

9-1 Credit Principles and Practices**OBJECTIVES**

- *Recognize basic credit concepts and the reason for the use of credit.*
- *Describe practices businesses should follow in offering credit.*

CREDIT BASICS

Businesses operate through a cycle of production and sales. Products are produced or purchased for inventory that is then made available to customers. Customer purchases result in sales that reduce inventory and provide revenue for the company. A variety of administrative, operating, and marketing costs are generated by company activities in order to achieve customer sales. If revenues from sales are higher than the total of all costs, the company makes a profit.

The goal of all companies in completing the production-sales cycle is to generate a profit. That profit is not possible if products and services remain unsold. Companies look for ways to increase customer purchases of products and services. One of the ways to increase sales is to offer credit to customers. Credit is an agreement in which a borrower receives something of value in exchange for a promise to repay the lender at a later date.

Few businesses today have the choice to offer only cash sales. Almost all business-to-business sales and a large percentage of sales to consumers involve some form of credit. Businesses must make careful choices about the types of credit they will offer, the credit terms, policies, and procedures in order to make credit a profitable tool.

In the same way, businesses will not be able to finance all of their operations and activities with cash. Many of the resources to start a business such as fixed assets are very expensive. The business may not have adequate cash at the time of purchase but will pay for the expensive resource over a period of many years. When manufacturers purchase raw materials and other resources needed for production, they will not make money to pay for those purchases until products are finished and sold to customers. Businesses use credit to finance many of their purchases with the intention of making payment with revenues earned when products are sold. Just as with the decision to offer credit, using credit to finance operations must be considered carefully so that the cost of the credit is not greater than the benefits of its use to the business.

TYPES OF CREDIT AND CREDIT TERMS

Credit extended by a business is a part of a purchase agreement between the company and its customers. Credit is typically offered so customers can buy the company's products and services but delay payment until a later date. The business extending credit is known as the creditor or lender. The recipient of credit is known as the debtor or borrower. Credit offered to individual consumers by a business is consumer credit. Credit offered to a business customer by another business is trade credit. Credit is normally extended through a written document describing the terms under which credit is granted and payment will be made. That written document is called the credit agreement. Credit often has a cost attached to it in the form of interest. Interest is the price a borrower pays for the use of a lender's money. The agreement between the borrower and lender regarding the interest rate and the time period of the loan is known as the credit terms.

If credit is used by a business it must be recorded in the company's financial records. When the business makes a sale on credit, the order is placed, goods are shipped to the customer and subtracted from the company's inventory records, the customer is billed using the agreed-upon credit terms, and a customer record is created in accounts receivable. That account is an asset since it reflects money owed to the business by the customer. When the customer pays for the order, the company receives cash and that amount is subtracted from the customer's account.

The opposite action occurs when a company makes a credit purchase. The order is placed with a supplier and the goods are received. Since it is a credit purchase, no payment is made at the time. Instead the amount owed is recorded in accounts payable, creating a liability for the company. At the time payment is made to the supplier, cash is sent and the amount of the payment is subtracted from accounts payable.

THE CREDIT DECISION

Deciding to extend credit to customers or use credit when making purchases should be viewed primarily as a financial decision. Some businesses feel pressured into offering credit in order to meet customer expectations. Businesses that are offered credit from suppliers may decide it will be beneficial to obtain and use the purchases and delay payment until they have additional revenues. While almost all businesses offer some type of credit to certain customers and most businesses use credit to finance some of their assets, credit decisions should be made with clear understanding of how the decision will affect the company's financial condition. If the bottom-line result of the decision to offer or accept credit is a negative effect on the

company's balance sheet, income statement, or cash flow, it should not be extended or used without a reason that overrides the financial consequence.

There are several costs to the creditor for offering credit. The creditor does not have immediate use of the money, and there is the risk that some customers will not make payments when they are due. There is also the expense of managing the credit system. Those costs need to be balanced against any additional sales that are obtained due to the credit policy and the possibility of collecting a higher sale price or interest payments because of the policy. In addition, the company benefits from a reduction in inventory and the associated costs of storage. If products are sold, there is no risk of obsolescence or damage to the inventory.

When using credit to finance purchases, the primary financial considerations are any interest costs that increase the final price of the purchase, whether a lower price is available for paying cash, and the future effect on cash flow at the time payment must be made. If the purchase allows the company to maintain operations, increase sales, or reduce expenses that would not be possible if the purchase was not made, those results should be considered in making a decision to use credit.

PLANNING TO OFFER CREDIT

Most businesses today have little choice about whether to offer credit. Only the smallest businesses and a limited number of personal services businesses can expect every customer to pay cash. Credit is becoming the standard for many business and consumer financial transactions. Even retail transactions for very small amounts such as fast food, postage, transportation toll charges, and online music downloads are now processed using credit as payment.

IMPORTANCE OF CONSUMER AND BUSINESS CREDIT

U.S. consumers used credit cards to finance short-term purchases of over \$2 trillion in a recent year. Nearly three quarters of all American households have two or more active credit cards with monthly charges that average over \$200 and that carry an outstanding average balance of \$1,800. In addition U.S. consumers financed over \$1 trillion in purchases using loans from banks, finance companies, and other lenders. That amount does not include home mortgages, which accounted for an additional \$8.5 trillion of consumer debt.

