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INFLUENCING FACTORS IN DETERMINING CREDIT TERMS

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Abstract

Setting credit terms in compliance with stated credit policy of the company before taking a credit granting decision is very much essential for every business firm. Credit terms are the arrangements between buyer and seller which specify the conditions of payments of goods or services purchased.What credit terms will be followed by sellers is depend upon the seller's place in the market, and the credit terms on which he is buying from his own suppliers. Next most important aspect for the seller is that the availability of funds, he needs to finance his own credit sales.From the customer point of view, it is probably desirable to use credit limits, because this practice will tend to hold his temptation to overbuy or commit himself beyond his ability to repay.

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Introduction:

In the whole credit management programme it is hard to imagine anything which can be more important than the credit terms which are to be allowed to the buyer by seller. Creditor firm takes credit granting decision after analysing the credit worthiness of buyer. At the same time on the basis of such analysis creditor firm grades their buyers and such grading of credits is used as an aid to determine credit terms. The grading of credits makes certain that the analysis is orderly and systematic and that all significant elements are considered. Credit terms are the arrangements between buyer and seller which specify the conditions of payments of goods or services purchased.

Credit terms also referred as ‘credit line’ or payment terms are concerned solely with the payment aspect of sales. One should keep in mind that ‘credit term’ has no relation with ‘condition of sales’. The provisions of sales contract such as warranties, delivery guarantees and cancellation privileges are not within the scope of our discussion.Herewe are mainly concentrating on ‘credit limit’ and ‘credit period’. Credit limits is the maximum amount of credit allowed to a particular customer and ‘credit periods’ is the time period within which payment is made by the customer. It is seen that usually ‘credit period’ is more or less same in any particular line of business, (say 30 days) but ‘credit limit’ is determined for any particular customer on the basis of his financial position i.e. ‘credit limit’ may vary from customer to customer.

History of Credit Terms-

In this chapter, we first show how credit terms have changed with modern developments. Next, we point out some factors that determine or influence the credit period, maximum limit of credit and cash discount facility. Due to slow transportation system and communication problem very long terms of credit were in ruled in mercantile trade transaction throughout the business world in eighteenth century. Credit terms as long as 12 (twelve) months was normal amongst merchants.

During that period frequent buying was not possible for the buyer as the travel facilities were extremely limited and time consuming. Delivery of goods slow and undependable, that’s why buyer had to estimate their stock needs far in advance and to buy in large quantities. Credit terms of six to twelve months, used to be extended on the basis of promissory note.The supplier or creditor firm could discount for suchpromissory note for operating capital which was common at that time. Besides slow transportation and communication problem and other important reasonsfor longer credit terms was largely due to low cost money - the normal commercial rate of interest in the mid eighteen century was 3.5% (three and half per cent).

In this context, we find a Lancashire merchant named William Stout, complaining that, “it being now a year since I began trade. I find I have been too forward in trusting, too back ward in calling.”Credit terms applied in the modern business is the modified version of old one.

Elements of Credit Terms

Credit terms mainly consists three elements –

1. Credit period. 2. Credit limit 3. Cash Discount Terms.

Credit limit are set judgmentally by linking the results of the customer evaluation process and the benefit and losses from credit granting decision. Credit terms vary with different lines of business. Different terms may be extended to different classes of customers, mainly in determination of maximum amount credit allowed to any particular customer.The classification used the firm may be different from one firm to others as follows –

i. Completely reliable customers.
ii. Highly reliable customers.
iii. Slightly risky customers.
iv. Doubtful customers. or

A.Good B. Fair C. Poor

Properly used grading of credits should be aid to judgement. It helps the credit manager in deciding the maximum amount of credit to be allowed to his customer.It is easier to take decision regarding customers who fall under ‘A’ or ‘C’ category. Taking decision regarding customers failing under category ‘B’ is most problematic. It is assumed that such customer (B’ grade) possess those credit qualities which indicate that the credit will be redeemed but only after some difficulty or effort.Without having in mind a reasonable limit for the individual customer, the creditor may grant an excessive amount based purely upon payment habits which might be good until the point at which the customer is in ‘over his head’.

So far we discussed the necessity and advantages of setting credit terms for a business firm, now we consider the factors that influence the credit term.

Factors Influencing Credit Terms

As we stated earlier, number of factors are involved in the selection of credit terms, but their relative importance will vary according to the character and nature of the concerned business.

Traditional factors particularly, will have a significant influence on the decision as to which terms to allow. Let us see how each of these factors affects credit terms.

The Product :- Whether credit terms will be shorter or longer it depends upon the nature of product, the shorter the saleable life of the product shorter are the credit terms extended to the dealer in that product.

Buyer Position: -It should be kept in mind that, the creditor firm should be in a position to insist upon receiving detailed financial information from his customer. Before setting a credit term with a buyer, his ability to pay debts must be evaluated through thorough analysis of available financial information. In case of existing customer the company's experience with him is an important consideration at the time of reviewing credit terms with that existing customer.

Seller Position: - It is true that buyer view point will be important and it may well influence the seller a great extent, but at the end, it is seller who must decide on the facilities he will offer. The principal of all the conditions is of course payment. What credit terms will be followed by sellers is depends upon the seller's place in the market, and the credit terms on which he is buying from his own suppliers. Next most important aspect for the seller is that the availability of funds, he needs to finance his own credit sales.

Competitive Factors: - Credit terms of one firm are influenced by what others firms are doing. A firm charges Rs.120 per packet for a product and demands payment within 15 days of shipment. While his competitors sell the same quality product on same price but have 30 days terms. Obviously the firm with short terms has difficulty in selling. In such situations every firm should respond accordingly and charge their credit terms to cope with the competitive environment.

