Making Credit Decisions
Class Objectives

- Approval of credit for new customers
- Establishing credit limits
- Implementing credit limits for existing customers
- How to use credit scoring
- Credit approval for and management of marginal accounts
- Making credit decisions using limited customer information
- Conducting reviews of credit limits
New Account Philosophy

• The Role of Credit is to Support Sales
• The Role of the Credit Manager is to Protect Company Assets (A/R)
• The key is to find a way to make the sale while ensuring payment will be received.
Accounts for New Customers

- Should be approved quickly
- Promotes good will with sales and the customer
- Can be the first impression of how credit will handle the account.
- Sets customer expectations from the beginning
Ways To Approve Credit

- Regular Open Account
- Order to Order
- Pre-Payments COD
- Maximum Credit Limits
- Credit Ratings
- Credit Scoring
Things to Think About When Extending Credit

- What is My Profit Margin?
- Does the Customer Have the Resources To Pay?
- Is the Customer Credit Worthy?
- How Much Credit Are Other Suppliers Giving?
- When Can The Customer Pay?
- What Are The Terms of Sale?
Other Considerations

• Your company’s financial position
• Your competitive edge
• How quickly you need to turn receivables to cash so you can meet your monthly obligations
• Size of the customer’s project
• What can your company afford to lose?
## Lost Profits

<table>
<thead>
<tr>
<th>Loss</th>
<th>2% margin</th>
<th>3% margin</th>
<th>4% margin</th>
<th>5% margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$7,500</td>
<td>$6,000</td>
</tr>
<tr>
<td>$500</td>
<td>$25,000</td>
<td>$16,666</td>
<td>$12,500</td>
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<tr>
<td>$1,000</td>
<td>$50,000</td>
<td>$33,333</td>
<td>$25,000</td>
<td>$20,000</td>
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<tr>
<td>$3,000</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$75,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>$5,000</td>
<td>$250,000</td>
<td>$166,666</td>
<td>$125,000</td>
<td>$100,000</td>
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</tbody>
</table>
Impact of Credit Policy

• You can be tight on credit approval and loose with collections
• You can be loose on credit approval and tight on collections

But

If you are loose with credit approval and collections or too tight with credit approval and collections you are headed for disaster. You must have a balance.
Decisions Based on Limited Information

- Lack of bank information
- New business with no or low payment history
- No personal guaranty
- No response to credit references
- No signed credit application just a fact sheet
Something to Think About

Should you tell the customer what his credit limit is?
Should You Tell the Customer What His Credit Limit Is?

**Pro’s**
- Opens the door to talk about expectations
- Reduces embarrassment of holding orders if over the limit

**Con’s**
- Limits sales if prompt pay
- Customer may think he is worth more
- If you don’t talk to customer about it, you may extend too much credit.
- Courts may rule against you if you exceed the given limit
Establishing Credit Limits

- By Payment Record
- Amount Competitors Grant
- Low to Begin With Increase Later
- By Credit Rating
- By Formula Credit Scoring
- By Expected Sales Vs. Terms
Establishing Credit Limits Based on Your Own History

- Number of years you have been doing business with this customer
- What limits he has had in the past
- Pay habits over time
- Current payment trend
Staying Competitive in the Marketplace

- What terms are your competitors offering
- What high limits show on a credit report

**Note:**

Talking to competitors about terms can be an anti-trust issue. Never agree to match competitor terms unless there is a competitive reason to do so.

