2 The financial effects of credit management

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The cost of credit; Free credit?; The effect of credit on profits; The effect of credit on liquidity; The financing of credit; Cash flow; Measurement of debtors; Cash targets; Planning and budgeting debtors; Summary

THE COST OF CREDIT

Money costs money. That principle has to be the foundation upon which all credit transactions are based – that is to say that the granting of credit, though beneficial for business as a whole, is not without cost, either to the supplier or to the buyer, or to both. It follows therefore that the process of granting credit to customers, and the tasks of risk assessment and risk analysis, amount to no more than weighing the benefits of granting credit against the cost to the supplier of doing so. Furthermore, that cost element is not restricted to non-payment, or bad debt losses, but applies to cost of the credit period itself *and* the cost incurred in late payment. It should always be remembered that there is an inevitable time delay between funds being expended by the seller in acquiring raw materials and paying wages, etc. for the production and delivery of the goods and the receipt of funds from the buyer in respect of those goods or services. The cost can be passed on in prices or absorbed by the seller, but ignored it can never be.

The fact that money *does* cost money is reflected in interest rates. It is dangerous in times of low, or relatively low, interest rates for companies to play down the cost element of granting credit, or even to ignore it altogether. In the UK, interest rates have seen great variations in relatively short time spans. One criticism of government has constantly been that of instability – all businesses prosper better when able to plan and forecast over longer periods of time their borrowing costs. Stability of interest rates allows an element of certainty in forward planning and can dictate strategies on investment, marketing, employment, etc. All governments use interest rate manipulation as a method of regulating the economy as a whole, and that will probably always be true, but the policy has to have some built-in stability element for it to achieve the desired results.

When trying to offer simple illustrations of how credit is a cost to the seller it is better to ignore actual rates (as at the time of writing) or predicted rates, but to seek to demonstrate the cost of credit on a formula basis which can be readily understood. Interest rates in the UK, for example, hit their lowest for a generation in the first quarter of 2003, when a decade earlier rates had never been so high. A good example, therefore, would be to assume a seller's borrowing costs to be 12% per annum, because it is easily converted to 1% of the value of the unpaid invoices or debt for every month that elapses. Some companies allowing 30 days credit to their customers include one month's cost of borrowing in their prices. Others, perhaps more cost-conscious, include not one month's interest but the cost for the average debt payment period for all accounts. This may be seen to 'penalise' the prompt payers, who are in effect paying for the costs of late payment by the slowing paying customers. For that reason, some sellers invoke their right, under their conditions of sale, to charge extra interest for late payment. There are some companies, however, who do not build into their prices *any* element of the interest costs being taken into account. It is precisely because credit managers *know* that money costs money, that they should be able to clearly illustrate this fact to their colleagues in sales as well as finance. When customers ask for 'longer to pay' or when extra credit terms are being negotiated, the seller should always recover the extra credit cost either by openly adding it or by price increases.

In the five examples in Figure 2.1, all the firms have a 5% profit level where nothing is allowed in prices for credit and funds cost 12% per annum. It is easy to see how the cost of credit has a direct impact.

If cost/price inflation were present, its percentage should be added to the cost of money in calculating the true cost of credit. For example, if annual inflation is 6%, each month's delay in a customer's payment makes it worth 0.5% less when received. In such an example a 90 day delay costs the seller 1.5% for inflation, plus 3% for interest, totalling a flat 4.5% off the debt value when received.

	Firm A Cash only	Firm B Cash 2% discount	Firm C 30 days net	Firm D 60 days net	Firm E 90 days net
Annual sales	12 000	12 000	12 000	12 000	12 000
Debtors	0	0	1000	2000	3000
Net profit (before credit cost)	600	600	600	600	600
Cost of credit	0	(240)	(120)	(240)	(360)
Net profit	600	360	480	360	240
	5%	3%	4%	3%	2%

Figure 2.1 Depletion of profit by credit terms

FREE CREDIT?

It would be easy for anyone to assume that there *was* such a thing as free credit. The consumer is assailed from all angles with 'tempting' offers – '0% finance', '3 years interest free', etc. – and the advertising hype is at every turn, from cars to hi-fis, fridges to caravans, cruises to carpets. Perhaps this influence spills over into trade credit, where there may linger a perception among some companies, particularly those which are sales driven, that credit can be 'free'. The short answer is that it cannot. As we have seen, there is an effect on profit, which is a direct cost of credit impact. The fact remains that money costs money. Where the element of alleged 'free credit' may have some validity is for the buyer himself – it may be on the surface that the selling price of the car is £10 000, and the total amount to be paid over 3 or 4 years by the buyer is £10 000. Free to the buyer, then? Not if the price of £10 000 includes the sum of £1000 to cover credit costs!

