Principles of Business Credit

Eighth Edition

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NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT

Driving results

PART I

HOW CREDIT WORKS

1 Credit in the Business World

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The historical development of credit.
- The primary reasons credit is offered.
- The important elements of credit.
- The credit process and where credit fits into a business cycle.
- The different types of credit.
- The Federal Reserve System and its impact on the economy.

Chapter Outline

Questions for Discussion

THINK ABOUT THIS

Q. How would business be conducted in a world without credit?

Q. A new tech startup and a company that is speculated to have poor financial management both place an order with your company, what factors would you take into account when extending credit?

Q. How does credit change based on the industry or the economic and business conditions?

A Brief History of Credit

- Credit has been documented to have been used as early as 1300 B.C. by the Babylonians and Assyrians.
- Credit also played a fundamental role in financing the United States during the American Revolution.
- A group of men in Toledo, Ohio created the National Association of Credit Men in 1896
- This group evolved and expanded into today's NACM

Comprehension Check

Explain the reasons credit has evolved.

The National Association of Credit Management

Today with its network of Affiliated Associations, NACM represents more than 14,000 credit professionals worldwide. NACM's purposes and objectives are:

- To promote honest and fair dealings in credit transactions.
- To ensure good laws for sound credit.
- To foster and facilitate the exchange of credit information.
- To encourage efficient service in the collection of accounts.
- To promote and expedite sound credit administration in international trade.
- To encourage training for credit work through colleges, universities, self-study courses and other means.
- To foster and encourage research in the field of credit.
- To disseminate useful and instructive articles and ideas with respect to credit management techniques.
- To promote economy and efficiency in the handling of estates of insolvent, embarrassed or bankrupt debtors.
- To provide facilities for investigation and prevention of fraud.
- To perform other such functions as the advancement and protection of business credit may require.

Primary Reasons to Offer Credit

Business or **trade credit** has been part of the U.S. business scene for hundreds of years—and the use of credit in the purchase of goods or services is so common that it is taken for granted

The **primary reason** for a company to *offer credit terms to customers is to accommodate the sale of goods and services in order to create revenue.*

- Increase Sales
- Competition
- Promotion
- Credit Availability
- Convenience
- Demand
- Price

Comprehension Check

Explain why organizations like **NACM** evolved.

Elements of Credit

- Credit comes from the Latin: **credere**

- **Credit** *is the transfer of economic value now, on faith, in return for an expected economic value in the future*

Comprehension Check

List and explain the reasons credit is offered.

Explain why a sale may not occur without credit.

Important Elements of Credit

- Risk of nonpayment
- Timing
- Security
- Extra costs
- Legal aspects
- Economic influences

Comprehension Check

What does the Latin term ***credere*** mean?

Explain why selling on credit is more expensive than cash, but ultimately beneficial.

The 5 Cs of Credit

- Character
- Capacity
- Capital
- Collateral
- Conditions

Also Consider:

- Competition
- Common Sense

Comprehension Check

List and explain the important elements of credit.

The 5 Cs Application in the Real Word

RWP 1-1 **Real World Perspectives**

FIVE Cs OF CREDIT

When investigating a new customer or performing a review on a current customer who does not have financials to investigate, turn to a process that was employed nearly a half-century ago. The process is known as the 5 Cs of Credit: Character, Capital, Capacity, Conditions and Collateral.

A customer's character will define their willingness to pay for the product or service being provided. To develop an opinion on a customer's character, it is advantageous to review their management staff and see if they have been in the same form of business for a long period of time, or if this is their first time in the industry. If the business history is short, it is advisable to move with caution. Some of the steps a credit professional could take in this situation are to visit the customer, see how the business is set up and talk with the management to see what their growth plan or business plan is. Ask them if you can review their financials while you are there and discuss any flags that you may find. If the credit professional is unable to visit, a credit report could be pulled along with the references they provide to see what the payment history of the company is. Also check if the company has any judgments against them, if any of their accounts have been placed for collections, or if any liens have been established. When the credit professional performs the bank reference check, a review of the NSF checks that are reported and how long the bank account has been opened can also assist in defining character.

Unlike character, capital determines if the customer is able to pay their debts in a timely manner. Ideally, it is beneficial to have financial statements available for review. However, a credit professional is able to look at other factors if they are not available. A review of the customer's life cycle can define when the cash flow is at a high for the company and their expenses are at a high (i.e., a seasonal operation or companies that do not make payments at quarter end). A credit professional could use the third-party credit data that was pulled to see if there are any judgments or liens that might become due during the time frame when a payment would be expected. If the credit professional's industry has an Industry Trade Group, it would be beneficial to see how the company being reviewed is defined in the trade group ranking and see how they compare with companies that others in the industry sell to. If it is an existing customer and a review is being done, what the credit analyst has experienced with the customer could be taken into consideration when reviewing capital. If the credit analyst has developed a rapport with the accounts payable analyst, they may have additional insights as to how the company is performing based on previous conversations.

The capacity of a company shows the credit professional whether the customer has the proper legal structure to allow the corporation to continue making payments to the debtor. This can relate to the review of management that was performed in the character section by looking at the managers in charge of the three key business operations: marketing, financial and production. From the marketing standpoint, the credit professional could review the different business segments that the company is involved in as well as the company's marketing priority. From the financial standpoint, the manager that is in place can be researched to see what other companies they have been tied to. Look at the history of those companies and understand their general overall strategy. From the production standpoint, the credit professional could review the level of automation the company has to see if the it can keep up with changing demands of production. If the information on the managers is not available on the company's website, perhaps an Industry Trade Group would be able to provide the information, or use third-party credit ratings or certain websites such as Manta.com. Once the information about the managers is found, a great way to see their professional history and review the companies they worked for is to look on their LinkedIn profile.

When considering conditions, the general economic conditions that currently exist in the country where the company would be doing business are important. The credit professional would review the overall performance of the industry that they are operating in to help determine the amount of risk that is acceptable. A review of what the selling margin would be could possibly allow certain levels of risk to be overlooked, or if the customer also sells product to your company, a review of the payables due to them could help mitigate risk of open receivables.

Lastly, employing collateral would allow the credit professional to obtain a letter of credit as a payment option, a personal or a corporate guarantee from the company, any liens on equipment that might be able to be placed, and again, as in conditions, any payable that your company may owe them to offset any debtor obligation. If the credit professional is able to offset any liability with these options, the review of the customer could become easier.

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Graduate School of Credit and Financial Management class of 2016

Comprehension Check

What are the **Five Cs of Credit?**

Canons of Business Credit Ethics

Credit professionals pledge to:

- Adhere to the highest standards of integrity, trust, fairness, personal and professional behavior in all business dealings.
- Negotiate verbal or written credit agreements, contracts, assignments, and/or transfers with honesty, fairness, and due diligence to and for the benefit of all parties.
- Render reasonable assistance, cooperating with impartiality and without bias or prejudice, to debtors, third parties, and other credit professionals.
- Exchange appropriate, historical and current factual information to support the process of independent credit decisions.
- Exercise due diligence as required to prevent unlawful or improper disclosure to third parties.
- Disclose any potential conflict in all business dealings.

Comprehension Check

Why might one C be considered more important?

The Credit Process

- Sales makes contact and order is taken
- Credit department reviews customer for creditworthiness
- Good or service delivered on credit
- Payment is made on time/within terms

Operating Cycle

- **Operating cycle** - the period of time between the acquisition of material, labor and overhead inputs for production and the collection of sales receipts
- **Production stage** – material converted into goods
- **Collection Stage** – customer pays for goods that were purchased on credit

