburg (Drawee)	____________________ (Drawer)

In simple terms: A bill of exchange is a document that a person or enterprise addresses to a debtor, **ordering** that debtor to pay an outstanding debt before a specified date. The debtor must sign the bill of exchange after receiving it. A bill actually amounts to an **acknowledgement of debt** by the debtor. With the bill the debtor confirms that he or she owes the amount for which the bill was issued. The debtor undertakes (promises) to pay the amount owing before or on a specified date.

The place where the bill of exchange is payable by the due date is called the **domicile**. When a bill is accepted, the name of the acceptor's bank and also the place of payment are usually indicated, for example: payable at ABC Bank Ltd, Cape Town.

The following parties are involved in a bill of exchange:

- **The drawer**. This is the person who writes out or draws the bill. In other words, the drawer is the person or enterprise that the money is owed to - the **creditor**.

- **The drawee**. This is the person on whom the bill is drawn, in other words the person who owes the money - the **debtor**. When the drawee accepts the bill (by signing it) he or she becomes the **acceptor** (the one who has accepted the bill). The drawee must accept the bill **before** it can be a legal document.

If the drawee agrees to the terms and amount of the bill of exchange, the word "accepted" is written across the face of the bill. The date is added and the person signs his or her name. If a bill is drawn on an enterprise, it is signed by a certain person on behalf of the enterprise.

*If the drawee accepts the bill, he or she undertakes to pay the bill in accordance with the terms and amount specified. However, the drawee may also change the terms or amount of the bill. This is known as a **qualified acceptance**, meaning that the drawee has qualified, in other words changed or more specifically defined, the terms or amount of the bill. The payee must now decide whether he or she accepts the changed terms. If this is the case, he or she must sign the bill again (all changes must be signed by the drawer as well as the acceptor).*

- **The payee**. This is the person or enterprise to which the bill is made payable.

Every bill of exchange that is written out has a **tenor** (or term). This is the time from the date that the bill is written out to the due date. The due date is the date on which payment must be made. The tenure of the bill can be shown as, for example, 30 days after date (30 d/d), or 3 months after date (3 m/d).

The holder of a bill (a person or enterprise) can **discount** the bill before the due date at, for example, a commercial bank. This means that the holder can have the bill converted into money before the due date. It also means that the financial institution must now collect the money that is owed from the debtor.

If an enterprise, for example, discounts the bill before the due date, it pays a percentage of the value of the bill to the financial institution (this amount is based on the interest that must be deducted for the period the bill still has to run, and is called a **"bank discount"**). This means that the cash amount the enterprise receives when discounting the bill is lower than the value of the bill on the due date. However, the possibility of discounting the bill earlier gives the enterprise the opportunity to improve its cash flow, should this be necessary.

It is also possible for the acceptor of a bill to pay the bill earlier than on the due date (to “retire” the bill). In such a case the acceptor is entitled to a reduction in the amount due. The reduction in the amount due is based on the number of days before the due date that the account is paid. For example, if a three-month bill is paid one month before the due date, the reduction is based on a period of one month. The reduction in the amount due is called a **rebate**.

To summarise, the following **steps** are involved in using a bill of exchange:

❑ The enterprise (drawer of the bill of exchange) **draws a bill of exchange on the debtor -** the bill is written out and addressed to the debtor. **The amount due and the date on which the amount must be paid (the due date) are clearly indicated**.

❑ The debtor receives the bill of exchange, signs it and also indicates the date on which it is signed. In other words, **the debtor accepts the bill and then returns it to the enterprise**. Only then the bill becomes a valid document, that is after the debtor or **drawee** has accepted it.

❑ The enterprise deposits the bill of exchange at the bank a few days before the due date. **The bank sends the accepted bill of exchange to the debtor’s commercial bank. On the due date this bank debits the debtor’s account with the specific amount**.

Steel Dezign is an enterprise that manufactures steel products and sells these products to contractors. On 1 June 1996 Steel Dezign draws a ***bill of exchange*** *on Bridges CC for an amount of R100 000, due on 1 August.*

i) *Identify the parties involved in the bill of exchange in the example above.*

ii) *Define each party's responsibility in one sentence.*

iii) *What is the tenor of the bill in the example above?*

- ❑ **Promissory note**

A promissory note is an unconditional promise in writing from one person to another, signed by the maker of the promise. The person promises to pay an amount of money (that is due) to the specified person, his or her order or his or her bearer, in return for products or services received. This amount can be paid on demand, or on a certain date or a date still to be determined in future.

The following parties are involved in a promissory note:

- ❑ **The maker (or drawer)**. This is the person who writes out the promissory note, signs it and is responsible for payment (the person who owes the money).
- ❑ **The payee**. This is the person to whom the promise is originally made.

Just like a bill of exchange, a promissory note can be negotiated, discounted, retired (paid early) or dishonoured.

DIFFERENCES BETWEEN A BILL OF EXCHANGE AND A PROMISSORY NOTE	
BILL OF EXCHANGE	PROMISSORY NOTE
❑ Drawn up and signed by the creditor	❑ Drawn up and signed by the debtor
❑ It is an order	❑ It is a promise
❑ It must be accepted before the debtor is under an obligation to pay	❑ It does not need to be accepted, because the debtor's signature is already on it
❑ Three parties may be involved: drawer, drawee and payee	❑ Only two parties are involved: maker and payee

6.4 INFORMATION ABOUT CREDIT TERMS

It is very important that the enterprise granting credit must give the credit applicant **complete information** about the credit terms. Customers who use consumer credit should be clearly informed about the type of credit plan used. For example, an account holder with a revolving credit plan over a six-month period must pay a certain instalment on the account every month, and **not only** at the end of the six-month period. If the customer does not know exactly what is involved in a revolving credit scheme, it may result in late or no payments. This in turn could cause collection problems for the enterprise and so incur additional costs.

Account holders should also be given information about the way in which the account can be paid. They should further be informed whether interest will be charged on overdue accounts. The enterprise thus has the **responsibility** to **explain** the credit terms in detail to new customers.

Information about the credit terms and managing credit in general is especially important when customers are using credit for the **first time** in their lives. This group of customers will not necessarily be aware of all the credit terms. They may not even know the meaning of concepts such as repayment terms, interest charges, financing costs, credit limits, outstanding balance and available credit.

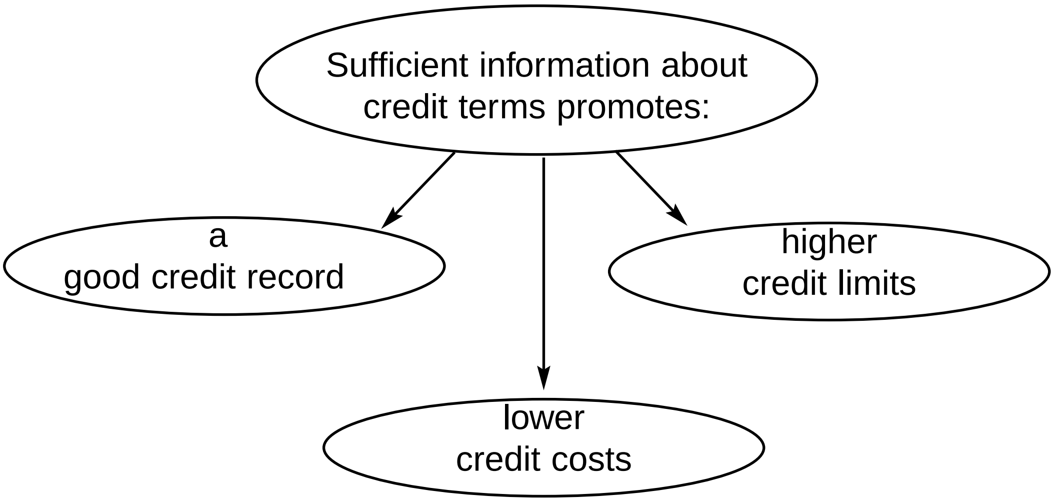
The enterprise thus has a responsibility to inform customers who are using credit for the first time about all these aspects. It can give this information to the customer in writing, for example together with the letter notifying the person that his or her credit application was successful. However, this can also be done personally, for example when the person goes to the store to collect his or her account card.

If account holders understand and have enough information about the credit terms, they will be more likely to manage their accounts in a responsible way. This contributes to:

❑ a good credit record

❑ lower credit costs (for example, it will not be necessary to pay interest on overdue accounts)

❑ the possibility of higher credit limits in the long term (credit limits can only be increased if the account holder manages the account responsibly and makes payments regularly and on time)



From the enterprise's point of view sufficient information about credit terms also has certain advantages, specifically with regard to the collection of accounts. If debtors pay regularly and on time, the enterprise will have very few collection problems. The cost of collection will also be lower. The enterprise's turnover rate of debtors will be higher, which will have a positive effect on its liquidity position and cash flow. If the customer is informed, it will also prevent disputes that might damage the relationship between the buyer and seller.

As with consumer credit, credit terms should also be clearly explained to new customers using financial and trade credit. In the case of trade credit especially, where specific terms are often set for individual buyers, these terms should be clearly communicated. Aspects that should always be explained include interest charges, unearned discounts and orders that cannot be taken if the account is overdue. Where enterprises have standard terms, a copy of the terms can be included with each price list. The details could also be sent to potential customers together with a quotation.

In some cases a buyer might try to change the terms by writing other terms on the order. The seller must then decide whether the revised terms are acceptable, or whether he or she will insist that the quoted terms remain unchanged (competition in the market can play a role in such a decision).

6.5 SUMMARY

In this chapter we saw that the enterprise must have clear guidelines for its credit terms. The enterprise cannot obtain the best possible advantage from credit without clear credit terms. We examined the following aspects of credit terms:

- ❑ The type of credit
- ❑ The credit period
- ❑ The method of payment
- ❑ Cash discounts and the discount period
- ❑ Interest charges
- ❑ Seasonal offers

We discussed the most important negotiable instruments. These instruments are generally used in practice to pay accounts.

In the last section of the chapter we saw that it is essential for the enterprise to communicate the credit terms to buyers. Without detailed information problems could arise with the late payment or non-payment of accounts - something the enterprise would like to avoid at all costs.

CREDIT TERMS	
❑ Types of credit	❑ Types of consumer, trade and financial credit
❑ Credit period	❑ Number of days/months
❑ Method of payment	❑ Cash, cheques, postal orders, debit orders, electronic transfer of funds, bills of exchange, contra accounts, advance payments
❑ Cash discount and discount period	❑ Discount, number of days
❑ Interest charges	❑ Late payments
❑ Seasonal offer	❑ Adjustment of credit terms

6.6 SELF-EVALUATION

1. Fill in the missing word(s):

   - The method of payment by which a debtor pays an amount directly into a creditor's account is called a ______________

   - A cheque is ________________ when the bank refuses to pay it out.

   - If the bank countersigns one of XY Enterprise's cheques, that cheque is called a ________________ cheque.

   - If enterprise A sells a bill of exchange with a tenor of 60 days to a commercial bank before the due date, the bill of exchange is ________________

   - If enterprise A draws a bill of exchange on enterprise B, and enterprise B accepts it, B is called the ________________

2. Indicate whether the following statements are true or false:

   - A crossed cheque that has been transferred can be paid directly into a bank account without an endorsement. (TRUE/FALSE)

   - Two parties are involved in a promissory note. (TRUE/FALSE)

   - There is no difference between a bill of exchange and a promissory note. (TRUE/FALSE)

   - ABC Bank will not refuse to pay out a cheque dated 16 April 1996 on 10 April 1996. (TRUE/FALSE)

   - With bills of exchange as a method of payment, creditors are ensured that they will receive their money on a certain date. (TRUE/FALSE)

3. Use the following table to discuss credit terms in detail:

CREDIT TERMS	
❑ Types of credit	❑ List the types of consumer, trade and financial credit
❑ Credit period	❑ Meaning Standard credit period Factors influencing the credit period
❑ Method of payment	❑ Cash, cheques, postal orders, debit orders, electronic transfer of funds, bills of exchange, contra accounts, advance payments
❑ Cash discount and discount period	❑ Meaning Purpose and advantages Unearned discounts
❑ Interest charges	❑ Meaning Purpose
❑ Seasonal offer	❑ Meaning Advantages and disadvantages for the buyer and seller

6.7 REFERENCES

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CHAPTER 7

THE COLLECTION OF DEBTORS IN THE ENTERPRISE

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CHAPTER 7

THE COLLECTION OF DEBTORS IN THE ENTERPRISE

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ❑ *discuss the importance of collection*
- ❑ *discuss the reasons why enterprises would like to collect debtors as soon as possible*
- ❑ *explain the objectives of collecting debtors*
- ❑ *briefly explain the role of the credit manager in collecting debtors*
- ❑ *discuss, in detail, all the factors that may lead to collection problems*
- ❑ *discuss guidelines for and requirements of effective collection in detail*
- ❑ *define a collection policy*
- ❑ *discuss the factors influencing the formulation of a collection policy*

7.1 INTRODUCTION

In any enterprise the success of credit sales is determined by how effectively debtors and overdue amounts are collected. The enterprise can only truly experience the advantages of credit when the debtor has paid the account in full. However, collecting debtors is not always a problem-free process. The reality is that some debtors will probably not pay their accounts on time (or will not pay their accounts at all). Suppliers of credit (trade, consumer and financial credit) always bear the risk of late payments and bad debts.

Enterprises always attempt to collect their debtors as soon as possible. At the same time, they are attempting to convert (change) debtors into cash as soon as possible. This means that they try to make the capital used for financing the debtors available as soon as possible so that it can be used for other purposes in the enterprise. The effective collection of debtors thus has a **positive influence** on the turnover rate of debtors, as well as on the enterprise's cash flow position.

