13 Making Credit Decisions

Overview

The basic objective in making credit decisions is to find ways to approve an order with reasonable expectation that the customer will pay in accordance with established credit terms. A decision to grant or not to grant credit affects sales revenue, profit, production and procurement. If the customer is a good credit risk, the order may be approved as submitted. Otherwise, alternatives should be developed that are acceptable to the credit department and the sales department—and still meet the customer's needs.

It is desirable to establish routine procedures for making most credit decisions. Credit approval, through the use of order limits or overall credit limits, can streamline the workload in the credit department. The goal is to approve credit with minimum delay, provide customers with prompt service and control administrative costs. If routine orders can be processed quickly and efficiently, the credit professional has additional time to devote to more demanding credit matters. This chapter discusses approaches and decision factors associated with making credit decisions with speed, accuracy and efficiency.

THINK ABOUT THIS

Q. What influences when or how often a customer's credit file should be reviewed?

Q. When can it be beneficial to take on marginal business?

Q. What should be taken into consideration when approving credit for new customers?

Q. What factors influence the introduction, use and review of credit limits with customers?

Q. What constitutes marginal business, and how can marginal business be an essential component of a credit portfolio?

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Approval of credit for new customers.
- Establishing credit limits for customers.
- Available security devices.
- How credit scoring is used to help manage credit.
- Credit approval for marginal credit accounts.
- Making credit decisions using limited customer information.
- Conducting reviews of credit limits.

Chapter Outline

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Accounts for New Customers

Introduction

All orders should be processed as quickly as possible, particularly first orders from new customers. Prompt handling of initial orders often means continuing sales. Many credit grantors take a conservative approach with initial orders, unless the customer's reputation and history are such that credit risk is not an issue. Under certain circumstances, the Equal Credit Opportunity Act (ECOA) requires notification of an adverse action in connection with an application for credit. Depending on the applicant's gross revenue, the creditor must notify the applicant either orally or in writing within 30 days or within a reasonable amount of time. The same procedures for approving initial orders from new customers can also be used for established business customers that have not purchased for some time. When processing first orders, or sporadic orders from existing customers, there are several issues to consider:

- How much credit is required?
- What is the profit margin on the product being sold?
- Does the customer have the resources to pay? Is the use of trade credit for convenience as designed, or is the trade creditor being used as a substitute for a bank loan?
- When will the customer pay? Does the customer's history suggest that, regardless of creditworthiness, there might be a potential risk of slow-pay, dispute or litigation?
- If the customer does not currently have resources to pay timely, is it likely that the customer will have them by the time payment is due?
- How much credit do other vendors offer this customer, and is the request in line with like suppliers?

Approval of Small Initial Orders

If initial orders are small, the time and expense of a credit investigation may be unjustified. Automatic credit approval may be established for all orders that fall below a specified amount. This system might be considered *criteria-based,* meaning that one or more decisive factors are used to automate credit approval. In this case, the criteria would be the maximum amount of credit all new customers receive without investigation. Criteria-based automated credit approval should be guided by the credit grantor's credit policy and should be reviewed from time to time according to market conditions, the effect of competition, credit terms, loss experience and other elements. While individual losses will occur, the impact of extra collection expenses on overall results can be reduced by accelerating the collection procedure, writing off non-performing or under-performing accounts, or placing them with third-parties for collection. Follow-through is an important requirement of an automated approval system. Small first orders may be trial shipments that could lead to long-term, profitable relationships. The automated approval system might suggest criteria for sales personnel to include an estimate of the customer's potential credit requirements, thereby initiating a credit investigation to determine credit ability of the customer in preparation for larger orders from the customer in the future.

Comprehension Check

Some companies establish a way to automatically approve small orders. Supply a justification of this policy.

Approval Based on Credit Reporting Agency Ratings and Scores

Another method of handling initial and future orders without extensive investigation is to use credit report scores as the basis for the amount to be approved. This method of approving orders provides the following advantages:

- Documentation of actions taken.
- Little or no need for exhaustive investigation for each account when it falls within set criteria.
- Efficient use of time for other, more exacting duties.

- Exceptions to the policy or marginal cases are more easily identified and can be examined carefully by the credit department.

Many companies have developed a credit scoring system and initial order limit based on key factors such as third-party credit scores, clear bankruptcy history and clear public records.

Non-Routine First Orders

If a first order fails to meet the requirements for streamlined approval, the decision to investigate may rest on the answers to the following questions:

- Is the order large enough to warrant the cost of investigation?
- Is the potential for future sales large enough to merit a full credit analysis?
- Is the treatment of non-routine orders covered by company policy?

Terms Other than Open Account

If the circumstances do not warrant open account credit, the sale may be made on some other basis, such as cash in advance, cash on delivery, sight draft, certified check, cashier's or bank check, or standby letter of credit. Of these methods of payment, only a cashier's or bank check and standby letter of credit can guarantee payment, because in these instances the bank's credit is substituted for the customer's.

A payment on a certified check can technically be stopped for just cause by the customer, and many banks are encouraging their depositors to use bank checks instead of certified checks.

Cash on delivery can be troublesome if the cash is not available when delivery is attempted. If materials are produced especially for the buyer and are not salable through other outlets, the buyer's refusal to accept delivery could create additional costs or even cause total loss to the seller. In such cases, if the credit risk is not acceptable, the seller may want to ask for full cash payment in advance. Even on goods that are not perishable, terms other than open account, except for cashier's or bank checks and letters of credit, may expose the seller to the risk of paying for such expenses as round-trip transportation, repacking and losses in transit if the buyer refuses to accept delivery. This risk should be considered in evaluating the prospect.

Credit Availability and Limits for New/Existing/Repeat Customers

Purpose

As soon as possible after first-order approval, controls should be established to ensure prompt and appropriate disposition of further orders. The basic means of control is the credit limit or maximum amount of risk to be taken on any customer.

While credit limits should not limit sales potential, a company must ask itself two key questions: How much exposure is it willing to take with its customer base? Will it be liberal or conservative in its credit granting philosophy?

Difference between Credit Line and Credit Limit

The description "credit line" is sometimes used when "credit limit" is meant. The two terms are not the same because a **credit line** *implies that credit has been committed or will be granted up to a specific amount usually for a given period of time, as in the case of a bank line of credit.* A **credit limit** *indicates that a credit grantor retains discretion over the granting of credit.* In other words, a credit limit is the maximum amount that a seller is willing to risk in an account.

Comprehension Check
What is the difference between **credit line** and **credit limit?**

A maximum dollar amount is placed on orders that can be made or accumulated on open account credit, without promise or commitment to reserve a certain amount of purchase money in that amount at any time.

Underlying Factors

A **customer's credit limit** *is usually based on the requirements for the supplier's products and the ability of the customer to pay its debts. Other factors include the seller's credit policy, demand for the product, the size and financial condition of the buyer and seller, and the extent of competition.* In all cases, the ability of the customer to pay its debts must be evaluated by an analysis of:

- Financial information.
- Agency ratings, reports and credit scores.
- Bank checks.
- Trade clearances and other data as warranted.

A new customer's requirements can often be estimated by the sales staff at the time the initial order is placed, or the credit professional may be able to determine the customer's credit requirements through direct contact with the customer. A customer that furnishes all information requested by the credit department is usually considered less of a risk than one who is not accommodating.

