CHAPTER 16

Credit

Section 16.1

Credit Basics

Essential Question

What are typical terms associated with using credit?

Objectives

After completing this section, you will be able to:

- **Summarize** the purpose and importance of credit.
- **Identify** the types of credit available to individuals and businesses.
- **Describe** the charges associated with using credit.
- **Discuss** the possible outcomes of using credit unwisely

Section 16.1 Review

Check Your Understanding

1. Explain the debtor-creditor relationship.

   Answer: A debtor-creditor relationship is a legal relationship based on good faith that both parties will uphold their end of the agreement. The debtor must repay the creditor based on the terms of the agreement.

2. Why is credit important in the economy?

   Answer: It provides consumers, businesses, and government additional buying power needed to support production and distribution of products. Credit keeps cash flowing through the economy and drives economic growth.

3. What are the most common types of credit available to individuals and businesses?

   Answer: The most common types are closed-end credit and open-end credit.

4. What is the formula used to calculate simple interest?

   Answer: Principal (P) × Rate (R) × Time (T) = Interest

5. What is the risk of overusing credit for a business?

Answer: Businesses that overuse credit run the risk of cash flow problems. If most of the cash of a business is going toward loan payments, money may not be available to pay business expenses.

Build Your Vocabulary

As you progress through this course, develop a personal glossary of key terms. This will help you build your vocabulary and prepare you for a career. Write a definition for each of the following terms and add it to your personal glossary.

credit

Answer: Agreement between two parties in which one party lends money or provides goods or services to another party with the understanding that payment will be made at a later date.

creditor

Answer: Party extending credit; also called the *lender*.

debtor

Answer: Party receiving credit; also called the *borrower*.

consumer credit

Answer: Credit granted to individual consumers by a retail business.

business credit

Answer: Credit granted to a business by a financial institution or another company.

trade credit

Answer: Line of credit granted from one business to another for a short period of time to purchase goods and services.

closed-end credit

Answer: Loan for a specific amount that must be repaid with interest by a specified date or according to a specified schedule.

secured credit

Answer: Credit loans that require collateral.

installment loan

Answer: Loan for a specific amount of money that is repaid with interest in regular installments.

principal

Answer: Amount of money borrowed.

finance charge

Answer: Total amount paid by a borrower to a lender for the use of credit.

open-end credit

Answer: Agreement that allows the borrower to use a specific amount of credit over a period of time.

unsecured credit

Answer: Credit granted based on a signed credit agreement. Also referred to as a *line of credit* or *revolving line of credit*.

annual percentage rate (APR)

Answer: Annual cost of credit charged by a lender.

Section 16.2

Business and Credit

Essential Question

Why do businesses extend credit to customers?

Objectives

After studying this section, you will be able to:

- **Discuss** the costs and benefits of extending credit to customers.
- **Explain** how businesses obtain and use credit.

Section 16.2 Review

Check Your Understanding

1. Why do some businesses prefer to accept bank-issued credit cards, such as MasterCard and Visa?
   Answer: An advantage to accepting these cards is that the financial institution is responsible for collecting the money owed, not the business. The financial institution pays the business immediately and then collects the money owed for the sale from the customer.

2. List the three Cs of credit that help evaluate a customer's creditworthiness.
   Answer: The three Cs of credit are character, capacity, and capital.

3. Identify the rewards of extending credit to customers.
   Answer: The greatest reward for a business is the generation of sales. Consumers often spend more when using a credit card than if they are paying cash. Another reward of extending credit to customers is building customer loyalty.

4. What are the five Cs of banking that lenders use to evaluate a business seeking credit?
   Answer: The five Cs of banking used to evaluate businesses for credit are character, capacity, capital, collateral, and conditions.

5. Explain the meaning of the trade credit term *n/30*.
   Answer: The trade credit term *n/30* means the buyer has 30 days from the date of purchase to pay the net amount of the purchase.

