2.0 LITERATURE REVIEW

2.1 What is Credit?
According to the Dictionary of Modern Economics, to ‘give credit’ is to finance, directly and indirectly, the expenditure of others against future repayment. Suppliers’ or producers’ (indirect) credit or commonly referred to as "trade credit" is the focus of this study. To extent "trade credit" means that we are giving time to customers to pay for goods which we have supplied. The credit terms may vary depending on the nature of the business.

In economics term, credit control is a general term denoting the set measures used by the monetary authorities to control the volume of lending by certain groups of financial institutions. However, in the business and commercial context, where non-financial institutions are concerned, credit control denoted the set measures by the traders/suppliers' or producers' of goods to control the volume of credit extended to each if its customers; usually restricting the credit period and the credit limit given to its customers.

According to MMAG 3 – Accounts Receivable Management, “debtors or accounts receivable is generated when an enterprise, having granted credit, accepts, in lieu of cash, a written or implied promise to pay in the future for delivery of goods and services. In today’s business environment, competitive pressures, customer preferences and promotional selling opportunities lead the management of most enterprises to offer credit".
2.2 Why Do Businesses Extend Credit?

Availability of credit is essential and provide a vital stimulus to trade. If everything is to be transacted in cash, then before any trading is done, the financing facilities whether internal or external are required to be arranged to generate immediate cash facilities to pay.

According to Lesley Bernstein (1977), the main inducement on the customer’s side to use credit facilities is that it allows the customer to spread the financial load and budget expenditure. Applying the “trading up” policy, with credit facilities, the customer can buy when he wants to instead of waiting until he actually accumulated the money, and this means that he can buy more appropriately for this needs. Three main advantages are to be gained from credit trading:

• Increased turnover brought about by the attraction of a new range of customers. Greater profits follow, provided, of course, that the costs of giving credit are either fully covered or limited to a proportion of additional overhead costs.

• A larger turnover means that the business can expand. The greater the increase in size, the better and more varied will be the services and merchandise it can offer to the customer.

• A larger turnover leads also to increase buying power, i.e. the trader will be in a position to buy in bulk or negotiate other favourable discount terms. Cost decreases can then either be used to boost profits or passed on in goodwill to the customer.
2.3 The Importance of Credit Control

Credit control is a management tool to assist in the smooth and effective running of a business and is part of the smooth and effective running of a business and is part of the planning and control mechanism of a well run business (LEDU, 1997). It is necessary and important to operate and maintain an effective credit control system in order to ensure that payment are received by the end of the credit period. Otherwise, cash flow problems may arise and might bring down the company despite having profitable business, as the saying goes:

"Sales are sanity
Profits are vanity
But cash flow is King!"

Good credit control should assist in the selling process and enable a business to manage its cash resources to achieve maximum profit. According to Local Economic Development Unit (LEDU) in Northern Ireland’s LEDU Guide to Credit Control, 1997, good credit control is a balancing act between selling, profitability, liquidity and risk. A good credit control management will help to ensure that:

- Sales are only made to a customer, who is likely and able to pay for the goods or services supplied.
- Profits will follow from the sale.
- Profit will crystallize into cash and improve liquidity, which is the blood of any business.
- The risk of selling on credit is kept to a level consistent with the aim of increasing sales.
According to John Argenti, 1976, in his book on “Corporate Collapse – the causes and symptoms” – lack of information and control have been identified as major causes of corporate collapse, particularly in the aspect of credit control and management. Apart from management defects, operating defects such as overtrading, can be directly attributable to lack of credit control and cash flow management.

2.4 Set-up of Credit Control Department

According to John Arnold, the purpose of Credit Control Department is to carry out credit/collection policy with the aim of protecting the debtor asset. Credit is controlled by three basic elements: (1) Credit limits (2) Terms (3) Sound debt collection routines.

It is important to have credit controller in any organisation, whether small or large, or whether using a proper departmental set-up or as an integral part of the Finance and Accounts Department, depending on the size of their customer base or the nature of their business. Credit controller could provide a check-and-balance in the business dealings as sales department, owing to their nature of chasing after sales, would tend to neglect the credit control considerations.