*The **turnover rate of debtors** refers to the rate at which debtors are converted into cash. This can be explained as follows: When people buy from an enterprise on credit, they become debtors and they owe the enterprise money. When the debtors pay their accounts at the end of the month, they settle their debts and the enterprise receives its money. In the enterprise's books, the entry "debtor" is now changed to "cash" (money).*

*The number of times per year that debtors are converted into cash is the **turnover rate of debtors**.*

*We can also express the conversion of debtors into cash in terms of **days**. For example, it may take 45 days before the debtors are converted into cash. In other words: it takes on average 45 days to collect the debtors. In this case we refer to the **collection period** of debtors.*

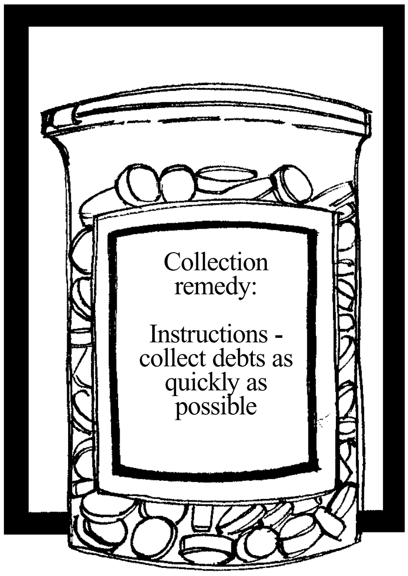
NOTE:
The turnover rate of debtors is influenced by various factors such as the industry in which the enterprise operates, the credit standard and the credit terms. If the enterprise grants a credit period of 60 days, it is obviously unrealistic to expect a debtor turnover rate of 30 days. In the same way, an enterprise with a revolving credit plan over six months will not expect to collect all the outstanding debtors within the first two months. What this enterprise does want to do, however, is to collect all the money that is due at the end of the first month. The objective of converting the debtors into cash as quickly as possible should thus be seen in perspective.

The purpose of this chapter is to emphasise the importance of effective collections. We will start by looking at the reasons why enterprises want to collect debtors as quickly as possible. We will investigate the problems enterprises experience with collections and what they can do to manage collections as effectively as possible. We will also discuss the importance of a collection policy, as well as the factors influencing the formulation of the collection policy.

7.2 THE IMPORTANCE OF COLLECTION

In the introduction we mentioned that the **collection of debtors plays a key role** in the success of the enterprise's credit sales. It is a common saying in the credit world that a sales transaction is only finally concluded once the full amount has been paid. By now you know that, the longer the enterprise has to wait for its money, the greater is the risk of granting credit. The costs of collecting debts also become higher, and this has a negative influence on the enterprise's income. The enterprise thus cannot afford to delay in collecting its debts!

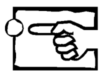
Many enterprises grant cash discounts with the purpose of encouraging debtors to pay their accounts more quickly. Enterprises also attempt to collect overdue accounts as soon as possible. (The longer the account is overdue, the greater the risk of bad debts.)



The **effective collection** of debtors has several **advantages** for the enterprise. This is why the enterprise would like to collect debtors as quickly as possible. Let us look more closely at the reasons why enterprises want to collect debtors as soon as possible.

Reasons:
Cheaper
Easier
Reduced risk
Increased turnover rate
Improved cash flow
Image of creditworthiness
Reduced need for finance
Positive effect on sales
Good payment habits
Prompt payment

❑ It is **cheaper to keep an existing account active** than to open a new account. It is very expensive to open new accounts because there are costs involved in, for example, handling the credit application, processing the application, collecting credit information about the applicant and issuing customer cards.



NOTE:
The enterprise must handle all existing accounts in such a way that there are advantages to have these accounts on their books. The way in which the enterprise collects accounts may help a great deal to keep existing accounts active. For example, it should begin to follow up overdue accounts as soon as possible, and act professionally towards debtors to retain their goodwill.

❑ The collection of debtors is **made easier**. The **longer** the enterprise waits before starting with the collection of debtors, the **more difficult** it becomes to do the collection. The enterprise should thus start preparing its collection activities as soon as a purchase has been made.

EXAMPLES

❑ *Telephone the debtor and establish whether the order has been put together and delivered correctly. If there is a problem, it can be rectified immediately. In this way potential collection problems can be eliminated.*

❑ *Control and file the delivery notes. A delivery note is a document that the buyer has to sign on delivery of the ordered products. If the buyer has any enquiries about the order, the enterprise can refer to the delivery note.*

- ❑ *Send out invoices and accounts as soon as possible, so that the debtors receive these in time. If the customers receive the accounts shortly after doing the purchases, the transaction will still be fresh in their memory. At the same time this gives the customers the opportunity to provide for paying the account - financially as well as, for example, in terms of time.*
- ❑ *Regularly check accounts to identify any possible problems, for example an amount that has become overdue.*

It is very important, therefore, that the enterprise should **identify** overdue accounts **at an early stage**. Identifying these accounts early will eliminate many problems for the enterprise. For example, the cost involved in collections will be lower and legal action against the debtor will be less likely. At the same time the enterprise will retain the debtor's goodwill.

- ❑ There is a **reduced risk of bad debts**. The longer collection is delayed, the greater the possibility of bad debts.

- ❑ There is an **increased turnover rate of capital** invested in the debtors. This means that the capital is available sooner to be used (invested) for another purpose. The enterprise now actually needs less capital for financing the debtors (that is, it has a smaller capital requirement for financing the debtors).

- ❑ The **cash flow position** of the enterprise **improves**. This has a positive influence on the levels of cash in the enterprise (the levels of cash increase). Slow collection results in lower levels of cash, while effective and timeous collection may increase the levels of cash in the enterprise. Enterprises that sell mainly on credit depend on the collection of debtors for a large percentage of their cash flow. Effective collection thus helps to improve their liquidity position.

- ❑ As a result of the increased cash flow, the enterprise is in a **better position** to **pay its creditors sooner**. It this way it ensures that it can **establish** and **strengthen** its **image of creditworthiness**. If funds for paying its creditors are available in time, the enterprise can also use the discounts offered by suppliers. Collecting the debtors quickly increases the enterprise's cash flow and makes it possible for the enterprise to pay its creditors within the discount period. The enterprise could then also make use of special offers or bargains.

- Improving the cash flow and collecting the debtors quickly give the enterprise the advantage of a **reduced need for external short-term finance** (for example bank loans). Instead of using a loan or an overdraft facility, the enterprise uses internal funds (that is, money available within the enterprise itself). An enterprise with a reduced need for external short-term finance can, among other things, save money on interest.

- Speedy collection also has a **positive effect on the enterprise's sales**. If the collection of debtors is done slowly and many accounts are overdue, it means that the customers concerned cannot make any new purchases from the enterprise until their accounts are settled. A customer will not easily buy from an enterprise where he or she has an overdue account. Therefore, if there is a large volume of overdue accounts, it may affect the enterprise's sales.

- In the long term, effective collection helps the debtor to **establish good payment habits**. Debtors tend to start paying their accounts in time because it has a positive effect on their credit record.

- If an enterprise has **a reputation for effective collection**, this will encourage **prompt payment**. When the enterprise gives approved credit applicants information about credit terms and the credit period, it must also stress the importance of prompt payments. It must emphasise that the enterprise **expects** prompt payments, because of the great effect such payments have on the enterprise's cash flow position and ability to pay its creditors.

i) *What positive effects does effective collection have for the enterprise's cash flow?*

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ii) *List three ways in which an enterprise can ensure that its debtors pay their accounts on time.*

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iii) Indicate whether the following two statements are true or false:

- ❑ *Slow collection does not bring about a greater risk of bad debts for the enterprise. (TRUE/FALSE)*
- ❑ *Effective collection contributes to greater sales volumes. (TRUE/FALSE)*

iv) Justify each of your answers in iii) above in two sentences.

In collecting debtors, the enterprise thus tries to achieve the following **basic objectives**:

- ❑ Favourable turnover rate of debtors or debtors collection period (which results in improved cash flow)
- ❑ Low collection costs
- ❑ A minimum amount of bad debts
- ❑ Keep existing accounts active (account holders should continue to purchase on credit)
- ❑ Retain the goodwill of debtors (collect the account in such a way that the debtor is not lost for the enterprise, but returns to buy from it again)

These objectives will help the enterprise to attain its primary objective, namely **maximum profitability**.

In your own words, describe the role of the credit manager (or the person responsible for credit and collections) in collecting debtors.

If you are unsure of the credit manager's role, refer to chapter 4.

One of the credit manager's tasks is to manage the debtors of the enterprise in such a way that:

- the maximum cash flow is ensured
- there is a minimum amount of bad debts

The collection of debtors arises directly from this task. Although credit managers do not deal with the collection of debtors themselves, they have to ensure that it is done in a responsible way. The credit manager (in a large enterprise it could also be the collections manager, who would report to the credit manager) must ensure that:

- the collection period of debtors corresponds to the credit period that is granted

- overdue accounts are immediately identified with the help of a good follow-up system

- potential problem cases are identified before they become an actual problem for the enterprise. (For example, if an account is always paid late over a specific period, it may indicate that the debtor has cash flow problems. If the enterprise continues to sell on credit to the debtor, it will only make the problem worse. At this point the enterprise must act by, for example, stopping any further purchases. Should the debtor then be declared bankrupt, the enterprise's losses will not be that large)

- each step in the collection of overdue accounts is recorded

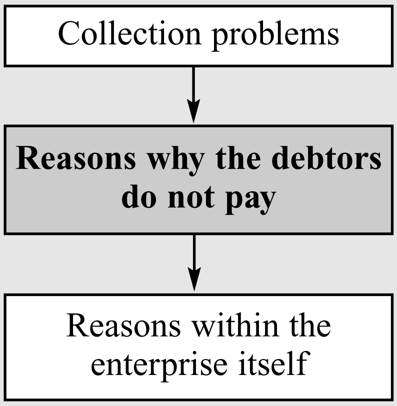
- the collection activities are cost-effective (the income received from an overdue account must justify the cost involved in collecting it)

- bad debts are kept to a minimum

7.3 COLLECTION PROBLEMS

Enterprises often have problems in collecting debtors. These problems may be caused by a variety of factors. Firstly, there are those factors that directly cause **debtors not to pay their accounts**. Secondly, there are factors arising from the **way** in which enterprises **manage** the granting of credit and collections.

COLLECTION PROBLEMS



- ❑ **Reasons why the debtors do not pay**
- ❑ Reasons within the enterprise itself

Reasons:
Does not understand terms
No account
Disputes amount
Unearned discount
No cash
Ineffective administration
Irresponsible
Waits a long time
Amount small
Buys too often
Waits deliberately
Dishonest
Excuses
Bankruptcy
Death

❑ **Reasons why the debtors do not pay**

❑ **The customer does not understand the credit terms**. For example, the customer may be unsure about the meaning of a credit period of 30 days. Is it 30 days from the date of purchase, or 30 days from the date on the account statement?

❑ The debtor **did not receive an invoice and an account statement**. Many debtors think that if they do not receive an account statement, it is not necessary to pay. The enterprise may have posted a statement to the debtor, but if the debtor fails to receive it , for example because it was lost in the post, the account may not be paid.

❑ The debtor **disputes (argues about) the amount** of the account, and for this reason the account is not paid. In the case of trade credit, enterprises can also object to the account. These objections are then said to be the reason for not paying the account. For example, the enterprise may say that the wrong order was delivered, that the order was incomplete, was not received, that the contract price was incorrectly shown, that the address of the enterprise was incorrect or that the enterprise has not received a duplicate invoice.

❑ The debtor has **taken an unearned discount**. This means that the debtor takes the discount after the discount period has elapsed. The enterprise may demand that the debtor pays the outstanding amount, and the debtor may refuse to do so.

❑ Late payment can also be caused by the fact that the debtor may **not have the cash** to settle the account, in other words does not have the money to pay the account. This does not always mean the debtor is insolvent - the cash flow problems may be temporary (for example because of serious illness, temporary unemployment or large unexpected financial obligations). In the case of trade credit the **economic conditions** in which the enterprise operates, or **events** such as strikes (loss of production and sales) may lead to temporary cash flow problems.

- ❑ The debtor is **not able to administrate his or her financial affairs effectively**, and this may cause the accounts to be paid late or to remain unpaid. Accounts thus become overdue as a result of poor financial planning and control by the debtor (for instance, the debtor's account may get lost, and he or she will simply not follow this up).

- ❑ The debtor is **irresponsible** and does not accept that he or she has the obligation to pay the account within the credit period. The debtor has no **financial discipline**.

- ❑ The debtor is in the **habit of waiting a long time** before paying the account. Such debtors are called "slow payers". The person or enterprise does pay all accounts, but never on time.

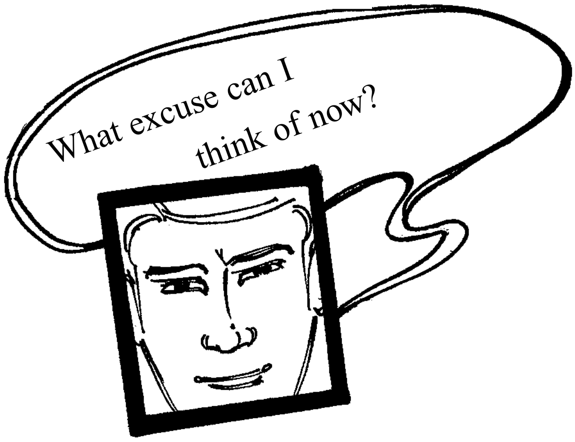
- ❑ It may also happen that a debtor ignores an account because the **amount due is very small**. The debtor argues that this small amount could be added to the balance of the next account, and both accounts could then be paid at the same time.

- ❑ Debtors may **buy on credit too often** and as a result may not be able to pay the account.

- ❑ Debtors **deliberately wait longer** to pay their accounts. For example, the debtors may wait for a reminder to pay. These debtors are in fact using the credit supplier's money to finance their capital requirements.

- ❑ The debtor is simply **dishonest** and does not want to pay the account. The debtor complains or makes an enquiry about the account and tries to have the amount due reduced by **dishonest or unfair objections**. For example, a debtor may pretend that he or she has not in fact bought a certain product, or may deliberately send a post-dated cheque to delay the payment of the account.