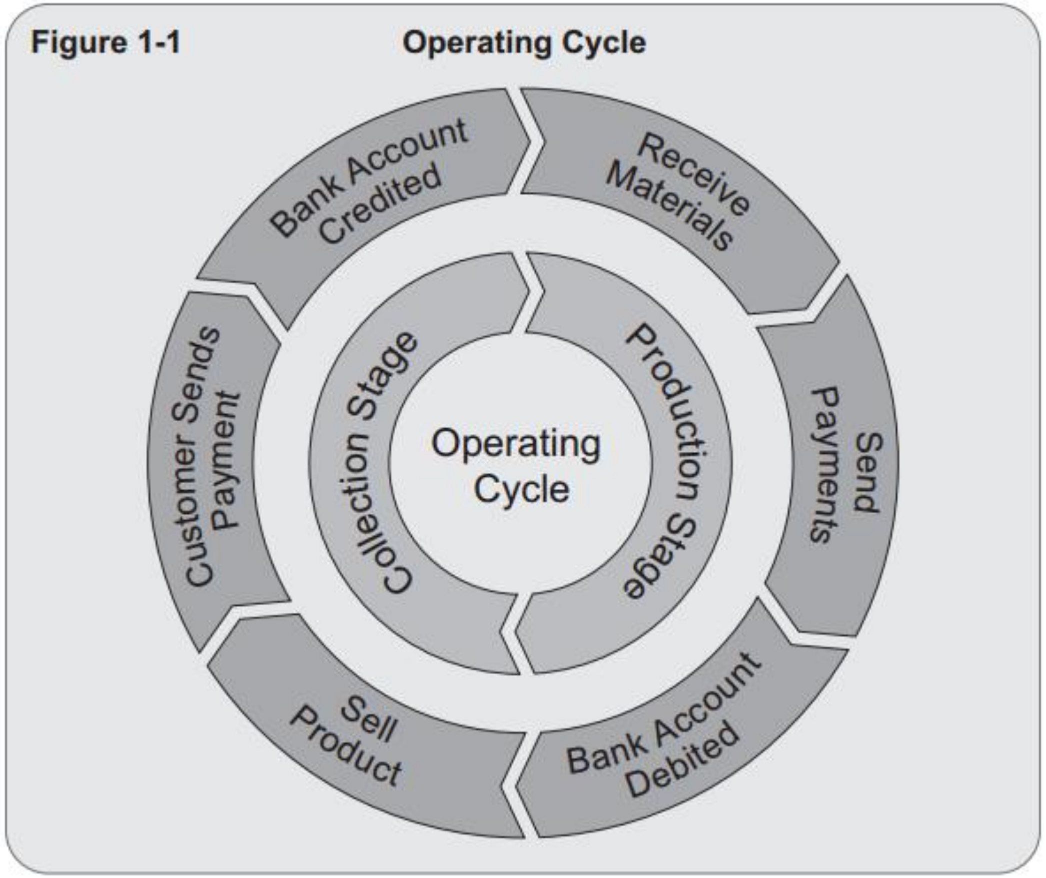
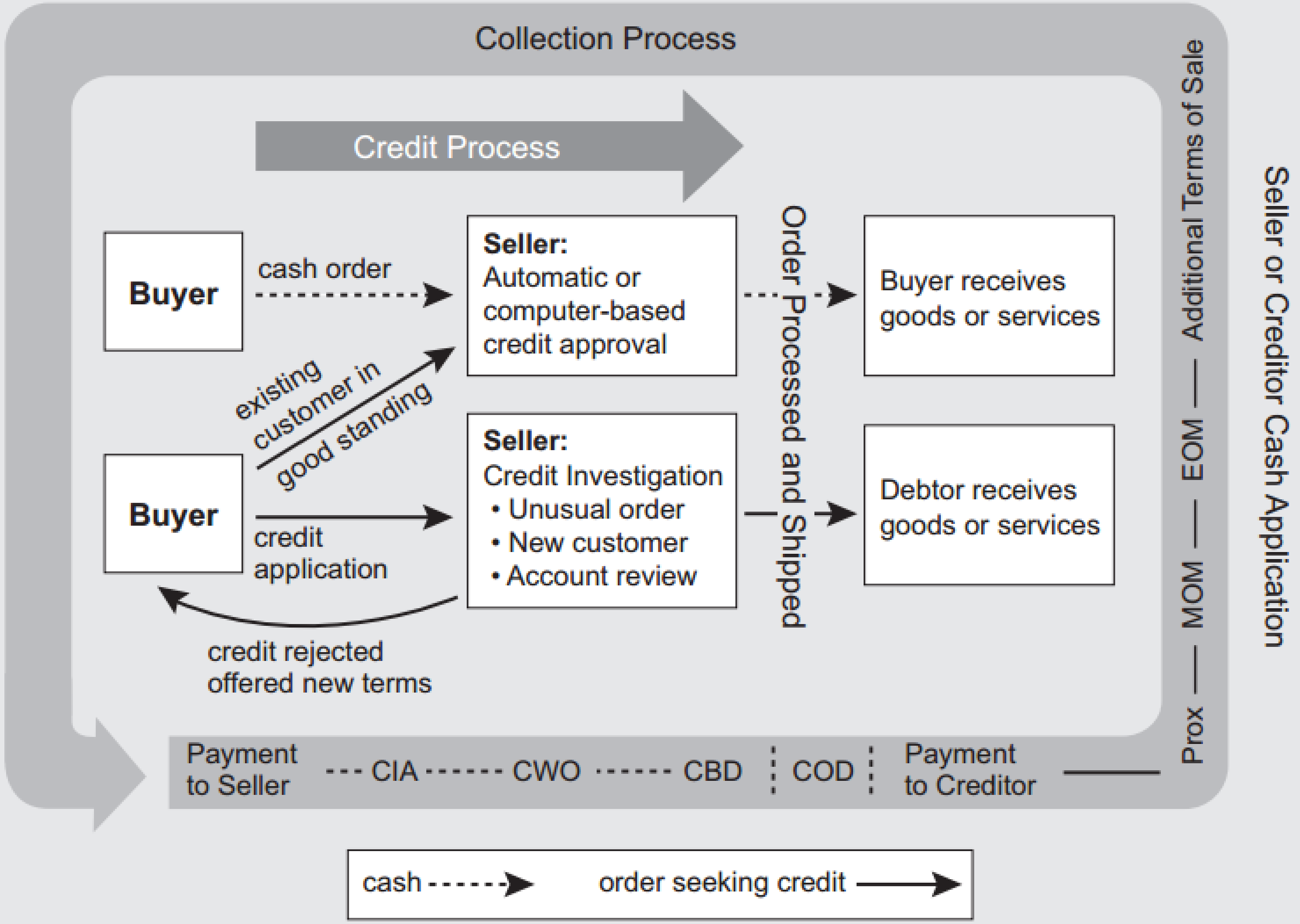


Figure 1-2 Credit and Collection Cycle



Types of Credit

- Public credit
- Private credit

Comprehension Check

Define operating cycle.

Why will a manufacturer be both debtor and creditor at any given time?

Public Credit

- Federal
- State
- Local

Private Credit

- Investment credit - Bonds
- Consumer credit
- Agricultural credit
- Business credit
- Bank credit

Comprehension Check
Define and give an example of **public credit.**

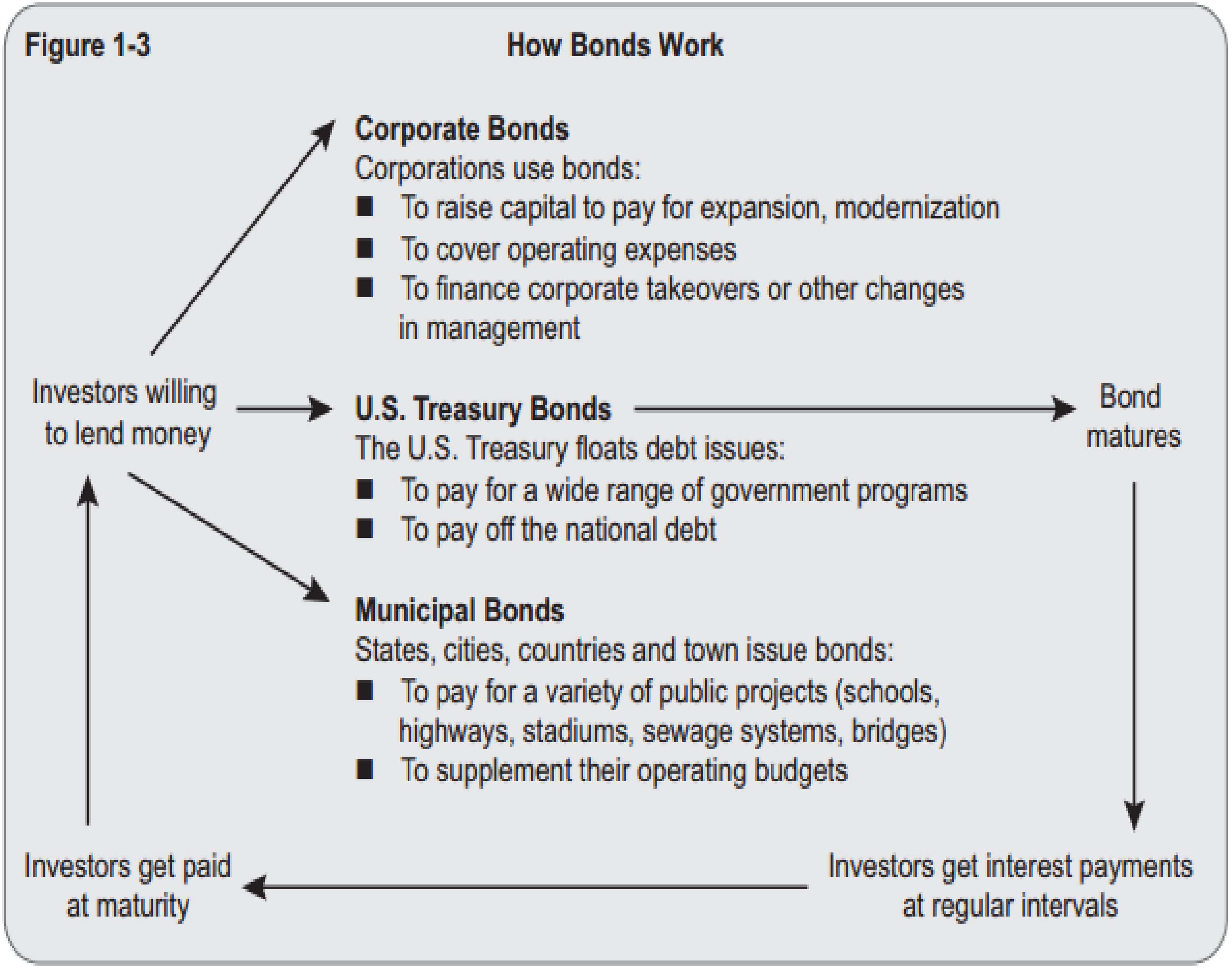


Figure 1-3 How Bonds Work

Investment Credit

- Bonds or fixed-income securities
- Asset-backed bonds
- Debentures, most common are corporate bonds
- Secured bonds
  - Mortgage bonds
  - Equipment trust certificates (ETC)
  - Collateral trust bonds

Comprehension Check

What is the most common type of **corporate bond?** List its characteristics.

What is the difference between a **secured bond** and a **debenture?**

How do mortgage and collateral bonds compare?

Consumer Credit

- Consumer Credit
- Open-end Credit
- Closed-end Credit
- Incidental Credit

Comprehension Check

Define **consumer credit.**

List and explain three ways consumer credit can be classified.

Agricultural Credit

- Adapted to the specific financial needs of agricultural operations, which are determined by planting, harvesting and marketing cycles
- More risk to creditor
- Many laws treat this type of credit separately

Comprehension Check

What are the major types of **private credit?**

Business Credit

Extensions of credit primarily for business or commercial purposes.

The important characteristics of business credit are:

- Selling terms are relatively short.
- Transactions are usually on open account or unsecured, but may be partially secured or secured in full.
- Cash discounts may be offered for payment before the net due date.
- The terms include transactions to manufacturers, wholesalers and retailers, but specifically exclude the consumer.
- The timeliness in reaching a decision whether or not to extend credit is often much more critical in the business setting. Delays in the manufacturing process can increase costs and reduce the quality of perishable goods.

- **Unsecured Open-Account Credit**
- **Secured Credit**

Global Business Credit

Dealing in the global setting requires a credit manager to be conscientious of additional risks when dealing internationally.

- **Country risk**
- **Currency issues**
- **Culture**

Banking Credit: Banking Vs. Business

Banks furnish money,

Businesses furnish goods or services

Comprehension Check

Explain what **open account credit** is.

What is the difference between **unsecured** and **secured credit**?

The Federal Reserve and the U.S. Payment System

The **Federal Reserve Bank**, more commonly known as the Federal Reserve or the Fed, is the U.S.'s central bank

The Federal Reserve System is made up of:

- **Board of Governors**
- **Federal Open Market Committee**
- **12 regional banks and their branches**

Structure

The Board of Governors

- The "governance agency" of the Federal Reserve System located in Washington, D.C.
- The Chairman of the Board reports to Congress.
- Sets the regulations for the entire system
- Term limit is 14 years
- They have four monetary policy tools:
    1. **Open market operations**
    2. **The discount rate**
    3. **Reserve requirements**
    4. **Contractual and clearing balances**

Structure
The Regional Banks

12 regional banks functions:

- Operating their portion of the nationwide payment system.
- Distributing currency throughout the region.
- Supervising regional member banks and bank holding companies.
- Serving as bankers for the U.S. treasury.
- Acting as a banker's bank—a depository institution for the regional banks (responsibilities include lending money to depository institutions through the discount window).