Influences on Credit Decisions for the Credit Grantor

Profit Margin

For the credit grantor, net profit margins on the products or services sold are a significant factor in the decisions about how much and when to grant credit to its customer base. Company credit policies are generally closely correlated with profit margins, as described below. (*See* Figure 13-1 for additional details about profit margins.)

1. If the profit margin on a particular product is high, the seller can afford to accept a greater credit risk and make more credit available.
2. If the company's credit policy is conservative and profit margins are slim, credit limits may be more restrictive.
3. If demand for a company's product is greater than its production capacity or if there is an industry-wide supply shortage, sales may be made primarily to the most select class of customers, with credit limits to marginal customers curtailed.

Consideration must always be given to the long-term supply outlook for products the credit grantor sells. Greater credit risks may be taken when a credit grantor operates under one or more of the following:

- High overhead which demands increased production for profitability.
- A highly competitive market which affects profit margin by meeting the competition.
- Introduction of a new product line or expansion into a new territory/market means higher expenses.
- Product sales that require major capital investment such as equipment and/or fixed assets.

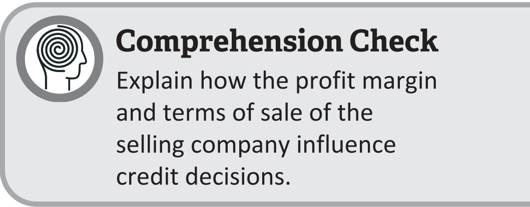
Figure 13-1 **Lost Profits**

The table below demonstrates what happens when a company with a net margin of profit of 2% does not collect $5,000 in accounts receivable. The sales force must make up that loss by selling $250,000 in products or services in order for the company to "break even" on the loss of $5,000. This means more time and expense are associated with staying even than can be exercised in getting ahead. This does not take into account the necessary efforts to collect each new sale within credit terms. In common vernacular, this scenario could be called "spinning your wheels."

If you have an actual loss of:	and your net profit is:				
	2%	3%	4%	5%	6%
	you will require this amount in additional sales to offset the loss:				
$300	$15,000	$10,000	$7,500	$6,000	$5,000
500	25,000	16,666	12,500	10,000	8,333
1,000	50,000	33,333	25,000	20,000	16,667
3,000	150,000	100,000	75,000	60,000	50,000
5,000	250,000	166,666	125,000	100,000	83,333

Terms of Sale Influence Credit Limits

Financial exposure is greater when credit terms are longer. A credit limit of $10,000 might be adequate for a company purchasing $5,000 per week on terms of net 10 days. But if the terms were net 60 days, a much larger limit would be required. The credit limit is also influenced by the collection effort that may be required. The seller must determine if sufficient personnel, time and information are available to follow a large number of high-risk accounts. If such factors are inadequate, lower limits most likely should be set. In the final analysis, profits on the good sales should exceed losses on the bad sales. A high bad-debt record is not necessarily the mark of poor credit judgment because it may be an indication that excellent credit judgment is being used to maximize net profit. On the other hand, low bad-debt losses with a high record of order refusals could be an indication that the credit policy is actually inhibiting sales efforts and restricting net profit. A certain amount of bad-debt loss has to be anticipated and should be acceptable to management.



Establishing Credit Limits

Credit-granting companies establish their credit limits based on factors that represent their own set of unique circumstances, policies, conditions, etc. No two companies are the same and no two sets of policy are the same. Some factors to be considered are:

Competition. In this method, the amount of the credit limit is determined by matching the amount (or average amount) granted by like or similar competitors. Outside reports and other credit information sources are used to identify competitive limits. If the creditor is not the same size as comparable competitors or plays a distinctly different supply role (much larger or smaller), it will be difficult to establish reasonable credit limits using this method.

By Formula. In this method, several calculations are made and averaged to determine the credit limit to be assigned to the customer. Key financial data, such as net worth, inventory, current assets and/or net working capital are used, assuming the customer accommodates the credit grantor's request for information. These data items are divided by the number of creditors to determine the amount per creditor. Amounts are then averaged to set the credit limit. It may be difficult to obtain an accurate estimate of the number of creditors. This method is often used to calculate a preliminary estimate and is then further developed by one or more of the other methods.

Payment Record. The credit limit can fluctuate depending on the customer's ability to pay on terms. This has the advantage of making credit decisions more routine, unless the customer does not pay on time, when a more detailed credit review process would be triggered. This type of limit encourages additional sales and is popular with sales staff.

Payment Performance. This popular method adopts a conservative risk management approach and rewards new customers as they continue to do business with the company. This is often used when little payment history is available. While limiting the company's exposure, it does limit the speed at which sales can grow.

Period of Time. Purchases made over a specific period of time, such as a week or month, cannot exceed the credit limit. This is useful in cases where many shipments may be made to a customer from various company locations. Orders can be approved in a more routine manner using this method, as long as the overall credit provided does not exceed the credit limit.

Expectation of Use. Sometimes referred to as requirements, this method sets a credit limit based on the expected dollar volume of credit sales over a period of time (i.e., a year). This figure is then divided by the number of orders expected throughout the year to estimate the credit limit. This method, like the formula method, is often used to obtain a preliminary estimate that can be defined further by one or more of the other methods.

Agency Scoring and Ratings. This method may be used for new or existing customers to assess risk and determine credit limits. Figure 13-2 details NTCR and D&B rating guidelines.

Comprehension Check

Discuss three common methods used to establish a credit limit.

Figure 13-2 Agency Scoring and Ratings

NTCR Predictive Score

Predictive Score is based on the unique tradelines gathered by NACM Affiliates. The scoring model predicts late payments and severe delinquency looking forward six months. The predictive variables include current aging status, historical aging (including trends and variance in payment trends) and other business characteristics. From the data on hundreds of thousands of businesses, common characteristics are examined on the business subject and, depending on how closely or remotely that subject matches the characteristics, the score is assigned a range, from high risk to low risk. In cases where not enough data exists, no score is assigned. If the business subject is already delinquent to the degree that the score is trying to predict, no score is assigned in the low to high range because there is no need to predict something that has already occurred. Each report contains a complete credit score explanation. The Predictive Score ranges from 450 (high risk) to 850 (low risk). The Risk Class includes 1 (low risk), 2, 3, 4A, 4B and 5 (very high risk). The score leverages 12 months of historical trade data to predict future behavior.

D&B Viability Rating

Viability Score assesses the probability that a company will no longer be in business within the next 12 months compared to all U.S. businesses within the D&B database. The Viability Score is best used when ranking all businesses within a portfolio especially for identifying the most valuable prospects for sales and marketing. The score ranges from 9 (high risk) to 1 (low risk).

Portfolio Comparison compares a company to businesses assigned a similar D&B "model segment" classification which is determined by the amount and type of data available. The four model segment types include: Available Financial Data, Established Trade Payments, Limited Trade Payments and Firmographics (a set of characteristics of organizations which are most likely to spend money on your product or service) & Business Activity. This score analyzes the risk level of a business for credit risk management purposes. The score ranges from 9 (high risk) to 1 (low risk).

