1 Why Grant Credit?

1.1 INTRODUCTION

Many executives conclude that *a certain level of receivable balances outstanding permanently is an inevitable cost of doing business* and assign the task of credit management a status equivalent to that of routine housekeeping, like clearing waste-bins or deciding which brand of toilet paper to purchase.

Deciding who to grant credit, when and how much. Allowing transactions to go ahead "on credit" and following up to collect the money. In many quarters the perception is that these are not glamorous tasks, they add only costs, they are chores undertaken perforce, not by choice, like vacuuming the house, or sweeping up fallen leaves.

Old Style Executive (OSEx): (Thinks) I am in business therefore I give credit. (Says to Human Resources person) You better hire some pesky "business prevention officers", but be sure to employ less than we need and pay them "peanuts". Can't afford any more non-contributors draining away my quarterly bonus, but must keep those investment analysts off my back.

HR person: Okay, Boss.

This attitude is good news for executives who hold the opposing view. It hands them a competitive advantage on a silver platter!

Granting credit to customers – buyers of your goods and/or services – is not simply a natural outcome of being in business. "I am in business therefore I give credit" is *not* a natural law.

Credit is a powerful strategic tool in the hands of a competitive entrepreneur. It should be fashioned and moulded, given or withheld, in accordance with the strategic interest of the business.

New Style Executive (NSEx): Great news! OSEx has just told his professional credit manager to stop wasting time on ideas and focus on traditional methods of micro-managing accounts!

On average, businesses have about 28% of their assets invested in outstanding receivable account balances. These balances form a large part of working capital, and freeze cash out of reach. As an (admittedly extreme) example, BP had more than US$26 billion locked up in receivables as at 31 December 2001.

In the twenty-first century – the information age – a growing proportion of enterprises (such as trading, hospitality, information and knowledge-based businesses) have

a relatively small fixed asset base, leading to an even heavier weighting of receivable balances on their balance sheets.

In addition to the impact on a company's balance sheet structure, receivable balances impact liquidity and cost of capital. Therefore a decision to grant credit is an important investment decision, with strategic implications. Armed with this understanding, it is easy to conclude that giving credit is a decision not to be taken lightly:

NSEx: Hire the best receivables portfolio strategist available. Offer a seat on the Executive Committee. I don't want cash frozen without purpose, our cash has to work for us 24/365!

People Manager: I know just the person. Thought you'd want the best.

No business "has to give credit". The innate power of credit either to propel a business forward, or to bring it to its knees, requires that every business should consciously decide whether to grant credit and, if yes, on what terms. In every case these strategic decisions should be made at the highest level and reviewed regularly.

When executives consider credit strategy questions they take into account the reasons why it may be prudent to offer credit, the tactics available to be employed in managing that credit day to day, and the ways in which the often significant balance sheet impact of credit decisions can be optimized. These considerations give rise to a formal credit policy to guide the day-to-day micromanagement of individual buyer accounts.

Strategic reasons for granting credit fall in five main categories, as detailed below.

1.2 PRODUCT OFFER ENHANCEMENT CREDIT STRATEGY

The basis of this strategy is the belief that a customer faced with a choice between a certain product "without credit" or "with credit" would choose to buy from the seller offering credit. Supplier credit is, generally speaking, the cheapest form of short-term finance, hence its importance as a part of the mix of features of any product offer. Thus if a company's product is already competitive on grounds of price, quality and delivery, it may be enhanced by adding credit terms:

NSEx: Why are we offering credit terms with this product? We're not a bank!

Sales Executive (SEx): Well all our competitors offer credit.

NSEx: Unacceptable answer! Our product is superior. Buyers are climbing over each other to buy from us, we should let their bankers do the financing.

SEx: Well no, Boss, our competitors match us on quality, price and delivery. If we withdraw credit we'll have to offer something to compensate or we'll lose business!

Alternatively a business may decide to add credit terms as a feature in order to equal its competitors, or to enhance its credit terms in order to better the competition.

