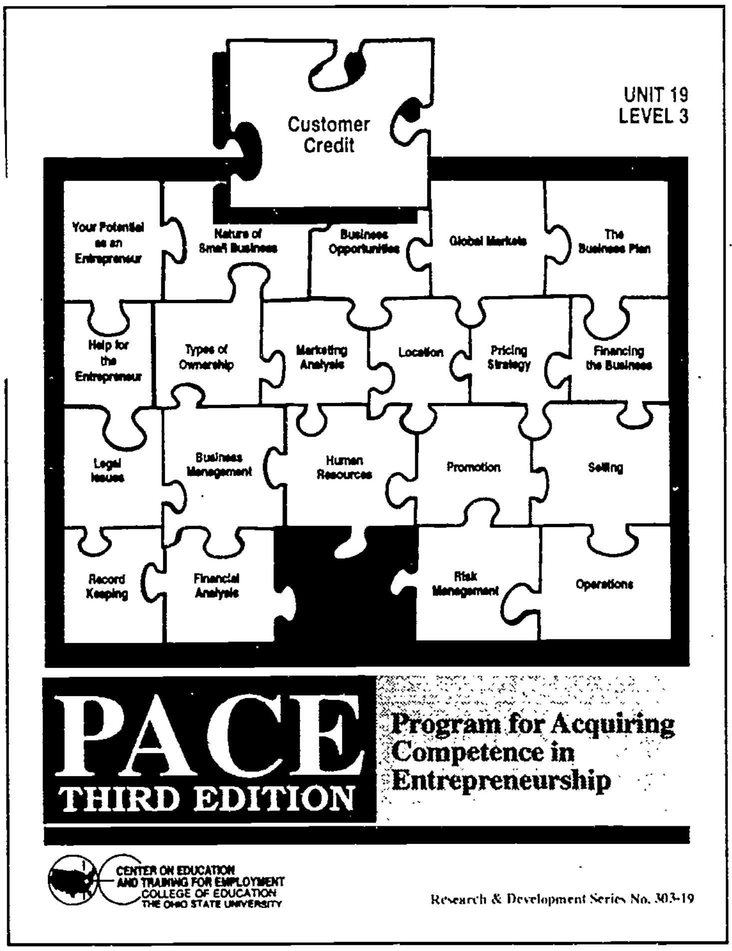
DOCUMENT RESUME

ED 373 256 CE 067 090

TITLE	Customer Credit. Unit 19. Level 3. Instructor Guide. PACE: Program for Acquiring Competence in Entrepreneurship. Third Edition. Research & Development Series No. 303-19.
INSTITUTION	Ohio State Univ., Columbus. Center on Education and Training for Employment.
PUB DATE	94
NOTE	32p.; For the complete set, i.e., 21 units, each done at three level , see CE 067 029-092. Supported by the International Consortium for Entrepreneurship Education, the Coleman Foundation, and the Center for Entrepreneurial Leadership Inc.
AVAILABLE FROM	Center on Education and Training for Employment, 1900 Kenny Road, Columbus, OH 43210-1090 (order no. RD303-19 IG, instructor guide $4.50; RD303-19 M, student module, $3; student module sets, level 1--RD301M, level 2--RD302M, level 3--RD303M, $45 each; instructor guide sets, level 1--RD301G, level 2--RD302G, level 3--RD303G, $75 each; 3 levels and resource guide, RD300G, $175).
PUB TYPE	Guides - Classroom Use - Teaching Guides (For Teacher) (052) -- Guides - Classroom Use - Instructional Materials (For Learner) (051)
EDRS PRICE	MF01/PC02 Plus Postage.
DESCRIPTORS	Behavioral Objectives; Business Administration; *Business Education; *Competency Based Education; *Credit (Finance); *Entrepreneurship; Learning Activities; Money Management; Postsecondary Education; Secondary Education; *Small Businesses; Teaching Guides
IDENTIFIERS	*Customer Services; *Program for Acquiring Competence Entrepreneurship

ABSTRACT

This instructor guide for a unit on customer credit in the PACE (Program for Acquiring Competence in Entrepreneurship) curriculum includes the full text of the student module and lesson plans, instructional suggestions, and other teacher resources. The competencies that are incorporated into this module are at Level 3 of learning--starting and managing one's own business. Included in the instructor's guide are the following: unit objectives, guidelines for using PACE, lists of teaching suggestions for each unit objective/subobjective, model assessment responses, and overview of the three levels of the PACE program. The following materials are contained in the student's guide: activities to be completed in preparation for the unit, unit objectives, student reading materials, individual and group learning activities, case study, discussion questions, assessment questions, and references. Among the topics discussed in the unit are the following: the relevance of customer credit, guidelines for granting credit, legal rights of credit grantors, managing credit and collection, and credit promotion plan. (KC)



INSTRUCTOR GUIDE

Unit 19

Customer Credit

Level 3

Objectives:

- Analyze the relevance of customer credit for your business.
- Develop guidelines for granting credit in your business.
- Analyze the legal rights of credit grantors.
- Design a system for managing credit and collection.
- Prepare a credit promotion plan.

HOW TO USE PACE

- Use the objectives as a pretest. If a student is able to meet the objectives, ask him or her to read and respond to the assessment questions in the back of the module.
- Duplicate the glossary from the *Resource Guide* to use as a handout.
- Use the teaching outlines provided in the *Instructor Guide* for assistance in focusing your teaching delivery. The left side of each outline page lists objectives with the corresponding headings (margin questions) from the unit. Space is provided for you to add your own suggestions. Try to increase student involvement in as many ways as possible to foster an interactive learning process.
- When your students are ready to do the *Activities*, assist them in selecting those that you feel would be the most beneficial to their growth in entrepreneurship.
- Assess your students on the unit content when they indicate they are ready. You may choose written or verbal assessments according to the situation. Model responses are provided for each module of each unit. While these are suggested responses, others may be equally valid.

Objectives	Teaching Suggestions
1. ANALYZE THE RELEVANCE OF CUSTOMER CREDIT FOR YOUR BUSINESS	
Is offering credit relevant for your business?	Introduce students to the general issues related to customer credit.
What considerations should be included in credit and collection policies?	Have students express their opinions on what factors entrepreneurs should consider when making credit decisions.
2. DEVELOP GUIDELINES FOR GRANTING CREDIT IN YOUR BUSINESS	
What are some examples of easy going and strict collection policies?	Have students compare their own business' credit policies with those of other firms. Clearly distinguish between credit and collection aspects.
3. ANALYZE THE LEGAL RIGHTS OF CREDIT GRANTORS	
What are your legal rights in utilizing secured versus unsecured recovery devices.	For this entire section it would be most useful to have an attorney as a speaker. Prepare students in advance by defining the new concepts introduced in this unit.
What are the legal rights of the secured party?	Link the concepts of secured loan, chattel mortgage, bailment lease, and repossession rights.
What are the legal requirements for open-end and closed-end credit?	Ask students to define open-end and closed-end credit. Lead questions and answers to gauge the student's comprehension.
What should open-end credit advertising disclose?	Have students compare open-end and closed-end credit advertisement disclosures. Sample credit advertisements or applications would be helpful.
What should closed-end credit advertising disclose?	Refer to above suggestion.
What are provisions of the Truth in Lending Act?	It would be useful to provide students with copies of legal provisions of the Equal Credit Opportunity Act.
What are the provisions of the Equal Credit Opportunity Act?	Divide the class into teams. Have team representatives debate the requirements of the Equal Credit Opportunity Act. Open the discussion with a historical perspective of credit before this regulation was enacted.
What are the provisions of the Fair Credit Reporting Act?	The instructor should handout copies of credit report forms from the local credit bureau.
4. DESIGN A SYSTEM FOR MANAGING CREDIT AND COLLECTION	
What credit information management resources and systems are available?	Acquaint students with various sources of credit information available to entrepreneurs. Have students do library research to gather more information about these sources.

