



THE CREDIT COLLECTIVE

HOW TO CREATE AN EFFECTIVE CREDIT & COLLECTIONS POLICY

What Is A Credit & Collections Policy And Why Do We Need One?

A Credit & Collections Policy should be an organized, repeatable practice or philosophy that a company adopts in order to control the risk it assumes when extending net payment terms to its customers. It can be as general or as specific as your company would like it to be.

First and foremost, you should have a credit and collections policy in order to protect your accounts receivable. You probably go to great lengths to conceive (or license), design, manufacture, warehouse, market, sell and ship great product. Obviously, these are essential to your businesses success. For without great product, in stock, how can you make sales?

But a sale that doesn't get paid is not a sale. It is a loss. Your company's accounts receivable is a short-term asset. Along with cash and inventory is one of the most important assets you have. The more predictably and effectively you can convert your A/R, the better your cashflow will be. Solid A/R is insurable, factorable and is taken into consideration when your company applies for loans and credit lines.

Imagine what would happen if you walked into a bank and asked for a loan without offering collateral. Or if you tried to get a car financed with just the names of three people you've paid as references. Obviously, you would be turned down. There is very little difference between being a trade creditor and being a loan officer. Both are lending capital: one in the form of cash, the other in the form of product that you've already invested cash into.

In addition to protecting your investment, a pre-set Credit & Collections Policy will give stability, efficiency and effectiveness to your company. A solid, repeatable policy allows all departments to understand your company's values and work flows. Without it, there is no set way of doing things that pertain to cashflow. It also prevents any misunderstandings between the sales and credit departments which can sometimes cause unnecessary friction.

Another benefit to having a set policy is that it will provide consistent customer care. By knowing how accounts will be cleared for credit and the manner in which collections will be conducted, customers will know exactly what to expect when dealing with your company. The better focused your company is, the higher the likelihood is that your customers will understand and follow your requirements.

How Do You Create A Credit & Collections Policy That Works For You?

Knowing your company's level of risk tolerance, your cash-on-hand and your access to capital will go a long way in helping your company to determine its credit mission. Will your company be liberal, moderate, conservative or some combination such as:

- Liberal on credit/conservative on collections
- Moderate on credit/moderate on collections
- Conservative on credit/liberal on collections

Your decision will guide you in all of the choices that you make from here forward, so think it through before making a snap decision.

For instance, if you want to be *conservative on credit but liberal on collections* that means your company will take very little risk. Your credit department will spend the lion's share of its credit and collection efforts in determining who will receive terms. You will, most likely, end up with fewer credit customers and more cash customers. The credit customers you do have will, if you've vetted them properly, for the most part pay their bills on time. This means your company won't have to devote too much effort on the collections side (other than utilizing best invoicing and statement practices.)

If you decide to be *moderate on credit and moderate on collections* then your company will accept some prudent risks. Creditworthiness will be determined by checking trade references, joining trade industry groups and the Better Business Bureau. Your collection efforts will be more flexible. If you use DSO (Days Sales Outstanding) to assess the strength of your receivables, your acceptable DSO number will be higher than average.

A company that that strives to quickly gain as much market share as possible would be *liberal on credit and conservative on collections*. This company is willing to take the greatest upfront risks by granting open terms to all customers, regardless of their payment experience. Of course, at the very least, the credit department would use trade industry groups to look for alerts and ask peers about obvious red-flags. However, because it will have a great deal of its future cash-flow tied to unknown receivables, this company would need to have a conservative and strong collections policy to stay on top of customer payments.

Once you've determined what your mission and philosophy is you can set out to do some more specific work. How detailed you get depends on your own desire for a stricter or looser policy. But whatever you decide, just realize, that accounts receivables represents future money. It is the gatekeeper to your company's cash flow... the lifeblood of any business.

What Are Your Goals?

There are a couple of different ways to approach this. If you have a desire to keep things simple, you may employ a goal that all new accounts are on pre-payment terms for the first three orders, and then be converted to net terms if requested. In such a strategy more focus would be on precise invoicing and collections.