The impact of this strategy will usually be that those companies that have better quality credit analysis, and/or are less risk averse, and/or employ the best tactics to minimize credit risk, and/or have the largest margin available to absorb credit losses

(through receivables not collected and/or late payment) will be the most successful competitors in the medium to long term. This emphasizes the need for good quality, yet aggressive, commercially minded credit management.

1.3 COMPARATIVE COST OF MONEY CREDIT STRATEGY

If it is cheaper for a supplier to borrow money than it is for its buyer, a potential "win–win" situation arises that can additionally provide a competitive advantage. A supplier could provide credit but simultaneously increase its margin to recoup the additional cost of capital incurred. If the cost of money difference is sufficient between the seller's jurisdiction and the buyer's, the overall cost of the goods should nevertheless be lower than it would be if the buyer used local finance, hence the description "win–win".

SEx: (To Credit Executive) Our distributor in Ukraine can't afford to increase purchases to meet local demand. He simply can't afford to borrow funds at 40% p.a. to pay cash in advance.

Credit Executive (CEx): We can borrow funds at 4% p.a. If I can cover the payment and transfer risks for less than 6% p.a., could we do a deal? We'll have to recover our extra costs!

SEx: Sure! He could eat 10% p.a. and still make a tidy profit. It's another "win–win" for proactive credit!

Any supplier utilizing this strategy must, however, take into account any negative effect buyer receivable risk may have on its cost of capital. Cost of capital will be discussed in more detail in another chapter. Suffice it to record at this point that the greater the risk inherent in a company's receivable portfolio, the greater the cost of borrowing funds or raising capital to fund its activities. Hence it is vital that all ramifications of granting credit are carefully weighed when calculating the net present value of such a decision, compared to the net present value of a decision not to grant credit:

CEx: Have you weighed all the ramifications?

SEx: Of course! They're all included in the margin!

CEx: Hmmmm. (Thinks) I hear a band playing "Believe that if you like!"

1.4 CREDIT STRATEGY FOR ADMINISTRATIVE EFFICIENCY

The granting of trade credit may be motivated by a desire to capture certain administrative efficiencies and thus reduce operating costs. Efficiencies available include: reducing numbers of invoices, reducing cash handling, reducing numbers of shipments, reducing storage costs, and increasing sales volumes (i.e. reducing fixed costs per item).

Cash in advance (CIA) or cash on delivery (COD) payment terms require the issue of an invoice with each order and, in the latter case, the handling of cash by delivery personnel. Where CIA terms are used in relation to the almost continuous delivery of goods – such as the provision of jet fuel to airlines – quantities and prices have to be estimated prior to delivery, resulting in extensive reconciliation work and the risk of unauthorized credit exposures arising from time to time. The related administrative costs, unplanned credit risks and security risks can be avoided, and deliveries can be speeded up, if formal credit terms are granted.

It may be necessary in many circumstances for suppliers to introduce minimum order quantity restrictions, to avoid incurring excessive freight and handling costs. In these instances buyers unable to pay in advance for such a large order will require assistance through the provision of supplier credit.

On the other hand, in cases where the cost of storage of seasonal goods is lower at the point of consumption or sale than at the place of production, it is advantageous for producers to shift this burden to their buyers. Trade credit often plays a key role in enabling relevant markets to capture this efficiency.

The prime example of this credit strategy is provided by the agricultural fertilizer market. Manufacturers of chemical fertilizer operate a year-round production cycle but farmers only utilize fertilizer during a short period prior to planting. Farmers usually have cheaper storage facilities for fertilizer than those that could be provided for such quantities at the places of production. There are also transport savings available if fertilizer is shipped steadily throughout the year, rather than in a concentrated pre-season period. However, the only way to capture the potential storage and transport savings for the fertilizer and agricultural industries is for the manufacturers to grant supplier credit to farmers, from the time of delivery until the farmers realize cash from the sale of related crops.

Supplier credit can increase sales volumes thus enabling manufacturers to capture economies of scale and to reduce the proportion of fixed overheads per item produced. A good example of this is car manufacturers offering 0% financing incentive programmes, to encourage buyers to bring forward their purchase decisions and thus increase near-term sales volumes.

