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PREVIEW

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THE FUTURE ROLE OF THE CREDIT FUNCTION

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THE FUTURE ROLE OF THE CREDIT FUNCTION

A dissertation submitted to the faculty of the Lubin Graduate School of Business, Pace University, in partial fulfillment of the requirement for the Degree of Doctor of Professional Studies.

WALTER S. HUNT

1983

ABSTRACT OF D.P.S. DISSERTATION

WALTER S. HUNT

THE FUTURE ROLE OF THE CREDIT FUNCTION

The purpose of this study was to ascertain what the future role of the credit function would be in manufacturing industries. This prediction was to be determined by evaluating ratings of specific statements in the credit work area for past, present and future periods. A fifty statement survey was mailed to credit executives and management executives employed in the chemical industry. Two other groups were also included, faculty members and managers of credit association chapters. Three hundred and fifteen surveys were mailed and 207 anonymous responses received. The statement rankings were applied against a series of three way contingency tables.

A second survey consisting of interviews among banking and business people familiar with industrial credit practices listed reasons for accepting or rejecting the implied trends.

Salient points were that in the future the accounts receivable asset will be managed like other company investments to fit in with company needs and objectives. The credit department will not act as an independent unit in a company and credit departments will no longer be considered adversaries of the sales and marketing functions. An activist role will be assumed or sought out in business activities aided by an increasing favorable image of the credit department and an upgrading of staff quality.

While credit work will still carry a "specialist" label, future credit department employees will come from other business and educational disciplines. Computers will facilitate greater involvement of credit personnel in business transactions and also foster credit people performing cash forecasting, estimating receivables levels for corporate planning, predicting financial impairment of customers and counseling management of financially marginal companies.

While the days sales outstanding (DSO) ratio, will remain a common measurement of accounts receivable vitality, other statistics such as average days past due and average number of days credit granted will be considered more meaningful standards.

Bad debt ratios probably will not be a prime measurement of a credit department's efficiency and effectiveness.

There was no strong preference for either a physically centralized or regionalized form of organization for credit departments in the future and a reporting line to a treasurer was preferred over a reporting line to a controller or marketing executive.

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PREVIEW

CHAPTER I

THE PROBLEM

Trade credit or, more commonly, the receivable investment on the balance sheet of the selling company, represents a sizable, on-going, although short-term, asset of American corporations. The growth of trade credit to the second largest asset in many industrial organizations is of interest to business analysts as they measure and interpret the movement and strength of this use of company funds. The receivable asset is also being subjected to greater scrutiny by corporate executives in order to manage systematically all resources of their company. As a result, the credit function and the personnel associated with it are undergoing an emphasis change regarding the role of this corporate activity. What was once a standard to be adhered to is now a resource to be managed.

Statement of the Problem

The purpose of this study is to predict the future role of the credit function in manufacturing industries.

Specific Problems

The first problem is to examine the traditional role of the credit function.

The second problem is to identify the current and future influences on the work and composition of the credit function.

The third problem is to analyze the impact of these factors on the traditional role of the credit function.

DEFINITION OF TERMS

The following definitions will be used for the purpose of this study:

"Credit" is the ability to obtain something of value in exchange for a promise to pay at some future date.

"Trade credit" is the dollar amount resulting from the sale of goods or service by a manufacturer or distributor to another manufacturer, distributor or retailer.

Delimitation

This study will be limited to the credit function in chemical manufacturing corporations located in the United States.

Need for the Study

In 1958 Edward Curtis, researching credit departments for an American Management Association study, stated that business could no longer rely entirely on personal knowledge of the integrity of customers and that full-time credit specialists were needed who would accept the maximum amount of credit sales and hold down losses to an absolute minimum.¹

In 1969, this statement was confirmed by Beckman and Foster who wrote that during the 1950's and early 1960's the credit departments of larger companies had changed only in number of personnel since the early 1930's.² The credit department activity from the 1930's through the 1950's generally was confined to stressing the receipt of payments as soon as invoices were due, writing collection letters on

¹Edward T. Curtis, Credit Department Organizations and Operation (New York: American Management Association, Inc., 1958), p. 6.

²Theodore Beckman and Ronald Foster, Credit and Collections (New York: McGraw-Hill Book Company, 1969), p. 73.

past due invoices and containing bad debts to a minimum level.³

Otto Steinhaus, a general credit manager for an agricultural chemicals company, who saw a somewhat proper managerial and financial role for credit personnel regretted this change. The credit function was losing its historic role as guardian of the flow of current cash while marketing personnel were engaged in "fancy footwork" in selling chemicals.⁴ Steinhaus was particularly concerned over the use of long terms of sale in the agricultural chemical industry without apparent regard for the inordinate risk of loss, as well as the effect on company finances when receivables remained outstanding for many months in any one or several years.