The higher the limit the higher the risk.
### Credit Scoring

#### Credit Limit Table

<table>
<thead>
<tr>
<th>D&amp;B Rating</th>
<th>Credit Limit</th>
<th>D&amp;B Rating</th>
<th>Credit Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>5A1</td>
<td>$1,000,000</td>
<td>CB1</td>
<td>$25,000</td>
</tr>
<tr>
<td>5A2</td>
<td>$1,000,000</td>
<td>CB2</td>
<td>$25,000</td>
</tr>
<tr>
<td>5A3</td>
<td>$300,000</td>
<td>CB3</td>
<td>$7,000</td>
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<tr>
<td>4A1</td>
<td>$750,000</td>
<td>CC1</td>
<td>$10,000</td>
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<tr>
<td>4A2</td>
<td>$500,000</td>
<td>CC2</td>
<td>$10,000</td>
</tr>
<tr>
<td>4A3</td>
<td>$250,000</td>
<td>CC3</td>
<td>$3,000</td>
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<tr>
<td>3A1</td>
<td>$300,000</td>
<td>DC1</td>
<td>$5,000</td>
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<tr>
<td>3A2</td>
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<td>DC2</td>
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<tr>
<td>3A3</td>
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<td>DC3</td>
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<tr>
<td>2A1</td>
<td>$100,000</td>
<td>EE1</td>
<td>$5,000</td>
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<tr>
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<td>2A3</td>
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<tr>
<td>1A1</td>
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<td>FF1</td>
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<tr>
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<td>$75,000</td>
<td>FF2</td>
<td>$1,000</td>
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<tr>
<td>1A3</td>
<td>$25,000</td>
<td>FF3</td>
<td>$500</td>
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<tr>
<td>BA1</td>
<td>$50,000</td>
<td>GG1</td>
<td>$1,000</td>
</tr>
<tr>
<td>BA2</td>
<td>$50,000</td>
<td>GG2</td>
<td>$1,000</td>
</tr>
<tr>
<td>BA3</td>
<td>$15,000</td>
<td>GG3</td>
<td>$500</td>
</tr>
<tr>
<td>BB1</td>
<td>$30,000</td>
<td>HH1</td>
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</tr>
<tr>
<td>BB2</td>
<td>$30,000</td>
<td>HH2</td>
<td>$1,000</td>
</tr>
<tr>
<td>BB3</td>
<td>$10,000</td>
<td>HH3</td>
<td>$500</td>
</tr>
<tr>
<td>Rules and Criteria</td>
<td>Red Declined</td>
<td>Yellow Conditions</td>
<td>Green Approved</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>--------------</td>
<td>------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>(One Failed Rule Equals Decline)</td>
<td>(Number of Instances or Occurrences)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30+</td>
<td>4 or more</td>
<td>3</td>
<td>2 or less</td>
</tr>
<tr>
<td>30 – 59 days past due</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60+</td>
<td>3 or more</td>
<td>2</td>
<td>1 or less</td>
</tr>
<tr>
<td>60 – 89 days past due</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>90+</td>
<td>3 or more</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>90 – 119 days past due</td>
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<td></td>
<td></td>
</tr>
<tr>
<td># of Trades Past Due</td>
<td>4 or more</td>
<td>3</td>
<td>2 or less</td>
</tr>
<tr>
<td>30+</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td># of Trades 60+ Past Due</td>
<td>3 or more</td>
<td>2</td>
<td>1 or less</td>
</tr>
<tr>
<td># of Trades 90-180 Past Due</td>
<td>3 or more</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>COLL Collection</td>
<td>3 or more</td>
<td>2</td>
<td>1 or less</td>
</tr>
<tr>
<td>Tax Liens</td>
<td>3 or more</td>
<td>2</td>
<td>1 or less</td>
</tr>
</tbody>
</table>
Limiting Exposure

- Reduce exposure on marginal accounts with lower credit limits and shorter terms

Note:
Anytime you make special deals to limit exposure of marginal accounts you run the risk of forgetting to follow up.
Example 1

- Customer credit report shows customer is paying suppliers on time
- Your Sales person says he anticipates sales of $5,000 per month.
- Terms are set at Net 60 days
- Minimum terms will need to be at least $10,000
Example 2

- Marginal customer and you want to limit exposure
- Customer expected to buy $5,000 per month
- Terms set at N10 days
- Credit limit could be less than $5,000
What is a Marginal Account?

- Slow Payments
- Finances are Inadequate
- Weak Management
- Poor Credit Rating
- Low Profits
- High Maintenances
Keys For Managing Marginal Accounts

1. Understand There Is Higher Risk
2. Identify Marginal Accounts
3. Find a Way to Regularly Track or Monitor
   - Have Sales Increase Margins If Possible
   - Watch for Red Flags And Say No When You Need to.
4. Keep Sales Informed
5. Reduce Exposure Lower Limit Order to Order
6. Get Security
Question

Do you think the use of credit limits helps you manage your A/R?

- Yes
- No
- Credit Limits don't matter because in our company they don't mean anything.
Reviews of Credit Limits

• Regular reviews of credit limits/files should be done:
  – Review your history and customer payment trend
  – Do you have a signed application or contract
  – New Credit report
  – Customer’s potential growth
  – New bank information
  – Trade group information
Exceeded Credit Limits

- Should be Reviewed.
- Is account Prompt?
- Are Other Suppliers Still Selling?
- Have Sales Increased If Yes Why?
- When Was The File Last Updated?
- Has Credit History Changed?
- Does This Customer Have Extended Terms?
- Does Sales Have A Strong Relationship With This Customer?