Data Depth Indicator represents the level of predictive data available for a company. This indicator is based on a scale from A to G where A indicates the greatest level of predictive data, such as financial statements, and G reflects a minimal level of data, such as firmographics only.

Company Profile describes a company based on a combination of five categories: Financial Data Available, Number of Trade Payments, Company Size, Years in Business and Firmographic Data. The five categories are rated based on: not available, available (3+ trades), medium and established.

Credit Scoring*

Scoring to assign credit limits is a popular tool of credit analysis. Companies identify the factors they consider most meaningful and create a scoring matrix to increase efficiency in making routine decisions and to determine the creditworthiness of a customer. A **credit score model** can be built to include internal information or a combination of internal and external information such as business and personal credit information on the principals. Such models *convert available data about a customer to a statistical number (scale) based on influencing elements including NAICS code, payment history, principal information, financial data, outside credit information, etc*. Credit scores make credit decisions data driven and less reliant upon subjectivity.

The variables are input into a computer model, which assigns them point values creating a scoring matrix. According to Charles L. Gahala in his book *Credit Management, Principles and Practices*, credit scoring can be based upon any of three different approaches to developing the scoring model:

1. **Behavioral Models.** These models require a significant pool of customers' records that are carefully analyzed to identify factors that can be used as predictive variables. With the use of statistical predictability, these models allow identifying the relevant tradeoffs or correlations among factors and assigns statistically derived weights, which constitute the base of the scoring model.
2. **Rules-Based Models.** These models are based on traditional standards of credit analysis and they require a set of simplistic rules. Factors such as the business's payment history, bank and trade references, credit agency ratings (such as D&B rating), number of years in business, and financial ratios are scored and weighted to produce an overall credit score.

   The decision of which factors to use, and how each of these factors will be scored and weighted, is generally based on the credit executive's past experience with their company, the products or services offered, and the industry that the company is in. For this reason, these models are also known as **Judgmental Models**, and are enhanced by benchmarking industry financial profiles with peer groups, and by the use of factors that reflect the company's policies and individual´s characteristics .
3. **Neural Models.** Artificial Neural Networks (ANNs) or Neural Network Models are "distributed information-processing systems composed of many simple interconnected nodes inspired biologically by the neurons of the human brain." These models employ "the parallel processing of math-based historical experiences and logic-based patterns." ANNs have emerged effectively in credit scoring because of their ability to model non-linear relationship between a set of inputs and a set of outputs.

The Use of an Internal Credit Scoring Model

Banks and credit card companies were the first to use credit scoring models due to the high volume of low amount transactions involved in consumer credit. Credit scoring became a necessity for these financial institutions to approve and service their clients in a cost-effective and timely manner. Today, most retail credit decisions are taken automatically on the basis of statistically derived models that score consumer behavior.

For commercial credit underwriting, the use of scoring models as a tool can also be beneficial. However, it can have a negative impact if it is overestimated over human judgment. Businesses often use scoring models as a platform for building an overall view of the customer, which will become a basis for forming a credit decision, like establishing a payment term and amount of credit, frequency of credit monitoring, delegation of authority, and approving credit limits.

The Pros of Credit Scoring Models

1. **Increase speed and reduce response time.** The use of models allows credit professionals to evaluate borrowers faster, and consequently reduce their response time to customers. In addition, models can be easily modified to either ease or restrict credit granting depending on the company's strategies.

2. **Quantify risk and improve management control.** Credit scoring allows the credit professionals to quantify risk, and to fine tune credit risk guidelines over time. It also allows credit professionals to put a limit on the amount of risk the company is willing to take based on the company's risk appetite corresponding to each risk category.
3. **Consistency, accuracy and objectivity.** The use of a scoring model generates consistency in data gathering and decision-making, minimizing the subjective component that results from humans weighing factors according to personal experiences, and in many cases, the personal relationship developed with customers. When efficiently used, a well- structured credit rating system helps the credit monitoring functions to have consistent check on credit assessment. A company that has multiple credit functions can achieve consistency in its methodology by adopting a credit scoring.
4. **Reduce personnel and credit investigation costs.** The use of credit scoring can reduce the need for research, verification, analysis, and the elaboration of reports, resulting in fewer personnel costs.
5. **Decision support and planning tools.** Credit scoring also enables the credit professional to assess the quality of the accounts receivable portfolio, and take preventive actions and/or adjust policies accordingly. It can also be used to forecast bad debt reserves based on the past bad debt experience for customers falling within each risk category.
6. **Prioritization of collection activities and reduced bad debt loses.** Credit risk scores facilitate the development of collection strategies for low-, medium- and high-risk customers because the credit scores can quickly identify high-risk customers.
7. **Comply with audit mandates.** Scoring provides a sound basis for consistent processes which makes compliance with regulations such as the Sarbanes-Oxley Act, and the Antitrust laws easier.
8. **Knowledge transfer mechanism.** A credit scoring model can be developed to replicate a proven decision-making process which can be shared and utilized by new staff.
9. **Ease of implementation.** A credit scoring model that is rules-based can be developed in-house using the company's credit policies and decision processes without requiring the services of a costly third party to create and maintain the model.

The Cons of Credit Scoring Models

1. **Qualitative factors and situation-specific judgment.** Credit scoring models limit the use of subjective factors, such as the customer's management team, its strategy and/or competitive position, exposure to litigation, etc. There is a chance that making a sale to a favorable customer based on qualitative factors may be missed, if decision is solely based on the credit score.
2. **Dependency and lack of judgment.** In some cases, scoring models can cause credit professionals to only rely on the credit score and make poor credit decisions.
3. **Insufficient and/or heterogeneous pool of customers.** In order for statistical models to work effectively, the pool of customers must have similar characteristics to consistently predict behaviors.
4. **Obsolescence of historical information.** Due to the rapid changes that have taken place in the last 10 to 15 years, past events may be less relevant to predict the future and obsolete data may provoke statistical errors.
5. **Statistical Difficulties.** One of the challenges encountered by credit professionals is the selection of predictable variables and weighting of predictable variables that will be utilized in the model. There is also a challenge if data is not sufficient to establish behaviors.

Comprehension Check
Explain credit scoring techniques and the pros and cons for their use.

Other Factors to Consider in the Credit Decision Process

In commercial lending, the decision to grant credit based on a credit scoring system alone may not consider other factors that may significantly impact the credit risk determination of accounts. Judgment should be exercised by considering the following additional factors:

- Country risk.
- Appetite for risk.
- Willingness to pay.
- Age of credit and financial data used for credit scoring.
- Potential of customer.
- Competitor's action.
- Notes to financial statements.
- News reports, periodical articles, etc.
- Weather patterns.
- Credit insurance.

**Excerpted from the NACM Graduate School of Credit and Financial Management project, 2015.*

Implementing Credit Limit Decisions

Credit limits serve a variety of purposes: as a guideline for order approval, to minimize upward spiral of orders and to call immediate attention to any change in a customer's purchasing or payment behavior. Any order that does not exceed the limit can be approved without further investigation or analysis. Orders exceeding the limit signal the need for examination of the account and may lead to holding shipments to the customer until the over-limit situation has been resolved.

Some companies would rather not establish a firm credit limit, opting instead for a flexible limit based on previous experience with the account. Flexible limits have the advantage of being easy to implement with little impact to the customer and the sales department. Unless payments are not made on time there may be little need for further involvement at the credit department level.