The real nature of both perceived, and perhaps actual, free credit lies in the inability of companies to recognize and account for the cost of credit. Because trade credit rarely includes the cost of credit as a separately shown item on the invoice, it is easy for the uninitiated to accept that credit is free. As we have seen, this is far from the case. The best thing would be for everyone to be able to accept the definition of credit as being something (money) which is bought from a supplier (bank) at a price, in just the same way as any other goods or services are bought.

The real rub comes in the form of extended credit, not negotiated or agreed with special terms, but taken by buyers in the form of late payment. Unless interest is charged, *and collected*, on such accounts, then the supplier *is* effectively giving free credit, the effects of which hit the bottom line just as surely as bad debt losses.

There is, of course, another cost associated with the granting of credit, which further erodes any notion that may linger of credit being free. The credit grantor has to establish and operate a credit department, which involves all the usual costs associated with any working office department, not least of which will be staff salaries. In real terms, the costs associated with financing a debtors ledger will be saved by employing dedicated credit staff and thus reducing the debtors ledger.

THE EFFECT OF CREDIT ON PROFITS

Unless a seller has built into his selling price additional costs for late payment, or is successful in recovering those costs by way of interest charged, then any overdue account will affect his profit. In some competitive markets, companies can be tempted by the prospects of increased business if additional credit is given, but unless it can be certain that additional profits from increased sales will outweigh the increased costs of credit, or said costs can be recovered through higher prices, then the practice is fraught with danger.

Company A	Situation A	Situation B	Situation C	Situation D
Sales	12 000 000	16 000 000	15 000 000	18 000 000
Credit days	60	90	90	120
Debtors	2 000 000	4 000 000	3 750 000	6 000 000
Net profit (before cost of credit)	600 000	800 000	750 000	900 000
Cost of credit	(240 000)	(480 000)	(450 000)	(720 000)
Net profit	360 000	320 000	300 000	180 000

Figure 2.2 The effect of credit on profit

In Figure 2.2 Company A has a 5% profit level where nothing is allowed in prices for credit and funds cost 12% per annum. Under its normal terms of 60 days, it is achieving sales of £12 000 000 per annum, and a net profit of £360 000. In an attempt to increase sales, credit terms are increased to 90 days, and targeted sales to go up by one third to £16 000 000. It will be noted, however, that net profit would drop to £320 000. Sales in fact only increase by a quarter to £15 000 000, and the net profit achieved is only £300 000, a decrease of £60 000 on increased sales of £3 000 000. In some desperation, the company extends credit to 120 days and sales are now 50% higher than originally, at £18 000 000. Net profit, on the other hand, is now *down* 50% at only £180 000.

Putting it the other way round, see what can be achieved by increasing sales and *reducing* debtors. If sales of £12 000 000 with debtors of £3 000 000 (90 days) could be brought down to debtors of £2 000 000 (60 days), then reducing debtors by one month saves £120 000 per annum – more than enough to cover the salary of a good credit manager!

Most companies can readily see losses incurred by bad debts, customers going into liquidation, receivership or bankruptcy. The writing off of bad debt losses visibly reduces the Profit and Loss Account. The interest cost of late payment is less visible and can go unnoticed as a cost effect. It is infrequently measured separately because it is mixed in with the total bank charges for all activities. The total bank interest is also reduced by the borrowing cost saved by paying bills late. Credit managers can measure this interest cost separately for debtors, and the results can be seen by many as startling because the cost of waiting for payment beyond terms is usually *10 times* the cost of bad debt losses.

Figures 2.3 and 2.4 are in active use by many credit managers to demonstrate the need for the right action at the right times. By preventing a bad debt loss, or at least reducing the loss by the time the customer fails, a credit manager avoids the impact of cancelling out previously booked profits on very large sales values. On the chart for overdues, the intersection of borrowing cost with the net profit margin shows the window of time available for collection before the sale becomes a waste of time. Clearly, high margins and cheap money allow a soft

Bad debt	Pre-tax profit percentage			
£	5%	8%	10%	12%
50	1000	625	500	417
500	10 000	6250	5000	4170
5000	100 000	62 500	50 000	41 700
10 000	200 000	125 000	100 000	83 400
50 000	1 000 000	625 000	500 000	417 000

Value of previous sales on which profit has been lost, or extra sales needed to recoup the bad debt total.

