Advanced Professional Certificate in Working Capital Management

Credit Policy and Risk Management

Credit Policy

A credit policy is a set of guidelines that a business uses to determine whether to extend credit to customers and on what terms. The credit policy outlines the criteria used to evaluate customers' creditworthiness, the maximum credit limit for each customer, and the process for collecting past-due payments. A well-designed credit policy can help a business manage its accounts receivable, reduce the risk of bad debts, and improve cash flow.

Key terms and vocabulary related to credit policy include:

* **Creditworthiness**: The ability of a customer to repay a loan or credit extended by a business. Creditworthiness is typically determined by evaluating a customer's credit history, financial statements, and payment behavior.
* **Credit limit**: The maximum amount of credit that a business is willing to extend to a customer. Credit limits are typically based on the customer's creditworthiness and the level of risk associated with extending credit.
* **Credit evaluation**: The process of assessing a customer's creditworthiness. Credit evaluations typically involve reviewing the customer's financial statements, credit history, and payment behavior.
* **Credit risk**: The risk that a customer will be unable to repay a loan or credit extended by a business. Credit risk can be managed by setting credit limits, evaluating creditworthiness, and monitoring payment behavior.
* **Accounts receivable**: The amount of money owed to a business by its customers for goods or services that have been delivered but not yet paid for. Accounts receivable is typically reported as an asset on a business's balance sheet.
* **Days sales outstanding (DSO)**: The average number of days it takes for a business to collect payment for its accounts receivable. DSO is a measure of a business's efficiency in collecting payments from its customers.
* **Bad debts**: Accounts receivable that are unlikely to be collected due to the customer's inability to pay. Bad debts are typically written off as losses on a business's financial statements.

Risk Management

Risk management is the process of identifying, analyzing, and mitigating risks that could negatively impact a business's operations, financial performance, or reputation. Effective risk management can help a business protect its assets, reduce uncertainty, and improve decision-making.

Key terms and vocabulary related to risk management include:

* **Risk**: The possibility of loss or harm due to exposure to uncertain events. Risks can be categorized as strategic, operational, financial, or reputational.
* **Risk identification**: The process of identifying potential risks that could affect a business. Risk identification typically involves conducting a thorough analysis of the business's operations, processes, and external environment.
* **Risk analysis**: The process of evaluating the likelihood and impact of identified risks. Risk analysis typically involves quantifying the potential loss associated with each risk and determining the probability of the risk occurring.
* **Risk mitigation**: The process of reducing or eliminating the impact of identified risks. Risk mitigation strategies can include avoiding the risk, transferring the risk to another party, reducing the likelihood of the risk occurring, or accepting the risk.
* **Risk management framework**: A structured approach to managing risks that includes policies, procedures, and controls. A risk management framework typically includes a risk management plan, a risk assessment process, and a risk monitoring and reporting process.
* **Risk appetite**: The level of risk that a business is willing to accept in pursuit of its objectives. Risk appetite is typically established by senior management and is based on the business's risk tolerance, risk capacity, and risk strategy.
* **Risk tolerance**: The amount of risk that a business is willing to accept in pursuit of its objectives. Risk tolerance is typically established based on the business's risk appetite and risk capacity.
* **Risk capacity**: The amount of risk that a business can afford to take based on its financial resources, organizational structure, and risk management capabilities.
* **Enterprise risk management (ERM)**: An integrated approach to risk management that considers the entire organization and its interconnected risks.

Examples and Practical Applications

Credit Policy

A business's credit policy should be tailored to its specific needs and risk appetite. For example, a business that sells high-value goods on long payment terms may have a more rigorous credit policy than a business that sells low-value goods on cash-on-delivery terms.

A credit policy typically includes the following elements:

1. **Credit evaluation criteria**: The criteria used to evaluate a customer's creditworthiness. This may include the customer's credit history, financial statements, payment behavior, and industry risk.
2. **Credit limit determination**: The process for determining the credit limit for each customer. Credit limits may be based on the customer's creditworthiness, order size, and payment history.
3. **Credit approval process**: The process for approving credit applications. This may include a credit application form, a credit evaluation checklist, and a credit approval committee.
4. **Payment terms**: The terms under which credit will be extended, including the due date, late payment fees, and interest charges.
5. **Collections process**: The process for collecting past-due payments, including invoicing, follow-up

calls, and legal action.
6. **Risk management**: The process for managing credit risk, including monitoring payment behavior, setting credit limits, and evaluating creditworthiness.

Risk Management

Effective risk management requires a systematic and proactive approach. The following are examples of risk management strategies that businesses can use to mitigate potential risks:

1. **Risk avoidance**: Avoiding activities or processes that pose a significant risk. For example, a business may choose not to enter a new market if the potential risks outweigh the potential benefits.
2. **Risk transfer**: Transferring the risk to another party, such as an insurance company. For example, a business may purchase insurance to protect against property damage or liability claims.
3. **Risk reduction**: Reducing the likelihood or impact of a risk. For example, a business may implement safety procedures to reduce the risk of workplace accidents or install fire suppression systems to reduce the risk of property damage.
4. **Risk acceptance**: Accepting the risk as a cost of doing business. For example, a business may accept the risk of market volatility as a normal part of operating in a particular industry.

Challenges

Effective credit policy and risk management require ongoing monitoring and evaluation. Businesses may face the following challenges:

1. **Changing market conditions**: Changes in the market, such as new competitors, changing customer preferences, or economic downturns, can impact a business's credit policy and risk management strategy.
2. **Lack of data**: Inadequate data or poor data quality can make it difficult to evaluate creditworthiness or identify potential risks.
3. **Regulatory compliance**: Compliance with regulations related to credit reporting, data privacy, and financial reporting can be complex and time-consuming.
4. **Resource constraints**: Limited resources, such as staff, budget, or technology, can make it difficult to implement and maintain effective credit policy and risk management processes.
5. **Cultural resistance**: Resistance to change or a lack of understanding about the importance of credit policy and risk management can hinder implementation and adoption.

Conclusion

Credit policy and risk management are critical components of working capital management. A well-designed credit policy can help a business manage its accounts receivable, reduce the risk of bad debts, and improve cash flow. Effective risk management can help a business protect its assets, reduce uncertainty, and improve decision-making. By understanding key terms and concepts, businesses can develop and implement credit policy and risk management strategies that are tailored to their specific needs and risk appetite.