- ❑ Debtors commonly use **excuses** to avoid having to pay their accounts on time. For example, with trade credit, an enterprise may say that the person who has to sign the cheque or approve the payment is not available. Debtors may also say that the cheque is in the mail, or that the enterprise is waiting for a copy of the invoice or account before it can make the payment.



Which other excuses have you encountered?

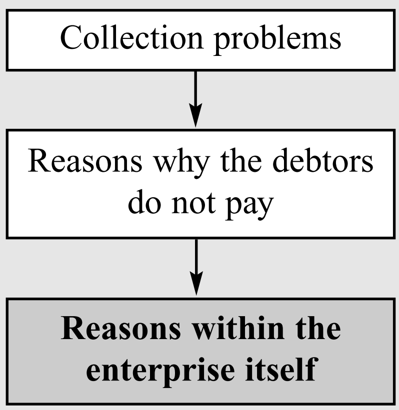
- ❑ Debtors who are on the **verge of bankruptcy** will obviously pay an account late or not at all.

- ❑ The debtor has **died**. In such a case the account must be paid from the debtor's estate.

- ❑ **Reasons within the enterprise itself**

We usually associate overdue accounts with debtors that fail to pay their accounts. However, the way in which the enterprise manages the granting of credit and the collection of debtors can also result in late payments.

COLLECTION PROBLEMS



- ❑ Reasons why the debtors do not pay
- ❑ **Reasons within the enterprise itself**

Factors:
Credit assessment
Inadequate guidelines
Not enough time
Too late
Afraid of losing customers
No control
Order incorrect
Amount greater than quoted
Intangible products

The **following factors** may lead to collection problems:

- The way in which the enterprise does **credit assessments**. The enterprise's credit standard is relevant here. If the credit standard is too low, it means that credit will be granted to people or enterprises that are actually poor credit risks. In such a case the enterprise creates its collection problems right at the beginning with the opening of the account. Credit may also be granted to poor credit risks when the sales staff are eager not to lose their sales commission. Another problem that might arise because of credit assessment is that too much credit may be given, in other words the credit limits that are granted may be too high.

- The enterprise does not have **adequate guidelines** for the collection of debtors. For example, the credit policy may not provide answers to questions such as the following:

  - When will the enterprise start with the collection procedure - how long after the due date?
  - At which intervals will collections be followed up?
  - Should the enterprise charge interest on overdue accounts?
  - In which circumstances can the enterprise grant extensions for payment and for how long?
  - How long must an account be overdue before the debtor's credit facilities are suspended?
  - When will overdue accounts be handed to a collection agency?

- The enterprise **does not give enough time and attention** to the collection of debtors (especially in the case of small business enterprises). It may happen that the enterprise is not aware of the **great effect** of overdue accounts on its cash flow. The enterprise could perhaps be emphasising maximum sales too much and losing sight of the negative effect of overdue accounts on its profits.

- The enterprise may begin with the collection of overdue accounts **too late**. Overdue accounts are identified only long after the due date.

- The enterprise is **afraid of losing its customers** and for this reason does not follow a strict collection policy. This approach does not only result in collection problems, but also causes a considerable delay in the turnover rate of debtors. It may finally also lead to cash flow problems in the enterprise.

- The enterprise may also experience collection problems if there is **insufficient control of the administration of debtors**. For example, debtors may receive incorrect or incomplete accounts. A debtor may be debited for an amount of R130 for goods purchased on 20/3/97, for instance, while he or she may actually have bought goods to the value of R120 on 13/3/97. Enterprises may also have incorrect information about customers, for example an incomplete address.

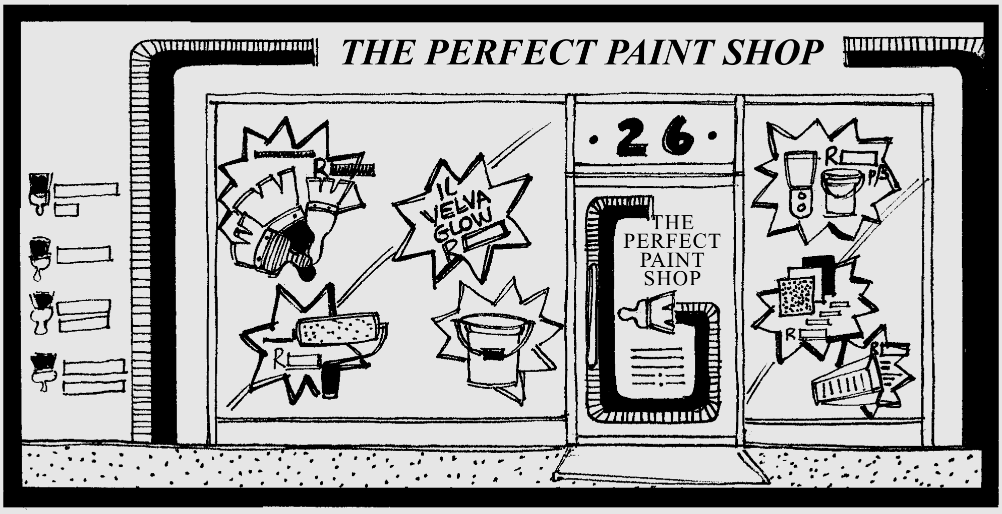
NOTE:
*It is **very important** to update the information on debtors **continuously**. Incorrect or incomplete information can bring the collection of debtors, especially overdue accounts, to a standstill!*

- Late payments may also result from an **order that was made up incorrectly** or goods **damaged** during transport.

- If one enterprise is buying goods from another, late payments may result if the **amount due is greater** than the price that was originally **quoted** by the seller.

- Collection problems may also be experienced if an enterprise **does not sell tangible (touchable) products**, but offers a service, such as a medical examination or any other consultation. In such a case there is no tangible product that the enterprise can repossess. If an enterprise sells furniture or cars, for example, it may take the product from the debtor if the account is not paid. Such enterprises generally have fewer collection problems than those selling non-tangible products. Enterprises offering services on credit should thus give special attention to the collection of accounts.

Study the following example and identify the factors that could have led to collection problems in the enterprise described. Underline the possible causes of the collection problems.



Greg concentrated on the marketing of his shop and on liaison with customers and completely left the administration to Dawn. Although Dawn did the general bookkeeping of the shop very carefully, she did not spend a great deal of time on managing the debtors. Credit sales were recorded very accurately and there was seldom any problem with a customer's order. Dawn also very seldom made an inaccurate entry on the individual debtors' accounts, and enquiries about entries on accounts were minimal.

Because Greg gave a great deal of attention to the sales and marketing functions, he knew most of his customers very well. In an attempt to save postage, Greg started to personally hand account statements to customers when they came to the shop. This resulted in some account holders not receiving any statements for up to two months, and as a result they made the assumption that they did not have to pay. Greg also often granted extra credit to a person he knew very well, without first finding out if that person would be able to afford it. Greg was of the opinion that it was good to help customers, "because it builds my business".

Dawn spent so much time on processing transactions that she did not have much time left to give any attention to the collection of debtors. When she did look at the position with the debtors, she did not know where to begin and what to do to ensure that the account holders pay their accounts. There were no guidelines in the enterprise about the way in which debtors had to be collected. In extreme cases she would telephone a debtor and ask if he or she was aware that the account had last been paid three months ago or longer. In many cases the debtor answered: "No, because I have not received an account again".

7.4 GUIDELINES AND REQUIREMENTS FOR EFFECTIVE COLLECTION

Studying the collection problems of an enterprise makes it possible to identify certain guidelines and requirements for effective collection. If the enterprise follows these guidelines and requirements, it will achieve its basic objectives with collection. This in turn will have a positive effect on the enterprise's primary objective (maximum profitability).

GUIDELINES FOR EFFECTIVE COLLECTION

- ❑ Emphasis on collection
- ❑ Collection policy
- ❑ Debtors control system
- ❑ Identification of overdue accounts
- ❑ Collection objectives
- ❑ Collection procedure
- ❑ Information about credit terms
- ❑ Credit standard
- ❑ Attitude/approach of credit management
- ❑ Effective administration of debtors
- ❑ Distinction between personal relations and business relations
- ❑ Cost-effectiveness
- ❑ Trained collectors

The enterprise can eliminate collection problems to a large degree by **emphasising the importance of collection more strongly**. The enterprise must have a **collection policy**. The collection policy is part of the enterprise's overall credit policy and must include information on the following:

- ❑ How long the debtors may be overdue
- ❑ The way in which overdue accounts must be identified
- ❑ The procedure that should be followed to collect the accounts
- ❑ The collection aids (such as the telephone and letters) that should be used
- ❑ The way in which the effectiveness of the collection of debtors will be measured (which aids will be used, for example the turnover rate of debtors, or the number of days that the accounts are outstanding)

A well-formulated credit and collection policy is a useful aid for the enterprise. Among other things, it ensures that the enterprise makes sound credit decisions. By now we know that credit decisions have a direct influence on the success of collections in the enterprise. Poor credit decisions often lead directly to collection problems.

Write down the reasons why poor credit decisions can lead to collection problems.

Later in this chapter we will return to the collection policy and the factors influencing the formulation of this policy.

Every enterprise must have an **effective system for controlling debtors**. Controlling debtors in the enterprise is aimed at:

- ❑ restricting investment in debtors to a minimum
- ❑ improving cash flow in the enterprise
- ❑ keeping the cost involved in overdue accounts and bad debts to a minimum

It is important to know what the situation is with debtors in the enterprise, because this serves as the point of departure for all the collection activities.

To attain the objective of debtor control, the enterprise must always be **fully informed** about its debtors. For example, it must know how much the debtors have bought (how much they owe), how much they must pay, which debtors have not paid their accounts and how long they have not been paying their accounts (how much debt is overdue).

The enterprise must keep a record of all transactions and payments in which the debtors are involved. This means that the enterprise must have a **sales ledger**. The purpose of the sales ledger is to keep a **record** of:

- ❑ all the sales transactions on credit between the enterprise and its debtors

- all the payments the enterprise has received from its debtors

- the changes that should be made to a debtor's account, for example:
  - when products are returned and a credit note is issued
  - when payment by a debtor is not accepted, for example a cheque dishonoured by the bank

When a person or enterprise returns goods to the enterprise or sends it back, the enterprise issues a credit note. The debtor's account is then credited with the amount of the goods. This means that the debtor's debt is reduced with the amount of the credit note.

To record the transactions that took place between the enterprise and the debtors, the enterprise uses the information on sales slips and invoices, and credit notes (these documents are called source documents). An account statement is then compiled on the basis of the information on the invoice and/or the credit notes.

It is important that invoices, credit notes and account statements should be designed in such a way that all the necessary information can be **clearly indicated**. The information on the documents must be easy to read. It is also important that the person receiving the documents concerned must know whether it is an **invoice** or an **account statement**. The name of the document must be clearly shown at the top.

With regard to the invoice and the account statement it is important that the following information must be shown:

- *The number of the invoice or account statement*
- *The seller's reference number*
- *The seller's name, address, telephone and fax numbers*
- *The debtor's name and address*
- *The debtor's account number*
- *The date of the document*
- *The order date and details about the purchases (the items purchased, and the number of items purchased)*
- *The enterprise's VAT number*
- *The due date and the credit period*
- *On the account statement specifically, the amount due and any amounts overdue*

The recording of all payments received are based on the cash, cheques, debit orders, postal orders, bills of exchange and electronic bank transfers (methods of payment) received by the enterprise.

The enterprise must also have **an effective system of identifying overdue accounts**. In practice the computer is used to do this. If an account (or an instalment) had to be paid and this was not done, the enterprise can establish this by computer within a day after the due date. In other words, the enterprise will do an **age analysis** of debtors. In this way overdue accounts can be identified.

The total percentage of outstanding debtors can only be reduced if the enterprise succeeds in, or even just tries to, collect every overdue account individually. (Possible adjustments in the credit and collection policy may also reduce the percentage of outstanding debtors.)

In its simplest form, the **age analysis of debtors** is the process by which the enterprise gets a general overview of all accounts, particularly overdue accounts. The process can be made more extensive by including an analysis of the history of payments (indicating, among other things, the last date of payment), and a credit rating code (where applicable), as well as any other necessary information.

The accounts included in the age analysis will immediately show overdue amounts. The **status** of a specific account or even of a group of accounts can be quickly determined with this analysis.

The information in the age analysis can be broken down further by grouping together all the accounts in a certain age group. For example, all accounts that are more than 90 days overdue are placed in one group to receive special attention. (The collection procedure changes as the age of the overdue account increases. We will discuss this in the following chapter.) Table 3.1 is an example of an age analysis showing the overdue accounts individually.

The enterprise must have clear **collection objectives**. Apart from the overall objectives such as a favourable turnover rate of debtors and a minimum amount of bad debts, specific objectives must also be formulated for the short term, for example for every month.

EXAMPLE

- *Determine, for example, how many accounts per month must be handled by a collector, for instance 200 accounts. (These figures will depend on the total number of overdue accounts.)*
- *Determine what percentage of the overdue accounts must be collected within the month concerned - for example, you could determine that 50% of the accounts outstanding for 30 to 60 days must be collected within the following month. The collection objectives can be set out in a simple table:*

30-60 days	60-90 days	90-120 days	120+ days
50%	40%	30%	30%

TABLE 3.1

The enterprise must also have a **clear collection procedure** so that collections can be done according to a plan. This enables the collectors to carry out the collections in a logical and systematic (consistent) way. If the enterprise does not work according to a plan, it may result in a great deal of confusion and inefficiency. The collectors must know exactly which procedure they should follow to collect the overdue amounts. For example, if the debtor fails to pay an account, the first contact with the debtor will be in the form of a reminder, and not in the form of threats to take legal action.

Unplanned collections ultimately result in high collection costs, while the number of overdue accounts remain the same! The collection procedure is discussed in detail in the next chapter.