Robert Kaplan, writing several years later, found too many credit managers believing the marketing department's objective was sales maximization while that of the credit department was credit loss minimization through selling only "gilt edge" accounts.⁵ He was suggesting that the opportunities for more sales and profits were being frustrated by credit personnel who believed their job performance was measured by recording the smallest dollar amount of bad debts annually. Kaplan recognized the inherent contradiction in objectives of the sales and credit departments. He believed that the emphasis by credit department personnel on a customer's ability to pay derived from some

³Curtis, p. 6.

⁴Otto Steinhaus, "Stop, Look and Listen," Commercial Fertilizer (July, 1962), p. 24.

⁵Robert Kaplan, "Credit Risks and Opportunities," Harvard Business Review (March-April, 1967), p. 83.

undefined management pride in maintaining stringent credit practices when in reality that management should be concerned with the utilization of credit services to contribute to profits.⁶

Growth in Accounts Receivable as an Asset

During that period when Steinhaus was writing and upon which Beckman & Foster commented the receivables of non-financial corporations were increasing in all business lines, not only in agricultural chemicals. Trade receivables in the seven years from 1955 to 1962 gained 60 billion dollars, or 75% (see Appendix A, figure 2)⁷ By 1962 the trade debt of non-financial corporations was far greater than the business lending of the entire commercial banking system and exceeded the volume of corporate bonds and state and local securities (see Appendix A, figure 1)⁸. Seiden, commenting on the volume of trade credit, said that quality is not the paramount concern of trade creditors. The primary interest is sale of goods and services⁹

Concern for the Quality of the Accounts Receivable Asset

In April 1965 The Research Institute of America noted that data from the F.T.C.-S.E.C. Quarterly Financial Report for manufacturing corporations showed that non-financial trade receivables of domestic

⁶Kaplan, p. 84

⁷Dun and Bradstreet, Inc., Growth of the Credit Function (September, 1962).

⁸Martin H. Seiden, The Quality of Trade Credit (New York: National Bureau of Economic Research, 1964), p. 1.

⁹Seiden, p.1.

companies had increased 142% in the previous ten years but that collection periods for these trade receivables were now averaging 44 days versus 32 days in 1954.¹⁰ The publication questioned whether trade credit was dangerously swollen. A survey by the staff of the Research Institute revealed that while businessmen were aware of their own companies' increased accounts receivable totals, few were knowledgeable about this condition in all manufacturing industries. Since inventories now appeared as a less volatile asset because businessmen had learned how to use computers to smooth out too rapid buildups or hasty depletions, the research staff suggested that the accounts receivable asset should now receive closer attention.¹¹ Two courses of action were mentioned: an increase in personnel for proper analysis of the makeup of accounts receivable and improved collection practices.¹²

Different Viewpoints on Coping with Receivables Growth

In the 1950's there had been stress by credit department managers on procedures to cope with the increasing size of trade receivables, improving routines for collecting accounts, filing, recordkeeping and correspondence.¹³ The addition of more credit personnel mentioned by Beckman & Foster implemented these activities.

¹⁰Research Institute of America Recommendations (April 30, 1965), p. 1.

¹¹Research Institute, p. 1

¹²Research Institute, p. 1

¹³Curtis, p. 6, 7.

Others believed that timely and detailed information critical for efficient collection activity was lacking. This need was satisfied in part when credit department operations began to use electronic data processing systems.¹⁴ In addition to shortening the time for processing customer accounts receivable data to credit personnel, the use of computers had a second benefit; slowing the increase in credit department personnel through the elimination of much manual work.¹⁵

Need for Cash Resources

Other analysts such as Arthur B. Toan, Jr., noted that the increasing dollars in accounts receivable began to affect corporate liquidity:

A corporation's credit policy quite clearly affects its flow of cash and while corporate policies should not rise or fall solely or even primarily on the basis of their impact on cash, it is a fact that available cash is in many enterprises a major factor limiting what the corporation can actually do.¹⁶

Toan recognized that in order to be competitive managements must consciously commit a certain amount of company cash to finance sales as well as to maintain specific inventory levels, but managements preferred the cash to be outside of their control the shortest possible time.¹⁷ This policy in practice often posed the dilemma of

¹⁴Alice G. Dorworth, "Electronic Data Processing Systems," Credit Management Handbook (Homestead: Richard D. Irwin, Inc., 1963), p. 406.