Those who favor a more formal system of establishing credit limits point out that the account may become overvalued quickly. Prompt payments initially are not necessarily indicative of future payment trends.

A formal analysis might set a credit limit high enough to eliminate the need for a review every time a new order is received. However, after a period of time, the credit limit may simply become a matter of course, meaning that any order the customer places is approved. This basis for credit decisions should be reserved for only very substantial and financially sound customers.

An **order limit** *specifies the dollar amount that may be released without delay on any single order.* It differs from a credit limit, which is established without regard to the size of any particular order and is generally set at an amount that can be justified by the available credit information. Some companies place an order limit on every account. This usually serves as a secondary credit check, so the customer's file is reviewed when either the credit limit or order limit is exceeded. An order limit may be particularly useful in a decentralized credit organization where it is impractical for order processing points to keep complete records of receivables.

One variation of the credit limit is based upon the amount that the creditor is willing to have outstanding at any time. This method requires complete records of unpaid invoices and of orders approved but not yet shipped. When the total outstanding balance exceeds the limit, any further orders are referred for approval.

Credit Limit Management

Companies will often create their own in-house forms with formulas which reflect their company's tolerance for risk. Some of the forms are created in Excel and are manually populated and routed for approvals. Other companies have invested in ERP solutions which provide electronic workflow documents to increase or decrease a customer's credit limit, as well as route the documents through several layers of management, depending on the requested

credit limit amount and risk class of the customer. Generally, different levels of management approvals are required before credit limits are assigned to customer accounts. For example, if a credit limit is over a certain level, the credit analyst is the final approver. If the credit limit is above the first level, but below a higher level, the credit manager is the final approver, and if the limit is over the highest threshold, the treasurer, CFO or executive credit committee is the final approver. Credit limit form formulas will provide the credit analyst with a recommended credit limit sufficient for the opening order and ongoing purchases, according to the payment terms, time frame and volume of purchases, and in line with the customer's risk class, payment history, trade volume, etc.

Communicating Credit Limit Decisions

Many companies advise their sales department of the credit limits assigned to customers, often expressing the limits in terms of units (300 tons, 20 carloads) or dollars allowed during a given period of time. If, for example, a customer has a credit limit of $5,000 on terms of 1/10, net/30 and consistently discounts, this customer could be

Real World Perspectives

RWP 13-1

FIVE BIGGEST MISTAKES B2B CREDIT MANAGERS MAKE

Credit managers must balance the conflicting needs of revenue and business credit. But there are core best practices which are universal to all our efforts to bring the money in. Below are five mistakes credit and collection professionals make and how to fix them.

1. **Not giving reasons for your credit decisions.** Credit professionals should verbalize their well-thought-out, sound reasons to the stakeholders when presenting the bad news. Too many credit professionals impose, rather than sell their credit and collection decisions. When someone simply says "no," even if they have the authority, their credibility and reasoning can be questioned. If decisions are always supported with facts, data and experience, then stakeholders will come to understand that the decisions are based on sound judgment.

2. **Not meeting folks halfway.** Rarely are credit decisions black and white. There are situations where credit professionals need to stick to their assessment and give solid reasons for the decision. However, most day-to-day credit decisions exist in a grey area where company exposure can be controlled by limiting credit lines, modifying terms of payment, or allowing other functional groups to take a portion of the financial risk. Collaboration with other stakeholders can make all the difference between a new business partnership and no revenue.

3. **Operating in a silo.** No department or function can operate in a vacuum. A company is made up of individuals who work in groups, and they must rely on each other as if it is a living ecosystem. Hold weekly meetings with staff; have weekly meetings with direct stakeholders. Get out of the office/cube and visit with internal customers, who know who and what problems may emerge.

4. **Focusing solely on bottom-line savings, while ignoring top-line growth.** Credit and collection managers have a reputation for wanting to collect all of the receivables on every sale, at the expense of not making every sale. Credit professionals must find a balance between the two: develop a certain appetite for risk that is based on historical bad debt expense, as well as current data and information regarding the true financial health of the customer in both the short and medium range; long-term financial health is something that can be managed throughout the life of the customer relationship. It is dynamic and always changing. To keep it all in check, put strong processes and procedures in place to monitor exposure and periodically evaluate current and future risk.

5. **Not identifying the root cause of collection issues.** What's stopping the money from coming in the door? There's always a reason invoices aren't getting paid. Typically, the least common of these reasons is a customer's cash flow; the most common reason for non-payment (or late payment) is that the invoice is incorrect or not in a "format" that the customer can use. The ultimate goal of any order-to-cash process is to make the customer happy and to allow them to be a self-payer. In other words, don't provide customers any excuse not to pay the bill; this needs to be a constant driver for every organization and is one that requires a great deal of collaboration and diplomacy between the various order-to-cash stakeholders.

George Waters, Global B2B Credit Professional, Published on LinkedIn July 2016

sold from $10,000 to $15,000 per month. Because of discount payments, the highest credit would still be expected to remain within the credit limit of $5,000.

Informing Customers of Credit Limits

There is considerable debate about whether to inform customers of their credit limits. There is no law or regulation that requires such compliance. Of course, a credit grantor cannot discriminate when approving credit, and certain rules apply whenever an adverse action is taken either upon approval or after the account has been established. Review the ECOA rules when facing these circumstances.

In some companies, the credit limit is the maximum amount that will be shipped to the customer before initiating a review of the credit file for that customer. In other companies, it is simply the maximum amount that will be shipped to the customer before that amount is paid down or paid in full. The particular definition depends on the creditor's policy regarding credit extension. There are distinct advantages and disadvantages of advising customers of credit limits. The decision to advise or not to advise is dependent on each creditor's company policy and management philosophy. Here are some advantages and disadvantages to consider:

Advantages

- Opportunity to discuss and possibly adjust the limit in order to sell more.
- Opens discussion about payment expectations and to obtain more information.
- Reduces embarrassment of holding orders when/if customer is over limit.
- Creates a chance to help a marginal customer become more solvent.

Disadvantages

- Possibly damages goodwill.
- May restrict purchases to the credit limit imposed.
- Customer may be offended/insulted by what it perceives to be an insufficient credit limit.
- Raises questions as to how or why the credit limit was determined.