Figure 2.3 Effect of bad debts on sales

Cost of borrowings	Net profit on sales				
	10%	8%	6%	4%	2%
5%	24.0	19.2	14.4	9.6	4.8
6%	20.0	16.0	12.0	8.0	4.0
8%	15.0	12.0	9.0	6.0	3.0
10%	12.0	9.6	7.2	4.8	2.4
12%	10.0	8.0	6.0	4.0	2.0
15%	8.0	6.4	4.8	3.2	1.6

Number of months overdue after which profit is absorbed by interest cost.

Figure 2.4 The effect of overdues on profits

impact, whereas high interest rates combined with poor margins require very strict collection processes.

Presenting the kind of tabulation shown in Figures 2.3 and 2.4 to senior management sharply demonstrates the value of proactive credit management, from the initial process of opening a customer account to the monitoring of that account on the ledger throughout its existence. It also emphasizes, if such emphasis is necessary, the need for the company to have collection policies and procedures which encourage prompt and effective action in the right places at the right time.

THE EFFECT OF CREDIT ON LIQUIDITY

Liquidity is cash, or cash is liquidity. From either angle, the answer is the same. Looking at a company's balance sheet can reveal the ability of the company to meet commitments as and when they fall due, or whether all their resources are tied up in fixed items such as land or buildings. A company rich in fixed assets may still be short of cash and therefore have difficulty in meeting current obligations. Imagine owning your own house in the leafy suburbs, but having no income and facing this quarter's electricity bill – the house may well be worth £250 000, but the bank account is empty and the only way the electricity bill can be paid is by selling off some of the family silver. Ownership of valuable fixed assets may have a favourable effect on the creditworthiness of an individual or a company, because if push came to shove, the supplier can take comfort from the fact that assets can be sold off to meet debts. Fixed assets, on the other hand, have little or no impact on credit *ability* – it is the ability of the buyer to pay bills when they are due which can make or break.

The cash needed to run a business comes from somewhere, and at its most basic, there are two contributors:

- owners' capital and reserves
- borrowing.

The first relates to the amount put into the business by its owners – proprietors, shareholders, etc. – and the amount built up in reserves from trading profits from previous years. It makes good business sense to utilize some of the profits to create reserves which can assist survival during more difficult trading conditions. The second comes in the form of capital and loan financing, usually from the bank, and assists in the purchase of fixed assets such as plant and equipment, as well as contributing to working capital. Most credit managers recognize a third source of finance, which even though it may be unofficial is quite often seen as the most readily available – trade suppliers. It is an indication of inevitability that if the owners have no more funds and the bank will not extend any further facilities then the business will rely upon suppliers to enable it to continue trading. It is for that reason that credit managers focus on working capital as a major contributor to the credit decision.

THE FINANCING OF CREDIT

Buying the daily newspaper at the local newsagents is a simple enough transaction by any definition. Though the purchase itself is for cash, the deal is in fact at the end of a very long line of credit arrangements, some substantial. The newsagent receives supplies daily from the wholesaler (which may or may not involve credit), and the wholesaler receives supplies daily from the newspaper publisher (which almost certainly will involve credit). Looking at the newspaper itself, however, reveals a maze of manufacturers, service providers, wholesalers and distributors, all dealing with each other on credit terms. Many of those suppliers have their own line of credit deals leading up to supplying the newspaper publisher – trees to paper, chemicals to ink, aluminium to printing plate, etc. – each subsequent deal being dependent on satisfactory completion of previous deals. Throughout this credit chain, sellers are supplying buyers, credit terms are negotiated, invoices raised and payment collected.

The payment of each credit transaction between each of the interested parties has an effect on the whole to a greater or lesser extent, and if a link in that chain is weak, or even broken, this impacts on all, even to the extent of the consumer being not able to walk into the newsagent and purchase the finished product.

The chain can be complicated further by the wide variation in credit terms on offer and taken throughout the cycle. The aluminium supplier wants payment in 30 days, the printing plate manufacturer has terms of 60 days, the publisher 10 days and the wholesaler cash! The balance between the need to pay and the receipt of funds is therefore delicate, and it is the gap between buying in the raw materials, making the product, selling the product and getting paid that has to be funded.