Objectives	Teaching Suggestions
How can credit be managed?	Have students solve problems on credit limits. (Use the example provided in the text or from your own examples).
5. PREPARE A CREDIT PROMOTION PLAN	
What are some illegal collection practices?	Role play types of legal and illegal collection practices.
What various collection procedures are used?	Have students write short reminders for past due bills. They should compare their reminders with the one provided in the text.
What are some examples of a collection letter series?	Refer to above suggestion. It is critical for students to get used to the wording of this type of letter.
How can credit promotions be planned and implemented?	Engage students in a discussion on relationships between credit policies and promotions. Strongly highlight the importance of credit in marketing.
What are some sources of new credit accounts?	Have students list sources of new credit accounts. Refer again to the relationship between credit and marketing.
How can new accounts be obtained?	Have students express their own ideas on how entrepreneurs can open new accounts.
How should a credit promotion letter be written?	Have students write a credit promotion letter. They should compare their letters with credit promotion letters used by other firms.
What are some reasons for contacting inactive and active clients?	Restate to students the importance of maintaining and increasing the credit client base.
Why should credit be continually promoted?	Use a local newspaper or magazine to demonstrate the importance of credit promotion.

MODEL ASSESSMENT RESPONSES

1. Granting credit to customers can increase the sales and thus, improve the cash flow. Wise credit policies allow the entrepreneur to spend more time on selling products rather than collection activities.

2. Open-end credit plans allow customers to continuing charging as long as they meet their monthly payments. Interest is computed on the amount owed each month. Under closed-end credit plans, clients charge their accounts only once, when they buy the merchandise, and then they pay for it on a installment basis. The total interest owed is predetermined.

3. Open-end credit advertisements must disclose (1) the time period when the client must pay the credited amount in order to avoid financial charges; (2) the method of computing the balance on which the finance charge is based; (3) the method of computing the finance charge, including any minimum charge; and (4) the annual interest rate stated in its exact terms.

4. Closed-end credit advertisements should disclose: (1) the amount of down payment requested (or the fact that no down payment is required); (2) the total number of payments, their exact amount and due dates; (3) the annual interest rate; (4) the total cost to the buyer (the deferred payment price).

5. Regulation Z (or the Truth-In-Lending-Act) controls the information needed by consumers to compare different credit sources, use of credit cards, settlement of disputes over credit accounts errors, and information that must be disclosed by credit issuers.

6. The Equal Credit Opportunity Act (or Regulation B) attempted to remedy injustices regarding credit discrimination against women. In the past, creditors would not grant equal credit opportunities to men and women.

7. Legal security devices used by the credit grantors include: (1) conditional sale, (2) chattel mortgage, and (3) bailment mortgage.

8. Illegal collection practices include: (1) use of obscene words; (2) telephone harassment at inconvenient times or places; (3) impersonating government officials and attorneys; and (4) obtaining information under false pretenses.

9. When promoting credit, an entrepreneur should consider the (1) customer's credit limit estimation, (2) client's major credit card(s), and (3) an endorser, if the customer is under the age of 18.

10. Credit promotions policies are part of the overall marketing strategy. Six related strategies are: (1) obtaining new charge customer accounts; (2) mailing out promotion letters to prospective clients; (3) mailing out personalized "thank you" letters to good credit customers; (4) contacting inactive clients; (5) attracting new credit customers through department store credit cards; and (6) increasing sales to all existing credit customers.

Support for **PACE, Third Edition** provided in whole or in part by:

International Consortium for Entrepreneurship Education
and
International Enterprise Academy
Center on Education and Training for Employment
The Ohio State University

The Coleman Foundation

Center for Entrepreneurial Leadership Inc.
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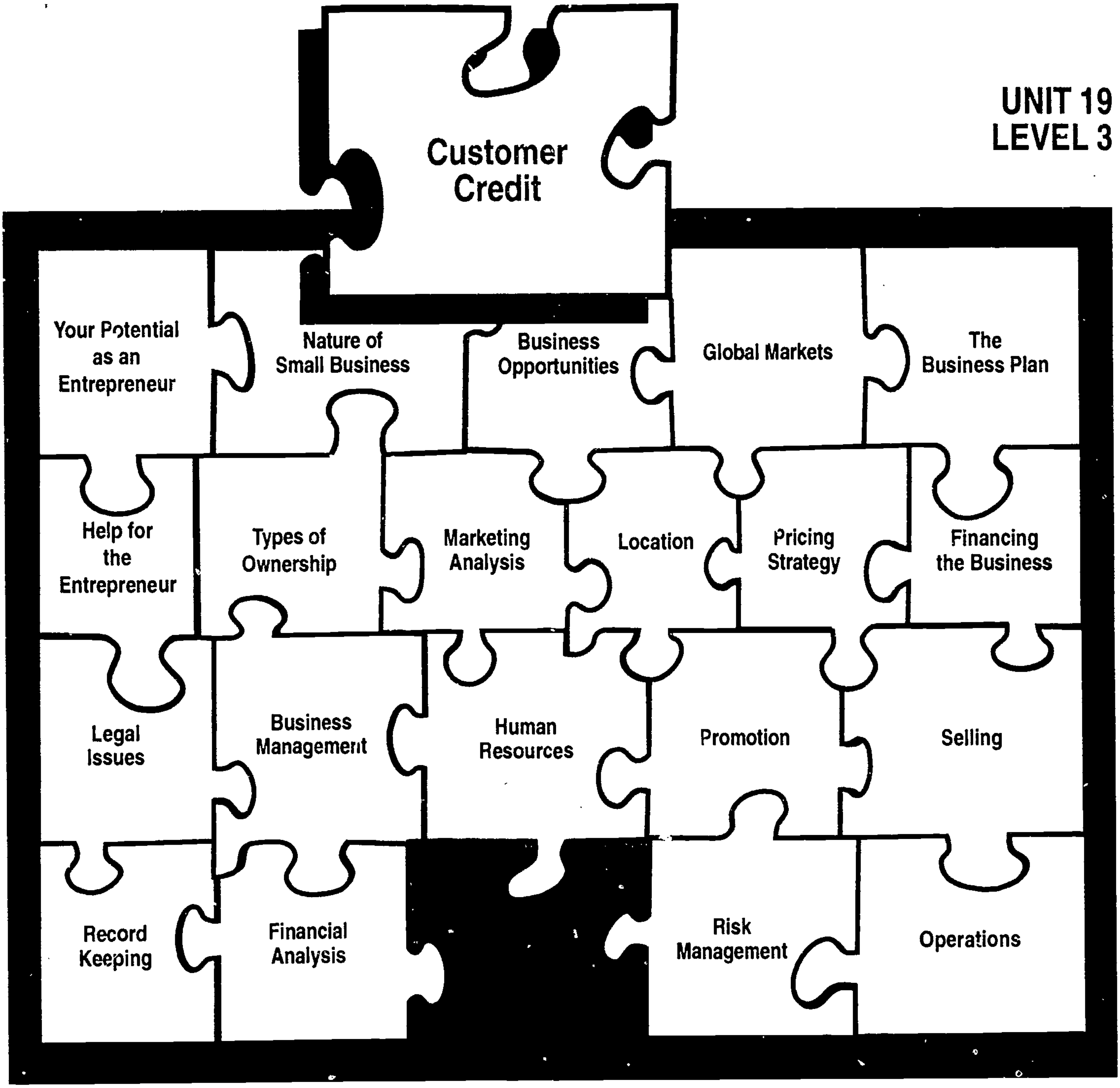
UNIT 19
LEVEL 3



PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

CENTER ON EDUCATION AND TRAINING FOR EMPLOYMENT
COLLEGE OF EDUCATION
THE OHIO STATE UNIVERSITY

Research & Development Series No. 303-19

CUSTOMER CREDIT

BEFORE YOU BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read What are the Objectives for this Unit on the following page. If you think you can meet these objectives now, consult your instructor.

3. The following objectives were met at Level 1 and Level 2:

   Level 1

   - Identify the different types of credit.
   - Give the reasons for offering customer credit.
   - Identify the advantages and disadvantages of customer credit.
   - Describe the basic guidelines for evaluating credit applicants.
   - Examine credit collections procedures.

   Level 2

   - Discuss the importance of offering customer credit.
   - Examine the criteria for granting credit.
   - Analyze the credit options for your small business.
   - Describe the use of credit records.
   - Analyze the procedures used for credit collections.

4. Look for these business terms as you read this unit. If you need help with the meanings, ask your instructor for a copy of the PACE Glossary contained in the *Resource Guide*.

Bailment lease	Lease/purchase agreement
Cash on delivery	Open-end credit
Chattel mortgage	Regulation B
Closed-end credit	Regulation Z
Conditional sale	Secured loan
Credit promotion	Security

CUSTOMER CREDIT

WHAT ARE THE OBJECTIVES FOR THIS UNIT?

Upon completion of this unit you will be able to—

- analyze the relevance of customer credit for your business,
- develop guidelines for granting credit in your business,
- analyze the legal rights of credit grantors,
- design a system for managing credit and collection, and
- prepare a credit promotion plan.

WHAT IS THIS UNIT ABOUT?

Have you ever seen an ad that read, "No money down," or "100 percent financing available," or "Thirty-six months to pay?" Such statements alone, without further information, violate the Federal Truth in Lending Act. Whenever sellers advertise that goods may be purchased on credit, they must disclose in the advertisement the exact cost of purchasing on credit.

Are you, as a prospective or present business owner, familiar with the basic credit laws and related legal requirements and recourse of a creditor? In addition to the legal aspects of credit, are you able to analyze the pros and cons of various credit and collection policies? Can you develop an effective series of collection reminders, letters, and follow-up procedures? Are you familiar with information management resources that can assist creditors? Do you know how an effective credit promotion can be planned and implemented?

As manager of a small business you must be knowledgeable in the above credit and collection topics. This unit addresses the following questions as you apply your understanding of the information in this unit through individual, group, and case problem assignments:

- Why is it important to consider offering customer credit?

- What are effective guidelines for granting credit?
- What are your legal rights as a credit grantor?
- How will you design systems for managing credit?
- What are the key elements of a credit promotion plan?
- How will you develop a credit promotion plan?

IS OFFERING CREDIT RELEVANT FOR YOUR BUSINESS?

This question is best answered by responses to these and other questions. What is the current economic atmosphere? What is the nature and extent of the competition? What sort of credit arrangement does the competition have? What credit arrangement do you have with your suppliers? And the most important question, can you afford **not** to offer credit?

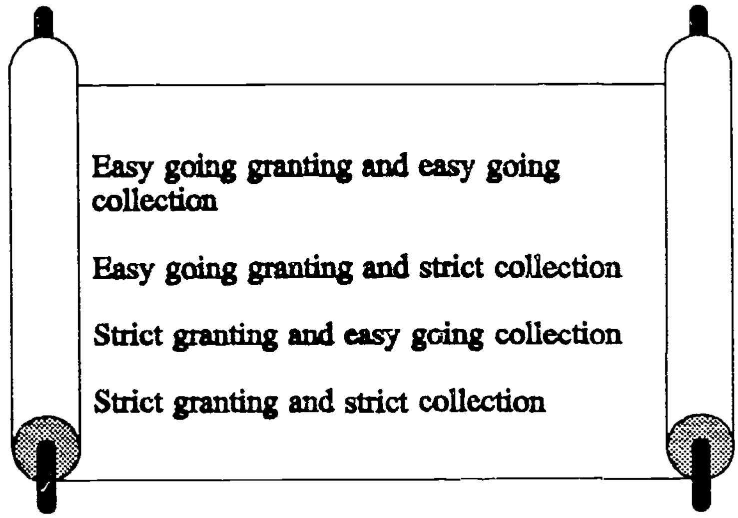
In the early days of American business, most transactions were either on a cash or barter basis. These days are long gone; most modern economies are based on credit. It is not so much a question of *if* you will offer credit, but to *whom will you offer credit*, *how much will you offer*, and *how will you collect* outstanding monies.

Properly applied, a good credit policy can increase the sales and thus cashflow of any business. Wise credit decisions on the part of a small business person allows him or her to spend less time worrying about credit and collections and more time producing and/or selling products or services.

WHAT CONSIDERATIONS SHOULD BE INCLUDED IN CREDIT AND COLLECTION POLICIES?

The establishment and execution of credit and collection policies can minimize problems associated with accounts receivable. Whether a firm has an easy going or strict credit and collection policy depends on these factors:

- The profit margin on the merchandise
- The line of business and its customers
- The policies of competitors
- The phase of the business cycle at the time
- The store's competitive position
- The financial and other circumstances peculiar to the business



WHAT ARE SOME EXAMPLES OF EASY GOING AND STRICT COLLECTION POLICIES?

Businesses with similar merchandise, similar customers, and similar images usually have similar credit policies. When two firms have different merchandising policies, the differences are usually reflected in their credit policies. Credit policies, easy going or strict, may be divided into the four categories described below.

Easy going granting and easy going collection. A business using this policy extends credit to consumers with excellent, good, and average credit ratings, as well as to those with just fair or poor credit standing. The aim is to achieve the highest credit sales volume possible. Little pressure is used in collecting.

Easy going granting and strict collection. Under this policy, credit is granted to all classes of risks. Usually the granting of credit is liberal for two reasons: the business needs to win business from the competition, and the owner believes that he/she can be a better collector than the competition. This type of business requires steady cash-flow and uses a great deal of pressure in collections.

