# Credit Management in the Enterprise

# 1

CONTENTS PAGE

## Study Objectives

After studying this chapter, you should be able to:

- discuss, with practical examples, co-operation and the importance of co-operation between the credit department and the other functions and departments of the enterprise
- discuss the importance of co-operation between the credit and sales departments
- explain the role of credit management in customer service
- briefly explain the necessity of co-ordinating credit management activities
- discuss the importance of the credit and collection policy in the enterprise
- explain the purpose and content of a credit policy
- list the advantages of a written credit policy
- discuss the factors influencing the credit and collection policy
- explain the difference between credit policy, procedures and rules
- give inputs for the formulation of a credit policy and procedure

## INTRODUCTION

Credit management is no longer a “necessary evil” in the enterprise. It makes an important contribution to the enterprise’s growth and survival. In conjunction with the other enterprise functions, it helps the enterprise to attain its objectives. Credit management, therefore, is not an isolated activity within the enterprise. Continuous liaison and interaction with all the other functional departments such as the marketing, finance, production and human resources departments are vital. Only by co-operating with these departments can the credit management contribute to reaching the enterprise’s objectives, including its primary objective of maximising profitability.

Credit management in the enterprise cannot be planned and controlled without proper guidelines. If credit management activities are carried out randomly, the enterprise has no guarantee that they will be successful. It also makes it more difficult to attain credit management and enterprise objectives. For this reason a well-formulated credit and collection policy is of the utmost importance. The credit and collection policy provides broad guidelines for making decisions about credit and collections in order to attain the enterprise’s set objectives.

In this chapter we will study the following:

- Firstly, we will investigate the importance of co-operation between credit management and the other activities in the organisation, and the co-ordination of their activities.

- In the second part of the chapter we will look at the importance and the purpose of, and the factors influencing the credit and collection policy.

- In conclusion, we will discuss the policy, procedures and rules applied in the credit department.

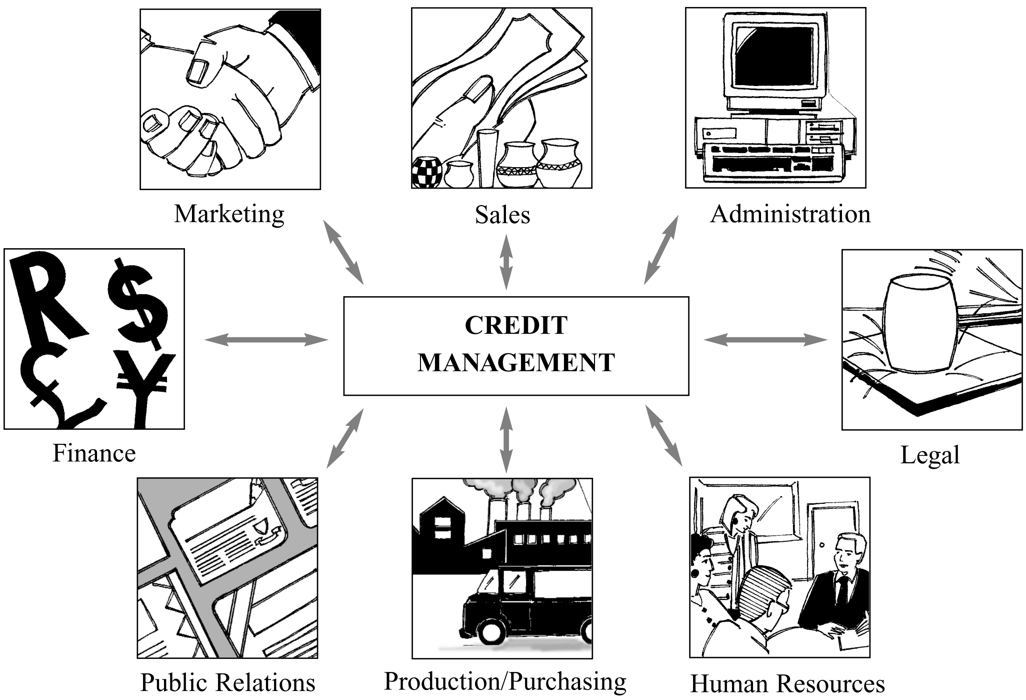
## CO-OPERATION BETWEEN CREDIT AND THE OTHER ENTERPRISE FUNCTIONS

Every enterprise granting credit, whether this be consumer, trade or financial credit, must organise its credit and collection activities in some way or another. Depending on the size of the enterprise, the nature of its activities and its number of credit sales, a separate credit department is set up, or credit activities are incorporated into, for example, the marketing or finance department.

For the purposes of this chapter, let us assume that the enterprise has a separate credit department headed by a credit manager. Even when credit activities are incorporated into the finance department, for example, the principle of co-operation still applies and a credit policy is still a necessity.

**Co-operation** between the **various enterprise functions** and **departments** is **important** to attain set objectives. All the functions work together to ensure that the enterprise will be **successful**.

In the same way, **co-operation between the credit department and other departments** in the enterprise is important. The importance of this co-operation is indicated by the following examples:



- **The finance department**. The credit manager gives valuable inputs that the financial manager can use to manage, among other things, the enterprise's current assets. The finance department must plan the enterprise's cash flow and provide for possible shortages. The granting of credit and the conversion of debtors into cash directly influence the enterprise's cash flow position.

- **The administration department**. One of the functions of this department is to keep a record of account payments, which provides important information for the credit department. The credit department needs this information to determine, for example, which accounts are in arrears and have to be followed up. The administrative function is also responsible for developing information systems within the enterprise. Without the necessary liaison with this department, the needs of the credit department in terms of these systems will not be met. The credit department needs to obtain information about, for instance, debtors as quickly as possible to ensure a prompt reaction to customer complaints.

- **The legal department**. In financial institutions and large enterprises with a separate legal department, liaison with this department is essential. The credit manager hands overdue accounts to the legal department for collection. The legal department also assists with drawing up contracts (e.g. installment contracts).

- **The sales department**. Liaison with the sales department is essential because, among other things, the sales staff should know what the minimum requirements are for a person or enterprise to buy on credit. The sales staff should also know how to handle a credit application - in other words, according to the guidelines provided by the credit department.

