

Financial Intelligence

Credit management

A sale is a gift until it's paid for

 **blue dot consulting**
Chartered Accountants & Business Advisers

If your business model doesn't allow you to be paid upfront.....read on.

Successful credit management should be front and centre for all businesses, irrespective of the wider economic circumstances. Of course, in 2009 we're seeing a massive contraction of credit across the world which makes your own credit management much more important.

This article sets out a comprehensive framework for credit management which will help you to lower your risk and put more money in your bank.

Establish a credit management policy for your business

Your credit management policy has to apply across the entire business, just as a smoking policy or a pension policy would. All areas of your business need to buy in to it and apply it otherwise it simply won't work.

The policy should cover areas such as:

- Standard credit terms as part of your terms of trade
- Credit vetting prospects and existing clients
- Pricing
- Prompt raising of invoices
- Credit insurance
- Early payment discounts, interest on late payments
- Putting slow payers on STOP
- Collection procedures and targets
- Legal recourse

It is sensible to review the policy from time to time but more importantly it's vital to ensure that your policy is being applied consistently across your prospects and customer base.

Once the policy is in place, it might be appropriate to include it on your website.

Prevention is better than cure

There are several steps that can be taken to reduce the credit risk before a sale is made.

Firstly, consider checking the credit worthiness of your prospects before you go too far through the sale process.

There are several credit rating agencies in the UK (Graydon UK and Experian are two examples) and they will supply you with online credit reports and ratings which will help you to determine whether you want to proceed with a given prospect.

Many credit rating agencies can supply marketing lists pre-screened to contain only prospects with a decent credit rating.

So, there really is no excuse to sell to high risk prospects in the first place.

Moving forward through the sales cycle, you can subscribe to online monitoring services where the credit agency will notify you of changes to your clients' credit ratings.

Agreement in writing

It pays to have clear and unambiguous terms and conditions and to get these agreed in writing.

It almost goes without saying that prices and payment terms should be set out somewhere in the documentation, but sometimes these are dealt with separately, which is an opportunity to lose sight of the payment terms, so be careful.

In a perfect world neither you nor your customer will have to blow the dust off the T&Cs, subject to periodic review, but it's important to know they are on file if you need them.

Strangely, this is an area that businesses can be lax on and so it's important that the chief executive

leads from the front and ensures T&Cs are always in place before goods or services are delivered.

A useful online resource for T&Cs is NetLawMan. You can start with one of their contracts and adapt it to your own business before running it by your lawyer if you need to.

Understand your route to getting paid

Every business should be compelled to sell to a large, multinational organisation every now and then just to be reminded of the pain you have to go through sometimes to get paid.

"We can't accept an invoice without a signed purchase order"

"What's your vendor number, we can't set up a new supplier account without a vendor number"

"I'm sorry but all invoices over £50,000 have to be signed off by two directors"

"Our accounts payable department is in the Netherlands"

We've all heard these, or similar comments, and they drive you mad, but forewarned is forearmed.

With your customer, create a flowchart of their system for receiving, authorising and paying suppliers' invoices.

If invoices over £50,000 require two signatures, then send your invoices more frequently for smaller amounts.

If you need a purchase order and a purchase order number then make sure you get one.

Get the email addresses of your buyer and of the accounts payable person so you can send your invoices electronically and ensure they can't say they haven't got your invoice.

A cautionary note: this type of work is not usually natural territory for sales people, so training might be required and it's another area where the chief executive might have to lead from the front so that others follow.

Debt collection procedures

Invoices and statements

Debt collection begins with ensuring you have sent the correct invoices, as soon as possible, to the right person – preferably electronically.

Many businesses send statements to clients each month. If you wish to do this, then also try to do it electronically to save both time and money.

80:20 rule

It's likely that 80% of your credit risk lies in 20% of your ledger. Therefore, make sure you can identify the risky debtors and concentrate on them.

Ensure your Aged Debtor report is in order of the largest debtor down to the smallest, instead of in alphabetical order.

It's good to talk

The most effective credit control is done by telephone, putting consistent pressure on your client to pay.

Better still if you can effect a "Pincer Movement" on your client, with your credit controller talking to their accounts payable team and your sales people talking to the buyers.

Again, if it comes to it, your chief executive should call theirs if there is a problem that can't be solved through routine channels.

The last resort

If all options for getting paid have been exhausted then stop selling to the non-payers because you're just pouring good money after bad.