Chapter 3 will look in detail at company credit policies, but suffice it to say at this stage that every company supplying goods or services on credit has to know what it can afford, and what it is willing to afford, by way of funding that credit gap. The longer the credit period (the time between supply and receipt of payment) and the larger the value of debtors, the more expensive it is to finance. It follows that companies look to keep debtors to a minimum, as a proportion of sales, and work towards collecting receipts to due date.

CASH FLOW

Even in an ideal world, with all customers paying on time (!), granting credit means that there will be a credit period that will require funding. The company's working capital, made up from owners' capital and reserves and borrowings, is further supplemented by operational cash flow – indeed, as already seen, that cash flow may in effect *be* the company's only real working capital.

Cash flow is defined in different ways but always comes back in the end to its effect on the surplus, or profits, of the business. The dictionary definition of cash flow is quite straightforward, being 'the movement of money into and out of a business'. Accountants define cash flow as net profits before tax plus depreciation added back, since it has not really left the cash coffers; this may well be technically correct but is not as graphic as 'I know it's my round, but I am suffering from cash flow problems, old boy'. Money comes in from paid sales and goes out in expenses to achieve those sales, mainly to creditors for supplies and in salaries and operating costs. If more goes out than comes in, and if the time lapse between in and out needs financing, then the business falls back on its resources or its borrowings to fund that gap. Bank overdrafts are meant to cope with that circumstance, and it is a fact that the two major users of expensive bank overdraft borrowings are unsold stocks and uncollected debtors.

Successful entrepreneurs, on whose every word market commentators hang, will delight in retelling their tales of growing from humble beginnings to mighty commercial empires, and more importantly exactly how they did it. We have all heard the stories about being in the right place at the right time, having a worldbeating product, or knowing the market place better than anyone else. By their own admission, however, the real key to their success was, and is, their ability to keep close control over cash flow, avoiding holding excessive stocks and collecting debts on time. Those failed geniuses, in whom observers may point to technical expertise or wonderful inventions in their financial obituaries, invariably collapsed because they focused on technical matters and forgot about cash flow. When bills could not be paid, the major suppliers and the banks closed the doors. It appears that this message is still lost on the vast array of small businesses and SMEs which in the last decade of the twentieth century and to date have been gradually replacing the larger companies and corporations as the mainstay of many economies including the UK. A major element missing from business plans submitted to banks for funding approval remains that covering arrangements for invoicing and account collection – small businesses still believe that simply doing a good job and/or supplying a good product is reason enough to be paid on time. It can come as a great shock, if not a fatal blow, to discover that though the world may beat a path to your door for the product, you have to do something positive to ensure timely payment.

At its simplest, the result of the total efforts of a business is its net profit, after deducting interest on borrowings. The way it manages its major asset, debtors, greatly influences that 'bottom line'. Businesses today pay high interest rates compared to their low net profit margins. It follows, therefore, that in order to reduce the impact of interest expense, they must concentrate on ensuring well-managed debtors (that is, unpaid sales) in proportion to all sales made.

Sales *volume* is not the same thing, and is often confused with financial success. Inadequate sales are of course lethal if they are insufficient to cover costs, but so too are booming sales if they produce massive unpaid debts for long periods. The interest cost of borrowing, while waiting for so much money to come in, can easily cancel out fragile net profits.

Every Profit and Loss Statement shows 'Interest Paid' as the last cost before Net Profit Before Tax (NPBT). The interest item results from how the net assets have been managed, that is, stock control, credit control on debtors and the credit taken from suppliers. In most companies, Interest is less than 10% of profits, but where it gets to 50% or more, the business is usually destined to fail within a year. This is because the assets are so out of control that the cost of financing them can never be recovered in trading profit and the company is producing more profit for the bank than for its shareholders! But even the bank becomes concerned above the 50% level, which is why it then appoints an administrative receiver to protect its own interests (see Chapters 5, 6 and 8 on risk analysis and pointers to insolvency).

There are four key items which progressive, and successful, companies insist on being tightly managed:

1 annual profit growth percentage, to equal or exceed sales growth percentage
2 cash flow effectiveness, to minimize external debt
3 efficient use of assets, that is, as slim as possible to achieve sales
4 interest avoidance, since the cost is a drain on profits.

