Establishing an effective credit policy

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"A policy may be defined as a general course of action developed for recurring situations, designed to achieve established objectives"(Miller)

Why develop a formal credit policy? There are at least four reasons:

- Managing your company's receivables involves limiting bad debts and improving cash flow. Cash and receivables are two of any organization's most valuable current assets. A well reasoned and structured approach is vital.
- Having a policy helps maintain consistency throughout your department. It establishes that there is a process to the way you conduct business.
- Decision-making follows a logical progression. This provides a sense of fairness that will improve relations with internal and external customers.
- Lastly, it provides visibility for the credit department as a separate entity and properly positions the credit department within the context of the organization as a whole. (Miller)

Credit management policies provide specific rules regarding transaction size, signing authority, collateral requirements, customer type, payment terms, transaction types, and deal stipulations.

Any company's credit policy will likely be driven by its' sales goals and tolerance for risk. Collection goals are linked to targets that drive the accounts receivables process. Those collection goals provide the basis for benchmarking your department's performance.

Installing a very liberal credit policy will increase both sales and bad debt. At the other end you could install a very conservative policy of selling to only well-established companies with strong financials. This will result in much fewer sales but very little in the way of bad debt. Most likely, the optimum for your organization lies between these two extremes.

Establishing performance standards should ensure consistency in your credit and collection processes. When set up appropriately they can really revitalize your order-to-cash cycle.

Benefits of a Credit Policy:

- Effective portfolio management of key accounts
- Providing excellent customer service
- The ability to track the effectiveness of your collections efforts
- Maintaining a strong DSO(Days Sales Outstanding)
- Establishment and assignment of credit ratings
- Conducting trend analysis on problems and disputed billings
- Establishment of recovery action for problem accounts
- A procedure for resolving internal / external customer inquiries in a timely fashion

Once the credit policy and departmental goals have been established they are not etched in stone. It will be necessary to both monitor and perhaps revise one or both from time to time in order to measure results against desired standards.

In addition, a changing business climate or organizational goals will necessitate adjustments.

Conditions That Affect A Credit Policy:

1. Market Competition
2. Overall health of the economy
3. Company Profit margins
4. Desirability of the customer
5. Sales numbers / goals
6. Inventory levels
7. Product Obsolescence
8. Selling Season(s)
9. Cash flow requirements of the company

Credit department goals should be updated monthly or quarterly and included in the policy. Goals should take into account current market conditions and the overall direction of your organization. Within different industries and/or companies there are several key indicators that get monitored when judging department performance.

A few of the more common Key Performance Indicators (KPI) are:

- DSO – Days Sales Outstanding
- Percentage of Receivables to collect (monthly goals)
- Bad Debt Write-off percentage
- Percentage of Aging Over 90 Days
- Dollars collected month

As mentioned earlier, the identification of departmental roles and assigning areas of responsibility is key to a well functioning team. Senior staff and the credit manager should work together in deciding who does what within the department. Who will approve special terms? What will be the credit authority for each level up the chain of command? Who can write off outstanding balances and how much? Which team member can approve collection settlements, etc.?

Below is a typical department member list. A job description of each position should also be included:

Chief Executive Officer
Chief Financial Officer
Controller
Credit and Collections Manager
Credit and Collections Supervisor
Credit and Collections Lead (Optional)
Credit and Collections Specialist

The process of determining credit risk and establishing credit limits will be key to your entire organization. Who you decide to extend credit to will ultimately determine how successfully you will collect outstanding dollars.

In approving new accounts credit professionals usually implement some combination of the following:

-Financial Statements

-Bank References
-Trade References
-Dun & Bradstreet customer reports
-Credit Scoring reports [Dun & Bradstreet, Graydon, Experian, etc.]
-Security Deposits
-Insurance Certificates

Collection Procedures. The procedures that a company uses in order to provide adequate cash flow is at the heart of the credit function. Management needs to implement an efficient and effective process for collecting delinquent accounts.

The collection procedure section should include:

- When and how to contact a customer: phone, fax, email.
- How often to contact a customer for follow up.
- When to place an account on credit hold.
- Procedures for resolving disputes, deductions, issuing credit, etc.
- Procedure for assigning delinquent accounts to an outside collection agency.
- When to write off an account to bad debt.

Terms and Conditions are used to define an agreement between buyer and seller that includes specification of any restrictions regarding the use of goods or services. The terms and conditions document should also spell out information regarding delivery, who pays shipping costs, payment terms, even late fees if appropriate between a buyer and seller.

Any exceptions to a company's standard terms for payment must be authorized by upper management and approved based upon competitive practices and a satisfactory ROI (Return on Investment).

Ideally, a company's T's and C's will minimize the likelihood of a dispute between both parties. Having a written policy dealing with terms of sale issues is essential.

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