A typical set-up of credit control section whether as an independent department by itself or as a part of the Finance and Accounts Department is to place the management of accounts receivables under the stable of Credit Control
Department. This credit control section or department would be taking charge of accounts receivable management, inter alia.

- Processing credit application
- Credit review and monitoring
- Collections of accounts receivable
- Debts recovery
- Credit Notes
- Settlement of disputes
- Maintaining the full set of accounts receivable subsidiary ledger
- Making decision on issuing stop delivery order or further delivery order
- Managing delinquent account
- Legal recovery – liaising with solicitors

With the above typical set-up, there would accountability on the collection and recovery of account receivables and credit control, it could a part of the Finance and Accounts Department or utilizing some of the same staff for small and medium size businesses where separate credit control department could not be cost effective, but nevertheless, the responsible person could be clearly defined and made accountable and so as to avoid “pointing fingers” as and when credit control and collection issues and problems arisen.

2.5 The Role of the Credit Manager

According to William D. Huber (1999), emerging modern approach credit management emphasis the need to have clear segregation of duties to resolve conflicting interests between sales and accounts receivable recoverability and
responsibilities. Sales personnel can not have the ultimate say over credit limits and credit terms of the customer. Sales are not made just to achieve budget or volume, the emphasis is on profitable volume and taken into account the risks of bad debts.

With such emerging modern approach, the role of credit manager has been given more weight and emphasis and the advent of user-friendly systems and computerised software solutions to managing credit information and establishing control processes, pro-active reporting, monitoring and follow-up could be made possible.

William D. Huber (1999) further outlined the typical work of the Credit Controller in promoting business transformation and becoming one of the most influential voices of the company with their key customers and other companies:

- Determination of credit policy and implementation of the policy.
- Credit risk evaluation of key customers
- Establish payment terms and credit limits and safeguarding the company's profits through risk mitigation via credit security policies such as requesting collaterals such as bank guarantees, corporate or personal guarantees, cash only policy.
- Collect credit information from BASIS/CTOS/Dun & Bradstreet, local sales force, other credit managers, audited accounts, bank statements, etc.
- Contribute to the company's profits through diligent credit assessment, application and control without burdening the system with excessive conservatism resulting in lost sales.
- Effectively help marginal accounts to turn around into very reliable and profitable customers.
• Cross-functional participation in issue resolution, training of sales personnel as well as customer’s personnel for the enhancement of policies, procedures and practices.
• Consistently seek additional means for gathering market intelligence: sales force, other credit managers, trade press, audited accounts, etc.
• Provides management (especially sales and finance) with a clear, focused and objective view of financial consequence of their credit management and collection practices.

At the same time, while the Credit Manager may be better informed and educated, and have many more tools such as automated decision solutions, credit scoring systems, etc.- the critical human factor in the evaluating credit decisions, human judgement or guesswork or intuition will always be a part of the credit manager’s responsibility mixed in with the subjective qualitative assessments and the objective financial analysis of a customer – a computer can only tell us if the figures are feasible, only a Credit Manager has “a gut feeling”!

2.6 Duties of tomorrow’s credit manager

With the emphasis on credit management, tomorrow’s credit managers would no longer be those unqualified employees and assisted by clerks. Nevertheless, as effective credit management has yet to be high in priorities, it would be difficult to recruit personnel of the requisite qualifications and experience in Malaysia.

Stephen Barratt (1999) proposed the below emerging new roles that tomorrow’s Credit Manager must play in addition to the traditional disciplines:
• **Deploying organisational philosophy** – by understanding a company’s core business at all levels and tailoring credit policies to complement and nurture the same.

• **Understanding strategic planning** for the whole organisation – credit management must learn to look beyond traditional boundaries. A broad and informed view of every aspects of their business is the key to integrating Credit Management into the overall company structure. Knowledge of manufacturing, sales and marketing; and detailed understanding of the industry in which the organisation operates and the factors that influence the industry are essential.

• **Leadership** – Credit managers would no longer other tasks i.e. Office Manager, Personnel Manager or Assistant Accountant. They will assert their importance by providing confident highly visible leadership within the Credit Department and elsewhere. The voice of Credit Manager must become as influential as that of the Sales Manager.

• **Improved communication skills** – implementation of effective credit policy now requires high negotiation skills at all levels and across all boundaries and runs effective meetings.

