



Credit Policy Planning in Medium Scale Business

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Abstract

In dealing with the factors affecting credit policy, a management should consider external and internal information before creating a policy. Internal factors include the structure and the amount of available bank assets and liabilities, and the type, state, and composition of available banking facilities and personnels. Meanwhile, external factors include the atmosphere of the business world in general and banking sector in particular, bank location, and others. The factors that need to be considered in credit policy cannot be separated from the problems that exist in banking activities. Since the factors affecting credit policy act as a guideline which influences credit management, it is important to analyze these factors. This research maps out some important factors in credit management and recommends certain practical steps that can be taken in credit management.

Keywords: *Credit management, Internal factors, External factors, Credit policy*

1. Background of the Study

The intermediary function of banking shows constant increase from year to year. The amount of banking loans granted in 2012 was 507.8 trillion Rupiah, which suggested a 16.9% increase from the sum of 434.3 trillion Rupiah in 2011 (Ikatan Bankir Indonesia, 2014). This growth indicates the importance of proper credit management to improve and increase economic growth. The credit grant process is a dynamic process that requires the consideration of prudence and loan segment characteristics. In terms of time, credit schemes can be categorized into long term, medium term, and short term schemes. Long-term planning normally takes more than five years; medium term three to five years; and short term one year. Credit planning determines how credit should be granted in the future in order to achieve the predetermined credit objectives. Hence, some of the most important factors in credit planning include macro economic and monetary conditions, capital market activities, and financial institutions. The purpose of this research is to analyze the factors affecting credit policy planning in medium scale enterprises.

2. Theoretical Review

2.1 Factors to consider in planning credit policy

As stated above, the creation function is one of the main functions of a bank. Consequently, the bank's success in managing credit determines its success in generating profit or maintaining sustainability. In determining credit policy, banks must consider several factors (Ikatan Bankir Indonesia, 2014): (1) Important factors in credit policy, which states that: (a) The credit policy must be in accordance with the vision, mission, corporate plan, and business plan of the bank; (b) In granting loans, the bank must be able to supervise credit portfolio as a whole, set a standard in individual loan grant, and set a standard for the stages of credit grant with the addition of internal supervision; (c) The credit policy is considered good when it covers the prudence principle in credit management, credit management and organization, credit approval policy, documentation and administration, credit supervision, and credit settlement; (d) The credit policy serves as a guideline, and should be reflected in the credit policy guideline used by every bank; (e) The credit policy must be submitted to and approved by the board of commissioners; and (f) Bank of Indonesia should supervise, monitor, and

assess the implementation of credit policy in a bank; (2) The prudence principle in credit management, which consist of: (a) Main credit policies which regulate: (1) healthy credit procedures which include credit approval procedures, documentation and administration procedures, and credit supervision procedures; (2) credit with special treatment; (3) credit with capitalized interest; (4) non-performing loan settlement procedures, bad debt write-off procedures, and non-performing loan reporting procedures; and (5) collateral settlement procedures for credit items owned by the bank as a result of credit settlement result; (b) Bank's credit policies for associates and major debtors which consist of: (1) Limitation on the maximum amount of overall provision of credit facilities provided by the bank to the related parties in percentage figure based on the sums of credit amount and calculated bank capital; (2) Syndicated and consortiumed loan provision procedures for related parties in which the risks are shared with other banks; (3) Credit terms for the related parties, particularly the comparison between the predetermined loan interest rate and other debtors, as well as the form and type of collateral; and (4) Bank's policy in giving loans to the related parties in relation to the credit regulations, particularly those of BMPK's; (c) The inclusion of economic sector, market segment, business activities, and high-risk debtors; (d) Risky credits, which include: (1) speculative credit; (2) credit without sufficient financial information; (3) credit which requires special skills not owned by the bank; and (4) credit for non-performing debtors and/or to other banks; (e) The credit quality assessment procedures must be based on certain procedures which ensure that the credit collectibility assessment performed by the bank is in accordance with the regulations of the Bank of Indonesia; and (f) Credit officers must project professionalism and integrity, which means that the credit policy must state clearly that the credit officers are members of the board of commissioners, and that the management will display professional manners in their credit management by being honest, objective, careful, meticulous, and aware of the banking regulations.