Figure 1-4 **Boundaries of Federal Reserve Districts**

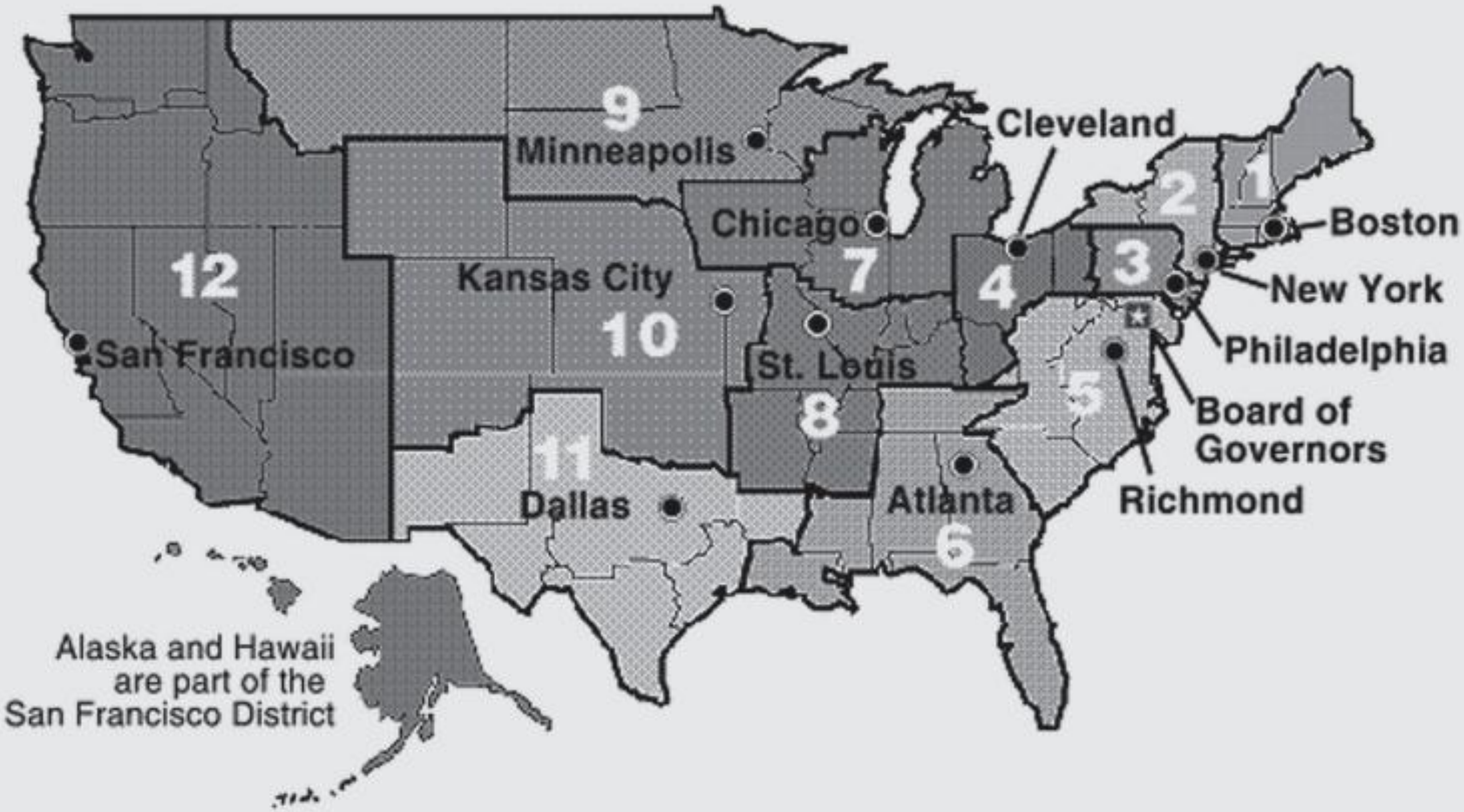


Figure 1-5 **Federal Reserve Banks**

Number	Letter	Bank	Branch
1	A	Boston	
2	B	New York	
3	C	Philadelphia	
4	D	Cleveland	Cincinnati, OH Pittsburgh, PA
5	E	Richmond	Baltimore, MD Charlotte, NC
6	F	Atlanta	Birmingham, AL Jacksonville, FL Miami, FL Nashville, TN New Orleans, LA
7	G	Chicago	Detroit, MI
8	H	St. Louis	Little Rock, AR Louisville, KY Memphis, TN
9	I	Minneapolis	Helena, MT
10	J	Kansas City	Denver, CO Oklahoma City,OK Omaha, NE
11	K	Dallas	El Paso, TX Houston, TX San Antonio, TX
12	L	San Francisco	Los Angeles, CA Portland, OR Salt Lake City, UT Seattle, WA

Structure

1.*Federal Open Market Committee*

- Buys and sells securities on the open market in order to control the money supply
- The board of governors meets eight times a year in order to set a target for the **federal funds rate,** *the interest rate charge for banks to borrow money from the federal reserve overnight.*

Federal Reserve Areas of Responsibility

- To guide **monetary policy** for economic stability
- To **regulate** and **supervise** banking institutions in the U.S.
- To provide **financial services** to banking institutions, the U.S. government and foreign official institutions

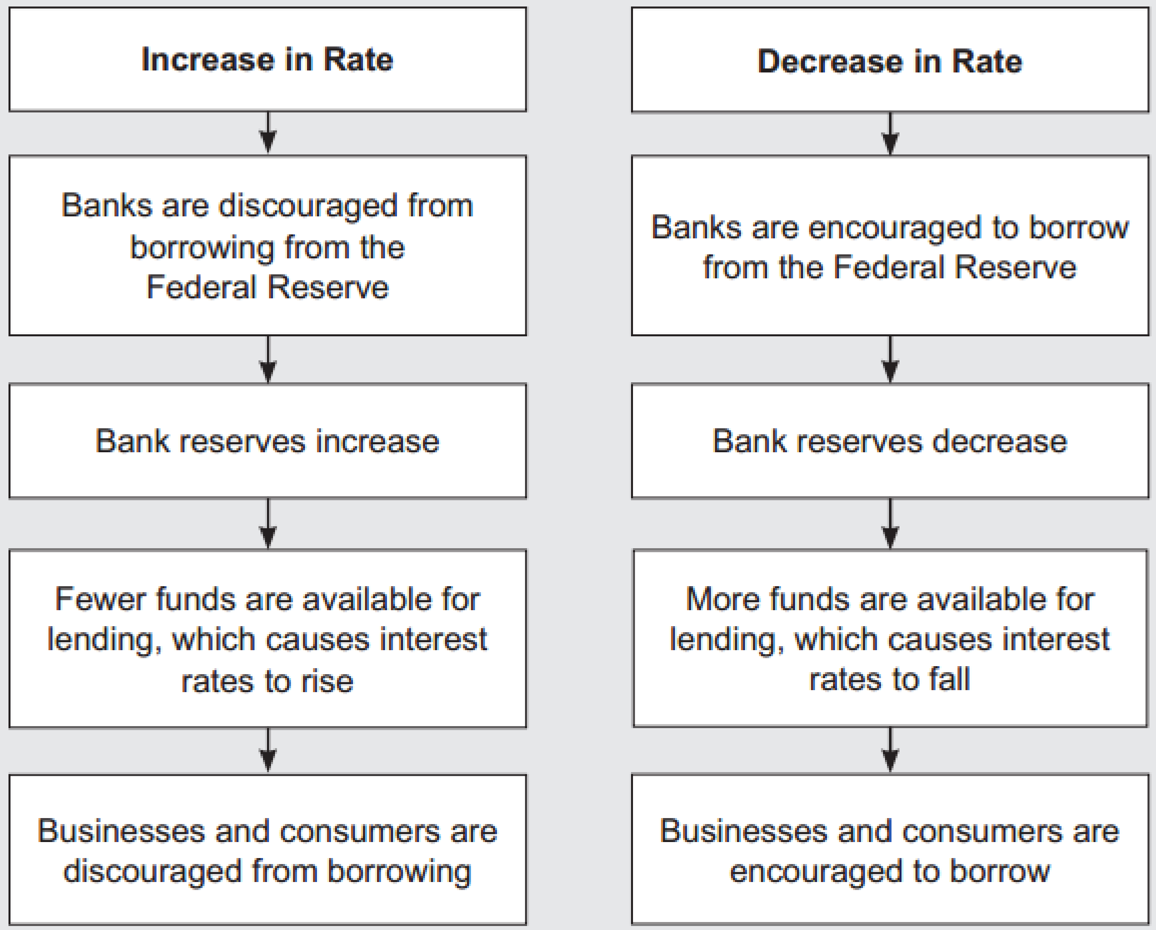
Comprehension Check
Explain the structure of the **Federal Reserve.**

Monetary Policy

2.The Discount Rate

- The **discount rate** *is the interest rate Federal Reserve banks charge their member banks for short-term loans.*

