PART III
EXTENDING CREDIT

Chapter 8: Credit Policy and Procedures
Chapter 9: Credit Applications
Chapter 10: Terms and Conditions of Sale
Chapter 11: Credit Investigations
Credit Policy and Procedures

Overview

A well-defined credit policy allows a business to achieve established goals and serves as a guide in determining how to handle a variety of situations. In the decision-making process, credit policy is interpreted and applied to actual situations with guidelines or procedures that are devised by credit professionals to standardize the requirements assigned to the department. Companies can publish procedure manuals as ready references for employees.
Credit Policy and Procedures

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DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:
- The purpose of a credit policy.
- The advantages of an implied over a written credit policy.
- How a credit policy is developed.
- The components of a credit policy.
- How to create an effective credit department.
- Establishing terms of sale and credit limits.
- How to handle collections and bad debts.
- Types of credit procedures needed.

Q. Can a credit policy be flexible enough to accommodate a changing business and economic environment?
Q. As the company’s goals change with the market, how does the credit department ensure that its policies can reflect those changes?

Chapter Outline

1. Defining Credit Policy 8-2
2. Credit Procedures 8-20
Defining Credit Policy

A credit policy is designed to provide consistency across departmental functions. Because credit policy concerns the company as a whole, it is usually established by top management. The chief credit professional and associates along with the heads of other interested departments can also be consulted as policy is created and updated. The format of a credit policy is specific to the company preparing the policy; it must reflect the company’s receivable management goals. Every credit professional should be provided with a written policy statement—one that is used as a training aid, is fully understood and accepted by sales as well as the credit staff.

An effective credit policy permits and encourages the fullest development of the opportunities in administering credit. It provides the latitude to plan departmental operations within the scope of the company policy, while creating effective procedures and techniques to implement that policy and establish adequate controls. It can assure that there is consistency in the company’s dealings and interactions with its customers and it provides a means of recognizing the importance of the credit function to the company.

The first step is the formulation of credit policy which begins with the establishment of objectives. What does the company want to accomplish? If these objectives are to be attained, what should be the role of the credit department? The next step is a thorough analysis of the context within which the credit policy must operate, including the following factors:

- The established company policies.
- The objectives and policies of the other departments.
- The primary industry characteristics, such as current credit practices, the role of credit in competition, the company’s position in the industry.
- The company’s financial resources.

After these steps have been completed, the credit policy can be formulated. Within the given context, the credit policy sets a course of action that is expected to help the company meet its objectives.

A Written Policy vs. an Implied Policy

There are two ways a policy can be disseminated: implied or written. An implied credit policy exists, but it is not officially stated (or written). It has little or no official expression of approval and can be difficult to perceive and, therefore, be left to interpretation. By definition, the understanding of unwritten policy depends on oral communication or on inference from the decisions made by senior credit personnel. A stated credit policy is set forth in writing and usually has the support and approval of senior management. As the policy is available to everyone in the same form, there are usually fewer misunderstandings. A stated policy indicates a basic honesty and integrity in intention. It generates confidence and stability and serves as a good training tool.

Consideration of a written policy by the professionals concerned also helps to reveal differences in their understanding of what the policy is and areas in which it is inadequate. A written policy is useful because it can be a source of stability and continuity in the operation, not only of the credit department but also of the company as a whole.

Individual credit professionals and other administrators tend to vary unconsciously in their credit thinking as they interpret and react to the conditions and problems with which they work. Unwritten policy is thus subject to gradual, unnoticed changes while a written policy lessens the possibility of this kind of variability; it requires that changes in policy be conscious and intentional. In this way, policy becomes a vehicle for reviewing the credit department’s effectiveness.

Removing credit policy from dependence on the knowledge and experience of one or a few individuals tends to ensure consistency regardless of changes in department personnel. There is a greater probability of consistent decisions under a written policy, especially in large and complex credit organizations, where many people are dealing with the same types of problems and where they can be separated organizationally or geographically. If needed,
customers may be shown a copy of the policy statement, so they can see that they are not being given unusual or discriminatory treatment.

### Importance of Credit Policy

A credit policy is a guiding principle used to establish direction for the credit function in an organization, in order to achieve the objectives of minimizing risk and maximizing profitability, while maintaining a competitive advantage in the marketplace. Credit is an investment that companies make through its receivables. The credit department manages this investment, maximizing the benefit of the investment while minimizing the cost of nonpayment and looking for the greatest possible return at an acceptable risk. The acceptable risk is defined through policy.

A credit procedure is a series of steps to be followed on a consistent basis for recurring credit situations, to accomplish the goals outlined in the company’s strategic planning framework and/or internal audit framework. Together, credit policies and credit procedures are used to empower the people responsible for the credit process by providing the direction and consistency they need for successful execution.

All companies, whether they sell on credit or cash, should have a credit policy. The policy provides a framework for making effective credit decisions. When a company sells on credit, individual credit decisions follow a pattern consistent with the company’s overall goals and objectives. Companies vary widely in how they express a stated policy. It is often formulated in very broad terms, such as “to maximize sales with minimum losses,” and fails to differentiate one customer from another or to provide a useful basis for individual credit decisions. Cash only is a form of credit policy whereby the company adopted the policy that no credit will be extended.

Sound credit policy must be effectively communicated, both inside and outside the credit department. Whether policy is disseminated orally or in writing, there must be clear mutual understanding as to what it is and how it is to be applied. The company may also wish to make its credit policy known to organizations and individuals outside the company, such as its banks, credit insurers and customers. Depending on the situation, define the purpose such a publication is expected to serve, the nature and duration of the relationship and the competitive role of credit.

To be effective, policy must be directly and explicitly related to action. The top credit executive should take the steps necessary to translate broad, flexible policy statements into guides that can be used by credit personnel in the daily operation of the department. This usually begins with establishing short-term objectives and determining for the short run what the emphasis is to be within the range of decisions provided by policy. Probably the most significant single step when implementing credit policy is creating an atmosphere that encourages credit department staff to think in terms of policy and to be aware of the effect of their individual credit decisions on the company’s commitment to the accounts receivable investment and to department and company operations.

### Developing a Credit Policy

A formal written credit policy should serve as a constant, practical guide for conducting all of the processes in a credit and collection function. A policy should be reviewed and updated periodically to align with organizational objectives and changing internal and external conditions.