• **Creating teams** with external and internal players – creating smart partnerships with lawyers, debt collection agency and inter-department staff, etc. would provide added value to the Credit Department.

• **Defining and complying with processes** – compiling and ensuring compliance with operations manual and policies using “systems”.

• **Direct interface with customers** at a much wider level – helping the sales team to make a sale by proactive ways such as “pre-checking” the credit worthiness and offering advice to customers experiencing financial difficulties.

Stephen Barratt(1999) also noted the following additional advanced skills which are the keys to unlock the future role of Credit Managers:

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1. **The Internet** – wide variety of information is available to credit managers. On-line credit search or company search (Dun & Bradstreet / BASIS) are also available.

2. **Outsourcing** – no need to develop “in-house” collection software system as reliable, proven, integrated systems are now available. Use of debts collection agencies for over a certain period would enable more time to be spent on crucial matters and allow specialists utilisation.

3. **The computer** – Credit Managers must be highly computer-literate as the central to the information revolution is the computer.

- Other technologies – allied technological aids to future Credit Managers are:

1. **Credit scoring** – software applications that provide technical method of evaluating the credit worthiness of potential customers by using formula for financial analysis with the benefits of speed, accuracy, consistency, reduced personnel cost and more informative management reports.


3. **E-mail** – instantaneous and cheaper than facsimile and the advantage of retrieving, editing and printing document files.


5. **Advanced Communications** – such as video conferencing.

6. **Predictive Dailing** – computer scheduled automatic dailing of debtors by telephone collectors (tele-collectors) and modern call centre technologies such as Call Line Identification (CLIP) and Computer Telephony
Integration (CTI). As a debtor is called, often automatically, all file details come up on-screen and results can be entered.

7. **On-line banking** – Electronic Funds Transfer (EFT) would widely used and allow constant access to statements, etc.

8. **Point-of-sale Device** – mobile hand-held units such like mobile phones, enable credit card payment to be taken on the spot.

Barratt (1999) further illustrated the below future business transformation:

**Figure 1:** The Future of Credit Managers' Role in Paperless Environment

Based on Figure 1 above, business processes in this new millennium will be transformed into a paperless environment and accordingly, the role of credit managers and the method of credit management would need to be transformed in line with the new environment as illustrated below:
• New customer information

Application for credit account would be done on-line. Customers can download application for credit from or apply on-line or via electronic mail (e-mail). Upon receiving the credit application, the Supplier could process the application and obtain customer’s further information from the customer’s website and credit search, etc. If communication is required, video conferencing could done without both parties leaving their office and provide personal contact instantaneously.

• Order entry/invoicing/cash receipts/credit memos

Using EDI, orders can be received, processed and shipped with minimal human intervention. Invoices are processed and sent to customer via EDI and posted to a data file for reference with no hard copy required in this paperless environment.

Details relating to any payment difference are similarly communicated between vendor and customer. Returns, over, short and damaged product is “video-taped” (photo-scan) and transmitted to vendors with reports tying physical product to values in questions, so appropriate adjustment can be made timely. All payments are received electronically via electronic fund transfer (EFT) or via Secured Electronic Transaction (SET).

• Credit analysis/collection efforts/communication

With all on-line and paperless transactions, analysis will be on-line with updated information at our finger tips. All payments received are immediately reflected on customer accounts and the system will automatically calculate days outstanding (DSO) by invoice rolled up by product line to total customer level.
Payment trend details and analysis are available for review and serves as an important tool in discussions with customers and management. Overdue customers are continuously monitored to prevent new orders from shipping.

Communications is performed through the system so that all concerned are made aware of these situations as and when they arises and what action is required (e.g. payment, deduction or payment commitment) before orders can be released.

Credit departments are systematically linked with the sales department’s staff and customers to quickly communicate vital information about orders, invoices, deductions and myriad of other issues associated with doing business in this age of technology.

As a conclusion, the Credit Managers of Tomorrow will have to be a multi-talented, highly flexible, self-motivated achiever of the highest order. They must be hands-on with information technology’s (IT) applications. Technology may reduce the number of credit personnel due to its easy accessibility via IT and may also lead to centralisation of Credit Departments.

