

Things to Consider When Setting and Communicating Credit Limits

Credit limits serve a variety of purposes. Companies can use them as a guideline for order approval, to minimize the upward spiral of orders or to call immediate attention to a change in a customer's purchasing or payment behavior.

Often the tendency is to let the credit limit become simply a matter of course, which means that a company approves any order the customer places. This basis for credit decisions should be reserved for only very substantial and financially sound customers. Consider the following information when working with credit limits:

Setting Limits

Credit departments can automatically approve orders that don't exceed an established limit. Orders that do exceed limits signal a need for further investigation or analysis of the account and could cause a firm to halt shipments to the customer until the situation has been resolved. A formal analysis might set a credit limit high enough to eliminate the need for a review every time a new order is received.

A credit limit is established without regard to the size of any particular order and is generally set at an amount that can be justified by the available credit information. In addition, some companies place an order limit, which specifies the dollar amount that may be released without delay on any single order. This usually serves as a secondary credit check so the customer's file is reviewed when either the credit limit or order limit is exceeded. An order limit may be particularly useful in a decentralized credit organization where it is impractical for order processing points to keep complete records of receivables.

One variation of the credit limit is based upon the amount that the creditor is willing to have outstanding at any time. This method requires complete records of unpaid invoices and of orders approved but not yet shipped. When the total outstanding balance exceeds the limit, any further orders are referred for approval.

Communicating Credit Limit Decisions

Many companies advise their sales department of the credit limits assigned to customers, often expressing the limits in terms of units (300 tons, 20 carloads) or dollars allowed during a given period of time. If, for example, a customer has a credit limit of \$5,000 on terms of 1/10, net/30 and consistently discounts, this customer could be sold from \$10,000 to \$15,000 per month. Because of discount payments, the highest credit would still be expected to remain within the credit limit of \$5,000.

Informing Customers of Credit Limits

There is considerable debate as to the advisability of informing customers of their credit limits. There is no law or regulation that requires such compliance. Of course, a credit grantor cannot discriminate when approving credit, and certain rules apply whenever an adverse action is taken either upon approval or after the account has been established.

In some companies, the credit limit is the maximum amount that will be shipped to the customer before initiating a review of the credit file for that customer. In other companies, it is simply the maximum amount that will be shipped to the customer before that amount is paid down or paid in full. The particular definition depends on the creditor's policy regarding credit extension. There are distinct advantages and disadvantages of advising customers of credit limits. The decision to advise or not to advise is dependent on each creditor's company policy and management philosophy.

Some companies prefer not to establish a firm credit limit, opting instead for a flexible limit based on previous experience with the account. Flexible limits have the advantage of being easy to implement with little impact to the customer and the sales department. Unless payments are not made on time, there may be little need for further involvement at the credit department level. Those who favor a more formal system of establishing credit limits point out that the account may become overvalued quickly. Prompt payments may be a buildup for later—and larger—unpaid orders.