There are four essential elements of credit policy:

1. **Establishing the credit standard.** This component describes the profile for an acceptable credit customer, including appropriate details and examples.

2. **Determining credit availability.** This component describes how the maximum amount of available credit is computed and managed, including decision criteria for reducing or increasing a customer’s availability of credit.

3. **Setting credit terms.** This component stipulates the exact terms of sale for each class of customer.
4. **Defining collection policy.** This component provides criteria for regular collections and exception collection procedures for past due amounts.

The short-term application of **policy should be flexible**, consistent and fair, allowing for the credit professional’s judgment. Some policy statements describe the degree of tolerance by using such phrases as “whenever possible” or “under usual conditions.” Building in flexibility allows the policy to be used intelligently and in different approaches without the need for a formal change. Consistency ensures that the policy will be applied in a similar manner for like situations. Fairness ensures that all relevant facts and issues will be considered for each credit decision. Allowing for judgment encourages personal insight, develops better perspective and helps ensure a correct analysis of relevant matters.

The role of credit is influenced by a number of **general factors**, including the stability of demand for the industry’s products and the rate of technological change. A company’s current financial position can be decisive in the short-term application of policy. For example, severely limited working capital can require emphasis on prompt collections and rapid turnover of accounts receivable. New companies often have cash flow problems. As a start-up company matures and cash flow improves, policy can be changed. Changes in economic and political conditions and increased litigation in the collection of accounts can also prompt changes in policy.

The **type of customer** can have a limiting influence on the credit policies of all companies in an industry. Where the buyers’ lines of business are characteristically short of capital, it is unrealistic for credit policy to be unduly restrictive. If an industry has many well-capitalized customers, the company that takes additional risk must expect additional return for this added risk. With enough good credit risks available to provide adequate profits, there must be an added incentive to make sales to fair or marginal risk customers. If the buyers are in control of the industry, the seller may have to offer longer terms.

The **geographic locations of customers** can have a direct bearing on policy with variations in credit terms offered. Widely separated markets require particular modifications in credit analysis and in collection efforts. A highly concentrated selling and buying area, on the other hand, involves a special type of price competition and service requirements.

**Overall economic conditions** can be significant in determining how policy is to be applied over shorter periods of time. When the business environment is stable and/or expanding, the ability of debtors to pay their invoices is somewhat improved; however, there is a danger that they may overbuy. If the business environment is contracting or slowing, debtors tend to delay payment of their invoices and credit requirements may tend to be stricter. Concurrently, companies are faced with the problem of meeting their bottom line in the face of decreasing sales and a customer base with more leverage.

**Business conditions** specifically affecting the areas or industries in which the company operates are also of major importance in policy application, such as those in a particular region, in the United States as a whole or in areas of foreign trade. Not all segments of the economy change at the same rate or in the same direction. The company can change emphasis, redefine responsibilities and adjust procedures in order to meet changing conditions. During prosperity and expansion, the credit department can help develop new markets or products. In a recession, the emphasis may be on greater care when selling to marginal accounts. The same credit policy is in effect during all phases of the cycle, but its application changes.

In many cases, the company’s **competitive position** within its industry will influence how a company can apply its credit policy. While credit is not generally a competitive tool, a company can use the policy for competitive purposes. The credit professional must evaluate the company’s long-range ability to compete and the competitive conditions within the industry. This would include analysis of the company’s present position within the industry and its financial strength as well as an awareness of the strength of its sales organization and its position in product development. If a seller is not a major market leader, it may have to match the best terms, instead of being in firmer control over what terms it offers. For example, many companies whose position is undisputed or have substantial market share can demand strict credit policy whereas a start-up company may find it advantageous to be more lenient in its credit policy.

The **merchandising policy** of a company often influences credit policy. For example, a company may be required to place machinery in the hands of a limited number of franchised dealers on some basis to enable them to sell a
maximum volume during a relatively short retail buying season. This may involve longer terms of sale in order to coordinate with manufacturing and shipment needs. Large extensions of credit can be required in relation to the financial responsibility of the dealers. Reliance is placed on the character and capacity of the dealer to a far greater extent than on capital. The essential factors are experience and proven ability in selling competitively, collecting effectively and operating profitably.

The type of merchandise affects the credit policy of the seller in a number of ways. The length of terms offered could be a function of the product’s shelf life (those that can spoil will require shorter terms, so terms are usually net 7, 14 or 21 in the food industry), variations in demand (seasonal products can have differing terms depending on the time of year), and cost/price of the product (more expensive items such as jewelry can have longer terms while cheaper products can have shorter terms). Also, terms may be somewhat more liberal if the merchandise can be repossessed in the same condition as it was sold.

If goods have been stored in inventory for some time and an opportunity arises to dispose of them, credit policy should be sufficiently flexible to approve the transaction. An extreme example of this situation is the case of the shoe wholesaler that has stored some out-of-style shoes for a number of years and then receives an offer for the entire lot. Even if the customer wants extra terms or is not a good credit risk, it is doubtful that the shoe wholesaler will refuse the offer.

When merchandise can be obtained readily by the supplier, there is no need to restrict sales to customers unless warranted by financial or credit risks. When a particular item is scarce, however, credit policy can be influenced to the extent that stricter requirements are set for customers needing that item.

In the case of particular commodities, such as spirits and liquors, government regulations specify credit policies or procedures that must be followed by the seller. There, the overall policy must take the regulations into consideration.

Margins on the merchandise are important: when profit margins are slim, the credit department must be more vigilant with its oversight of its accounts. High-margin goods may enable credit professionals to approve sales to fair and marginal accounts more easily and more quickly as it may be more profitable to check orders and rely on overall profits to cover relatively bad-debt losses. Changes in profit margins can cause credit policy to change. For example, a new product line initially may have low profit margins. Accordingly, credit policy may be very tight. As profit margins increase, credit policy can probably loosen.

The price range of merchandise similarly influences credit policy. It is generally easier to establish a uniform liberal policy that applies to all customers when the unit price of merchandise is relatively low. Even on a wrong decision, the dollar amount of risk is not great. On a large ticket items, however, credit exposure is greater and a more detailed analysis is usually conducted before a customer order is approved.

**Foundational Components of a Credit Policy**

There are several key questions which build the foundational components of the policy.

