PAYLINK

HOW THE CREDIT POLICY OF A BUSINESS IMPACTS THE BOTTOM LINE PROFITABILITY





Every business relies on the demand for its product or service to be successful. This demand is the major determinant for profits – the more sales you make, the more profits you make. Sales, on the other hand, rely on a number of factors; some are controllable by the business and others are not.

> **The major factors that are controllable by the system include sales price, quality of product, advertisements, and the business credit policy.**

In today's world, businesses have gone beyond "the usual" and have transcended into a more robust space that is characterized by constant advancements. A business' main objective lies at the center of its bottom-line profitability, which is a term that refers to the final profitability of the business after deducting all expenses from revenues. Simply put, the business's success or failure can be characterized by its net profit or bottom-line profitability.

For many years, the credit policy has been one of the backbones of controlling the cash flow of a business, which has a direct effect on the profitability of the business. While the credit policy has remained a key ingredient in business, management and businesses look for better ways to get their credit policy more effective and streamline their respective accounts receivables processes.

In this white paper, we delve into the impacts of credit policies on a business's bottom-line profitability. To do justice to this effectively, we have to understand the scope of credit policy, the relationship between Days Sales Outstanding (DSO's), Weighted Cost of Capital, and the credit policy for a company. We would also delve into setting up the credit policy, implementing the credit policy, the benefits of credit policy, and how to assess the performance of a credit policy by a credit management department.



UNDERSTANDING CREDIT POLICY

DEFINING CREDIT POLICY



To be able to define credit policy, we must draw a definition from the word "policy". A policy can be defined as a general course of action created for recurring situations to achieve specific and established goals and objectives.

Drawing from the definition of policy, we can say that a credit policy is the general course of action or the guidelines that established a framework for consistent credit decisions within an organization. This framework is designed to set the terms for credit and payment for customers and layout the action to be taken in the case of late payment.

NUGGETS
Good Credit management is critical for business success. It can mean the difference between success and failure.

TYPES OF CREDIT POLICY

In understanding credit policy more, we need to understand the two types of credit policy that exist.

1. Expansive Credit Policy (Also known as Lenient or Loose credit policy)
2. Restrictive Credit Policy (Also known as Tight or stringent Credit Policy)

EXPANSIVE OR LENIENT CREDIT POLICY

The lenient credit policy involves the business selling to its customers liberally and freely even to customers with unknown creditworthiness. With this type of credit policy, there is the tendency for sales to increase drastically thereby increasing the profit of the business. The downside of this type of credit policy is the risk of entering into bad debts, which can lead to a problem of liquidity for the business.

RESTRICTIVE OR STRINGENT CREDIT POLICY

The Stringent credit policy involves the business being very selective when offering credit extensions to customers. Credit extensions are only offered to customers with good creditworthiness that is well-founded and proven. Due to the high standards, there is a low possibility of experiencing bad debts, but this also brings about restricted sales margin and profits margin.

WHAT A CREDIT POLICY ADDRESSES

The ultimate goal of a credit management department is to create a balance between the two types of credit policies and maximize the overall return for the business.

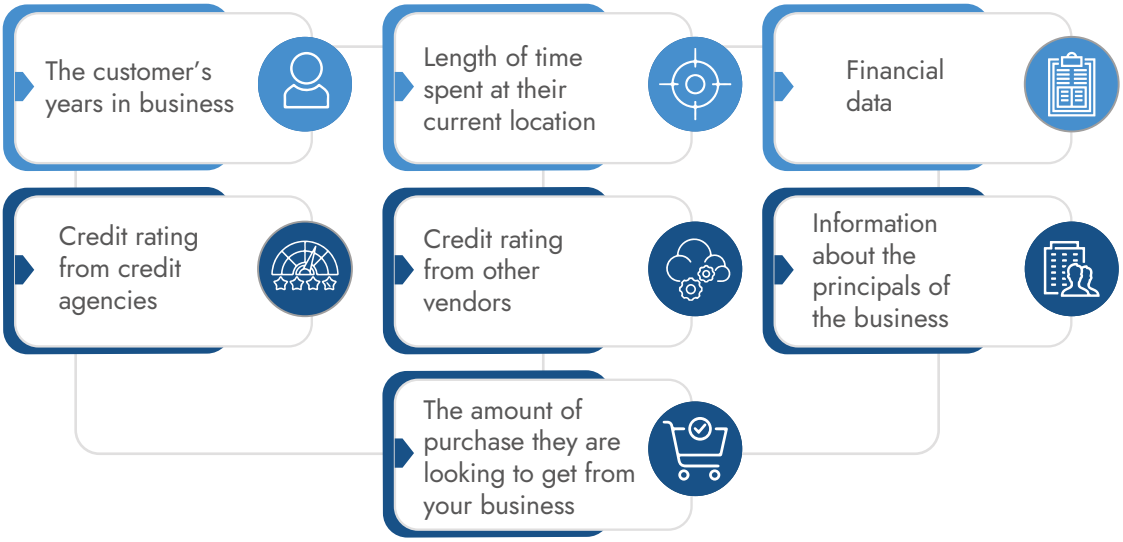
In creating a credit policy, certain areas must be addressed by the business to fulfill its purpose; which we would see later is to boost sales and impact profitability. If done wrongly, the credit policy can affect the business negatively and increase the losses of the business through customer default. The main areas to be addressed in a credit policy include:

1. Customer information
2. Documentations
3. Credit Limits
4. Credit Terms
5. Pre Payments
6. Payment Acceptance Methods



CUSTOMER INFORMATION

This area is very important because it has to deal with the information concerning the customer before making a credit decision. Major information to look out for includes:



DOCUMENTATIONS

At this point, you must take into cognizance the contracts, purchase orders, bills of landing, credit applications, sales agreements, invoices, delivery receipts, correspondences, etc.

CREDIT LIMIT

This area covers the amount of credit (in dollar figures) you are willing to give and the parameters/circumstances that surround giving such credit.

NUGGETS
Do not give credit extensions to customers until their identity is verified and their creditworthiness is confirmed.

CREDIT TERMS

If an agreement is reached between your company and a customer, then you need to define the terms such as when the payment is due, the penalties for late payments, and the discounts on early payments.

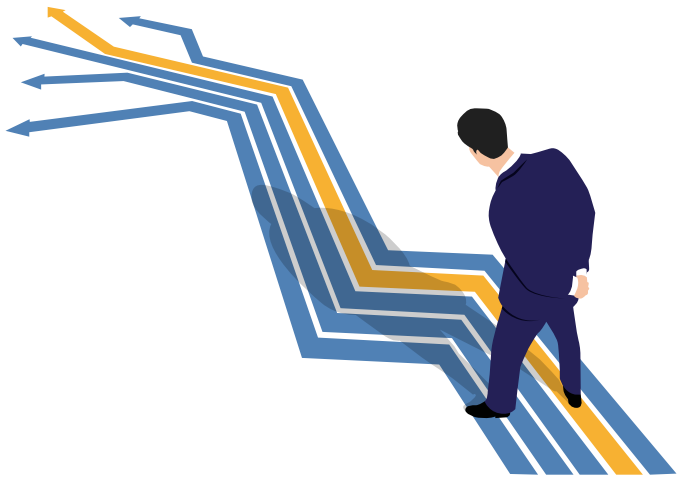
PRE PAYMENTS

Your business could request that a customer pay a certain deposit before he gets access to the credit from your business.

PAYMENT ACCEPTANCE METHODS

This aspect is very critical in terms of avoiding fraud and the likes. At this point you have to offer a PCI Compliant solution that gives business customers the ability to make payment for goods and services in the most convenient and user friendly way.

REASONS FOR A CREDIT POLICY FOR YOUR BUSINESS



There are various reasons for offering a credit extension for a customer. One of the main reasons for offering credit extensions using stipulated credit policies is for marketing and investment. The credit offered acts as the main part of the company's marketing strategy or sales package. If a company were to offer only cash on delivery to their customers, they stand a risk of losing their valuable customers to the competition. The consequence of this is the exposure of the company to credit risk especially bad debts and past-due accounts.

Another key reason why credit policies are important for businesses is to minimize the carrying cost of receivables. Companies often allow customers to get their goods or services on credit and input this on their financial reporting as receivables. Receivables are usually recorded at the time of sale of goods or when the service has been delivered but not paid. Once payments from the customers are received as is in the credit policy, the receivables decrease. It, therefore, means that the carrying cost of receivables can be equated with the time cost of money. To understand the carrying cost of receivables, you need to look at the Weighted Cost of Capital.