A bit more time-consuming, but safer way to approach goals would be to implement an objective, measurable strategy. This would take into consideration factors such as:

- DSO (Days Sales Outstanding)
- CEI (Collectible Effectiveness Index)
- Acceptable percentage of bad debt write-offs
- Acceptable percentage of receivables by aging
- Yearly review of accounts
- Length of time taken to approve credit
- Cost of credit approval

Some companies simply create a generic statement that states how the goals of the credit and collections department will be to safeguard the receivables of the company. For some, the more concrete the goals, the better it will be for the company. Besides being a more proactive way of protecting the company's cashflow, it's better to know what to do. You can always change things if they aren't working.

Who Has What Responsibilities Pertaining To Credit And Collections?

In order to keep the wheels of your company rolling smoothly, you should know who is doing what and who is making decisions. You should consider this from both a workflow and workstop perspective.

For our purposes, workflow encompasses the way customers and orders will be analyzed, processed, invoiced and collected. Although it's more or less a simple task to determine, for larger companies it can get more complicated. Who is responsible for collecting the required documentation from the customer (signed purchase order and credit sheet?) Who does the actual credit research? Who analyzes the results of the research? Who determines the credit limits? Who then does the invoicing and the customer follow-up?

Workstop is entirely different. Generally speaking, if you've set up a good workflow this won't occur. However, sometimes there are changes and you need to know what to do in those situations. For instance, if a customer wants to triple its credit limit, who gets to approve that? The Sales Manager? The President? The Controller?

What if an existing customer suddenly begins to pay late and the credit manager wants to place them on credit hold, but the sales manager wants the order shipped, who resolves the conflict? Or, perhaps one of your oldest and best customers doesn't respond to dunning efforts and the

invoice goes 90 days late. The collections manager wants to send the account to legal, but the sales manager doesn't. What's the way out of this workstop?

The more thorough you can be in determining a process and a chain of command, the stronger your credit and collections policy will be.

What Is Your Credit Evaluation Process?

Consider this one of the most essential parts of the entire plan and how detailed you get will depend on the size of your company and its credit philosophy. Of course, as with other parts of your plan you can make it as general or as detailed as fits your desires.

Something general could be: "The Credit and Collections Department will evaluate and determine appropriate terms and credit limits for all accounts. Decisions will be based on references, payment histories and alerts obtained through The Credit Collective and financials submitted by the customer. No credit scoring methods will be used. Should the account go beyond terms, the credit and collections department will utilize its best judgment and industry-accepted practices to collect the debt."

A more formal approach to this process could actually spell out procedures for credit limit ranges (e.g., limits between \$500 - \$5,000 is a no-score method, limits between \$5,000 - \$10,000 utilizes both the no-score method and a D&B or Experian report, orders above \$10,000 require all of the preceding plus current customer financials.)

Although there are many things that could be included in this section, one other recommended process is that you determine what documents are required and who is responsible for obtaining them. For instance, the sales manager will submit orders for all new customers with a signed credit application. If the customer is an individual, that credit application will include a signed, personal guarantee.

When it comes to establishing terms of sale it is recommended that you follow the generally accepted terms of your industry. Industry credit groups like the ones administrated by The Credit Collective can provide you with this information. Of course, you can also take into consideration the scarcity and demand for your product. With more popular items, you could consider giving shorter terms.

What Is Your Collections Process?

When you think of collections think of it in terms of cashflow vs. cashstop processes and break them down in that manner. The Cashflow Process would be everything that occurs following the approval of a credit limit and terms. This would include the How's and When's of invoicing, follow-up calls, pre-due date calls and payment processing.

Of course, things don't always work out the way we want so if a customer does not pay its invoice in a timely manner you need to have a Cashstop Process. Things to consider in this

dunning process will go back to your company's philosophy. Will you be liberal, moderate or conservative in this area? If retaining a customer -- even one that is not paying you -- is far more important than collecting a debt, then your strategy will be more delicate than if getting paid is the most important thing.

Every company has its thresholds for debt loss. To one company bad debt is defined as uncollectible money. For another, it is defined as any money that is not paid within terms. And still another company could define it somewhere in the middle, as money that was collected through third-party collections. Although on the balance sheet it is only reflected as uncollected monies, knowing your philosophy will help you to determine your collection policy.

At the end of the day, you will need to measure how well your policy and process is working. Don't wait until you're in trouble. Rather, evaluate this as frequently as possible; at least once a quarter. Although there are many methods for evaluating the effectiveness of your credit and collections policy, such as an acceptable aging average and percentage of bad debt write-off, there are two calculations that are commonly used. There is a sample and detailed explanation on the following pages.