Security Instruments and Actions against Default

- **Guarantee.** An instrument containing a promise by a person, persons or company to pay or perform an obligation owed in the event the debtor does not pay or perform. It can take the form of a personal or corporate guarantee.
- **Cross-Corporate Guarantee (CCG).** This ties a parent company to a subsidiary. *Action: If the subsidiary does not pay, the parent company will pay.*
- **Irrevocable Letter of Credit.** This substitutes a bank's credit for that of the customer. It allows the supplier to initiate a draft against the letter of credit upon delivery of goods.
- **Subordination Agreement.** This agreement can improve a supplier's priority position by establishing a higher priority claim to the customer's assets, especially if a significant portion of a customer's debt is owed to officers or stockholders.
- **Security Agreements.** *Action: Request security documents, such as bond forms for construction, before creating a new account.*
- **Financing Statements.** Article 9 of the Uniform Commercial Code, titled Secured Transactions, deals with the creation of security interests in personal property. The most common forms are inventory, accounts receivable and equipment. *Action: These can be used to secure **inventory**. They can be filed in conjunction with a Purchase Money Security Agreement or Interest (PMSA or PMSI). A PMSI is a security interest or claim on property that enables a supplier to have a priority ranking on their products ahead of other secured creditors. It allows the suppliers to repossess the products sold to the customer should that customer default on their payments.*

- **Mechanic's Lien.** A statutory lien on a building (and usually the land it occupies) in favor of suppliers of material and contractors to secure their interest on a particular construction project. *Action: Follow the statutory requirements of each state for filing liens.*
- **Notice to Owner (NTO).** *Action: Follow state guidelines for NTO schedules as they vary by state.*
- **Payment and Performance Bonds.** *Action: Before relying on a payment bond, the supplier should send a letter to the bonding company to confirm the existence of the bond and learn its coverage with respect to the material. Since the type of project and the notification rules vary substantially, questions should be referred to the legal department through the chief credit professional.*
- **Bond Claims.** They are usually provided by the General Contractor (GC), especially if it is a public job. Occasionally, the sub-contractors under the GC will have to provide their own bonds, but other times the sub-contractors work under the umbrella of the GC. *Action: Follow the state guidelines for bond deadlines because these vary by state.*
- **Joint Check Agreements (JCA).** A joint check agreement is a device whereby the ultimate user or beneficiary of material supplied by an original seller agrees with the original seller and its supplier to make all payments to the supplier by checks payable to both the seller and the supplier. *Action: When the General Contractor (GC) pays the sub-contractor for materials, the GC writes the check to the sub and seller's company. The sub endorses the check and forwards the check to seller for deposit. This check does not include labor and is for materials only. Sometimes the GC wants to use their own form, but the seller's can use their own form as well.*
- **Real Estate Mortgages (Deeds of Trust).** Sometimes a customer will offer a first or second real estate mortgage (deed of trust) as security for open account arrangements. *Action: This can be an effective method of securing an account but a number of factors must be considered, such as determining the value of the property, the marketability of the property, liens and encumbrances on the property, the payoff on the first mortgage, and whether the first mortgage permits a second mortgage.*
- **Job Contracts.** They are terms of sales for specific job*. Action: Sales usually handles these, but they can be handled by the credit manager.*
- **Accounts Receivable (A/R) Insurance.** This is a form of credit insurance offered by commercial insurers to businesses. A/R insurance can take the form of multi-buyer insurance (a pool of receivables) or key buyer insurance. *Action: The cost-benefit must be weighed. A/R insurance can be particularly useful for new or rapidly growing businesses that cannot afford to do credit checks. For a relatively low fee, A/R insurance protects a company against loss on receivables, including default, bankruptcy or simply slow payment.*

Comprehension Check

List some available security devices.

Handling Marginal Business

General Considerations

Marginal customers *fall short of expectations and present an abnormal risk even when full information is available.* Many companies define marginal risks as having one or more typical characteristics:

- Management can be either inexperienced or lack depth and succession planning.
- Finances are inadequate. Companies are not adequately capitalized for their transaction volume or are not generating sufficient profits.
- Payments are slow. Terms of sale are not observed, requiring extra collection efforts.
- Merchandise is bought in too small quantities and/or provides low profitability.

RWP 13-2 **Real World Perspectives**

THE ONE THAT GOT AWAY

I had worked for a company as credit manager for less than a month when we received an order for $3.1 million from a customer with a credit limit of $500,000 and a high credit of less than $400,000. I updated the credit report and went to meet with my boss, the division CFO, and his boss, the general manager (GM). I explained that there was not enough information on file to justify releasing the order pending. I was told to make arrangements to fly out the next day—if possible—to meet with the customer to try to qualify the account for a $3.1 million credit limit.

After meeting with the customer's CFO and reviewing the customer's financial statements, which were weak and showed a significant downward trend, I was convinced that there was no way that the order pending could be released on open account terms. I shared my insights, observations and concerns with the CFO and GM as soon as I returned to the office. They thanked me for my efforts and my input, and then the GM instructed me to release the order anyway. In response, I sent him an email with a copy to my manager. In part, it said:

> *"As you instructed in our meeting this morning, I have released the order pending for $3.1 million for production and shipment. I remain concerned about the possibility of default and will keep you informed of any problems involving this customer."*

Approximately 50 days later, the customer filed for Chapter 11 bankruptcy protection still owing the $3.1 million—making our company the single largest unsecured creditor. On a dotted line basis, I reported to the corporate treasurer, and when he was notified of a potential $3.1 million loss, he told me to fly out and meet him ASAP to discuss this problem—and to bring the credit file.

The treasurer started the meeting by telling me that this was one of the largest bad debt losses the company had ever incurred. He added that he was disappointed and deeply concerned that the loss had occurred less than three months after I was hired. In response, I produced from the credit file my trip summary memorandum, which read in part:

> *"There is no safe way to make this sale. The only reason to do so would be if our need for this $3.1 million in sales exceeds our concerns about a potential $3.1 million loss."*

The second document I handed him was a copy of my email confirming the general manager's verbal instructions to release the order pending. In total, the meeting lasted about 10 minutes. The treasurer thanked me for making the trip, and instructed me to leave the credit file with him and to take the next day, a Friday, off. The following Monday, the general manager was fired and the CFO was given an opportunity to accept early retirement. I continued to work for that company for more than five years before leaving for greener pastures, but this incident was never discussed with me again.

What is the moral of the story? **Document, document, document!** Document your decision-making process, and *always* document management overrides. You never know when adequate documentation might save your job.

Michael C. Dennis, MBA, CBF

- Orders often exceed predetermined credit limits.
- The customer has a low composite credit score.

Marginal customers may be a necessary and important source of business. Those with good growth prospects offer an excellent opportunity for a supplier to make profitable sales, despite the fact that credit requests are high in relation to net worth. A well-balanced receivables portfolio should include a percentage of marginal accounts because they satisfy the need for additional business in a specific market. A supplier that has excess production capacity or needs a wider market base should be willing to take a greater credit risk. This is especially true when the better customers have absorbed fixed costs, and marginal accounts are required only to cover incremental or out-of-pocket costs.

Comprehension Check
List and discuss the characteristics of a **marginal account.**

Profit Issues

Profit on incremental sales to marginal customers may materially improve the earnings of the business, even allowing for increased credit losses. Assume a company is operating at less than capacity. If all of its fixed costs and acceptable profit are covered at present levels of production, any increase in output would only require expenditure for the direct, out-of-pocket costs of the additional sales. If these make up 40 percent of the selling price, the remaining 60 percent would be profit. Any incremental sales that sustained less than 60 percent bad-debt losses would increase the company's profit. A number of factors related to profit margins may influence the decision to sell to marginal accounts. A seller with a wider profit margin can afford to take greater credit risks. The higher the prospective customer's profit, the fewer units it must sell to pay its supplier. Disposition of the customer's profit should also be considered. As the marginal account customer reinvests its earnings during good times, its improved financial condition tends to ensure its continued existence.