WEIGHTED COST OF CAPITOL (WACC)

Weighted average cost of capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All sources of capital, including common stock, preferred stock, bonds, and any other long-term debt, are included in a WACC calculation. A firm's WACC increases as the rate of return on equity increase, as an increase in WACC denotes a decrease in valuation and an increase in risk.

Below is the calculation of Weighted Cost of Capital:

$$WACC = \left(\frac{E}{V} \times R_e\right) + \left(\frac{D}{V} \times R_d \times (1 - T_C)\right)$$

In a sense, receivables are the lifeblood of the cash flow for a business. It is essential for calculating the profitability of the business and providing insight into indicators of your business income.

Where

E = Market value of the firm's equity

D = Market value of the firm's debt

V = E + D

R_e = Cost of equity

R_d = Cost of debt

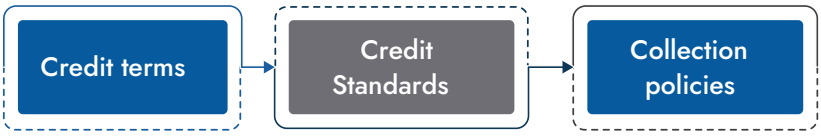
T_C = Corporate tax rate

Other reasons for getting your business' credit policy right include:

1. To develop an optimal level of sales.
2. Minimize bad debt to the barest minimum.
3. Infuse organization and cost containment into your credit department.

THE THREE DIMENSIONS OF CREDIT POLICY (THE 3 CS)

The three main aspects or dimensions of a business credit policy are the





CREDIT TERMS

Credit terms are the prerequisites with which a business sells its products or offers its service to its customers on credit. These are designed with relation to the repayment of the credit amount. When talking about credit terms, two areas must be covered – the credit period and the cash discount.

The credit period deals with the duration for which the credit extension is offered to the customer. It is usually stated as a net date. For instance, "net 30" means payment is to be made within 30 days from the date of purchase or sale.

The cash discount is a method used to persuade the customer to make payments on time. Cash discounts must show the discount rate and the period for which the discount is offered to the customer.

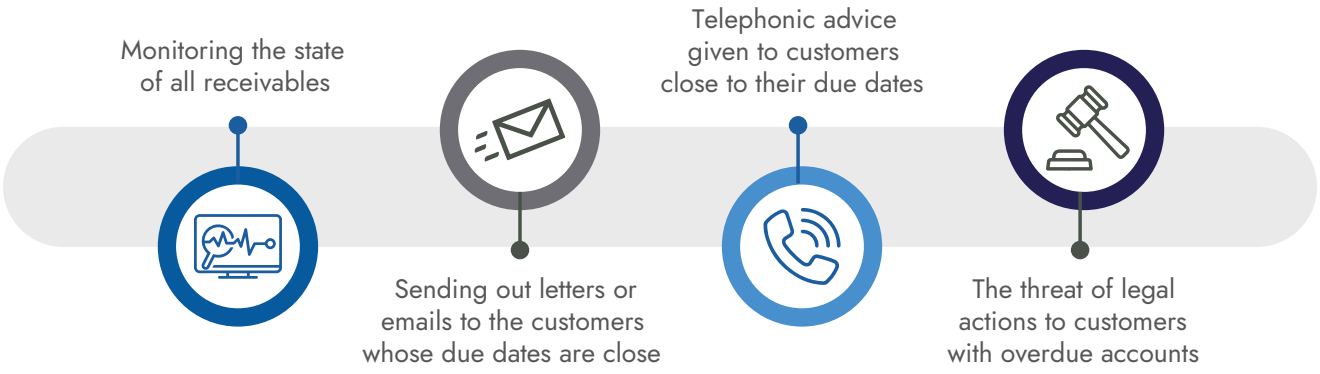
CREDIT STANDARDS

Credit standards are instruments that reflect the financial strength and creditworthiness of a customer. A customer must meet the credit standards to be eligible for credit. If a customer does not meet the standards of the credit terms, they can still purchase the product or service but this time using more restrictive terms. For instance, if a business offers a regular credit term that allows payment after 30 days, this credit term might apply only to qualified customers who are creditworthy. The business' credit standards are used to determine which customer is qualified for the regular credit terms and the amount of credit they are qualified to get. The credit standards are influenced by some factors: the character of the customer towards paying, the capacity of the customer to pay, collateral, assessment of the customer's financial reserves, and the economic conditions, both general economic conditions and economic conditions of the region that might affect the customer's ability to pay.