- A. CEI (Collection Effectiveness Indicator) - a better indicator of collections effectiveness as it measures performance over time. The closer to 100% the better.
- B. DSO –Expresses the (aggregate) average time, in days, that receivables are outstanding. It helps determine if a change in receivables is due to a change in sales, or to another factor such as a change in selling terms. An analyst might compare the days' sales outstanding with the company's credit terms as an indication of how efficiently the company manages its receivables. The closer to company's terms (e.g., Net 30) the better.

Conclusion

While it may seem a daunting task, creating an effective Credit & Collections Policy will make and keep your company stronger. Unfortunately, for most small businesses this aspect is all too often ignored. That is the reason most small businesses don't grow into big businesses. After all, at the end of the day, you're not only in business to make and sell great product, you're in business to make money. That's why, in good times or bad, it's a best business practice to know your company's financial goals and plan how you will accomplish them.



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SAMPLE DAYS SALES OUTSTANDING (DSO)

DSO: Expresses the (aggregate) average time, in days, that receivables are outstanding. It helps determine if a change in receivables is due to a change in sales, or to another factor such as a change in selling terms. An analyst might compare the days' sales outstanding with the company's credit terms as an indication of how efficiently the company manages its receivables. The closer to company's terms (i.e., Net 30) the better.

Samples Formula:

$$\frac{\text{Ending Total Receivables} \times \text{Number of Days in Period Analyzed}}{\text{Credit Sales for Period Analyzed}}$$

$$\frac{\$5,000 \text{ Open Receivable} \times 30 \text{ (one month DSO)}}{\$3,500 \text{ (new receivables in that month)}}$$

$$\frac{\$150000.00}{\$3,500}$$

Approx. 42 Days Sales Outstanding (indicates and average of 42 days to pay invoice). At Net 30 terms, avg. payment is 12 days late.



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SAMPLE CEI CALCULATION

CEI (Collection Effectiveness Indicator) - a better indicator of collections effectiveness as it measures performance over time. The closer to 100% the better.

Here is an example of how to calculate the CEI for a 3 month collection period based on the sample data given.

Sample Data:

	Credit Sales	A/R Balance	Current	31-60	61-90	90+	Totals
Jan	3,400	6,210	3,350	1,800	995	65	
Feb	3,600	6,015	3,555	1,600	800	60	
Mar	3,900	6,325	3,650	1,750	855	70	6,325
Totals	10,900						

- Beginning Receivables = 6,210
- Credit Sales = 10,900
- Ending Total Receivables = 6,325
- Ending Current Receivables = 3,650
- Period = 3 months (N)

$$\frac{\text{Beginning Receivables} + (\text{Credit Sales}/N) - \text{Ending Total Receivables}}{\text{Beginning Receivables} + (\text{Credit Sales}/N) - \text{Ending Current Receivables}} \times 100$$

$$\frac{6,210 + (10,900/3) - 6,325}{6,210 + (10,900/3) - 3,650} \times 100$$

$$\frac{6,210 + (3,633) - 6,325}{6,210 + (3,633) - 3,650} \times 100 = \frac{6,210 + (3,633) - 6,325}{6,210 + (3,633) - 3,650} \times 100 =$$

$$\frac{3,518}{6,193} \times 100 = .5680 \times 100 = 56.80\% \text{ CEI}$$



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Sample Company's Credit Policy

Mission:

The Credit Department will be responsible for gathering, investigating and evaluating all new accounts in order to keep a high quality of accounts receivable while selling to all customers that represent prudent credit risks.

Goals:

To open and maintain as many credit accounts as possible while maintaining the following:

1. To maintain an average CEI above 80%
2. To maintain an average DSO below 40 days
3. To maintain 80% of A/R in current aging, 15% in 30 Days, 4% in 60 + and 1% in 90 +

Organizational Responsibilities:

The Credit Department reports to the office of Treasurer. Functions include the application of payments, establishing credit limits, and monitoring collection of receivables.

The Credit Manager establishes limits of up to \$10,000. Higher limits are approved by the Treasurer or above. If credit privileges are withdrawn from a customer, it is our policy to consult with the sales department in the decision process. If a consensus cannot be reached, the situation is referred to the President.

