

Credit & Collections for Business

March 2012

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Whether to extend credit to customers can be a difficult decision for a business owner. In most cases, if you're considering whether or not to do so, you probably don't really have an option. Think through the decision carefully and set your credit policy up front. Once you have a collections issue is not the time to be deciding how you're going to handle the situation.

Business Credit Policy

If your business is going to offer credit, you need a credit policy. Your business and the amount and types of credit you offer will affect the type of policy you need. No matter how large or small, your credit policy should cover at least the following:

- Types of credit offered
- Who gets credit and how much do they get
- How you will handle collections
- What you'll do if they don't pay

Business Credit Options

For business credit, there are typically four types of credit offered:

- Cash
- Checks
- Credit Cards
- Open Credit Account

Cash – Cash (as in currency) is not actually credit, but cash, as a category, can take several forms, some of which are credit. Businesses don't pay their bills or remit invoice payment via currency. They do use wire transfer and letters of credit. A wire transfer is the safest type of cash transaction as you don't have to do anything to complete the transaction. You give the wiring instructions to your customer who electronically transfers money into your bank account. A letter of credit is a guaranty from a bank to transfer funds to you upon certain conditions being met. This type of transaction is typically used for international business transactions where the businesses may not know each other well and are concerned about the transaction or economic risk.

Checks – Checks are typically considered cash rather than credit. However, if you accept a check as payment for goods or services, you assume the risk that the check will bounce. What types of checks you accept in what amounts and from who should be addressed in your credit policy.

Credit Cards – Credit cards are thought of as similar to cash, except they're really like a check, except with fees. Different types of cards carry different fees from 1.5% to over 5.0%. The fee amount depends on the size of the transactions and the volume of business you conduct on the card type.

Open Credit Account – Open credit accounts are the most risky kind of credit and where we'll spend most of our time in this paper. An open account involves extending a certain amount of credit to your customer under specific repayment terms. They vary from COD, which is really no terms at all, to net some time period in the future. You may incentivize early payment by offering discount terms. Discount terms are typically a small percent discount (1.0% - 2.0%) for quick payment of the invoices. Typical discount terms might be 1% 10 days, net 30 days, meaning the customer can take 1% off the invoice amount if they pay within 10 days otherwise the invoice is due in full within 30 days.

The types of credit you offer and the terms under which that credit is granted will likely be determined by your industry. Most industries have standard terms offered by the major player or players in the industry. If you offer something different, make sure you understand the consequences of doing so. Credit terms can be used as a sales tool, in fact, credit terms is a function of product price. The terms also affect your cash flow and credit risk. Once you decide on your standard terms, reformulate your financial models and cash flow reports to determine the impact of the proposed terms on your cash flow. While your initial credit policy will likely be re-written a few times as you get experience in your industry and dealing with your customers, the impact on your cash flow of your terms shouldn't be a surprise. Factor in typical industry repayment statistics like DSO (days sales outstanding) and bad debt percentages into your financial models.

Determining Creditworthiness

If you decide to offer credit in your business, understand up front that some businesses will not pay on time (shocking, isn't it) and some will not pay at all (the dreaded "Maalox moment"). Following a well thought out credit policy will help minimize those bad debts and slow payers, but you'll never eliminate them completely. Taking reasonable precautions to minimize the credit risk to your business will allow you to sleep at night. The thoroughness of your credit investigation will depend on the type and amount of credit you extend and your tolerance for credit risk. Following some basic guidelines will assist you in formulating a plan that works for your business.

1. **Use a Credit Application** – have a credit application that collects the information you want and defines your repayment terms. Get a signature from your customer from a person who has authority to legally bind the customer to pay. It does no good to get a truck driver or secretary to sign a credit application unless they happen to be an owner. Usually, you'll need a corporate officer's signature of vice president or above. There will always be some customer who refuses to sign your credit application. Usually they'll refer to their 'corporate policy' or other such nonsense as that. Many big public companies will have such a policy. Decide up front under what circumstances you'll forgo the signature and stick with that decision. Once an account goes bad, it's too late to get a signature. If you do have to begin legal action against a delinquent account and have no signature from someone with authority to bind the company to pay, you will lose. Period. Just keep that fact in mind when you decide whether to do business with a

company who refuses to sign. The signature only says that if I buy something from you, I agree to pay you for it. Why would any honest business have a problem with that?

2. **Create a Credit File** – determine what financial and business information you need from a potential credit customer and keep updated current information in a central location. A simple file folder will suffice. What should be in your credit file? Well, that depends on your business and the risk you actually face. Here's some examples:
 - a. Business Credit Report
 - b. Business Financial Statements
 - c. Owner's Personal Financial Statement
 - d. Public Records Information
 - i. Property, Payroll and Income Tax Liens
 - ii. Mechanics Liens
 - iii. Security Agreement filings
 - iv. Mortgages
 - e. Correspondence
3. **Set Underwriting Guidelines** – Determine the criteria for granting credit. What amount of credit will you allow and under what terms. You may choose to offer the same credit terms to every customer. Although you don't have to, it's best to limit the circumstances under which you'll grant unusual or non-standard terms.