2.7 Debtors/Accounts Receivable Management

Working capital management would encompass current asset management (cash management, inventory management and accounts receivable management) and short-term financing (accruals, accounts payable, short-term bank loans) and the cash conversion cycle (Brigham,Gapenski & Ehrhardt
Accounts receivable often constitute a significant portion of assets and are, therefore, a major business investment. Successful control of the accounts receivables process demands development of appropriate credit, collection and financing policies comparable to enterprise's profit, liquidity and market share.

It was noted that the aftermath of the 1997 financial crisis in Malaysia had lead to a tighter form of credit control with shorter terms and very much emphasis placed on collaterals and in several circumstances, oil and gas companies such as Shell Trading Malaysia Sdn Bhd or building materials manufacturers such as Pahang Cement Marketing Sdn Bhd and Malayan Cement Berhad (Blue Circle Group) strictly imposed a 100% collateral requirement either on bankers' guarantee or letter of credits (LC) on its distributors/dealers. (Source: Writer's dealings with them in the course of business).

Long established trading companies now began to realise that businesses based on 'trust' alone, i.e. giving credit without documentation and on mutual trust and understanding that one will supply whilst the other would pay when it is due, is no longer suffice in this changing business environment. The objectives of accounts receivable management are:

- To ensure that all sales are paid for, within the agreed period of credit, without alienating customers, and
- To administer and collect debts with minimum cost.
Accounts receivable management begins with the decision whether or not to grant credit and ends when settlement is received in payment for the goods or services provided. According to Van Horne (1983), the credit evaluation process involve three main related steps:

1. Obtaining information on the credit account applicant,

2. Analysing information to determine the applicant's credit-worthiness,

3. Making the credit decision — establishes whether credit should be extended and if so, what is the credit limit and the credit terms and any other conditions.

The above credit evaluation process would be further discussed in the ensuing sections.

2.8 Credit Policy & Practice

According to paragraph 3 of The Malaysian Management Accounting Guideline (MMAG) No. 3 - Accounts Receivable Management issued by the Malaysian Institute of Accountants (MIA), accounts receivable policy development is subject to internal and external business constraints and require careful evaluation of the policy's potential impact on:

- sales volume
- cash management objectives and procedures
- direct and indirect costs of receivables management, and
- customer relations
Accounts receivable policy should be reviewed at least annually since policy changes could be required to adjust for changing internal and external conditions, such as:

- changing business objectives
- varying competitive industry standards
- fluctuating interest and foreign exchange rates
- inflation
- rapidly increasing credit volume
- technological advances
- global trade pattern trends

2.8.1 Accounts Receivable (AR) Policy Formulation

According to MMAG 3 (paragraph 7), it is critical that the accounts receivable (AR) credit, collection and financing policies complement marketing, sales and production policies and, therefore, be compatible with the enterprise’s overall objectives. The policies should be clearly communicated in writing to ensure effective AR management and credible, consistent customer contacts.

2.8.2 Credit Policy

Wong Y.K.(1994) stated that the purpose of the credit policy is to define the credit management department function and its responsibilities as well as to set down the objectives of credit management. The function of credit management is to protect the investment in accounts receivable of the company, as well as to
maintain the lowest level of receivables, commensurate with the inherent risks in achieving sales objectives.

According to MMAG 3 (paragraph 8), factors that could constrain or influence credit policy include:

- ability to finance the credit policy
- industry credit terms
- competitive issues
- the size of customer base and relative profile of major customers
- sales volume
- late payments and defaults
- promotional activities that may require a target market base
- sovereign risks and credit policy on export sales

Five (5) variables that establish the terms of sales and the acceptable level of credit risk:

1. **Credit Quality Standard** – the 5 Cs of Credit i.e. character, capacity, capital, collateral and conditions. Information concerning a customer’s credit worthiness can be obtained from many sources:
   - previous credit sales experience with the customer
   - external credit information available from public reports e.g. newspaper
   - credit association reports
   - credit reporting agencies such as Dun & Bradstreet
   - other major vendors
   - financial institution such as the customer’s bank
The information gathered could be summarised in a credit report which typically include the following information:

- corporate summary financial statements, key ratios and trend analyses,
- a credit history showing payment timing, credit limits and any actions that have been necessary to secure payment,
- a precise identification and description of the enterprise’s operations,
- a description of the owners and managers, their background, and strengths, and pertinent details such as lawsuits and bankruptcies, and
- a summary credit classification rating.