- **The marketing department**. Liaison between the credit department and the marketing department (which in effect includes the sales department) is important for a number of reasons, of which we will mention only a few here. Firstly, the credit department can provide valuable information about the market in which the enterprise operates, and about the consumers in these markets. The credit department continuously liaises with its customers and, in the process, obtains **direct information** (first-hand information) from them. In this way the credit department becomes aware of their customers' needs, and it can give the marketing department information about these needs. In terms of credit exchange agreements, the credit department also liaises with other enterprises selling on credit (the enterprises exchange information about debtors). Some of these enterprises may be competitors of the enterprise, and in this way the marketing department may obtain information about competitors.

- **The human resources department**. The credit department cannot function without employees. The enterprise employs people with the help of the human resources department.

- **The public relations department**. The credit department is able to form a good idea of the customers' perceptions (of how the customers see the enterprise). The enterprise can use this information in ensuring that customers react positively to it and its products. Remember, it is cheaper to retain existing customers than to find new customers.

- **The production and purchasing departments**. Credit management can obtain information about the quality of the enterprise's products or services from customers (especially in the case of trade credit and financial credit), and pass this on to the production and purchasing departments. Information about the specific products required by customers can also be obtained. This enables the departments concerned to make any necessary adjustments (for example, to buy products of a higher quality).

***Example*** *A clothing manufacturer decides to enlarge the factory so that more clothes can be manufactured (this manufacturing process is the enterprise's production function). If there is no co-operation and co-ordination with the other enterprise functions, the following problems may arise (and the enterprise's profits may suffer):*

★ *There may be too few sewing machines (because the purchasing function has not been informed of needs in this regard)*

★ *There may be a lack of funds (because the financial function was not involved in planning)*

★ *There may not be enough workers to manufacture the additional clothing (because the human resources function was not informed)*

## *Tasks of Credit Management*

The necessity of co-operation becomes even more apparent when we look more closely at the **tasks of credit management**. These tasks are:

- to formulate a credit and collection policy
- to introduce credit facilities and programmes to the market
- to assess the creditworthiness of credit applicants
- to make decisions about granting credit
- to control all the debtors' accounts and
- to collect debtors

Let us now see how these tasks underline the importance of co-operation. Co-operation with the other functions is essential for the following reasons:

- **To formulate a credit and collection policy**. This policy is formulated in co-operation with top management and the other functional managers (such as those of the sales and finance departments). All the role-players give their inputs for the drawing up of the final policy, which becomes part of the enterprise's overall policy and procedures. As a last step, top management has to approve the policy.

- **To introduce credit facilities and programmes to the market**. Enterprises selling on credit are constantly developing new credit programmes and introducing these to the market. The enterprise has to inform existing and potential customers of these new credit facilities. (If the market is not informed, it will have a negative effect on the enterprise's sales figures and income from credit.) The enterprise's credit facilities can be advertised in, for example, magazines, newspapers and on television. Enterprises with trade credit facilities can introduce these facilities to their customers at trade fairs and in trade journals. Sales representatives also play an important role in this regard. The marketing department is equally important because it is responsible for advertising.

- **To assess the creditworthiness of credit applicants**. The credit department must be geared to handling new credit applications - it should have a suitable computer system and enough employees. The administrative and human resources departments will play a role here.

- **To make decisions about granting credit**. This task involves, among other things, decisions on credit limits. Guidelines for determining credit limits cannot be drawn up without inputs from the finance department, because the enterprise does not have unlimited funds to invest in debtors. The credit department must know how much money is available for financing debtors, and this will influence credit limits.

- **To control all the debtors' accounts**. Control in general involves comparing actual activities with the standards or objectives set for these activities. If the debtors' accounts are not controlled, the credit department will not know what the actual status of debtors is. (Here the administrative function plays an important role in documenting payments.) Even when debtor administration is carried out by the credit department itself, co-operation between these two departments is still very important. To control debtors, it is also important to identify overdue accounts as early as possible, because these accounts will influence cash flow. (For this liaison with the financial department is necessary.)

- **To collect debtors**. The credit department attempts to collect debtors as quickly and efficiently as possible. The conversion of debtors to cash flow has a direct influence on the management of the enterprise's cash flow. (Liaison with the finance department is important here.)

It is clear, therefore, that the credit department cannot perform its tasks in isolation - co-operation and co-ordination are important.

i) List at least four departments that the credit department must liaise with, and give a practical example of co-operation in each case.

ii) Why do you think it is necessary for the credit department to co-operate with the other departments in the enterprise?
Give reasons for your answer.

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***Example***

*If the enterprise experiences cash flow problems, the financial department must give sufficient information about this to the credit department. This will enable the credit department to adjust the way in which debts are collected. Examples of adjustments are to set a higher target amount for the next month, to revise the collection procedure or to pay personal visits to debtors with large overdue accounts.*

*Let us look at another two examples:*

★ *During the course of marketing research, the marketing department may identify a need for a new credit product. This information must then be provided to the credit department so that it can investigate the possibility of a new credit facility and develop such a product where feasible.*

★ *If the customer service department constantly receives the same queries about a certain aspect of the account statement, this information should be passed on to the credit department - it may be necessary to redesign the account statement.*

Apart from the obvious reasons why there should be co-operation and co-ordination between the credit department and the other departments, it is also important for the following reason:

In the past the value of credit management for the enterprise was frequently underrated. The credit department was seen as a department with little other function than collecting debtors, and which served only to limit sales. By communicating and co-operating with the other departments in the enterprise, the credit department **can demonstrate the importance of its contribution to the enterprise**, and show how it can assist the enterprise in attaining its objectives. In this way, the position of credit management in the enterprise can be strengthened.

Credit management **contributes substantially** to the enterprise's **long-term growth** and **survival**. For this reason the inputs of credit management about aspects of strategic management are important. The credit and collection policy also cannot be formulated without the inputs of top management and other departments.

Credit management also has a key role with regard to the enterprise's **cash flow**. The credit department assesses credit applications, grants credit and is ultimately also responsible for the collection of the money. When an enterprise sells on credit, it needs working capital to finance the debtors. The enterprise must know ahead of time how much capital it has available to finance the debtors. This capital represents a cost to the enterprise, and if it was not necessary to use it for financing the debtors, the enterprise could have used it in other ways to ensure a return. In certain cases enterprises are forced to use loan capital to finance its debtors, which increases the cost of credit.

It is important that the capital invested in debtors should be made available as soon as possible to be used again. The capital that becomes available from debtors (it becomes available when the debtors pay their accounts) has a positive influence on the enterprise's cash flow. It enables the enterprise to meet its own financial obligations, such as paying its own accounts. The longer capital is tied up in debtors, in other words the longer the debtors take to pay their accounts, the smaller the enterprise's cash flow becomes. Poor cash flow has a negative effect on the enterprise's liquidity (its ability to pay its accounts regularly and on time), and if this does not receive attention, it can do great damage to the enterprise's creditworthiness, growth and survival in the long term. The inputs of credit management are thus essential for **financial planning and control**.