- **What is the credit department’s mission?** This can also be called a vision or purpose. It states the overall objective for the credit function. The credit department’s mission statement defines its goals, ethics, culture and norms for decision-making. The best mission statements define at least three dimensions: what the credit department does for its customers, what it does for its staff and what it does for its company.

- **What are the goals?** Goals can be specifically stated, such as a quantifiable measure, or more generally as an expressed desire to achieve improvement in a specific area.

- **What are the roles and specific authorities of the credit management and staff?** This defines the boundaries of the credit function, often in terms of interactions with other departments.
• What are the primary criteria for evaluating customer credit? This describes credit procedures in more detail, listing key aspects of the credit review and analysis processes.

• What are the company’s terms of sale? Terms should be spelled out by major product line, with any qualifications or restrictions included.

• What are the credit limits? These should be set by the credit policy.

• What does monitoring of accounts consist of? The credit policy should set parameters for this function.

• What are the normal collection procedures? This describes the steps to be taken in customer collection activities.

• When is the account considered to be a bad debt? The credit policy describes the procedures for assessing an overdue account.

• What does reporting to management consist of? How often and to whom is a report made?

Credit Department Mission Statement
The mission statement should express the long-range focus of the policy and define the purpose of the credit department. It will summarize how the credit function will contribute to sales growth and profitability though risk management and customer relationships.

Goals and Objectives of a Credit Department
The goals and objectives of the credit department should describe how the company expects to measure the effectiveness of its credit function. Goals should track with current market conditions, be consistent with the strategic direction of the organization and reviewed and updated annually. Goals and performance against goals should be communicated on a regular basis to the entire credit organization.
Five key credit department objectives:

1. Develop an optimal level of sales and cash flow, while limiting delinquencies and bad debt losses and working effectively with sales and other departments.
2. Minimize the carrying costs for accounts receivable.
3. Minimize risk and bad debt losses while maintaining a competitive advantage.
4. Monitor the costs incurred by the credit department such as operating costs and expenses within the credit department to benchmark standards.
5. The credit department must convert accounts receivable to cash as quickly as possible and communicate the condition, cost and trend of the company’s investment in receivables to management.

To help the company achieve overall objectives, each department, including the credit department, should reach specific goals. Set forth in credit policy, these objectives define desired accomplishments for each department. The policy is established to meet the objectives of the company, which are determined before any other actions can be taken. Some factors to consider when developing goals could be:

- Terms of sale.
- Monitoring credit risk.
- Relationship to the sales department.
- Training and development of credit personnel.
- Amount of capital committed to accounts receivable.
- Measurement of the status of the accounts receivable investment.

Many companies monitor standard benchmark statistics, some of which are:

- Days sales outstanding.
- Days delinquent sales outstanding.
- Number of active accounts being managed by credit and collections.
- The average dollar size of these accounts.
- The average dollar size of invoices.
- The number of invoices being managed.
- The percentage of invoices over 30 days, over 60 days and over 90 days past due.
- Dollars collected by collector.
- Dollars collected per month per employee of the credit and collection function.
- Changes month over month in dollars collected per employee.
- The percentage past due for each collector.
- The number of deductions/debits outstanding.
- The dollar value of debits/deductions outstanding.
- The percentage of deductions over 30 days, over 60 days and over 90 days past due.
- Bad debt write-offs as a percentage of sales.

**Boundaries: Organizational Roles, Responsibilities and Authority**

While the organization of a credit department is not determined by credit policy, it plays an important part in putting policy into action through specific assignment of responsibility and delegation of authority. *Credit policy establishes the broad limits for decisions over a long period of time. To make these limits a workable guide to decision-making, it is necessary to specify who has the authority to make different types of decisions and within what range personnel may exercise their judgment. For example, the authority to make exceptions to basic policy is usu-
ally limited to the chief credit professional. Authority for various levels of personnel is often stated in terms of the amount of credit involved. The definition of authority should make clear the channels through which an order must move until it is finally approved.

Defined organizational roles and responsibilities for each person involved in the credit function will help to achieve the most effective results possible. Clearly defined roles and responsibilities help streamline operations, prevent redundancy, provide clarity of tasks and improve productivity. An organizational chart will help clarify the role of each position in the company and show the nature over which authority exists and where decision-making should be made.

**POINTS TO CONSIDER**

- Has the company clearly communicated who has overall responsibility for the credit and accounts receivable functions?
- Who has the authority to approve credit applications?
- Who has the authority to change credit limits?
- What is the credit function’s credit line approval hierarchy (how much each person is authorized to approve)?
- Do credit limits above a certain amount require approval from company’s senior management?
- Who has authority to hold orders?
- Who has authority to shut off accounts?
- Does the sales department have authority to override the credit manager? What circumstances require the intervention of sales? Who has ultimate authority if sales and credit do not agree?

**Credit Evaluation**

Credit decisions should be based primarily on the credit applicant’s willingness to pay, as evidenced by its payment history, and on its ability to pay, as evidenced by its financial situation. Other factors relating to the applicant, such as its legal form and the industry in which it operates, plus years in existence, should also be considered. After evaluating the information, however, the decision to offer or refuse credit to a customer is often at the credit manager’s discretion.

When credit policy addresses a company’s credit evaluation philosophy, the criteria to assess risk and determine credit limits is clearly established. The goal of defining and establishing how credit evaluations are conducted is to build consistency around the evaluation process.

The Five Cs of Credit are the basic components of credit analysis. Using the five Cs to evaluate a customer incorporates both qualitative and quantitative measures.

The Five Cs of Credit are:

1. **Character.** The history of the business and experience of its management are critical factors in assessing a company’s ability to satisfy its financial obligations.
2. **Capacity.** Make sure to assess the capacity of the business to operate as an ongoing concern in every credit decision.
3. **Capital.** Analyze the financial strength of the organization in order to determine its ability to meet financial obligations in a timely fashion.
4. **Collateral.** Debtor support in terms of specific assets used as collateral can enhance a customer’s creditworthiness. Resources such as liens on specific assets, letters of credit, pledges of stock or bonds and personal or corporate guarantees can each afford an opportunity to ultimately extend credit.
5. **Conditions.** General economic conditions in the world, the country, the community and the industry will exert a modifying influence on the financial analysis of an account.
The credit policy defines whether credit applications are required for all prospective customers. The credit application begins the relationship-building process and is an initial source of information to begin a fact-finding, fact-verification mission about the applicant. In addition to using the credit application as an investigative tool, the credit application should create a contract between the seller and the customer.