COLLECTION POLICY

Collection policy deals with the business' procedures that are followed to collect the receivables and past-due accounts. The collection policy aims to accelerate the collection of credits from slow-paying customers and work towards reducing bad debt losses. For example, a business can send an email/letter to a customer when the payment is about ten days late, then followed by a more severe email/letter, followed by a phone call when the payment is not gotten within thirty days. Once it gets to this stage, the account is then transferred to a collection agency after 90 days of non-receipt of payment.

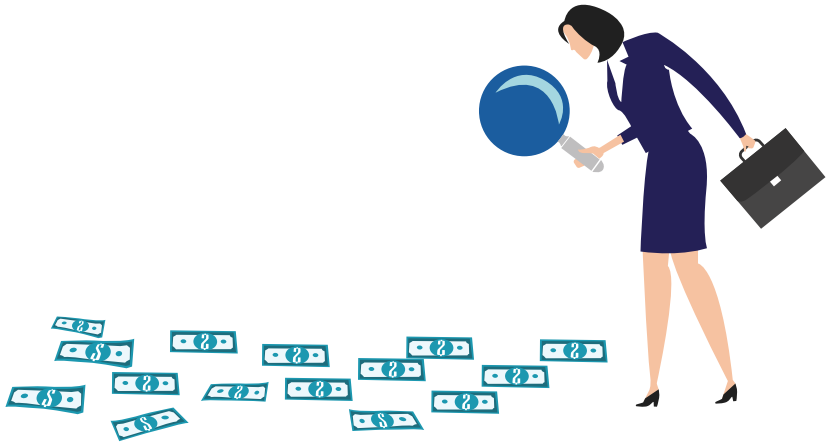
A collection policy usually consists of the following:



DAYS SALES OUTSTANDING AND HOW IT AFFECTS YOUR CREDIT POLICY

Apt management of the number of receivables is anchored in the understanding of the debt collection cycle. This cycle begins with the customer's purchase and ends with the cash received. Therefore, any speeding up of the order and shortening of receivables collection will reduce the required working capital. Consequently, a business should apply techniques that allow monitoring of the level of receivables.

A good indicator appropriate for evaluating the average amount of time required to collect an account receivable is the average collection period (ACP), also known as days sales outstanding (DSO) or days in receivables.



Days Sales Outstanding or DSO gives us an evaluation of how your business is collecting those receivables. It is a key performance indicator (KPI) that describes the average number of days a company takes to collect what is owed after sales completion. The ability of any single business to collect receivables has a direct influence on the cash flow of the business. Since every operation and growth of a business is fundamentally linked to cash, it is important to effectively collect that money and put it back into the business.

To calculate DSO, we use the formula below:

DSO = Accounts receivable / annual revenue per day

DSO = S/365

Where S stands for annual Sales.

The annual revenue per day is calculated by dividing the annual revenue by the number of days in a year.

The formula for DSO is thus represented below:

$$DSO = \left(\frac{Accounts \quad Receivables}{Total \quad Credit \quad Sales} \right) \times Number \quad of \quad days$$

For a company to be profitable, the DSO must be low. This indicates a good sign and a fact that receivables are collected quickly. On the other hand, if the DSO is high, it indicates that it takes a longer time to collect the receivables and could lead to cash flow problems, operational mishaps, and rock-hard problems for the credit department. When dealing with DSO, it is important to look at it with context to the company's terms and goals.

When DSO is very high, it is very crucial to investigate why your customers are taking a long time to make payments. This can be caused by anything, from your sales team being too relaxed in collecting receivables to the poor set up of sales terms. Sometimes it can be due to a lack of optimizing your billing and receiving process. Whatever the case is, you need to carry out an investigation.