Strict granting and easy going collection. Businesses that use this policy do not grant credit to customers who are poor credit risks. But the firm isn't strict when it collects payments from customers. The owner justifies this approach by carefully selecting credit customers who he or she believes can be trusted to pay their bills.

Strict granting and strict collection. Sometimes firms find it necessary to become more strict in their credit granting and collection policies. When the size of the losses in their consumer credit divisions increases because of the cost of borrowing money and other operating expenses, the companies become more selective in adding new accounts and more forceful in collecting overdue payments.

A summary of a credit card and/or direct credit policy is as follows:

- Put in writing a policy that include the objectives and the procedures for credit sales.

- Establish clear procedures for authorizing credit purchases, stipulating the amount that can be allowed and the procedures for recording all the necessary information.

- Evaluate, at least once a year, the benefits and costs of credit, including a review of alternatives that could be used to reduce the total cost of granting credit.

- Provide a fairly clear-cut procedure for establishing credit limits for each individual.

- Change credit limits based on experience with customer payment practices.

- Develop a reporting system that allows easy review of outstanding balances at least once a month.

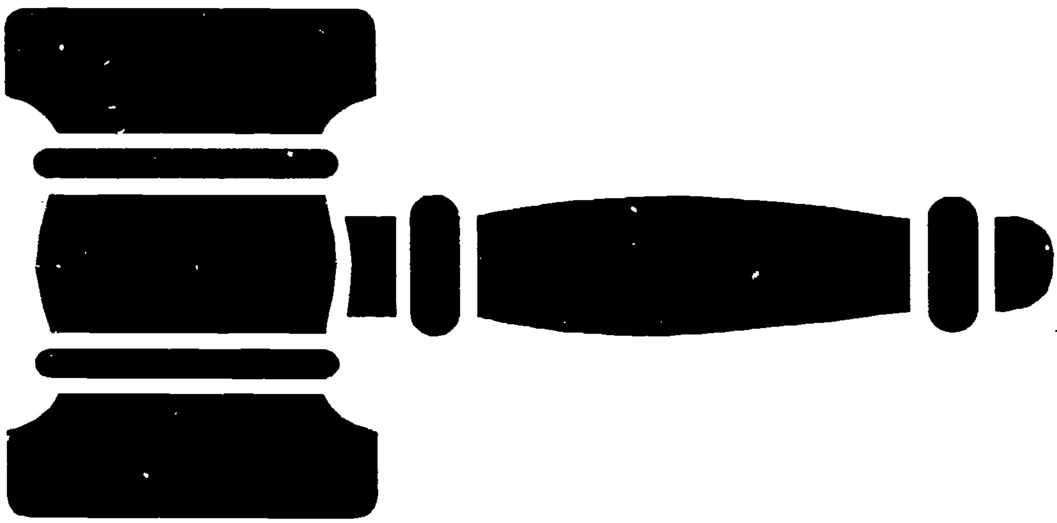
- Establish and adhere to a clear procedure for following up on late payments.

With the increased availability of computers it is possible for a credit manager to have instant access to all credit files. Computer programs that automatically identify those customers who have exceeded their credit limits are available. Credit managers can easily review the current status of customer accounts before approving additional credit. It is also possible for sales personnel to determine the credit status of customers by using electronic cash register terminals programmed to provide such information.

In addition to determining the credit status of customers, a business may receive computer printouts (credit-card bulletins) of lost, stolen, or withdrawn credit cards. If the credit card number is not in the bulletin and the purchase amount does not exceed the credit limits, the sale may be charged to the card.

Businesses who check customer credit frequently install a small direct-access computer in their firms. The use of credit cards and computers reduces the number of decisions to be made by sales personnel in making a charge sale. Since credit card companies assume much of the responsibility for collecting payment from the customer, their fee of 3-6 percent of the amount purchased may be well worthwhile. Entrepreneurs are increasingly adopting computerized credit systems for the above reasons.

All policies must be reevaluated periodically to determine their effectiveness. If your business already has policies for accounts receivable management, evaluate them according to the policies presented in this unit. If you do not presently have credit and collection policies, you can use this unit as a guide in establishing those policies.



WHAT ARE YOUR LEGAL RIGHTS IN UTILIZING SECURED VERSUS UNSECURED RECOVERY DEVICES?

Businesses are much more willing to extend credit if they have some assurance that they will get paid. Such assurance is known as *security*. A *secured loan* is one in which creditors obtain rights to something of value belonging to the borrower, from which they can recover the money if the borrower fails to pay. An unsecured loan does not have this feature.

One commonly used security device is a *conditional sale*, in which goods are sold with the understanding that the title remains with the seller until the purchase price is paid. A good example of this type of security occurs when you purchase a car. The bank will hold title to the vehicle until the total obligation is met. Another method is a *chattel mortgage* (mortgage on personal property), in which the buyer takes title to the goods but mortgages them to the seller. A third security device is a *bailment lease*, under which the buyer rents the goods from the seller. When the amount of the rental payments made equals the purchase price, the buyer takes title to the property by paying a token amount, usually one dollar.

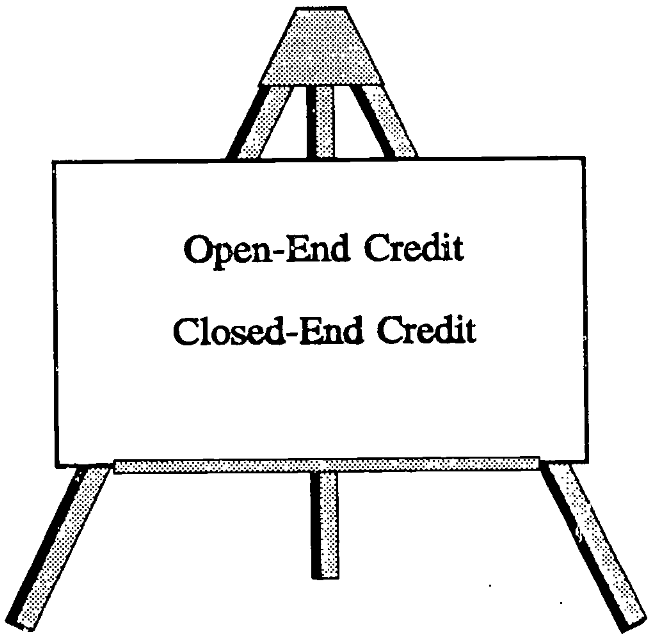
WHAT ARE THE LEGAL RIGHTS OF THE SECURED PARTY?

If a debtor fails to pay the amount owed, the secured party has the right to repossess the goods. This repossession must be accomplished without *breaching the peace* (causing a disturbance). If the debtor refuses to surrender the goods, the secured party may either repossess them (with some exceptions) or sell them. The sale may be a public sale (an auction) or a private sale, as long as the terms of the sale are reasonable.