It is not rocket science to suggest that good credit management benefits all four items!

An often quoted formula or ratio to indicate efficiency and effectiveness is ROCE, *Return On Capital Employed*. This is usually calculated as:

$$\frac{\text{Return (net profit before tax)} \quad 100}{\text{Capital employed (borrowing)}}$$

The more switched-on finance directors, as well as credit managers, know only too well that faster cash collections improve the ROCE on two fronts – by reducing the interest expense, profit is increased, and at the same time borrowings are reduced. Two for the price of one fits in well in the bargain-conscious environment of today!

MEASUREMENT OF DEBTORS

Knowing where we want to be and how we want to get there is very much dependent on knowing where we are today. It is not enough to wait until the auditors are in to see that debtors are out of control, or are growing at a faster rate than we expected in relation to sales. Effective credit management looks to be able to respond immediately to demands, but more importantly looks to be able to see what is happening, not just as it happens, but even before it takes hold. The most common measurement of the debtors situation is expressed as *Days Sales Outstanding* or DSO. There are a number of ways of calculating DSO, and these are dealt with in some detail in Chapter 14, but the most usual calculation is by way of the *count back* (sometimes called the *add back*) method. This measures the level of debtors, indicating the speed of cash intake, and an example of a DSO ratio is shown in Figure 2.5.

The calculation is done at month end, taking total debtors (current, overdue and disputed), and deducting total monthly sales going back in time until all the debtors figure is used up. In the illustration, therefore, August debtors equalled all the sales for the last 65 days = 65 DSO. This means that sales take an average of 65 days to be paid.

31.8.xx	Total debtors	£1 200 000		
	August sales	(£650 000)	=	31 days
		£550 000		
	July sales	(£490 000)	=	31 days
		£60 000		
	June sales (total £600 000)	(£60 000)	=	3 days
				65 days

Figure 2.5 Standard DSO calculation

A feature of any meeting of credit managers is a comparison of their DSOs. 'Mine is smaller than yours' is not necessarily a bad thing, but nor is it necessarily a good thing either! When looking at performance indicators, such as DSO, it is important to benchmark against the same industry standards. DSO as a measurement by itself does not indicate better or worse performance than *everybody* else, but does measure your own receivables performance against both your own credit terms and those of your competitors in the same industry with the same terms. One drawback of being the credit manager of a company which is part of a larger group with diverse business operations is that Head Office can fall into the trap of comparing your DSO, as a subsidiary in, say, printing and publishing, to that of another subsidiary making high performance racing car engines! The printing and publishing sector credit manager needs to be compared with other businesses in printing and publishing in order for that comparison to have genuine relevance.

Given the importance to competitiveness of debtors and cash flow, it makes sense to find out the level of cash inflow being achieved by major rivals. Every company should aim to be better than the DSO average for its own industry.

It is, however, worth remembering that the aim of good credit management is to contribute directly to profitable sales growth, and to be overzealous in collection and account approval could have a negative impact on sales. It has been successfully argued therefore that though a *reduction* in DSO is always desirable, maintaining DSO at its present level while at the same time sales have gone up by 150% over the same period could well be seen as successful credit control – the investment in debtors has remained stable but sales have shot up, so profits should reflect that success.

The DSO can be used to show how an improvement in DSO performance can also give some degree of competitive edge. For example:

> You sell £14.6 million a year
> = £40 000 per day on average
> Debtors run at about £2.4 million, that is, 60 DSO.

Your competitor has similar sales but debtors of 70 DSO.

> So, you have £400 000 more cash to use (10 days × £40 000)

Your competitor must borrow an extra £400 000 at, say, 10% per annum, costing £40 000 off his net profits.

Another example of DSO contribution can be illustrated by the following. A company has sales of £22 million; makes an average profit margin of 4%; and has unpaid sales of 72 DSO. If it collected cash just 10% faster (65 DSO) its Profit and Loss Account and Balance Sheet would show the following improvement:

£000	*at 72 DSO*	*at 65 DSO*
Sales	22 150	22 150
Profit before interest (7%)	1542	1542
Debtors (= borrowings)	4370	3945
Interest expense (at 10% p.a.)	437	395
Net profit	1105	1147
NPBT as % sales	5.0%	5.2%
Increase in profit	–	42
Reduction in borrowings	–	425

It is relatively easy to collect cash 10% faster, given top-level support, a good review of procedures and resources and a well-planned and directed strategy. To improve more than 10% would involve radical changes, and in any case, gradual targeted improvements are generally more successful and reduce the potential for negative customer impact.

