SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 403

SUBJECT NAME: WORKING CAPITAL MANAGEMENT

UNIT-V

TOPIC NAME: CREDIT POLICY

A firm's credit policy is the set of principles on the basis of which it determines who it will lend money to or gives credit (the ability to pay for goods or services at a later date).

In simple terms, the credit policy of a financial institution or business is a set of guidelines that highlight the following points–

- The terms and conditions for supplying the goods on credit
- customer credit worthiness
- collecting procedure
- precautionary steps in case of customer default

In economics, credit policy is government policy at a particular time on how easy or difficult it should be for people and businesses to borrow money and how much it will cost. This is done through change in interest rates.

Credit policy varies from firm to firm and is based on the particular business, cash flow circumstances, industry standards, current economic conditions and the degree of risk involved. It also has impact on performance, as a relaxed credit policy boosts sales but also increases defaults and bad debts whereas a conservative credit policy may restrict sales but will also minimize defaults.

Example: The use of clauses such as “3/10 net 30” is a part of credit policy. The clause states that if the customer pays the money within 10 days then he/she/it is eligible to 3% discount on the total amount else the entire amount is to be paid within 30 days.

TYPES OF CREDIT POLICY:

Credit policy is an important part of the overall strategy of a firm to market its products. It refers to those decision variables that influence the amount of trade credit i.e. investment in receivables. Credit policy can be lenient or stringent.
There are two types of credit policies. Let us know about them in brief.

a) Lenient/Loose/expansive Credit Policy:

Under this policy, firms sell on credit to customers very liberally even to those customers whose creditworthiness is not known or doubtful. Because of liberal policy, sales increases and as a result, profit also increases but bad debts also increase and hence the firm faces the problem of liquidity.

b) Stringent /Tight /Restrictive Credit Policy:

Here, the firm is very selective in extending credit. Credit sales are made only to those customers who have proven worthiness. Because of tight credit standards, chances of bad debts and other credit costs are minimized but at the same time sales and profits, margins are restricted.

Therefore, the objectives of credit management should be the achievement of a balance that maximizes the overall return of the firm. The firms normally follow a credit policy which is in between lenient and stringent credit policies.

ASPECTS OF CREDIT POLICY:

The important dimensions of a firm's credit policy are credit terms, credit standards and collection policies.

1. Credit Terms:

Credit terms are the stipulations under which the firm sells on credit to its customers. These are with regard to the repayment of the credit sales amount.

- **Credit period:**

It is time duration for which credit is extended to the customers. it is generally stated in terms or a net date. For example, 'net 30' refers to the payment to be made within 30 days from the date of the credit sale.

- **Cash discount:**

In order to induce the customers/debtors to pay their bills early, the cash discount is allowed. It indicates the rate of discount and the period for which the discount is offered. The customer is expected to make the payment by the net date if he does not avail himself of this discount offer.

2. Credit Standards:

Credit should be allowed to only those customers who contribute good credit risk. Credit standards are the basic criteria for extension of credit to customers. They are influenced by three C's of credit viz..

1. Character: The willingness of the customer to pay.
2. Capacity: The ability of the customer to pay.
3. Condition: The prevailing economic condition.

Liberal credit standards push up sales by attracting more customers. But, this increases the incidence of bad debts loss, investment in receivables and cost of collection. Stiff credit standards tend to depress sales but at the same time, also reduce the incidence of bad debt loss, investment in receivables and collection costs.

3. Collection policy:

It should aim at accelerating collection from slow payers and be reducing bad debts losses. The collection program should consist of the following:

- Monitoring the state of receivables.
- Dispatch of letters to the customers whose due date is nearing.
- Telegraphic and telephonic advice to the customers around the due date.
- The threat of legal action to overdue accounts.

If the firm is strict in its collection policy with the permanent customers who are temporarily slow payers, they get offended and shift to the competitors and thus, the firm loses its permanent business.

If the firm is lenient in collection policy, receivables increase and thus profitability reduces.

Hence, the optimum collection policy is a trade-off between costs and benefits which maximizes profitability and the value of the firm.

4 COMPONENTS OF A CREDIT POLICY:

Business clients often prefer to be billed for purchases rather than paying upfront. That means you may need to establish receivable accounts for most business-to-business transactions. Unfortunately, it also means cash flow complications or worse if you take on commercial clients who don't pay on time, or at all.