BAD DEBT LOSS RATIO (BDL)

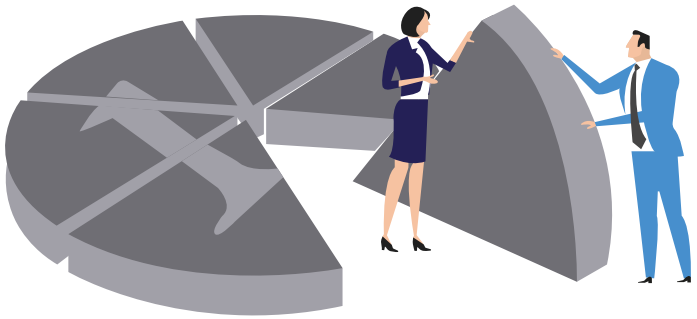
The business should not neglect the unexpected increase in DSO as it may be caused by an increase in bad debts. In such cases, it is recommended to enlarge the analysis with constant monitoring of the bad debts loss ratio (BDL). It represents the proportion of the total receivables that are not paid and is computed as follows:

$$BDL = \frac{E_{BD}}{S_C}$$

Where EBD represents bad debts expenses

SC represents credit sales.

An increase in the bad debt loss ratio increases the costs of extending credit..



THE IMPORTANCE OF CREDIT POLICY

Credit policy offers a structural approach to managing risks within a business, especially when it has to do with the debt collection process.

The credit policy allows for a consistent approach amongst all your customers removing room for personal bias when it comes to the process of decision-making.

A credit policy provides business consistency and departmental reputation.

Having a credit policy provides insight on how you can get new customers and how much credit the business is ready to offer in terms of value and time.

It gives your sales and credit department clear objectives on how to work together in growing the business.

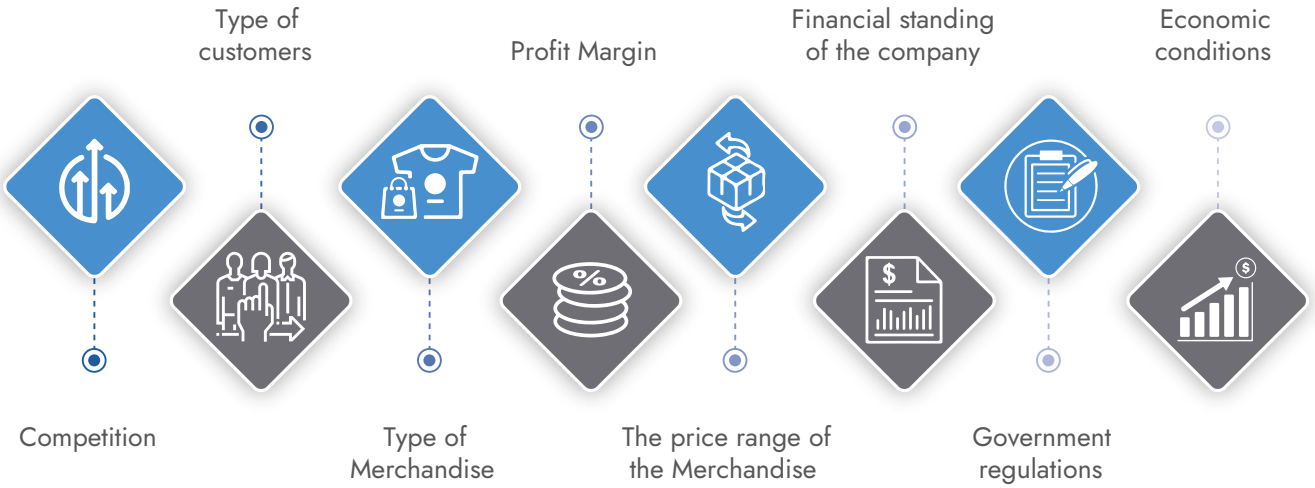
It gives insight into the necessary steps needed to mitigate risk and cut down on losses while maximizing profits.

It helps to define the authority levels so that work can be easily delegated to the appropriate level within the business and senior management can review significant risks and the smaller ones are taken care of at the ground level.

The credit policy gives your customers a sense of accountability especially in an industry known for slow payments.