## *Hints for Promoting Co-operation with the Other Departments in the Enterprise:*

- Communicate with all the departments - effective communication has a positive effect on co-operation.

- Ensure that there is a clear credit and collection policy. This must be in writing, so that every department will know exactly what it entails.

- Compile a credit manual in which the rules and procedures that must be followed are briefly set out.

- Draw up reader-friendly credit reports on credit and collection activities and indicate how the credit department can make a positive contribution to attaining the enterprise's objectives. Send these reports to all the departments in the enterprise.

- Promote credit management in the enterprise so that the various role-players will gain insight into the present role of credit management, and the role it could play in future.

## CO-OPERATION BETWEEN CREDIT AND SALES

While it is essential for the credit department to co-operate with all the departments of the enterprise, co-operation with the sales department is especially important. We are therefore going to look at this aspect in greater detail.

### *Conflict between Credit and Sales*

We will be referring to the sales department throughout this section. Remember, however, that the sales department forms part of the overall marketing function in the enterprise.

In many enterprises there is **conflict** between the sales and credit departments. This conflict can be ascribed to a **lack of understanding** of each other's roles. For example:

- The credit department believes that the sales staff would like to sell as much as possible to ensure high sales figures and commission, ultimately leaving the credit department to deal with a great many overdue and bad debts

- The credit staff think that the sales staff do not always give them all the available information when the creditworthiness of an applicant is assessed, because the sales staff would very much like to conclude the sales transaction and are afraid that credit will not be granted

- The sales department believes that the credit department does not understand the importance of sales - that it limits sales and disregards the needs of customers

- The sales department thinks that the credit department is too slow in assessing credit applications and that potential transactions are lost in this way

## *Eliminating the Conflict*

There are various steps that can be taken to reduce this conflict. For example:

- The credit and sales departments can have **joint meetings**. This will make the staff of both departments aware of each other's duties, responsibilities, difficulties and problems

- Sales staff can be **informed** of the meaning of credit

- The administrative work of sales staff can be **limited**

- There should obviously be **communication** between the two departments. The importance of communication cannot be overemphasised. The two departments should **understand each other**. They should also learn to **listen** to each other, and not merely to talk. By listening and asking questions, every department can establish exactly what the function and responsibilities of the other department involve. In this way understanding will be promoted. In theory, co-operation of this kind seems easy to attain, but in practice problems due to a lack of communication between sales and credit often still exist. Instead of eliminating problems by communicating with each other, the staff of the two departments avoid each other.

- The sales staff should **not overcommit** the credit department. In other words, the sales department should not tell a customer on behalf of the credit department that, for example, there will be no problems in obtaining credit, while this will in fact not be the case (the sales staff should thus not create high expectations). Also, the sales staff should not expect the credit department to give a great amount of credit when a customer's current credit record is merely average. Actions of this kind can damage the relationship between the two departments, and ultimately the relationship between the debtor and the enterprise may also suffer.

- **Adequate feedback** from the sales staff is important. For example, if the customer is not completely satisfied with a product or service, he or she usually contacts the sales staff (specifically in the case of trade credit). The customer may then obtain the sales representative's approval to delay payment of an account until the problem has been solved. If the sales representative does not give this information to the credit department, the credit department may start with the collection activities because the account is overdue. This will cause dissatisfaction on the part of the customer. If the credit department had known about the problem and the arrangement made by the sales representative, it would not have proceeded with collection and the problem could have been avoided. Remember, it is important for the enterprise to retain the goodwill of debtors.

- Sales staff should realise that the function of the credit department is **not to ruin the prospect of new sales**. Together with the sales department, the credit department strives to contribute to maximum turnover, **but** it does so while taking the risk of credit into account. If the credit department does not keep a watchful eye on the credit risk, the profit generated by sales may be neutralised by bad debts.

- The credit staff themselves should also promote co-operation with the sales department. The credit staff should give the sales staff **clear guidelines** about the terms on which credit is granted. A credit manual with a concise explanation of procedures should be given to the sales staff. Remember that the sales staff may not have time to read through thick manuals - they have to concentrate on selling the enterprise's products.

- Credit staff should ensure that there is a clear **credit policy**. All sales staff should know the credit department's requirements for assessing accounts objectively. If a sales representative omits information or provides outdated information, it may result in an application being refused. The sales staff should realise that **all information** - positive and negative - should be given to the credit department. The sales staff should also be fully informed of the current credit terms. They may not, in order to close a deal, adjust credit terms in any way they wish.

- The credit department should also regularly **inform** the sales department of **payments received** for outstanding or overdue accounts. This will enable the sales staff to sell to the account holders again and obtain business in this way.

- Credit managers should accompany sales staff when they pay **personal visits** to customers (in the case of trade credit). This will give credit managers the opportunity to meet the customers. Such a meeting might result in the adjustment of the customer's credit limit, for example, or an arrangement that could pave the way for further sales. The credit manager might also hear something that may lead him or her to be more cautious with the customer, and thus to require greater security for a higher credit limit. If the credit manager is with the sales representative and explains the situation to him or her, the representative will usually agree with the manager's reasons and approach. (If the sales representative is not present, he or she might have a different opinion.)

i) List four possible reasons for a lack of co-operation between the sales and credit departments.

ii) How would you solve these problems?

## Credit and Customer Service

Co-operation between the various departments in the enterprise highlights the advantages of a team approach. Where credit management is concerned, many enterprises also follow a team approach in dealing with credit, sales and customer service. These departments are combined with the purpose of serving a customer in such a way, right from the outset, that the enterprise **retains the customer**. By using the team approach, the conflict between the sales and credit departments can be eliminated to a large extent, because the two groups perform their activities together. For example, the sales staff may inform the credit department of a possible transaction, and the credit department can then complete a credit investigation.

The team approach also enables the customer service department to solve any problems the customer may have. Customer service is aimed at **keeping the customer satisfied** and **handling all possible problems and queries**. It is important that the credit department should be aware of the **value of customer service**, because this service has an effect on the payment of accounts and the retention (keeping) of customers. The sooner a customer's problem can be solved, the sooner the enterprise can expect payment. Non-payment often occurs because the customer is dissatisfied. Instead of passing on the problem to someone else, the credit department itself can investigate. In so doing, it may solve the problem more quickly, receive its payment sooner and satisfy the customer at the same time. Remember, a satisfied customer will return to buy from the enterprise again.