The enterprise must ensure that **all customers** to whom credit has been granted are **fully informed of the credit terms**. They must know exactly when and how they must pay. When the customers open their accounts, they must already be informed of the credit terms, and at the start of the credit period the enterprise must make sure that they know how long this period is. (We emphasised this aspect in chapter 6.) To eliminate any possibility of misunderstanding, the enterprise could indicate the due date as follows on the account statement:

"Your payment should reach us before or on 30 June 1997."

Another factor that could help to reduce collection problems is an **optimal credit standard**. (The credit standard was discussed in chapter 5.) During the credit assessment the enterprise should already use the credit standard to distinguish between good and poor credit risks. When an applicant's creditworthiness is determined, the enterprise should find out whether he or she satisfies the requirements set by the enterprise before he or she is allowed to buy on credit.

Do you still remember what a credit standard is? Write down the keywords of the definition:

The credit department's **attitude** towards collections is also important. The credit department should not be afraid to collect overdue accounts - regardless of what the customer might think of them. After all, it is the customer's responsibility to pay the account on time. However, the overdue amount should be collected in such a way that the **goodwill** of the customer towards the enterprise remains unchanged.

In cases where the debtors give specific reasons for not paying their accounts, the enterprise must take these reasons into consideration.

List three reasons that you would regard as valid for a debtor not to pay his or her account.

It remains important, however, that the enterprise should ultimately put its own interests first. The enterprise also has certain set objectives it must attain. If the payment of accounts is unnecessarily delayed, therefore, it should insist on immediate payment.

The enterprise must further ensure that the **accounts** it sends to the debtors are **correct** and **on time**. It should try to **send out** its invoices and account statements **as soon as possible**. The sooner the documents are posted to the debtors, the greater the possibility that the payment will also be received sooner.

Collection problems can also be eliminated if the enterprise is careful to distinguish between **personal relationships and business relationships**. Here we refer specifically to small businesses, where it can easily happen that the owner of the enterprise is a personal friend of his or her customers. This creates the danger that the small business manager may grant an extension of the due date to a friend, without thinking of the negative results this might have.

Can you write down the negative results of such an action?

Enterprises, and especially small businesses where personal relationships with customers can develop more easily, must treat all its debtors in exactly the same way.

The collection of overdue accounts must be **cost-effective**. The enterprise cannot incur costs in collecting an account when the overdue amount is too small to justify the cost. The value of the overdue accounts collected must justify the money spent on collecting it.

The enterprise must have **trained collectors**. Every enterprise - large or small - uses people to collect its overdue accounts. We already mentioned that this process should be carried out in such a way that the enterprise retains the goodwill of its debtors. This implies that the person who contacts the debtors should have certain characteristics. The person must:

- ❑ be trained for the job
- ❑ be able to communicate well
- ❑ be able to listen well
- ❑ be able to identify problems
- ❑ be able to negotiate
- ❑ be able to obtain information
- ❑ be able to act in a courteous and friendly way

Refer back to the example of "Perfect Paint". Which practical suggestions could you give Greg to help him solve his enterprise's collection problems?

7.5 COLLECTION POLICY

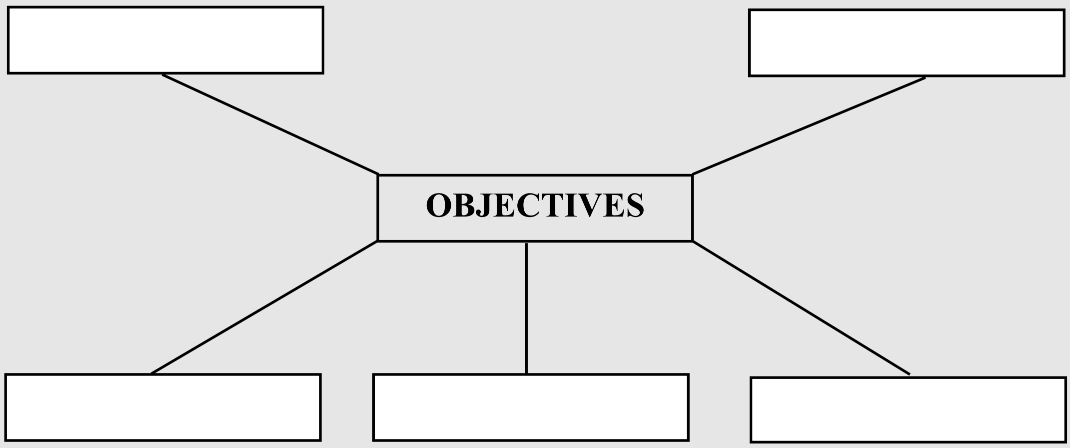
In chapter 3 we saw that the collection of accounts (debtors) is one of the main components of the credit and collection policy.

The collection policy provides guidelines that the enterprise can use to:

- ❑ speed up the collection of debtors that do keep to the credit period (by, among other things, solving potential problems immediately, and sending out invoices and account statements on time)
- ❑ collect accounts, and specifically overdue accounts, as effectively as possible with the help of certain procedures

*A **procedure** is the steps that have to be followed to attain objectives. In the context of the collection of overdue accounts a procedure is the steps the collector must follow to collect the account. (In this case the objective is to collect the account.)*

i) In the space provided below, fill in the basic objectives that the enterprise tries to attain with the help of the collection policy:



ii) Which other objective(s) is/are supported by the objectives you mentioned above? Write these down.

The objectives of collection support the primary objective of the enterprise, namely maximum profitability, as well as the overall objectives of credit management.

7.5.1 Factors influencing the formulation of the collection policy

We have already identified certain factors influencing the enterprise's credit terms and credit period. In the same way, we can also identify factors influencing the formulation of the enterprise's collection policy.

i) *Which factors influence an enterprise's credit terms and credit period?*

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ii) *In your opinion, which of the factors you listed above will also influence the formulation of the collection policy?*

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iii) *With the factors you mentioned in mind, study the following section and complete the activity at the end.*

Factors:
Financial position
Products on services
Profit margin
Credit policy
Credit terms
Competition
Image
Experience

Let us now examine the **most important factors** that should be taken into account in **formulating** a collection policy:

- **The financial position of the enterprise**. This refers to the amount of capital that the enterprise has available to finance debtors. The enterprise attempts to increase the turnover rate of the capital (to make it more profitable). The enterprise must also pay its own creditors and must ensure that capital invested in debtors becomes available as soon as possible to do these payments on time. The amount of capital available thus influences the way in which the enterprise will collect debtors. For example, if an enterprise has cash flow problems, it should be very strict in collecting debtors. (It must collect the debtors as soon as possible.) In this way the enterprise's cash income is increased and it can meet its own obligations.

- **Products or services that are offered**. In the case of durable goods it is possible to allow longer credit periods or a liberal (more relaxed) collection policy (because the enterprise can repossess the product if the debtor does not pay). In selling convenience goods and services, however, the approach of the enterprise should be that payment should be done as soon as possible (because in such a case debtors often "forget" that they bought the product or service).

- **Profit margin**. The cost involved in the collection of debtors must be of such a nature that the enterprise can still make a profit on credit sales. It must be worthwhile to sell on credit. If the enterprise has a high profit margin, it may afford to take a more liberal approach to the collection procedure. A small profit margin, on the other hand, requires collections to be strict, effective and as cost-effective as possible.

- **Credit policy**. A liberal credit policy should be balanced by a strict collection policy, and the other way around. A liberal credit policy may cause a great deal of capital to be invested in the debtors. (With such a policy credit is granted easily, with the result that many customers buy on credit.) In such a case the extent of bad debts can be very great if the enterprise does not follow a strict policy in collecting the accounts. Granting credit easily often leads to ineffective collection. Buyers must know exactly what the credit terms involve and must know that the enterprise expects prompt payment. The enterprise must have an effective collection procedure when credit is granted easily.

- **Credit terms**. The enterprise's credit terms have a direct effect on the collection of accounts. For example, if the enterprise grants cash discounts, what will happen if a debtor takes an unearned discount? What will the enterprise do if a debtor pays an account with a cheque to the value of the amount due minus the discount (after the expiry date for the discount)? The enterprise may decide to return the cheque to the debtor, or to deposit the cheque but debit the debtor's account with an amount equal to the unearned discount. Another example is the charging of interest: if the enterprise charges interest on overdue accounts, it should do so consistently.

  The method of payment also plays a role. For example, if the enterprise requires debtors to pay by way of debit orders, it is less likely that there will be many overdue accounts. When accounts are paid by way of cash or cheque, the risk of unpaid accounts is greater.

- **Competition**. The activities of competitors influence the activities as well as the collection policy of the enterprise. If competitors have a liberal credit and collection policy, the enterprise cannot be too strict with its collections, because it may lose potential sales. It should therefore try to achieve a balance between the advantages and disadvantages of granting credit. If the enterprise grants a credit period of 30 days, while competitors grant a credit period of 3 months, the enterprise will have to consider carefully how it could achieve a balance between maximum sales and a minimum amount of bad debts.

  The collection policy can be relaxed to make the enterprise more competitive. However, common sense and sound business principles should always be kept in mind. Liquidity and the ability to pay all debt at any time (solvability) are more important than a slight advantage over others in a competitive environment.

- **Public image of the enterprise**. The enterprise's collection policy must contribute to create an image of sound and effective business principles. The enterprise should not become known as "easy" (this has negative results). An enterprise must become known for carrying out its collections effectively and consistently - even if this means that it must sometimes have a summons issued against debtors.

- **Previous experience**. If all debtors paid their accounts regularly and on time, enterprises would spend much less on collection. Unfortunately this is not the case. An enterprise selling on credit knows that some debtors are slow or do not pay their accounts on time. There are various reasons why debtors fail to pay their accounts on time. Debtors can be classified into certain categories depending on the reasons for non-payment.

  The collection policy can be formulated in such a way that the enterprise provides for each of these categories of debtors. For example, because certain debtors do not adhere to the credit terms, the enterprise can indicate the due date clearly on the account and demand that the account is paid before this date.

i) *In the squares below, write down the most important factors influencing the formulation of a collection policy:*

A:	*B:*	*C:*	*D:*
E:	*F:*	*G:*	*H:*

ii) *To which square does each of the following belong? Write down each sentence in the correct square.*

- ❑ *The enterprise has a bank overdraft facility*
- ❑ *The enterprise sells paint*
- ❑ *The enterprise has a low profit margin on its products*
- ❑ *The credit period is 90 days*
- ❑ *Other enterprises are strict in collecting debts*
- ❑ *The enterprise is known for effective collection*
- ❑ *The enterprise provides for debtors who do not manage their finances well*

7.6 SUMMARY

In this chapter we emphasised the importance of effective collection and the influence this has on the enterprise's objectives. We saw that the effective collection of overdue accounts is significant because it has a direct influence on the success of credit sales. The importance of timeous collection is clear when we examine all the reasons why enterprises would like to collect debtors as quickly as possible.

We also saw that enterprises may have many problems with collections. These problems arise directly from activities on the part of the debtors, but may also arise from the way in which enterprises deal with their investments.

Fortunately, there are solutions to collection problems. Enterprises must be prepared to give time and attention to collection. Also, there should be clear guidelines that enterprises can follow. Here the collection policy plays an important part. We saw what the collection policy involves, and discussed the various factors influencing the formulation of the collection policy.

7.7 SELF-EVALUATION

1. Which of the following are reasons why an enterprise would like to collect debtors as quickly as possible? Put a tick in the appropriate column.

REASONS	YES	NO
❑ The longer the account is overdue, the greater the risk of bad debts.		
❑ The turnover rate of supplies improves.		
❑ The enterprise needs less working capital.		
❑ The enterprise can pay less interest to the bank.		
❑ It results in a good credit record.		
❑ The enterprise can finance more debtors.		

2. Fill in the missing word(s):

   The objectives of collecting debtors are:

   - ❑ a favourable ....
   - ❑ a minimum ....
   - ❑ .... collection costs
   - ❑ keeping existing accounts ....
   - ❑ retaining ....

3. Discuss six responsibilities of the person doing the collections in an enterprise. Give a practical example of each.

4. Complete the following by writing down key words.

REASONS FOR (CAUSES OF) NON-PAYMENT BY DEBTORS. GIVE AT LEAST 12 REASONS.	SOLUTION FOR EVERY CAUSE.
1.	1.
2.	2.
3.	3.
4.	4.
5.	5.
6.	6.
7.	7.
8.	8.
9.	9.
10.	10.
11.	11.
12.	12.

5. Discuss, in detail, all the possible reasons for collection problems caused by the enterprise itself.

6. Discuss the following guidelines for effective collection in detail:

- ❑ Effective system for the collection of debtors
- ❑ Effective system for identifying overdue accounts
- ❑ Collection objectives and policy
- ❑ Trained collectors

7. Can you list any other guidelines for doing collections effectively? Write them down below.

8. Discuss the following statement in no more than 10 sentences: "An enterprise's collection policy should be an aid for carrying out the collection of debtors as effectively as possible."

9. What is the difference between a collection policy and a collection procedure?

COLLECTION	
POLICY	**PROCEDURE**

10. A new enterprise planning to sell furniture on credit must formulate a collection policy. Which factors should the enterprise take into account in formulating its policy? Give practical examples.

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CHAPTER 8

THE COLLECTION PROCEDURE

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CHAPTER 8

THE COLLECTION PROCEDURE

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ❑ *discuss the most important principles of the collection procedure, and the requirements it must meet*
- ❑ *list and explain the phases in the collection procedure*
- ❑ *list and discuss the different collection instruments*
- ❑ *recommend additional aids that the enterprise could use to collect debtors*
- ❑ *draw up a collection procedure*
- ❑ *suggest how the effectiveness of the collection procedure can be evaluated*

8.1 INTRODUCTION

We already know that enterprises granting credit cannot do without an effective collection policy. The basic objective of granting credit is to obtain financial benefits by increasing the income from sales. This in turn contributes to higher profitability for the enterprise.