Build Your Vocabulary

As you progress through this course, develop a personal glossary of key terms. This will help you build your vocabulary and prepare you for a career. Write a definition for each of the following terms and add it to your personal glossary.

proprietary credit card
Answer: Credit card that can only be used in the stores of the company that issued it.

credit policy
Answer: Written set of guidelines used by an organization to determine how many and which customers will be approved for credit.

three Cs of credit

Answer: Criteria used to evaluate the creditworthiness of consumer credit applicants, including character, capacity, and capital.

credit report

Answer: Record of credit history and financial behavior for a business or individual.

credit bureau

Answer: Private firm that maintains consumer credit data and provides credit information to businesses for a fee.

credit score

Answer: Numerical measure of a loan applicant's creditworthiness at a particular point in time. Also known as the *FICO score*.

credit risk

Answer: Potential of credit not being repaid.

accounts receivable

Answer: List of the individuals or businesses that owe money to a company.

accounts receivable aging report

Answer: Report that shows when accounts receivables are due, as well as the length of time accounts have been outstanding.

collection agency

Answer: Company that collects past-due bills for a fee.

five Cs of banking

Answer: Criteria lenders use to evaluate the creditworthiness of businesses, including cash flow, capacity, capital, collateral, and conditions.

Chapter Summary

Section 16.1 Credit Basics

- Credit is an agreement between two parties in which one party extends credit and another party receives credit. The purpose of credit is to serve as a medium of exchange that allows individuals, businesses, and governmental agencies to buy goods or services now and pay for them later. Credit is also important to the economy because it keeps cash flowing and drives economic growth.
- Various types of credit are available to individuals and businesses. The most common types are closed-end credit and open-end credit. Installment loans are a common type of closed-end credit. An example of open-end credit is a credit card.
- Using credit is not free. The finance charge for the use of credit includes interest and fees. The total amount paid for the use of credit is based primarily on the interest rate charged, amount of credit used, and length of the repayment period. Businesses that extend credit must comply with both federal and state credit laws.
- Using credit unwisely can create financial disasters. Consumers who overuse credit run the risk of not being able make payments on time, which results in a lower credit score and higher interest rates. Businesses that overuse credit may not be able to pay business expenses and risk lawsuits.

Section 16.2 Business and Credit

- There are both costs and benefits to extending credit to customers. The costs may directly affect the profit of a business. Many businesses add a markup to the price of products to cover the cost of credit. The greatest benefit to offering customers is the generation of sales. Offering credit can create steady income for a business. Building customer loyalty is another benefit of extending credit to customers. Customers appreciate the convenience of using credit for purchases.
- Most businesses need credit at some point in their operation. For short-term credit needs, many businesses use bank-issued credit cards. Bank loans may be needed for long-term credit needs. To determine if a business has the ability to repay a loan, lenders evaluate businesses based on the five Cs of banking. Types of business credit include supplier financing and bank financing.

Review Your Knowledge

1. Identify some of the benefits of credit.

   Answer: Credit provides the following benefits: ability to use goods and services as they are being paid for, opportunity to buy costly items, source of funding for emergency or unexpected expenses, and convenience of carrying a credit card instead of cash or a checkbook.

2. What is an amortization table?

   Answer: An amortization table is a schedule that shows the amount of interest and principal for each payment so the loan can be repaid within a specific period of time.

3. Describe the charges associated with using credit.

   Answer: An annual percentage rate (APR) is the annual cost of credit charged by a lender. The higher the APR, the larger the finance charges. A finance charge includes interest and fees. The interest rate represents the cost of the loan and is expressed as a percent of the amount borrowed. Fees include items such as application fees and other necessary processing costs.

4. What are the three factors that contribute to the total amount paid for using credit?

   Answer: The total amount paid for the use of credit is based primarily on the interest rate charged, amount of credit used, and length of the repayment period.

5. Discuss the possible outcomes of using credit unwisely.

   Answer: Using credit unwisely can create financial disasters. Consumers who overuse credit run the risk of not being able to make payments on time, which results in a lower credit score and higher interest rates. Businesses that overuse credit may not be able to pay business expenses and risk lawsuits.

6. Discuss the costs and benefits of extending credit to customers.

   Answer: There are many costs involved when businesses extend or accept credit. These costs may directly affect profit. The costs include transaction fees for accepting credit and debit cards, having cash tied up if trade credit has been extended, bad debts decrease the net income of a business, and the additional paperwork required to extend credit. The greatest benefit for a business that extends credit to customers is the generation of sales. Offering credit through credit cards, installment loans, and trade credit can create steady income for a business. Businesses also typically charge interest and finance charge on unpaid balances. These interest charges become another source of revenue for the business. Another benefit of extending credit to customers is building customer loyalty.

7. What information is provided about business or individual on a credit report?

   Answer: A credit report shows the number and types of credit accounts and indicates any that are past due, how promptly credit cards and loans were paid in full, timely payment of other bills, current total outstanding debts, and amount of available credit on credit cards and home equity loans.