The credit department strives to **keep existing accounts active**. This is cheaper than constantly opening new accounts. Once an account has been opened, the enterprise would like to keep it profitable over a long period. This also enables the enterprise to build good customer relations in the long term. By direct involvement in customer service, the credit department can make an active contribution to attaining the objectives of credit management. Through good customer service, the relationship with the sales department can also be enhanced, because this department also attempts to serve customers as efficiently as possible.

If the credit department provides a customer service, it can deal will customer complaints itself and so ensure that accounts are paid on time. When a customer's problems have been solved, he or she is usually willing to pay the account.

The credit department can also improve its customer service by paying special attention to the way in which it communicates with customers - whether this is by phone, personally or by mail. For example, how should the collection clerk talk to a debtor when telephoning him or her about an overdue payment? If the debtor feels that the collection clerk is not courteous enough, payment of the account will only be further delayed. Debtors should always be treated in such a way that their goodwill is retained, and this is only possible where there is good customer service. Every customer thinks that he or she is the only person supporting the enterprise - and should therefore be treated accordingly!

***Example***

★ *Accounts will be paid more promptly if the credit department itself deals with queries and problems regarding incorrect prices, unauthorised deductions such as interest or discounts, or prices on the account statement that do not correspond with the quoted prices. In such a case the problem is not passed on to another department - the credit department itself deals with it and tries to solve it as soon as possible.*

★ *If the credit department is directly involved in customer service, it can solve problems such as debtors who cannot pay, or who cannot pay the whole amount because of temporary cash flow problems. The credit department can then make the necessary arrangements with the debtor to pay, or can arrange for payment to be postponed.*

Make a list of ways in which the credit department can provide customer service. List ways other than the ones mentioned above. Hint: Talk to customer service staff and find out what they do.

## CO-ORDINATION OF CREDIT MANAGEMENT ACTIVITIES

The different credit management activities should all be co-ordinated. In looking at the structure of the credit department in a large enterprise granting consumer credit, for example, we can identify the following **departments:**

- New accounts - applications for new accounts are processed in this department and the applicants are informed whether they will be allowed to buy on credit.

- Customer service - this department deals with the queries of customers, for example about a payment that is not shown on the most recent account statement, or an incorrect account statement.

- Payments - here all payments received by mail are processed.

- Debtors administration and control - this department deals with the debtors' ledger and controls the debtors (this includes aspects such as the balancing of the debtors' ledger, credit balances, non-payments and returned cheques).

- Collections - this department is responsible for collecting overdue accounts.

If these departments do not cooperate, credit and collection activities will not be efficient. This means that the objectives of credit management will not be reached.

***Example***

★ *New accounts cannot simply be opened immediately without considering the collection of accounts that may be overdue.*

★ *Control of debtors is not possible if the enterprise does not keep an exact record of all payments made. Without control it is also impossible to determine which debtors are in arrears.*

Where only one person is responsible for credit applications and the collection of accounts, it is easier to co-ordinate activities. However, when an enterprise grows and the credit department is subdivided into various sections, co-ordination and co-operation must be strongly emphasised.

Granting credit and collecting debtors are not two completely independent activities.  The credit policy provides for the degree of risk that the enterprise is willing to accept with credit sales.  The investment in debtors, as well as the extent of bad debts, is influenced by this degree of credit risk.  If the enterprise has a liberal credit policy, it may have a very large capital investment in debtors (credit is easily granted, which means that many customers buy on credit).  The extent of bad debts may also be very great, for the very reason that credit applications are not assessed very strictly.

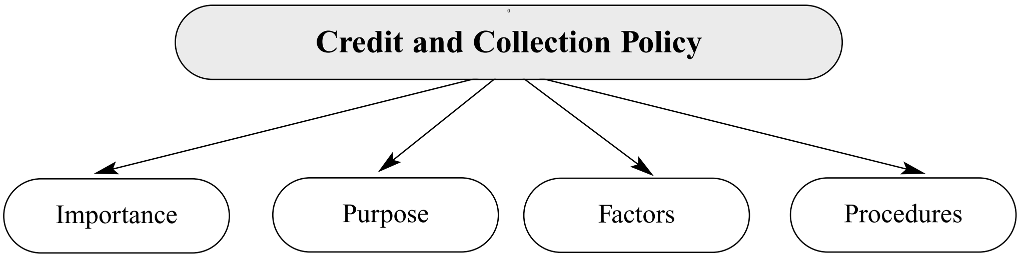
Obviously, the opposite is also true.  A strict credit standard and a thorough assessment of credit applications can ensure that the enterprise's bad debts remain low, provided that debts are collected effectively.

The way in which debtors are collected also influences the amount of capital invested in debtors, and the extent of bad debts.  Collection is aimed at making the invested working capital available as quickly as possible.  Without effective collection, the working capital cannot be used profitably.  The stricter the collection procedure, the smaller the investment in debtors - the debtors are converted into cash more quickly.  Strict collection also does a great deal to limit bad debts - the enterprise begins with the collection of debtors at an early stage and does not wait until the account is overdue. When debtors are collected sooner, the need for capital to invest in debtors is reduced and there is a smaller likelihood of bad debts.

Match each of the concepts in column A with a description in column B:

| | **A** | | **B** |
|---|---|---|---|
| 1) | Liberal credit management | A) | Provides for degree of risk |
| 2) | Credit policy | B) | Influences level of investment in debtors |
| 3) | Strict credit standard | C) | Leads to large capital investment in debtors |
| 4) | Method of collection | D) | Results in fewer bad debts |
| 5) | Strict collection procedure | E) | Debtors are converted into cash more quickly |

## The Credit and Collection Policy




In this study material we frequently refer to the credit and collection policy - the policy providing guidelines for **credit and collection activities**. Note, however, that in practice people often simply refer to the "credit policy" when they actually mean the credit and collection policy. When we refer to the "credit policy" only, you should also understand this as including collections.

It will be impossible for an enterprise to attain any of its objectives if it has no clear guidelines for decision-making. For example, there should be specific guidelines to make employment decisions (stipulating how many new staff members should be appointed, how their salaries should be determined, and so on). These guidelines are contained in the enterprise's human resources policy. Generally, therefore, the purpose of any policy is to provide guidance for the enterprise or a certain department within the enterprise. Enterprises selling on credit cannot make sound decisions without a credit policy. All the credit and collection activities are carried out with a view to attaining certain objectives, for example a minimum of bad debts or the maximum sales. Ultimately these activities contribute to the enterprise's primary objective, namely maximum profitability.