The way in which collections are done directly influences the enterprise's debtors turnover rate, cash flow and working capital requirement. If the debtors are collected ineffectively, the benefits of credit and the value of objective credit assessments are diminished. In the long term it also has negative results for the enterprise's cash flow position.

The collection of debtors is just as important a task of the credit department as credit assessment and decisions on granting credit.

The **collection policy** (part of the overall credit policy) provides **guidelines** on how the enterprise must deal with collection to attain its abovementioned objectives.

The collection policy also **provides** for specific **collection procedures** that the enterprise can use to collect debtors. Such a collection procedure consists of various steps.

The aim of this chapter is to examine the meaning of a collection procedure and to determine which basic requirements such a procedure should meet. In the previous chapter we said that the collection policy provides guidelines for:

- ❑ speeding up the payment of accounts
- ❑ collecting overdue accounts

In this chapter the main emphasis will be on the **collection of overdue accounts**.

We will investigate the steps in the collection procedure and look at the various instruments (aids) that the enterprise can use for collection. We will then conclude the chapter by discussing ways of evaluating the effectiveness of collections, and the aspects that contribute to effective collection.

8.2 THE BASIC REQUIREMENTS OF A COLLECTION PROCEDURE

The collection procedure is aimed at **converting** debtors into cash **as rapidly as possible**. The following are the **basic requirements** of a collection procedure:

- ❑ Collect the money of the debtors as soon as possible to attain the required levels of cash (remember, enterprises usually have certain restrictions with regard to the level of debtors that they can finance)

- ❑ Retain the goodwill of the customer during the collection procedure
- ❑ Carry out the collection procedure correctly and consistently
- ❑ Keep a record of all the actions carried out during the collection procedure
- ❑ Ensure that the collection procedure remains cost-effective

Let us see what exactly these requirements mean. An enterprise selling on credit provides goods and/or services to people or enterprises and allows them to pay for these later. Granting credit has advantages for the enterprise, but it also involves costs. If the enterprise does not **convert the debtors to cash as soon as possible**, many of the advantages of credit will be lost. For example, the cost of credit, the cost of financing debtors and the cost of bad debts will increase.

In such a situation, the enterprise's cash flow position will deteriorate and the risk of bad debts will be greater. The enterprise will need more working capital and may be forced to use external short-term finance. An enterprise should thus not wait too long before it starts collecting overdue accounts.

However, the enterprise may also lose good credit risks if its collection policy is too strict. Debtors who usually pay their accounts on time, but for some reason did not pay one particular account by the due date, may decide not to buy from the enterprise again.

The **timing** of collection activities is thus important. The enterprise should consider how long it should wait after the due date of an account before starting to collect it. The logical answer to this question is "immediately".

In practice, however, this cannot always be the case. The enterprise must keep in mind that if it applies the collection procedure too rapidly and too drastically, it **may lose its customers and thus future sales**. A collection policy that is too strict has a negative influence on the enterprise's goodwill. It may also damage its competitive position and public image. On the other hand, if the enterprise waits too long before it collects overdue accounts, this will have a negative effect on its primary objective, namely maximum profitability.

We can thus draw the following conclusion: The enterprise tries to obtain a **balance** between maximum collection, on the one hand, and the minimum loss of goodwill and bad debts, on the other hand.

It is important that the collection procedure should be carried out **correctly and consistently**. Overdue accounts must be **identified immediately** so that the enterprise can start its collection activities. (Here the computer is a valuable aid.) It is of little use for the enterprise to start the collection procedure as long as 60 days after the due date of an account. The longer the enterprise waits to collect an account, the smaller the chance of success.

If the first step of a collection procedure is a reminder (in other words, if the enterprise starts the collection procedure by sending the customer a second account), it must be followed up consistently. The enterprise continues the collection procedure until it has received payment or until it decides to write off the account as bad debt.

The enterprise must keep a **record** of all the communication between the collection department and the debtor.

EXAMPLE

i) The enterprise sends a letter to the debtor as a reminder that the due date has expired and that no payment has been received.

ii) The enterprise telephones the debtor at work. The debtor promises to pay the outstanding amount of R300 on 1 July 1996.

iii) On 1 July 1996 the enterprise receives a cheque to the value of R200 with a letter from the debtor promising to pay the outstanding R100 on 15 July 1996.

The enterprise can keep a record by, for example, compiling a **collection record card** (diagram 8.1). On this card all the actions taken are noted, together with the dates on which the actions were carried out and the reaction. In practice this information is stored on computer.

COLLECTION RECORD CARD Name and address of debtor: Account no.: Telephone no.: Contact person (in the case of an enterprise):			
Date	**Outstanding amount**	**Action taken**	**Reaction**
18/6/96	R300 (30+dae)	Sent letter to debtor	No reaction
30/6/96	R300 (30-60)	Telephone debtor at work	Promise to pay next day

DIAGRAM 8.1

The enterprise may also draw up a **collection procedure statement** which will provide information about all the outstanding accounts. Diagram 8.2 is an example of such a statement.

OUTSTANDING DEBTORS									
Account-number	Debtor	Outstanding amount			Action/steps taken				Reaction
		60	90	120	1	2	3	4	

DIAGRAM 8.2

It is also important that the collection procedure must be **cost-effective (economical)**. The cost an enterprise incurs in collecting an overdue account must be justified by the advantages of this action. The enterprise cannot spend R100 to collect an overdue account of R60. In many cases the enterprise recovers the collection cost from the debtor (the debtor must pay the cost that the enterprise incurs in collecting the debt).

- ❑ *State your opinion about the basic requirements of the collection procedure.*

- ❑ *Would you suggest any additional requirements? Write these down.*

- ❑ *Write down the basic collection objectives of an enterprise. (Go back to chapter 7 if you are uncertain about these.)*

- ❑ *How are the requirements for collecting debtors supported by the collection objectives?*

We can list the following additional requirements of a collection procedure:

- ❑ **It must be easy to understand**

- ❑ **It must be easy to apply**

- ❑ **It must be effective (it would be useless to carry out a number of steps but not recover any money)**

- ❑ **It must result in rapid action (the enterprise should not delay in collecting an overdue account)**

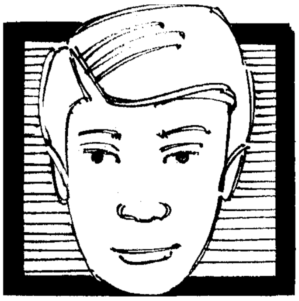
Did you consider these aspects when you had to write down additional requirements?

8.3 COLLECTION PROCEDURE

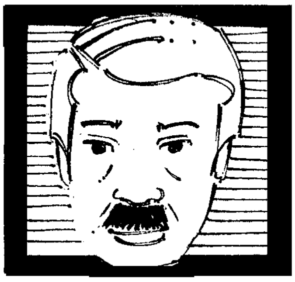
Many enterprises begin with the collection procedure only after a debtor has not paid an account. Other enterprises telephone their debtors before the due date to find out whether an order was correctly made up and delivered, and whether the customer is satisfied. This eliminates potential collection problems and delays in the payment of accounts. Many enterprises thus actually start the collection procedure at a very early stage. Remember, in chapter 7 we said that speeding up payment is also a collection objective.

8.3.1 Phases in the collection procedure

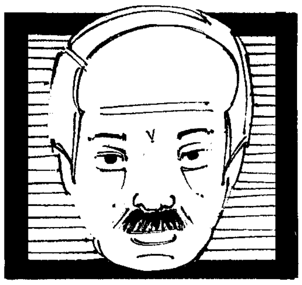
There are three phases in the collection procedure, namely:



Reminder phase



Follow-up phase



Drastic phase

❑ **Reminder phase**

In this phase the debtor is **reminded** that the account is **outstanding**. This can be done, for example, by sending the debtor a second account statement (a copy of the first account).

We have already seen that there are various reasons why debtors do not pay their accounts on time. If a debtor has lost the first account or genuinely forgotten to pay the account, a reminder is usually all that is needed to obtain payment. However, that group of debtors who are aiming to wait as long as possible before paying their accounts will need more than a reminder.

Enterprises often use **stickers** on the account to draw the debtor's attention. The outstanding amount can also be marked with a **highlighter**. Many enterprises also indicate on the account that it has been outstanding for longer than 30 days and that payment is required now. It is also useful to point out the enterprise's credit terms to the debtor again.

- ❑ **Follow-up phase**

If the reminder phase does not produce any results, the enterprise implements the follow-up phase. The debtor may not be in a position to pay - he or she may not have the money, or may have bought too much on credit. **Ongoing contact** with debtors who have overdue accounts is absolutely essential; this will give the enterprise a better chance of receiving payment. In this phase the enterprise tries to determine why the debtor has not paid the account. Aids that are very helpful in the follow-up phase are the telephone and follow-up letters. The enterprise may also pay a personal visit to the debtor, but in such a case the outstanding amount must justify the cost involved. Small business enterprises and enterprises granting trade credit may find personal visits helpful.

Usually, some of the debtors targeted during the follow-up phase immediately pay their outstanding accounts after a telephone call or first letter. Unfortunately, however, there is often also a group of debtors who still pay no heed to these measures.

- ❑ **Drastic phase**

If all previous efforts to collect an overdue account were unsuccessful, the enterprise will implement the "drastic phase". This means that the enterprise will hand over the account to a credit collection agency or an attorney. Again, it is essential that the cost of using such an agency should be taken into account. The same applies when legal steps are taken against a debtor in arrears. The enterprise may also decide to draw a bill of exchange on the debtor.

i) *Write down the reasons why debtors do not pay their accounts in column A.*

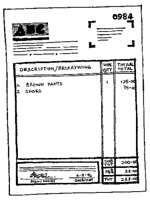
ii) *Next to these reasons, in column B, state in which phase of the collection procedure you think these debtors will probably pay their accounts. Below are two examples:*

A *REASONS:*	*B* *PHASE:*
1. Debtor does not receive an account	*1. Reminder*
2. Debtor on the verge of bankruptcy	*2. Drastic*

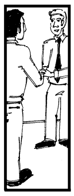
8.3.2 Collection instruments (aids)

The enterprise can use various aids during the collection procedure. The most common of these are the following:

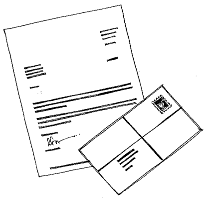
❑ Account statement



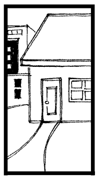
❑ Personal visit



❑ Collection letter

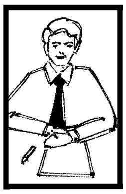


❑ Collection agency



❑ Telephone

❑ Attorney

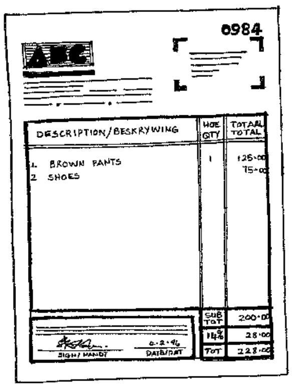


Different enterprises use **different collection instruments**, and also use these instruments in **different ways**. Every enterprise develops its own collection procedures to suit, among other things, its special circumstances, credit policy and the market in which it functions. For example, large enterprises with thousands of accounts will find it difficult to visit the debtors in arrears personally. On the other hand, for an owner of a small business enterprise it is often the easiest simply to visit the debtor and collect the outstanding amount personally.

The collection instrument used is determined by the phase of the collection procedure. For example, the enterprise will not send a final reminder to the debtor immediately after the due date, or will not already start threatening the debtor with an attorney during the reminder phase!

❑ **Account statement**

If the debtor has not paid the account or monthly instalment before the due date, the enterprise can send him or her a second account, or a duplicate invoice, immediately after the due date. This serves as the first reminder to pay.



The details indicated on the account statement include the following:

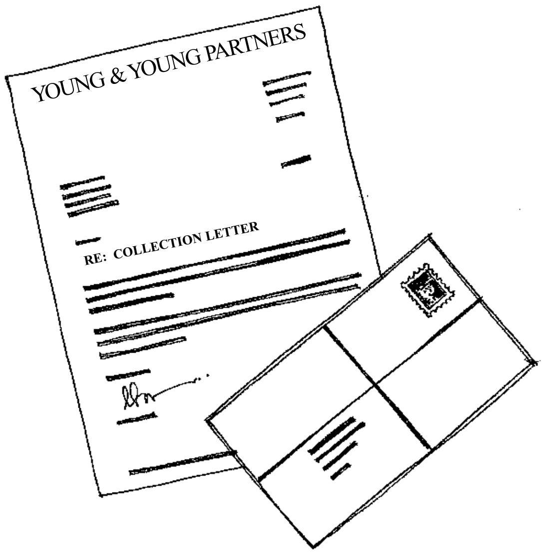
- ❍ The balance owing at the end of the previous month
- ❍ The purchases made during the past month
- ❍ The amount the debtor has paid during this month
- ❍ The amount still outstanding
- ❍ The amount that is due now

The account statement provides a **monthly overview** of the state of the debtor's account. (On receiving the account statement, the debtor has the opportunity to check the account and ensure that all the entries are correct.)

In practice, many enterprises buying on credit receive an invoice together with their order. The invoice gives details of the purchases, the price and the terms of payment. Many enterprises pay their creditors on the basis of the information contained in the invoice that was issued when the purchases were made. This means that the account statement received at the end of each month serves as a reminder of the amount owing by the enterprise.

❑ Collection letters

Collection letters are commonly used to collect debtors in arrears. The enterprise sends collection letters to the debtors in which the overdue amounts are brought to their attention and they are requested to pay.



If a debtor does not react to this letter, a second, more strongly worded letter can be sent. A series of letters is thus used, and the tone of every succeeding letter is different - the wording becomes gradually stronger. There are also increasingly shorter intervals between the letters. (It is good practice to attach a copy of the original invoice or account statement to the letter.)

