Turning Debtors Into Dollars

Effective Credit Management for Profit & Cash Flow

James Leong

• www.visions1.com.sg

James Leong, Chartered Accountant, is the managing director of VisionsOne Consulting Pte Ltd. His experience includes teaching as an Adjunct Associate Professor with National University of Singapore. His highly popular workshop, Finance for Non-finance Managers, has been attended by international participants from more than 18 countries.

Giving customers credit is a necessary part of business. So is managing it. Are you managing your credit function profitably? Are your customers the cause of your cash flow problems? What are some warning signals you need to heed when assessing your customers for credit worthiness?

Cost of credit

Most businesses offer credit terms to their customers. It makes your offer attractive to customers, and is often instrumental in getting the sales. Let's review the costs to the business when it offers its products and services on credit terms. They fall into 5 main categories:

- Cost of financing (borrowing cost or opportunity cost for funds tied up)
- Cost of running credit operations
- Cost of time to chase for debts
- Cost of bad debts
- Cost of debt recovery (legal)

Some best practices on managing credit operations

The first thing to do is by doing your part right. You incur unnecessary financing costs through delays in invoicing your customers. If you are slow in following up on overdue accounts, you create unnecessary cash flow pressure on your business. For a start:
Ensure customers are billed and invoices sent on time
Ensure accuracy of invoices
Follow up promptly from due date

Some common delay tactics

Whether your customers pay you on time, or at all, depend on two main factors: willingness and ability. Your customers may be able and yet unwilling to pay you on time. On the other hand, they may in fact be unable to pay you.

Here are some delay tactics commonly used by customers that might be symptomatic of problems with collection:

- Claiming that invoices are not received and asking for them to be resent
- Claiming that certain items on the invoice are not received
- Querying one small item on an invoice and not paying the entire invoice until that particular item is resolved
- Missing the cheque run and asking you to wait another month
- Claiming that the cheque signatories are out-of-town
- Changing payment habits: progressively slower payments

Three macro danger signals

Other danger signals about the company may also exist that could spell potential collectability problems. The credit controller usually has limited direct contact with the customers. On the other hand, the sales personnel would have first-hand, up-to-date knowledge of the customers. This is where the finance function can work closely together with the sales function to take precaution and pre-emptive action so as to avoid a loss for the company. In particular, sales people can look out for the following during their regular customer visits, and provide the following business intelligence to their finance team:

Significant changes in key management

When key management personal suddenly resigns, including independent directors, this could possibly indicate internal conflicts and major disagreements over the overall direction of the company. If this is true, it would have ramifications on the operations, and maybe even the very survival of the company.

High turnover in finance department

The finance head is usually the first one in the company to know if there is a serious financial problem. He may also resign if he disagrees with the CEO over the accounting treatment of a major transaction which he believes might compromise his professional integrity. A short tenure of a CFO or a rapid succession of CFOs is unhealthy to a company and acts as a strong warning signal to outsiders.

Also find out if there is rapid turnover of the accounts officer in charge of accounts payables. This could be indicative that this is a highly stressed position due to pressure from suppliers chasing for payments.

Loss of major customers and excess capacity

A loss of major customers could threaten the viability of a company. This is especially so if the company relies on a few major customers for its business.

If the company has excess capacity, it may very soon lead to losses and cash flow problems as it is not selling enough to at least break even.

Taking pre-emptive action

Should your company experience the common delay tactics from your customers, and if the three macro danger signals were present, then there may be a need to consider the appropriate course of action with respect to this group of customers. This could include progressively reducing the amount of credit given and putting them on the watch list for further signs of deterioration in payment performance. Prompt and strong collection efforts may need to be activated to ensure that you limit your exposure. This would ensure a better chance of recovery of your outstanding debts.

Proper credit screening

With regards to granting credit, prevention is indeed better than cure. If you are able to perform a quick financial review of the financials of a customer to check their financial ability before even calling on them to pitch a sales (refer to my article on "Upsizing financial intelligence in a financial crisis), it might save you time and headaches down the road. Time is money. The less time your company spends chasing after delinquent debts, the more time it could spend on generating sales dollars which are translated into real cash flows.

Conclusion

The credit management process does not end with the completion of the credit application form by the customer. It is an on-going process and vigilance will pay off handsomely in terms of protecting your company's profit and cash flow. The sales team is in direct contact with customers, and hence is in an excellent position to be the eyes and ears of the finance team with regards to accounts receivable collection. This collaborative partnership will help the company stay ahead of the game and not be caught unaware resulting in being saddled with bad debts which could in turn jeopardise the entire survival of your company due to poor profitability, losses and mounting cash flow problems. Remember that an ounce of prevention is worth a pound of legal letters.