Other Decision Factors

Product distribution affects the credit decision on marginal business. When new products are being promoted or when new distribution channels are being developed, marginal risks offer the seller an opportunity to maximize effectiveness. Alternative outlets must also be considered. Selling to one of a few marginal accounts may be considerably more economical than handling hundreds of direct retailer or manufacturer accounts. It may be constructive to refuse credit to a marginal risk and explore the possibility of selling to alternative outlets that present a more attractive financial picture. Obsolete or slow-moving inventory may be better sold to a marginal risk than disposed of or written off. Protective measures such as guarantees or security agreements perfected under the Uniform Commercial Code may reduce risk. Terms shorter than standard terms, COD, part cash in advance and cash before delivery may also be considered.

Comprehension Check
Why can selling to a marginal account be important to a business?

Decisions Based on Limited Information

Reasons for Limited Information

Credit information is readily available from many sources, and normal investigation usually produces adequate data for sound credit evaluation. Despite this, a credit department is sometimes obliged to act upon limited information—such as when a customer refuses to supply customary banking and trade references or financial details. Bank and trade reports can be gathered independently but with delays and greater cost. When customers refuse to supply information, their reasons should be ascertained. It is often possible to work out a basis upon which they will furnish adequate information. For example, financial data are sometimes refused because "we don't want our competition to know what we're doing." Assurances of confidential handling may satisfy this objection.

Time is of the essence and the urgency for credit action does not permit normal investigation. If the credit professional can find no way to obtain adequate information within the time available, the decision must be made on whatever information can be gathered. Unless the business is new, a payment record is almost always available. Perhaps full information is not available due to recent formation of the business or inadequate records kept by the customer. Here, the principals' past business records may be more important than financial details of the business itself. If historic information is lacking, credit grantors should proceed with caution. Sales may ask credit not to press

RWP 13-3

Real World Perspectives

ASK AND YE SHALL RECEIVE

I worked for 12 years at a small manufacturing business. When it was sold, I found myself looking for another position in credit. I was open to trying something new and different, and I went to work at a Big 7 accounting firm managing its receivables. I found myself in a different world!

This company had offices all over the country and internationally as well. I had a lot to learn. It became obvious that accountants are a little different in the way they think about and collect their receivables. The ones with the largest clients became partners, and these partners would do nothing that might offend their clients.

My first challenge was the New York office—the largest billing office of the firm. I had heard horror stories about how the partners there would allow no one to collect their money. So I booked my flight (Did I mention I live in a small town in North Carolina?), pulled out my best black business suit and headed to the "Big Apple."

The office on Madison Avenue was very impressive; the partners were so nice and seemed to welcome my help. Okay, not all of them, but one in particular had a major client that brought in millions. I gasped when I looked at the receivables and found that $500K was over five years old! In my old job, no money went uncollected, much less $500K.

When asked, the partner confessed that he had inherited this client, and that they were unlikely to pay because of the age of the invoices. Of course, this drove me crazy. Can you imagine my frustration? I humbly asked if I might try to collect this money. Literally, he wrung his hands, agreed, but made me promise not to upset them. UPSET *them*!

I began to prepare for my meeting with this important client, gathering time records, billing information—everything I could put my hands on. This went on for a couple of months. The information was professionally bound into a beautiful book—I was going in armed with everything I needed. Finally, the appointment was made.

The partner declined to attend the meeting. Big surprise; he had such *pressing matters* that day. For backup, I decided to take the tax administrator instead. I painstakingly briefed her on how we would handle it—who would present the information, what kind of deal we would cut and so on.

Let me set the scene as it was on that fateful day. In my best black suit again, I grabbed a taxi and headed down to the client's office. We rode the elevator and stopped on the top floor—the penthouse, no less. We were ushered into the main conference room and offered a wide selection of beverages. As we waited for the VP of Finance, I gazed out the window at the Statue of Liberty. What a view!

The VP arrived, and I told him we had $500K outstanding and that we would like to get that paid. He asked a few questions. (I had my hand on the beautiful, professionally bound book, ready to spring it on him.) Then he looked at me and said, "I will have my accounting department write you a check. You should have it by the end of the month."

My mouth must have dropped open—could it really be that easy? I thanked him for his time and for making this so easy. He just looked at me and said, "If we owe it, we will pay it. It's just that simple."

My heart was pounding as I got into the elevator. I looked at my co-worker and told her that we couldn't tell anyone how easy it was! Needless to say, I was the hero of the day, adding $500K to the bottom line—that money had been reserved as bad debt. The Partner was ecstatic but mystified. What kind of magic powers did I have??? I never did tell him!

I've since moved on, but I keep that story close to my heart. After nearly 20 years in accounts receivables, I always remind myself and those who work beside me: *"Sometimes, all you have to do is ask!"*

Amy D. McGuinn, CICP

for information because of possible adverse effects on future sales. This is an internal problem that should be resolved by discussion between the sales and credit departments. After review, departments should decide what action to take and how to proceed.

Other Factors

Decisions based on limited information involve factors that relate not only to the prospective customer but also to the supplier company. The general condition of the economy is very important. If times are prosperous, the risk of financial loss is reduced and the credit professional may be more likely to approve orders. Under depressed conditions, the risk of loss is higher and the credit professional may be more conservative in extending credit to customers.

In highly competitive situations, it may be necessary to approve orders on limited information. When there is an overabundance of products or a buyer's market exists, it is common to extend credit on a more liberal basis to maintain a reasonable market share. Conversely, when products are in short supply and a seller's market exists, credit analysis can be more strictly applied. Compiling information costs time and money, and a point is eventually reached at which more information is not worth the added cost. Properly interpreted and evaluated, limited information may be adequate for a yes-or-no decision, while a delay in reaching a decision may cause the seller to lose the order, the customer or both. The factors that apply to setting credit limits enter into decisions based on limited information. It may be helpful to review the situation with immediate superiors and top sales management. Such discussion creates common understanding of the problem, broadens the perspective of the credit professional and makes salespeople more aware of why it is desirable for them to obtain information from customers.

Review of Credit Limits

Regular Reviews

Credit limits *are based on information, assumptions, experiences, estimates, forecasts and economic conditions.* Since all of these factors can change, it is important to review credit limits and to identify the criteria that trigger such reviews. Credit procedures should provide for periodic review of all active files. For active customers, the review should be made annually, timed if possible to coincide with receipt of the year-end financial statements or before the customer's active season. For marginal risks, the review should occur at more frequent intervals: semiannually, quarterly or, in extreme cases, monthly. The periodic review can help keep credit limits flexible in order to meet the business needs of customers, and to accommodate the development of business obtained from aggressive and expanding concerns. The frequency and scope of review will vary with the type of customer, quality of risk and the amount of credit exposure involved. For top-tier accounts, it will tend to be nominal. As the quality of the account declines and the risk increases, the scope and intensity of the review will increase. A thorough and complete review should include the following steps, with particular attention to trends:

- Secure from the sales department an estimate of the customer's current and near-term needs.
- Request from the sales department an estimate of the customer's potential growth.
- Review the customer's recent payment record with the company.
- Review the latest agency reports to check for changes in ownership, operation, payment record, rating and financial information.
- Review and analyze latest financial statements, whether received directly or contained in an agency report. Obtain current figures if necessary.
- Review the most recent trade credit data and compare it with previous reports.
- Review the latest information from the customer's bank and obtain new information if necessary.
- Review notes resulting from direct contact with the customer.