2. **Credit Period** – length of time credit is granted.

3. **Credit Terms** – payment terms normally specified on the contractual documents, for example:

   - cash before delivery (CBD) or cash on delivery (COD)
   - cash terms – payment period of about 5 to 10 days
   - invoice terms- stipulate a net due date and a discount date.
   - periodic statements – statement of account terms
   - seasonal dating – payment is due on a date during the buyer’s season
   - consignment sales – to pay only when the goods have been sold.

4. **Discounts and Surcharges** - cash discount policy can be established to conform to industry norm or to stimulate or expedite receipt of cash. To be
effective, the discount rate must be higher than the customer’s borrowings interest rate.

5. **Credit Limits** - must be established for every account and must be reviewed regularly to ensure the credit limits remain appropriate, given business or other major changes.

### 2.8.3 Credit Instruments

Credit instruments are written payment contracts agreed to by the company and its customers which ranges from simple invoice to formal credit arrangements that are selected to reduce credit risk. Four major credit instruments are:

- open account-credit account based on invoice & acknowledged delivery order
- promissory notes – stricter credit obligation, for negotiated customised terms
- conditional sales contract (installment credits) – e.g. easy payment scheme
- documentary credits – for example, (a) letter of credit – payment made by bank & complying with all conditions, (b) commercial draft e.g. demand draft.

### 2.8.4 Payment Methods

Acceptable payment methods include advance payments, cash, cheque, credit card, or electronic funds transfer (EFT). Implications associated with each method should be assessed. Factors to consider when determining possible payment methods:
- provision of law concerning legal tender,
- standard trade practices,
- cost of processing,
- cash flow implications, and
- impact on collection risk

2.8.5 Collections Policy

The collection policy should specify:

- the employee directly responsible for maintaining the policy,
- cash management techniques to be used to optimise cash inflow (including prompt invoicing),
- a statement routine and payment processing method,
- responsibilities of sales staff and other employees who could have a negative or positive impact on collections,
- the consistency with standard procedures to be enforced,
- alternative methods to reduce risk of non-collection and circumstances of application, and
- a detailed procedure for handling past due accounts.

2.8.6 Credit Insurance

Collection risk can be reduced via shifting some of the risk of bad debts to a third party by purchasing credit insurance. The insurer and the company would share a percentage of the loss above the negotiated deductible amount. The risk level
had to be high enough (that would threaten the viability of the company) to warrant the insurance premium. Nevertheless, credit insurance is not popular in Malaysia at this moment.

2.8.7 Overdue Accounts

Collecting overdue accounts can be costly in terms of direct expenses and customer goodwill. The negative aspects of pursuing collections should be balanced against the benefits achieved by minimising the number of lost accounts, and reducing and controlling the collection period. Written procedures for collection process should outline:

- control and reporting mechanism;
- signing responsibilities for authorisation of adjustments, credits, returns, discounted items, bad debt write-offs and exceptions to established policy; and
- information required to prepare summary collection performance report.

In situation where customer with an overdue account may request further credit and the decision must be made concerning the steps to be followed until that customer has been re-established as a normal credit risk, the below policy actions could be applied:

- request prompt payment of the account,
- withhold approval or refuse to ship further goods until all past due payments are made,
- withhold approval until a partial payment is made, or
- refuse further credit.
Legal action can be initiated should be taken only after all collection avenues has been exhausted. If repossession of goods is required, the policy should be clearly stated and the rights of both parties must be clearly understood because wrongly action has legal consequences.

Management may decide to hire a **debt collection agency** to handle overdue accounts when the company's routine has been exhausted.

### 2.8.8 Collection Policy Review

The collection policy should be reviewed periodically to ensure it remains appropriate and effective – an analysis of collection cost compared to results achieved should be included. If changes to the collection policy must be carefully evaluated with respect to:

- influence on sales and net income,
- estimated collection period,
- effect on the debt loss percentage, and
- customer reaction.

Legal implication should be also evaluated on any policy changes.