FACTORS THAT INFLUENCE YOUR CREDIT POLICY

Certain factors come into play when creating your credit policy for customers. These factors include:



COMPETITION

Credit practices in the industry will affect the credit policy of any business. Competitive conditions attach great importance to the availability of credit. The business' credit policy is important to maintain or improve its competitive position within its industry. Even though credit is sometimes not a competitive tool, individual businesses can use it in this way if they so wish.

TYPE OF CUSTOMER

The type of customer has a direct and restrictive effect on the credit policy of all businesses in an industry. When the buyer's line of business is typically under-capitalized, excessive restrictions on credit policies are unrealistic. Businesses operating on this basis will not be able to maintain their market.

TYPE OF MERCHANDISE

The type of product or merchandise influences the business's credit policy in many ways. If the product has a relatively high-profit margin or high price, it tends to be sold in a freer manner or there is a tendency to use liberal credit terms. In addition, if the goods can be restored or returned under the same conditions as when they were sold, the terms may be more relaxed. On the other hand, if the service life or the shelf life of the commodity is short, the credit policy terms are likely to provide a shorter credit period. For example, products that may deteriorate or get bad easily require a shorter credit term; a good example is the credit terms of the food industry, which is usually net10.

PROFIT MARGIN

Profitability is important for any business. When profit margins are low, the credit department will be more cautious in choosing its accounts. High-profit margin products should at least, in theory, encourage credit professionals to approve sales to marginal credit risk accounts. This is to say, the higher the gross profit margin, the higher the credit manager's tolerance for credit risk. This is a general statement and is not always applicable.

PRICE RANGE OF THE MERCHANDISE

When the unit price of the product is relatively low, it is easier to establish a unified loose policy that applies to all customers. Even if the wrong decision is made, the dollar amount of risk is lower and the credit risk is higher. A more detailed analysis is usually performed before the customer order is approved.

FINANCIAL STANDING OF THE COMPANY

Company credit analysis provides a general assessment of the company's creditworthiness and can be used for various business and financial purposes including drawing up a working credit policy. This is necessary before accepting financial risks regarding the company's ability to fulfill its obligations in the future. This risk can exist in many ways. It is important to understand that the credit process is not limited to checking financial measures. Appropriate evaluation requires a broader framework, which involves a comprehensive review of the fundamentals of the business, including the judgment of the company's competitive position and the evaluation of management and its strategy as well as its financing. Many of these factors will have a direct impact on the key variables used to construct financial forecasts needed to provide future credits to customers.

GOVERNMENT REGULATIONS

For commodities, such as liquors and spirits, the government regulations specify credit policies or procedures that sellers must follow. For such cases, your credit policies must take into account these regulations. Generally speaking, the expected long-term trends in the economy also affect credit policy.

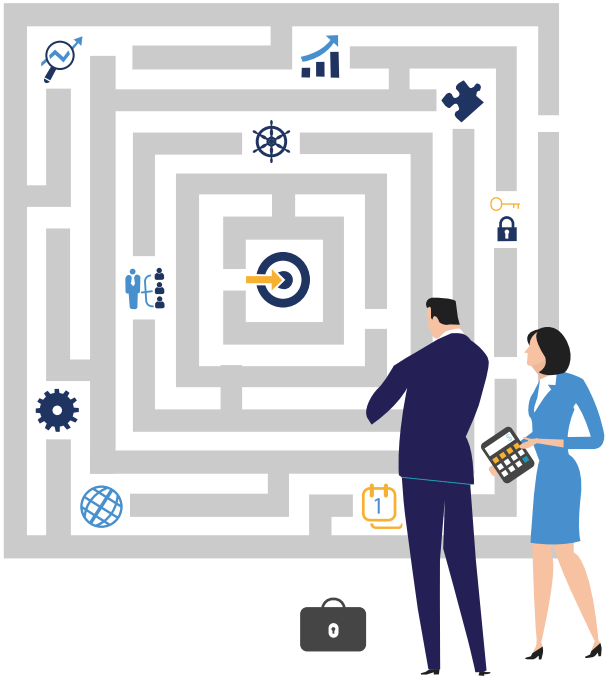
ECONOMIC CONDITIONS

Economic conditions are very important in deciding how to implement credit policies in a shorter period of time. When the time is favorable, the debtor's ability to pay will increase; however, there is a danger that they tend to overbuy. During business slow seasons, debtors often delay payment, and credit requirements are often stricter. At the same time, with the decline in sales, the company faces the problem of higher demand for credit customers and can lead to more declining sales.