Figure 1-6 Effects of a Change in the Discount Rate

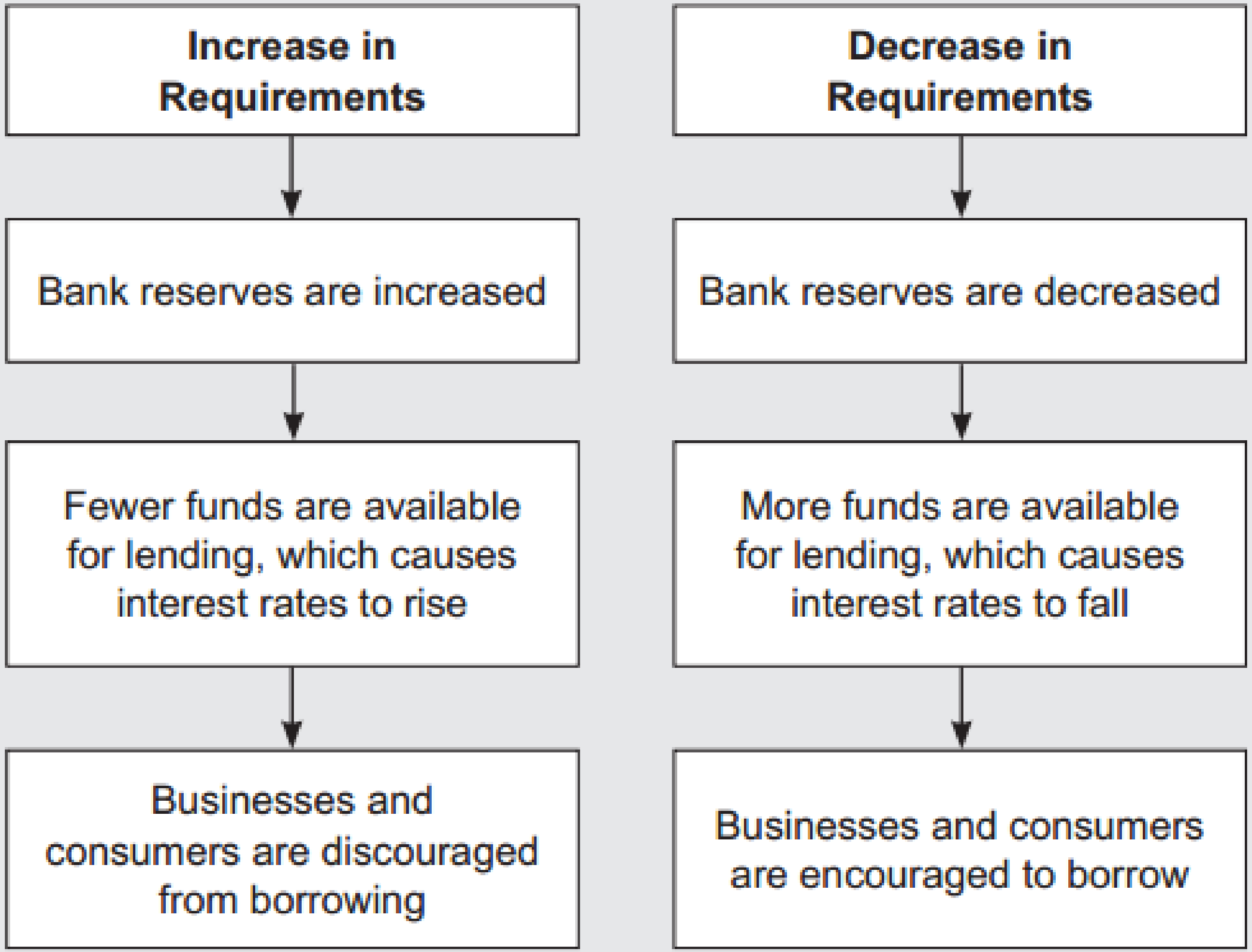


Monetary Policy
3.The Reserve Requirements

The portion of a member bank's deposits that must be held in reserve in its own vaults or on deposit at its regional Reserve bank

- Increasing the reserve requirement takes money out of the economy.
- Decreasing the reserve requirement increases the money supply.

Figure 1-7 **Effects of a Change in the Reserve Requirements**



Monetary Policy
4.Contractual Clearing Balances

- **Contractual clearing balances** *is an amount that a depository institution agrees to hold at its Federal Reserve bank in addition to any required reserve balance.*

Comprehension Check

Briefly explain the concept of **reserve requirement.**

What would the effect be if the Fed raised the reserve requirement? What if the requirement was lowered?

Banking Supervision

Board of Governors Responsibilities:

- Safe, Sound, and Competitive Banking Practices
- Protection of Consumers in Financial Transactions
- Stable financial markets

Comprehension Check

List the four major tools used by the Fed to expand or contract the money supply and to control interest rates.

Financial Services
The Banker's Bank

- Maintaining the banks' deposit accounts with the Federal Reserve.
- Providing payment services, including collecting and processing checks, bank-to-bank EFTs and ACH services.
- Distributing and receiving U.S. currency into and out of the banks' deposit accounts.

Comprehension Check

Must all banks belong to the **Federal Reserve System?**

Financial Services
The Government's Bank

- Acting as fiscal agents.
- Paying treasury checks.
- Processing electronic payments.
- Issuing, transferring and redeeming U.S. government securities.

Financial Services
Research and Information

Two important outlets for information the Federal Reserve conducts research on are:

- **The Beige Book** or Summary of Commentary on Current Economic Conditions – published 8 times per year
- **Fed Minutes** - released after each meeting, 8 times per year

Check Processing

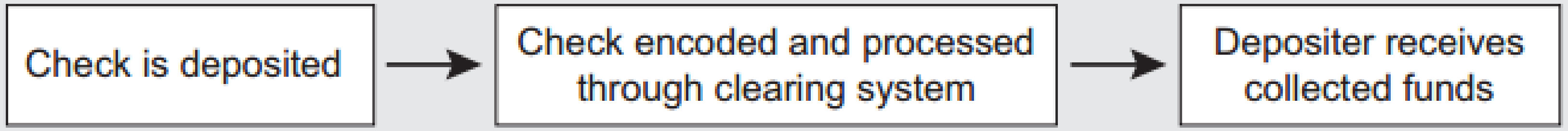
- The **MICR line** contains the following information:
  - **Routing number**
  - **Payor's account number**
  - **Sequence number**
  - **Encoded check amount**

Comprehension Check
What two publications does the Fed release to the public as part of their mandate to study the economy?

Check Clearing for the 21st Century Act (Check 21)

- Effects of Check 21:
  - Customers no longer receive cancelled checks with their monthly bank statements
  - Checks clear faster
  - Fraudulent checks are identified earlier as a result of the speed of check processing
  - **Availability float** time is reduced

Figure 1-9 Availability Float



Electronic Funds Transfer

Electronic funds transfer (EFT) *is the electronic transfer of money from one bank account to another,* either within a single financial institution or across multiple institutions, through computer-based systems and without the direct intervention of bank staff.

- **Automated Clearing House (ACH)**
- **Fedwire**
- **SWIFT**
- **CHIPS**
- **TARGET2**
- **TIPANET**

Comprehension Check

What is the **MICR** system?

What information does the MICR line contain?

Comprehension Check

Define the term **availability float.**

Define **check truncation.**

Federal Deposit Insurance Corporation

- Created in 1913 as an independent agency to preserve and promote public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for at least $250,000.

Comprehension Check

Define the term **electronic funds transfer.**

List the types of services for electronically transferring funds.

Online Business Banking

- Has simplified money management
- Easier to monitor accounts, financials, account history, and statements
- Transferring funds, pay bills, automatic payments, transaction alerts, cost savings, direct deposit ,etc.
- Can facilitate international business as well

Comprehension Check
What does the **FDIC** *not* insure?

Summary

- Credit has been documented to have been used as early as 1300 B.C. by the Babylonians and Assyrians. Credit also played a fundamental role in financing the United States during the American Revolution.
- Institutions like Dun & Bradstreet and NACM arose because of a clear need for information and resources, which include, but are not limited to the following:
    - Honest and fair dealings in credit transactions
    - Ensuring good laws for sound credit
    - Fostering and facilitating the exchange of information
    - Promoting and expediting information for international trade
- Training credit professionals
- The seven reasons to offer credit are:
    - To increases sales
    - Competition
    - Promotion
    - Credit availability
    - Convenience
    - Demand
    - Price

Credit involves trust and is ultimately more costly than dealing in cash, although the benefits can outweigh the costs.

Comprehension Check

What are some of the advantages of **online business banking**?

Summary Continued…

- The **six elements of credit** are:
  - **Risk of nonpayment**
  - **Timing**
  - **Security**
  - **Extra costs**
  - **Legal aspects**
  - **Economic influences**
- The **Five Cs of Credit** are character, capacity, capital, collateral and conditions, but one might want to also consider competition and common sense as additional Cs.
- The two types of credit are public and private. Public involves the government, while private extends to businesses and individuals.
- The five types of **private credit** are:
  - **Investment credit**
  - **Consumer credit**
  - **Agricultural credit**
  - **Business credit**
  - **Bank credit**

Summary Continued…

- The **Federal Reserve** is composed of the Board of Governors, the Federal Open Market Committee and the 12 regional banks.
- The Federal Reserve has four main tools that control the money supply and the monetary policy of the U.S., which ultimately controls and manipulates various interest rates. They include: open market operations, the discount rate, reserve requirements and contractual clearing balances.
- Besides controlling monetary policy and interest rates, the Federal Reserve also ensures safe, sound and competitive banking practices, consumer protection, stable financial markets, financial services and published economic research.
- The **FDIC** insures approximately $9 trillion (as of 2016), which correlates to $250,000 per depositor, per insured bank.
- **Online business** banking has simplified money management making it easier to monitor accounts, financials, account history and statements, as well as facilitating the transfer of funds between accounts and bank assisting domestic and international business

2 Credit in the Company

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Why credit is a function of business.
- The strategic role of credit.
- Where credit typically fits within the business organization.
- The role of credit in financial management.
- The role of credit in the operating cycle.
- The goals and core activities of a credit department.

Chapter Outline

Questions for Discussion

THINK ABOUT THIS:

Q. How is the role of credit perceived by different departments in the company?

Q. How can the use of credit facilitate the overall direction and objectives of a company?

Credit as a Business Function

- Business
- Business organization
- Strategy
- Strategic planning

The Strategic Role of Credit

- Amassing Information
- Credit Analysis
- Securitization
- Collection
- Cash Application
- Deduction Resolution

Comprehension Check

Discuss what the term **business** means.

What is meant by the term **order-to-cash?**

Define the term **strategy.**

What factors impact a company's strategic plan?

Credit within the Business Organization

Management of Accounts Receivable

Net Working Capital = Current Assets – Current Liabilities

Finance-Related Functions

- Protecting and managing the investment in the accounts receivable portfolio.
- Cash forecasting.
- The timely conversion of receivables into cash.
- Financial analysis.
- Handling of collateral that secures a customer's account.
- Deposit of funds and the relationship with banks.
- Handling customer deductions.
- Evaluation of economic trends on sales, receivables and collections.

Comprehension Check

Discuss a credit-related area that has both a financial and strategic implication.

The Role of Credit in Financial Management

- Financial Management:
  - Obtain cash from investors
  - Use that cash to buy productive assets
  - Operate those assets to produce additional cash
  - Return cash to the business and/or investors

Cash Management

- Managing Cash Inflows
- Internal Cash Flow Management
- Managing Cash Outflows

Comprehension Check

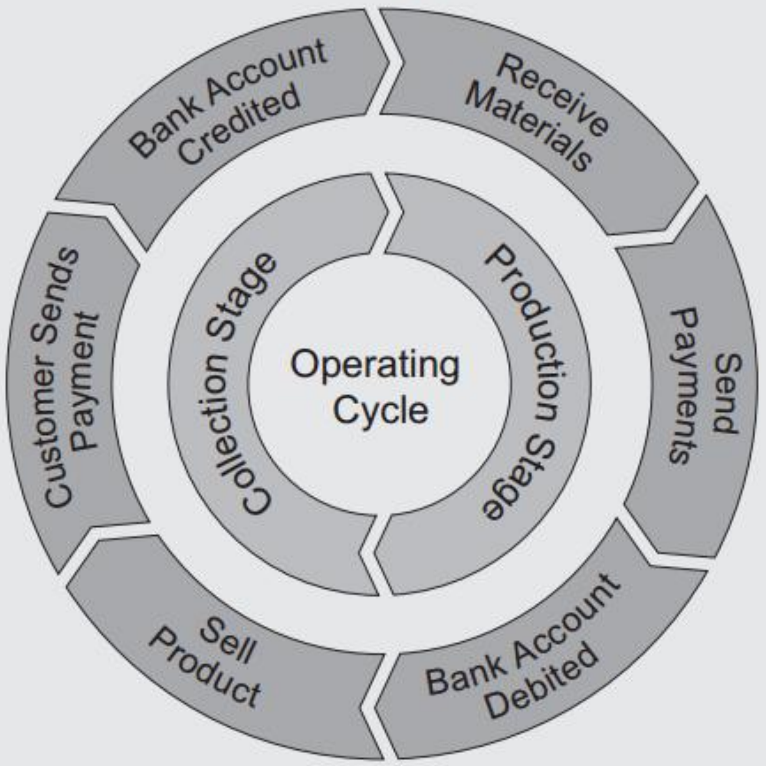
Using balance sheet logic, explain where the credit department falls within an organization.