Furniture Bob: Sign this magic finance agreement and you can take your chairs away today! Why wait to accumulate cash? Pay nothing for a year and a day! Sign up right away!

Furniture Buyer: Do you have a pen I could use?

1.5 CREDIT STRATEGY TO BUILD TRUST

The granting of credit can powerfully signal (a) that the supplier has confidence in the quality of the goods or services supplied and/or (b) that the supplier wants to establish a long-term relationship with the buyer.

A seller may overcome any reluctance to buy its product by effectively allowing the purchaser time to check the goods before payment becomes due. This signals confidence in the value provided by the product, and confidence that the purchaser will want to buy more in future.

Seller: We are so confident you'll like these z4x widgets and be desperate to have more, we offer open credit terms on your first purchase.

Buyer: Okay, I'll take two dozen!

It has been traditional to begin a new relationship with a buyer on "cash in advance" or "letter of credit" terms. As the relationship then develops over several years, terms would progress through "promissory note" and "documentary collections" until the relationship eventually matured to reach the state of "open credit". Thus open credit terms have come to be associated with long-term relationships founded on mutual knowledge, respect and trust. It may no longer be possible to develop commercial relationships so gradually, but open credit terms are still powerfully connected with mutual trust and the desire for a long-term association. Good quality credit management, based on good quality information and/or credit risk mitigation techniques, can enable open credit terms as a compelling indicator of trust – a key marketing device – even in cases where the relationship has not matured.

Seller: Your payment terms will be "open credit".

Buyer: Thank you, that will be very helpful. (Thinks) They trust and respect me. They obviously want a long-term relationship, yippee! I must phone their competitor tomorrow and cancel our meeting.

1.6 CREDIT STRATEGY FOR BUSINESS DEVELOPMENT

In some situations potential distributors may be start-up businesses without significant working capital and/or may be operating in a jurisdiction where it is not possible to raise venture capital or short-term bank finance. If a supplier is not prepared to create its own local branch or subsidiary to distribute and promote the sale of its products, it could assist its distributor by providing working capital through extended supplier credit. This would entail allowing the distributor to delay payment until it had actually received cash from end-user buyers or consumers. Terms such as "180 days after shipment date" or "60 days after the goods leave the distributor's warehouse" could be negotiated, depending on local conditions.

CEx: (To Kazakh distributor) How many days from invoice date do you need?

Kazakh distributor (KD): Sixty or maybe 90.

CEx: Well let's work this out. Twenty days transport and customs clearance, plus 5 days to move the goods to your depots. You're selling 20 cartons a day, on average, so add 35 days in inventory, and how long does it take to collect cash from your buyers?

KD: About 25 days.

CEx: Okay, say another 30 days, that's 90 days in total.

KD: Yes, as I said!

An arrangement such as this would increase administrative and monitoring costs, and increase the risk of loss due to bad debts, but the negatives should be weighed against the long-term benefits of developing a successful local distributor. Nonetheless any

potential loss should not be excessive because "there's no long-term if you can't survive the short-term" (Lawton, 2002).

1.7 CONCLUSION

The case for proactive decision making regarding credit strategy at the highest level of any organization is clear. Credit is potentially a powerful tool available to executives crafting an effective marketing strategy. If its potential is understood and used wisely, credit will promote success in the most competitive of circumstances. Conversely, those business leaders who accept credit passively, as a necessary chore, and leave it to meander through the enterprise without strategic direction, will ensure that credit adds little and will risk a credit-related disaster arising without warning:

Credit Analyst 2 (CAn2): (New in the organization) If only we had some strategic direction we'd know where to concentrate our resources.

Credit Analyst 1 (CAn1): (Been in place for a while) Don't worry, our fearless leader OSEx has everything under control. You just focus on catching up last year's annual account reviews. OSEx will take care of today and tomorrow.

CAn2: I just don't like nasty surprises . . . I lost my last job 'cause no one saw the broken rail ahead of the Enron locomotive.