CASH TARGETS

Following the DSO principle, it is not difficult to set cash targets to improve the level of debtors over time. DSO-based cash targets are covered in detail in Chapter 11, which concentrates on cash collections, but a simple example here will set the scene. If a company generally allows 30 days credit to customers but has a DSO of 65 days (as in the example shown in Figure 2.5 earlier), it might decide to target a one-day reduction each month for 12 months, to reduce the asset level to 53 days without detriment to sales efforts:

August DSO	65 days
Add September sales	30 days
	95 days
September DSO target	64 days
Cash required in September	31 days

The total cash to be collected in September would be the *equivalent of* 3/30 June Sales plus 28/31 of July Sales. The setting of a cash target is simply arithmetical, but achieving it needs specific approaches to larger customers. There are added benefits which make the task worthwhile, in that it normally leads to better payment continuing in the future with less collection effort and better customer relationships.

Offering a discount as an incentive to prompt payment always looks inviting, but can rarely be afforded. Just as many companies have no real grasp of the actual costs involved in the granting and financing of credit, even fewer seem to realize how much they may be 'giving away' by way of cash discounts. It may be, of course, that some element to cover cash discounts has been factored into the price of the goods, but this is rare – many companies have list prices and *trade* discounts, and some of those fall into the trap of offering cash discounts on top!

Just as a customer would be foolish not to take an offered cash discount, a supplier is unwise to offer one. The rate has to be high enough, say 2%, to be attractive to a customer, but it can still be abused by being deducted by late payers. The real annualized cost of a cash discount is usually much higher than the seller's cost of money and as such it would be cheaper to suffer a 90 day overdue account than to give away 2% for payment in 30 days. Better to establish firm net terms with customers and follow them up efficiently.

Discounts for prompt payment have a cost to the seller which can quite easily be calculated, and is best thought of in terms of the per annum, or annualized, rate of interest. There is a simple formula:

$$\frac{\text{Rate of interest} \quad 360}{\text{Credit period less the discount period}}$$

By way of an example, terms of payment of 2% discount for payment in 10 days against terms of 30 days net would be expressed as 2 × 360 divided by (30 – 10), which equates to 36% per annum. It is therefore clear that what on the face of it might not have appeared to be unreasonable, has in fact a quite sizeable impact on actual credit costs. Figure 2.7 illustrates this further.

A photograph of Aunt Edna on the beach at Bridlington is the freezing of a moment in time. It gives no explanation as to what brought her to the beach, what she was doing up to that moment, or what she did next. Apart from the smile for the camera, it does not tell us either anything really concrete about Aunt Edna, her state of mind, or health, or indeed her intentions. It simply records that moment in a very basic form. The debtors' figure on the ledger at any time is exactly the same as the snapshot of Aunt Edna. It provides the basic data of numbers

Credit Periods								
30 days Discount rate period			60 days Discount rate period			90 days Discount rate period		
(%)	(days)	% p.a.	(%)	(days)	% p.a.	(%)	(days)	% p.a.
1	10	18	1	10	7.2	1	10	4.5
1	15	24	1	15	8	1	30	6
2	10	36	1	30	12	1	60	12
2	15	48	2	10	14.4	2	10	9
3	10	54	2	15	16	2	30	12
3	15	72	2	30	24	2	60	24
			3	10	21.6	3	10	13.5
			3	15	24	3	15	18
			3	30	36	3	30	36

 Figure 2.6 Annual percentage costs of cash discounts

and values, but no more. To say, therefore, that there is an amount owing of £23 million as at 31 March says nothing about how that sum is made up in any detail, and certainly of itself cannot give any guide as to the age and collectability of all the individual debts. Finance Directors will often look at the figure and judge the impact of such a level of debtors on the profitability of the company. They can have some indication of possible speed of cash intake by way of the DSO calculation, but what they cannot see is how much *can* be collected, and how much is tied up in unresolved disputes, awaiting credits or awaiting replacement goods. The total debtors figure does not by itself indicate the age of individual debts, and it is only when the totals start to be broken down by analysis that the true state of cash inflow can be both seen and predicted.