List eight finance-related functions that the credit department manages.

Credit and the Operating Cycle

- Operating cycle
- Production stage
- Collection stage

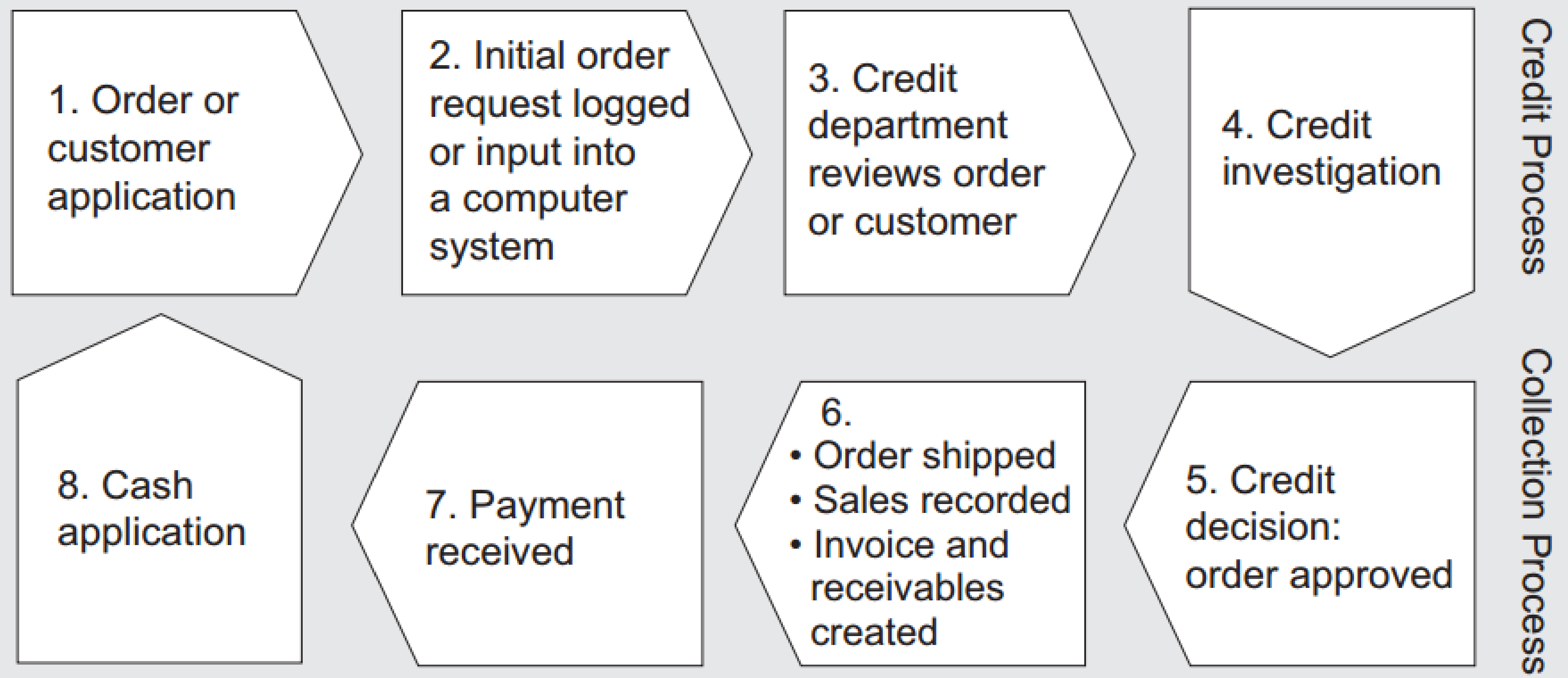
Figure 1-1 **Operating Cycle**



Comprehension Check

What is the goal of cash management?

Figure 2-1 **Credit and Collection Process**



Comprehension Check

List and describe the three broad areas of cash flow management.

The Core Activities of the Credit Department

- Customer and credit analysis
- Developing credit policy
- Managing the collection function
- Setting credit availability thresholds
- Management reporting

Comprehension Check

Describe the **operating cycle.**

Required Areas of Knowledge

- Accounting, Financial Analysis and Finance
- Business and Credit Law
- Business Communication Skills
- Management Skills, including Negotiation
- Customer Service
- Analytical Skills
- Computer Skills

Comprehension Check

List the core activities of the credit department.

The Credit Department's Goals

- Increased sales and profits
- Improved quality of work
- Decreased cost per unit of work
- Mitigating bad debt losses
- Monitoring credit department costs
- Measuring performance

Comprehension Check

Discuss some of the areas of knowledge or skill sets required for credit management.

Relationships with Other Departments

- Sales Departments
  - Marketing Risk
  - Marginal Accounts
- Purchasing Department
- Manufacturing Relationship
  - Approval subject to confirmation
- Information Systems
  - Process mapping
  - Electronic Data Interchange (EDI)
- Other Departments

Comprehension Check

List six goals and objectives of every credit department.

Organizing the Credit Department

Two essential functions:

1. **Defining responsibility**
2. **Staffing**

Comprehension Check

How can a less creditworthy company be used as a marketing strategy?

Comprehension Check

Describe an approval subject to confirmation.

Day-to-Day Administration

- The Credit Approval Process
- Account Establishment
  - DUNS number
  - Social Security
  - (EIN)
- Order Processing
- Accounts Receivable Administration
  - **Quantitative Data**
- Collections and Adjustments

Comprehension Check
How does the credit department interact with other departments to meet the goals of the organization? Choose one and be specific.

Comprehension Check
Define the term **electronic data interchange.**

Credit Operations

- **Lockbox Operations**
  - A lockbox is a check collection system operated by a bank.
  - The bank receives and processes checks and then transfers the information to the company.
- **Collecting Accounts Receivable**
  - A collection effort is needed when payment is not received for invoices when they are due.
    - Letters
    - Phone calls
    - Emails
    - Visits
    - Third-party collections
- **Control and Follow-Up**
  - The concept of control and follow-up is to identify and remedy reasons for nonpayment.

Comprehension Check

What are the day-to-day steps in credit processing?

Summary

- The term business dates back to the 14th century and encompasses all organizational functions that seek to create a product or service, which are then sold to a customer for a profit.
- The credit department is involved in the business process from **order-to-cash.**
- Credit plays a strategic role in a business' future goals and broadly involves **amassing information, credit analysis, securitization, collection, cash application and deduction resolution.**
- The credit department is responsible for a company's accounts receivable and is an integral part of a company's **working capital.**
- A credit department typically manages:
  - Protecting and managing the investment in the accounts receivable portfolio
  - Cash forecasting
  - The timely conversion of receivables into cash
  - Financial analysis
  - Handling of collateral that secures a customer's account
  - Deposit of funds and the relationship with banks
  - Handling customers' deductions
  - Evaluation of economic trends on sales, receivables, and collections

Comprehension Check

What is a **lockbox?**

Summary Continued…

- The **collection cycle** commences directly after the sale of a product or service and it is important to understand that the work of the credit department continues even after the product is shipped.
- The core activities of a credit department are customer and credit analysis, developing credit policy, managing the collection function, setting credit availability thresholds and managing reporting.
- Goals of the credit department are, but are not limited to, the following:
  - Increased sales and profit
  - Decreased cost per unit of work
  - Mitigating bad debt losses
  - Monitoring credit department costs
  - Measuring performance
- The credit department maintains a relationship with other departments in a business including the sales, legal, purchasing and manufacturing departments.
- Day-to-day administration includes the credit approval process, account establishment, order processing, accounts receivable administration, as well as collections and adjustments.
- Credit policy is a critical component when extending credit, pursuing delinquent accounts and resolving disputes.

3 Organizing the Credit Department

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Organizational options for the credit department.
- Centralization vs. decentralization.
- Responsibilities of management.
- Effective credit policies and procedures.
- How to build a strong credit team.

Chapter Outline

Questions for Discussion

THINK ABOUT THIS

Q. How do the operations of a business change the structure and function of the credit department and vice versa?

Q. What is a credit manager's role in setting credit policy, hiring and continuing the professional development of the credit department's staff?

Organizing the Credit Department

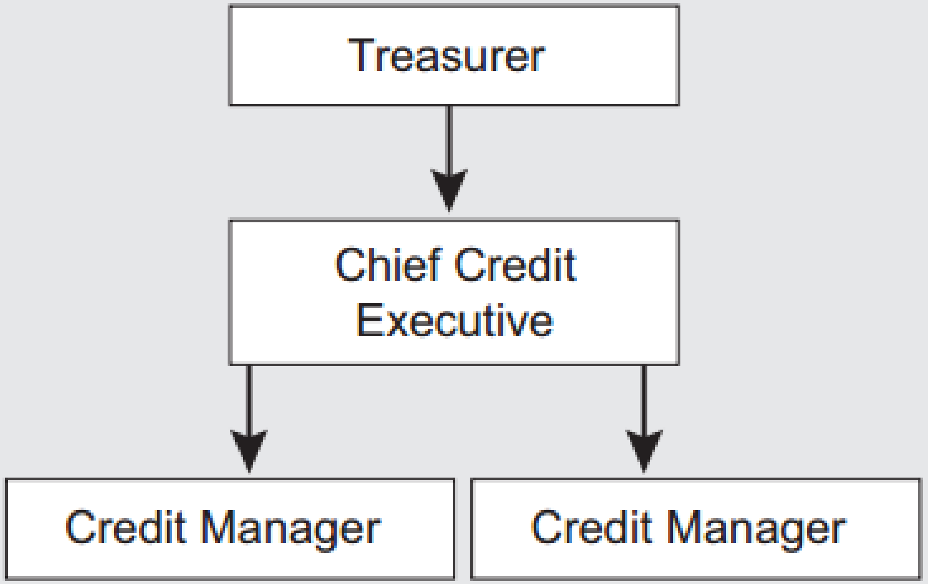
- Organizing the Credit Department
- Centralization vs. Decentralization
- Management Responsibilities
- Business Organization
- Building the Credit Department Team

Centralization vs. Decentralization

- **Centralized Structure**
  - The credit function is controlled and administered from a principal or central location.
- **Decentralized Structure**
  - The credit function may report to a principal location with credit personnel located at remote offices.