If the goods are consumer goods and the debtor has paid 60 percent of the cash price or more, the secured party cannot keep the goods. They must be sold. The debtor is entitled to receive any surplus of a sale after expenses have been paid, the debt has been satisfied, and any other security interests have been paid off. The debtor is entitled to be notified of any such sale, and, in most cases, has the right to buy the goods back.

is to open an account and buy things from time to time on account (on credit). This is called *open-end credit.* Open-end credit may be obtained by opening a charge account at a particular store or by using a credit card. Open-end credit is so called because people can keep adding to the amount they owe for as long as they keep making monthly payments. Interest is computed on the amount that is owed each month.

The other way that people buy things on credit is called *closed-end credit.* This type



WHAT ARE THE LEGAL REQUIREMENTS FOR OPEN-END AND CLOSED-END CREDIT?

There are two basic ways that goods and services can be bought on credit. One way

of credit is used when someone buys one item, such as a car or a piece of furniture, and agrees to pay for it later on an installment basis, usually monthly. Closed-end credit is also involved when someone obtains a loan and agrees to repay at a later date.

WHAT SHOULD OPEN-END CREDIT ADVERTISING DISCLOSE?

An advertisement for open-end credit should disclose the following items:

- The time period within which the customer must pay in order to avoid a finance charge
- The method of computing the balance on which the finance charge is based
- The method of computing the amount of the finance charge, including any minimum charge
- The annual percentage rate

An example of the proper advertising disclosure for open-end credit might read as follows:

- No finance charge is incurred if payment is received within 30 days from the closing date shown on your monthly billing statement.
- If any purchase remains unpaid for 30 days from the closing date shown on the monthly billing statement, a finance charge at the periodic rate of 1-1/2 percent per month of the total past due balance is imposed.
- The annual percentage rate is 18 percent.
- The minimum monthly payment is $10.

WHAT SHOULD CLOSED-END CREDIT ADVERTISING DISCLOSE?

An advertisement for closed-end credit should disclose the following:

- The cash price
- The amount of down payment required or the fact that no down payment is required
- The number of payments, the amount of each payment, and the due dates or period between payments
- The annual percentage rate stated in exact terms
- The deferred payment price (that is, the total cost to the buyer)

A proper advertising disclosure for closed-end credit might read as follows:

- The cash price is $100. There is no down payment.
- There will be 12 monthly installments of $10 each.
- The annual percentage rate will be 35 percent.
- The deferred payment price will be $120.

Truth in Lending Act

WHAT ARE PROVISIONS OF THE TRUTH IN LENDING ACT?

To protect the consumer who buys on credit, the federal government has passed a law called the *Truth in Lending Act*. Under this act specific rules known as Regulation Z must be followed by people who extend credit to others.

Regulation Z

The purpose of *Regulation Z* is to let consumers know the exact cost of obtaining credit. With such information, people can compare different sources of credit. They can shop around for credit and save money by obtaining it at the lowest cost. The regulation applies whenever credit is extended to people for personal, family, household, or agricultural purposes. It does *not* apply to an extension of credit of over $25,000 except in the case of real estate transactions.

Regulation Z also regulates the use of credit cards and sets limits on the amount of money people must pay when their credit cards are used without their authorization. In addition, it provides a procedure for settling disputes over billing errors on certain types of accounts.

Under regulation Z, anyone issuing credit must disclose two things before completing the transaction: (1) the finance charge (the actual cost of the loan in dollars and cents) and (2) the annual percentage rate (the true rate of interest computed according to a special formula).

WHAT ARE THE PROVISIONS OF THE EQUAL CREDIT OPPORTUNITY ACT?

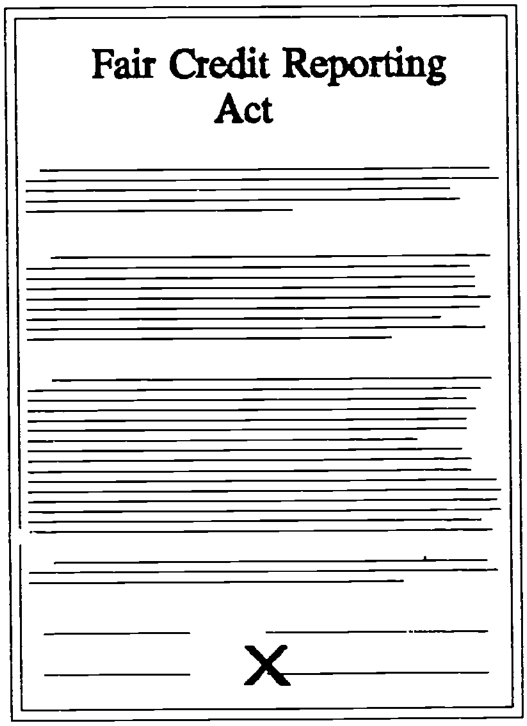
In the past, women were denied credit in situations identical to those in which men would have received it. When married couples applied for credit, the wife's income often was not considered on the theory that she might have a child and stop working. In addition, when a husband and wife received credit, the account was usually recorded in the husband's name only; the name of the wife was not included. As a result, many married women did not have a credit history in their own name. This made it difficult for them to get credit if they were divorced or widowed. Single women also encountered problems in obtaining credit because of various credit biases and policies.

To remedy these injustices, the United States Congress passed the *Equal Credit Opportunity Act of 1975*. Under this act, creditors cannot discriminate against any person on the basis of sex or marital status in any aspect of a credit transaction. Specific rules implementing the act are found in a law known as Regulation B, issued by the Board of Governors of the Federal Reserve System.

Regulation B

Under *Regulation B* of the Equal Credit Opportunit·· Act, the following rules apply when creditors evaluate applications:

- Creditors may request and consider information about a person's spouse only when the spouse will be using or will be liable for the account or when the spouse's income is being relied upon.
- Alimony, child support, and maintenance payments must be considered as income to the extent that such payments are likely to be made consistently.
- Creditors may not discount a spouse's income because of sex or marital status nor may they discount income obtained from part-time employment.
- Creditors may not ask about applicant's birth control practices or child bearing plans, nor may they assume that a woman will leave the labor force to have a baby.
- With certain exceptions, creditors may not close an account because of a change in marital status, unless there is evidence that the person is unwilling or unable to pay.
- Creditors may not use unfavorable information about an account a person shared with a spouse or former spouse, if the person can show that the unfavorable history does not accurately reflect his or her own willingness or ability to repay.
- When an application for credit is denied, creditors must also provide, upon request, the reasons for the denial.



WHAT ARE THE PROVISIONS OF THE FAIR CREDIT REPORTING ACT?

The *Fair Credit Reporting Act* deals with unfavorable reports issued by credit bureaus. These reports, which contain personal data, character studies, as well as other credit information, are frequently issued to insurance companies, businesses, or prospective employers. When rejecting an applicant, the company must supply the applicant with the source of its credit report, thus giving the person the opportunity to challenge the report.

The Fair Credit Reporting Act also provides that the credit reporting agency must tell the individual the nature of the information which it has on file. If the information is incorrect or incomplete, a person has the right to correct the report and provide supporting information. If the report is proved to be inaccurate, the reporting agency must delete it and send deletion notices to businesses and others who have received reports containing the information. In cases of erroneous reports, the person has a right to know who received the credit record in the past *6 months*. If the report was sent to companies where a person had sought employment, the person must be advised of the distribution of such incorrect information during the past *2 years*.