2.2 Credit Management and Organization

The credit management and organization (Ikatan Bankir Indonesia, 2014) must meet the following requirements: (a) Credit policy must include organization members and credit management, as well as the authority and responsibility of the organization members and credit officers; (b) In addition to credit officers, the board of commissioners and directors must have a credit policy committee and credit committee; (c) The management must state the membership and authority of the credit policy committee in written agreement; (d) The basic functions of the credit policy committee are: (1) providing input for the board of directors; (2) supervising the implementation of credit policy; and (3) supervising the credit portfolio; (e) The responsibilities of the credit policy committee are: (1) submitting a periodic report on the supervision result and the implementation of credit policy to the board of directors and a copy of the report to the board of commissioners; and (2) providing the board of directors with suggestions and remedial measures; and (f) The tasks of the credit committee are: (1) Approving or rejecting credit applications accordingly; and (2) Coordinating with the Assets and Liability Committee (ALCO) on funding.

2.3 Credit Approval Policy

The credit policy should include credit approval policy (Ikatan Bankir Indonesia, 2014) which contains: (1) The total relationship concept of credit application. Credit approval should not be solely based on one transaction or one credit account. Rather, it should take into account the overall credit assessment of the credit applicant which is given and/or will be given by the bank, or also known as total relationship concept; (2) Limitation of credit approval authority. Credit policy must include the rationale and criteria for the credit approval authority limit. The authority limitation for credit approval must be made in written agreement through the decision made by the board of directors. This agreement must at least state the amount of credit and the appointed loan officer; (3) The responsibilities of credit breaker officials are to: (a) Ensure that the granted loans are in compliance with the banking regulations and the principles of healthy credit; (b) Ensure that the implementation of the credit grant is in accordance with the bank's credit policy and the guideline for credit enforcer; (c) Ensure that the credit grant is based on honest, objective, and meticulous calculations in order to avoid non-performing loan; and (d) Ascertain that the given loan will be paid back in time and not develop into non-performing loan; (4) The credit approval process requires the following: (a) The credit approval process requires a written credit application which contains all the necessary information and meets the bank's requirements. The bank must then confirm that the fund and information stated in the credit application are true; (b) The credit analysis should display the total relationship concept of credit application, state all information regarding the business and applicant data in a complete, accurate, and objective manner, and provide an assessment on the feasibility of the credit application amount and the project or the financed business in an objective manner. Credit analysis should also assess the character, capacity, capital, collateral, and condition of the debtor's business, also known as the 5C's; (c) The recommendations for

credit approval are compiled in written format based on the credit analysis which has been performed; (d) The credit approval must take into account the analysis result and recommendations; differences must be clearly stated in writing; (5) The credit agreement states that the credit application for every approved loan must be made in the form of loan agreement. This agreement comes in the form of written agreement and contains the following prerequisites: (a) It fulfills the legal requirements and validity to protect the interest of the bank; and (b) It states the amount, duration, repayment procedure, and other credit requirements stated in the credit agreement; and (6) The approval of loan disbursement, which follows the following principles: (a) The bank will only approve loan disbursement when all the requirements in the credit agreement are met by the credit applicant; and (b) Before disbursing the loan, the bank must ensure that all juridical aspects related to the credit have been settled in order to provide adequate protection for the bank.

3. Research Methods

This research uses literary study. The literary study method is used to collect data from various relevant literary sources to discuss the research problems. The literary sources in this study include works on the credit management of medium scale business, credit management in banking, and credit management advice from financial management consultants. This research employs qualitative approach in its data analysis. The data analysis process consists of the following three stages (Sugiyono, 2014): (1) Data reduction, which summarizes, categorizes the main subjects, focuses on important things, and looks for patterns; (2) Data presentation, which systematically compiles and present the data; and (3) Decision making, which draws conclusion from the research in order to answer the predetermined problem statements.