Centralized – Credit Controlled and Administered at a Headquarters Office

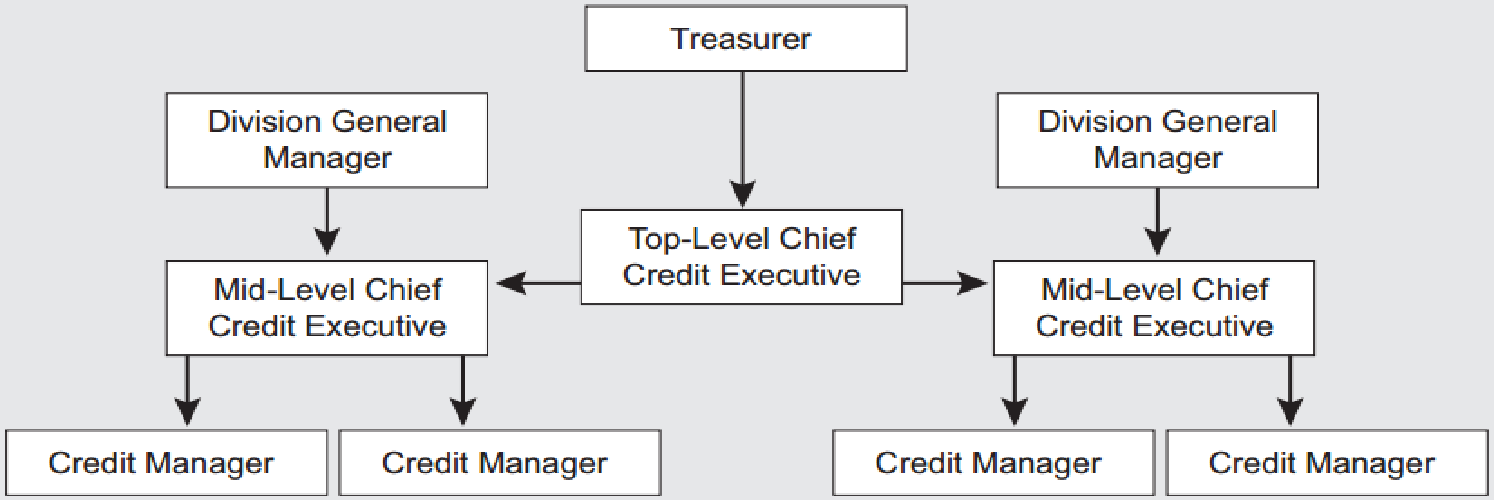
Figure 3-1 Centralized Offices with Credit Controlled and Administered from a Headquarters Office



Decentralized - Credit Controlled at Headquarters but Administered from Decentralized Locations

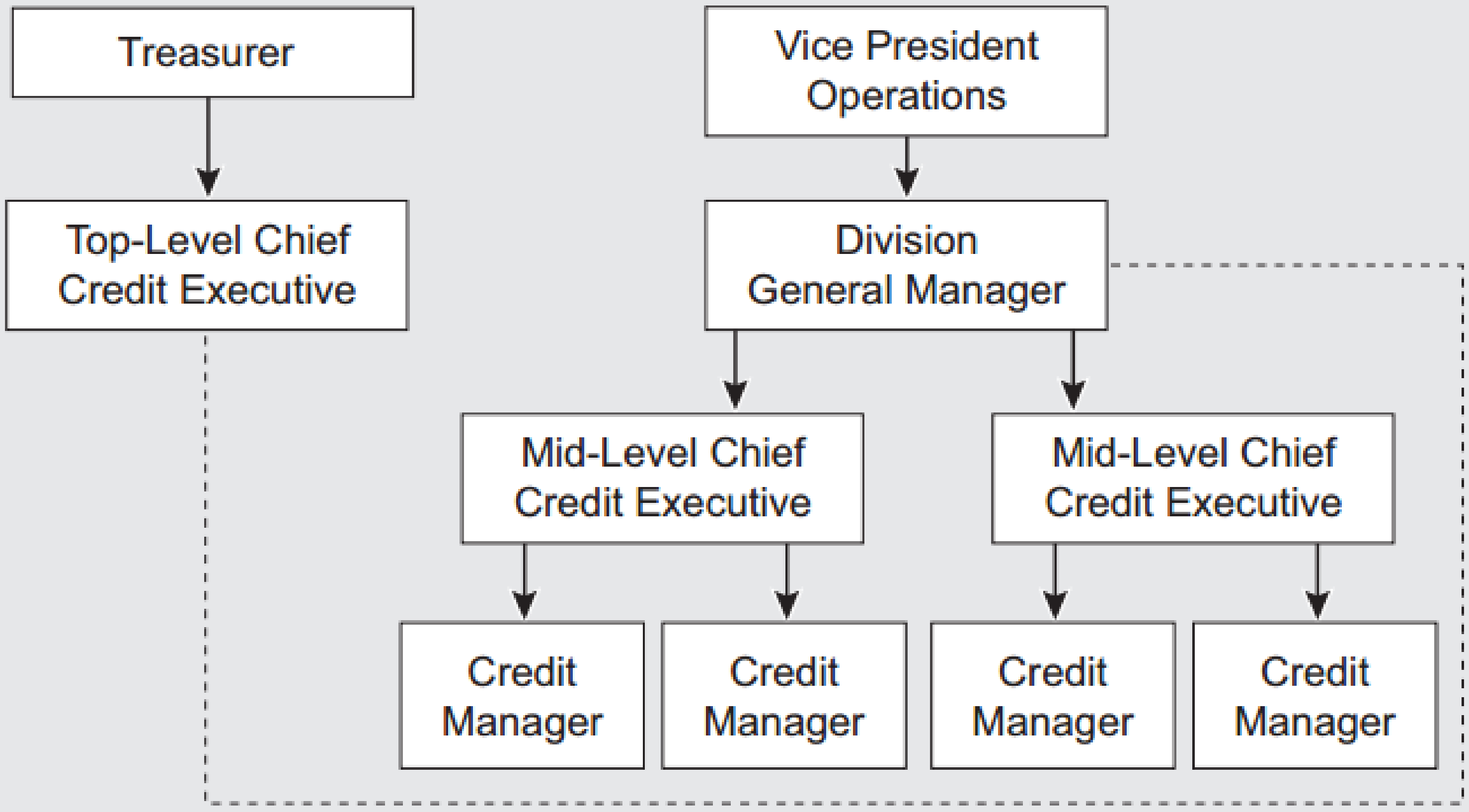
- *While authority in credit and collection is provided by the executive-level credit manager, in all other respects middle management establishes the procedures to which the credit professional must conform.*

Figure 3-2 Decentralized Offices with Credit Controlled from a Headquarters Office



Decentralized - Credit Controlled and Administered from Decentralized Locations with a Staff Office at Headquarters

Figure 3-3 Decentralized Offices with Staff at Headquarters Office



Benefits of Different Organizational Strategy

Benefits of Centralization

- Economies of Scale
- Consistency and Control

Benefits of Decentralization

- Internal and External Relationships
- Involvement in Setting Strategic Priorities

Comprehension Check

Describe how the credit function would operate if credit is controlled at a headquarters office but administered from decentralized locations.

Management Responsibilities

- Planning
- Organizing
  - An ideal department structure requires careful planning
- Staffing
  - To succeed, there are three steps to consider:
    1. Establish the results expected of each position and the criteria to be used to measure them.
    2. Determine what the person in each position has to do in order to produce desired results.
    3. Ascertain what knowledge, skills and personal qualifications are needed to perform the activities. Appropriate skills and abilities can be identified at points needed and instructions clearly specified.
- Leadership
- Control – regular review

Comprehension Check

List and discuss the benefits of a **centralized** credit operation.

Comprehension Check

List and discuss the benefits of a **decentralized** credit operation.

Business Organization

- Credit Policy and Procedures
  - Develop a Credit Application
  - Keep Credit Records
  - Produce Accurate Invoices
  - Deal with Past Due and Delinquent Accounts
  - Measure Effectiveness and Performance
    - Bad debt as a percentage of sales.
    - Days sales outstanding in receivables—current.
    - Days sales outstanding in receivables—past due.
    - Percent collected by aging period..
    - Etc.

Comprehension Check
What are some of management's responsibilities?

Building the Credit Department Team

- Importance of Job Description
- Selection of Personnel
- Training
- Credit Library
- Employee Enhancement

Comprehension Check
Give examples of various **credit procedures.**

Job Description

- **Job Description**
  - These written summaries ensure applicants and employees understand their roles and what they need to do to be held accountable.
  - Job descriptions also:
    - Help attract the right job candidates.
    - Describe the areas of an employee's job or position.
    - Serve as a basis for outlining performance expectations, job training, job evaluation and career advancement.
    - Provide a reference point for compensation decisions and unfair hiring practices.
- **Job Specification**
  - Individual tasks involved.
  - The methods used to complete the tasks.
  - The purpose and responsibilities of the job.
  - The relationship of the job to other jobs.
  - Qualifications needed for the job.

Job descriptions typically include:

•Job title.

•Job objective or overall purpose statement.

•Summary of the general nature and level of the job.

•Description of the broad function and scope of the position.

•List of duties or tasks performed critical to success.

•Key functional and relational responsibilities in order of significance.

•Description of the relationships and roles within the company, including supervisory positions, subordinating roles and other working relationships.

•Additional items for job descriptions for recruiting situations:

•Job specifications, standards, and requirements.

•Job location where the work will be performed.

•Equipment to be used in the performance of the job.

•Collective bargaining agreements if the company's employees are members of a union.

•Salary range.

Selection of Personnel

Special Characteristics and Abilities:

- An individual may not possess the full qualifications listed below; however, the higher the position level, the more likely the credit professional will be able to:
  - Determine appropriate methods of observing, organizing, analyzing and reporting data.
  - Meet new situations and changing conditions with initiative, adaptability and ingenuity.
  - Identify needs, unsatisfactory conditions and the causes of such conditions; handle unpleasant situations with tact, diplomacy and emotional stability.
  - Analyze complex problems constructively and follow up difficult situations with resourcefulness.
  - Make informed decisions and be willing to take considered risks for profitable company growth and development of sales potential.
  - Direct the work of employees effectively, exercising considerate interest and fairness in dealing with people and communicating effectively and convincingly through speaking and writing.
  - Handle customer and internal relations diplomatically and decisively when required.
  - Acquire and maintain the required job knowledge, conduct affairs with integrity and persevere in eliciting confidential information.