The actual amount of credit used by businesses is not as clear. Businesses carry debt in the values of their accounts receivable and accounts payable. Accounts receivable is credit extended to customers. Depending on the business, accounts receivable may include both consumer accounts and business accounts. Accounts payable is credit the company has received from other businesses. The percentage of total assets represented by the value of accounts receivable may range from ten percent to almost 50 percent. Accounts payable as a percentage of total liabilities is typically a smaller percentage but often averages 25 percent of all liabilities or more. Considering the total value of companies' assets and liabilities, extending and receiving credit is an important business activity.

ALTERNATIVES FOR OFFERING CREDIT

Once the decision has been made that offering credit is an important and appropriate strategy for the business, two decisions will follow:

1. What categories of customers will be offered credit?
2. What type(s) of credit plans will be used?

Who Should Receive Credit. The choice of which customers will be eligible for credit involves financial and legal questions. Credit should be extended when it improves the financial position of the company. Customers who will pay cash if credit is not offered are not good prospects since the cost of the credit reduces the profit from the sale. Customers who are not good credit risks should not be offered credit since the business will suffer losses when accounts are not paid.

From a legal standpoint, businesses cannot discriminate when deciding who should and should not be eligible for credit. That does not mean that individuals and businesses cannot be evaluated to determine if they are a good credit risk. It does require that credit decisions be based on identified standards and criteria. Anyone who meets the established standards must be offered credit. Credit terms should be the same for everyone who meets the criteria.

The decision about who should receive credit should be determined by considering the effect of the decision on sales and profits. Will offering credit to business customers rather than final consumers increase sales? Will setting a minimum dollar limit on the use of credit increase the number of customers who purchase more expensive or larger quantities of products?

Types of Credit Plans. Businesses have two options when choosing to offer credit. They can use a self-managed credit plan or a contracted credit plan with a financial services firm. With a self-managed credit plan the company administers the credit program and assumes all risks and returns. There are several forms of self-managed plans that will be discussed later in the chapter.

With a contracted credit plan credit services are provided by a financial services firm for a fee. In general, with contracted plans, the financial services firm assumes the costs and risks of managing the credit plan and receives any profits. In some agreements the financial services company may share the risks and profits with the contracting business.

A common type of contracted credit plan is to accept customer credit cards. Credit card systems are owned and managed by banks (Visa, MasterCard), financial services companies (American Express, Discover), or individual businesses such as retailers, oil companies, and telephone services. In order to accept a credit card, the business needs to establish an agreement with each credit card originator or a third-party company that has established relationships with the credit card companies and serves as an intermediary between the credit provider and the business accepting the card from customers.

To be able to accept credit cards, the business will have upfront costs for transaction processing equipment and usually a small start-up fee from the credit card issuer. In addition there are ongoing costs that can include a monthly statement fee, a per-transaction charge, communication cost, and charge-back fees for sales returns by customers. Finally, the largest expense is a discount from the sale price that the business must pay on each transaction. The discount is a percentage of the sale price normally in the range of 1.5-3.0 percent. The percentage charged by the credit card company is smaller as the volume of credit sales by the business increases. In making the decision to accept credit cards or not, the business will have to balance the convenience and expectations of customers and the reduced credit risk with the upfront and ongoing costs compared with maintaining a self-managed system.

FOCUS ON: Strengthening Your Online Security

As more and more companies provide their customers with online access to accounts, security becomes a concern. To protect yourself and your family, follow these guidelines:

- *Install and update high-quality Internet security software that includes anti-virus and anti-spyware protection and a home network firewall.*
- *Create and use strong passwords and change them regularly. Use a different password for each account. Don't store passwords on your computer.*
- *Don't provide personal information online if you didn't initiate the contact. Even then make sure you haven't been transferred to a different web site during your transaction.*
- *Make sure every web site for online transactions is secure. Do online business only with companies that have strong security records.*
- *Never click on a link in an e-mail message from someone you don't know or completely trust.*
- *Always access your accounts from your own computer. Using another computer, especially in a public area such as a school, library, Internet cafe, or hotel, may leave behind your account information.*
- *Be especially careful when using wireless connections, which are particularly vulnerable.*
- *Check your accounts regularly and match the account information with your online activities.*

9-2 Offer and Use Credit

OBJECTIVES

- ***Describe the major decisions that are part of a company's credit policy.***
- ***Explain the factors a business should consider when deciding to use credit.***

DEVELOPING EFFECTIVE CREDIT POLICIES

When a business decides to offer credit through a self-managed system it can quickly run into trouble if credit is not carefully controlled. Customers are quick to accept credit if it is offered, but sometimes they are not as quick to pay. While most customers will be reliable credit users, a few who end up making late payments or not paying at all will quickly add to the costs of doing business and use up all of the profits that had been anticipated when the decision was made to offer credit.

COSTS OF OFFERING CREDIT

Assume your company just made a \$5,000 credit sale to a customer and the payment is due in one month. If you make a 5 percent net profit on your sales you expect to earn \$250 profit when the customer pays for the order. However, credit has some immediate costs and potentially some larger long-term costs to your business. The first cost is the loss of \$5,000 cash for one month that you would have had if payment was made immediately. If you have to borrow money to finance the sale, \$5,000 borrowed at 8 percent for one month equals \$33.33. That seems like a very small amount until you begin to add the costs of financing the credit sales of every customer. If you actually have cash on hand so you don't have to borrow money to finance the credit, you lose the interest you could have earned. If you can receive 4.5 percent on a short-term money market account, you give up \$18.75 on the \$5,000 you could have invested. Again, that is a small amount on one sale but if you had 100 credit customers, the interest you did not earn would be nearly \$2,000.