It is very important for a seller to know its customer. To make sound credit decisions, organizations will typically leverage various information provided on a customer’s credit application along with other external resources available. The credit policy defines which external resources are required as part of the credit investigation that culminates in the commercial credit-granting decision.

External resources include:

- Industry credit groups.
- Credit agency reports (NACM, D&B, Experian, Equifax).
- Financial statements.
- Trade references.
- Bank information and references.
- Public records.

Comprehension Check
What credit procedures are used in evaluating credit?

Terms of Sale
A credit policy should provide information about the terms of sale between the company and its customers. The policy should clearly detail who must approve requests for special terms. It is important for all parties to know when payment is expected for the product or service. If terms are varied due to certain customer classes, then the policy should include a discussion of the different types of terms that can be authorized.
credit limits

the credit policy should explain how the credit department establishes credit limits for all active customers. credit limits should be based on each customer’s credit rating, ability to pay and expected volume of purchases. financial statements and trade information are sources of information typically used to assign credit limits. the credit policy should specify who is responsible for approving credit limits and if alternate approval is required for credit limits that exceed a certain amount.

the goal is to set credit limits that are flexible yet appropriate for the customer’s risk level. slower paying customers should be provided with more conservative credit limits while prompt paying (lower risk) customers should have more freedom with their credit limits. if credit limits are set correctly then slower paying customers will be more easily recognized more frequently for potential credit hold review and stronger payers will not.

upon evaluating credit information, some companies use a strategy of segmenting customers into various credit limit parameters. one approach is to identify customers as low, moderate, or high risk. segmentation helps to set credit limits and prioritize collections.

points to consider

• are credit limits assigned to customers to help control credit risk?
• has the financial strength of the creditor been considered in establishing credit limit parameters?
• are credit limits determined logically and consistently, then properly approved?
• are sales and customers promptly notified of credit decisions and limits?
• are customer’s credit exceptions monitored daily, such as, exceeding credit limit and/or past due situations, to proactively manage risk/customer exposure?
• is written approval required by the credit manager if orders exceed the pre-approved credit limit or if the customer has past due invoices?
• does the credit department review larger credit limits on a periodic basis?
• are all credit limits subject to revision, based on changing levels of creditworthiness?
Monitoring Accounts

The credit policy should summarize the process of re-evaluating credit for existing customers along with the sources of information commonly used in the process. Establishing regular credit evaluation as part of the credit policy will allow the company to monitor any changes in the risk level of the receivable portfolio. The company can then adjust credit and collection policy accordingly. Specifically, if the portfolio is becoming a little more precarious than the company’s tolerance for risk permits, the credit policy and collection plan should be tightened.

POINTS TO CONSIDER

• Do policies and procedures address how often to re-evaluate credit for existing customers?
• Are critical customers evaluated at least annually?
• Does management use other tools besides the A/R aging report to monitor credit?
• What other data sources are used for the purpose of account monitoring (sales associates, trade magazines, news wires, business and credit information companies)?
• Are credit re-evaluations for smaller customers performed at the first sign the customer is facing possible financial trouble?
• Do credit personnel check each customer’s credit status (credit limits and past due invoices) before releasing orders?
• Who has the approval to release orders if a customer has exceeded its credit limit or if invoices are past due?
• Does the credit policy identify other approaches to reduce credit risks for marginal accounts, such as obtaining a security interest or guarantee?

Collections

The credit policy should identify what methods credit personnel will use to collect receivables, particularly past due accounts. The best collection process is one which is proactive and consistent, and which reflects the mission and goals of the credit department. The collection procedure should be prioritized according to both the customer’s risk and exposure level.

This section should include:

• When to contact a customer.
• How to contact a customer.
• When to place an account on credit hold.
• How to resolve disputes, deductions, etc.
• When to turn over delinquent accounts to an outside collection agency or attorney.
• When to write an account off to bad debt.
• Authorizing settlements.
POINTS TO CONSIDER

- Has the company established a clearly defined process for collecting past due accounts, beginning when an account first becomes delinquent and continuing until the debt is collected or when the collection cost exceeds the benefit?
- Does the company use multiple collection strategies (telephone, email, fax, letter)?
- Does the credit policy contain a statement that reinforces ethical behavior and credit professionalism when communicating with customers and salespeople?
- Is there a policy for when to place an account on credit hold and does it have the buy-in of sales?
- Are customers and customer service, shipping and sales personnel notified immediately, as applicable, of a potential credit hold situation before the hold actually goes into effect?

Real World Perspectives

TEXTING WORKS BEST

Connecting with clients who owe your business money can in some cases present a challenge. Particularly in a world with so many options for communication, from cell phones to email, finding the right medium to relay messages that an account is late, or very late, and must be paid is of utmost importance. As we all know, the longer our business waits past the due date for payments, the less likely we’ll see payment on that account.

When trying to reach high profile or troubled accounts, one method I began using more and more over the past four years is text messaging. In fact, these days I rarely leave a voicemail if I don’t reach someone. That’s because I don’t think many people actually listen to voice messages nearly as much as they look at a text. A person may be in transit, busy or in a meeting. But even if someone is in a meeting, they can still respond to a text. And generally, my customers do. It doesn’t work all of the time, but it usually works the first couple of times, at least until they realize who it is. Also, with clients who have an iPhone, I’m able to see if the person read the message. With voicemail or even email, it’s common that people don’t hear or respond in a timely way, if at all.

Texting technology has improved the collectability of accounts, and that’s mainly a matter of the improved means of communication. The more communication you have, the more of a customer’s story you have and the more likely you are to collect on your invoices. Now, just because you’re in contact sooner with your customers doesn’t mean they’ll have the money to pay you, but it does mean you’ll have the chance to understand their situation a little earlier in the process. Every customer has a finite amount of money, so if I can beat the other vendors to the table, then I’ve succeeded in reaching them that much sooner and will ultimately have fewer problems collecting down the road.

