19BAE711-WORKING CAPITAL MANAGEMENT

Credit Policy

A credit policy is a set of guidelines that a company establishes to determine the terms and conditions for extending credit to customers. It aims to manage credit risk and ensure that sales on credit are converted into cash in a timely manner.

Objectives

1. **Minimize Credit Risk**: Reduce the risk of non-payment or late payment from customers.
2. **Maximize Sales**: Increase sales by offering competitive credit terms.
3. **Optimize Cash Flow**: Ensure timely collection of receivables to maintain liquidity.
4. **Customer Relationships**: Foster good relationships with customers by providing clear and fair credit terms.

Key Components

1. **Credit Terms**:
    - **Credit Period**: The duration within which the customer must pay the invoice (e.g., 30 days, 60 days).
    - **Discounts for Early Payment**: Incentives offered for early payment, such as 2% discount if paid within 10 days.
    - **Late Payment Penalties**: Interest or fees charged for payments made after the due date.
2. **Credit Limits**:
    - **Customer-Specific Limits**: Maximum amount of credit extended to a particular customer based on their creditworthiness.
    - **Order-Specific Limits**: Limits on the amount of credit for individual orders or transactions.
3. **Credit Evaluation**:
    - **Creditworthiness Assessment**: Evaluation of a customer's ability to pay based on financial health, payment history, and credit reports.
    - **Credit Application Process**: Procedure for new customers to apply for credit, including necessary documentation and approvals.
4. **Collection Procedures**:
    - **Invoicing**: Timely and accurate invoicing practices to ensure customers receive and process invoices promptly.
    - **Follow-Up**: Regular follow-up on overdue accounts through reminders, phone calls, or emails.
    - **Debt Recovery**: Steps for recovering bad debts, including engaging collection agencies or legal action.

5. **Credit Monitoring**:
    - **Regular Reviews**: Periodic review of customer accounts to assess ongoing creditworthiness.
    - **Aging Analysis**: Analysis of outstanding receivables based on the length of time they have been overdue.

Credit Evaluation

Credit evaluation is the process of assessing a customer's ability and willingness to repay credit extended to them. It is a crucial step in managing credit risk and ensuring that sales on credit are financially sound.

Objectives

1. **Assess Creditworthiness**: Determine the likelihood of a customer repaying their debt.
2. **Set Credit Limits**: Establish appropriate credit limits based on the customer's financial health.
3. **Reduce Bad Debts**: Minimize the risk of non-payment or late payment.

Key Factors

1. **Character**:
    - **Credit History**: Review of the customer's past payment behavior and history with other creditors.
    - **Reputation**: Assessment of the customer's reliability and reputation in the market.
2. **Capacity**:
    - **Financial Statements**: Analysis of financial statements to evaluate the customer's profitability, liquidity, and solvency.
    - **Cash Flow**: Examination of cash flow statements to assess the customer's ability to generate cash to meet obligations.
3. **Capital**:
    - **Net Worth**: Assessment of the customer's total assets minus total liabilities to determine their financial strength.
    - **Equity**: Evaluation of the amount of equity capital the customer has invested in their business.
4. **Collateral**:
    - **Secured Assets**: Identification of assets that can be pledged as collateral to secure the credit.
    - **Valuation**: Determination of the value of collateral offered by the customer.
5. **Conditions**:
    - **Economic Conditions**: Consideration of current economic conditions that may impact the customer's ability to repay.
    - **Industry Factors**: Analysis of industry-specific risks and conditions affecting the customer's business.