Now consider the possibility that the customer never pays the bill and the products purchased cannot be recovered. First your business loses the \$250 of income that will now have to be made up from other sales. But more importantly you have lost the full cost of the product, \$4,750, which you will have to recover from additional sales. With a 5 percent profit margin, that will require additional sales of \$95,000 just to recover the cost of the loss from offering credit to that customer. With that example you can see that decisions to offer credit to customers should be made very carefully. If you offer credit to reliable customers who would otherwise not buy or who might increase the amount of their purchases due to the availability of credit, the financial results can be very positive. That same \$5,000 sale results in \$250 of profit that might not otherwise be obtained. One hundred credit customers averaging \$5,000 in sales provides an additional \$500,000 of sales and a \$25,000 gain in net profit.

CREDIT POLICY DECISIONS

The accounts receivable of a company are the value of products and services that have been sold but for which payment has not been received. The credit policies of the business are an important factor in determining the percentage of sales that will initially be classified as accounts receivable, how long sales will remain in that account, and ultimately how much of the accounts receivable is converted to cash when credit customers pay their accounts. Important decisions in establishing a company's credit policy include when credit will be offered, what standards will be used to offer credit, and what the credit terms will be.

When to Offer Credit. Some businesses make credit generally available for all products any time they are offered for sale. That means that if a customer meets the business' credit standards, credit can be used for any purchase. If the business decides to contract its credit services to other businesses or to accept credit cards, that policy is acceptable. The contracted company accepts the risk of offering credit for a fee and maintains the accounts receivable. The business making the sale receives payment quickly rather than having to wait until the customer actually pays the credit company.

With a self-managed credit system, if there is no policy regarding when to offer credit, credit sales can grow rapidly and cash flow may become a problem. With favorable credit terms, customers are likely to use credit and delay payment. The company will not receive cash until the end of that credit period. There are many purchases that customers are likely to make even if credit is not available. Customers are willing to pay for many products immediately. Recognizing when credit is needed to make a sale and when it is not needed provides the business with greater control over both credit sales and cash. Three possible criteria for when to offer credit include:

1. Offer credit to specific categories of customers. Examples include offering credit to business customers but not to individual consumers, or only to customers who purchase minimum dollar amounts or quantities of products.
2. Offer credit for specific types of products. High-value, customized, or complex products may warrant credit to encourage sales, while inexpensive products that are regularly purchased do not require credit to stimulate sales.
3. Offer credit during particular sales periods or times of the year. For some companies, there are times of the year when sales do not match production levels. Offering customers credit to purchase during slow sales periods may encourage sales. At the end of a sales season as products age, credit may encourage customers to purchase remaining products. Matching credit to cycles of high and low cash flow can help companies maintain healthy cash balances.

Credit Standards. Credit standards are the guidelines used by a company to determine if a customer is eligible for credit. A customer who is creditworthy has characteristics making it highly likely that credit payments will be made on time and in full. The characteristics typically considered when determining whether a customer is creditworthy or not are often referred to as the 4 C's of Customer Credit and are identified in Figure 9-1.

FIGURE 9-1

The 4 C's of Customer Credit

Character	Collateral (Capital)
Capacity	Conditions

- **Character.** Character is the personal qualities of the credit applicant that demonstrate responsibility and dependability. Character is determined through such things as personal references, good credit in the past, employment history, and circumstances that demonstrate good judgment.
- **Capacity.** Capacity is often considered the most important of the four factors. Capacity is the ability to make the required payments. It is determined by examining the personal and business financial resources of the customer, the current amount of cash available, assets that can quickly be converted to cash, and demands on those assets.
- **Collateral.** Collateral is the value of assets of the credit applicant that can back the request for credit. Creditors take less risk when the credit applicant has resources that can be claimed if credit is not repaid. For businesses applying for credit, creditors will also look at the value of the business' capital or the amount of personal wealth the owners have invested in the business. Persons who have risked a significant amount of their own money in a business provide evidence they are committed to the success of the business.
- **Conditions.** Conditions refer to factors that are generally outside the control of the borrower or lender but that can affect the risk. Most often conditions refer to the economy and whether it is strong or weak. A strong economy makes it easier for a business to extend credit and for the borrower to have the resources to make payments. As the economy weakens, both the lender and credit applicant may be at greater financial risk. Some specific factors such as changing technology, outdated business practices, or competitive pressures in an industry are conditions that can affect credit decisions.

Before companies offer credit, they need to consider each of the four characteristics and decide what will be acceptable in each category. Some companies develop ratings systems in which customers are classified based on their credit characteristics. "A" customers are strong credit candidates and will be granted the highest amount of credit and best credit terms. "B" customers will have credit limits and restricted credit terms. "C" customers will not be granted credit until their credit characteristics improve.