In terms of texting etiquette, we’re still figuring that out as we go. The best method I find so far, though, is to first identify myself, then get to the point quickly by saying something like: “Hi, I’m with company X. Your account is past due. Give me a call to work out arrangements.” If you don’t identify yourself, it winds up slowing how the client responds to an unknown sender. Generally, I don’t put dollar figures in the first text with a client, but if the conversation takes on a life of its own, then absolutely, I include dollar amounts. With one particular client that I’ve been texting back and forth with for a while, I’ll send him a text with just a question mark. We’re so familiar with each other, he’ll understand that to mean “Where’s my payment?!” He’ll eventually come around to paying me because he knows what I’m looking for. Another benefit to using text messages is that, unless the users have deleted the message string, they’ll be able to quickly scan previous texts and grasp the gist of those collections conversations.

To date, most of our customers aren’t paying through text messages. We do have Square (a credit card processing service) and are setting up Apple Pay (a mobile payment service), so we know we’ll be able to receive payment this way, but it’s not something we’ve taken on yet, though it’s likely just a matter of time before we do.

Shane Norman, CCE, is the credit manager at Wheeler Machinery in Salt Lake City
Bad Debt

At some point, nonpaying customers have to be accounted for. This usually means deleting them from the company’s books and from regular accounts receivable records by writing off the outstanding receivable as a bad debt. Some companies establish Allowance for Bad Debt Accounts, contra asset accounts, in order to recognize that write-offs are inevitable and to provide management with estimates of potential write-offs.

An account is written off when there is no probability that it will be collected and when it complies with Internal Revenue Service regulations regarding bad debt write-off. Some companies do not choose to set up allowance accounts; they keep the doubtful accounts on the A/R until such time as they qualify for partial or full write-off.

The policy should address:

• Conversion of an open account to a note.
• Customer counseling.
• Collection agencies.
• Use of outside attorneys and lawsuits.
• Customer bankruptcy, preference claims, bulk sales and assignments for the benefit of creditors.
• Authorization for accounts written off to bad debt.

POINTS TO CONSIDER

• Does the company prepare a Reserve/Allowance for Bad Debt on a consistent basis?
• Is there a collection process in place to determine when an account balance should be considered uncollectable?
• Are bad debt write-off approval amounts assigned to departmental personnel, as set by the hierarchy of authorization levels?
• Do credit professionals participate on creditors’ committees?

Other relevant items that may be mentioned in a credit policy include: comments on ethics, legality, quality, industry-specific programs, personnel, credit interchange and professional organizations, systems, deductions, returned checks, collection mechanisms, international trade and record retention.

POINTS TO CONSIDER

• Are deductions handled promptly to assure quality receivables?
• Do customer inquiries receive immediate attention?
• Does the company share receivables and trade information with credit bureaus or credit associations?
• Is business information shared in compliance with NACM’s Canons of Business Credit Ethics?
• Does management periodically review and revise credit policies and procedures, as necessary, to reflect changing business conditions?
Deductions*

A significant challenge facing credit personnel in many industries is the issue of deductions. These deductions, also known as chargebacks, billbacks and many other names occur when a customer either short pays an invoice or takes a separate line item credit on their payment.

Deductions found their origin in the apparel industry with penalties for non-compliance, either a set amount per incident or a percentage of the total invoice or order, but soon migrated into all of consumer products manufacturing. With the advent of “Big Box” stores and mass merchandisers, getting paid through deductions became a normal course of business.

The challenge of deductions can range anywhere from ½ to 3% of annual sales, excluding trade-related deductions, monies offered in exchange for promotion of a particular product, and have been reported as high as 10% of a company’s accounts receivable balance.

The reasons for deductions can vary greatly, but can typically be divided into three main categories:

1. **Planned deductions** are typically trade related and part of the budgets set up by sales departments for the promotion of their product. Advertising, product promotion with specific dates, products and reduced pricing involved in the contract; billback allowance, special deals offered to incent customers to move a product where items are “billed back” to the manufacturer; slotting fees, amounts charged by retailers to have products placed on their shelves; and other similar claims typically comprise this category and represent a large percentage of incoming deductions. Because these deductions are expected and budgeted for, a credit professional should focus on quick resolution as there is very little opportunity for recovery of these claims unless the customer failed to abide by the terms of the contract, such as deal dates and minimum buys, couldn’t provide proof of performance (copy of ad or reduced pricing) or other contractual issues. The sooner these deductions are credited to the correct general ledger or promo account, a budget or “wallet” allocated by sales to customers on an annual basis, the less impact they will have on aging.

2. **Preventable deductions** are taken for compliance-related claims. They include: EDI/ASN [Electronic Data Interchange (EDI)] is the transfer of data from one computer system to another by standardized message formatting. Advance Shipment Notice (ASN) is a document that provides detailed information about a pending delivery) issues, improper labeling, early or late shipments, pricing and any other violations of the routing guide, (instructions and the rules of engagement for shipping products from suppliers to customers), provided by the customer. These items create a significant, negative impact to deduction balances, aging and the company’s bottom line. The goal for these claims is to prevent them before they happen where possible. A proactive approach is necessary and will reduce the risk on the current balances as well as prevent future claims from being taken. These claims generally require cross-departmental cooperation from other areas such as shipping to resolve. Negotiations are common and can be used to not only reduce the amount being penalized, but also for a grace period to correct problems before future fines are assessed.

3. The last category is **painful deductions**. These can include items from the first two categories, but also cover shortage deductions (both full carton and concealed), post audits and unearned cash discounts (a liability recognized over time). If a company offers terms, they list the percentage of the discount, normally 1-2%, and by when the customer must pay their invoice in order to earn the discount. For example, 2% 10, net 30 would mean a 2% discount is offered if the invoice is paid by the 10th day (normally, payment must be sent by the 10th date in order to receive the discount) If no discount is taken, the customer would have up to 30 days to pay. Other associated terms are DOI (date of invoice), ROI (receipt of invoice) and ROG (receipt of goods). These claims are
typically invalid, but take a significant amount of time and resources to resolve and recover. Consistent and regular follow-up on these items is critical to protect profit margins and to ensure the company does not become a target for abuse in the future.

A key to effective deduction management includes the following: identify, quantify, analyze and strategize. The importance of properly identifying deductions can’t be stressed enough. The credit professional can’t manage a problem they don’t understand. Knowing where the specific challenges lie helps to focus efforts and resources.

In addition to understanding the type of problem, being able to associate it with a dollar amount is crucial (quantify). Senior management will be more likely to provide assistance and support if they know how much the problem is costing the organization.