Credit Evaluation Methods

1. **Financial Statement Analysis**:
   - **Ratio Analysis**: Use of financial ratios (e.g., current ratio, quick ratio, debt-to-equity ratio) to assess financial health.
   - **Trend Analysis**: Examination of financial trends over time to identify improvements or deteriorations.
2. **Credit Scoring**:
   - **Automated Scoring Models**: Use of credit scoring models to evaluate the creditworthiness based on various financial and non-financial factors.
   - **Credit Reports**: Review of credit reports from credit bureaus to assess the customer's credit score and history.
3. **Qualitative Assessment**:
   - **Management Evaluation**: Assessment of the customer's management team and their experience, skills, and track record.
   - **Market Position**: Evaluation of the customer's competitive position in the market.
4. **Third-Party References**:
   - **Trade References**: Contacting other suppliers or business partners to gather information on the customer's payment history.
   - **Bank References**: Obtaining references from the customer's bank regarding their financial stability and creditworthiness.

Control Aspects

Implementing strong control mechanisms is essential to ensure that the credit policy is effectively enforced and credit risks are managed.

Internal Controls

1. **Credit Approval Process**:
   - **Approval Hierarchy**: Establishing levels of authority for credit approval based on the amount of credit requested.
   - **Documentation**: Ensuring all credit applications and approvals are well-documented and stored securely.
2. **Credit Monitoring**:
   - **Regular Reviews**: Conducting periodic reviews of credit limits and terms for existing customers.
   - **Aging Reports**: Generating and reviewing aging reports to monitor outstanding receivables.
3. **Collection Procedures**:
   - **Timely Invoicing**: Ensuring invoices are issued promptly and accurately.
   - **Follow-Up Mechanisms**: Implementing systematic follow-up procedures for overdue accounts.
4. **Segregation of Duties**:
   - **Role Separation**: Separating responsibilities for credit approval, invoicing, and collections to prevent fraud and errors.

External Controls

1. **Credit Insurance**:
   - **Policy Coverage**: Obtaining credit insurance to protect against the risk of non-payment by customers.
   - **Risk Transfer**: Transferring a portion of the credit risk to the insurance provider.
2. **External Audits**:
   - **Audit Reviews**: Engaging external auditors to review credit policies, procedures, and adherence to internal controls.
   - **Compliance Checks**: Ensuring compliance with regulatory requirements and industry best practices.

Conclusion

A well-defined credit policy and thorough credit evaluation process are essential for managing credit risk and ensuring the financial stability of a company. By implementing robust control mechanisms and regularly reviewing credit practices, companies can effectively balance the need for sales growth with the management of credit risk.

Credit Control

Credit control is the process of managing and regulating the credit extended to customers to minimize the risk of bad debts and ensure timely collections. It is a crucial component of a company's overall credit management strategy.

Objectives

1. **Minimize Bad Debts**: Reduce the incidence of uncollectible accounts.
2. **Improve Cash Flow**: Ensure timely collections to maintain liquidity.
3. **Enhance Profitability**: Increase the profitability by reducing the cost of carrying receivables.
4. **Customer Relationship Management**: Maintain good relationships with customers while ensuring they adhere to agreed credit terms.

Key Components

1. **Credit Approval Process**:
   - **Creditworthiness Assessment**: Evaluate the creditworthiness of potential and existing customers.
   - **Credit Limits**: Set appropriate credit limits for customers based on their financial health and payment history.
   - **Credit Terms**: Define the terms and conditions under which credit is extended.
2. **Monitoring Receivables**:
   - **Aging Reports**: Regularly review aging reports to monitor outstanding receivables and identify overdue accounts.
   - **Credit Utilization**: Track the utilization of credit limits to ensure customers do not exceed their approved limits.
3. **Collection Procedures**:
   - **Invoicing**: Ensure accurate and timely invoicing to customers.
   - **Follow-Up**: Implement systematic follow-up procedures for overdue accounts, including reminders and phone calls.

- **Collections**: Use collection agencies or legal action for delinquent accounts when necessary.

4. **Customer Communication**:
   - **Regular Updates**: Keep customers informed about their account status and any outstanding balances.
   - **Dispute Resolution**: Address and resolve any billing disputes promptly to prevent delays in payment.