4. Discussions

4.1 Working Capital Management Functions

Working capital management plays an important role in any company. Weston and Bringham in Ahmad (1997: 1-2) argue that working capital management is crucial in business due to the following aspects: (1) Many studies conclude that financial managers spend most of their time managing internal affairs on day-to-day basis, which is a part of working capital management; (2) The amount of current assets is often more than half of the total assets, and tends to be unstable; (3) The relation between sales growth and the need for capital in current assets is close and direct; (4) Working capital management is particularly important for small companies for the following reasons: (a) The investment in fixed assets can be reduced by renting or leasing, but current assets, receivables, and inventory cannot be avoided; (b) There is a relatively small number of companies which enter long-term capital market, which results in reliance on trade payables and short-term bank debt as capital. Consequently, the increase in current debt will reduce the net working capital. Meanwhile, Ahmad (1997:6) suggests that the role of working capital management is based on the two functions of working capital, which are: (1) Supporting production activities and sales, and acting as an intermediary for inventory purchase expenses and sales, as well as payment acceptance; and (2) Closing fixed expenses and funds that are not directly related to production and sales. Home and Wachowicz (1997: 215) add that working capital management serves as a basis for two major corporate decisions. Working capital has several posts that normally serve as an important element in the creation of working capital for a company. This suggestion is expected to motivate proper working capital management. In general, the nature of working capital is flexible; it can be reduced and increased according to the company's needs. The difficult part is to determine the amount of change required. Additionally, each company may have different types of working capital according to their business types and needs. The working capital in a company can be categorized based on the need for such working capital (Riyanto, 1999: 58). The following parts will discuss about the two classifications of working capital.

4.2 Permanent Working Capital (Working Capital)

Permanent working capital is a compulsory working capital for any company to perform its functions within a single accounting period. The permanent working capital is divided into: (a) Primary working capital, which refers to the minimum amount of working capital needed by a company to ensure the sustainability of its business activities; and (b) Normal working capital, which refers to the amount of working capital needed for production activities at normal capacity. The understanding of normal capacity is dependent upon the company's condition.

4.3 Variable Working Capital

Variable working capital refers to the required working capital in certain periods. The amount of this capital varies according to the circumstances within the period. Variable working capital can be divided into: (a) Seasonal working capital, which refers to the fluctuating amount of working capital as a result of seasonal change; (b) Cyclical working capital, which refers to the fluctuating amount of working capital as a result of product demand change; and (c) Emergency working capital, which refers to the fluctuating amount of working capital as a result of undetermined causes, such as fire, flood, earthquake, labour strike, and others. (a) Seasonal working capital (seasonal working capital) is the amount of working capital amount of change caused by the change of seasons. (b) Cyclical working capital (cyclical working capital) is a number of working capital in the amount varies due to changes in product demand. (c) Emergency working capital (emergency working capital) is the amount of working capital change of unknown cause before (eg fire, flood, earthquake, labor strikes, and so on).

4.4 Working Capital Calculation

Husnan (1998: 544) mentions a couple of methods that can be used to calculate working capital through the various viewpoints on the definitions of working capital. To estimate working capital (current assets), a working capital turnover method is used. The turnover of current assets components can be calculated as follows (Brigham 2011:650):

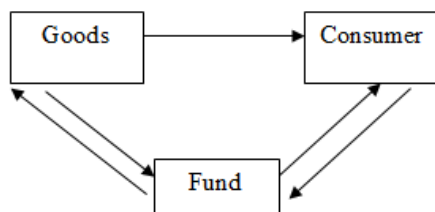
- $Inventory\ Conversion\ Period = \frac{[Inventory]}{[Cost\ of\ goods\ sold\ per\ day]}$
- $Average\ Collection\ Period = \frac{[Receivables]}{[Sales:365]}$
- $Payables\ Deferral\ Period = \frac{[Payables]}{[Cost\ of\ goods\ sold:365]}$

This method can determine the number of days it takes for each component to return to its original state. Thus, the dependent period of the working capital fund is obtained from the addition of days in which the fund is involved. This means that the working capital turnover is the 365-day working capital turnover, which determines how many times the working capital can circulate and return to cash in one year. This method can also determine the turnover of each component in the working capital, also known as *cash cycle*. This term denotes how long the cash will be tied to the working capital before returning to cash. This method acknowledges two important things: (a) The funding of working capital may have been partially provided by other parties in the form of spontaneous funding; and (b) The fund needed to finance the credit should not include the element of profit. This method has an obvious distinction; the exclusion of profit in credit account. It means that the profit earned through credit should not be included in the calculation of working capital.

In principle, this method is equal to cash budgeting. The difference is that only cash flows relating to expenditure or daily operation income are considered. It does not include, for example, the purchase of fixed assets, repayment of long-term credit, and others. The amount of working capital required in a period is indicated by the comparison between incoming cash deficit and cash outflow. This method emphasizes on the calculation of working capital in terms of cash, because it only considers the comparison between cash inflow and outflow, rather than other components. These methods will be useful when adjusted to the company's needs. Hence, it is common for companies to implement different methods in their working capital management. Nonetheless, all the methods refer to the funding used to cover daily operations. The difference lies in the components used by each company.

