How Much Credit Should You Grant Your Customers?

Credit professionals field questions daily from their sales department, senior management, customers and others along the supply chain. However, one of the most important questions for creditors comes from themselves. "How much credit should I grant my customer?" Pam Krank, president with The Credit Department Inc., reviewed this question in detail this month during a webinar on the topic for NACM. Krank will also dive into credit management data analytics at the 123rd annual Credit Congress in Colorado this May.

To answer this question, it all starts with a credit policy, said Krank. The credit policy sets forth a company's risk tolerance which in turn determines credit strategies which equal credit line recommendations. "Not all credit lines are the same across your customer base," noted Krank. Several factors can determine this including the industry of the customer as well as the global economy.

The probability of a global recession is increasing due to a slowdown in global growth, and creditors don't want to be the last to know of a recession, said Krank. Companies are also looking out for their own best interests and are trying to extend payment terms to help their own cash flow. So, often times the decision on whether to grant credit comes down to a business decision rather than the credit recommendation based purely on numbers.

Traditional methods of setting credit lines revolve around customer payment records, financial data and credit reports, yet not all methods are equally reliable, according to the webinar. Setting lines based on credit reports has some challenges including that not all vendors report and the report is based on factual data; however, reports do give a broad picture of a vendor and can assist in the process. Credit lines based on current customers can increase when they pay within terms (reward performance), but there is some risk with ongoing increases or too much of an increase at one time.

The credit application is also a great tool to help calculate the amount of an unsecured credit line a customer should be given, if at all. Two important pieces of financial data are revenue and accounts receivable totals. Creditors can use these to calculate customer day's sales outstanding to see how fast they are getting paid from their customers. But, the most important piece is the bank release, said Krank. "Bank information is as critical as seeing financials. That's a company's life blood." This helps determine how much credit should be given. If there's no money in the bank, that could mean they have no way of paying back the debt. Creditors want to know where the cash for payment will be coming from. Questions credit professionals should ask the bank include what's the average deposit balance, are there any overdrafts, is there availability on a line of credit, among others.

Once all the information is gathered, the goal is to come up with a credit decision: yes or no, in simple terms. Credit departments must define the size of the balance of the credit line, which is often unique to the business. A credit line of $10,000 might be a large line for a small organization, while to a big-box store, it is considered relatively small.

Credit lines should be based on the capacity of a customer's cash flow and not its assets. They are also based on internal margins and the importance of a customer to your business. However, there are some exceptions like there are to all rules. This goes back to business versus credit decisions. If there is a security option such as a mechanic's lien or personal guarantee, a larger amount of credit might be extended compared to a customer or transaction that has no safety net. Once the credit line decision has been made, the upkeep of the line only begins.

“Credit professionals should never be surprised by a portfolio,” said Krank. Line renewals are based on risk of default and, depending on the size of the risk, a timely review must be considered. Accounts with high risk should have a follow-up every quarter, while lines with a low risk might only be reviewed once a year. Accounts should also be monitored based on new information such as public record changes. “That is the No. 1 indicator of future default besides past bankruptcy—if they didn’t pay taxes and have a federal tax lien. Not paying the federal government likely means you’re not going to get paid,” explained Krank.

There are three main points to consider when determining the amount of credit a customer should receive: establish an internal risk tolerance policy, gather all important data to make the decision based on the size of the credit request and verify the customer’s cash flow.

Michael Miller, managing editor