Credit Terms. The final decision when developing a credit policy is to establish credit terms that will be offered to customers. Credit terms define the agreement between the creditor and customer regarding the length of time until credit is due, the interest rate and when it is applied, any early payment discounts, and penalties for late payment.

It is a standard practice when offering business credit to offer a period of time in which the business can pay without interest or penalty. That time period is often 30 days. To encourage early payment, the seller may offer the buyer a price discount if payment is made within a few days, often 10, after the product and invoice have been received. A notation on the invoice identifies the credit terms: "2/10, net 30" means a 2 percent discount is offered if payment is received within 10 days. If that discount is not taken, the full amount (net) is due in 30 days. The terms of "3/10, 1/30, net 60" offers a 3 percent discount for a payment in 10 days, 1 percent discount if paid between 10 and 30 days, or full payment due within 60 days.

Consumer credit terms typically offer a period of time in which payment can be made with no interest charges. Some retailers such as furniture stores offer an extended period, often several months or even a year, when no interest or payments need to be made. At the end of that period, if full payment is not received, the credit customer will be charged a high interest rate that may accumulate from the date of the purchase. Other consumer credit terms are more standard. A specified interest rate is identified that is computed from the date of the sale with a minimum payment that must be made on a monthly basis, or the total amount owed is divided into equal monthly payments for the length of the credit agreement.

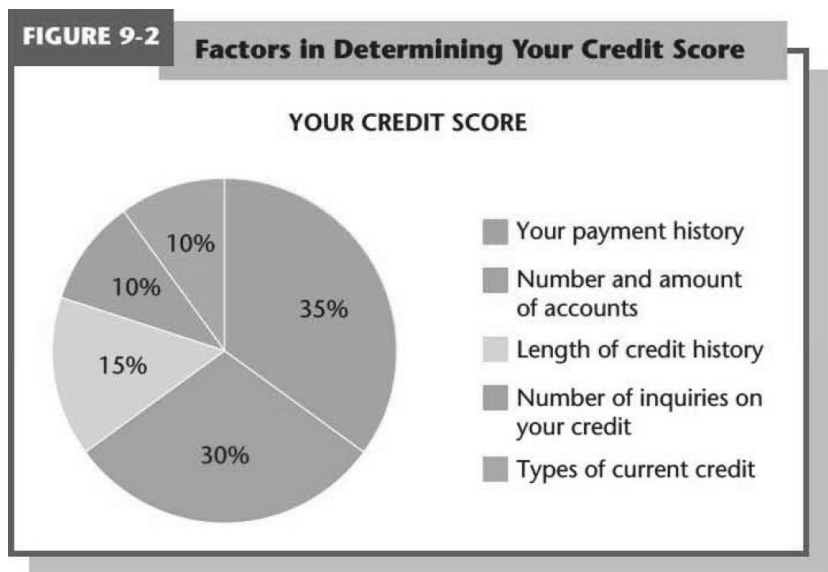
MAKING CREDIT DECISIONS

In order to maintain credit standards, a business must have a procedure for gathering information about possible credit customers. Most companies have a simple credit application that asks the applicant for personal and financial information as well as credit references. Then the credit history of the applicant is checked using a credit reporting company. Three companies are the primary sources of consumer credit information in the United States – Equifax, Experian, and TransUnion. The major supplier of business credit information is Dun & Bradstreet. These credit reporting companies collect detailed information on the credit histories of individuals and businesses. They then sell the information including credit rating scores to businesses for use as a tool in making credit decisions.

Businesses submit information to each credit reporting company on the credit transactions of all customers including any credit accounts opened and closed, all purchases made on credit, payments made and missed, dates of late payments, and any other significant customer activities and business actions related to the account. Based on the information accumulated,

the credit reporting companies develop a credit score for each individual consumer. An individual credit score is made up of several factors that are shown in Figure 9-2. Each factor is assigned a weighted value based on its importance to make up a percentage of the final score.

In their reports on the creditworthiness of businesses, Dun & Bradstreet provides a number of specific ratings and scores related to the financial strength and credit history of each company. The reports include a financial stress score, a credit score, a 12-month credit payment rating, an overall credit rating, and a recommendation on the amount of credit that should be extended. A full credit report also provides detailed financial data on the company and other key public information such as bankruptcies, lawsuits, and organizational or ownership changes.



DECIDING TO USE CREDIT

Many businesses must carry high dollar values of inventory as a part of doing business. Manufacturers require raw materials, parts, supplies, and packaging materials in order to produce their products. Retailers must carry a variety of products with adequate assortments of each product to be able to meet customer shopping expectations. The costs of those inventories cannot be recovered until the manufacturer completes production and then sells and distributes the finished goods to its customers or until the retailer's customers make their choices and pay for their purchases.

Inventory costs account for thousands of dollars for those businesses. If the business must pay those costs at the time they are purchased, it will require an expenditure of cash which is likely to put real pressure on the cash balance of the company. Even if products are resold in a few weeks, the cash will not be replaced until money is collected from customers. Often inventories are carried for months and credit is extended to purchasers, delaying even further the time when payment is received.

One way to remedy the cash crunch faced by businesses is to use credit to purchase products and services. When credit is accepted, the required payment is delayed until the business will be in a better financial position to pay for the purchases. Of course, the risk associated with the decision to use credit is that there will not be adequate cash at the time payment is due. Also, the credit terms often include a rather high interest rate so the cost of the purchase increases by the amount of interest charges. Businesses must decide whether the risk and increased cost is worth the short-term availability of cash and access to products and services they would otherwise have difficulty purchasing.