The credit policy serves as a guideline for making decisions about credit and collections in order to attain the set objectives. The credit policy also indicates where credit fits into the enterprise and what the enterprise attempts to achieve with credit.

### *Importance of the Credit and Collection Policy*

The importance of the credit and collection policy is emphasised by the fact that this policy provides **guidance** for the enterprise's credit and collection activities.

- The policy contributes to **effective decision-making** to achieve objectives.

- It **facilitates the planning and control** of debtors.

- It also contributes to **consistent decision-making** about credit and collections. The credit department cannot make one decision about a certain issue today, and then a completely different decision about it tomorrow. One debtor should also not be favoured at the cost of another.

- A policy ensures that the **staff** in the credit department **know** what they have to do, whom they report to and what their authority and responsibilities are.

- The credit and collection policy shows in **which direction** the enterprise would like to move with its credit and collection activities. For this reason the policy provides guidelines on, for example, the enterprise's credit standard, the credit terms and the collection of debts.

- A well-formulated policy which is effectively applied can result in the **better employment of the available working capital** in the enterprise. When there is an effective policy, the turnover rate of debtors is increased (the collection period is shorter). The capital becomes available more quickly and can be used to address another need sooner (which would not be the case if the enterprise had to wait a long time for its money).

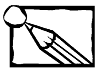
- The policy enables the enterprise to **distinguish between good and poor credit** risks. Remember, the credit policy is aimed at managing the debtors of the enterprise in such a way that it contributes to attaining the enterprise's objectives. This will not be possible if no distinction is made between good and poor credit risks.

- A policy **reduces collection costs**. If there is no policy, and thus no clear guidelines for assessing risk, poor credit risks could be accepted, which will ultimately lead to collection problems. It may also result in debtors not paying their accounts in time, or in overdue accounts not being identified at an early stage. In such a case the enterprise would have to incur additional costs to collect the accounts.

- A policy helps the enterprise to **limit bad debts**. Without a policy, there is a possibility that credit may be granted recklessly, which will ultimately result in bad debts.

- A clear credit and collection policy is a **valuable aid** for the **training and development** of credit staff. (It gives the staff specific guidelines according to which they should act.)

- It makes it possible to **delegate tasks**. We already know that the credit manager does not perform all tasks him- or herself. The credit policy enables the credit manager to assign tasks to subordinates, and they then know exactly what the limits of their decision-making powers are.

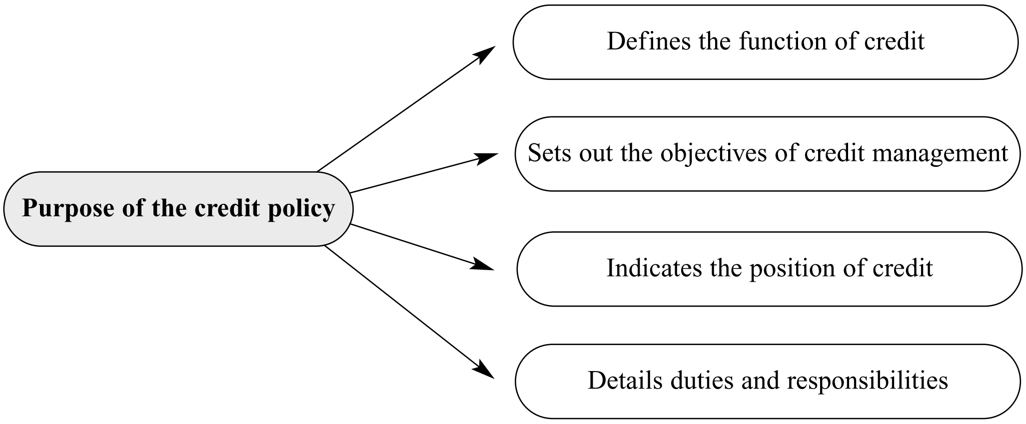


The credit policy:

- contributes to effective decision-making
- provides guidance for credit and collection activities
- results in working capital being used more effectively
- serves as an aid in training and developing staff

Explain each of the statements above with the help of a practical example:

## *The Purpose of the Credit Policy*




It should already be clear that the enterprise cannot function without a credit policy. Let us now see exactly what we mean by saying that the credit policy "provides guidance" for the enterprise's credit activities. In other words, let us look specifically at the purpose of a credit policy:

- It **defines the function of credit** within the enterprise. By granting credit and collecting debtors, the enterprise attempts to achieve the maximum number of sales, but at the same time to keep bad debts to a minimum. The credit department strives to obtain a **balance between the maximum sales and market share**, on the one hand, and **the maximum cash flow and minimum bad debts**, on the other hand. The primary function of credit is therefore to **manage the enterprise's debtors** in such a way that the **enterprise's objectives** will be reached. This means that credit must be granted in such a way that the capital invested in the debtors will contribute to maximising profitability. Capital invested in debtors which does not provide a return is "dead" and is not used to the enterprise's advantage. (Many enterprises refer to the "management of the credit portfolio" instead of the **"management of debtors"**).

- The credit policy sets out the **objectives of credit management**. The objectives of credit management are to:

  - collect information about the environment
  - increase sales and income from sales

- limit the cost of granting credit as much as possible
- keep the risk of credit low
- improve cash flow (through effective collections)
- keep bad debts low
- liaise with other departments
- improve customer relations

The various tasks of credit management arise from these objectives. The policy thus also gives broad guidelines on the tasks of credit management, for example on how decisions about credit assessment or the collection of debtors should be made.

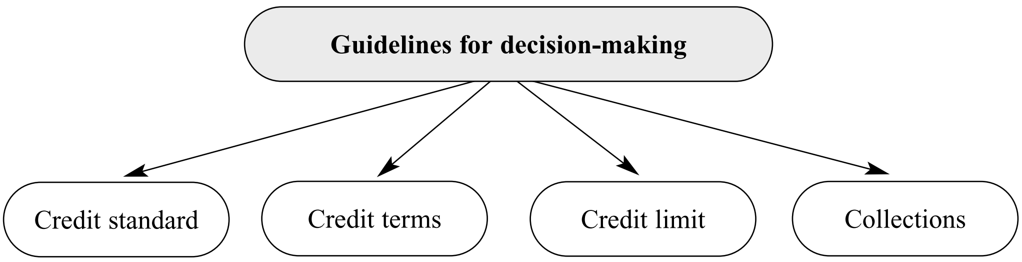
- A policy indicates the **physical position of credit** in the enterprise by way of the organisation structure. The organisation structure represents the framework within which enterprise activities and functions are carried out. This structure clearly shows lines of authority. It shows, for example, whom the credit manager reports to, who has which responsibility and who has the final decision-making authority in the credit department. Remember, the position of the credit department in the enterprise is not the same in all enterprises. In one enterprise the credit manager may report to the financial manager, in another to the marketing manager, and in some enterprises directly to the general manager.