Luckily, you can minimize the risk of delinquent accounts by creating strong payment and credit policies.

Consider these four methods:

1. Credit eligibility standards:

Research new clients by purchasing business credit reports or contacting credit departments in your industry. Before extending credit, confirm that they have made good on previous obligations.

2. Credit terms:

Consider industry practices and the creditworthiness of individual customers when crafting your policy. In some industries, new customers might start with a "net 30" standard, allowing them 30 days before payments become delinquent. But one size doesn't necessarily fit all. Your best customers may warrant longer payment terms, such as 60 to 90 days. Some industries have their own billing practices, such as the construction industry, where customers are usually billed with a series of invoices.

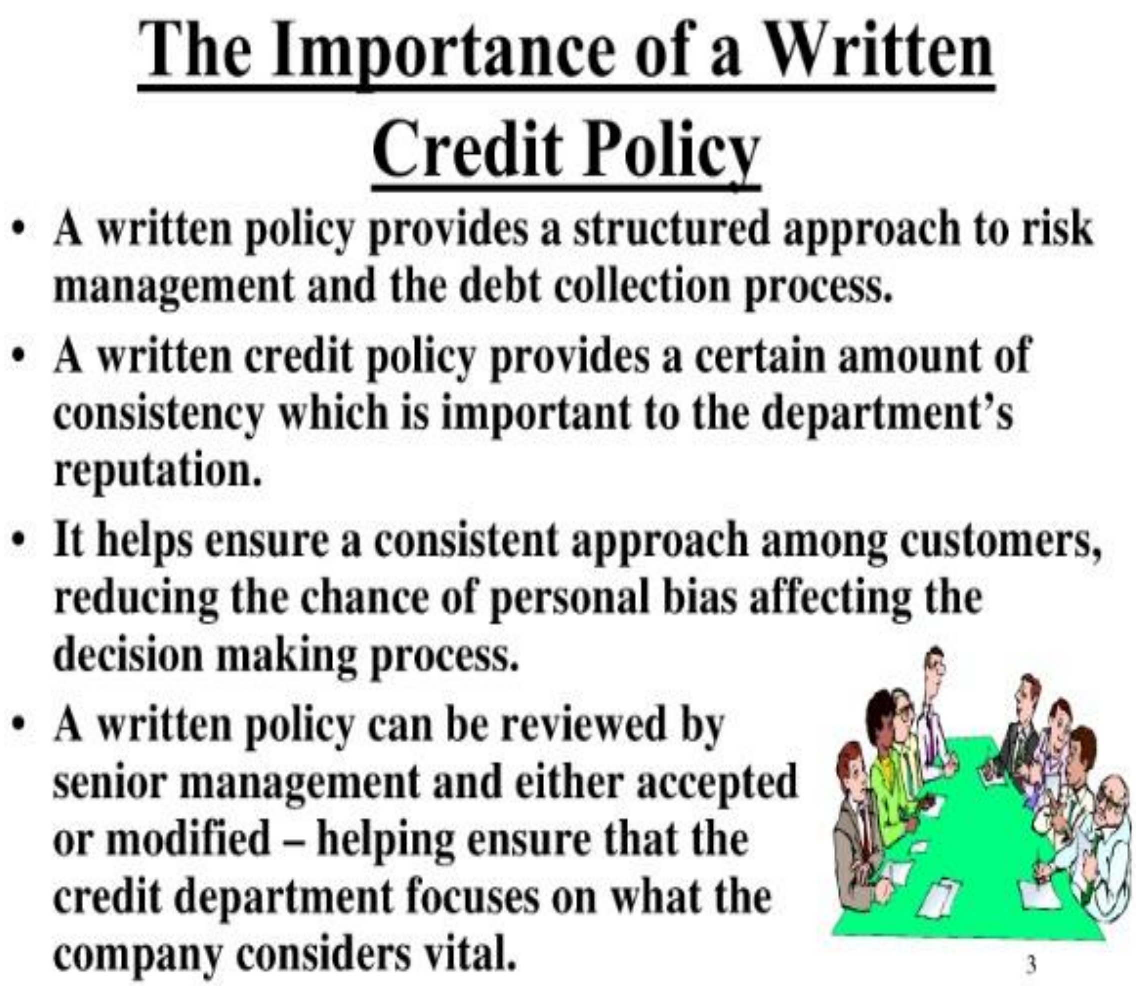
3. Clear documentation:

Requirements for purchase orders, contracts, credit applications, sales agreements and invoices should all be documented and made clear to the client. The policy should include examples of each type of form, and specify the circumstances under which each would be appropriate and/or mandatory. Having formal procedures in place will make clear to your clients that you are diligent about the payment process and expect timely payment.

4. Collections:

Your policy guidelines should explain in clear language the steps you'll take if an account becomes delinquent. You should provide information on late fees, charges, overdue notifications and when delinquent accounts will be reported to credit agencies and/or turned over to a collection agency.

IMPORTANCE OF A CREDIT POLICY:



FORMULATING A CREDIT POLICY:

Formulating a Credit Policy

- **The process begins by understanding the objectives established for the credit department**
- **It recognizes the importance of consistency in the decision making process**
- **It must take into account the resources and resource constraints facing the credit department**
- **It should make allowances for scenarios in which flexibility in credit decision making would be desirable**

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REVELANCE OF CREDIT POLICY:

The Relevance of a Credit Policy

- **Credit policies differ from company to company in length, content and complexity.**
- **Credit policies must also change over time.**
- **To be relevant and worthwhile, a credit policy must be current, not out of date.**
- **In other words, credit policies must be reviewed and updated periodically.**
- **The decision *not* to periodically update the credit policy manual is probably the biggest reason that credit policies are not viewed as essential by many creditor companies.**

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ADVANTAGES & DISADVANTAGES:

Advantages of a Customer Credit Policy:

1. **Payment in different currencies.** One of the advantages of a credit policy that accepts electronic forms of payment such as credit cards is that the math is already done for you. Currency transfer is usually quite easy, as the payment to you will be in U.S. dollars while the person making the purchase will get charged in their own currency. This makes it easier to accept payment from people in foreign countries or visiting tourists.
2. **Ease of use.** Using electronic forms of credit are extremely easy these days with the advent of such point-of-sale technologies as Square and Apple Pay. For services such as Square, when you sign up the company will supply you with a point-of-sale card reader that can be set up very quickly. Also, with phone apps such as Venmo, Zelle and countless others that allow instant online payment transfer, the days of needing a cash register are long gone.
3. **Customers more likely to spend more.** Studies show that people are much more prone to overspending and making impulse purchases when they have a form of credit in their wallets as opposed to a wad of cash. Psychologically, it's much more difficult to watch cash disappear. While some customers will always prefer to deal with cash, one of the advantages of a credit policy is that you open yourself up to a whole demographic of customers who will be more willing to pay for your goods and services if you accept credit.
4. **Convenient recordkeeping.** That paper trail you've been trying to keep on your customers becomes much easier when you have an itemized list of credit transactions your bank can provide on monthly statements. When it comes time to balance the books and pay taxes, most customer transactions done through a bank can be easily downloaded to financial programs such as QuickBooks and Fresh Books.

Potential Disadvantages of Customer Credit:

1. **The cost of cash discounts.** You may offer discounts on your services to entice customers to spend their money with you by paying cash only, or for early payment on their credit accounts. While the tactic may in fact bring in more business, you run the risk of losing money if too many customers take advantage of your generosity. It's a gamble, and you'll have to decide if the payoff is worth it.
2. **Dealing with bad debts and potential fraud.** If a customer fails to pay on their credit accounts, or even worse, defaults or goes into bankruptcy, you may have to write off that loss, eating into your potential profits. The same thing can occur if a bad actor uses a stolen credit card to make a fraudulent purchase at your shop; most card companies won't hold customers liable for those purchases.
3. **Transaction fees.** The ability to accept credit payments and use point-of-sale technology can have its disadvantages as well; while it's easy, it's not cheap. Most services will charge your business a fee, usually about 3%, to accept credit card transactions, which can add up for a small business.
4. **Complicated accounting.** If your business is large, or you accept a large number of credit accounts, you could be in for a lot of paperwork and the need for more staffing to handle your accounts. You may need to hire people to deal with sales, accounting and collections to track down late accounts or handle legal issues stemming from non-payment.
5. **Loss of goodwill.** While accepting credit can attract good customers, the need to constantly hound a late-paying client can make for a stressful situation. Everyone falls into tough financial times, and while no one wants to repeatedly ask for payment or charge late fees, it's a part of business. You'll have to decide if repeat business with a late-paying customer is worth the hassle.