- Make a personal call, if considered advisable, on the customer.
- Appraise historical information on the new principals when important changes in management take place.
- Decide whether the credit limit and payment terms are reasonable for the customer's financial strength and credit standing, in line with company credit policy, and adequate to supply the customer's needs.

Comprehension Check
When should credit limits be reviewed?

Improved Credit Situations

The most desirable reason for an off-schedule review of a customer's credit limit is a marked improvement in its credit position. Being aware of this type of improvement offers great sales possibilities. When a customer's financial condition and payment performance improve substantially, it may be possible to extend larger amounts of credit, with fewer orders referred for review. These steps can result in increased sales and profits and in better service to the customer.

Changes in Business Conditions

Changing conditions in business, in a particular industry or in a geographic area generally may warrant a review of accounts. Improving conditions in the country, market area or industry of the customer should trigger a review for the purpose of raising its credit limit. A nationwide recession, poor crops in a given section, a prolonged strike and many less dramatic changes can each have serious consequences. If prolonged or severe enough, they not only can affect the marginal business but the well-financed, well-managed company as well. Reassessment of credit availability in terms of new situations can be advantageous to both supplier and customer.

Exceeded Credit Limit

Orders that exceed the customer's credit limit require a review to determine whether the customer will pay and when it will do so. The credit professional will need financial and background material that justifies additional credit. Answers must be obtained to such questions as:

- Do current liabilities exceed current assets on the customer's balance sheet?
- Are trade payments prompt?
- What is the experience of other suppliers on the risk?
- Are other suppliers placing undisputed claims for collection?
- Is there any evidence of careless or unreliable performance by the customer?

If satisfactory answers to these questions cannot be obtained, it may be possible to work out a collateral security or other special arrangement reducing or eliminating the credit risk. However, if the available information indicates ability to pay but not within terms, the question is whether additional cost of the expected delinquency will make the receivable unprofitable.

Extraordinary Credit Needs

Requests for credit not warranted by the customer's financial condition may lead to sales and profits which otherwise would not materialize or, on the other hand, to increased credit losses or expanded slow receivables. Thorough investigation and current information should support a decision to extend unusually high credit.

Reasons for Unusual Needs

The common reasons for extraordinary credit needs are:

- Expanding sales.
- Initial or seasonal buildup of inventory.
- Special contracts.
- New or recently established business. In a highly competitive economy, buyers frequently count upon credit from suppliers as the principal source of operating capital.
- Continuing credit for normal needs when there is a moratorium on previously incurred debts.

Probability of Collection

Once the reasons for unusual needs have been established, the seller must evaluate the probability of collection. Since the amount of credit is excessive by accepted financial standards, the decision usually must be based on non-financial factors, such as the personal background and integrity of the principals, business ability, experience with other suppliers, relations with their bank, and willingness to supply financial information. Legal advice should be sought on special contracts to avoid difficulty in connection with performance, payment specifications or quality of goods. Payment specifications merit particular attention. Long-term payments carry greater hazards than short-term payments. A general guide is to negotiate for payment schedules that match the customer's cash receipts.

Seller Considerations

It is also important to determine whether the seller's accounts receivable will be adversely affected. If an unusually high accounts receivable concentrates overall portfolio credit risk in a set of customers, it may be advisable to determine the value of continuing to sell to those accounts based on the concept of return on investment.

Accounts may be classified into risk categories and incremental sales compared to incremental profits for each category. Overall company policies should also be considered on requests for unusually large amounts of credit. Such factors as profit margins, desirability of the revenue generated by the customer, distribution requirements, competition, establishment of a new product, opening a new sales territory and efficient use of production facilities must be considered.

Extended Terms

While the element of risk is common to all credit transactions, the degree of the risk varies with the credit period (i.e., the longer the credit, period, the greater the risk). When circumstances appear to justify credit terms that extend beyond the usual period, and which are not generally offered to the same classification of customer, a credit grantor must determine if there is a reason to extend terms that will satisfy antitrust regulations. Antitrust regulations are intended to avoid anti-competition, restraint of trade and pricing issues. Often, considerations such as geographic anomalies or economic conditions will meet concerns involving antitrust. Other reasons include meeting the competition, financial hardship and rehabilitation of the customer. Legal counsel may be helpful in certain circumstances and a review of antitrust regulations is recommended.

Terms of sale may be regarded as a part of the price. Credit professionals should be aware that extended payment terms may be regarded as a change in price favoring a particular customer. If extended terms are granted to one customer, they should be available to others under comparable circumstances. In addition, it should be recognized that terms concessions to some customers may be unfair to those that pay on standard terms. Accordingly, the seller should make some provision for recovery of the added costs that extended credit terms may create.

Comprehension Check

Explain the statement:
The longer the credit period, the greater the risk.

Establishing the Necessity for Extended Terms

In any individual case, the need for additional time must first be confirmed. The conditions that bring about this need are similar to those that underlie requests for unusually high credit, such as expanding sales, seasonal financing of accounts receivable and inventory, and special contracts. Occasionally a customer with limited resources requests longer terms until additional capital becomes available. Current financial information is essential. In a new

business, the financial data alone may justify the decision. Where the customer seems to lack operating capital to finance expanding sales, the credit professional should try to determine whether the sales forecasts are realistic. Here, the views of the sales representative handling the account can be valuable. If the need stems from a special contract, it should be examined with particular regard to the payment schedule. When additional time is needed until other capital becomes available, seek verification from the source of expected funds.

Terms Offered by Competitors

Another reason for considering extended terms, and an important one in many industries, is often simply a matter of meeting competition, and is not related to actual customer need. This issue requires the attention of both the sales and credit teams. The credit professional should analyze the risks involved, but the ultimate decision is usually that of senior management. Claims of extended terms should be verified before a decision is made to meet competition. Requests for lengthened terms to meet competition frequently stem from customer reports of special arrangements offered by competing suppliers which may be misunderstood or mistaken. If the reports are verified, a decision mutually acceptable to sales and credit management can be achieved.

Determining Whether Extended Terms Are Realistic

If the customer's need is established, the credit professional must decide whether the proposed extended payment arrangements are a realistic means of meeting this need. This means answering such questions as:

- Will temporary assistance from the supplier give adequate financing?
- Does available information, including sales forecasts and cash inflow forecasts, indicate that funds will be available to meet obligations as they mature?
- Will there be adequate funds to resume normal payments as agreed?
- Does close analysis indicate that such aid would serve no long-term purpose and that the actual need is for equity capital or long-term debt?

A manufacturer can help a customer by supplying products on extended terms, but this is not realistic if the supplier-customer relationship is relatively new and not profitable to the seller. On the other hand, if a long-time customer fails, the profit earned by the supplier over the years may more than offset any one-time loss. In deciding whether to offer extended terms, the determining factor is often the bigger picture of the entire relationship between buyer and seller. If a customer's need is established and extended terms are considered, the credit professional should give close attention to the amount of credit to be granted under these terms, keeping in mind the increased risk and the legal implications.