If you feel it is worthwhile going to court then you have to issue a written

warning that this will happen in not less than seven days; this is called a Letter before Action. Then, you have to see it through, otherwise your threat is not credible and the client has won.

There are many legal services you can use to process your legal claim and specialists in the field, Thomas Higgins Partnership, would be a good first base.

Measuring collection performance

Aged debtors

The most-used performance tool is the Aged Debts report, which lists all of your customers with outstanding debts and breaks them down by age.

It's vital that this report has the biggest balance at the top and the smallest at the bottom (rather than being an

alphabetical list) so you can concentrate on the largest balances first.

Don't overlook any customers at the bottom of the list who have negative balances – this can mean you owe them money or an invoice, credit note or some cash has been allocated to the wrong account. Whatever the problem, try to correct it quickly.

You can use this report to establish targets for credit control, such as a maximum value or % of the total for each column. For example:

- Debtors over 60 days old should not exceed £20,000 or 10% of the total
- Debtors over 90 days old should not exceed £10,000 or 5% of the total

Anyco Limited		Descending order by balance					
Aged debtors report							
	Current	1 - 30	31 - 60	61 - 90	> 90	TOTAL	
Combustible Marketing	5,750	0	617	0	4,639	11,005	
TNT Explosives	2,952	0	2,996	6	0	5,954	
Patience Virtue	1,175	0	4,700	0	0	5,875	
Bland Tabasco	0	0	1,469	2,585	0	4,054	
Distinctive Media	0	2,934	0	0	0	2,934	
Printers Devil Ltd	0	0	2,703	0	0	2,703	
Darjeeling	0	1,340	1,351	0	0	2,691	
Whiskey Jar Limited	0	0	0	118	1,701	1,819	

Anyco Limited		Alphabetical order by customer					
Aged debtors report							
	Current	1 - 30	31 - 60	61 - 90	> 90	TOTAL	
A I Limited	0	771	787	0	0	1,558	
Agile Moldings Limited	0	121	0	106	0	227	
All Star Petrol	0	0	0	0	1	1	
Andrew Boston	0	0	0	353	705	1,058	
Angela Dalglish	0	0	0	0	705	705	
Anita Harris	0	173	0	0	0	173	
Arboretum Limited	0	0	0	0	585	585	
Ball and Son	0	1,265	0	0	0	1,265	

Try to stop the balances in the 61-90 day column moving into the >90 column next month.

Cash collection

Another very simple target is the amount of cash collected each month. You can have a minimum collection level and then consider paying bonuses to your credit control team for beating the basic target.

Debtor days ratio

This ratio looks at the average sales you make per day and asks how many days' sales are built up as unpaid debts.

There are several different ways of calculating the ratio and the key is to be consistent. Here is an example:

Annual sales (including VAT) are £2.5m. Therefore, average daily sales are:

$$£2,500,000 / 365 = £6,850.$$

Debtors are £400,000.

Debtor days are:

$$400,000 / 6,850 = \mathbf{58 \text{ days}}$$

This means that you have 58 days of sales tied up in debtors at the moment.

The aim is to reduce debtor days, hopefully as sales increase.

Other credit management tools

Credit insurance

It's possible to insure your business for the risk of not being paid by a client.

You pay a premium and the credit insurer will give you credit limits for each client, or a group of clients, and provided you stay within the credit limit the insurance policy will compensate you if the client goes under.

Two of the larger credit insurers in the UK are Euler and Coface.

Factoring

Under a factoring arrangement, you effectively sell your unpaid sales invoices to the factoring company (usually a bank). They pay you, say, 80% of the value of the debts upfront, they are responsible for credit control and, once they have collected the money from your client they will pass on the balance, less their charges.

The factoring company will also charge you interest on the money they lend you.

Cash accounting for VAT

You can adopt "cash accounting" for VAT, provided your annual sales are below £1.35m and several other requirements are met.

Under cash accounting you only pay over VAT on your sales invoices which have been paid in the quarter and you can only reclaim the VAT on bills you have actually paid.

Most PC-based accounting systems will let you do this and, although it doesn't improve credit control, it can help with the cashflow effects of money being collected more slowly than you would like.

Summary

Effective credit management is too important to be left to take care of itself. By using some of the tools in this article you can reduce risk and increase your bank balance, leaving you more time to concentrate on the future instead of the past.

At Blue Dot Consulting we advise clients on credit management processes as well as carry out credit control for a number of companies.

If you would like to know how Blue Dot Consulting can help your credit management, please call Michael Austin on 020 7384 6800.