The next key step is to analyze the deductions in more detail. Is the challenge in logistics, compliance or some other area? Once it is narrowed down, it is easier to identify the root cause of the problem. For example, if shortages are a challenge, the following questions can be asked:

- Is the challenge with concealed or full cases?
- Are the shortages coming from a particular distribution center or warehouse?
- Is it a particular SKU or Stock Keeping Unit, a unique identification number assigned by the warehouse, causing the shortages?

And so on ...

Once the analysis is completed, the credit department can begin to strategize a response and also identify what other departments or personnel need to be involved in the solution.

After research is complete, the next step is to quickly get the valid deductions cleared and off the aging report. If a claim is valid and there is no opportunity for recovery, it shouldn’t remain on the trial balance sheet month after month.

Invalid deductions need to be addressed quickly and consistent follow-up given in order to bring them to resolution. Remember the goal is two-pronged: repayment and prevention.

Not only should the invalid deduction be repaid, the situation should be prevented from happening again in the future.

Regardless of the approach, the more opportunities there are to be proactive when dealing with deductions, the more effective the management. Minimizing negative impact in this area of responsibility will be a key factor in long-term success.

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**Reporting to Management**

Reporting is delivered to senior management, executive management or the management team, which is generally a team of individuals at the highest level of organization management who have the day-to-day responsibilities of managing a company or corporation; holding specific executive powers conferred onto them with and by authority of the board of directors and/or the shareholders.

Companies have different approaches to management reporting for credit and collections and must determine what the right measures are, how often reports should be generated and reviewed, what action is to be taken and who is to take that action. A meaningful measure fills a need and meets a specific objective. Meaningful measures will support the organizations’ mission and help reach organizational goals. A measure must be compared to some standard or it has no meaning. Goals can be set by identifying the current state, the past state and the direction of the performance being measured in accordance with past organization or industry values or trends. The right measure will express a value that complements and supports the objectives of the company, division, department or subgroup.

The statement that a sale is not complete until the cash is in the bank is both familiar and true. A business organization would soon run out of operating capital if it were not continuously replenished through collection of its
receivables. Unless receivables are converted to cash on schedule, some of the company assets are unproductively tied up. Therefore, CFOs and management are concerned about credit and collections’ impact on working capital and rely on accurate and informative reporting to understand the health of the business. Credit and collections reporting can be categorized in the following sections: cash flow forecasting and working capital management reporting and these can be separated into two disciplines—financial and operational.

Financial reporting is done to support the financial statements, i.e., detailing the support for the bad debt reserve. Operational reporting is to measure performance of activities or persons or groups that are responsible for actions.

**POINTS TO CONSIDER**

- Does the company prepare reports that monitor the performance of the accounts receivable function?
  
  Such as:
  - Accounts receivable aging analysis, including amounts and percentages of delinquent accounts in each aging category.
  - Accounts receivable turnover or days sales outstanding ratios.

- Bad debt/recovery analysis.

- Are reports of such information prepared at least monthly, and the results compared to preceding periods and industry statistics?

- Are reports distributed to relevant parties as determined by guidelines or needs of the company (e.g., senior management, sales, controller, etc.)?

**Review of Credit Policy**

In order for a credit policy to maintain its relevance and continue to have a positive impact on cash flow and revenues, it must be reviewed at definite stated intervals and also in response to a changing economy, market conditions and the competitive environment.

One means of reviewing credit policy is by conducting a credit department audit. The audit should review all department activities in light of the overall policy. The result of the audit should be an objective evaluation of the department’s effectiveness, as well as the identification of any areas that need improvement.

At the time of review, information must be gathered indicating the present position and progress of the department in relation to its objectives. Short-term goals provide convenient intermediate benchmarks toward long-term objectives. If performance is satisfactory, the existing policies should be reaffirmed or new objectives set. If credit performance is less than expected, there should be a critical examination of both the policy and the way it has been applied.

The steps for changing policy are much the same as those used for its initial development. Proposed changes should be discussed with the same people who participated in the formulation of the policy whenever possible. When the changes become definite, they should be carefully communicated to all the individuals and departments concerned.

**Credit Policy Focal Points**

When a company is developing a new credit policy or is reviewing an existing one, a number of factors should be considered. Some of these are internal in nature while others are external. Depending on the company, they vary in relative importance. Together they establish the context within which credit policy must operate. Here are the major focal points that could require a policy and/or procedure:

**Focus on development of an optimal level of sales**

1. New customers:
   a. Require credit application with each request.
b. Communicate expected turnaround time for making a credit decision on new accounts.
c. Define how the request for credit and the credit decision are communicated.
d. Establish and maintain current credit department files, including contents of the files.
e. Authorize and communicate credit limits.

2. Terms of sale:
   a. Terms established by industry; clear communication internally and to customers.
   b. Consistently applied and monitored discount chargeback follow-ups.
   c. Consistently applied and monitored late payment service charges.
   d. Requests for extended term arrangements; necessary approvals clearly specified.
   e. Blanket approvals (small orders below a specified amount are either cash or automatically approved).
   f. Consignment sales.
   g. Export sales and letters of credit
   h. Sales to a debtor in possession in Chapter 11 bankruptcies

3. Credit investigations:
   a. A sign-off policy for responsibility of the control of the account developed by the size of the account.
   b. Use of credit reporting agencies clarified by the requirements for types of reports to be utilized.
   c. Obtaining bank references detailing the type of information needed.
   d. Obtaining trade references with details of information needed.
   e. Financial statement requests from customers and analysis of statements with key focal points.
   f. Use of collateral (include sample documentation, specify authorized signatures and clarify the safeguarding of documents held in storage).
   g. Perfecting liens under Article 9 of the Uniform Commercial Code.
   h. Guarantees (personal and corporate).
   i. Warehouse receipts.
   j. Letters of credit (details by types of L/C).
   k. Subordination agreements.
   l. Lien searches.
   m. Pledge of stocks, bonds or certificates of deposit.

