CONSUMER AND COMMERCIAL CREDIT MANAGEMENT

Seventh edition

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Preface

CREDIT!

This word, written or spoken, has brought happiness and opportunities to millions of American consumers and business firms. American individuals have used credit to improve their standard of living, and American business firms have used credit to improve and enhance their profit position.

Unfortunately, however, there is another side of the coin. Many consumers and business enterprises have also experienced a great deal of unhappiness and great losses because of their unwise use of credit.

To repeat the opening sentence in the Preface of the 1960 edition of this book, "Credit is an increasingly important force in the lives of all of us today"—this is as true in 1984 as it was in 1960.

This seventh edition is smaller than the sixth edition—511 pages as compared with 660 pages. The number of chapters has been reduced from 28 to 22. However, the coverage of credit activities has not been reduced. In fact, it has been greatly expanded and, of course, updated. The reduction has been effected by combining the material in several chapters into one chapter, eliminating duplication of material, cutting out nonessential material, and rearranging various topics. To a great extent these changes resulted from the suggestions and recommendations of two reviewers: John L. Grim, Youngstown State University, and Ray McAlister, North Texas State University. I am very grateful for their advice and comments.

The greatest revisions occurred in the two chapters describing the activities of Dun & Bradstreet, Inc., and those of other commercial credit reporting agencies. I appreciate the extensive help I received in revising these chapters. In addition, many other individuals contributed their time and effort in revising the other chapters of the book. To them, I express my thanks.

Recognition is given to Professor Robert S. Hancock, who coauthored the first two editions of this book. It is sad to report that Professor Hancock passed away early in 1982.

Any and all suggestions from the readers of this book will be most welcome in order that the book may continue to tell the complete story of the management of credit and collection activities.

Robert H. Cole

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Background to the Field of Credits and Collections

CHAPTER 1
Credit in the Economy

Every day in every way, we become more and more involved in the world of credit.

Thus there is a challenge to individual consumers, retailers, service concern operators, wholesalers, manufacturers, financial executives, and government officials to have and to maintain a fully complete and clear understanding of what credit is, what it does, what it can do, and what it cannot do. To help meet this challenge, it is necessary that the current role and functioning of credit be carefully examined; that inquiry be made into the changes in the various types of credit plans and into those factors which encourage or inhibit growth; and that identification be made of the social and economic goals to be served by credit and the manner in which these goals can best be reached by industry and government working together. Likewise, it is important that we clearly understand the legal framework, both federal and state, within which our credit and collection operations are conducted.

During the past two decades, the federal government, state and local governments, and business enterprises have greatly expanded their use of credit to carry on their many and varied operations. Likewise, American consumers used credit widely and extensively to purchase homes, to buy automobiles and the ever-widening array of consumer goods, to repair and improve their residences, and to obtain the services needed and desired to live in this 20th century. Thus the terms *installment credit, revolving credit, open charge credit, service credit, bank credit card credit, cash loan credit, commercial credit, financial credit,* and *public credit* have become familiar to most of us.

The consumer's attitude toward credit has changed substantially over the years, and the incurring of individual debt has attained a relatively new respectability. Likewise, the enhanced financial security experienced by an increasing proportion of consumers has permitted them to satisfy wants and desires far in excess of their basic needs. While such financial security does not always suffice for outright cash purchases, it still has proved sufficient to cover a series of payments and interest charges resulting from credit purchases of the ever-increasing array of goods and services.

The attitude of more and more retailers and service concern operators has become increasingly favorable toward the use of consumer credit, as they have discovered that the acceptance of credit from consumers can be a powerful competitive device by which to expand sales, profits, and market share. This attitude is reflected backward through the channels of distribution and has had its favorable effect upon the operations of wholesalers, manufacturers, and financial institutions.

The emotions of many people, however, have been and continue to be stirred when they hear the word *credit*. In fact, some individuals condemn all types of credit, and particularly installment credit, without stopping to analyze just what our nation would be like without credit. The simple fact is that the United States runs on credit. If all credit activities were stopped right now, the wheels of business as we know it would come to a screeching stop. Just how many manufacturers, wholesalers, retailers, and service concern operators would be able to stay in business without credit? Not many. Just how many individuals would be able to buy homes, cars, and appliances without some form of credit? Not many. Just how many people would be willing to pay cash each time to the paper boy (at 6 A.M.) or to pay for their utilities such as gas, electricity, water, and telephone on a strictly cash basis? Not many.

Thus credit has become one of the many social inventions with which we are familiar and which we use more and more, whether we be the consumer, the retailer, the wholesaler, the financial institution, the manufacturer, or any one of the many other institutions engaged in the marketing of goods, services, and money.