WHAT CREDIT INFORMATION MANAGEMENT RESOURCES AND SYSTEMS ARE AVAILABLE?

The manager of a small firm should get to know and understand various sources of credit information. Certain types of information are sold by the mercantile credit agencies; other types are available from them as a service or on an exchange-of-information basis.

Arrangements can be made with suppliers' credit departments to exchange information. This type of interchange can be very valuable when up-to-date sales and payment records of current or prospective customers are being sought. The business owner should recognize that a firm's performance with major suppliers is also a matter of its record in the trade.

Banks are usually good sources of information about their depositors. Often, they can make a good estimate of the amount of credit a depositor can handle. They can also help get credit information on out-of-town customers—particularly if it is important to process a new order speedily or to check out a possible bankruptcy situation. The business owner should be careful not to take advantage of a bank by making too many requests for credit information.

Firms needing daily credit information—for example, a retailer checking on consumer credit applications—should consider buying the services of their local credit bureau. Credit bureaus are particularly effective in rating persons living in the local trading area. Their effectiveness is increased through their cooperation with the *International Consumer Credit* Association or the *Associated Credit Bureaus of America*. These associations develop credit information on persons who have moved from one town to another.

Services offered by credit bureaus include checks on newcomers in the trading area, written and telephone credit information on individuals, data on changes in customers' credit risk status, assistance in tracing customers who leave town without providing a forwarding address, and collection of poor risks accounts.

A typical consumer credit report includes such information as:

- credit accounts maintained
- history of purchases
- balances due
- promptness of payment
- period of time that the account is maintained
- consumer's net worth (home, car, and so forth)
- employment verification (data on income, position, and duration of job);
- character information (police record, if any).

A business need not be a member of the local bureau to obtain credit information;

usually, however, nonmembers pay higher charges for services.

Manufacturers and wholesalers often use the services of *mercantile credit agencies*. Privately owned and operated, these agencies continually collect, analyze, and evaluate credit information on business firms. Their credit ratings are based on the observed experience of the reporting firms. Services are provided by fee, based on the range of information required.

Among the general mercantile agencies, Dun and Bradstreet, covering many industries through the country, is the best known. Dun and Bradstreet offers their reference book, credit reports, and other special information to firms that buy its service. The reference book includes credit ratings, evaluations of financial strength, and other vital credit information. *Lyon Furniture Mercantile* Agency provides data on furniture retailers for furniture manufacturers and wholesalers. The *Jewelers Board of Trade* offers similar services to the jewelry industry. The *National Credit Office*, originally organized to handle credit inquiries in the principal textile trades, now also reports on banking, metals, electronics, leather, furniture, paint, rubber, and chemicals.

The business owner should also keep in touch with competitors and other firms whose activities are related to the firm's customers. The exchange of credit information between business managers can be quite valuable—particularly if a customer's financial position weakens. Timing is vital if the business owner hopes to protect the firm's position as a creditor.

Credit and collection skills can be improved by attending financial workshops and by reading current literature on the subject. Workshops are given by local credit organizations, universities, trade associations, and other educational groups. Any number of publications are available through organizations or libraries, publishers, the Small Business Administration, other state and national governmental organizations, and many other sources.

HOW CAN CREDIT BE MANAGED?

The important question for a business manager is not whether to grant credit to an individual customer, but rather how much credit to grant. For this reason, the manager should review the credit application carefully to establish the initial credit limits. Such limits may be changed later, based on the customer's payment record.

To prevent credit sales from exceeding profitable limits, it is necessary to set credit limits for customers. Generally, credit limits are based on several factors: the required payment period, the customer's past payment record, and the customer's potential for future payments. A credit limit is not the maximum amount of credit a customer is allowed at one time. Rather, it is the maximum amount the customer's account is allowed to reach before the account is reviewed. The manager will review the customer's history of payments, the amount of credit still due, and the amount of additional credit requested. Then the credit manager may decide to revise the credit limit.

A credit limit can be established by following three rather simple steps:

1. Estimate the total amount of business you can expect from a customer during the year. Allow for increases or decreases in sales.

2. Divide the total expected sales figure by 12 to determine the monthly sales that you can expect.

3. Multiply the monthly sales figure by the number of monthly payment periods in the credit plan the customer is using. The figure resulting from this multiplication will be the credit limit for that particular customer's account.

An example of this procedure follows:

> Last year Charles Gordon purchased \$1,200 worth of merchandise from The Baker Firm. The purchases were spread fairly evenly over the year, and Mr. Gordon paid his 90-day account promptly. The credit manager expects that Mr. Gordon will buy about 6 percent more merchandise in the coming year. The quarterly credit limit for Mr. Gordon should be \$318.
>
> \$1,200 + 6% increase = \$1272
> \$1,272 ÷ 12 = \$106
> \$106 x 3 = \$318

To assist businesses in setting credit limits, information about individuals and about their payment records can be obtained from credit bureaus. These inquiries cost money. Yet, when large amounts of credit are involved, such inquiries may save money.

Some smaller businesses will grant direct credit only if the individual customer has a major credit card. The business manager assumes that an individual must be a good credit risk if a major credit card company has approved the individual for credit.

Sometimes with a young person, generally 16-18 years of age, a business manager may ask for an endorser, usually the person's parent. The endorser is held responsible for the bill if the individual fails to pay. Another way to reduce the risk is to insist on a substantial down payment for large purchases.

In deciding on credit limits, some banks, credit organizations, and large businesses use a point system. They give a number of points for owning a home in the community, points for having a bank account, points for length of time on the job, and points for the level of income. All these points, when added together, determine the amount of credit an individual is granted.

WHAT ARE SOME ILLEGAL COLLECTION PRACTICES?

The federal government and some states have laws protecting consumers against certain kinds of harassment and deceptive bill collection practices. It is a violation of the **Federal Trade Commission Act** for a creditor to use any deceptive means to collect debts or to obtain information about debtors. Creditors may not use forms, letters, or questionnaires for the purpose of collecting debts unless they state that they are for that purpose.

In 1977, the United States Congress also enacted the **Fair Debt Collection Act**. This act makes it a federal offense for debt collectors to threaten consumers with violence, use obscene language, or contact consumers by telephone at inconvenient times or places in an effort to collect a debt. Other parts of the law prohibit debt collectors from impersonating government officials or attorneys, obtaining information under false pretenses, or collecting more than is legally owed.

In some states, it is also illegal to inform a debtor's relatives, employer, or other close associates about a debt in order to obtain payment. Additionally, collection letters may not be sent in such a way that the envelopes indicate that a debt is owed. These laws are designed to prevent unfair collection practices and to protect debtors from embarrassment and invasion of privacy.

The legal rights and recourse of debtors and creditors are extremely important. Owners of businesses offering credit to their customers need to be aware of these provisions. The business is required to inform the customer of such rights and avenues of recourse. Legal advisors such as government agents, attorneys, and accountants should be contacted for additional clarifications and interpretations of credit laws.

WHAT VARIOUS COLLECTION PROCEDURES ARE USED?

An understanding of applicable credit laws is necessary when a business manager establishes and executes collection policies and procedures.

