MANAGEMENT OF RECEIVABLES

CREDIT POLICY

Credit Policy: Types and Aspects

Credit policy is an important part of the overall strategy of a firm to market its products. It refers to those decision variables that influence the amount of trade credit i.e investment in receivables. Credit policy can be lenient or stringent.

There are two types of credit policies. Let us know about them in brief.

a) Lenient/Loose/expansive Credit Policy:

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

b) Stringent /Tight /Restrictive Credit Policy:

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

Therefore, the objectives of credit management should be the achievement of a balance that maximizes the overall return of the firm.

Aspects of Credit Policy:

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

1. Credit Terms:

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

1.1 Credit period:

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

1.2 Cash discount:

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

2. Credit Standards:

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

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

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

3. Collection policy:

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

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

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