8. How do accounts receivable affect the cash flow of a business?

   Answer: Customers that fail to pay bills on time may create a cash-flow problem for the business that extended the credit. The accounts receivable is a list of the individuals or businesses that owe money to a company. Maintaining enough cash flow is critical to keep a business open.

9. How do conditions affect the ability of a business to repay a loan?

   Answer: Conditions relate to the overall environment in which the business operates. This includes the strength of the overall economy, the local economy, and the industry in which the business competes. A business is more likely to receive a loan when economic and industry conditions are good, and its competitive position is strong.

10. What are the most common terms for using trade credit?

    Answer: For trade credit, terms of the line of credit is most often 30 or 60 days. This means that the purchase is interest free for 30 or 60 days. Full payment is expected at the end of the time period. If the bill is paid in full by the specified date, no interest is charged. However, if the bill is not paid or not paid in full by the specified date, interest charges are applied.

Apply Your Knowledge

1. Credit serves many purposes for consumers and businesses alike. Write several paragraphs that summarize the purpose of credit in our economy.

   Answer: Student answers will vary. Evaluate each response individually.

2. Credit has a different level of importance for individual consumers and businesses. Explain the importance of credit for consumers and businesses. What is the recurring theme for both parties?

   Answer: Student answers will vary. Evaluate each response individually.

3. As a consumer, when is it acceptable to use credit? When is it unacceptable to use credit?

   Answer: Student answers will vary. Evaluate each response individually.

4. When considering a customer for credit, lenders review all the information on the credit application and credit report. What kind of information do you think could hurt a customer's chance of getting credit? Make a list of five items that could reflect negatively on someone's creditworthiness. Briefly describe how to fix or avoid each.

   Answer: Student answers will vary. Evaluate each response individually.

5. List the five Cs of banking used to evaluate the ability of a business to repay a loan. Describe what information a business can provide or may be requested to provide for each item listed.

   Answer: Student answers will vary. Evaluate each response individually.

You Do the Math

Functions

Both businesses and individuals invest money and take out loans. Compound interest is exponential. This means that previously earned interest itself earns interest in the future. This can be thought of as interest on interest. The future value of a balance with compound interest is calculated by multiplying the present value by one plus the annual interest rate taken to the power of the number of terms.

$FV = PV \times (1 + r)^n$

In this equation, *FV* is the future value, *PV* is the present value, *r* is the annual interest rate, and *n* is the period of time over which interest is compounded.

Solve the following problems.

1. A business has placed $10,000 in a certificate of deposit (CD) that earns 3.78 percent interest per year. The term of the CD is three years. How much money will the business have at the end of the term?

   Answer: Answers may vary slightly due to rounding.

   $FV = PV \times (1 + r)^n$

   $FV = \$10,000 \times (1+.0378)^3$

   $FV = \$10,000 \times (1.118)$

   $FV = \$11,180.00$

2. Elija has taken out a small business loan of $25,000 for a term of five years. The interest rate is 2.9 percent annually. How much interest will have been paid at the end of the loan?

   Answer: Answers may vary slightly due to rounding.

   $FV = PV \times (1 + r)^n$

   $FV = \$25,000 \times (1+.029)^5$

   $FV = \$25,000 \times (1.154)$

   $FV = \$28,850$

   $\$28,850 - \$25,000 = \$3,850.00$

   Elija will have paid $3,850.00 in interest.

3. A florist needs to purchase a new delivery van. The amount that will be financed is $36,575. The dealership is offering three financing options: 4.9 percent for 48 months, 1.9 percent for 60 months, and 0.9 percent for 72 months. Which option results in the lowest total interest paid?

Answer: Answers may vary slightly due to rounding.

First option:

$FV = PV \times (1 + r)^n$

$FV = \$36,575 \times (1 + .049)^4$

$FV = \$36,575 \times (1.211)$

FV = $44,292.33

$44,292.33 – $36,575 = $7,717.33 in interest

Second option:

$FV = PV \times (1 + r)^n$

$FV = \$36,575 \times (1 + .019)^5$

$FV = \$36,575 \times 1.10$

FV = $40,232.50

$40,232.50 – $36,575 = $3,657.50 in interest

Third option:

$FV = PV \times (1 + r)^n$

$FV = \$36,575 \times (1 + .009)^6$

$FV = \$36,575 \times 1.055$

FV = $38,586.63

$38,586.63 – $36,575 = $2,011.63 in interest