Whether or not your business chooses to use cash discounts for prepayment or delinquency charges for overdue payments, a systematic follow-up procedure should be employed with all past due accounts. Usually, this will take the form of a series of reminders, letters, and telephone calls.

Figure 1 is an example of a reminder sent to customers who have not paid their bills within 30 days. These reminders may be a brief photocopied form letter.

The tone of each letter should become progressively more forceful, with suggestions of more serious action introduced in each.

REMINDER OF PAST DUE BILLS

Our records show that your balance for the amount of $49.00 is now past due. Please give this your prompt attention. (Finance charges on overdue accounts are charged at the rate of 2 percent per month.)

If payment has been made by the time this reaches you, please disregard this reminder and accept our thanks.

Figure 1

WHAT ARE SOME EXAMPLES OF A COLLECTION LETTER SERIES?

When an account is approximately 30 days past due, the first collection letter should be sent. Since the account cannot be considered seriously delinquent at this time, the tone of the letter should be moderate. Subsequent letters should establish a firmer tone, so that the customer is made aware of the seriousness of the situation.

Figure 2 is an example of a 30-day letter, and Figure 3 is an example of a second letter sent 30 days after the first letter.

The tone that you establish depends on the type of relationship that you maintain with your customers. However, the ground rules should be clear. Past-due accounts should not be ignored.

An even more persuasive approach is the use of the telephone. The ground rules are basically the same. You must become progressively firmer with each call, and must indicate that stronger measures will be used if necessary to ensure prompt payment.

The telephone has the added advantage of flexibility, since you can be more direct and obtain knowledge of the customer's situation. A customer's immediate reactions can be obtained from a telephone conversation.

Dear Ms. Adams:

Our payment records show your account with a current balance of $714.54. Of this balance, $179.90 is now past due. If our records do not agree, please contact our office as soon as possible to discuss the discrepancy. If our records do agree, and a payment for the past due amount has not already been mailed, please do so today.

You have an excellent credit record with our company and we look forward to your check by return or express mail to ensure a continued and positive relationship.

Thank you for your time and prompt consideration.

J.R. Oliver

Figure 2

If this letter is unsuccessful in obtaining results, a more forceful letter should be sent 30 days later.

You acquire this knowledge through asking questions such as the following:

- "Is there a problem? We never had difficulty with your account in the past."

- "How much would be a reasonable amount for you to pay each month? Perhaps $50, $60?"

- "How soon can we expect payment of this amount?"

Try to avoid closed-ended questions that can be answered "yes" or "no." If the creditor gives you an answer such as, "I'll mail it today", reply with "I appreciate that. Then I can expect it in 2 or 3 days. If I don't have it by then, I'll phone again." Another technique is to ask them for their check number. Be sure that the creditor realizes that you do not intend to ignore the situation.

HOW CAN CREDIT PROMOTIONS BE PLANNED AND IMPLEMENTED?

Once credit card and collection policies and procedures have been formulated, it is logical that effective *credit promotions* should be planned and implemented.

Is the promotion of credit worthwhile? In those businesses where credit can be extended, the answer definitely is "yes." There are good reasons why effort should be made to increase credit volume.

Charge accounts have made buying more convenient for customers. Surveys show that credit customers buy better merchandise and buy more goods than do cash customers. The convenience of paying once a month, of being able to buy on impulse or for necessity, rather than as funds dictate, and of being able to take advantage of attractive offers, more than exceeds any inconvenience.

A credit customer offers the store greater sales potential. A closer relationship is established between customer and store, cemented by the very nature of the credit privilege. Patronage takes on the form of habit, and customers tend to regard the store somewhat as a shopping home. It is looked upon as "their" store. As a result, credit customers are apt to become boosters for the store. Being store-conscious, they give more careful and more frequent attention to the store's newspaper advertisements. They are also good recipients of direct-mail advertising.

Present and New Customers

To promote credit, three avenues should be considered: (1) obtaining new accounts, (2) getting inactive accounts to resume buying, and (3) increasing sales to all credit customers. Effort should be directed toward getting more business from existing customers and adding more good customers.

WHAT ARE SOME SOURCES OF NEW CREDIT ACCOUNTS?

There are many sources from which credit account prospects may be obtained. Here are a few:

- Current cash customers

Dear Ms. Adams:

We have received no response to our last two mailed statements, nor to our letter of December 7. Your entire account is now 60 days past due. The total due is $714.54.

If there is some reason why you cannot make this obligation or you are dissatisfied with our service, please contact us so that we may work with you.

Our intent is not to endanger your credit rating that we know you've worked hard to build, nor to dissolve the good relationship we've had to date. If you contact us immediately, we can probably avoid filing an unfavorable report with the credit bureau or passing this obligation on to our collection agency.

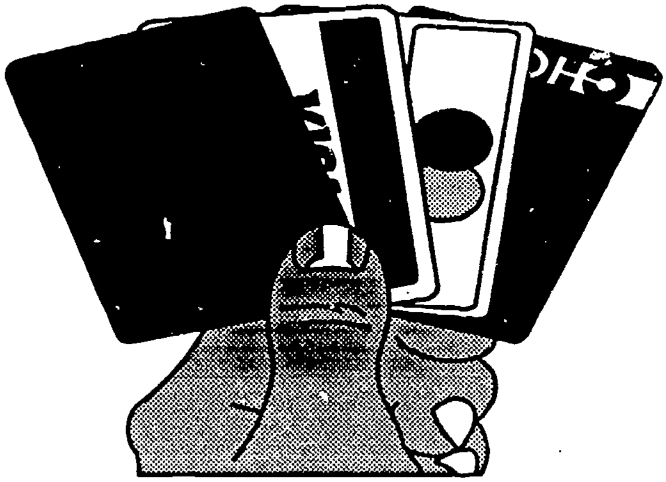
A self-addressed envelope is enclosed for your convenience. Thank you in advance for your cooperation.

Sincerely,

J.R. Oliver

Figure 3

- New residents in a community
- Newly married couples
- Customers who use credit accounts
- People for whom the store cashes payroll checks
- COD customers (Cash on Delivery)
- Layaway customers
- Recommendations from good customers
- Customers to whom service is given, such as alterations or repairs
- Sources such as reliable recommendations, teachers' lists, clubs, newspaper publicity about promotions, store personnel (relatives), etc.



HOW CAN NEW ACCOUNTS BE OBTAINED?

Obtaining new charge customers is desirable, but simply adding names to a current list is not enough. Not all accounts are the same as far as sales potential is concerned; some are more desirable than others. For example, an ideal customer would be that person who would buy primarily in one store and would have only that account. A person with accounts at many different stores enjoys a top credit rating, and their buying at any one store may be limited. The highly desirable type of credit prospect has been described as: young, from a middle income group, with few if any accounts at other stores. Whether the prospect is classed as ideal or average, however, effort should always be made to "sell" the store.

In attempting to get new customers, the usual careful selection procedures should be followed. Some stores obtain credit reports on prospects beforehand, whereas others extend the invitation first and then check the applicant. In either case, investigation of a customer must be carried out before the account is opened.