¹⁵Dorworth, p. 406.

¹⁶Arthur B. Toan, Jr. "The Impact of Corporate Policy on Cash Flow," Financial Executive (November, 1963), p. 13.

¹⁷Toan, p. 14.

contradictory goals.

One approach to increasing cash flow was to shorten the time between customer payment and the availability of funds. The practice of credit personnel receiving checks directly, a special business intimacy which allowed the individual credit person to monitor an account closely, had become an anachronism. Since credit departments were generally located at company headquarters or perhaps with several satellite company facilities located elsewhere in the country, the time span between a customer's mailing a check and its eventual deposit in the creditor's bank became an important factor. This "float," or the number of days between a customer's mailing a check and the actual availability of those funds to the recipient vendor, could range from two to six days.¹⁸ Companies selling to customers anywhere in the United States began establishing "lock boxes," which were only check receiving addresses of banks where funds were deposited to the company account. These "lock boxes" were established in areas where customers were clustered. Each day's deposits were then wire transferred to a company's main bank. Victor L. Andrews subsequently stated in a First National Bank of Atlanta publication that:

The management of cash involves the quick movement of remittances from customers in dispersed locations to a central location and a well-planned lock box network is the best means to obtain customer cash fast.¹⁹

¹⁸Statement by Craig Ford, Vice President Mellon National Bank, in a personal interview, New York City, January, 1971.

¹⁹Victor L. Andrews, Cash Management Forum, First National Bank of Atlanta, Vol. 1, Number 1, (January, 1975).

Volk, writing several years later, urged a return to collection specialists as the best means to speed customer payments into a company's lock box network. He recommended a pin-pointing of effort with one group concentrating on collecting, and another adjusting claims while also providing incentives to sales personnel to assist in obtaining payments from customers.²⁰

Trade Credit as an Adjunct to Marketing

Carl Reiser, writing in Fortune magazine, touched upon another vital concern of management when he stated in 1963 that the problem many manufacturers were facing was how to use credit as the vital sales tool that it is without paying too high a price for their sales.²¹ Reiser's survey of manufacturers showed that while some reported that a minority of their accounts just took extra time in paying their debts, other companies deliberately offered easier or longer terms unofficially.²² In some industries, the Fortune article stated, liberal terms were as meaningful as price and quality.²³ Reiser concluded that to maintain or increase sales, corporations were forced to get deeper and deeper into financing their customers and that most companies were not concerned about their bad debt loss ratios.

In the Fall of 1966 the National Association of Credit Management

²⁰Douglas A. Volk, "Managing Accounts Receivable - Systematically," Management Accounting (July, 1980), p. 46.

²¹Carl Rieser, "The Great Credit Pump," Fortune (February, 1963), p. 150.

²²Rieser, p. 123

²³Rieser, p. 123

and the Harvard Business Review sponsored a survey to determine the reasons for the continuing growth in trade credit. Some of the respondents to the survey stated:

Damn the receivables; full sales ahead.

Sure, Receivables have gone up but so have our profits.

Yes, we are liberalizing our trade credit and we can afford it. It is one of the competitive rewards of being financially strong.²⁴

John Landsberg of the Chemical Bank offered another view of the position of receivables in company planning. Corporate strategy involves positioning and conversion of resources to assure attainment of objectives. Accounts receivable are in effect a portfolio of investments that overall should balance risk and return with need to penetrate new markets or maintain old ones.²⁵

The Increasing Cost of Trade Debt

While earlier expressions were indicative of some manufacturers' feelings about expanding trade credit, there were substantial increases in bad debts. In the years 1954 through 1966 sales of non-financial corporations increased 200% while bad debts rose 400% (see Appendix A figure 3)²⁶. The total amount of trade receivables written off against operating income from 1955 to 1966 had increased from \$1.4

²⁴Credit and Financial Management (February, 1967), p. 27.

²⁵John Landsberg, "Managing the Accounts Receivable Portfolio," Credit and Financial Management (April, 1980), p. 11.

²⁶Dun and Bradstreet, Inc., Growth of the Credit Function (September, 1962).

billion to \$4.2 billion (see Appendix B table 1.)²⁷ The cost of liberalized trade credit was no longer an insignificant total.