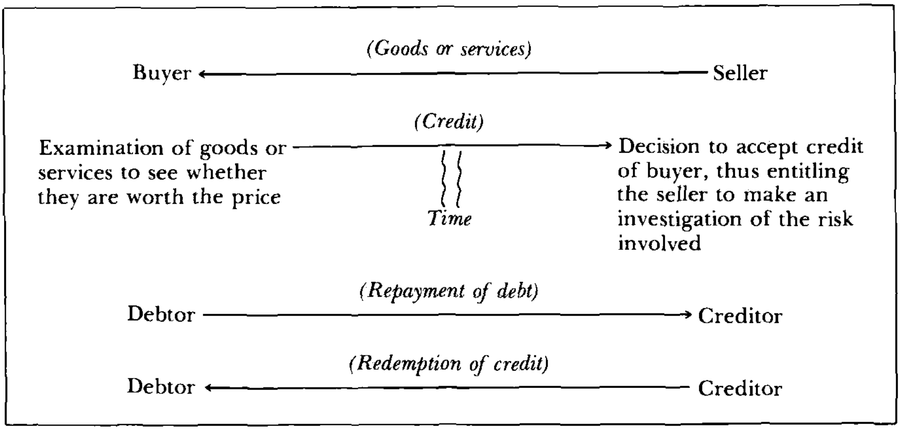
WHAT CREDIT IS

The term *credit* has been defined in many ways and by many writers. When analyzed, however, many of the proposed definitions are simply descriptions of credit or statements as to the use of credit, rather than definitions of credit itself. To contribute to an understanding of what credit is and what it does, the following definition will be followed throughout this book: *credit is a medium of exchange of limited acceptance*. The diagram shown in Figure 1–1 illustrates this definition.

Medium of Exchange

In Figure 1–1 it is seen that credit acts as a medium of exchange in that it facilitates the passage of goods or services from seller to buyer.

FIGURE 1–1
How Credit Works



Just as money is recognized in our economy as a medium of exchange permitting the easy passage of goods or services between seller and buyer, so is credit recognized.

Credit, viewed as a medium of exchange, does have particular characteristics. It is a medium of exchange which is created at the time of the transaction and which arises for the purpose of facilitating that particular exchange. It is a medium of exchange which, after being issued, does not close the transaction; there is a promise that at some future time a further step will take place, that the credit will be redeemed by the process known as payment.

The creation of this medium of exchange brings into existence certain rights and privileges. With this thought in mind, we may point to the fact that credit is given by the buyer to the seller, and the seller exchanges goods or services for the buyer's credit. It is only after agreeing to accept the buyer's credit that the seller transfers the goods or services. Whereas in actual practice it is more common to say that "Store X offers credit to its customers," the fact is that Store X is simply accepting (or refusing) its customers' credit for the goods and services it has for sale.

Limited Acceptance

When a customer offers a merchant $10 today in exchange for a sport shirt priced at that figure, the retailer does not stop to analyze whether the $10 should be accepted (except perhaps for caution against counterfeiting) but takes the money, knowing that in turn others will be highly willing to accept this $10. Thus our metal money and paper money today have a characteristic that can be called "unlimited acceptance." Therein lies the main difference between credit, which is generally considered to have limited acceptance, and money, which has unlimited acceptability.

This limited-acceptance concept of credit is perhaps more clearly understood when reference is made again to the definition diagramed in Figure 1–1. While it is true that the buyer has the option of examining the goods or services to see whether they are worth the price asked by the seller and whether to offer credit for them, the seller also has the right to make an investigation of the buyer and to decide whether to accept the individual as a credit risk. For, in every credit transaction, there is a passage of time before repayment of the debt occurs. It is because of these two elements, "risk" and "time," found in every credit transaction that credit has limited acceptance.

When the two parties to a transaction exchange goods or services for credit, we call them "buyer" and "seller," but after the exchange we can and do use the legal terms indicative of their continuing relationship, namely "debtor" and "creditor." The exchange does not end their relationship, which continues into the future and links them until the credit is redeemed by the exchange of money for the credit of limited acceptability first offered by the buyer and accepted by the seller. Upon payment, the buyer's credit is returned, and the buyer is in a position to reuse this credit in purchasing other goods or services if a seller can be found who is willing to accept this credit.

Credit as an Act versus Credit as a Power

It should be recognized that credit as an act may be measured in terms of actual dollars. In other words, when a person offers credit to a retailer for a suit of clothes and the retailer accepts the person as a credit risk, a credit act has taken place and a dollar amount can be placed on the indebtedness incurred.

Credit, however, also may be thought of as a power inherent in all of us—the power to create a medium of exchange. The quantity of this power which each of us can issue depends upon the acceptance we can obtain for it—upon how many persons we can induce to accept our credit and in what amount. Everyone, however, has a quantity limit which is raised by the ability to convince others that additional credit should be accepted in exchange for the goods, services, or money sought. Thus for all practical purposes credit as a power cannot be measured.

The power to issue credit is thus limited by the extent to which we can convince others of its acceptability. The credit record we make as