CREDIT POLICY CHALLENGES

LACK OF SUFFICIENT CREDIT HISTORY

Many people may not realize that no or limited credit history can cause problems, just like negative information on your credit history. If you do not currently have a credit history, you are not the only one in that boat. One in ten adults has no credit history with one of the country's top three credit reporting companies. Many more people do not have enough credit or bad credit, and cannot establish a credit score. People with little or no credit history may find it difficult to get good creditworthiness to access credit for products or services.



CUSTOMERS TAKING ADVANTAGE OF CASH DISCOUNT

You can offer discounts for your products or services to attract customers to spend money with you by paying only cash or for early payment in their credit account. Although this strategy may bring more business, if too many customers take advantage of your generosity, you may lose money. This is a gamble and you have to decide whether the reward is worth it.

BAD DEBTS, IDENTITY THEFT, AND POTENTIAL FRAUD

If a customer's credit account defaults, or worse, files for bankruptcy, they may have to write off the loss and reduce their potential income. The same can happen if criminals use stolen credit cards to make fraudulent purchases from your business; most credit card companies will not hold customers responsible for these purchases.

COMPLEX ACCOUNTING

If your business is large, or you accept a large number of credit accounts, you may have a lot of paperwork and need more staff to handle your accounts. You may need to hire people to handle sales, accounting, and collections to track overdue accounts or deal with legal issues caused by non-payment.

NON-WORKING CREDIT POLICY

While some businesses have a credit policy, the major challenge lies in the fact that the credit policy is not working. The credit department could be slow in implementing the business' credit policy or outrightly forgo the credit policy.

TECHNOLOGY AS A SOLUTION FOR CREDIT POLICY



The world is changing, and also are the rules of the game, especially with the entry of Covid-19 which has pushed a lot of businesses to transcend into the new reality in all sectors. The credit policy sector has not been left out in this new wave of advancements. Technology has so far given birth to new solutions to help handle the challenges of credit policy.

In this section, we look at how technology has influenced the credit management sector. One thing is sure, the complexity associated with credit policy and credit management has been brought to a crust by advancements in the business space. Some remarkable ones include:

- Advanced payment methods
- Online banking systems
- Automated invoicing
- Online credit scoring
- Credit policy calculator



ADVANCED PAYMENT METHODS

It goes beyond telling that online credit card payments, ACH transfers, and online debit card payments have given customers a wider option to choose from when addressing payments. This new advancement in payments now makes the process easier, more convenient, and faster than the traditional methods. Furthermore, if you are having issues with getting a customer to make a payment then you can take a card payment over the phone, which removes the need for excuses when it comes to payments with a check.



ONLINE BANKING SYSTEMS

Advances in technology have brought about online banking, which allows a business to easily log in and check if a customer has made payments. With applications available to download online to your phone, you improve the communication between the business and the customers.



AUTOMATED INVOICING

With the advancements in technology, many programs can automatically send you invoices and reminder emails when needed. You can also set reminders on when a courtesy call is to be made to customers to confirm receipt and remind them of their upcoming payment deadline.



ONLINE CREDIT SCORING

The present technology wave has seen an increase in relevant information and credit scores provided online. This has drastically affected the speed and cost of credit scoring of customers. This means that companies can access important information about their customers faster and cheaper, which can help them make informed decisions about whom to do business with and offer credits to, thereby significantly reducing the possibility of delayed payments and bad debts.



CREDIT POLICY CALCULATOR

Credit policy creation or updating has never been easy as it involves many complex areas. It is no news that an effective credit policy is an essential component for business success and for the business to maintain its profitability through its accounts receivables. The credit policy calculator analyzes your present credit policy by weighing every aspect of your credit policy along with current accounts receivable processes. This helps to streamline the business for optimal profitability.



THE CREDIT POLICY CALCULA TOR – WHAT ARE WE IN FOR?

Your credit policy is vital to your business growth and is a means to survive in a highly competitive market. It will affect your accounts receivable and will affect the profitability of your business or company. However, if your credit policy does not achieve the best results, you will not be able to achieve this goal, so you will use the credit policy calculator to conduct a comprehensive review of your credit policy.