How collectable are the debts on the ledger? Are they new and worthwhile, or very old and mostly uncollectable? It is well known that the older a debt is, the harder it becomes to collect. Many experts in the collection of debts apply percentage probabilities to the age of debt, e.g:

Age	*Worth %*
Current, i.e. within terms	100
60 days overdue	80
180 days overdue	50
12 months overdue	10

Is there a high level of queries and disputed accounts, and are these recent or long-standing? It may well be that the ledger represents a mixture of all these – mostly current debts, but with some old, some very old, some disputed, some with genuine customer queries yet to be resolved. The aged debt analysis is the most prestigious management tool in this respect, showing at a glance the status of debts within the total. It is an established fact that for lenders, auditors, analysts and those on the acquisition trail, the liquidity of any company can be judged largely by the quality of its debtors.

Whether judging liquidity in general, or simply assessing the collectability of debts in particular, the analyst, the auditor, the lender and the acquisition predator look at the two main elements of the debtors ledger – age and risk. It helps if risks are coded to indicate an opinion as to the solvency of the buyer – for example, A (no risk), B (average risk), C (high risk), etc. – but even in the absence of risk codes, the details held in each customer file should point to degrees of risk. Some debts, already identified by the seller as uncollectable, may have Bad Debt Provisions shown against them, and it may also be that there is a special section of the ledger, headed Bad and Doubtful Debts, into which all those seriously uncollectable debts have been transferred for ease of identity. Such a section of the ledger also serves the useful purpose of clearing some 'dead wood' from the 'live' ledger and enabling uncluttered focus on those debts which are worthwhile.

The aged debt analysis also, of course, by definition shows at a glance all the customer accounts by invoice age – not yet due, current, one month overdue, two months overdue, three months overdue and three months and over. On the balance sheet, debtors are a *current asset* and should be capable of conversion into cash within 12 months, and usually much sooner. There are many reasons for debts to be written off, usually insolvencies, but it is a sad fact that many debts are written off by companies simply because they have not been collected and have become so old as to be more difficult to achieve success. This is apart from the obvious effect of old age in that any profit to have been derived from that sale has long been eaten up by interest costs and further pursuit has become uneconomic. In such circumstances, the passage of time has made proving the debt in the first place more problematical, staff at buyer and seller have come and gone, invoices or delivery notes have gone missing, and the whole scenario has become untenable.

Time is of the essence, and it is not an option to let debts collect themselves. The whole sequence of delivery, invoice and account collection is a disciplined time-constrained exercise, and the aged debt analysis is the window on liquidity for anyone to peer through.

Many sales personnel are on a basic salary, with commission earned on sales, and each year, or sales period, they can be set targets for the following period. Achieving those sales targets can earn 'extras' over and above commission, which can range from cash bonuses, through a whole variety of gifts and incentives, to top awards of holidays, cars, etc. In other words, it is an established feature of sales and targets to provide a varied array of incentives to encourage the meeting of those targets and the rewarding of such achievements. The same principle can apply to those whose task it is to turn sales into cash. It is doubtful if such collection activity earns holidays in the Bahamas, but bonuses and gifts are by no means uncommon. There are many ways to set targets for cash collection, according to company cultures and cash needs, but given that there is a clear list of debts becoming due on defined dates, plus other debts past their due dates, it is very simple to define the expected cash, based upon that date plus the known payment habits of customers and various states of solvency.

Targets have to be achievable, even if difficult, because the surest way to demotivate any staff member is to set impossible aims. Total cash targets should comprise individual customer accounts, rather than simplistic overall percentages, and input into those targets should come from the collectors themselves. They know their customers, both from a payment habit perspective and from a culture and reality standpoint, and have the experience of actual collections to add to an accurate and meaningful collection objective. It will be for more senior management to verify that such targets are acceptable, again based upon culture and cash needs, but once accepted it becomes the collectors' commitment for that month, which can represent a considerable motivation to deliver.

There will be further discussion of cash targets and incentives in Chapter 11, but it is worth noting here that incentives can carry dangers. Just as it would be inefficient business practice to offer incentives to sales staff to bring in orders regardless of risk, and then expect uninvolved credit people to try to collect from customers who have no liquid resources, so too would it be to set cash collection targets that would ride roughshod over good credit management practice. It would be easy to collect from customers if there was no concern about repeat orders or future business – the essence of effective credit management is to educate customers to terms and to promote profitable trading.