**Minimize the carrying costs of receivables**

1. Follow-up system for past-due accounts:
   a. Responsibility and time interval for initial follow-up.
   b. A systematic program for additional follow-up.
   c. Statements or collection letters.
   d. Holding orders.
   e. Deductions and open credits.
   f. Personal visits (written summary report required).
   g. Exchange of credit information related to customer payment experience.
   h. Unauthorized shipments.
2. Internal credit department reports (assign responsibility, clarify timing and include a
distribution list for each report):
   a. Aging of receivables.
   b. Over credit limits report.
   c. Response on open items by category and age (deductions, credits, unearned
discounts, service charges).
   d. High risk account report.
   e. Report for accounts with collection agencies or in litigation.
   f. Bad debt write-off report.
   g. Travel and expense reports.

Minimize bad debt losses
1. Conversion of an open account to a note.
2. Customer counseling.
3. Collection agencies.
4. Use of outside attorneys and lawsuits.
5. Customer bankruptcy, bulk sales and assignments for the benefit of creditors.
6. Credit professional participation on creditors’ committees.
7. Authorization for accounts written off to bad debts.

Credit department organization and cost containment
1. A formal organizational chart that clarifies the positions of each member of the credit
department (authority and responsibility should be clear).
2. Human resources within the credit department:
   a. Recruiting and hiring guidelines.
   b. Educational requirements by position.
   c. Experience requirements by position.
   d. Training and development guidelines.
3. Performance review criteria with a regular periodic performance review.
4. Membership in professional organizations.
5. Workshop and tuition reimbursement guidelines.
6. Promotion and termination guidelines.
7. Credit department budget guidelines:
   a. Responsibility for preparation and content.
   b. Specific items for which policies and procedures need to be developed, including
      salaries/incentives, space and equipment, supplies, training and education, travel
      and entertainment and collection and investigation expenses.

Checklist for a Well-Defined Credit Policy
A well-defined and complete credit policy includes:
1. Formal organization of department.
2. Job description, titles and review process.
3. Credit department budget guidelines.
4. Credit documentation required for credit file.
5. Methods of gathering credit information.
6. Time limits for credit decisions.
7. Establishment of terms of sale.
8. Established credit lines and procedure for establishing new lines.
9. Procedure for communicating the decision to the customer.
10. Procedure for communicating the decision to management.
11. Procedure for communicating the decision to the sales department.
12. Procedure for communicating the decision to operations.
15. A collection policy that deals with slow-paying accounts.
16. A collection policy that minimizes bad debts.
17. A policy for unearned discounts/unauthorized deductions.
18. A policy for the handling of disputes.
19. A policy for the handling of returned and damaged merchandise.
21. A policy for the use of a guarantee.
22. Guidelines for reporting to upper management.

**Example of a Credit Policy**

An example of a credit policy is shown in Figure 8-1. It is not presented as a complete or perfect policy statement, but it provides a concrete illustration of some of the concepts discussed. Like many policy statements, this one interweaves the department’s objectives, such as “to help build a broad and durable customer relationship” and “with an aim toward promoting sales.” These lead directly into policy statements: “The credit department shall endeavor to find a suitable credit basis on which to deal with every customer;” “Marginal credit risks are to be dealt with when they are needed to complete operating schedules, and as long as they constitute a source of added net profit to [company name].”

Specific practices are implied in the policy statement but are detailed in other documents. The procedures designed to find a credit basis for sales to every customer, for example, cover such matters as obtaining financial information, establishing terms of sale and setting credit lines.
The credit department shall function under the supervision of the treasurer, and its activities shall be coordinated with overall corporation policy and the activities of the sales department.

It shall be the responsibility of the credit department to help build a broad and durable customer relationship for [company name] Corporation. In the performance of this duty, the credit department shall maintain a positive and constructive attitude toward [company name] Corporation’s customers. Discrimination in customer relationships is to be avoided. Likewise, the credit and sales departments shall maintain a cooperative attitude, with an aim toward promoting sales.

Within the bounds of sound credit practices, the credit department shall endeavor to find a suitable credit basis on which to deal with every customer that the sales department desires to have purchase our products. The decision as to what constitutes a suitable credit basis shall rest with the credit department. From the standpoint of credit, no customer shall be denied the right to purchase our products until every means of selling to that customer has been exhausted.

Standards by which credit risks are accepted or rejected shall be flexible enough to permit the maximum of profitable sales by [company name] Corporation. Marginal credit risks are to be dealt with when they are needed to complete operating schedules, and as long they constitute a source of added net profit to [company name] Corporation.

Customer contacts are to be kept on a dignified and friendly basis, conducted so as to promote a wholesome respect for [company name] Corporation and its business practices.

Credit department practices shall be designed to permit the maximum number of orders to flow without interruption through the sales department, but to provide for interception when necessary as a means of safeguarding credit extensions.

The credit department shall keep the sales department fully informed regarding the status of a customer’s account when the free flow of orders from that customer is in jeopardy.

The credit department has the collection responsibility. Sales department advice or direct help may be sought in exceptional cases.

All credit decisions shall be independently made and shall conform to requirements of law.

Credit Procedures

Closely allied to assignment of responsibility is the development of detailed procedures for day-to-day operations. These translate the general policy instructions into clear-cut rules for specific situations, including such matters as order flow, maintenance of credit files and preparation of periodic reports.

One of the principles for delegating authority and establishing procedures is to include as many situations as possible in the routines administered by lower-level personnel. This allows credit professionals, who are more highly qualified by training and experience, to deal with more complicated situations.

The following questions could be included in Credit Procedures for Evaluating Credit:

1. Does the company consider the following data concerning the general business entity when evaluating credit applicants:
   - Confirmation of the legitimacy of entity via Secretary of State, credit agency report, etc.?
   - Form of entity (sole proprietorship, partnership, corporation, government agency)?
   - Industry in which the company operates and the applicant’s position in the industry?
   - Years in existence?

2. Does the company evaluate the following factors concerning the credit applicant’s supplier payment history:
   - Payment experience?
   - Consistent treatment of suppliers?
   - Length of relationship with suppliers?
- Any suppliers restricting credit?
- Any lawsuits, liens and/or judgments present?

3. Does the company evaluate the following factors concerning the credit applicant’s
   banking relationship:
   - Loan payment experience?
   - Average deposit balances?
   - NSF History?
   - Availability and compliance on bank/credit lines?
   - Are loans/credit lines secured or unsecured? If secured, what is used as collateral?

4. Is the reliability of financial information on credit applicants considered, including the
   extent of outside CPA involvement, if any (i.e., audited/reviewed/compiled/etc.)?