TYPES OF BUSINESS CREDIT

There are several sources of credit available to businesses and several types of credit from those sources. Businesses can look to their suppliers, banks, and other financial organizations, or they can issue their own commercial paper.

Supplier Financing. Just as a business can offer credit to its customers, it can look to its suppliers for credit on purchases. Suppliers may be willing to offer trade credit to their customers. Trade credit is, in fact, the most important source of short-term credit for most small businesses.

Trade credit from suppliers is offered to businesses with a good credit rating. Usually businesses requesting a large amount or ongoing access to trade credit will have to provide adequate financial information or credit references to the supplier. The supplier may purchase that information from credit reporting businesses such as Dun & Bradstreet.

Most trade credit offers a period of time, often 30-60 days, to pay for an order with no cost to the customer. A discount is often offered to encourage prompt payment, such as 2 percent if payment is made within 10 days. Some trade credit carries an interest charge if payment is delayed for an extended period of time. That interest rate is often quite high. A rate of 1½ percent per month is not unusual, which is equal to an 18 percent annual percentage rate.

Bank Financing. Banks that work with businesses recognize the importance of short-term financing and often offer several options for business credit. Those options include promissory notes, lines of credit, and revolving credit.

A promissory note is a loan for a specific amount, purpose, interest rate, and time period. It usually is secured by business assets and has a specified payment plan.

A line of credit is an informal agreement between the business and its bank identifying a maximum amount of money the business can borrow. The business can obtain a portion of that amount as needed to meet business expenses and will make regular payments to the bank for the interest charges. The business can pay back principal as resources are available to reduce interest charges and to increase the available balance of the credit line.

Revolving credit is similar to a line of credit but is a formal loan agreement for a specified amount of money, time period, and interest rate. The revolving credit agreement commits the bank legally to offer the credit and the borrower usually pays a small annual fee to maintain the agreement.

Credit from Other Financial Organizations. There are other financial organizations in addition to banks that provide short-term financing for businesses. They include insurance, commercial finance, and investment companies, and large private companies with financing divisions. Private financial organizations offer the same types of credit products as banks, including secured loans, which are inventory and accounts receivable loans where the borrower's inventory or receivables are pledged as security.

A unique way to obtain cash without the use of credit is through factoring. Factoring is the sale of accounts receivable. Private companies, known as factors, will purchase accounts receivable from a company at a discount, often as high as 25 percent. They then become the collection agency and receive payment from the customer. The company selling the account has immediate use of the money and usually no liability if the factor is unable to collect the account. However, factoring is usually expensive and may not be viewed positively by the customer, whose account must now be paid to the company that purchased the account.

Commercial Paper. Very large companies with strong financial positions can create their own financing through the sale of commercial paper. Commercial paper is a short-term unsecured promissory note issued by a business to obtain short-term financing. Commercial paper is issued for a period of 2 to 270 days and is purchased by other banks, investment firms, or other businesses. While the loans are unsecured, they are rated by Moody's and Standard & Poor's, which affects the amount the issuing company receives when the paper is sold.

DETERMINING THE COST OF CREDIT

Using credit usually comes at a cost to the business. As with any financial decision, the company must balance the cost of obtaining credit against the value received from the use of the money. If that value exceeds the cost, it makes sense to obtain the credit. The analysis of costs and benefits should include consideration of any unanticipated risks such as a downturn in the economy or an increase in the business' expenses before payment is due that could affect the ability to pay the cost of the credit.

The Cost of Trade Credit. Trade credit may be one of those instances where you can get "something for nothing." Because trade credit is often stated as net 30, the business is able to obtain the goods but withhold payment until the end of the 30 days. In that way, the business is using the supplier's money for the full 30 days at no cost. If that is the only variable being considered, there is no reason not to accept the trade credit.

Trade credit often comes with an incentive for early payment in the form of a discount. If the terms of the credit are 2/10, net 30 the purchaser receives a 2 percent discount on the cost of the purchase if payment is made within 10 days. Should the business take the discount and pay early or pay the full amount at the end of 30 days? To make the decision, the business needs to calculate the cost of delaying payment and paying the full cost. Using 2/10, net 30 credit terms, the calculation is:

$$\text{Cost of Credit} = \frac{\text{Discount Percentage}}{100 - \text{Discount Percentage}} \times \frac{365}{\text{Payment Period} - \text{Discount Period}}$$

$$\text{Cost of Credit} = 2/98 \times 365/(30-10)$$

$$\text{Cost of Credit} = 0.0204 \times 18.25$$

$$\text{Cost of Credit} = 0.3724 \text{ or } 37.24 \text{ percent}$$

The calculation shows that the cost of delaying payment until the end of the 30 days and forgoing the discount is an annual interest rate of 37.24 percent. That is a very high cost, since it would be possible for most businesses to borrow the money needed to pay the bill at a lower interest rate and earn the discount. If the percentage of discount is lower or if the number of days the business is given to pay the full invoice without interest charges, the cost of credit goes down. The cost of trade credit should be compared to the cost of borrowing funds or the interest rate available for investing unused cash to determine when payment should be made.

