Why Credit & Collections Are Crucial to Business Success

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There's an old saying in business that "a sale isn't a sale until you get paid." This reflects the fact that while sales are certainly nice, credit and collections are just as important to a company's long-term financial success. In fact, an argument could be made that credit and collections are even *more* important than sales.

Why? Because companies are more likely to fail due to cash flow problems stemming from poor credit policies and collection procedures than they are from a sales slowdown. Therefore, it's critical to establish firm policies for how your company will grant credit to new customers and go about collecting money from customers to whom credit is granted.

Establish a Formal Credit Policy

Every business should have a formal credit policy that details in writing how decisions are made when it comes to granting trade credit. This isn't something that should be handled based on "gut feelings" by owners and managers about a customer's ability to pay. By drafting a formal credit policy, you will show your customers that you're serious about credit and collections — as well as provide yourself with some legal protection should it ever become necessary to take a customer to court for non-payment of an invoice.

As you establish your credit policy, do so with your cash flow needs in mind. Start with the level of cash needed to meet your daily working capital expenses. Also, carefully monitor your days sales outstanding (or DSO) to determine how long it's taking you now to collect accounts receivable. Based on these factors and your industry's norms, determine what kind of payment terms you can offer to customers — for example, net-15, net-30 or net-45 days.

Next, draft a credit application. All new customers should be required to complete the application before credit is granted — no exceptions! A credit application typically should include the following:

- A description of your criteria for evaluating credit.
- The maximum amount of credit that will be extended to customers.
- Your specific payment terms.
- Accruing interest and penalties payments that are late.
- Steps that will be taken to collect past-due receivables.

You should also use the credit application to ask customers for credit references. It is important to ask these references the customer's payment patterns. Before credit is granted, you may decide to run credit checks with Dun & Bradstreet. There is a small fee for running a customer credit check, but this could more than pay for itself if it uncovers past payment problems with a customer.

Set Firm Collection Procedures

Establishing a formal credit policy is just half the credit and collections battle — the other half is setting firm procedures for collecting accounts receivable. The payment terms you offer to customers don't mean anything if you aren't willing to enforce them with collection procedures that have teeth.

This starts with generating an accounts receivable aging report that will tell you the current payment status of all your customers (e.g., 0-30 days, 31-60 days, 61-90 days, 90 days+) and exactly how much money (if any) they owe. With this information in hand, you can focus your collection efforts on the customers who are most likely to pay the most amount of money the soonest.

Studies have shown that the longer past-due receivables stretch out, the less likely they are to ever be collected. This makes taking prompt action on past-due accounts critical. As soon as accounts become past due, you or a manager in your finance department should contact the customer by phone or email to politely inquire about the payment status. The late payment might just be an oversight, or maybe the customer is experiencing cash flow problems. Either way, you need to know why payment is late so you can plot a course of action going forward.

If the customer is upfront and honest about their cash flow problems, you might consider offering them a payment plan — especially if it's a long-standing customer who has paid promptly in the past. If you do, put the plan in writing and specify the amount and frequency of payments and the date when full payment is due, as well as the interest rate (if any). It's generally smart to require that full payment be made within six months.

If a past-due client is dodgy or uncooperative, then you must decide whether to take more aggressive action. For example, you could send one or a series of dunning or collection letters reinforcing the payment terms and the fact the client is in past-due status. The letter(s) should detail the steps you plan to take going forward to collect payment, including possibly retaining an attorney or hiring a collection agency. But this is a serious threat that shouldn't be made lightly. You must weigh the possible loss of future business with this client, assuming you want to keep the client, against the cost of writing off the debt to decide the best course of action to take.

Concluding Thoughts

While sales are nice, credit and collections are just as important to your company's financial success, if not more important. This makes it critical to establish firm policies for how your company will grant credit to new customers and go about collecting money from customers to whom credit is granted. Every business should have a formal credit policy that details how credit-granting decisions are made, as well as firm procedures for collecting accounts receivable. An outsourced CFO services provider can help you draft a formal credit policy and establish procedures for accounts receivable collections.

About CFO Edge

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