While bad debt charges are quite visible in their effect on earnings of a company, the slower collection of accounts receivable is a less obvious cost. At the end of 1966 manufacturers' trade receivables were being collected on an average of 41 days (see Appendix A figure 4).²⁸

Total dollars in non-financial trade receivables in 1966 were \$142 billion with some \$38 billion beyond the 30 day standard terms of sale of most U. S. manufacturers.²⁹ This \$38 billion past due, statistically at least, represented excess company investment. Fred Weston of U.C.L.A. took note of the current past due trade receivable balances in a speech before the National Association of Credit Management, stating that management of the receivable asset involved achieving the most effective mileage from this investment.³⁰

The implications of liberal credit policies that may foster receivables growth and thereby necessitate additional financing is often the result of inconsistent management decisions. Walla implies

²⁷Internal Revenue Department statistics furnished by Rowena Wyant, Vice President, Business Economics Division Dun and Bradstreet, Inc.

²⁸Credit Research Foundation, Inc., A Summary of Domestic Trade Receivables (February, 1978) p. 1.

²⁹Credit Research, p. 1.

³⁰Opinion expressed by Fred Weston in an address, ("The Evaluation of the Credit Manager,") at the National Association of Credit Management, Seattle, Washington, May 17, 1966.

that company officials often support receivable expansion as an indicator of growth but may not examine other possibilities such as the institution of discounts to slow this asset expansion.³¹

Management Viewpoint on Accounts Receivable Growth

Merle Welshans, Professor of Finance at Washington University, St. Louis, Missouri, writing eight months after Westons's talk, summarized a survey undertaken by the National Association of Credit Management showing the growth in accounts receivable now meant, "What can credit do for profit?", instead of the former standard, "What can credit do for sales?"³² Welshans specifically emphasized that 50% of the respondents answered "yes" to the question, "Is granting trade credit to high risk or marginal customers influenced by the profit margins involved?"

By 1970, the total dollars of manufacturers' trade receivables had risen steadily since 1959 and were now being collected on an average of 45 days from invoice date (see Appendix A figure 4).³³ This total appeared to confirm what some respondents to the 1966 Harvard Business Review - National Association of Credit Management survey on growth of trade receivables had commented to the effect that trade receivables

³¹Tirlochan S. Walia, "The Explicit and Implicit Cost of Changes in the Level of Accounts Receivable and the Credit Policy Decision of the Firm," Financial Management (Winter, 1977), p. 75.

³²Merle T. Welshans, "Using Credit for Profit Making," Harvard Business Review (January-February, 1967), p. 141.

³³Credit Research Foundation, Inc., A Summary of Domestic Trade Receivables (February, 1978).

were "out of hand".³⁴

In 1978, however, Kim and Atkins wrote that managements intuitively recognized that investments in accounts receivable did support an objective of wealth maximization.³⁵

A staff report of the Credit Research Foundation again emphasized the point that aggressive risk taking or selling financially marginal customers may be the most important activity of credit executives. The Credit Research article stressed another point, however, that marginal accounts should be sold as one path to increasing the customer base.³⁶

Ways to Contain Accounts Receivable Growth

J. Allen Walker, a former General Credit Manager of Standard Oil of California, observed in 1970 that industrial credit departments needed a well thought out credit policy and not a list of procedures to respond intelligently to the growth of trade credit in relation to sales, the declining quality of trade credit, the blurring between credit and financing, the creating of competition with terms of sale, and the marketing implication of credit.³⁷

Weston, in his Seattle, Washington speech, suggested that credit personnel stress sound management and control practices in counseling

³⁴Welshans, p. 142.

³⁵Yong H. Kim and Joseph C. Atkins, "Evaluating Investments in Accounts Receivable: A Wealth Maximizing Framework," The Journal of Finance (May, 1978), p. 403.

³⁶Credit Research Foundation, Inc., "Mining Marginal Accounts--or Gold is Where You Find It" (April, 1980), p. 1.

³⁷Credit Research Foundation, Inc. (April, 1970), p. 2.

customers as a possible means of reducing overdue receivables without a consequent decline in sales.³⁸

Carpenter and Miller, more than a decade later, offered an approach to controlling accounts receivable levels with a procedure for weighting the days sales outstanding number over a three month period. Their approach, it was claimed, was free of the adverse effects of sales fluctuations and changes in collection experience. Both writers indicated, however, that the trend of the days sales outstanding number might be the most important statistic in their procedure.³⁹

Although the accounts receivable collection rate for industrial manufacturing concerns started to decline after 1970, reaching 41 days in 1974 before rising to almost 45 days at the end of 1978, the total dollars outstanding in trade receivables continued to increase throughout the 1970's by 8% a year (see Appendix B table 2).⁴⁰

Reasons for Continued Expansion of Accounts Receivable

In 1967 a symposium of business executives in the industrial equipment field stated, "Credit has been and will continue to be an important marketing tool."⁴¹ The director of merchandising services for International Harvester said that his company frequently bypassed

³⁸Weston, Seattle, May 17, 1978.