Financial statements can be a great source of information for granting credit, but it's usually difficult to get out of private companies on a regular basis. As well, credit reports from the major business credit reporting agencies will give some excellent background information on the owners and the locations where they operate and any major problems facing the company. However, you need to understand the limitations of a standard business credit report in predicting repayment of your invoices. Many companies don't report their credit experience to the credit reporting agencies. Dunn & Bradstreet, D&B, is the major business credit agency. Does your company report credit transactions to D&B on a monthly basis? Generally, only the very large companies have the technical personnel and available technological infrastructure to collect and report this information on a monthly basis. Without all companies reporting, the information contained in the business credit report is incomplete and could potentially be completely inaccurate at predicting repayment.

Require your customer to disclose their major vendors for the products they use in their business. Call the references to see how the customer actually pays their bills. Don't be lured into using utility bills and vehicle gas credit cards or banks. These types of references are not useful. Utilities and vehicle gas credit cards will always be paid first to ensure that the business can continue operating. Banks are so concerned about being sued, that they typically only reveal information that is so cryptic that it's not useful. And, if there really is bad information there, they won't tell you. Require references that are providing the products and services that your customers use for their business. Who will you be replacing as a vendor? And why? How much credit does your potential customer have outstanding and how are they handling the repayment? Are they tapped out with other vendors and now hoping to use you to run up another account? This is the most useful information you'll get and should be the basis of your credit decisions.

Talk to other providers of business credit in your industry and share factual, historical information in a confidential credit setting. You can share information with the credit or financial personnel of your competitors about potential customers as long as you don't disclose the information outside of the credit environment and the information is factual and historical. You can't mutually decide how to handle the account in the future. You can only discuss the past. However, under that context, you should develop a close relationship with your counterparts in your industry and share this type of information as you can prevent a potential customer from running up a bill at every provider in town. If you know a potential customer has a large bill with your competitor and have no more credit, you shouldn't expect them to pay you.

4. **Start Small** – In most cases, a new customer will only require a small amount of credit. Be wary of the new customer who requires extensive credit on the first sale. As individual customers perform under initial credit granting, you can increase or decrease their credit limit as the situation dictates. Not every customer will need or warrant the same amount of credit. Newer companies and those without sterling credit should be given lesser credit limits than those well established companies with excellent payment records. Remember, you don't have to grant credit to companies who don't pay within terms.

Resist the temptation to grant special long terms for a specific amount of time unless it is for only a small percentage of the customer's total credit line. For example, if a customer is opening a new location and you want to offer 'stocking' terms to help them establish the location, do so on only a couple of invoices or limit the terms to a small percentage of their line. If you typically offer 1% 10 Net 30 Days, offering Net 60 Days on a couple of invoices, shouldn't have a dramatic affect on their ability to pay. But don't convert their entire account over to Net 60 Days and expect to be able to go back to 'normal' terms in a few months. Once you've given them an extra 30 days to pay, they will have to pay two months worth of invoices at once to get the terms back to standard. Most companies will not have the cash flow to actually do this.

5. **Be Consistent** – Once you establish a standard for granting credit, evaluate all accounts in the same way. Don't treat two accounts with the same risk differently. You can treat accounts with different risk differently, but you can't treat accounts with similar risk differently without creating your own risk problems.

Collections

Collecting overdue accounts is a burdensome task for many businesses. However, with the right attitude and consistent application of basic principles, it's really not that difficult and doesn't have to be an unpleasant task. I have found that a pleasant demeanor and a respectful but insistent attitude will help complete this task to good effect.

Using a simple four-part strategy will make your collections easier and help get the results you desire.

1. Call regularly
2. Be consistent
3. Ask for a commitment
4. Expect to be paid

Call Regularly – establish a routine for making your collection calls. Whether you do it on certain days of the week or certain times of the day isn't as important as doing it regularly. Don't skip a week because you don't want to do it. Establish a routine and pick up the phone. Don't rely on letters, statements, post cards or other written communication to do your collections. Effective collections is about becoming the squeaky wheel and putting yourself in a position that your customer wants to pay you first.

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It's on you to train your customer to expect to pay you on time. You have provided a good product or service at a good price when the customer wanted it. Now, they need to pay when the invoice is due. Start new customers out by explaining up front that you will provide good products and services and you expect them to pay. For a new customer, when the first invoice is sent out, follow-up in a few days and confirm that the invoice was received, that the mailing address is correct and that there were no problems with the order. While you should treat this call as a customer service, you're really laying the ground work to establish prompt payment habits from your customers. Then, if the payment isn't received within a couple of days of the due date, call the customer back and make sure there aren't any problems and confirm that the payment will be forthcoming. Make sure to speak with a decision maker. Establish a relationship with the person who pays the bills, and while this is difficult to do in a large company, get as high up the corporate ladder as you can.