### 2.8.9 Financing Policy

The company can finance accounts receivable internally or externally

- with its own resources – internal financing
- through financial institutions – external financing
- with resources from an external source using methods such as,
- with externally issued retail credit card system (e.g. VISA, Mastercard)
- private label financing – similar to credit card but the credit function is performed in the name of seller
- pledging of accounts receivable- known as invoice discounting in Malaysia
- **factoring** – the sale of receivables would be highlighted in this study.

2.8.10 Accounts Receivables Procedures

MMAG 3 further elaborated in detail the accounts receivable procedures which should be considered in writing up a procedure manual in relation to:

- Credit Approval Procedures
- Collection Procedures
- Processing Payments
- Past Due Accounts

2.9 Policy and Procedure Analysis and Amendments

2.9.1 Monitoring standards

A monitoring system is important to monitor receivables on a regular basis for comparison with industry and budgeted standards as without it, receivables will build up to excessive levels and cash flows will decline, and bad debts will offset the profits on sales. According to MMAG 3, several commonly used monitoring calculations are as follows:
• Historical trend analyses – of credit acceptance levels and bad debts losses

• Credit Acceptance Index – the percentage of credit applications approved

• Bad Debt Ratio – losses from unpaid credit sales over total credit sales

• Days Sales Outstanding (DSO) – the average collection period

• Ageing Schedule – grouping of outstanding receivables by account age

• Payment Pattern Approach (or Balance Pattern Analysis) – schedule for monthly uncollected receivable balances that remain outstanding at the end of each quarter.

Days sales outstanding (DSO) and debtors ageing analysis/schedule are commonly used and analysis must be constantly monitored in order to:

• detect trends.

• monitor how the company’s collection experience compares with its credit terms.

• monitor how effectively the credit department is operating in comparison with other firms in the industry.

If the DSO starts to lengthen, or the ageing analysis begins to show an increase percentage of overdue (past-due) accounts and it is not due to sales fluctuations (seasonal variation that distort DSO and ageing analysis), then the company’s credit policy may need to be tightened. Correction action is often needed, and the only way to know whether the situation is getting out of hand is with good receivables control system.
In Malaysian application, according to **Selangor & Federal Territory Machinery Hardware Merchants Association (SAFMA)**, the speed of mailing invoices after delivery of physical goods is of primary importance as customers would take the invoice date to be the date of commencement of credit period. It is common for companies to date their invoice to be the same as the delivery order date. Some companies would mail their invoices almost immediately or at the same time with delivery order.

However, in hardware and building materials industry according to SAFMA, their members normally ensure that their delivery orders are duly signed and acknowledged receipt by their customers before the invoicing (though the invoice date would still be dated the same as the delivery order date). This is to reduce the number of credit notes for wrong billings. This is especially important for products like steel products where the final quantity or weight could only be determined upon actual physical delivery of goods.

For simplicity reasons, SAFMA members do not follow exact credit period on their credit accounts. They do not calculate the credit period based on per invoice basis. Instead, credit period are mainly operating on monthly basis, i.e. if the credit terms is sixty days (60 days), all invoices billed on August 2000 must be settled by 31 October 2000. This means that takings in the earlier days of the months would enjoy more than 60 days credit as the credit period is calculated from the last day the takings’ month. This practice is intended to avoid
inconvenience and time consumption in identifying the exact credit period for each invoices.

On the other hand, for very short credit term transactions that are below 30 days, the credit period would run from each of the invoice date. For example, if an invoice is strictly 14 days, then it must be paid with the half month period calculated from the date of invoice. In practice, it is usual for SAFMA members to segregate or distinguish the short credit term invoice from the normal credit term invoice for any one customer.

Statement of accounts needed to be mailed promptly and as soon as possible to enable customers to verify the total invoices due for the respective month and to avoid any omission of payment on invoices that are due for payments and to ensure all purchases and credit notes are taken in and payments have never been made for the outstanding balance due on the statement of account.

2.9.2 Policy Analysis

Accounts receivable policy must be reassessed at least annually to ensure that it remains consistent with

- corporate marketing and financial objectives,
- industry norms, and
- consumer expectations.

It is necessary to understand the impact on related elements and to anticipate the probable reactions of customers and competitors in evaluating proposed receivables policy changes.