5. Is the credit applicant’s financial information evaluated and historically trended, using
   techniques such as:
   - Ratio analysis?
   - Cash flow analysis?

6. Are the results of the financial analysis clearly documented?

7. Are credit decisions and the support for those decisions documented for future
   reference?

8. Do certain accounts get automatic credit approval (based on dollar limits under a certain
   amount)?

9. What credit scoring techniques are used to evaluate credit worthiness?

10. Has the customer demonstrated the ability to pay bills in a prompt manner?

11. Is there a special process for riskier accounts?

12. How does the prospective customer compare to other companies in its peer group?

13. Are credit decisions made within a reasonable time frame, as outlined by the organiza-
    tion’s guidelines?

The following could be included in Credit Procedures for Credit Approval and Administration:

- **Terms of Sale.** A complete list of the terms offered by the company and a brief explanation
  of how they are used.

- **Terms Codes.** Terms of sale can be coded to facilitate processing of information and the
  code should be shown on all sales orders and invoices. The procedure for administering the
  codes should be described, including the treatment of multiple codes and exceptions.

- **Credit Instructions.** Daily routines used to process all orders in accordance with prescribed
  credit lines and terms. Forms should be shown wherever used.

- **Credit Recommendations.** Organizations using referral limits that recommend credit for
  approval to a higher level should include the recommendation form.

- **Credit Files.** List of information that must be kept up to date, such as current credit agency
  reports, credit recommendations and financial statements.

The following could be included in Credit Procedures for Collections:

- **Normal Procedures.** Each account is a separate collection problem. Placing it into a category
  by size or type assists in determining the...

Comprehension Check
What credit procedures are used for credit approval and administration?
intensity of collection effort required. Several means for collection follow-up are letter, email, phone, personal visit and joint credit and sales action. Copies of the series of form collection letters should be included.

- **Collection Schedule.** Collections should use a definite schedule that will provide for systematic review. Details should be described.
- **Lockbox System.** Descriptions, such as bank procedures and company guidelines for returned check processing, and other tasks, should be included.
- **Advance Payments.** Procedures for handling these items should be described.
- **Customer Deductions.** Copies of typical correspondence and departmental guidelines should be included.
- **Note Arrangements.** Copies of the notes used by the company should be included. In addition, important points in preparing notes should be included, such as correct maturity date, correct interest rate and correct signature.
- **Account Referral.** If normal collection procedures fail to net the necessary results, the account should be placed with an attorney or collection agency. Typical documentation should be included as exhibits.
- **Creditors’ Extension Agreements.** As a major creditor, a company can initiate or join in a creditors’ extension agreement to permit a debtor to set aside existing debt under an established plan. Standard documentation should be included.
- **Bankruptcy Proceedings.** Standard documentation and procedural guidelines should be included.
- **Allowance for Uncollectibles and Write-offs.** Guidelines for reporting and handling these items should be discussed.

### Comprehension Check

What credit procedures are used for collections?
Key Terms and Concepts

Advance Shipment Notice (ASN), 8-14
Advertising, 8-14
Analyze deductions, 8-15
Bad debt, 8-13
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Strategize response, 8-15
Terms of the contract, 8-14
Terms of sale, 8-9
Trade-related deductions, 8-14
Unearned cash discounts, 8-14

Comprehension Check

1. What is a policy?
2. Why is the difference between an implied and a stated credit policy?
3. What is a procedure?
4. List the four elements of a credit policy.
5. What questions build the foundational components of a credit policy?
6. What credit procedures are used in evaluating credit?
7. What credit procedures are used for credit approval and administration?
8. What credit procedures are used for collections?
A company’s credit policy is typically designed and established by top-level management.

The first step of a **credit policy** is to establish objectives.

A credit policy can either be **implied** or **written**. A **written** or **stated policy** leaves fewer chances of error or misunderstanding across the organization or credit department. A written policy also ensures consistency throughout an organization as it pertains to managing its credit.

Credit policy varies in complexity. For instance, cash only is a form of a credit policy that may be instituted by a business.

Credit policy establishes the direction of the credit function within an organization, while credit procedures govern the steps used in the overarching principle. In order for a policy to be effective, it must be directly and explicitly related to action.

The four essential elements of credit policy are:
- Establishing the credit standard
- Determining credit availability
- Setting credit terms
- Defining collection policy

The short-term application of a policy should be flexible.

**General factors** that influence the role of credit within an organization include:
- Type of customer
- Geographic location of customers
- Overall economic conditions
- Business conditions
- Competitive position
- Merchandizing policy
- Type of merchandise
- Margins on the merchandise
- The price range of merchandise

The mission of a credit department should establish the long-range focus of the policy and define the purpose of the credit department.

The five key credit department objectives are:
- Optimize sales and cash flow
- Minimize carrying costs for accounts receivable
- Minimize risk and bad debt
- Monitor the cost of the credit department
- Convert accounts receivable to cash as quickly as possible

Several factors, such as terms of sale and credit risk, influence the goals of the credit department. Monitoring these factors using standard benchmarks, like days sales outstanding or average dollar amount of invoice, may be essential in reaching organizational goals.

Within a credit policy, it is important to define organizational roles, responsibilities and authority surrounding credit decisions.

When evaluating creditworthiness, it is always important to consider the Five Cs of Credit, while basing a decision primarily on the credit applicant’s willingness to pay, taking into consideration their payment history and ability to pay, as shown by their financial situation.
• Credit policy should specify the following:
  – Terms of sale
  – Credit limits
  – Monitoring accounts
  – Collections
  – Bad debt
• It is critical to realize that a sale is not complete until payment is received.
• Credit and collections reporting can be categorized as: cash flow forecasting and working capital. Therefore, these can be separated into two disciplines: financial (reporting to support the financial statements) and operational (reporting to measure the performance of individuals or groups within an organization). Furthermore, a measure has no meaning unless compared to a standard.
• In order for a credit policy to remain effective, it must be reviewed and updated during specified intervals, in tandem with changing economic, market and competitive conditions. It should be reviewed based on its ability to meet the five key credit department objectives.
• Procedures must be set for both credit approval and administration and for collections. Procedures for credit approval may include: credit instructions, term codes and credit files. Procedures for collections may include: a collection schedule, advanced payments, note arrangement and bankruptcy proceedings.

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