These are the above mentioned factors which should be taken into consideration at the time of determining effective credit terms. These are the common factors and apart from this, each business, whether large or small, has its own special circumstances and conditions according to its size and nature of the business, which will add to this list. At last, we give a look at all the factors, which includes –

i) Availability of Capital; ii) Cost of capital (interest cost, in case borrowed capital); iii) Existence of a buyer's or seller's market; iv) Sales target; v) Profit Margin; vi) Degree of credit risk with which credit sales will be involved; vii) Turnover of the goods (Short credit period will he allowed, if the buyer resells them at once); vii) Buyer's financial position. (determination of credit term based on the results obtained from evaluation of buyer's financial position); viii) The degree of complexity or time which is involved in the production of goods or machinery; ix) Competitive factors; x) The marketing policy of the seller.

Determination of Credit Limit

Now, we are highlighting on importance of setting credit limit. Setting a credit limit is an extension of credit determined in advance based on the result obtained from the credit evaluation.Credit lines are sometimes interpreted as the maximum amount of credit the company is willing to extent the ceiling above which the risk is too high to accept.It represents the amount of credit extended to a buyer on the basis of evaluation which he can incur and repay promptly.Thus, determination of 'Credit Limit' involves two aspects – on the one hand credit firm decides the maximum amount of credit the company is willing to extend to its customers or the fund available at its disposal to finance both receivables and stock.On the other hand 'credit limit' related with the maximum amount of credit to be extended to any particular customer must be decided. Credit limit for any customer may be set as 20% of net working capital or 25% of net worth or by means of a formula derived from a weighted aggregate of several financial relations. Credit limit is set by the firms according to the credit standard set by them earlier. Credit standard of any firm is influenced by general business conditions, competition and the market.

Proper use of a credit limit at the right time can help both customer and creditor. Credit executive differs as to advisability of notifying customers of their credit limits. However, most credit men agree that marginal customers whose credit limits are inflexible, should always be informed. The following are the advantages of telling the customer his credit limit –

1. If nothing is mentioned about credit limit to the customer earlier and subsequently an order withheld, embarrassment and misunderstanding may result.
2. The customer can plan his purchase in accordance with his credit limit.
3. In notifying a customer of a line, an opportunity is afforded to discuss it with him and to offer suggestions which may help to improve his position.

On the other hand, some disadvantages of telling the customer his credit limit are –

1. The customer may consider the limit as an inflexible maximum and many confine his purchases to the original line even when a larger line has become reasonable.
2. The customer may be offended if he feels that the limit is a reflection on his credit standing.

3. The customer may buy from other supplier rather than ask for credit extension.

Profitability and degree of risk varies with the credit terms. Now, in case of an order which exceeds the customer's credit limit or requests for payment privileges extend beyond established credit terms. In arriving at a decision regarding an order which exceeds the normal credit limit, the credit managers have to know –

- ❖ Is he (customer) able to pay the bill? and
- ❖ When will he pay?

For this purpose credit manager needs to investigation further the following aspects –

1. The customer's past payment record whether the outstanding balance of his open account to be in proportion to his trading assets? If ledger experience with the account indicates that the customer has been meeting his obligations promptly, or that a gradual increase has occurred in orders, he probably has an expanding business that warrants additional credit.
2. A strong financial statement showing increased business and profits usually calls for increased credit.
3. The opinion of the other suppliers and agency reports about the credit rating of the customer.

Thus, the accounts placed on the book should be re-examined periodically to ascertain whether any substantial changes have taken place. In an efficient credit department reviews of credit terms should be made at these terms –

1. When addition credit is requested.
2. When new financial statement becomes available.
3. When there is a change in customer payment pattern
4. When the credit manager learns from internal sources, such as his salesmen, that the customer has experienced an unusual increase or decrease in business.

<u>Discount Terms:-</u>

It is a usual practice in trade credit to quote two options involving the time and amount of payment. One option is usual credit period and other is earlier payment option to get the goods in lesser price. The main objective of allowing cash discount facility –

- ❖ To reduce working capital requirements.
- ❖ Reduce credit or collection expenses.
- ❖ Reduce delinquencies and credit losses.

- Improve competitive position.

Firm generally offers cash discount to accelerate its collection procedure and induces customer to make prompt payments. The percentage discount and period during which it is available are reflected in the credit terms. From the buyers point of view acceptance of cash discount facility is profitable because the cash discount given by the businesses is considerably higher than the discount charged by the banks for lending funds. Therefore it is extremely profitable for the buyer to borrow from a bank the required amount to take advantage of cash discount.

Conclusion:

From the point of view point of sellers, the chief advantage of cash discount is that early payment by this customer gives him ready cash and it reduces the danger of bad debt.The main consideration in discount terms is that the relative financing cost is saved to the seller by the early payment versus the cost of early settlement discount.A firm must determine whether a speed up in collection can create more benefit than the cost of increasing the discount. Thus the discount terms will only have a point when the sellers can identify clear benefit through their use. It is therefore necessary to plan the follow up policy and procedures very precisely in advance of the introduction of the system.

From the above discussion we can conclude that credit terms are determined in advance based on the results, obtained from credit evaluation. It facilitates the handling of accounts and serves as a guide in taking credit granting decision. Credit terms should be flexible and subject to constant review and revision because of changing business conditions. Factors influencing credit terms may be changed due to economic condition or any other specific reason. So, it is advisable to the firm to re-examine periodically to ascertain whether any substantial changes have taken place in the accounts placed on the books.

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