

YOUR GUIDE WHAT IS THE COST OF CREDIT?

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The best advice any business can follow to ensure they do not experience any credit control issues is to make sure payment is received in full before providing any goods or services.

But with any business to business transactions, unless your product or service is unique and very much in demand, you will find that, by not offering credit terms to your customers, you may put yourself at a competitive disadvantage.



Any decision to offer credit contains an element of risk and involves you, the supplier, in cost.

Costs can be divided into 5 different headings:

- > Lost opportunity
- > Bad debts
- > Administration
- > Financing
- > Extended credit

LOST OPPORTUNITY

You have probably heard the phrase 'Cash is King'. Cash tied up in your debtors is cash that can not be used in your business to pay off your overheads, to invest, or to buy other goods or services to develop your business. You may be able to borrow against cash owed to you by your customers (your debtors ledger balance), which is a business asset, but only at additional cost.

BAD DEBTS

The definition of a 'Bad Debt' is a debt that is unrecoverable and is therefore 'written off' (deducted from) the bottom line (net profit). A debt may become unrecoverable for several reasons.

- > Insolvency - your customer goes into receivership or liquidation (limited company) or bankruptcy (an individual such as a sole trader or partnership)
- > Disputed Invoices - where to pursue the debt through legal channels is not financially viable.

Effective credit management can help you to minimise risk but it will never eliminate it.



ADMINISTRATION

Offering credit to customers will always involve additional administration, which in turn increases costs. Overdue accounts have to be administered effectively to reduce the financial cost to your business of customers paying beyond terms. These costs can include:

- > Stationery and other office expenses
- > Overheads such as heat, rent
- > Salaries for credit staff
- > Setting up costs, status reports
- > Collection costs such as legal fees

It is important to realise, effective credit management skills employed by a business can help to keep the administration and financial costs to a minimum and is well worth an investment in time and cost of training staff to ensure your business has a robust credit policy and a clear 'order to cash' process.

FINANCING

In essence, extending credit means lending money. In providing the customer with a product or service you, the supplier, are lending the customer money, interest free for a defined period. You may be doing this by operating an overdraft and paying interest. Therefore it is vital that finance costs to a business are kept to a minimum by strong credit management procedures.

EXTENDED CREDIT

Late payment can cost businesses an incredible amount of money. It has a significant and negative effect on its ability to pay overheads and manage cash flow. The business may therefore need to increase its own borrowings, and in some cases, may face liquidation. Slow payment also damages the credit reputation of the supplier. The supplier can lose credibility. A further knock on effect is that the risk of bad debt increases - the older a debt becomes, the more difficult it is to collect.

Businesses need to extend credit and therefore must accept the costs incurred.

However, it is vital to understand that these costs must be controlled.

Slow payment and bad debts significantly increase costs and impact on the profitability of the business as a whole.