

The Entrepreneur's Guide to Financial Maturity ® **Your Credit and Collection Policies and its impact on Cash Flow**

If you have been in business for several years, by now you might have experienced some cash flow problems. If sufficient sales are being generated, typically the problem would arise when there is a build up in accounts receivables. Cash flow often dwindles when clients or customers are paying 60 or more days past the due date. Undoubtedly, if a high percentage of a company's accounts receivables are past due (unpaid for 60 day or longer), unless your profit margins are extremely high, it will eventually cannibalize many of the company's financial resources and create a cash crunch.

One warning sign is when the percent of past due accounts receivables exceeds 20.0% of total outstanding receivables. Management must understand the cause of the company's poor collections and must take corrective actions, immediately. If the past due accounts exceeds the 30.0% level the company may have to bring in a professional to develop an action plan. Most companies would be struggling to survive by the time the past due accounts exceeds 30.0%.

There can be several issues as to why significant amounts of a company's accounts receivable do not get paid on a timely basis. For example, if there are:

- Lack of customer diversification
 - Industry Diversification
 - Geographical Diversification
 - The company's client base
- Customers expectations were not met
 - Product or service specification shortfalls
 - Installation and/or servicing problems
 - Unsatisfied customers
 - Missed deadlines
- Poor communications

- Poor Credit Policy
 - Providing credit to companies that are poor credit risks
 - Providing credit to companies that have a poor payment history with vendors
 - Failing to monitor customer accounts receivables balances
 - Failing to address collection issues immediately
- No Credit Policy
- Poorly drafted contracts
 - Containing ambiguity
 - Containing undefined duties, responsibilities and obligations of parties
 - Failing to address contingencies that arise

Some of those issues listed above relate to the product or service that is being delivered. Many issues relate to credit policies and documentation.

Customers might withhold payments to gain the product or service providers attention. For example, if operational or servicing issues are causing accounts receivables to swell and the issues are not appropriately addressed the product or service provider (vendor) will fail. If the salespeople are being overzealous and overselling the product or service, this will cause unmet expectations. Again this issue needs to be addressed. These operational and sales issues are not the primary focus of this article. The primary focus of this article is the correlation between a company's credit and collection policy and cash flow.

Establishing a Credit Policy:

Whenever a company is not being paid in full, in cash, at the time a product or service is provided, that company is extending credit. Although there are numerous companies that provide a product or service that collect at the delivery of the product or service, today's society has become less dependent on cash and more dependent on credit, checks or other methods of payments. A vendor has several options including:

- Accepting cash, money orders or COD
- Requiring a deposit or retainer prior to commencing work, ordering materials or shipping a product

- Accepting checks – with verification
- Accepting checks – without verification
- Accepting various credit cards
- Requiring automatic periodic payments by Electronic Funds Transfer or Credit Card
- Requiring progress payments
- Billing terms – discounts for early payments
- Billing terms – interest on late payments
- Curtailing additional work on client until past due payments are cleared up
- Executing contracts with appropriate provisions to cover a wide array of situations that may or may not occur

Obviously, before establishing a credit policy, a vendor must understand the risks and their tolerance to risk, the implications of taking too much risk or having too stringent, too lax or no credit policy. A relatively small company that does not have significant amounts of cash or capital often can not afford the same credit policy as its better capitalized competitors. Slow payment or non-payment by a small number of medium sized accounts can cause a small vendor to go under. Whereas, the same number of slow payers or non-paying customers probably will not have a significant impact on the larger, better capitalized vendor. Simple steps such as curtailing additional work on a client until past due payments are cleared up are often not even considered, often resulting in larger losses.

Understanding the competitors credit policies are important. However, their policies can not be adapted blindly, without the appropriate client-by-client due diligence. It is doubtful that a seasoned competitor will accept every client that applies, neither should you. Failing to match a competitor's credit terms may put a company at a competitive disadvantage, but it does not necessarily mean a lost sale. Often it is a differentiator not necessarily a deal killer. The vendor must differentiate its product or service (from its competitors) and develop other incentives so that the customer purchases from them.

It is important to recognize the implications of having clients that do not pay. If a vendor has an average profit margin of 20% and a customer that owes \$1,000 does not pay, it means that the vendor must sell at least \$5,000 of products to recover from the loss.

It is important to understand if a company lacks customer diversification and has more than 50% of its revenues generated from a few clients, that company can easily get themselves in a situation where 20% or more of its accounts receivables are past due. Similarly, when a vendor attempts to acquire a client that is considerably larger than its average size client; there can be a significant financial risk.

Vendors often try to acquire “trophy” clients, such as clients that have a great industry reputation or celebrity status clients that can enhance a vendor’s reputation or increase the vendors profile within a market niche. Often an entrepreneur is blinded by the upside, without understanding the downside of these transactions. Often larger clients or trophy clients will require significant discounts. What if they become a slow payer or worse? There are certain trophy clients that take the position, “you want to get paid, sue me.”

If margins are thin, will the vendor be able to raise funds secured by the receivable or will the vendor be able to factor the receivable and still make money? Many of the larger companies have billing cycles, if a vendor misses a billing cycle it could be close to 60 days before the vendor gets paid. The lack of cash flow from a major client could create major cash flow problems, especially with a large the initial order. The vendor must make sure its capital base and/or financing is in place before accepting the order.

Anyone involved with collections can agree that, unlike fine wine, accounts receivable deteriorate with age. The longer it takes to collect, the less likely it will be collected (unless you have sufficient collateral). Most accounts receivable that are 90 days overdue cannot be financed or alternatively are financed or sold at a steep discount. There is a greater likelihood you will not recover 100 cents on the dollar if the accounts receivable isn’t paid within 90 days after it is due.

Small businesses and undercapitalized vendors should protect themselves against generating sales, especially large sales that have a good potential of remaining unpaid for 60 days.

Anticipated Impact on the Vendor’s Revenues and Cash Flows:

Credit policies should be reviewed and modified on a periodic basis. Clearly, a credit policy that was established during an economic boom will not necessarily be appropriate during economic slowdowns.

. A credit policy that was established when a company was small and could not absorb certain risks from slow payers might be adjusted to reflect its growth, stability and willingness to assume increase risks.

A company's credit policy must be consistent with its target market. If someone is trying to attract start-up companies as clients, a vendor should have a policy consistent with making it easy for start ups to do business with the vendor. For example, if the vendor prints business cards, incorporates businesses or provides other products or services, it should accept credit cards. If the vendor provides high priced services, accepting credit cards might not be an appropriate policy, accepting deposits or retainers might be more appropriate.

Financial Due Diligence:

Before you extend credit to a customer, or potential customer, the decision should be based on the best information available. At a minimum a vendor should obtain copies of credit reports and obtain credit references. Depending upon the size of the order, obtaining the customer's financial statements might be prudent. Banks and other financial institutions ask for financial statements prior to extending credit, it is appropriate for many vendors to do the same.

Contracts:

If complex products or services are being sold, it would probably be more appropriate to enter into a contract that details the terms, conditions and payments due and their due dates. A vendor might want to stipulate its rights to discontinue working on the project in the event of late payments, defaults etc. For provisions to be included in a contract consult an attorney.

Financial Maturity® is a registered trademark owned by Morris Bocian. Copyright © 2003, 2004 and 2005 Creative Business Planning Incorporated. All rights reserved. All information is from sources deemed reliable. Such information has not been verified and no express representations are made nor implied as to the accuracy thereof, and it is submitted subject to errors and omissions, and is subject to change or withdrawal without notice.