The purpose of this tool is to help you analyze the current process including your business functions and processes that are an inherent part of your credit policy. It can also help you determine the actual cost (hard cost or soft cost) of the accounts receivable.

THE END GOAL OF THE CREDIT POLICY CALCULATOR

After using the credit policy calculator to fully review your accounts receivables, you can determine the following results for your business:

1. Accelerated Cash Flow
2. Reduced Bad Debts/ Write-Offs
3. Optimized Efficiencies
4. Improved Profitability
5. Mitigated Risks
6. Earned Trust and Reputation

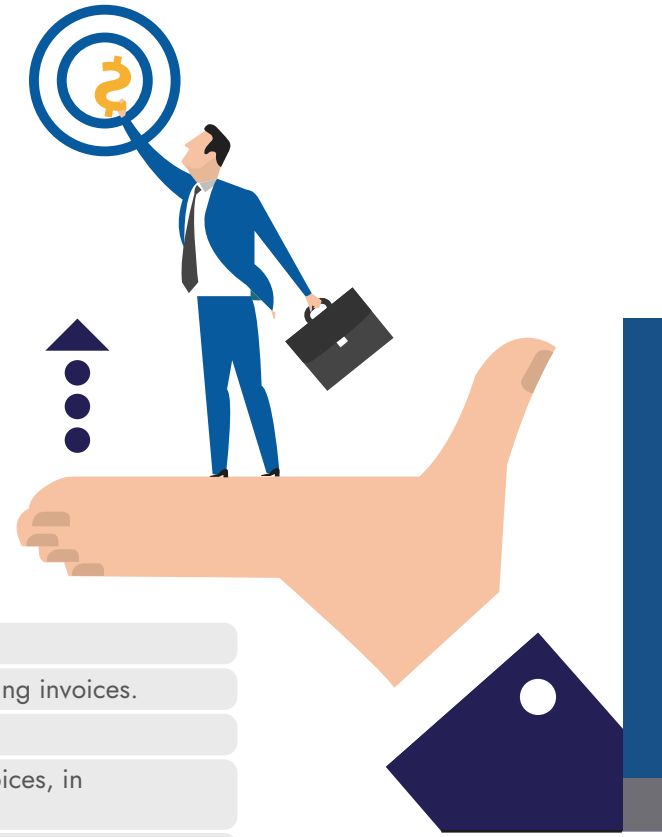


This is done by helping you:

- Compare the cost of credit and checks.
- Review the impact of your Credit Policy on the profitability of your business.
- Show you how an optimal Credit Policy can impact costs.
- Help you discover the overall costs of the payment methods you are using.
- Determine policies for your company.

In the end, the primal goal is to see that your Credit Policy is efficient enough to impact your accounts receivables and in turn, lead to increased profitability.

FINAL THOUGHTS



The impact of a credit policy on a business's profitability is enormous and carries with it the key to the success or failure of a business. The playing field has become more competitive, this is why every business needs to stand out with a workable credit policy that will not only retain their customers but also ensure that the business avoids bad debts. The entry of technology into the credit policy space has brought about the credit policy calculator, which has impacted the profitability of the business.

The credit policy calculator comes with lots of features that ensure that your existing accounting processes are not affected but rather are synchronized for better effectiveness and sustainability for positive outcomes. Some of the features include:

- Robust API that integrates with existing accounting systems
- Company branded customer portal for making payments and viewing invoices.
- Online reporting portal
- Capable of handling all Payment Acceptance Methods (Email, invoices, in person, online, and phoned in payments)
- Customized Click to Pay button.
- Level II & Level III data included with credit card transactions resulting in lower interchange costs.
- Installment Billing
- Recurring Billing
- Streamline invoice processes

With all these technological features integrated into any credit policy payment system, there is hardly any room for lapses that will amount to a decline in profits. Leveraging technology and transitioning from Terms to a more robust system of credit policy now has a significant positive impact on the bottom line profitability for a business.

Every business is unique and has its own data parameters for their customer demographics, To see how efficient your credit policy is working and the impact it has on your business' bottom line profitability, email creditpolicy@paylink.cc for access to the Credit Policy Calculator. Enter the data as it pertains to your business and see what impact making adjustments to your current credit policy has on your profitability.

www.paylink.cc