The enterprise can send letters by ordinary or registered mail. The advantage of registered mail is that the enterprise can be sure that the debtor has received the letter, because it has to be handed to him or her directly. The enterprise can also personally deliver the letter to the debtor; in such a case the debtor must sign for the letter.

In writing and sending collection letters, we can also distinguish between three different phases:

❍ The reminder phase

❍ The follow-up phase

❍ The drastic phase

These phases correspond to the phases of the collection procedure which we identified earlier.

❑ ***Reminder phase***

The debtor is reminded that he or she has not yet settled the outstanding account (the enterprise has not yet received payment). The letter has a friendly tone and the debtor is usually requested to ignore it if the payment has already been mailed or made personally.

❑ ***Follow-up phase***

If the reminder has not produced any results, the enterprise can proceed to the follow-up phase, in which more strongly worded letters are sent to the debtor. The enterprise aims to collect the outstanding amount, but at the same time to retain the goodwill of the debtor. In the follow-up phase the enterprise can also, for example, find out why the debtor has not yet settled the account.

❑ ***Drastic phase***

A collection letter with "drastic implications" is sent to the debtor, compelling him or her to settle the outstanding account before a certain date. If payment is not made before this date, the enterprise will hand over the account to an attorney or collection agency.

It is important that the enterprise should ***by no means consider sending such a collection letter to the same debtor twice****. The letter will immediately* ***lose its impact and meaning****. The enterprise must also ensure that it does proceed with the planned course of action if no payment has been received by the specified date.*

The way in which a collection letter is drawn up and written (the wording of the letter) is an important requirement for:

- ❍ the success of the collection programme
- ❍ retaining the debtor concerned
- ❍ protecting and enhancing the enterprise's image
- ❍ achieving the collection objectives

The enterprise may not communicate in a slanderous way with the debtor of an outstanding account. The collection letter must be worded in such a way that it does not constitute a personal attack on the debtor. There may also not be any untruths in the letter.

Writing collection letters thus requires **certain skills**. For example, a writer of collection letters should have a good knowledge of human behaviour. This will ensure that every individual debtor is correctly dealt with, especially when personal letters are sent to the debtors.

Collection letters should thus meet certain **requirements**. The **basic principles and requirements of letter-writing** should be taken into account. The overall impression created by the letter will affect the image of the enterprise, and thus it is essential that the letter should be neat and correct. The writer of the collection letter should keep the following in mind:

- ❑ The **purpose of the letter**. The aim of the letter is to collect an outstanding amount or an amount in arrears. The enterprise tries to collect the money in arrears as soon as possible. However, it is still important that the letter should have a friendly tone, without straying from the point. The customer will then have no reason for refusing to do business with the enterprise again.

- ❑ The **grammar and spelling in the letter should be correct**. It is also very important that the **debtor's name is spelled correctly**. The writer must further ensure that no errors are made in the amount due (for example, R150,49 instead of R105,94) or the debtor's account number (NXO336 instead of NXO366). If such errors occur, the letter loses its impact and purpose.

- ❑ The **layout of the letter must be logical**. The layout depends largely on the preferences of the enterprise or the letter-writer.

- The **message must be to the point**, and written in short, comprehensible sentences that do not insult the reader. Instead of writing "you have not yet paid the account", for example, the writer could say "we have not yet received the payment of your account". The way in which the message is communicated **(how)**, is often more important than the message itself **(what)**. If debtors receive collection letters that arouse their anger (remember, they know they are in arrears), they may simply decide never to buy from that enterprise again.

COLLECTION LETTER

- *The letter is **planned**:*
  - *Formulate the purpose of the letter*
  - *Obtain all the necessary information*
- *The letter is **drawn up**:*
  - *Arouse and hold the reader's interest*
  - *Make sure that the letter has the correct tone and reflects the correct attitude*
  - *Ensure clarity, correctness, conciseness, logical coherence (order) and politeness*
  - *Retain the debtor's goodwill*
- *The letter is **edited**:*
  - *Check the letter for any spelling or grammatical errors*
- *The letter is **sent/mailed** to the debtor personally, in one of the following ways:*
  - *Send it by ordinary mail*
  - *Register it*
  - *Deliver it personally*

The writer of a collection letter should have all the **necessary information about the debtor**. This includes:

- the outstanding amount
- the date on which the last payment was received from the debtor
- the date on which the debtor made the last purchase
- the debtor's history of late payments, if any

This information enables the letter-writer to approach the debtor in the correct way.

It is also important that **all the relevant information should be made available to the receiver of the letter (the debtor)**. This includes:

- ❑ the outstanding amount
- ❑ the date before or on which payment of this amount is required
- ❑ procedures the debtor can expect if the enterprise has not received payment before or on the specified date

By specifying a date on which payment is required, the enterprise is in fact suggesting a solution to the problem of the overdue account. It is also good practice to attach a copy of the original invoice or account statement to the letter.

Another requirement is that the enterprise must keep a **record of all letters** sent to the debtor. This will ensure that a person does not receive the same or a similar letter more than once. It will also ensure that a debtor does not receive a further notice requesting payment from the enterprise after he or she was informed that the outstanding account would be handed over to an attorney. The enterprise must also ensure that no further letters are sent to the debtor after the outstanding amount has been paid. Such carelessness can do a great deal of damage to the enterprise's collection procedure.

i) *Can you think of any reasons why carelessness will damage the collection procedure? List three reasons:*

ii) *List the requirements that a collection letter must meet.*

iii) Evaluate the following collection letter on the basis of the requirements above:

XYZ ENTERPRISES

P O Box 00204
JOHANNESBURG
18 June 1996

Our ref.: PD222904
Yourref.: XYZ05

Mr Day

Account number:

Your account to the value of R11 083 has now been outstanding for 60 days. We will appreciate it if you will pay this oustsanding amount as seepdily as possible. The credit period is strictly 30 days. It is debtors like you our company must get rid of, so pay immediately.

Thank you
Yours faithfully

XYZ ENTERPRISES

In practice, two types of collection letters are distinguished:

- Standard collection letters
- Personal collection letters

❑ Standard collection letters

Computers are a valuable aid in the use of standard collection letters. The format of the standard letter is stored on computer. At the press of a button the letter is called up and the particulars of the debtor are filled in. However, it is important that the letter must be personally signed by the collection officer or collection manager. Only then does the letter have authority.

Standard collection letters are usually drafted in series. The content and the composition of the series of letters are based on common collection problems experienced by the enterprise. Letters of different lengths and with different approaches are drafted. In this way provision is made for every possible situation that may cause an account to be in arrears, as well as for the period the account has already been in arrears.

Each series of collection letters is numbered, as is each letter in a particular series. For example:
Series X consists of five letters, numbered 1 to 5.
Series Z consists of four letters, numbered 1 to 4.

After all the available information on an overdue account has been studied, the person responsible for collections in the enterprise may decide to send the following letter to the debtor: series X, number 2. This letter must be printed individually and signed by the person responsible for collections.

We must emphasise again that the enterprise must ***never send the same letter to the same debtor more than once****. It is thus essential to keep a record of the letters sent.*

Large enterprises with a larger number of debtors usually also have a larger number of outstanding accounts or accounts in arrears. It makes sense for these enterprises to use a series of collection letters. Because there are more accounts in arrears, these enterprises can save considerable time when drafting and writing collection letters.

It is unnecessary to draft the same basic collection letters over and over again. The danger of drafting collection letters overhastily is also eliminated. By using a standard letter the enterprise ensures that the basic principles of collection letters are taken into consideration.

Small businesses often use standard collection letters sold by stationers. The following letter is an example of such a standard collection letter:

FINAL NOTICE

FINALE KENNISGEWING

OF INTENTION TO PROCEED IN THE COURT OF CIVIL JUSTICE FOR RECOVERY OF DEBT
VAN VOORNEME OM IN DIE SIVIELE HOF GEREGTELIKE STAPPE TER INVORDERING VAN SKULD TE DOEN

Whereas you,
Aangesien u,

are truly and justly indebted to
werklik en wettiglik aan

in the sum of
die bedrag van

for goods sold and delivered/services rendered, the aforesaid amount being considerably overdue, of which
skuld vir goedere verkoop/gelewerde dienste, en die bogenoemde bedrag vir 'n aansienlike tydperk agterstallig

fact you have been repeated notified.
is, 'n feit waarvan u reeds herhaaldelik in kennis gestel is.

Therefore you, are hereby given
Derhalwe word u, hiermee

finale notice of intention to
finaal deur kennis gegee van sy/hulle

take legal proceedings for the recovery of the sum hereinbefore stated, unless the said amount be
voorneme om geregtelike stappe ter invordering van die bogemelde bedrag te doen, tensy die

paid to
genoemde bedrag aan

on or before
voor of op betaal word

Signature
Handtekening ....

Date/Datum ....

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paid to
genoemde bedrag aan

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voor of op betaal word

Signature
Handtekening ....

Date/Datum ....

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Whereas you,
Aangesien u, [ ]

are truly and justly indebted to
werklik en wettiglik aan [ ]

in the sum of
die bedrag van [ ]

for goods sold and delivered/services rendered, the aforesaid amount being considerably overdue, of which
skuld vir goedere verkoop/gelewerde dienste, en die bogenoemde bedrag vir 'n aansienlike tydperk agterstallig

fact you have been repeated notified.
is, 'n feit waarvan u reeds herhaaldelik in kennis gestel is.

Therefore you,
Derhalwe word u, [ ] are hereby given
hiermee

finale notice of
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take legal proceedings for the recovery of the sum hereinbefore stated, unless the said amount be
voorneme om geregtelike stappe ter invordering van die bogemelde bedrag te doen, tensy die

paid to
genoemde bedrag aan [ ]

on or before
voor of op [ ] betaal word

Signature
Handtekening ....

Date/Datum ....

❑ Personal collection letters

If the enterprise has not received payment after two or three letters, a **personal letter** can be sent to the debtor concerned. In this letter the debtor is ordered or given a final warning to pay.

The letter is directly addressed to the person who has to pay the account. In the case of consumer credit, this is the individual debtor, and in the case of trade credit it is the person who has to approve payments in the enterprise concerned.

Let us examine a few **examples of collection letters**. The first letter is an example of what a collection letter should **not look like**. If no other collection steps were done before this letter, it will be difficult to retain the goodwill of the customer.

Much Better Pharmacy
P O Box 45667
Florida
1710

Dear ....Mr Smyth............

We refer to invoice ..No 161.. *dated* ..15 / 2 / 96.. *for the amount of* ..R15.60.

Since this amount has been in arrears for some time, payment must be made within the next seven days. If not, we shall have no alternative but to forward the account to an attorney for collection.

Thanking you
D. Pharmacist

(The pharmacist will in any case have to consider whether the costs involved in the collection of R15,60 by an attorney is justifiable.)

The following is an example of a collection letter in the reminder phase:

XYZ LTD

P O Box 45667
Cape Town
8000
20 June 1996

Mr A Van Rensburg
14 Koedoe Street
Cape Town
8000

Dear Mr Van Rensburg

Account number: AVR 09876

We wish to remind you that your account of R150,62 for goods bought on 15 May 1996 was payble before or on 15 June. If your payment has already been mailed, please ignore this letter.

Thank you in anticipation.

Yours faithfully
Koos Kalitz

Suppose that Mr Van Rensburg does not respond to this letter. A second letter will then be sent to him. This letter could read more or less as follows:

Dear Mr Van Rensburg

Account number: AVR 09876

Your account of R150,62 is still in arrears. We would appreciate it if you could pay this outstanding amount before or on 30 June 1996. Our credit period is strictly 30 days after the date of purchase.

Thank you

Yours faithfully

Koos Kalitz

If Mr van Rensburg still fails to settle the outstanding amount, XYZ LTD can now send him a more strongly worded letter. A letter in this phase could be formulated as follows:

Dear Mr Van Rensburg

Account number: AVR 09876

The amount of R150,62 is already 60 days in arrears. We expect you to settle this outstanding amount within seven days of the date of this letter. Should you fail to do so, we shall be obliged to suspend your account facilities and to forward the account to a collection agency. The costs involved in such an action will be recovered from you.

We trust that you will settle the account immediately.

Yours faithfully

Koos Kalitz

Commercial banks also frequently send collection letters to clients. This is done, for example, in cases where clients fail to make a payment on their long-term loans on time, or where they are constantly exceeding the limits of their overdraft facilities.

Commercial banks normally use the telephone to contact a client. If clients constantly fail to meet their obligations, they will be requested to make a personal visit to the bank. By way of discussion the bank will then try to determine the reasons for the debtor's actions. The bank will also suggest certain solutions to the problem.

If clients then still fail to meet their obligations, the bank sends them a collection letter in which they are requested to pay the outstanding amount. The following letter is an example of such a collection letter to a client who continues to exceed the overdraft bank facility:

ABC BANK

P O Box 12345
Cape Town
8000
15 November 1996

Mr X Best
P O Box 78910
Cape Town
8000

Dear Mr Best

CHEQUE ACCOUNT NUMBER: 12345678 OVERDRAFT FACILITY: R5 000 OUTSTANDING BALANCE: R8 789,26

The limit of R5 000 extended to you in terms of an overdraft facility is constantly exceeded without prior arrangements having been made with the bank. You will agree that we cannot continue on this basis. In consideration of the above, we would like to inform you that your overdraft facility has been cancelled. It has also been decided to cancel your cheque account facility because of the unsatisfactory way in which this account is managed.

The full outstanding amount of R8 789,26 plus 25% interest, calculated from 16 October 1996 up to and including the day of payment, must be settled within 10 days of the date of this letter.

Should you fail to heed this request, we shall have no alternative but to institute legal proceedings against you.

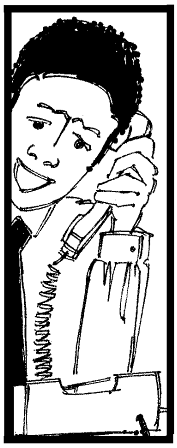
We trust that you will attend to this matter urgently.