The Cost of Loans. Before borrowing money from a bank or other financial institution, businesses should determine the real cost of the loan. That cost can then be compared to the costs of other sources of financing and the financial benefits the business will receive from the use of the borrowed funds.

Loans vary in their costs based on a number of factors. The most important factor is the financial condition of the borrower. A financially healthy company can usually obtain a loan at a much lower interest rate than one that has financial problems. A second factor is the general state of the economy and the availability of funds. Somewhat surprisingly, interest rates are usually lower when the economy is weak. Money is usually more readily available at that time and the risk of inflation is low, so interest rates fall. With a strong economy, businesses make strong demands for money, so the money supply is reduced and interest rates begin to increase.

Many business loans are provided with a variable interest rate, meaning the rate can be adjusted up and down by the lender based on changing market rates. Small interest rate adjustments on large loan amounts can dramatically change the cost to the borrower. The cost of a loan is also affected by the way interest is calculated. Simple interest is calculated on an annual basis. Compound interest is calculated more frequently and adds that amount to the value of the loan. The more frequently interest is compounded, the more expensive the loan. Finally, some lenders add fees to the cost of the loan. Those fees must be added to the loan to determine its actual cost.

FOCUS ON: Building Your Credit Record

Almost everyone uses credit at some point in their lives. Most people use credit regularly and extensively. A good credit record makes it easier to obtain credit, whether for financing a car, purchasing a home, or buying clothing, a computer, or other personal items. While most people can obtain a credit card even if they have a poor credit record, the terms under which the card can be obtained and the interest rate charged will be much higher for those with a poor credit rating. The cost of credit for people with poor credit is always much higher than for people with a good record.

Many people have credit problems and end up with a poor credit rating before they realize the problems it creates for them. Making late payments or ignoring some bills, failing to respond to contacts from collection agencies, and maintaining high balances on a number of credit cards will lead to a low credit score. Once the problem is recognized and a person needs to obtain credit, it may be too late. That credit will be denied and it will take a long time and a great deal of effort to rebuild a strong credit record.

Here are some steps everyone should follow to build a good credit record from the very beginning:

- 1. Open a savings account in your own name and make regular deposits. This step will establish a relationship with a bank.*
- 2. Once you have adequate savings, open a checking account or obtain a debit card. Maintain a reasonable balance in the account and use it infrequently. DO NOT overdraw the account.*
- 3. Establish credit in your own name. The credit can be with a local retail store, a cellular telephone service, a gasoline company, or a prepaid or secured credit card. Use the credit for small, infrequent purchases and make sure to pay the full balance when it is first due.*
- 4. Maintain a part-time job (full-time in the summer if possible) to develop an employment history. Save a large part of your paycheck to be able to demonstrate a strong financial position when you apply for credit.*
- 5. Protect your personal information and your credit record. Do not share your credit card with friends or let them charge items on your store account with the promise to pay you back. Check your credit record at least once a year to identify and correct any inaccurate information.*
- 6. If you run into credit problems, act to resolve them immediately. Talk with your parents, meet with the company where you have the problem, and make arrangements to pay your debt as quickly as possible. When you ignore a credit problem, it only gets worse.*

9-3 Collection Procedures and Legal Requirements

OBJECTIVES

- Describe effective collection procedures for credit accounts.
- Recognize legal requirements for credit and collections.

Establishing Collection Procedures

One of the greatest costs to a company that operates a self-managed credit system is the loss from unpaid accounts. A credit account that has not been paid by the due date according to the credit terms is a delinquent account. Most credit customers pay their accounts. If a company maintains an effective procedure to screen customers, less than five percent of accounts receivable will be behind in payments by more than 30 days. Between one and two percent of accounts will remain uncollected after 90 days, at which point the likelihood of collecting the money owed is very low.

An account that is no longer considered collectible is known as a charge-off. To avoid charge-offs, businesses need to develop collection procedures. Collection procedures are the steps a business follows to keep customer credit payments up to date. Collection procedures should be planned and put in place before credit is offered to customers. Customer payment of accounts can be improved by offering discounts for early payment and charging interest if accounts are not paid on time. Specific collection procedures should be designed to quickly obtain payment of past due accounts while maintaining positive customer relationships. The steps in effective collection procedures are shown in Figure 9-3.

FIGURE 9-3

A Systematic Collections Procedure

Follow these steps to improve collections of accounts receivable.

1. Carefully screen credit applications
2. Maintain complete and up-to-date account information
3. Ensure speedy and accurate invoicing
4. Monitor accounts receivable
5. Take immediate action following established procedures
6. Use customer-friendly but effective collection strategies
7. Escalate collections before it is too late
8. Establish final collection and charge-off standards

Select Customers. Most collection problems can be eliminated before a customer makes a credit purchase. Using a credit application that determines the financial health and credit history of a customer allows the businesses to avoid offering credit to high-risk customers. The business may decide to extend credit to a customer who does not have a strong record but can limit the amount of credit offered and monitor the account carefully.

Maintain Records. Complete and up-to-date customer records are critical to effective credit and collections. Accurate contact names, telephone numbers, and e-mail addresses are needed to follow up on billing and payment questions and quickly resolve any problems.