Overdue Accounts

Slow payment is one of the factors that most frequently lead to account review. If slow-paying customers are approached as a partner to the sale, it may be possible to convert them to prompt and profitable accounts. As a starting point, credit information should be reviewed and brought up to date. The sales department's appraisal of the risk and potential may also help decide how a past-due account should be handled. If the review indicates that additional credit is too risky, friendly but firm efforts should be initiated to collect the past-due amount. Internal controls can be set up to prevent shipment of new orders until the past-due amount has been paid. If a new order is received, the credit department may tell the customer that additional credit will be extended after past-due bills are paid.

Some problems associated with past-due accounts may be solved by amortizing payment of all or a portion of matured balances over a period of time, with a provision for prompt payment of any new credit. Amortization plans may also provide for conversion of extended open account balances to interest-bearing notes. The objective is to return the accounts to a current basis by liquidating the frozen balances. However, unless such plans are based realistically on the customer's ability to meet the schedule of payments out of profits or otherwise, they may serve

only to complicate the situation. The assessment of late-payment service charges can provide inducement to pay promptly and is used for that purpose in a number of industries.

Other Reasons for Reviews

A credit file should also be reviewed upon receipt of information that is deemed unusual or significant, such as:

- Receipt of a new financial statement.
- A change in the accounting method for reporting sales and income.
- New auditors.
- The death of one of the principals.
- The admission of a new partner or other change in management.
- A change of banks.
- A change in the legal structure of the entity (e.g., from a proprietorship to a corporation or LLC).
- A merger or an acquisition.

Figure 13-3

	NEW CUSTOMER RISK REVIEW CHECKLIST	Comments	Completed?
1	Completed and signed credit application (or written approval from management if requirement is waived)		
2	Sales-initiated customer form is completed and approved		
3	Financial statements (Full set if purchases are expected to exceed a certain level. If lesser volume, obtain written or verbal information to calculate key ratios.)		
4	Resale tax certificate (if a U.S. entity) is sent to tax department (dated copy retained by credit deptartment)		
5	Legal name verification via Secretary of State websites		
6	Third-party credit reports, including key scores		
7	Bank references		
8	Trade references (3)		
9	Review customer's website and online presence		
10	Generate internal credit score		
11	Credit limit determination		
12	Security instruments		
13	Evaluation and approval		

Information from other sources may also spark a review. Local newspapers often publish changes in ownership and management while public record sources document suits filed, legal actions and information on customers. Industry and trade publications are useful sources of information about individual customers and conditions in the industry. General business conditions are discussed in financial newspapers and financial sections of leading newspapers, and periodic analyses are issued by prominent banks and a number of government publications. *These sources are reliable methods of learning about customers and can be proactively researched using various online search engines and news alerts.*

Credit professionals should be alert for any indications of a customer's financial difficulty, including reduced agency ratings, increasingly irregular or delayed trade payments, reports of contentiousness, protested checks, filing of tax claims, perfected security agreements or failure to maintain scheduled payments on debentures, mortgages or other fixed obligations. There is a great danger in presumptions based on incomplete surface indications. These should always be explored. Thorough investigation is often required to assess their significance. Any decision to curtail credit or to question a customer's creditworthiness should be delayed until complete information can be ascertained. A selling firm's own experience with bad debts, slow collections, financial requirements or marketing strategy can cause credit policy changes that would call for review of all customer credit files.

Figure 13-4

	EXISTING CUSTOMER RISK REVIEW CHECKLIST	Comments	Completed?
1	Completed and signed credit application (or written approval from management if requirement is waived)		
2	Sales-initiated customer form is completed and approved (if requesting additional credit limit)		
3	Financial statements (Full set if purchases are expected to exceed a certain level. If lesser volume, obtain written or verbal information to calculate key ratios.)		
4	Resale tax certificate sent to tax department (if a U.S. entity and if the previous certificate has expired)		
5	Legal name verification via Secretary of State websites		
6	Third-party credit reports, including key scores		
7	Bank reference to update availability and relationship		
9	Review customer's website and online presence		
10	Generate internal credit score		
11	Credit limit determination		
12	Security instruments		
13	Evaluation and approval		

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Comprehension Check

1. Some companies establish a way to automatically approve small orders. Supply a justification of this policy.
2. What is the difference between **credit line** and **credit limit?**
3. Explain how the profit margin and terms of sale of the selling company influence credit decisions.
4. Discuss three common methods used to establish a credit limit.
5. Explain credit scoring techniques and the pros and cons for their use.
6. List some available security devices.
7. List and discuss the characteristics of a **marginal account.**
8. Why can selling to a marginal account be important to a business?
9. When should credit limits be reviewed?
10. Explain the statement: The longer the credit period, the greater the risk.

Summary

- The basic objective in making credit decisions is to find ways to approve an order with reasonable expectation that the customer will pay in accordance with established credit terms.
- New orders should be processed as quickly as possible in order to ensure continued sales. When processing new orders, consider:
  - How much credit is required?
  - What are the profit margins on the products being sold?
  - When will the customer pay?
- Credit investigations may not be necessary for all sales. Credit policies that establish terms for automatic credit approvals and approvals based on a creditor reporting agency's rating or score can save time and money for a credit department. Some, but not all, benefits include:
  - Documentation of actions taken
  - No need for exhaustive investigation
  - Efficient use of time
- When first orders cannot be streamlined by using an automatic credit approval system or credit ratings, an organization may sell on other terms such as cash in advance or certified check.
- **Credit limits** may be assessed based on:
  - **Financial information**
  - **Agency ratings, reports and credit scores**
  - **Bank checks**
  - **Trade clearances and other data**
- Profit margin of a product can have serious implications for a credit decision. For example, high profit margin can allow a seller to accept a greater credit risk.
- Financial exposure is greater when credit terms are longer.
- Factors to consider when **establishing credit limits** are:
  - **Competition**
  - **By formula**
  - **Payment record**
  - **Payment performance**
  - **Period of time**
  - **Expectations of use**
  - **Agency scoring and rating**
- **Credit scoring** is a popular tool of credit analysis. A credit matrix can be used to assign certain credit bands to specific terms. Credit scoring models are also popular tools when making credit decisions. They can take into account various factors like the NAICS code, payment history and financial data to make an appropriate, unbiased credit decision.
- Many companies advise their sales department of credit limits. It also may be appropriate to inform the customer of credit limits. However, there are advantages and disadvantages to this practice including an opportunity to discuss and possibly adjust the limit in order to sell more, or the potential to damage goodwill between a customer and the seller.

- There are various security devices that may be used during a credit decision. Some include: guarantees, irrevocable letters of credit and subordinate agreements.
- Marginal risks may be essential to a business' receivables portfolio allowing for increased profit if the risk is justified.
- Credit managers may need to make credit decisions with limited information because of limited time or increased cost. There are many factors to consider when making decisions with little information, one being the overall economic environment at the time of the decision.
- **Credit decisions** should always be done on a specific timeline based on when certain information becomes available for that particular business. However, the frequency of review may be subject to change based on the business as well as other factors that include:
  - **Improved credit situations**
  - **Changing business conditions**
  - **Exceeded credit limits**
  - **Extraordinary credit needs**
  - **Extended terms**
  - **Overdue accounts**
- Other reasons for **review** include, but are not limited to, the following:
  - **New financial statements**
  - **New auditors**
  - **Merger or acquisition**
  - **Death**

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