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A MONTHLY GUIDE TO POLICIES, PROCEDURES, AND PRACTICES

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HOW TO: CREATE A SMART CREDIT POLICY

Long ago, merchants figured out how to create customers where none existed: credit. "A customer with $10,000 cash and $25,000 of available credit is a potential $35,000 customer," says Jerry Kobre, a retired garment manufacturer who advises companies for New York State Small Business Development Centers. For most companies, offering trade credit isn't optional: When your competitors do it, you are at a disadvantage if you don't—and on similar terms.

Of course, granting credit has costs. There is the expense of capital—either the actual cost of borrowing or the opportunity cost of lending, given that money advanced to the client could be put to other uses. There are the administrative costs of creating statements and collecting. Finally, some customer debt will go bad. A business can mitigate these costs by establishing a smart credit policy and then carefully managing accounts receivable. "If you're not turning receivables into cash, it affects the way you pay your vendors and affects your vendors' credit decisions toward your company," says Doug Swafford, credit and collections manager for U.S. Xpress Enterprises, a trucking company in Chattanooga, Tennessee.

The pages that follow will get you started. You may find yourself mediating between a sales team that's pushing to extend more credit and an accounting department urging prudence. "Ultimately," says Russ Sorkness, president of Sorkness Aviation, a parts broker, "the owner decides how much risk the company will take offering credit."

OFFERING TRADE CREDIT

1. Get a Handle on the Basics

Credit policy should be tied to your sales strategy, says Doug Swafford—more aggressive goals demand a looser spigot. Whatever your goals, the particulars will need to at least match the standards that prevail in your market for your business to be competitive.

Set the terms of sale. Two kinds of credit predominate in the business-to-business world. Open credit requires no down payment and levies no interest or carrying charges. The payment is simply due in full on the specified date, typically 30 days after the goods are delivered (widely denoted as "Net 30" on an invoice). Revolving credit, on the other hand, sets a limit on how much a customer can borrow. The customer pays interest only on the principal actually borrowed; as the debt is repaid, the credit available increases. (Credit cards are the most common example of revolving credit.)

These basics are among the "terms of sale" stipulated in a purchasing contract. In addition, the terms typically include discounts for early payment; a common incentive reduces the bill by 2 percent for full payment within 10 days. (In a 30-day cycle, this is denoted as "2% 10, Net 30.") Or you may demand a penalty or interest payment when a due date is missed.

Establish other conditions. You will also want to stipulate other aspects of the transaction, such as delivery obligations or remedies if a customer fails to pay the debt. Conditions typically include the right to pass on legal fees and collection costs to the customer, as well as the right to establish the venue and jurisdiction for legal action. Requiring the customer to inspect merchandise upon delivery and make objections promptly also strengthens your hand should the account go bad.

Commit your policies to writing. This offers some protection against lawsuits. Federal law prohibits manipulating credit terms as a means of indirect price discrimination. That said, "You're on safe ground in treating customers differently in credit terms if you're judging them by creditworthiness," says attorney Bruce McDiarmid, a partner with Pillsbury Winthrop Shaw Pittman in San Francisco. Courts, he says, rarely second-guess credit decisions made in good faith.

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2. Create Guidelines for Granting Credit

The amount of credit you grant—and who gets it—reflects your tolerance for risk. Why take any risk at all, especially now? Because doing so may increase your market share or win customers that will eventually bring you more business. And if the profit margin is high enough, you might come out ahead even if the customer later defaults. Swafford recalls one high-risk customer who defaulted eight or 10 months after being approved. "But in that time, my profits were something like 10 times the loss," he says.

Check the customer's history. Federal law obliges you to judge all applicants against the same standards, but you need not always go to the same length to verify creditworthiness. A small company, says Kobre, can rely on the CEO's judgment. As more buyers apply for credit, it's a good idea to standardize your evaluations.