Tools and Techniques

1. **Credit Control Software**: Use software solutions to automate and streamline credit control processes, including credit evaluations, monitoring, and collections.
2. **Aging Analysis**: Regularly perform aging analysis to categorize receivables based on the length of time they have been outstanding.
3. **Credit Scoring Models**: Implement credit scoring models to assess the risk associated with extending credit to customers.
4. **Customer Segmentation**: Segment customers based on their payment behavior and credit risk profile to tailor credit control strategies.

Strategies

1. **Early Payment Incentives**: Offer discounts or other incentives for early payments to encourage timely settlements.
2. **Stringent Credit Terms**: Implement stricter credit terms for high-risk customers while offering more flexible terms to reliable customers.
3. **Regular Reviews**: Conduct regular reviews of credit policies, customer accounts, and credit limits to ensure they remain appropriate.
4. **Training and Awareness**: Provide training to staff on credit control policies and procedures to ensure consistent application.

Risks and Challenges

1. **Credit Risk**: The risk of non-payment or delayed payment from customers.
2. **Economic Downturns**: Economic downturns can impact customers' ability to pay, increasing the risk of bad debts.
3. **Market Competition**: Competitive pressures may lead to more lenient credit terms, increasing credit risk.
4. **Fraud**: The risk of fraudulent activities, such as falsified credit applications or collusion between employees and customers.

Best Practices

1. **Comprehensive Credit Policies**: Develop and implement comprehensive credit policies that outline the criteria for extending credit and the procedures for monitoring and collecting receivables.
2. **Regular Monitoring**: Continuously monitor receivables and take prompt action on overdue accounts.
3. **Customer Communication**: Maintain open and transparent communication with customers regarding their accounts and any outstanding balances.
4. **Use of Technology**: Leverage technology to automate and streamline credit control processes for greater efficiency and accuracy.
5. **Periodic Reviews**: Regularly review and update credit policies and procedures to reflect changing market conditions and business needs.

Control Aspects

Effective control mechanisms are essential to enforce credit policies and manage credit risk.

Internal Controls

1. **Credit Approval Hierarchy**:
   - **Approval Levels**: Define levels of authority for approving credit based on the amount and risk associated with the credit.
   - **Documentation**: Ensure all credit approvals are well-documented and maintained for future reference.
2. **Segregation of Duties**:
   - **Role Separation**: Separate responsibilities for credit approval, invoicing, and collections to prevent conflicts of interest and fraud.
   - **Access Controls**: Limit access to sensitive financial information and credit control systems to authorized personnel only.
3. **Regular Reconciliation**:
   - **Bank Reconciliation**: Regularly reconcile bank statements with accounts receivable records to ensure accuracy.
   - **Internal Audits**: Conduct periodic internal audits of credit control processes to identify and address any discrepancies or weaknesses.
4. **Performance Metrics**:
   - **Key Performance Indicators (KPIs)**: Track KPIs such as Days Sales Outstanding (DSO), collection effectiveness, and bad debt ratio to measure the effectiveness of credit control processes.

External Controls

1. **Credit Insurance**:
   - **Policy Coverage**: Obtain credit insurance to protect against the risk of non-payment by customers.
   - **Risk Mitigation**: Use credit insurance to transfer a portion of the credit risk to the insurer.
2. **External Audits**:
   - **Audit Reviews**: Engage external auditors to review credit control policies, procedures, and adherence to internal controls.
   - **Compliance Checks**: Ensure compliance with regulatory requirements and industry best practices.
3. **Credit Reporting Agencies**:
   - **Credit Reports**: Use credit reports from credit reporting agencies to assess the creditworthiness of customers.
   - **Ongoing Monitoring**: Regularly monitor changes in customers' credit ratings and financial health.

Conclusion

Effective credit control is essential for managing credit risk and ensuring the financial stability of a company. By implementing robust internal and external control mechanisms, regularly reviewing credit policies, and leveraging technology, companies can optimize their

credit management processes and minimize the risk of bad debts. This, in turn, helps maintain healthy cash flows and supports sustainable business growth.