Yours faithfully

J Bank Manager

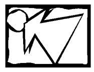
A small business enterprise that manufactures furniture and sells on credit has a debtor whose account is already 90 days in arrears. Write a personal collection letter to this debtor on behalf of the enterprise. Make your own assumptions about the other details of the matter.

❑ **The telephone**



The circumstances in which the telephone is used during the collection procedure depend on the enterprise's collection policy. Many enterprises use the telephone right from the start. They contact the debtor by telephone shortly after purchases have been made. With this telephone call the enterprise can determine whether the buyers have received the order and the invoice, and whether they are completely satisfied.

The enterprise can also once again confirm the debtor's terms of credit. If there has in fact been a problem with the order, the enterprise can correct this.



EXAMPLE
Suppose the buyer has not received an invoice. If the enterprise telephones him or her shortly after the date of purchase, this problem can be identified and corrected. A new invoice or account statement can then be sent to the debtor before the due date. In this way a delay in the collection of this account is prevented.

Some enterprises also telephone debtors after the due date to find out why the debtors have not paid. The telephone call is then confirmed by letter.

Other enterprises use the telephone only after they have had no success with collection letters to the debtor (that is, if the debtor has ignored the collection letters).

The **role of the telephone** in the collection of debtors is becoming increasingly important. As a means of communication between the enterprise and the debtor, it plays an important role in speeding up the turnover rate of debtors. **The telephone is cost-effective because, in most cases, the first call brings about the required response**. It also counteracts the increasing costs of personal collection. Other advantages of the telephone as an aid to collection are the following:

❑ It **speeds up** the collection of accounts in arrears

❑ It **saves time**

Advantages:
Speeds up collection
Saves time
Direct
Two-way communication
Reasons discussed
Adjustments
Facilitates matters
Updates details

- ❑ It gives the enterprise the opportunity of contacting the debtor **directly**. If one approach to the debtor does not work, it is easier to switch to another approach

- ❑ The telephone makes **two-way communication** with the debtor possible

- ❑ It gives the enterprise the opportunity of discussing the **reasons for the account in arrears** with the enterprise or individual concerned. For example, if the debtor objects to a particular statement, the collector can immediately explain the statement

- ❑ It gives the enterprise the opportunity of **making adjustments**, if necessary, regarding the collection of a specific debtor, such as granting an extension, or giving the debtor the opportunity of paying the account over a period of, for example, three months

- ❑ It **facilitates matters for the debtor**. The debtor can provide an immediate answer about the account in arrears without, for example, having to explain the situation in a letter

- ❑ It gives the enterprise the **opportunity to check and update** the debtor's details, if necessary (for example when there has been a change of address)

Limitations:
Promise not kept
Not only instrument
Not replacement

However, as a collection instrument the telephone also has certain **limitations**.

- ❑ It is easy for the debtor to **promise** payment on the phone and then to **fail to keep the promise**. (The debtor may promise to send the payment immediately and never do it.) It is easier to resort to excuses, complicated explanations, lies and, in some cases, rudeness over the telephone

- ❑ The telephone **cannot be the only instrument** used to encourage debtors with overdue accounts to pay. It must be used together with other aids such as written reminders and personal visits. The enterprise must also confirm the telephone call with a letter

- ❑ The telephone **cannot in any way replace** invoices, account statements and collection letters. If all of these are used, and there is good communication between the departments involved, this may have positive results

The **success** of the telephone as a collection instrument lies in **good planning**. It is essential to have all the **relevant information at hand** before the debtor is telephoned. All relevant documents, files and correspondence about the outstanding amount should be close at hand during the telephone conversation. A **record must be kept at all times** of all the actions carried out to collect amounts in arrears. This information is used to plan the telephone call to the debtor.

The **telephone call must be made to the correct person**. For example, if enterprise A's account is in arrears, the person responsible for the approval and payment of accounts should be contacted to ensure a meaningful discussion. If an enterprise has to collect an overdue account from enterprise A, it is also important to have the following information:

❍ The payment procedure of the enterprise

❍ The credit rating of the enterprise in relation to its sales volume

❍ The enterprise's history of payment (does the enterprise usually pay accounts on time or does it have a history of late payment?)

It is also essential that the **debtor should know** to whom he or she is talking, for example the collection officer of enterprise A who is phoning in connection with an overdue account of R250.

It is crucial that the people making the telephone calls should be **trained** for the task. A person doing collections by telephone should have **good telephone etiquette and know the techniques of telephonic collection**. The person must be able to act in a tactful, firm, mature and self-confident way.

It is also very important that the person should have the **ability to listen**. If he or she listens well at the beginning of the telephone call, it may save valuable time later and prevent tempers from flaring up. The collector must determine why the debtor has not paid and try to find a solution for the problem.

The main aim of the telephone call is to collect the amount in arrears. The collector should thus reach an **agreement** with the debtor about the **method and date of payment**. The collector must also keep a **record** of the agreement so that it can be followed up later.

TELEPHONE CALL

- ❑ *Collect all the **relevant information***
- ❑ *Telephone the **correct person***
- ❑ *Used **trained** staff*
- ❑ ***Listen** to the debtor*
- ❑ *Reach an **agreement***
- ❑ *Keep a **record** and **follow up***

Although collections by telephone are generally cost-effective, there are nevertheless certain costs involved that cannot be ignored. The advantages of collecting the overdue accounts by telephone must always outweigh the costs of using the telephone. The enterprise's aim is thus that the debtor should pay the full amount after the first telephone call.

As with all the other collection aids, the use of the telephone should be **well considered**. It is sometimes better to avoid contacting the debtor by telephone if correspondence has already been entered into. For example, if the enterprise is dealing with a "difficult debtor" or a debtor who is frequently in arrears, telephonic contact can weaken the enterprise's case (the debtor may decide not to pay).

Below is a telephone conversation between Enterprise A and one of its debtors. The debtor's account is already two months in arrears.

Enterprise A:	*"Good morning. Could I speak to Pam?"*
Pam:	*"Speaking."*
Enterprise A:	*"I'm phoning in connection with your account that's already two months in arrears. What are you going to do about this? I've been phoning you constantly for the past two months and every time you just promise to pay, but you never do. When are you going to pay?"*
Pam:	*"I would just like to say that your company has still not given any attention to my account queries. I'm still waiting for a new account. And anyway I told you last time that I don't have enough money to pay..."*

****

i) *Evaluate Enterprise A's approach to the debtor. Do you agree with the way in which the conversation with Pam was conducted? Give reasons for your answer.*

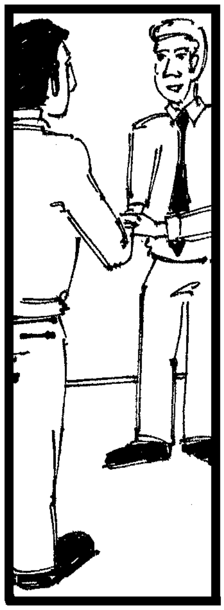
ii) *How should Enterprise A deal with this collection problem? What would you suggest?*

iii) *Could Enterprise A also have used collection letters? Give reasons for your answer.*

iv) *Write down how you would have conducted the telephone conversation with Pam.*

Advantages:
Idea of circumstances
Personal contact
Additional information
Reasons for non-payment discussed
Face-to-face visit

❑ **Personal visit**



A personal visit to the debtor enables the enterprise to form an idea of the enterprise or person concerned and the relevant circumstances. Enterprises granting trade credit can visit debtors personally when, for example, large amounts are in arrears or when there are constant collection problems. The owners of small businesses frequently visit their debtors personally to collect the money.

A personal visit enables the enterprise to make personal contact with the debtor and to request payment of the account in arrears. A personal visit has the same advantages as a telephone call. It also has the advantage that it gives the enterprise the opportunity of coming **face to face** with the debtor.

During the personal visit the enterprise can also obtain **additional information** from the debtor, such as the most recent set of financial statements (especially in the case of financial and trade credit). This information may indicate the possible reasons for the debtor's failure to pay. For example, the financial statements may indicate that the debtor has a severe cash flow problem and cannot pay the account for this reason.

Disadvantages:
Expensive
Time-consuming
Impossible if there are many accounts
Services difficult to obtain
Does not ensure success

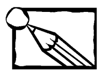
Disadvantages of the personal visit are that it is an **expensive and time-consuming** method. The credit department staff do not always have the time to visit debtors. However, the enterprise may also specifically employ people to go out with the aim of collecting accounts in arrears ("field collectors").

It will obviously be **impossible** for a clothing store with **two million** accounts, for example, personally to visit debtors whose accounts are overdue. It is also not always possible for the enterprise to obtain the services of good field collectors. One collector can only visit a limited number of debtors per day, even in areas where there is a high concentration of debtors. If the daily salary of the collector is divided by the number of visits on one day, it will be clear that every visit entails considerable expense. The enterprise also has no guarantee that all debtors who have received a personal visit will in fact pay their overdue accounts. This emphasises the high costs of personal visits as a collection aid.

In the case of enterprises granting trade credit, the **sales staff** can also be used as collectors. The debtors often place their orders with the sales staff, and so the sales staff have direct contact with them. As a result, it may be very difficult for the debtors to ignore the sales representative's request that they should pay the overdue account. Also, the sales representatives would like to receive another order from the debtors (because the representatives earn commission on orders). They know that this will be impossible if the debtors' accounts are overdue.

Sales staff can thus persuade enterprises with overdue accounts to pay. This also makes the sales staff responsible for implementing and applying the credit and collection policy in an effective way. The sales staff cannot write out any order merely for the sake of earning more commission - they should realise that sales transactions are concluded **only after debtors have settled their accounts**.

It is not always easy to use sales staff for collection purposes, however. Many sales representatives feel that collection is not part of their work.

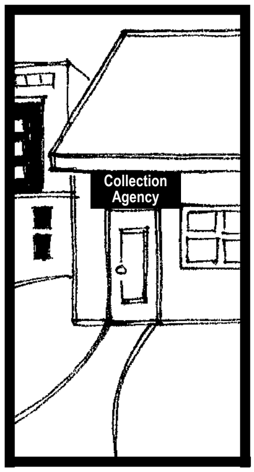


i) *Your sales staff do not believe that collecting overdue accounts is part of their work. How can you solve this problem? Make your own suggestions.*

ii) *What role can sales staff play during the collection procedure?*

iii) *Do you think that sales staff can already contribute to problem-free collection earlier, at the time of the sales transaction? Give reasons for your answer.*

❑ **Collection agency**



The longer an account has been outstanding, the more difficult it becomes to collect it. The enterprise itself first tries to collect the overdue account. If this is unsuccessful, the enterprise should consider forwarding the account to a collection agency. However, the enterprise should weigh up the cost of this collection action against the money it will obtain if the outstanding account is paid. It will only be profitable for the enterprise to use a collection agency if the income from the account will be higher than the costs involved in collecting it through an agency.

When a collection agency is used, a **third party** is involved in the collection of the debt. The enterprise should first **inform** the debtor that it intends to forward the overdue account to a collection agency if the account is not paid before a specified date. The debtor usually receives a letter from the enterprise with a **final** request for payment of the outstanding amount before a certain date. If the debtor does not react to this request, the account is forwarded to the agency.

*There is only **ONE** final letter or final reminder.*

The agency's objective is to collect the outstanding debt **as soon as possible**. If the enterprise itself deals with the debt collection, it is sometimes seen as just one of the many responsibilities of the credit department, and may be unnecessarily delayed. This increases the costs of collection.

Advantages: Rapid collection Total service Stricter attitude Urgency Insists on settlement Aware of problem Well-trained collectors

Another advantage of using a good collection agency is that it offers the enterprise a **comprehensive collection service**. This includes, for example, reconciling the account, tracing debtors who have absconded (run away), and eventually taking legal steps, if required. Using a collection agency also has the following **advantages**:

❑ The agency has a **stricter attitude** - the debtor has had enough time to pay the account or complain about the goods or services received

❑ The agency can request payment in a more **urgent** way

- ❑ The agency can insist on the **immediate settlement** of the account, for example: "The account must be paid before five o'clock this afternoon!"

- ❑ If the agency has to handle a number of different claims against the same debtor, it is **aware** of the extent of the debtor's problem - the debtor will consequently admit to his or her problem more readily

- ❑ The agency employs **collection specialists** who are all highly skilled in debt collection

The costs of using a collection agency vary, depending on the type of service required and the agency selected. Many agencies operate on the basis of "no collection - no cost". The agency charges a certain percentage of the debt that is collected successfully, but charges no fee for unsuccessful cases.

The approach and techniques used by the collection agency to collect overdue accounts are not fundamentally different to those used by the enterprise. The agency also uses notices, letters and telephone calls.

As soon as an overdue account has been forwarded to an agency, the agency immediately writes a letter to the debtor, notifying him or her that the creditor has forwarded the account to a collection agency. The debtor usually responds to this letter by giving reasons why the account has not been settled on time. In many cases the full settlement of the account is received after the first letter from the collection agency.

In collecting trade credit, the agency uses the following approach if the debtor has not responded within a reasonable time:

- ❍ An experienced collector makes a telephone call to the most senior officer in the debtor enterprise who is responsible for the payment of accounts

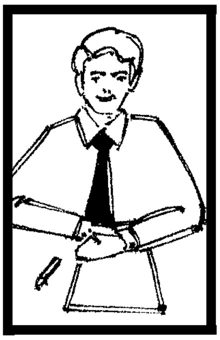
- ❍ The agency then tries to obtain some form of positive payment, or a promise to pay, from the debtor. This information is carefully recorded so that follow-up telephone calls can be made if the agency has received no payment within the specified period

During the collection cycle there is a constant flow of **correspondence and telephone calls** between the agency and debtors. The collection agency must report to the enterprise on all the outstanding accounts that have been forwarded to it. The agency must also indicate those accounts that will respond only to some form of legal action. The enterprise must react immediately to this report, because the accounts that have not been collected by the agency must be investigated thoroughly. The enterprise must decide whether it will hand these accounts over to an attorney, or whether it will write off the outstanding amount as bad debt.