³⁹Michael D. Carpenter and Jack E. Miller, "A Reliable Framework for Monitoring Accounts Receivable," Financial Management (Winter, 1979), p. 40.

⁴⁰Credit Research Foundation, Inc., A Summary of Domestic Trade Receivables (February, 1978).

⁴¹"What Role Should Credit Play in Marketing," Industrial Marketing (January, 1967), p. 60.

bank and financing institutions and sold to credit worthy farmers on extended terms. The President of American Photocopy Equipment Company of Evanston, Illinois, stated it was better to lease now than sell for cash later. Gordon A. Lowden, Executive Vice President of N.C.R., Inc., viewed credit as a vital factor in offering various financing plans to make it possible for every prospective customer to install N.C.R. equipment.

These comments by company officials bear out what Robert Bartels, Professor of Marketing at Ohio State, wrote in 1964. Sellers do not "give credit;" they perform a service and this credit service should be marketed like any other service and the market demand for it ascertained. Credit is the financing of markets and the essential idea of industrial credit is often misunderstood, suggests Bartels.⁴²

Dr. Harold W. Fox of De Paul University tied credit service closer to marketing by suggesting that credit service be tailored to a company's product life cycle: liberal credit lines to customers when a company is entering new markets and profits are large, and restrictive credit exposures to minimize potential bad debts or long overdue receivables when the market is declining and profits may be minimal.⁴³

The Need for More Research in the Area of Industrial Credit

The multifaceted character of industrial credit and the increasing

⁴²Robert Bartels, "Credit Management As A Marketing Function," Journal of Marketing (July, 1964), p. 60.

⁴³Harold W. Fox, "A Dynamic Perspective for Credit Analysis," Credit and Financial Management (January, 1977), p. 30.

demands placed upon credit personnel to possess a broad ranging business perspective and to be, at the same time, expert practitioners of the latest credit techniques, caught the interest of academic observers of business.

Dwayne Wrightsman stated that there was an absence of literature on optimal credit terms for accounts receivable but that there was no reason why companies must follow competitors' terms of sale if such terms were not to a company's advantage.⁴⁴

Credit terms should be established that provide maximum product sold and maximum profit, stated Wrightsman. Shorter terms would normally decrease sales but product quality or some company uniqueness might offset this potential negative influence. Wrightsman implied, however, that firms could control the size and turnover rate of their accounts receivable.

George L. Marrah asked for greater influence of a company's financial executives in establishing credit programs. Slow paying companies should only be accepted as customers or be extended payment terms offered to all customers in a specific market as long as profit from extra credit sales exceeded the added costs.⁴⁵ Marrah believed the financial executive of a company was the proper individual to guide credit personnel in establishing a credit policy that would encourage

⁴⁴Dwayne Wrightsman, "Optimal Credit Terms for Accounts Receivable," Quarterly Review of Economics and Business (Summer, 1969), p. 59.

⁴⁵George L. Marrah, "Managing Receivables," Financial Executive (July, 1970), p. 41.

sales, increase profits and, most importantly, keep the investment of receivables to a minimum.

Dileep Mehta objected to the absence of a systematic method for credit acceptance guidelines and the employment of conventional financial ratio measures based on the historical experience of a company. In the latter case past operating experiences may not be of optimal value for the company and therefore the ratios so derived can be of questionable worth.⁴⁶ Mehta believed an optimal credit policy was possible for any company if sufficient study was made of all phases of the credit activity, all costs associated with the accounts receivable asset studied, and criteria developed that aided in both routine and unique decision making.

In their article, "The Credit Granting Decision," Bierman and Hausman advocate probabilistic models for what they consider a most important decision-making area in determining the size and quality of a company's accounts receivable investment. Both individuals admit that the use of sales price and incremental costs used in their models implies that each product being sold which has a different incremental profit per dollar of sales theoretically will require a different credit policy and that this requirement may be frequently ignored in practice.⁴⁷ The authors seem to recognize that their theory and the practice of the credit function may not mesh but they make the point

⁴⁶Dileep Mehta, "The Formulation of Credit Policy Models," Management Science (October, 1968), p. B32.

⁴⁷Harold Bierman, Jr. and Warren H. Hausman, "The Credit Granting Decision," Management Science (April, 1970), p. B521.