- The credit policy **details the duties and responsibilities** of the credit function. For example, the credit manager is responsible for the **management of credit and collection activities**. This includes all decisions and recommendations about credit and collections. The policy must clearly show what the credit manager may do, and what decisions he or she may make, with what exceptions. Furthermore, the credit manager is also responsible for the training and evaluation of all credit staff. His or her duties and responsibilities also include the **delegation of authority**. The credit manager him- or herself can obviously not perform all the credit management tasks in the credit department. He or she has the final responsibility for the management of the credit department; however, the various tasks of the department are assigned to staff members who have to perform these tasks according to certain guidelines.

### *Guidelines for Decision-making*

***Example*** *The credit manager assigns the task of collecting debtors to the Head: Collections, or the task of deciding on credit limits to the Head: New Accounts. In cases where these staff members reach the limits of their decision-making authority, they involve the credit manager in the decision. For example, the Head: New Accounts may only have the authority to grant credit limits up to R5 000. If a debtor asks for a credit limit of R10 000, the credit manager him- or herself will have to decide whether this limit should be granted.*

Within the framework of the function, objectives, duties and responsibilities of credit management, the credit policy should provide guidelines for decision-making about the following:




- **The credit standard**
  What degree of risk will the enterprise accept; what are the minimum requirements; how is creditworthiness assessed; how and when is security required; which methods and sources of information are used, and when and how are these used?

- **Credit terms**
  - The form in which credit is granted, e.g. a revolving credit account or an open-book account
  - The credit period - the period for which credit is granted, e.g. 30 days
  - The method of payment, e.g. cheque, bill of exchange or electronic transfer
  - Cash discounts and the discount period, e.g. a 5% discount if the account is paid within 10 days after the date of the account statement

– Interest charges if the account becomes overdue, e.g. 3% above the prime bank rate

_ Seasonal offers, e.g. how the credit terms can be adjusted to provide for non-seasonal sales such as clothing purchases for the following season

- **Credit limit**
  How is the credit limit decided on, and according to which method is it determined; who determines credit limits; when may the credit limit be adjusted; how frequently must the credit limit be revised (the credit limit can be increased or decreased); what happens when the credit limit is exceeded; who must authorise higher credit limits?

- **Collection of accounts**
  How long may debtors be outstanding; how are overdue accounts identified; which procedure is followed to collect these accounts; which collection aids (e.g. telephone or letters) are used; how does one monitor the efficiency of account collection (which aids are used, for example the turnover rate of debtors, or the number of days payment has been outstanding)?

***Example***

*With regard to the credit standard, the credit policy may show that:*

★ *all customers must provide original, positive identification when applying for an account*

★ *the identity number of a person must be verified after the application form has been filled in*

It is always better for an enterprise to have a **written credit policy**. Any person in the enterprise can then read the policy to see exactly which guidelines should be followed in decision-making about credit. When there is any doubt about the decision to be made, the credit policy can be consulted. Where there is no written policy, the “small things” are often taken for granted or simply forgotten. For example, if a sales person increases the credit limit of an existing customer without consulting the credit department, it is very difficult to act if no guidelines have been set down in a written credit policy. In other words, in such a case it will not be clear who should make decisions about which issues. When the credit manager is not available, a clerk could make the decision, because it has not been specified in writing that the clerk may not do so.

*General Advantages of a Written Credit Policy*

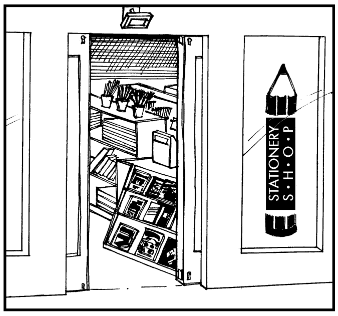
- When a policy is formulated and drawn up in writing, **every detail is carefully considered** to ensure that every person will use the policy will **understand it clearly**. For example, it must be determined who should decide on credit limits above a certain amount.

- It enables the credit department to **communicate** with the rest of the enterprise, and specifically with the sales department, about the **guidelines** for credit and collection activities.

- It contributes to the **effective functioning** of the credit department, because the staff know exactly how they should act in a particular situation.

1. Which other advantages does a well-formulated credit policy have for an enterprise? <u>Hint</u>: Go back to the section about the importance of the credit policy.

2. John is the owner of an enterprise selling stationery on credit to students. However, there are no clear guidelines John can follow for credit and collections. John asks you to help him formulate a credit policy.




   i) What is the purpose of such a policy?

ii) Which main points would you include in the credit policy?

iii) How would you justify putting the credit policy of John's enterprise in writing?

## *Factors Influencing the Credit Policy*

It should by now be clear that the enterprise can adopt one of two approaches with its credit policy; in other words either a liberal or a strict credit policy.

- The enterprise can have a **liberal credit policy**. Enterprises with a liberal credit policy grant credit "more easily". The credit standard is not so high and the enterprise is willing to accept "poor" credit risks (that is, credit involving high risk). These enterprises must be careful not to have a liberal collection procedure as well! If credit is easily granted, the enterprise must monitor the collection of debtors very carefully, because the risk of overdue accounts and bad debts is now greater (since average and poor credit risks are also accepted). In such a case stricter collection guidelines are necessary.