List the aspects you would regard as the advantages and disadvantages of a collection agency:

ADVANTAGES	*DISADVANTAGES*

❑ **Attorney**



The **final step** the enterprise can choose to take before writing off an outstanding amount as bad debt is to forward the account in arrears to an attorney. A good collection attorney will act quickly and try to collect the outstanding amount immediately. If the account cannot be collected in full, the attorney will at least try to reach a favourable agreement with the debtor. The attorney must submit progress reports on the collection action to the enterprise.

The enterprise can also use the attorneys of the collection agency. The advantage of this is that the agency has already done the **preliminary work** (before legal action is recommended). For example, at this stage the agency will already have investigated the circumstances regarding the debt and the validity of the debt.

In many cases legal action against a debtor leads to the liquidation of the debtor. Frequently, the enterprise receives only a part of the amount due, and the rest must be written off as bad debt. If the debtor is liquidated, the collection period is extended even further, and because the enterprise normally receives only a partial payment, it is usually better to come to an agreement with the debtor. The enterprise can, for example, grant a further extension of the payment period to the debtor, or accept a partial payment for the full settlement of the account. In this way the costs of legal action can be eliminated.

It is very important for the enterprise to consider the costs of legal action before accounts are forwarded to an attorney. The benefits that the enterprise will obtain by collecting these accounts should justify the costs that the enterprise will have to incur to collect the overdue amounts.

If the outstanding amount is too small to warrant the legal costs or any further collection costs, it is written off as bad debt.

The enterprise can provide for the writing off of bad debt on the basis of the enterprise's previous experience with writing off outstanding debts, as well as current trends, such as the economic conditions in the country. During an economic downswing, the possibility of an increase in bad debts is greater than during an economic upswing, when disposable income is greater. The enterprise can also compare the average age of the debtors with the credit period - the longer the period that the debt has been outstanding, the greater the possibility of bad debts.

EXAMPLE
Suppose John Smith bought furniture to the value of R1 500 from Furniture Land Ltd on 15 May. He had to pay a deposit of 10%. The outstanding balance was payable before or on 30 May. After John received the furniture on 20 May, Furniture Land Ltd sent him an account statement to remind him that he still owed R1 350. John failed to pay the outstanding amount before or on 31 May. Furniture Land Ltd can follow the following procedure to collect this outstanding amount:

❑ *It can send a copy of the account to John Smith, requesting him to pay the account before or on 14 June.*

- *If John does not pay the account before or on 14 June, Furniture Land Ltd could send a letter and another account, indicating that the account is still outstanding. It is important that the enterprise should indicate before or on which date payment is required, for example 30 June. At this stage the debtor can be telephoned to find out what the reasons are for the outstanding account. John could possibly promise to settle the account at this point.*

- *Assume that John does not settle the account. Furniture Land Ltd could send him a second letter immediately after 30 June, urgently requesting him to pay the account before or on 10 July. If this does not happen, the account will be forwarded to a collection attorney.*

We assume that John paid his account on 10 July!

- **Other aids**

In addition to the collection aids we have already discussed, a number of other aids can be used to speed up the collection of overdue accounts. Some of these are listed below:

- **Bills**. The enterprise can decide to draw a bill on the debtor in arrears, ordering him or her to pay before a certain date. The debtor must sign the bill. In doing so, he or she confirms that he or she owes the enterprise the amount for which the bill has been issued and undertakes/promises to pay the amount due before or on a specified date.

- **Telegram**. The telegram as a means of collection is directly addressed to the debtor concerned. It forces the debtor to take note of the content of the telegram. The telephone message is concise and to the point - long messages increase the cost of the telegram. The message is an urgent request to pay.

- **Postcard**. Postcards can be sent to debtors when it is difficult to contact them by telephone. The cards are then used to persuade the debtor to telephone the enterprise.

- ❑ **Interest on overdue accounts**. Although some debtors do not mind paying interest, others will pay their overdue accounts more quickly to avoid paying interest.

- ❑ **Stop credit sales to debtors in arrears**. As soon as an account becomes overdue, the debtor is no longer allowed to buy on credit. He or she may only buy on credit again once all overdue amounts have been paid.

- ❑ **Arrangements for deferred (postponed) payment**. Even though the enterprise would like to collect the overdue amount as soon as possible, it is always better to collect something instead of nothing. If a debtor really cannot pay, therefore, the enterprise might come to some special arrangement with him or her, for example allowing payment of the debt in instalments, or extending the payment period.

Match the words in column A to the descriptions in column B.

	A		*B*
1.	*Personal visit*	*1.*	*Can determine reasons for non-payment*
2.	*Telephone*	*2.*	*Final step*
3.	*Bills*	*3.*	*Ensures payment*
4.	*Account statement*	*4.*	*Aid if debtor cannot be reached by telephone*
5.	*Collection attorney*	*5.*	*Expensive and time-consuming*
6.	*Telegram*	*6.*	*Used to remind*

8.4 EFFECTIVENESS OF THE COLLECTION PROCEDURE

The effectiveness of the collection procedure has a direct influence on the enterprise's **cash flow position**. Debtors in arrears should be converted into cash as soon as possible. If this is not done and the problem of overdue accounts becomes more and more serious, the enterprise may develop serious **cash flow problems**.

The effectiveness of the collection procedure is influenced by the **cost** of collecting accounts in arrears. The enterprise should be aware of the exact costs involved in collecting overdue accounts, because the process must be **cost-effective**. Remember, the advantages of collecting overdue accounts must be greater than the cost involved in obtaining the outstanding amounts.

The **effectiveness** of the collection process can be **evaluated** in the following ways:

- ❑ Compare the amount actually collected with the objectives set at the beginning of the collection period (for example, that 60% of the accounts must be collected in between 30 and 60 days)
- ❑ Do an age analysis of the debtors. How has the picture of debtors in arrears changed? Are there fewer debtors who have been in arrears for more than 60 days?
- ❑ Determine the turnover rate of debtors. Is there an improvement in the turnover rate? How does this figure compare to the general norm, or to the figures for preceding years?
- ❑ Determine the collection costs for every R1 000 of outstanding debt collected
- ❑ Determine the percentage of debtors in arrears who settle their accounts after receiving the first copy of their account statement
- ❑ Determine the percentage of debtors in arrears who pay the outstanding amount after receiving the first collection letter

- ❑ How many telephone calls are made by a collection officer per day, what are the costs involved and how much money has been collected?

- ❑ How good are the results of every particular means of collection, and which method produces the best results?

- ❑ Which percentage of debtors in arrears are eventually forwarded to an attorney?

- ❑ Which percentage of debtors in arrears are written off as bad debt?

We discussed guidelines for effective collection in chapter 7. If the enterprise applies these guidelines right from the beginning, it will contribute to the attainment of its objectives. We saw, for example, that the enterprise cannot expect to have problem-free collection if credit is granted very easily. **Without an effective debtor administration system, effective collection is also impossible**.

Which other guidelines can you suggest to make the collection of debtors as effective as possible?

Did you think of the following?

- ❑ ***Keep credit limits low - the debtor must be able to afford the credit limit***
- ❑ ***Make sure that the debtor does not exceed the credit limit***
- ❑ ***Make sure that the debtor understands the credit terms***
- ❑ ***Draw up guidelines to help you determine when an account should be written off as bad debt (and there will be no further attempt to collect it)***
- ❑ ***Keep a record of the debtor's method of payment - the enterprise may be able to identify a trend in payment problems in this way***
- ❑ ***Keep special conditions and arrangements to a minimum***
- ❑ ***Ensure that the debtors database remains up to date (dated information makes the collection process more difficult)***
- ❑ ***Obtain the cooperation of the sales and marketing staff. Emphasise the importance of a healthy cash flow, and that information about changes in the behaviour and buying pattern of a debtor should be given to the credit department***
- ❑ ***Concentrate on the largest accounts that are in arrears. Keep the principle of 80%-20% in mind (this is explained below). Large outstanding amounts have a direct influence on the enterprise's cash flow position (if the enterprise can collect this large outstanding amount, it may be in a position to meet its own obligations)***

The 80%-20% principle can be explained as follows: In the case of trade credit it is possible that 20% of the customers buy 80% of the sales value (in other words, they represent 80% of the total debtors). An example of a typical ledger with 2 500 accounts to the value of R5 million and an average balance of R2 500 per account may be as follows:

Group	*Number*	*Value*	*Total*	*Average value*
A	*36*	*> R50 000*	*R3 024 000*	*R84 000*
B	*403*	*> R500*	*R1 853 000*	*R46 000*
C	*1 561*	*< R500*	*R106 148*	*R68*

This table represents a normal 80:20 ratio. In other words, 20% of the customers have bought 80% of the sales value. This example clearly indicates that category "A" can be regarded as the key accounts. This group of accounts has a significant effect on the debtor total (and also on the enterprise's cash flow). Late payments in this group of accounts will have to receive special attention to ensure that the enterprise's collection activities are as effective as possible.

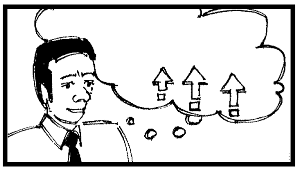
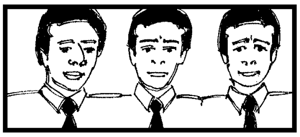
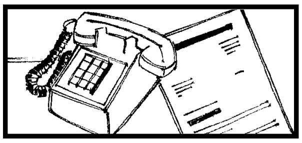
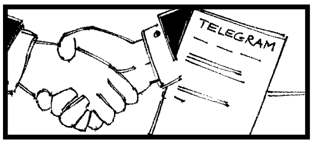
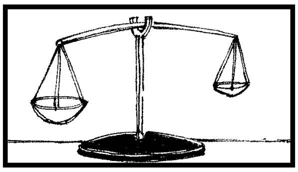
8.5 SUMMARY

In this chapter we first examined the basic requirements of the collection procedure. We saw that the enterprise must start collecting debtors in arrears as soon as possible to prevent the problem from becoming more and more serious, which could finally result in severe cash flow problems.

The different phases of the collection procedure were discussed. We also investigated the different instruments and aids that are available to the enterprise. How these aids are combined will depend on the enterprise's circumstances and its collection requirements at a certain time.

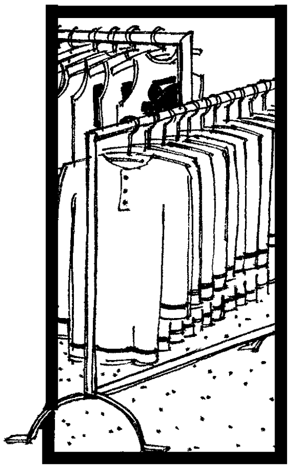
The cost of collecting debtors must be constantly monitored. The advantages of collecting an account in arrears must be greater than the cost involved. In addition to the cost aspect, the enterprise should also know how effective the collection procedure is as a whole. We saw that there are various guidelines that an enterprise can use to evaluate the effectiveness of the collection procedure.

Use the following table to make your own summary of this chapter. Write down keywords relating to each subject in the second column.

COLLECTION PROCEDURES		
	1. Objectives of the collection procedures	
	2. Basic principles of the collection procedures	
	3. Phases in the collection procedure	
	4. Different collection instruments	
	5. Additional aids	
	6. Evaluation of the effectiveness of the collection procedures	
	7. Guidelines for effective collection	

8.6 SELF-EVALUATION

FASHION BOUTIQUE CC



Fashion Boutique, a family clothing store in Bloemfontein, was established in 1990 by the Simon brothers, Peter and John.

From the beginning, there was very strong competition in the market because Fashion Boutique had to compete with established clothing businesses, including various clothing chain stores. At that stage many of the clothing chain stores already offered their customers a revolving credit scheme with a payment period of six months.

Fashion Boutique started selling on credit as soon as it was established. A revolving credit facility over a period of six months was introduced. The enterprise charges interest on overdue accounts at 24% per year, which is added to the instalment of the following month. In an attempt to speed up the collection of debtors, the enterprise grants a cash discount if debtors pay their accounts within 10 days of the date on the account statement.

Credit applicants are assessed with the help of a credit rating system. Their creditworthiness is assessed on a scale ranging from excellent to poor. Peter is responsible for credit assessment. In many cases, he relies on his own judgement and he often grants credit to uncertain credit risks.

At the end of the bookyear, on 30 June 1995, an investigation showed that the enterprise's debtor turnover rate compares poorly to the norm in the industry. This trend continued in the bookyear ending 30 June 1996.

The enterprise currently has severe cash flow problems and had to use its available bank overdraft facility more often during the past six months.

At the recommendation of Fashion Boutique's accountant, Peter and John reconsidered the way in which they manage credit and collections in the enterprise. They came to the conclusion that the collection guidelines were inadequate, and that instalments in arrears were not identified soon enough. Also, the method of credit assessment left much to be desired and definitely had to be adjusted.

1. Which basic guidelines will the Simon brothers have to keep in mind in developing a collection procedure for Fashion Boutique? Discuss.

2. Do you think that a good collection procedure will help to reduce or eliminate Fashion Boutique's cash flow problems? Give reasons for your answer.

3. Do you agree with the following statement?
"If a credit assessor relies only on his or her own judgement to assess creditworthiness, collection problems will result."
Discuss your answer.

4. Develop a collection procedure for Fashion Boutique and justify your choice of collection instruments.

5.i) Discuss the following collection instruments in detail:

- ❑ Telephone
- ❑ Collection letters

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ii) Complete the table below about the advantages and disadvantages of the following collection instruments:

- ❑ Personal visit
- ❑ Collection agency
- ❑ Attorney

Personal visit	Advantages:	Disadvantages:
Collection agency	Advantages:	Disadvantages:
Attorney	Advantages:	Disadvantages:

6. How can Fashion Boutique assess the effectiveness of the new collection procedure? Give at least five guidelines.

7. Which suggestions could you give the enterprise to make its collection even more effective?

8.7 REFERENCES

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