HOW SHOULD A CREDIT PROMOTION LETTER BE WRITTEN?

Credit promotion letters are an important part of the campaign to increase credit sales, and there is much to be said for their use. A letter goes directly to the prospect. It can be a personal message. It has the advantage of telling the business' story to a number of prospects at the same time. Letters should be individually typewritten on a good grade of paper and personally signed for best results. First-class postage should be used in the effort to make this a sincere, quality solicitation. A sample letter that could serve as ideal material for promoting credit business is shown in Figure 4. A word processor with a merge capability makes individually typed, personalized letters to large numbers of customers possible with a minimum of typing time needed.

WHAT ARE SOME REASONS FOR CONTACTING INACTIVE AND ACTIVE CLIENTS?

Although the extension of credit to customers may be considered a favor, the customer regards it as a right. One of the reasons for a decrease in credit purchases by a firm's present customers is the improper handling of customers by the firm's salespeople. The proper handling of customers is just as important as the proper handling of merchandise. Unsatisfactory merchandise can be returned and any dissatisfaction remedied, but making up for unintelligent treatment of customers is far more difficult. Customers rarely tell the firm when they are irritated or displeased; they simply take their trade elsewhere. Increasing sales to all credit customers and getting inactive accounts to resume buying can be achieved partly through intelligent and considerate treatment of the credit customers by salespeople.

About once a year, it pays to send a personal letter to good credit customers, thanking them for their patronage and cooperation. Letters of this kind are appreciated by your customers and they help to keep them as regular patrons.

WHY SHOULD CREDIT BE CONTINUALLY PROMOTED?

Department stores promote use of credit constantly. In fact, in the department store, credit is sold to customers much the same as is merchandise. Promotions of credit accounts must be a continuing program, because many customers are lost each year. Some discontinue patronage through what they consider faults of the store, but a greater portion of loss is the result of conditions over which the store has no control, such as deaths, changes of residence, and unemployment.

People like to be offered credit privileges rather than to be obliged to ask for them. A year-in, year-out program of account promotion should be maintained. It should include the securing of new accounts, the revival of inactive accounts, and the promotion of greater activity among accounts already on the books.

The cost to a store of opening a charge account has been estimated to be in excess of $25, including the credit interviewer's time, setting up the forms in the account file, the cost of credit investigation, and issuing the charge card. Losses due to bad risks in department stores are usually only a fraction of 1 percent of the sales. Some credit managers believe that if the loss is too low, the firm's credit policy is too strict, and they are not taking full advantage of their sales opportunities. The average charge account yields around $400 a year for the department store. Since charge customers spend more than cash customers, it is clear why so many stores steadily campaign for credit business.

SANSONE'S

(Date)

Mr. William Thomas
3430 Kellybrook Drive
Indianapolis, IN 46208

Dear Mr. Thomas:

We are always eager to add the names of those worthy of credit to our list of charge customers. Since you have been highly recommended, we invite you to open an account with us.

You will find that a charge account offers real advantages. It establishes a closer relationship between you and our store. Salespeople learn to know you and your preferences. Shopping is easier and quicker.

To make credit buying handy for our customers, we use the Credit Card system. Soon after you open an account, you will receive a credit card with our name and address on it. This card is inputted into our computerized cash register system. It identifies you immediately at the time of purchase and completes the sales transaction quickly and efficiently.

If you will complete the enclosed application form and mail it to us in the enclosed postage-paid return envelope, we'll arrange to open an account for you. We'll welcome you into the ranks of our charge customers, and we hope you'll always feel that Sansone's is your store.

Cordially yours,

Delia Moore

Figure 4

ACTIVITIES

The following activities are designed to help you apply what you have learned in this unit.

INDIVIDUAL ACTIVITIES

A.

The purpose of this activity is to assist you in reviewing some of the many legal terms and concepts applicable to credit and collections.

The following scenario represents a type of business where either an easy going, strict or most often, a combination of credit policies might be suggested.

Example:

Type of business: Lawn care service

Business environment:
Green Acres Lawn Care is a new business that has been advised that to meet the expectations laid out in the business plan they will need to capture approximately 7 percent share of the local market. There are three other lawn care companies servicing the area and each subscribes to a billing service and offers payment plans on landscaping jobs. Green Acres requires a relatively steady cashflow in order to maintain its equipment and payroll.

Recommended credit policy:
Easy going granting of credit, strict collection

Rationale:
By being the "new kid in town," Green Acres must build a client base as rapidly as possible. In order to do this, they must be competitive in regard to the offering of credit to as many people as possible. This easy going, less selective, approach will probably result in more clients, but may also create more collection concerns. A strict collection mechanism will be necessary in order to generate the income needed to meet operating expenses.

On a sheet of paper create your own scenarios that incorporate details that you think would help you make a credit policy decision for your business. Include as many details that you think might be relevant in supporting your chosen policy decision. Create two *easy going* and two *strict* scenarios using the same format as shown in the examples.

B.

As mentioned in this unit, the telephone can be a very effective collection tool. Write three collection telephone call scripts, one each for a client that is 30, 60, and 90 days past due. Be as realistic as possible without using actual names and businesses. Include hypothetical responses from the customers that will allow you to respond in an appropriate manner.

GROUP ACTIVITY

Working in teams of six to eight develop a plan to promote the use of credit for one of their businesses. The team should designate a recorder to take notes that will be used when organizing the actual plan. The plan should be organized according to how the group deems appropriate. Develop a name and general description of your business. Keep in mind the factors that make up a good credit promotion plan.

CASE STUDY

Daniel Meyer, owner of Meyer Mini Marts in and around Palo Alto, California, has run a successful one-store operation for nearly 5 years. Expanding from one store to six in a 6-month period, he personally hired all employees and trained them in the handling of credit. One result of this rapid growth was the development of a serious credit problem.

Six months into the expansion project, Mr. Meyer found that a very large number of old accounts receivable were uncollectible. It took his accountant another three months to determine that two of the new store attendants who worked evenings only were granting credit to customers unauthorized to receive it. They had, in fact, given credit to customers on the firm's list of poor credit risks.

The company's credit policy calls for having all credit sales checked at the home office every day. Because of the overload of work in the office, this important procedure had been bypassed and the resulting losses occurred.

DISCUSSION QUESTIONS

1. Did Mr. Meyer have a policy or a procedural problem?
2. How could Mr. Meyer have avoided the losses?

ASSESSMENT

Read the following questions to check your knowledge of the topics presented in this unit. When you feel prepared, ask your instructor to assess your competency on them.

1. Explain the importance of customer credit for the small business.
2. List two major differences between open-end and closed-end credit plans.
3. Identify four types of information that must be disclosed in open-ended credit advertisements.
4. Identify four types of information that must be disclosed in closed-end advertisements.
5. Explain the major purpose of Regulation Z of the Truth-In-Lending Act.
6. Identify the injustice that was attempted to be remedied by the Equal Credit Opportunity Act.
7. List three legal security devices that may be used by the credit grantor.
8. List four illegal collection practices.
9. What three things should be considered when promoting credit?
10. Identify the concept of credit promotion and list six related strategies.

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PACE

Units on the above entrepreneurship topics are available at the following levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business