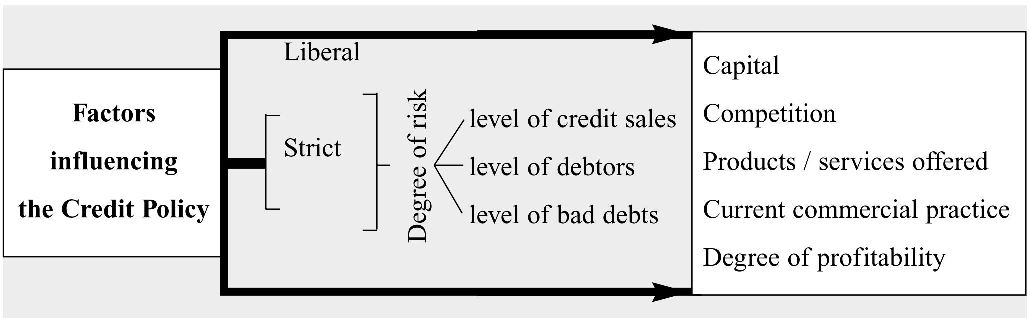
- The enterprise can follow a **conservative approach to credit risk**, in other words a **strict credit policy**. This means that the enterprise is not willing to "take big chances". A very strict credit policy (with, for example, strict selection criteria, a high credit standard and low credit limits) can reduce the income from credit sales. With such a strict policy, fewer people or enterprises qualify for credit (because in terms of the enterprise's credit standard, the credit risk is not good enough). This reduces the number of credit sales. However, it has a positive effect on the enterprise's collections, because collecting debtors is then usually easy.

The credit policy provides for the **degree of risk** that the enterprise is willing to accept in terms of credit sales. This degree of risk (as contained in the credit policy) influences the:

- level of credit sales
- level of debtors - the amount of capital invested in the debtors
- level of bad debts

In the same way, the collection policy also influences the level of debtors (how quickly are debtors collected, and how many debtors are outstanding?) and the extent of bad debts (how strict is the collection policy? - a strict policy results in fewer bad debts). The credit and collection policy must therefore be aimed **jointly** at contributing to the enterprise's primary objective. If the enterprise's credit policy is not very strict (in other words, if poor credit risks are also accepted), the collection policy should be strict. If this is not the case (if the enterprise grants credit to poor credit risks and is not very strict with the prompt payment of accounts), it will result in a level of outstanding debtors and a great number of bad debts.

It is clear, therefore, that the enterprise's **approach to risk** has a direct influence on the credit policy.



Other factors that influence the credit policy are the following:

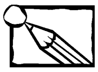
- **Capital** - the amount of capital the enterprise has available to finance debtors. If the enterprise has limited capital to finance debtors, it will, for example, set a shorter credit period. The enterprise will attempt to make the capital invested in debtors available as soon as possible so that it can be used for another purpose. For many enterprises, the final decision whether to grant credit or not actually depends on whether there is enough capital to finance the debtors (especially in the case of new and small businesses). The amount of capital available also influences the way in which the enterprise will collect the debtors. For example, if an enterprise has cash flow problems, it should have a strict collection policy - debtors should be collected as quickly as possible. In this way the cash income is increased and the enterprise will be able to meet its obligations again.

- **Competition**. The actions of the enterprise's competitors influence its activities and its credit policy. If the competitors have a liberal policy, the enterprise cannot be too strict with its policy (or it will lose possible sales). If competition is very severe, the credit terms can be a key factor in accepting an important order. For example, enterprises can allow a longer credit period. This will give them a competitive advantage above other enterprises. Remember, however, that if the enterprise grants a longer credit period, it will have to provide in some or other way for the longer period that it now has to wait for its money. The longer waiting period is "built into" the enterprise's product prices: it charges higher prices for its products. Some enterprises already have a competitive advantage, though, because not all enterprises sell on credit.

- **Products or services offered**. In the case of durable goods it is possible to allow longer credit periods or a liberal collection policy because the enterprise can repossess the product if the debtor does not pay. On the other hand, the point of departure in selling convenience goods and services is that payment should take place as soon as possible (otherwise the debtor may "forget" that he or she bought the product or service).

- **Current commercial practice**. The standard credit terms and collection procedures in the enterprise's industry influence the enterprise's credit policy. If a credit period of 60 days is the norm in the industry, enterprises usually adopt this as a guideline.

- **Degree of profitability**. Enterprises earning a large percentage of profit on the products or services sold can implement a more liberal credit policy. The greater credit risk, the longer waiting period, and the risk involved in waiting longer, are all offset by the higher profit margin. On the other hand, an enterprise with a low profit margin will be forced to follow a more conservative approach with its credit policy.



Refer back to the example of John, the owner of the stationery shop.

i) Which factors should you take into account in formulating John's credit policy?

ii) Justify your choice of factors with the help of practical examples that are relevant to John's enterprise.

## *Credit and Collection Procedures*

Once the credit and collection policy is in place, it is possible to develop **credit and collection procedures**. The procedures give a step-by-step explanation of precisely what, for example, a person in the new accounts department should do to open an account for a customer. This in fact means that **manuals** should be compiled that can be used or consulted in carrying out **daily tasks**. (These manuals can also be provided to the sales department to establish better co-operation with the sales staff.)

**Differences between Policy and Procedure**

| Policy | Procedure |
|---|---|
| * A policy provides broad **general guidelines** for making decisions in order to achieve certain objectives. The credit department should act within these guidelines to ensure that the objectives of credit management are achieved. For example, there should be guidelines that help the enterprise to decide whether a credit risk is good or poor. One of the objectives of credit management is to manage the risk of credit as effectively as possible. All decisions about credit risk should thus be aimed at reaching this objective in the long term. | * A procedure shows, in detail and step by step, which **activities** should be performed, how they should be performed, and in which order they should be performed to complete a specific task. For example, it would determine exactly which steps should be followed to set a credit limit (first make a decision about granting credit in principle, and then set a credit limit), or to fill in an application form for credit. |
| * A policy is **formulated once**, and afterwards adjustments are made if necessary. | * Procedures are **repetitive -** they are repeated over and over again. |
| * Policy is formulated by **top management**. | * **Supervisors** follow the procedures. |

In spite of the differences between policy and procedure, the two go hand in hand. In fact, the policy is implemented with the help of procedure.

A comprehensive **credit manual** should contain information about the following basic aspects:

- The purpose of the credit and collection manual
- The enterprise's current credit and collection procedures
- The credit application form for new accounts, and guidelines on completing this form
- The cases in which financial information about new applicants and existing debtors should be requested
- Who determines credit limits, and who may decide on which limit
- The annual revision of credit limits (especially in the case of commercial banks, where overdraft facilities are revised annually)
- Guidelines on dealing with requests for an increased credit limit
- The enterprise's standard sales terms, as well as special terms for, for example, established and new enterprises
- The enterprise's discount policy and interest policy (the interest charged on overdue accounts)
- Guidelines specifying how the sales staff can help with overdue accounts and the collection of these accounts
- Guidelines for identifying overdue accounts that will be written off as bad debt
- Notices of changes with regard to debtors, for instance changes of address, trade pattern, ownership and other changes that may influence the account

*The procedure that should be followed to verify the telephone number given on a credit application form may be the following:* ***Example***

- ★ *If a home telephone number is provided, use the Minitel telephone directory to determine if the number does belong to the customer*

- ★ *If the name of the applicant corresponds to the name given for the telephone number in the directory, or the applicant's home address corresponds to the address in the directory, the number is accepted as correct*

- ★ *If the telephone number is that of a neighbour or boarding house, the number should be circled and "no" should be written next to it. The person capturing the information on computer will then know that the home telephone number is not valid*

- ★ *If the number has been verified and accepted as valid, the person who verified it must sign next to the number and give it to the clerk capturing the information on computer*

- ★ *If the telephone number cannot be verified, for example if the number does not appear in the Minitel directory, the telephone numbers of a friend or relative should be confirmed*

In addition to policy and procedure, the enterprise also has certain rules. Rules are instructions that indicate exactly which actions should be taken in a certain situation, or what decision should be made in such a situation. Rules may not be deviated from or interpreted - they must be followed exactly.