When accounts cannot be collected using normal means, the Credit Manager recommends the use of a Collection Agency or attorney. The Treasurer and Sales Manager approve such requests.

Credit Evaluation:

The Credit Department establishes terms and limits for all active customers. Such terms and limits are based on the average terms and credit limits reported in The Credit Collective and financial statements, when necessary.

The department reviews larger limits on a periodic basis. All limits are subject to revision, based on changing levels of credit worthiness. Individual orders are referred to the credit department when an account is over its limit or 15 days past due, and an effort is made to resolve such problems. If satisfactory arrangements cannot be made, the order is withheld.

Collection:

We strive to have a consistent and courteous approach to collections in order to avoid any necessity to engage in dunning activities.

1. All customers will be invoiced on the same day as the shipment is sent. Invoices shall be sent separately from the shipment. Whenever possible, electronic invoicing will be used.
2. Customers will be contacted two weeks after the shipment in order to ensure the shipment arrived without damages and to check for any discrepancies with the invoice.
3. Accounts with open invoices above \$1,000 shall be called one-week prior to the due date in order to assure the invoice is scheduled for payment. If there are any discrepancies they will be discussed and solved.
4. Accounts will be called when they are one week past due and calls will continue weekly. If no payments are received after three calls, the sales representative will be asked to contact the customer.
5. If an account is 30 days late, Pre Collections services will be ordered from The Credit Collective.
6. If there is still no response, the account is considered for third-party collections and/or legal action.

In the case of bankruptcies, the Credit Department files proofs of claim. The department represents our company with creditor committees and coordinates activities with attorneys.

Terms of Sale:

Terms have been established as Net 30 days. All credit worthy customers are expected to pay within this period. Any exceptions must be based on competitive practices in accordance with established procedures. Companies seeking longer terms will be subject to closer scrutiny.

This policy will be reviewed on an annual basis.

Policy Approvals:

Credit Manager

Treasurer

Marketing Manager

President



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SAMPLE CREDIT REVIEW WORKSHEET CREDIT EVALUATION PROCEDURE

Purpose:

This procedure defines a company's approach to evaluating new accounts applying for net terms.

Details:

1. For any new account, the appropriate salesperson will obtain a credit application. This information will include a minimum of: tax identification number, business entity type, three trade references and telephone numbers, email address, bank information, and the names of the principals. The salesperson will estimate the amount of credit which the account may require over the course of a year and what their average orders will be. If the required limit is above \$20,000, a financial statement will also be obtained. If the account is the DBA of an individual, a personal guarantee will be obtained.
2. For any new account, the credit department will check The Credit Collective for any existing Alerts/Unalerts. If an account has received any collection Alerts within the past year, the account will be placed on pre-payment terms.
3. For limits under \$5,000, the credit department will submit a query to The Credit Collective and check three trade references. The credit department will consider if the customer has demonstrated an ability and willingness to pay at the required level, and a judgment will be reached.
4. For limits above \$5,000 the credit department do steps #2 and #3 above and will check the D&B rating.
5. For limits that are requested in excess of \$10,000, the credit department will do steps #2, #3, and #4 above. If no derogatory information such as judgments or liens are found, an appropriate limit will then be established.
6. For any higher limit in excess of \$20,000, a financial statement will be reviewed. Considerations will include liquidity and debt capacity. In general, we will require positive working capital, a debt:equity ratio of no more than 3:1, and our limit will not exceed 25% of the applicant's net worth unless approved by senior management.

7. Before rejecting any customer whose potential volume exceeds \$10,000 annually, the application will be forwarded to the Controller for review.
8. If necessary, the credit department may rely on guarantees or Letters of Credit to complete sales.
9. If net terms cannot be approved, the customer will be given the opportunity to purchase on a pre-payment basis and have credit re-evaluated after six months.
10. Any account that has not ordered within six months, then places a re-order shall be re-evaluated prior to the extension of terms.
11. Any account that seeks to increase its credit limit and/or credit terms shall be re-evaluated.
12. Any account that goes beyond 30 days past due will be placed on Credit Hold. Accounts on Credit Hold will be subject to re-evaluation of terms at the discretion of the Credit Manager.



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Credit Policy Worksheet

Mission:

Goals:

Organizational Responsibilities:

Credit Review Procedures:

Collection Procedures:

Terms of Sale:

Approvals:
