Paul Robbins training and consultancy

Credit Management

Lesson 2 – Granting Credit and Setting Up Customer Accounts & Customer Accounts – Legal and Ethical Aspects

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Factors Involved in Granting Credit

- The decision on whether to grant trade credit to a prospective customer will involve a range of factors in addition to the accounting ratios:
- **Ownership**
- **Location**
- **Available Information**
- **Sales Policy**

Factors Involved in Granting Credit

- **Ownership** – public sector organisations such as the NHS are very low risk when granting credit as they will always exist and there is almost no risk of them not paying their debts. Large private sector organisations such as Tesco are also low risk, although not as low risk as public sector organisations. Smaller organisations and new ‘start-up’ businesses are higher risk as there is a much greater likelihood of failure, resulting in irrecoverable debts

- **Location** – overseas companies are generally a higher risk than UK companies because it is harder to chase and collect debts in another country. There can be issues with currency risks (due to exchange rate fluctuations) and overseas governments preventing companies sending currency abroad

Factors Involved in Granting Credit

- **Available Information** – established business organisations will be able to provide a range of financial and non-financial information, whereas a ‘start-up’ business without any trading history will not be able to do so, which makes the decision on whether to grant credit difficult. In many cases, a ‘start-up’ business may initially have to trade on cash terms and the decision about granting credit deferred until there is sufficient information available

- **Sales Policy** – if a business is looking to grow, it may be prepared to offer trade credit to customers that are a higher risk than the business would normally allow, in order to gain additional sales. This is ultimately a decision that the senior management of the business would have to make

Refusing Credit

- The decision to refuse credit to a potential customer is a difficult one to make as it may result in lost sales, both now and in the future
- It is important that communicating the refusal of credit is done in a very tactful and diplomatic manner and in writing – failing to do this will most likely result in the potential customer never wanting to do business with us
- The potential customer should be offered the opportunity to trade on a ‘cash basis’ (payment on delivery) for the time being, with the application for trade credit to be reviewed again at some point in the near future

Halfway House Credit

- Whilst the decision on whether to grant trade credit has to be made objectively and in line with credit control policies and procedures, there may be some instances where the management of a company may agree to a compromise situation, in order to avoid the risk of losing a potential customer by refusing to grant trade credit to them

- This is known as ‘halfway house credit’ as the credit terms offered go part of the way towards the full trade credit terms that the customer wanted

- Examples include a shorter credit period (e.g. 7 days) and part cash / part credit terms (e.g. 50% cash on delivery and 50% on 30 days credit terms)

Changing Credit Terms

- An existing credit customer may request changes to their credit terms
- The request may relate to an increase in their credit limit, an increase in the period of trade credit allowed or possibly both
- Any decision on changing credit terms has to be made in line with the credit control policies and procedures, although management may make exceptions
- Before allowing changes to credit terms, it is important to check whether the customer has kept within their existing credit limit and paid invoices on time as requesting an increased credit limit and / or longer payment period can suggest that the customer is experiencing cash flow (liquidity) problems

Objectivity and Granting Credit

- It is essential for people working in credit control to be objective and free from any conflicts of interest, which could result in the credit control policies and procedures not being followed correctly
- Any actual or potential conflicts of interest that a credit controller has should be reported to their line manager who will decide what action to take
- Credit controllers should remain objective throughout all stages of the credit control process, from dealing with prospective customers and the opening of new accounts, dealing with existing customers and collecting outstanding debts. This is done by following the credit control policies and procedures

Opening New Customer Accounts

- When the decision has been made to allow a customer trade credit, their account should be opened immediately and the customer should be informed in writing in a formal letter covering the following elements:
- **The period which trade credit is initially provided for**
- **The credit limit on the account**
- **Credit terms**
- **Discounts available**
- **Payment details and any interest penalties for late payment**

Credit Terms

- The following are credit terms typically offered to customers:
- **Cash Terms** – cash on delivery (immediate payment) with no credit offered
- **30 Days From Invoice / Net 30 Days** – payment is due 30 days after the invoice date
- **Net Monthly** – payment is due on the last day of the month following the month in which the invoice was issued, in other words an invoice issued any time in July will be due on 31 August

Discounts and Interest Rates

- Prompt payment (also known as cash or settlement) discount is where a small percentage discount is given on the selling price in exchange for paying sooner than the standard credit terms allow for

- Offering a prompt payment discount can be seen as attractive when interest rates are high. This is because receiving money earlier will enable the business to either reduce its bank overdraft (payable at a high rate of interest) or invest the money (also at a high rate of interest)

- However, offering a prompt payment discount is not as attractive when interest rates are low. This is because the cost of offering the discount could be higher than the overdraft interest saved or bank interest earned

Calculating Simple Interest Rates

- Annual Cost of Discount (percentage) formula:
- [d / (100 – d)] x [365 / (N – D)] x 100
- Where:
- d = prompt payment discount percentage
- N = normal settlement period in days
- D = settlement period for early payment in days

Calculating Simple Interest Rates

- The business you work for is considering offering a 2% prompt payment discount in exchange for payment of invoices in ten days rather than the thirty days standard credit period. (You should assume that all customers will take advantage of the prompt payment discount offered)

- Tasks:

- Calculate the annual cost of discount as a percentage to two decimal places using the simple interest rate calculation

- The business could alternatively finance its invoices through the use of a bank overdraft with a 15% interest rate rather than offering a prompt payment discount. In this case, which is the better option for the business to use?

Calculating Simple Interest Rates

- Annual Cost of Discount (percentage) formula:
- [2 / (100 – 2)] x [365 / (30 – 10)] x 100 = 37.24%
- Where:
- d = prompt payment discount percentage 2
- N = normal settlement period in days 30
- D = settlement period for early payment in days 10
- It is cheaper to finance the invoices through a bank overdraft in this case

Calculating Compound Interest Rates

- <u>Annual Cost of Discount (percentage) formula:</u>
- [[1 + d / (100 – d)] ^ [365 / (N – D)] -1] x 100
- <u>Where:</u>
- d = prompt payment discount percentage
- N = normal settlement period in days
- D = settlement period for early payment in days

Calculating Compound Interest Rates

- The business you work for is considering offering a 3% prompt payment discount in exchange for payment of invoices in five days rather than the thirty days standard credit period. (You should assume than all customers will take advantage of the prompt payment discount offered)

- <u>Tasks:</u>

- Calculate the annual cost of discount as a percentage to two decimal places using the compound interest rate calculation

- The business could alternatively finance its invoices through the use of a bank overdraft with a 20% interest rate rather than offering a prompt payment discount. In this case, which is the better option for the business to use?

Calculating Compound Interest Rates

- <u>Annual Cost of Discount (percentage) formula:</u>
- [[1 + 3 / (100 – 3)] ^ [365 / (30 – 5)] -1] x 100 = 56.00%
- <u>Where:</u>
- d = prompt payment discount percentage 3
- N = normal settlement period in days 30
- D = settlement period for early payment in days 5
- It is cheaper to finance the invoices through a bank overdraft in this case

Interest Penalties for Late Payment

- Many organisations include the right to charge interest on late payments as part of their contractual terms and conditions for credit customers, although this is often only enforced as a last resort

- The law allowing interest to be charged on late payment of debts is the **Late Payment of Commercial Debts (Interest) Act 1998** modified by the **Late Payment of Commercial Debts Regulations 2013**

- This states that the interest rate that can be charged is the **Bank of England official dealing rate (base rate) plus 8%**. The interest is calculated on the **gross amount** and calculated for the period which the payment is overdue (in days), using a **simple interest rate** (days overdue / 365 days)

Interest Penalties – Worked Example

- The business you work for is owed £1,500 plus VAT from a credit customer
- The debt is 45 days overdue
- The Bank of England official dealing rate (base rate) is currently 0.5%
- ***Calculate the amount of interest which can be charged under the Late Payment of Commercial Debts (Interest) Act 1998, showing your answer to two decimal places***

Interest Penalties – Worked Example

- Formula: Gross Amount x (base rate + 8%) x (days overdue / 365 days)
- = £1,800 x 8.5% x (45 / 365)
- = **£18.86**

Retention of Title (ROT) Clauses

- Retention of Title (ROT) clauses (sometimes known as ‘Romalpa’ clauses) can be included on sales invoices
- These state that ownership (‘title’) of goods sold does not pass to the buyer until the goods have been paid for in full
- If the buyer does not pay for their goods or becomes insolvent, the seller can attempt to recover the goods from the buyer
- This works best where the goods are easily identifiable, but is much more difficult if the goods are either generic or are raw materials which have been included in manufactured products

Credit Insurance

- Credit insurance insures against the risk of loss through irrecoverable debts
- There are a range of credit insurance options available including:
- **Whole Turnover Insurance** – 75% to 90% cover across all trade receivables
- **Key Account Insurance** – 100% cover for a number of important accounts
- **Single Account Insurance** – 100% cover for particular accounts
- **Catastrophe Insurance** – protects against natural disasters

Export Credit Insurance

- Export credit insurance insures against the risk of loss through irrecoverable debts when selling to overseas customers

- This covers:

- **Credit Risk** – the risk of an irrecoverable debt due to the customer not paying and not being able to bring court action against the customer

- **Political Risk** – the risk of an irrecoverable debt due to political events such as overthrowing a government or economic collapse in an overseas country

Contracts

- **A contract is an agreement between two or more parties that is legally binding and enforceable in a court of law**
- Contracts can be written, spoken or even entered into through actions
- Contract law is a part of **civil law** which deals with disputes between two or more parties (a ‘party’ means a person or company)
- If one party does not fulfil part or all of the contract (e.g. does not pay for the work done), or does not do so satisfactorily (e.g. the work is not performed to an acceptable standard), the wronged party can sue for **breach of contract** and, if they are successful, are usually awarded **damages** (compensation)

Elements of a Contract

- Offer
- Acceptance
- Consideration
- Intention to Create Legal Relations

Offer and Acceptance

- The process of offer and acceptance is sometimes known as **agreement**
- The offer may be made by the seller or the buyer of the goods or services
- Once an offer is accepted a legally binding contract is formed
- An offer is different from an **Invitation to Treat** which is basically the seller inviting the buyer to make an offer – advertising usually falls into this category
- An offer may be terminated either after the expiry of a set time limit, if the person making the offer withdraws (revokes) the offer, by the other person making a counter-offer or by acceptance or rejection of the offer

Accepting an Offer

- Acceptance of an offer must be by a **positive action** which could include verbal acceptance, written acceptance or even through an action
- Acceptance must be **communicated** to the person making the offer, if necessary in a specific format (e.g. by email). **Silence or non-response to an offer cannot be interpreted as acceptance**
- There must be an **unconditional acceptance** of the offer made – any new terms introduced are seen as a **counter-offer** which revokes the original offer
- Acceptance which is ‘subject to contract’ is not legally binding until the formal contract is drawn up and signed by both parties

Consideration

- **Consideration is basically giving something of value in exchange for something else of value**
- For instance, when buying goods in a shop the seller (the promisor) agrees to supply the goods (consideration) and the buyer (the promisee) agrees to pay money for the goods (consideration)
- **Consideration must be sufficient but it does not need to be adequate**
- This means that, whilst something of value has to be exchanged, it does not have to be at any particular value – e.g. buying a Ferrari for £1,000 would be legally binding as there is sufficient (but not adequate) consideration

Intention to Create Legal Relations

- For a legally binding contract to exist, there needs to be an intention to create legal relations
- This means that all parties to the contract intend it to be legally binding
- Basically, the courts will interpret commercial agreements as being legally binding and social and domestic arrangements as not being legally binding

Termination of a Contract

- **Completion** – all parties have fully met their contractual obligations
- **Impossibility of Performance (Frustration)** – the contract is unable to be performed due to factors outside of the control of all parties
- **By Prior Agreement** – all parties agree in writing that if certain events happen then either party can withdraw from the contract
- **Rescission** – the contract is void, often due to mistake or misrepresentation
- **Breach of Contract** – one party fails to meet their contractual obligations

Contractual Terms

- **Conditions** – fundamental terms to the contract which, if broken, enable the wronged party to repudiate (end) the contract and claim damages in court
- **Warranties** – additional terms to the contract which, if broken, are not serious enough to enable the wronged party to repudiate (end) the contract, but they are still able to claim damages in court
- **Express Terms** – contractual terms which are explicitly stated in the contract and are binding on all parties to the contract
- **Implied Terms** – contractual terms which, whilst not explicitly stated in the contract are implied by custom and practice or by law

Remedies for Breach of Contract

- Whilst there are a range of legal remedies available for breach of contract, the most common remedy is **damages**, which is monetary compensation
- Sometimes the remedy awarded for breach of contract is **specific performance**, which forces the other party in the contract to complete their obligations under the contract
- The remedy of **quantum meruit** is where a person is awarded as much money as the work that they have done merits or deserves
- The remedy of **action for the price** is very common for unpaid business debts and the courts will award damages to the amount of money owing

Statute Law Relating to Sales

- Trade Descriptions Act
- Consumer Rights Act 2015
- Consumer Credit Act
- Unfair Contract Terms Act
- Late Payment of Commercial Debts (Interest) Act
- Data Protection Act 1998

Trade Descriptions Act

- This prevents manufacturers, retailers and service industry providers from making specific statements that are designed to mislead customers
- This should not be confused with generic advertising statements which are viewed in law as being ‘a mere puff or boast’ e.g. ‘your closest shave ever’
- It is a criminal offence to make false statements about goods offered for sale, for instance claiming that a coat is waterproof when it is not
- It is also a criminal offence to make misleading statements about services, e.g. claiming that a therapy is guaranteed to fully cure all types of back pain

Consumer Rights Act 2015

- The Consumer Rights Act 2015 states that consumers are entitled to expect that any goods that they buy from a seller are:
- **Of Satisfactory Quality** – this means that the quality is of the standard that a reasonable person would expect from an item of that description and price
- **Fit for the Purpose** – this means that the goods actually do what they were designed to do, e.g. a diver’s watch should be able to operate under water
- **As Described** – the goods must actually be what the seller claimed for them to be, e.g. a four-person tent must actually be able to sleep four people
- If any of these are not met, the consumer can claim a refund within 30 days

Consumer Credit Act

- The Consumer Credit Act regulates the majority of credit agreements covering credit cards, store cards, personal loans and bank overdrafts, as well as credit sale agreements, hire purchase agreements and hire (leasing) agreements

- The aim is to prevent consumers being pressured into signing unsuitable credit agreements through allowing them a ‘cooling off period’ during which time they are able to cancel any agreements they have entered into

- The act also states that, for sales of goods and services between £100 and £30,000, the seller and credit provider have equal liability for breach of contract or misrepresentation

Unfair Contract Terms Act

- The Unfair Contract Terms Act protects against any organisation which tries to insist on including unfair terms in its contracts

- For instance, if you took your car to a garage to be serviced and the contract said that the garage would not be liable for any damage incurred to the car whilst it was being worked on, then that would be an unfair contract term

Data Protection Act 1998

- Applies to data held about **identifiable living individuals**, but not companies
- Covers both electronic and paper based records
- Need to be aware of the **eight Data Protection Act principle**s
- *Please note that the whilst the Data Protection Act 1998 is what will be examined on, the law on this changed in May 2018 with the introduction of the General Data Protection Regulation (GDPR) although the two are very similar*

Credit Control and Professional Ethics

- Everyone working in Credit Control needs to ensure that they act ethically at all times by complying with the AAT’s fundamental ethical principles of:
- **Integrity**
- **Objectivity**
- **Professional Competence and Due Care**
- **Confidentiality**
- **Professional Behaviour**