The easiest way to check a customer's creditworthiness is to call two or three of its other trade creditors—ideally in your industry—and ask how promptly the customer pays. Ask the customer's banker if the company's lines of credit are in good standing. (You will get permission for this in the credit application; see "Craft a Credit Application," last page.) Then look at credit reports and scores. If you are talking about a very large credit limit, require financial statements and written bank and trade references.

If you deny credit, the law requires you to give an explanation if asked. "Point to objective data you used to evaluate the credit risk," says Scott Blakeley, a Los Angeles attorney who specializes in creditors' rights.

Ease into the relationship. A new customer should pay up front or on delivery. When you grant credit, keep the limit low initially and monitor the transactions in the first year. "If the customer is purchasing on a regular

basis and makes timely payments," says Sorkness, "its credit limit should be increased in graduated increments."

3. Manage the Books

The key metric in managing accounts receivable is how long, on average, it takes your customers to pay their bills. In general, be concerned if your average collection period is a third longer than the period established in your credit terms (40 days for a 30-day period). For a quick snapshot of the average collection period (also called days sales outstanding), divide outstanding accounts receivable by average daily credit sales. This does not account for fluctuations over time, and there are more precise (and complicated) calculations for average collection period, but it is a good rule of thumb.

Seller beware. It's also crucial to zero in on individual customers. "All credit activities should be tracked regularly: purchase patterns, average days to pay, and a change in the payment pattern," says Kobre. "Early intervention can pay big rewards in either limiting exposure or getting paid sooner." Your sales and marketing teams have an important role here, he adds. Not only may they be more likely to spot and resolve problems early, but a strong relationship with the customer may smooth the intervention. Play it safe by updating and reviewing credit files for all accounts at least semiannually. If you require financial statements, get new ones every two years.

Collection calls. In the case of delinquency, be prompt and persistent. "If follow-up contacts are not timely, it sends the message that customers need not have a sense of urgency," says Swafford. Your written policy should specify contact at regular intervals, starting with a reminder five to seven days after the due date. Further notice should escalate: A second written reminder might be followed by a phone call, followed by a final notice from a lawyer. If you still haven't been paid 30 days after the due date, it's probably time to turn the matter over to a lawyer or a collection agency.

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CRAFT A CREDIT APPLICATION

A credit application doesn't need to be long, but it should be carefully worded—it is, after all, a legal contract.

Be sure the customer provides the company's legal name and entity type, as well as the names of principals. If the business structure shields the company's owners from liability, you may want to extract a personal guarantee.

Ask for the contact info—telephone and fax numbers and e-mail and home addresses—for the principals, as well as for the person who will probably be your main contact: the accounts payable manager.

Ask for trade references, ideally in your industry, who can speak to completed transactions with the prospect.

Seek bank account information and contacts. Some lawyers recommend including a form that authorizes a bank to release the customer's records.

Include the terms and conditions, written so that the customer has to acknowledge agreeing to them—and require a dated signature.

NOTES:

EVALUATING CREDIT-WORTHINESS

What to look for in a prospective borrower's balance sheet? Doug Swafford, who has spent more than three decades managing lines of credit, likes to keep it simple.

The bottom line: Is the company profitable?

The cash-flow statement: Is cash flow positive—i.e., is the business taking in more than it is spending?

The receivables and payables balancing test: Calculate average collection and payment periods by comparing accounts receivable with operating revenue and accounts payable with costs. (This is all on the income statement.) Make sure the company's average collection period is roughly equal to its terms. Then, determine how fast the company pays its bills. "If its accounts receivable are turning over every 45 days, and it's paying bills in 50 or 55 days, then it has to wait to get paid before it pays you," Swafford says.

Resources

Regional affiliates of the National Association of Credit Management provide credit reports, industry data, and collection services to small companies; visit **nacm.org**. Its Useful Sites page has a primer on credit applications.

The Federal Trade Commission (**ftc.gov**) offers a guide to avoiding credit discrimination under the Guidance tab of the Competition section of the website.

The Virginia-based law firm Fullerton & Knowles offers free form downloads, including a credit application and a response form, at **fullertonlaw.com**.