Invoice Purchases. Most problems with prompt payments arise from errors or incomplete information on customer invoices or delays in preparing and mailing the invoices. Once an order is shipped, the customer invoice should be mailed immediately. The invoice must accurately bill the customer for the type and quantity of products shipped at the correct price. If the order is incomplete, that information must be clearly communicated to the customer. The credit terms should be printed on the invoice.

Monitor Accounts. Each customer account should be monitored to track payment history. Companies prepare an aging schedule that categorizes all accounts receivable by the length of time they remain unpaid. Figure 9-4 shows an aging schedule for a company's credit accounts. The schedule can be quickly reviewed to see the age of the accounts and how much of the total accounts receivable is in each age category.

FIGURE 9-4

An Aging Schedule for Accounts Receivable

Account No.	Age of Account (in Days)				Account Total
	0-30	31-60	61-90	Over 90	
101		\$6,500			\$6,500
102	\$2,400		\$4,900		\$7,300
103				\$1,025	\$1,025
104	\$6,950				\$6,950
105	\$1,950				\$1,950
106		\$2,100			\$2,100
107	\$3,250				\$3,250
108			\$1,990		\$1,990
Age Total	\$14,550	\$8,600	\$6,890	\$1,025	\$31,065
% of Total	46.84%	27.68%	22.18%	3.30%	

Take Action. A specific set of collection procedures should be in place that begins immediately when a payment is missed. The procedures should have as their primary goal to retain the customer, but they need to result in prompt payment of the overdue account as well. There are many forms of communication that can be used to contact the customer. Most credit procedures start by sending a copy of the customer's account with a reminder that payment is now due. The reminder should also clearly restate the credit terms including interest charges for late payment.

Use Customer-Friendly Strategies. If payment is not received shortly after the first letter is sent, the customer should be contacted by telephone. A well-trained member of the collections staff should remind the customer of the unpaid account, gather information on reasons that the account is unpaid, and discuss procedures for prompt payment. If the customer is not paying because of problems with the order or the product, those issues should be quickly resolved. If payment is delayed due to financial problems, alternatives for payment including a payment schedule should be agreed upon. If it appears that the customer is unwilling or unable to pay the overdue balance, restrictions on future orders should be placed on the customer's account.

Escalate Collection Contacts. If the late account remains unpaid after the initial contacts, additional formal contacts should be implemented on a regular schedule, usually every two to three weeks. A series of increasingly demanding but positive collection letters should be sent along with a bill of the account that clearly identifies the number of days the account is overdue and the new balance including interest. A telephone call should follow the letter since it is harder to ignore a personal contact than a letter. Neither the letter nor telephone call should be negative or threatening but should express the importance of the customer maintaining a good credit history and the need for prompt payment in order to retain favorable status as a customer. Depending on the location of credit customers, some companies arrange a personal visit as a final step in this stage of the collection process. The visit emphasizes the importance of payment and provides an opportunity for face-to-face discussions about payment plans.

Take Final Steps. Only a very small percentage of accounts will be collected that remain unpaid after all of the previous collection steps. A company will have to decide if additional procedures are warranted. The choices are to involve a collection agency, take legal action, or classify the account as a charge-off and terminate the relationship with the customer. A collection agency is skilled at late collections and focuses all of their attention on that effort. Collection agencies charge fees for their services that are in the range of 25-50 percent of the amounts collected. When contracting with a collection agency, it is important to select a company with a good reputation that follows all legal requirements for collections and consumer protection.

A company may decide to take legal action against a debtor. The cost and time involved should be weighed against the likelihood of success and the amount that may be recovered. Many companies decide it is better to classify the account as a charge-off. If credit customers are selected carefully, credit accounts are monitored, and specific collection procedures are implemented quickly, the number and amount of charge-off accounts should be low.

CREDIT LAW

Credit terms can be complex and difficult to understand. The agreement between lender and borrower establishes a legal relationship that may need to be enforced in courts. While most credit transactions are done honestly, some lenders have tried to take advantage of their credit customers. To regulate credit transactions and protect the rights of both lenders and borrowers, a number of federal laws have been enacted. Most states have credit laws that must be followed when business is conducted in that state. Laws have been developed that regulate offering credit, collecting accounts, providing credit information, and protecting the privacy and security of customer information.

THE TRUTH IN LENDING ACT

The Truth in Lending Act is designed to promote the informed use of credit and encourage consumers to compare the cost of cash versus credit as well as to shop for the least expensive credit. The Act requires businesses to disclose specific credit terms in all credit advertising. When granting credit, a business must provide the borrower with a written statement of the cost of credit and the terms of repayment before the agreement is completed. Both the dollar amount and annual percentage rate of a transaction must be specified.

EQUAL CREDIT OPPORTUNITY ACT

The Equal Credit Opportunity Act prohibits discrimination against credit applicants because of age, sex, marital status, religion, race, color, national origin, or receipt of public assistance. All credit decisions must be based on an analysis of financial capability related to the credit for which the person applied. If a consumer is denied credit, the law requires that the person be notified in writing of the reasons for the denial if requested by the consumer.

THE FAIR CREDIT REPORTING ACT

The Fair Credit Reporting Act was developed to increase the accuracy and privacy of information collected by credit reporting companies. Under the Act all consumers have a right to free yearly copies of their credit reports from each of the three national credit reporting organizations. The reports must contain all the information in the file at the time of the request. Each company must disclose who has requested the credit report in the past year. You are also entitled to a free report if a company takes a negative credit action against you. You must be told which credit reporting company provided the information on which the negative action was based.

If you question the accuracy or completeness of information in your report, you have the right to file a dispute with the credit reporting company and the information provider (the person, company, or organization that provided information about you to the credit reporting company). Both the credit reporting company and the information provider are required to investigate your claim and correct inaccurate or incomplete information in your report.

THE FAIR CREDIT BILLING ACT

The Fair Credit Billing Act deals with mistakes in credit bills sent to consumers. If a credit customer believes there is a mistake in a bill, the company must be notified in writing within 60 days. The complaint must then be acknowledged within 30 days unless the mistake has been corrected. The disputed amount does not have to be paid during the time it takes to resolve the complaint. Any finance charges against the disputed amount must be deducted if there was an error. If no error is found, the business must send another bill and can add finance charges on the amount due for the time it has been unpaid.

THE FAIR DEBT COLLECTION PRACTICES ACT

This Act applies to most types of individual and family debts, but it only applies to collection agencies rather than companies who manage their own collection procedures. It prohibits debt collectors from engaging in unfair, deceptive, or abusive practices when dealing with people who have overdue accounts. Specifically they may only make contacts between 8 a.m. and 9 p.m. They cannot make contacts at work and cannot use harassing or abusive language or procedures. They cannot lie or misrepresent what can happen to the borrower if the debt is not paid. Debt collectors must identify themselves when calling on the phone. If specifically requested in writing, they must end all direct contacts.

RIGHT TO FINANCIAL PRIVACY ACT

The Right to Financial Privacy Act recognizes that customers of financial institutions can expect a reasonable amount of privacy for their financial records. The Act establishes requirements and procedures for the release of financial records and imposes requirements on financial institutions for communicating with customers prior to release of personal information.

THE FINANCIAL MODERNIZATION ACT

The Financial Modernization Act includes provisions to protect consumers' personal financial information held by financial institutions. The Financial Privacy Rule requires financial institutions to give customers privacy notices that explain information collection and sharing practices. Customers have the right to limit some sharing of their information. The Act includes the Safeguards Rule, which requires all financial institutions to maintain safeguards to protect customer information. The rule applies not only to financial institutions that collect information from their own customers, but also to companies that receive customer information from the institutions.

FOCUS ON: Microfinance

How could a loan of \$50 result in a life-changing experience? In countries such as Bangladesh, Nepal, Philippines, and Zimbabwe, microfinance has helped to improve the economy and society. Microfinance, also called micro/ending and microcredit, involves programs of small loans to people for self-employment projects. The business activities generate income to provide for life necessities and family needs. Most microcredit efforts involve nonprofit organizations, which helps avoid political influences.

Most microfinance clients are low-income persons with no access to formal financial institutions. They are usually self-employed, often household-based entrepreneurs. In rural areas, clients are small farmers or food processing workers. In urban areas, microfinance activities include shopkeepers, service providers, artisans, and street vendors.

In southeastern Bangladesh, one of the poorest regions in the world, the Bangladesh Rural Advancement Committee (BRAC) loans money to women. Loans are made to help them farm fish, keep cows for milk production, grow vegetables, raise poultry, buy rickshaws, sew clothing, and sell cellular phone time in rural areas where no other phone service is available.

The women pay 15 percent interest on loans, which is much less than they would have to pay to loan sharks. BRAC also works to improve the health of women and children. Over 30,000 volunteers have been trained by BRAC to recognize and treat ten common illnesses.

Microcredit has also been successful in Zimbabwe to economically empower the poor. World Vision Zimbabwe provides affordable financing to improve the economy of rural areas. Entrepreneurs operate businesses and live on the income of the projects they started after obtaining inexpensive, small loans from World Vision Zimbabwe.

Over time, some microfinance programs have expanded to include other financial services. In addition to loans, savings accounts and insurance coverage may be provided. These services help borrowers build assets and protect against risks.

Chapter Summary

- *Many business-to-business sales as well as sales to final consumers are made using credit. Deciding to extend credit to customers or use credit when making purchases should be viewed primarily as a financial decision.*
- *Choosing which customers will be eligible for credit involves financial and legal criteria. When using credit to finance purchases, the primary financial considerations of a company are interest costs that increase the final price of the purchase, whether a lower price is available for paying cash, and the effect on cash flow at the time payment must be made.*
- *The credit policies of a business are an important factor in determining the percentage of sales that will initially be classified as accounts receivable, how long sales will remain in that account, and ultimately how much of accounts receivable is converted to cash when credit customers pay their accounts.*
- *There are several sources of credit available to businesses and several types of credit from those sources. Businesses can look to their suppliers, banks, and other financial organizations or they can issue their own commercial paper. A company must balance the cost of obtaining credit against the value received from the use of the money.*
- *One of the greatest costs to a company that operates a self-managed credit system is losses from unpaid accounts. Businesses must develop collection procedures that keep customer credit payments up to date and eliminate charge-offs.*
- *To regulate credit transactions and protect the rights of both lenders and borrowers, a number of federal laws have been enacted. Laws have been developed that regulate offering credit, collecting accounts, providing credit information, and protecting the privacy and security of customer information.*