4.5 Credit Management Principles

Medium scale entrepreneurs follow the following three principles: (1) It can be sold or created; (2) It is payable; and (3) There is a margin (*average gross margin 15%*). Picture 1 describes the interaction between goods, consumers, and funds. It shows how good debt management can result in profit. There is a correlation between fund and the purchase of goods from suppliers to be sold to consumers, because the fund is used to deal with suppliers and meet the consumers' needs.



Picture 1. Credit Management Process

4.6 Types of Fund in Credit Management

There are two types of fund in credit management: (1) Equity, which can be difficult to develop and carries the risk of fund limitation; and (2) Rotation of customer's and supplier's money. Companies have *terms of payment*, both from suppliers and customer sales. It means that the company can set a *term of payment* to manage the fund in which the down payment as a *term of payment* used for customers needs to be bigger than the one used for the suppliers, as shown by the following example:

Table 1. The relation between customers and suppliers

| Customer | Supplier |
|---|------------------------------------|
| Sales of Rp 100.000.000 with 15% margin | Purchase of goods of Rp 85.000.000 |
| DP 30% = Rp 30.000.000 | DP 20% = Rp 17.000.000 |
| Final payment 60% = Rp 60.000.000 | Final payment 80% = Rp 68.000.000 |
| Retention 10% = Rp 10.000.000 | |

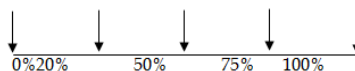
Source: Data Processed

The 30 million Rupiah down payment from the customer can be used as a down payment for the supplier, which amounts to 17 million Rupiah, with 13 million Rupiah excess. After the final payment is made, the company will have an approximate retention of 10%, which amounts to 10 million Rupiah. This amount can be saved or used to pay the 60 million Rupiah down payment for the goods. The primary focus revolves around the following: (1) Controlled term of payment; and (2) Controlled stock, which consists of fast-moving stocks and slow-moving stocks that are only purchased by request to keep the cash flow effective. Additionally, *account receivable* must be balanced.

4.7 Bank Funding

The risk of bank funding is that the bank interest may reduce company profit. As an example of *routine* funding, an annual target of 10 billion Rupiah may take up to 6 rounds of procurement. If the company chooses to use 4 rounds with 2.5 billion each, the maximum upper limit that can be used is 2.5 billion with an interest payment system that matches the upper limit. The control of *routine* funding can be performed through account receivable report and financial report. The company must pay attention to margin when making a business plan by including the element of bank interest in the calculation.

The control method for *non-routine* (project) funding involves: (a) Costing sheet/budgeting. Costing sheet must be detailed and include the type of procurement, the value of procurement, the process involved to determine gross margin, and bank interest rate; (b) Progress report and billing. The company must continue to monitor the project's development, as shown in the picture below:



Picture 2. Project Development Period

The progress of this project is closely related to the customer's term of payment, because the company can charge the customer according to the progress of the project. Therefore, the project executor must submit weekly progress report, whereas the financial department must submit weekly costing sheet; and (c) Refund by progress. The company returns the fund to the bank according to the project's progress to avoid misuse. Additionally, refund by progress will lead to efficiency and lower interest expense.

5. Conclusions

The conclusions of the research which analyzes the behaviour of entrepreneurs in the credit management of micro, small and medium enterprises with a focus on Surabaya and its neighbouring areas are as follows: (1) Medium scale entrepreneurs make credit decisions by considering the opportunities of making such decisions; (2) Medium scale entrepreneurs conduct their credit management by considering cash turnover, accounts receivables, and inventory; (3)

The consumable credit is limited to 30% in order to ensure the company's ability to repay their debt on time; and (4) Credit management must also consider the market's demand to determine fast-selling goods and ensure smoother cash flow. The suggestions from this research regarding the credit management planning for medium scale entrepreneurs in Surabaya and its neighbouring areas are as follows: (1) It is important for medium scale entrepreneurs to grasp the concept of credit in order to utilize cash turnover, accounts receivables, and inventory; (2) It is essential for banks to implement control in their credit management to avoid non-performing loans; (3) Fellow academicians are encouraged to further strengthen the theoretical study in credit management by exploring the factors that influence credit management; and (4) Readers and the general public can better understand credit management for middle scale entrepreneurs and use the knowledge as a reference in forming business partnership, particularly in terms of funding policy by means of credit for other entrepreneurs.

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