Training

- Preparation for credit training
- Considerations in Sound Credit Training
- On-the-Job Training
- In-House Training - **Onboarding**
- Observation Tours
- Job Rotation Program or Cross-Training

Comprehension Check
What are the components of a **job description?**

Employee Enhancement

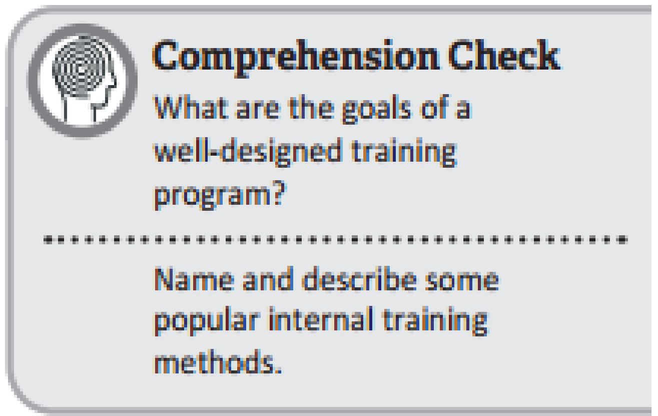
- ## Continuing Education
  - NACM – National Education Department
  - Local NACM Affiliated Associations offer in-house classes and Industry Credit Groups
  - NACM's annual Credit Congress
  - Graduate School of Credit and Financial Management
  - FCIB – International Education

Comprehension Check

What are the special characteristics and abilities to look for when selecting personnel?

Summary

- The credit department tends to remain fairly consistent in size and scope during changing business conditions, whether the economic conditions are good or bad, due to an increased support role when sales volumes increase, as well as increased support needed when delinquencies increase.
- Large variations exist among companies, but a credit department is inevitably either **centralized** or **decentralized**.
- **Centralized** credit departments are entirely based in the company's main headquarters.
- **Decentralized** credit departments are not housed in the headquarters, but report to the headquarters from a remote office or offices.
- The role of the mid-level credit manager and the top-level credit executive play similar roles over decentralized and centralized organization structure. However, their authority and duties may differ depending on the credit policies enacted by the credit department.
- The benefits of a centralized credit department include:
  - **Economies of scale**
  - **Consistency and control**
- The benefits of a decentralized credit department include:
  - **Internal and external relationships**
  - **Involvement in setting strategic priorities**



Summary Continued…

- The functions of management can be divided into five main areas:
  - **Planning**
  - **Organizing**
  - **Staffing**
  - **Leadership**
  - **Control**
- **Credit policy** and procedure are the guiding principles that empower the credit department and credit managers toward successful management and execution of business credit.
- **Credit policy** and procedures include:
  - Development of a credit application
    - This can also serve as a legally binding document to enforce terms and conditions set by the business
  - Keeping credit records
  - Producing accurate invoices
  - Dealing with past due and delinquent accounts
  - Measuring effectiveness and performance
    - Valuable measures of effectiveness and performance include, but are not limited to the following:
      - Bad debt as a percentage of sales
      - Accounts over 90 days past due
      - Aging of accounts receivable in dollars and as percentage of total accounts receivable

Comprehension Check
Describe why continuing credit education is vital.

Summary Continued…

- Clear and comprehensive jobs descriptions are essential to attracting the right candidates, describing the position, outlining performance expectations, qualifications, evaluation and job training, along with providing a reference point for compensation decisions.

- Training is an investment that is essential to any business and is essential to keep an informed, knowledgeable and up-to-date staff. Its primary responsibility is to allow employees to progress and reach whatever level of responsibility they can achieve within an organization.

- Training can be broken down into four general types each with their own individual benefits to an organization and employee:

  - **On-the-job training**
  - **In-house training**
  - **Observational tours**
  - **Job rotation program or cross-training**

- It is vital for credit professionals to continue their education because the business environment is always evolving. Without continuing education, a credit professional may put an organization at a higher risk of insolvency due to poor accounts receivable management, which inevitably affects an organization's cash flow.

Summary Continued…

- **NACM** provides outstanding continuing education programs on both a national and affiliate level. This includes a variety of live classroom courses, and online education through the Credit Learning Center (**CLC**), which can be accessed 24/7, as well as supplementary training that includes open forums, conferences, seminars and webinars.

- NACM's National Education Department manages a professional certification program, established in 1974, that sets the standards and regulations for professional certifications. The certifications include:
  - National Certifications
    - Credit Business Associate (**CBA**)
    - Certified Credit and Risk Analyst (**CCRA**)
    - Credit Business Fellow (**CBF**)
    - Certified Credit Executive (**CCE**)
  - International Certifications
    - Certified International Credit Professional (**CICP**)
    - International Certified Credit Executive (**ICCE**)

- The (CICP) can be earned after completing the internationally-recognized Associates of Executives in the Finance, Credit and International Business (**FCIB**) online course. The (**CICP**) is a lifetime award. Once the (**CICP**) is earned, those who aspire to continue their education and continue in the global credit community can apply for the (**ICCE**).

- Two additional options for continuing education are the Graduate School of Credit and Financial Management (**GSCFM**), as well as NACM's Credit Congress & Expo.

4 The Credit and Sales Partnership

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- How credit can be a sales tool.
- Describe the Cs of the credit and sales partnership.
- Dealing with new or potential customers.
- Dealing with existing customers.
- How credit contributes to the sales department.

Chapter Outline

Questions for Discussion

THINK ABOUT THIS

Q. How can the actions of the credit and sales department enhance the credit-sales partnership?

The Basis for the Credit-Sales Partnership

Credit as a Sales Tool

- Virtually every business transaction that concerns another business involves credit.
- Business credit is the single largest source of business financing by volume, even exceeding bank loans. Without business credit, the world economy would not exist.
- The availability of credit is a powerful selling tool and is used to:
  - Generate sales.
  - Improve profit margins due to sound credit decisions, which increase sales volumes.
  - Grow a potential market share.
  - Provide good customer service.
  - Strengthen customer loyalty.
  - Meet customer demand.
  - Remain competitive.

Figure 4-1 Credit and Sales

Credit and Sales: Are the Priorities Really That Different?

Credit and Collections

Meet financial objectives

Provide timely decisions

Maximize profitable revenue, managed risk

Provide a fair, consistent and predictable credit policy

Customer service

Keep stakeholders informed

Provide unique expertise to approve and retain customers

Proactive

An agent for process improvement

It Is Not a Tug of War

Sales

Meet sales objectives

Deal with fast-paced competitive environment

Profitable sales

Want a fair, consistent and predictable credit policy

Customer relationships

Be knowledgeable about account status

Able to identify “real” opportunities

Avoid shipment interruptions

Timely, accurate processes

The Cs of the Credit and Sales Partnership

- Communication
- Collaboration
- Cooperation

Communication

Sharing Information

- Sales and credit may have different customer contacts, ranging from the CFO to the inventory manager, bringing different pieces of information that are all important when evaluating credit:
  - **Purchasing.** Learning about competitors and what they did wrong, the price point for the product, order frequency and preferred lot size.
  - **Inventory Manager.** Learning where to ship product.
  - **The CFO.** Learning information about the company's financial results, both past and projected, the seasonality of the business, along with cash flow cycles, and the end customers.
  - **Accounts payable**. Learning payment cycles and methods of payment.
- The sales staff can be a valuable source of information for the credit department.

Communication Continued…

- Using technology
- Share initial credit investigation findings
- Join the sales team

Collaboration

Educate the Sales Team

- When credit and sales share information about the customer, it is a win-win for the credit grantor. If open or extended terms are not suitable for a new account, the credit department may offer alternatives, such as guarantees, letters of credit, credit insurance or graduated terms

- When a salesperson works in tandem with the credit department, they gain valuable information that will help them to maximize their chance of closing the sale

- Monthly credit/accounts receivable reviews that include members of both the sales and credit teams can be arranged to discuss:
  - New accounts and potential sales volumes.
  - Slow paying accounts.
  - Material quality issues that have the potential to delay payments.
  - Lost business.
  - New target markets and accounts.
  - Customers with favorable credit, where sales could be increased without increasing risk.
  - Potential changes of payments terms, both extended or shortened.

Cooperation

Customer Visits

This relationship can be strengthened by presenting options other than declining the sale:

- Joint Check Agreement.
- UCC Filing.
- Mechanic's Lien/Bond Claim.
- Deposits.
- Credit Card/Electronic Check.
- Credit Insurance.
- 50% Down, 50% on Delivery.

RWP 4-1 continued...

meeting had just taken place. I asked her how my "shill" had done, and expected that because she had placed a special call an apology was in order. When I told her that, she laughed and said that was definitely not the case.

She said that our fellow did extremely well, and that she was calling to thank me for what was an entertaining and new experience for a 341 meeting. There were the usual questions for the debtor, and she said our guy had been right in there, slicing down the essence of the banks' secured financing, the alleged reasons for the decline in sales income and the usual dissection of the business crisis that caused the filing.

What had really made her laugh was what happened when the usual claim was made that "the sudden downturn in sales was due to conditions beyond the control of the debtor management." In this case, the product was sunglasses, and the principal was simply claiming that a stretch of bad, rainy weather in the region had caused his sales to tank. Our sales manager then stood up, gave a one-minute explanation that he had long ago started tracking the data points of sunglass sales versus umbrella sales as part of his career duties, and produced a chart for the time period in question showing the same as well as weather stats for the alleged poor weather period—entirely disproving what the debtor had said. Our guy then launched a series of questions from a sales standpoint and quickly exposed that the chain's decline in sales was due to a cutback in marketing efforts, a series of bad decisions on pushing product, and diverting available cash to non-value added projects instead. The trustee said everyone except the debtor and his attorney was smiling by the time our sales manager finished.

From that point, our sales manager went back to his duties, with heartfelt thanks from our finance area and from me. The subsequent unsecured creditors' committee meetings were held by telephone. Building on the details the sales manager had gathered in the 341 meeting and brought back, we exposed an imperfection in the debtor's security agreement with their bank. We hired an attorney to represent the committee, and eventually by chasing that point we managed to gain a carve-out concession from the bank that resulted in a partial distribution to the unsecured creditors. Without the original assistance and attentiveness of our sales manager at the 341 meeting, that concession might never have happened.

I had always believed that in a manufacturing environment sales and credit are part of a team that needs to work together, with the mutual goal of finding customers that can purchase as much product or service as possible that they can pay for, and then keeping and maintaining that relationship. But even with that mindset, our sales manager surprised me—and taught me that the diversity of our backgrounds and purposes, when combined, is a tremendous strength when trying to reach the mutual goal that brings success to our employer.

The sunglass business that I worked for moved their headquarters elsewhere, after radically changing the existing business. I stayed in the area working for other employers, but now when a customer or client files for Chapter 11 protection, I always stop and wonder where I can find that national sales manager, and smile...