*Credit management may have rules such as the following:* ***Example***

- ★ *If the postal address of an applicant is a postbox number, the home address must also be filled in.*

- ★ *Information about a friend or relative must be provided.*

- ★ *The steps followed during the collection procedure must be recorded.*

Give an example of a procedure John could follow in collecting his enterprise's debtors.

## CONCLUSION

In this chapter we saw that it would be impossible for credit management to function in isolation within the enterprise. To attain the objectives of credit management and to contribute to maximising profitability, there must be co-operation between the credit department and all the other departments in the enterprise. Furthermore, the co-ordination of the various credit and collection activities is also of the utmost importance.

This chapter clearly showed the importance of a credit and collection policy. We saw that a well-formulated credit policy has many advantages for the enterprise. We discussed the purpose of the credit policy, as well as factors influencing the formulation of this policy. On the basis of the credit policy, credit and collection procedures are formulated to be used as guidelines for the daily tasks. In addition to the credit policy and procedures, there are also certain rules that apply in carrying out credit and collection activities.

## QUESTIONS FOR SELF-EVALUATION

1. Do you agree with the following statement?
"Co-operation between the credit department and the other departments in the enterprise is important, but if the credit department cannot get around to this, it is not the end of the world."

| YES, I agree | ☐ | NO, I don't agree | ☐ |
|---|---|---|---|

i) If you agree, justify your opinion:

______________________________________________

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ii) Go back to section 1.2 and 1.3 of the study material, read it through again and see if you still have the same opinion.

iii) If you do not agree with the statement, justify your opinion:

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iv) What would you recommend to improve this co-operation?

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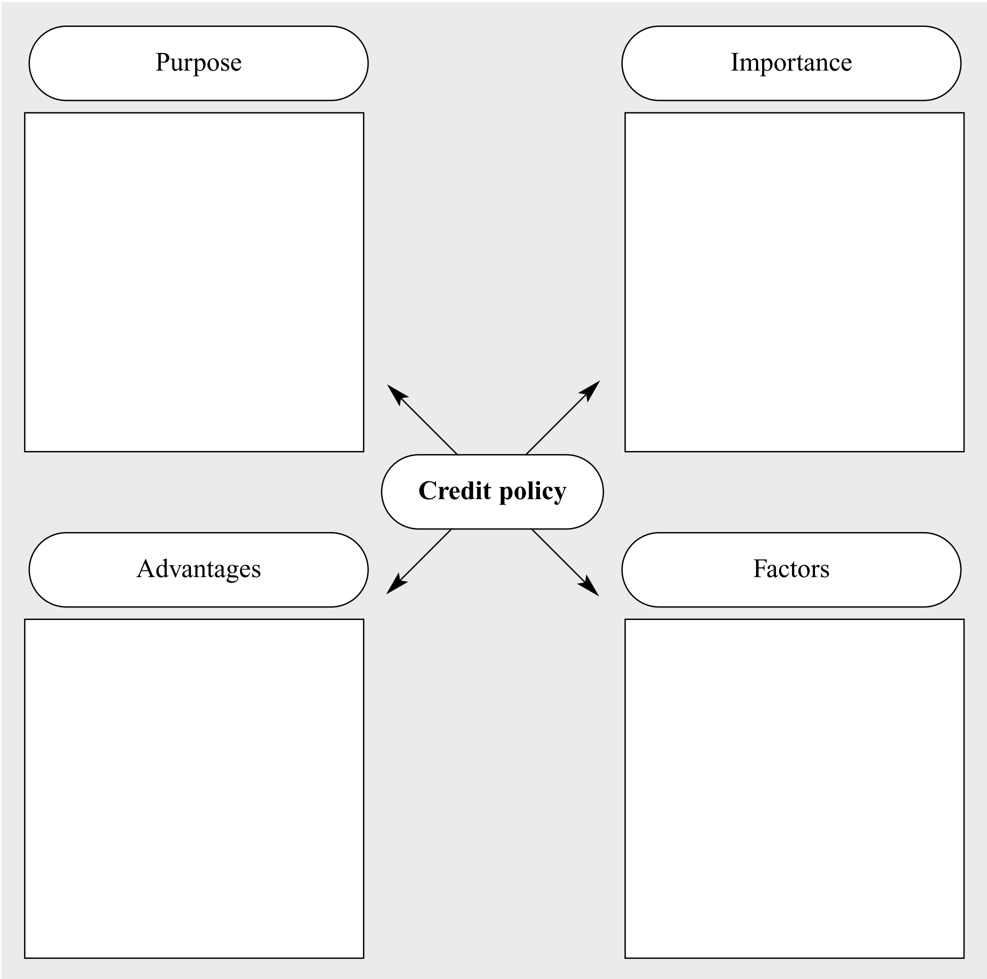
2. Discuss, in detail, the importance of co-operation between the credit and sales departments. Give practical examples to support your answer.

3. How can the credit department contribute to maximising profitability by way of its customer service? Discuss.

4. Discuss the credit policy with the help of the following diagram. Write down keywords only.




5. ABC Stores is a large enterprise that sells family clothing on credit.

   i) Using practical examples, explain what the purpose of a credit policy in ABC Stores would be.

ii) “The credit policy should provide guidelines for decision-making about various aspects.” Give practical examples of the aspects for which ABC Stores’s credit policy should provide guidelines.

iii) Suppose that ABC Stores would like to reformulate their credit policy. Which factors could influence the credit policy? Give practical examples. (Remember, you can make your own assumptions.)

iv) Summarise the most important differences between ABC Stores’ credit policy and their credit procedures.

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