Devote as much time as necessary to contact all customers who have past due invoices. Don't just call the ones who have the worst accounts. Those customers with only slightly bad accounts can be trained to pay promptly with only a little effort. If you don't have time to call all the accounts on a regular basis, consider splitting up the job with another person. Divide the customers into two groups and you always call one group and let the other person call the second group. Don't switch which group you'll call, be consistent.

Deal with deductions and discrepancies immediately. Customers who take a deduction will have no memory of why after a few weeks. The quicker you can resolve any account problems, the easier it will be to keep their account in good condition. You'll want to keep your customer accounts in good order. Nothing will stop a customer from paying quicker than them accusing you of mishandling their payments.

Call each customer to see when the past due invoices are to be paid and get a commitment. Make a note of the commitment in whatever system you use, and refer to your notes when you speak to the account. If you don't have an accounts receivable system that allows you to enter notes in an electronic format, use whatever format works for you. Create an index card system or a binder with loose leaf sheets in alphabetical order for each customer or even a word processing application will work. Whatever method you use, always document your conversation. If your customer promises payment of \$2,500 on next Friday, follow-up on next Friday if the payment is not received. Once the customer realizes that you are following up on their promises, they will stop telling you something just to get you off the phone and only tell you money is coming when it actually is. Part of your routine should be to have the same person call the same customer each time. You can't develop a relationship with the customer if a different person calls each time.

Consistency is the key to collections: call consistently, follow-up consistently, get commitments consistently, behave consistently.

Be nice. Remember, these are your customers. There's no need to raise your voice or speak to your customer rudely. Be respectful, but insistent that if your customer wants to buy on credit, they need to pay on time. Don't get into a "you'll get paid when I get paid" situation. That wasn't your deal with them. Remember, you need to be paid on time in order to meet your own obligations. Many a good business was put under by a lack of collections.

If your collection calls don't seem to get the expected results, maybe a visit is in order. Depending on your relationship with the customer, the salesperson who handles the account could have a discussion about timely payment of invoices in order to keep buying on credit. If you don't have a salesperson or the salesperson lacks the proper personality to get the job done, consider visiting them yourself. Schedule a face-to-face meeting with someone who makes the decisions and have a frank discussion about the relationship. Credit is just one facet of the customer relationship, so bring a senior salesperson with you to discuss how the entire relationship hinges on getting their account back on track. This will also lend credibility to your function and ensure that you aren't ignored in the future. If you're a small business, this is much easier to accomplish as you're probably the salesperson and collection person.

Don't threaten the customer. Once they realize that you don't mean what you say, you will lose ground in your efforts. Threatening conversation is usually not very useful to the dialog. If the customer isn't handling the account in a proper manner, then limiting their credit may be a useful tool to bring the account back into compliance. But don't tell them you are going to limit their credit unless you intend to do so. Never threaten an action that you aren't prepared to act on. If you need approval from someone else to limit the credit, get the approval before telling the customer what you intend to do.

Legal Issues & Bad Debt

Despite our best efforts, sometimes, bad debt happens. If you pay attention and limit credit when bad behavior starts, you can minimize the damage. But sooner or later, you'll have a customer go out of business or something else that may be completely beyond their control will happen and limit their ability to pay you. Hopefully, this will not happen often, but you should be prepared for when it does. When dealing with legal issues and bad debt there's one thing to keep in mind: if you have to sue, you lose. You should have as part of your standard terms and conditions of sale a clause that requires the customer to pay your costs of collections should they not pay. That will include interest, attorney fees, legal and court costs and so forth. However, it's much easier to get a judgment than it is to collect on one. If you've done things properly to this point then only rarely will you fail to get a judgment for the full amount of the bad debt and all fees and costs of collection. However, converting a judgment to actual cash rarely happens.

In a bad collection situation, you can use the costs of collection as a tool to gain leverage. If a good customer who is paying poorly thinks there are more fees and costs to be added if they don't pay, it might give them an incentive to make your payment more promptly. For a bad player, it won't make any difference.

Customers don't fail to pay out of spite. They generally want to pay and don't only because of cash flow problems. Once you let a problem get so bad that you have to take legal action, it's usually too late to expect to be paid. If they aren't paying you, there are probably others who aren't being paid either. Depending on your industry and how you do business, you may have some specific remedies for getting some of all of your money, but don't let that determine how you do business. Assume that once an

account goes legal, you're going to lose the amount of the account PLUS whatever you spend on attorneys and court costs.

Conclusion

A properly conceived and consistently applied credit and collections policy will result in more timely payment of invoices and less credit risk in your portfolio. In credit and collections, consistency is the key for getting results and training customer to pay on time.

Many organizations face financial challenges from time to time, or need financial leadership during periods of transition: early stage, rapid growth, acquisitions, restructuring or refinancing. With expert guidance and hands-on management from **Gryphon Growth Group** you can get control of your finances. We can step in at any time, identify and solve financial problems, and help you guide your company to higher levels of success.

Our approach is simple - we apply our experience with good, old-fashioned *hustle* to help our clients achieve their goals.

To learn more, we invite you to contact us today:

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