Bob Steve

RWP 4-1 continued...

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Bob Steve

Promoting the New or Potential Customer

- Two kinds of potential customers
  - Well-known, established businesses
  - Newly established

Comprehension Check
What are the **Three Cs** in the credit-sales relationship?

Investigating Potential Customers

- Three pieces of information are helpful:
  - The company's legal name
  - The complete company address
  - The names of the corporate owners, officers and registered agents
- This preliminary investigation is the first line of defense against fraudulent activity
- The following suggestions may help the creditor obtain this information:
  - Stressing the confidential nature of the information being requested. Credit information gathered should not be shared with any other department.
  - Emphasizing that the information being requested is standard operating procedure and an acceptable industry practice.
  - Asking for only necessary information and at the proper time. Potential customers shouldn't be asked for confidential credit information before they are convinced about the product or a sale is imminent.

The Established Customer

The Role of Sales with Established Customers

- When facing overdue invoices, sales may take one of the following roles:
  - Having no collection responsibilities so they may focus on sales. In these companies, all collection efforts are handled by the credit and collection departments.
  - Making the first attempt at collection. If that attempt is unsuccessful, the credit department assumes responsibility for collecting.
  - Personally collecting past due balances. The rationale for this policy is that the sale is not complete until the bill is paid. Collecting cash is part of the sales cycle and, therefore, the salesperson’s responsibility

The Role of Sales with Established Customers

- There are times when a late payment isn't really a collection problem, but rather the sign of a problem that occurred somewhere in the sales and delivery cycle. The sales staff may learn of these situations first.

- Among the reasons customers might not pay on time are:
  - An allowance claim is pending.
  - Shipment hasn't been received.
  - Merchandise was received after the specified acceptable arrival date.
  - Merchandise was misrouted.
  - Customer received the wrong merchandise
  - Customer received only a partial shipment.
  - Order was accidentally duplicated.
  - Order was over-shipped.
  - Some or all of the merchandise was damaged in transit or defectively manufactured.
  - Merchandise was refused without being reviewed and then returned.
  - Shipment was billed to the wrong company or department or the invoice contained the wrong prices, quantities, credit terms, etc.
  - Missing documentation (missing purchase order).
  - Service provided was incomplete or was unsatisfactory.
  - Service provided was by an unauthorized purchaser.

Comprehension Check

How can the sales department assist in the collection of past due accounts?

Credit's Role with Established Credit Customers

Figure 4-3 Customer Assistance Credit Services

The credit professional has an opportunity to provide information and resources to customers based on their experience and expertise. Care should be taken when giving advice to troubled customers. Refer them to their company accountant or legal counsel. The following is a list of a few of these services:

Financial Analysis
The credit department may have financial information and industry comparison data that they can share with the customer to assist them in understanding their financial position relative to their own industry and marketplace.

Cash Flow Control
The credit department can analyze a customer's credit terms and help it identify ways to increase cash flow by using net due dates, discounts, saving interest or finance charges.

Credit References
The credit department can show a company how to develop a good credit reputation with suppliers and how to leverage that reputation in future business relationships.

Loan Referrals
The credit department may know of other companies or lending institutions that would be willing to extend credit or lend money to the buyer. As a courtesy these referrals can be made.

The Credit Department’s Contribution to Sales

There are many opportunities for the credit professional to enhance the credit and sales relationship, such as:

- **Having a neutral, open-minded investigation of all prospective and current customers.**
- **Monitoring established customers for changes in financial stability.**
- **Recommending when potential credit problems may be prevented or avoided with cautious credit terms and conditions.**
- **Working with sales to develop a collection approach that collects cash, reduces risk and enhances customer relations.**
- **Taking immediate action on overdue invoices by:**
    - Promptly identifying these invoices.
    - Collecting all past due accounts quickly.
    - Using tact and diplomacy in dealing with overdue accounts.
- **Assisting customers by providing educational services.**

•Keeping information on accounts up to date by:

•Providing consistent and clear communication to all concerned.

•Keeping salespeople posted on the credit status of prospects and customers.

•Informing customers about their accounts and changes in their credit terms.

•Maintaining good communication with company management.

•Having a pro-sales attitude by:

•Keeping open communications among sales staff and management. Providing information and decisions as quickly as possible.

•Being focused on increasing overall company sales, profits and cash flow while managing credit risk.

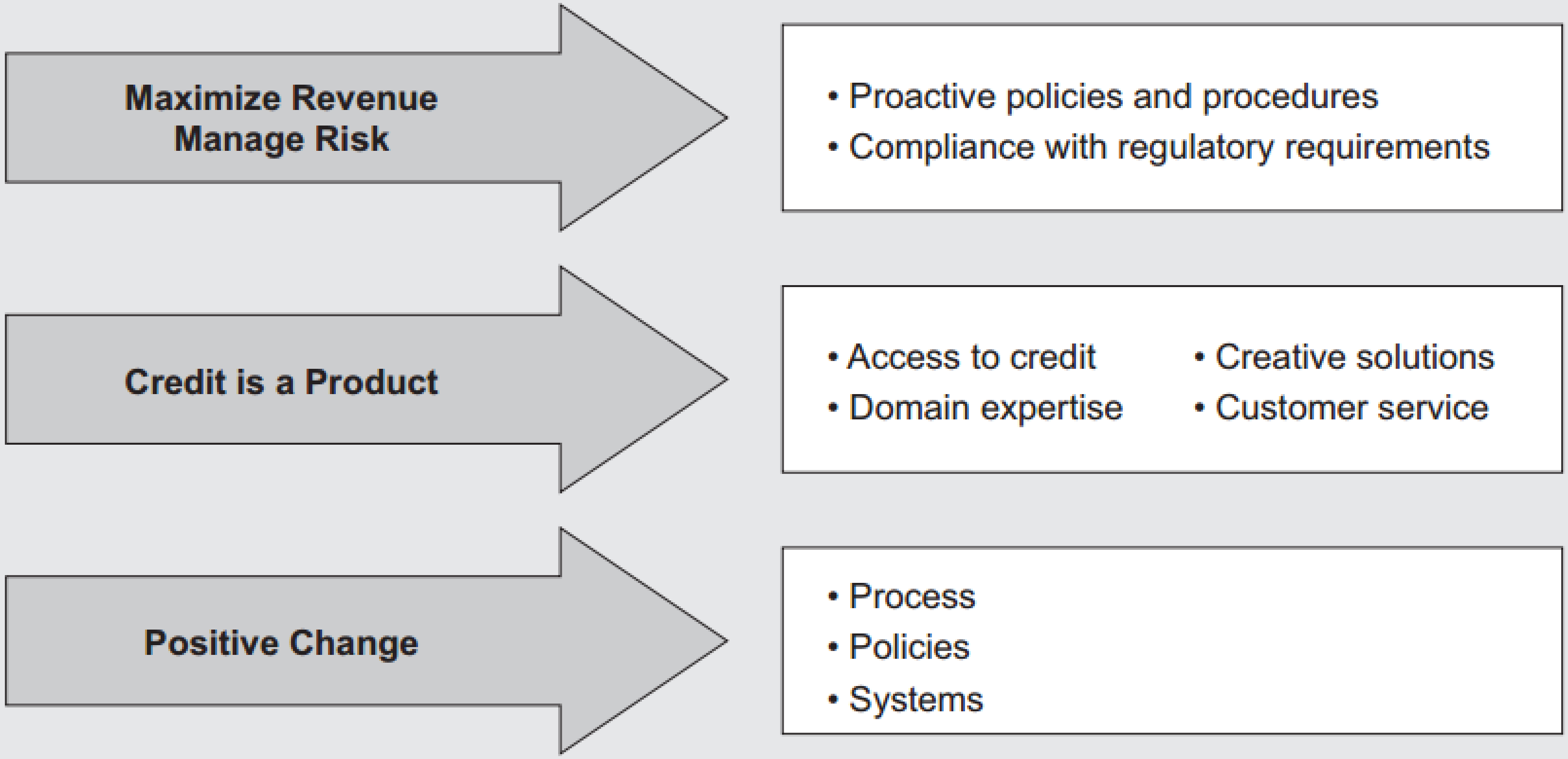
•Being objective and fair.

•Understanding the balance between increased sales and acceptable loss levels.

•Identifying flexible credit approaches that promote sales volume increases.

•Maintaining a credit program that is consistent with the industry, region and the customer’s economic conditions.

Figure 4-4 The Value That Credit Adds



Comprehension Check

Discuss what the sales department can reasonably expect from the credit department.

Discuss what the credit department can reasonably expect from the sales department.

Summary

- The credit and sales relationship should be a symbiotic one in order to foster a successful organization.
- Business credit is the single largest source of business financing by volume, even exceeding bank loans. When used correctly, the use of credit becomes a sales tool. Some of its features include:
  - Generating sales
  - Improving profit margins
  - Meeting customer demand
- The credit manager must maximize the benefit of investing while minimizing risk.
- The **Three Cs** of the credit and sales partnership include:
  - **Communication**
  - **Cooperation**
  - **Collaboration**
- By using the Three Cs as a standard of the credit and sales relationship, the overall information available to both the credit and sales department is increased, and ultimately should result in increased sales with decreased risk. The sales department will waste less time on higher risk clients, and the credit department will spend less time with collections.
- Conflict between the credit and sales department may arise when one perceives to be impeding the success of the other. However, the relationship between the departments can be strengthened by presenting alternative options instead of declining the sale. This may take a variety of forms such as using credit insurance or a mechanic's lien.

Summary Continued…

- With new or potential customers, the more information the sales department can obtain, the better the credit department can accommodate the terms for a sale, and the better the credit department can protect itself from fraudulent activity. The company's legal name, the complete company address and the name of the corporate owners, officers, and registered agents are good first steps in the process.

- It may be hard for the sales department to gain some of the information needed, stressing its confidential nature, acknowledging that the request is standard operating procedure and asking at the proper time may make it easier to obtain the necessary information.

- Companies should have a policy regarding the role of the sales department or individual salespersons if payment problems arise. In many cases, the salesperson may be the first person to learn of any payment problems and should communicate with the credit department in such a case.

- Late payments may not be a collection problem and may arise because of circumstances such as: shipment hasn't been received, merchandise was misrouted, or an order was accidentally duplicated.

Summary Continued…

- A credit department may also provide several **services to their customers** including:
  - **Financial analysis**
  - **Cash flow control**
  - **Credit references**
  - **Loan referrals**
- The credit department can make a large contribution to sales by monitoring established customer's financial stability, by recommending credit terms and conditions to reduce a potential credit problem, assisting the collection process, as well as many others.
- The relationship between the sales and credit department can be facilitated and supported if both departments focus on the core values and mission of the entire company. The common goal being, strengthen cash flow and provide customer service.

Principles of Business Credit

Eighth Edition

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