Nine Methods for Establishing Credit Limits

By establishing credit limits for customers, a creditor retains discretion over credit granting. In other words, it places a ceiling on the amount of orders a company can place and doesn't promise to extend credit further.

While credit limits should not limit sales potential, a company needs to ask itself two key questions: How much exposure it is willing to take with its customer base, and will it be liberal or conservative in its credit granting philosophy? To help answer those questions, companies use different criteria and experience patterns when establishing credit limits. A number of methods that firms use are listed below as well as some of the pros and cons attached to them.

Payment Record

Credit limits can fluctuate depending on the customer's ability to pay on terms. This has the advantage of making credit decisions routine, unless the customer doesn't pay on time, when a more detailed credit review process would be triggered. This type of limit encourages additional sales and is popular with sales staff.

Competition

A company determines the credit limit by matching the amount, or average amount, granted by similar competitors. It uses outside reports and other credit information sources to identify competitive limits. If the creditor is not the same size as comparable competitors or plays a distinctly different supply role—much larger or smaller—it will be difficult to establish reasonable credit limits using this method.

Secured or Unsecured

Lien rights may exist that create voluntary or involuntary security or collateral.

Payment Performance

This popular method adopts a conservative risk management approach and rewards new customers as they continue to do business with the company. It is often used when little payment history is available. While limiting the company's exposure, it does limit the speed at which sales can grow.

Period of Time

Purchases made over a specific period of time such as a week or month cannot exceed the credit limit. This is useful in cases where many shipments may be made to a customer from various company locations. Firms can approve orders in a more routine manner using this method, as long as the overall credit provided does not exceed the credit limit.

Agency Rating

This method is similar to that used for new customers. Companies that use it can set it up to operate routinely. It is fairly simple to communicate credit limits to other departments.

By Formula

Several calculations are made and averaged to determine the credit limit assigned to the customer. Firms use key financial data such as net worth, inventory, current assets and/or net working capital, assuming the customer accommodates the credit grantor's request for information. These data items are divided by the number creditors to determine the amount per creditor. Amounts are then averaged to set the credit limit. However, it may be difficult to obtain an accurate estimate of the number of creditors. This method is often used to calculate a preliminary estimate and is then further developed by one or more of the other methods.

Expectation of Use
Sometimes referred to as requirements, this method sets a credit limit based on the expected dollar volume of credit sales over a period of time such as a year. This figure is then divided by the number of orders expected throughout the designated time period to estimate the credit limit. This method, similar to the formula method, is often used to obtain a preliminary estimate that can be defined further by one or more of the other methods.

Collection
This method reflects confidence in the collection process of the credit granting company.

Financial exposure is greater when credit terms are longer. In the final analysis, profits on the good sales should exceed losses on the bad ones.

Source: NACM's *Principles of Business Credit*