PLANNING AND BUDGETING DEBTORS

Most people recognize the need for planning in some form or other, and would regard sudden whims or fancies as at best somewhat risky, and at worst foolhardy. Getting married, buying a house, going on holiday or changing the car often involve forward planning, with arrangements to be made and eventualities covered. Starting a business and seeking cooperation and assistance from the bank entails a business plan, with all aspects of the proposed business operation from marketing through production to cash generation being part of the plan. Financial planning in trading companies does in fact vary enormously. At one extreme, there is no advance planning at all, with day-to-day survival as the prime motive, borrowing what is needed at very short notice. At the other end of the scale, many multinational giants employ whole armies of planners and business analysts, who look at every aspect of the company's trading. They look at results, make forecasts based upon an array of 'knowns' and 'variables' (such as raw material costs, production expenses, wages, marketing expenses, etc.) and prepare budgets for the short, medium and long term.

The pressure for planning and forecasting can come from a variety of sources, and reaction to that pressure can have very significant impact upon day-to-day operations. It is well known, for example, that publicly quoted US corporations are expected to report results quarterly, and that each quarter's numbers can strongly influence how the company proceeds in the following quarters. On the other hand, some planning has, by its very nature, to be long-term. Building a new cruise ship incorporates a mass of planning on different levels, from design and construction through financial borrowing and outlay to actually earning income from fare-paying passengers – it could be many years before the ship actually earns profits for the owners and it may well take the whole lifetime of the ship in service for it to be seen to have paid for itself in total.

Cash planning is a crucial part of the overall process. As debtors are usually the largest company asset, that asset should be constantly under close scrutiny. Debtors represent cash and cash is the lifeblood of any business – knowing what we have, what we are expecting to have and when will enable us to know what we can spend, and when. Since debtors are a dynamic but risky asset, it makes sound commercial sense to know how debtors are made up and to have a real 'feel' for the collectability of sales. The size and quality of the debtors ledger should be regularly reviewed by the credit manager, the finance director and the main board of directors:

- the credit manager is controlling the ledger directly on a daily basis
- the finance director has an overview as and when required and
- the board of directors are kept informed by regular reports for action as needed.

The way in which the size and quality of the debtors asset is reviewed should involve the following measurements:

1 *Aged debt analysis:* listing all accounts in either alpha/numeric, or, better still, descending value order, with columns for current, 1, 2, 3 and over 3 months overdue, plus other details (these are described in later chapters). This measurement tool is used daily by the credit manager and is available for overview by the finance director.
2 *Cash target sheet:* listing the debts comprising, say, 80% of the month's cash requirement, however calculated, and showing actions taken, payments arranged and payments received. This would be used by the credit manager, and collectors, and updated daily.
3 *Cash forecast sheet:* showing total amounts of cash expected, split by type of account, either as single totals or divided into daily or weekly totals for the month ahead. It is useful to show the DSO which would result if the forecast were achieved. This would be prepared by the credit manager and used by the finance director.
4 *Monthly debtors report:* one page only, on the month just ended, showing total, current, overdue and disputed debtors, all in sections as required, with aged subtotals, and columns for last month and budget or forecast. A few lines of commentary should be included, to explain both exceptionals and ongoing actions. The report would be prepared by the credit manager and issued to the finance director and to the main board.

It may be necessary for the credit manager to also prepare and issue a separate schedule of disputed debts and unresolved customer queries. Although usually incorporated into the monthly debtors report as outlined above, there are circumstances where the level of queries or disputes is such that both the finance director and the main board should be aware of the impact on cash collection and cash inflow. There can be instances of queries appearing to get out of hand because of some change in processes or practices, and lack of response from those whose role should be to ensure customer satisfaction. In such circumstances, senior management should be involved in the task of putting matters right, and restoring the collectability of the debtors asset generally.

SUMMARY

The management of the cash-producing debtors asset should be proactive, and not simply reactive or, worse still, passive. Sales are made to customers who vary in states of solvency and liquidity, and therefore they *must* be risk-assessed in order to be able to decide both credit worth and credit ability. It follows that collections then have to be organized to suit both volumes and levels of difficulty.

Cash inflow can be measured by the DSO method and speeded up gradually, over time, by reducing the ratio of days sales unpaid. Companies should be aware of their industry average DSO and set out to improve their own competitiveness by having faster cash inflow and fewer bad debts than their rivals. All key managers, including sales, should know and understand the meaning of *Net* profit margin, and be fully aware of their own company's net profit margin. They should not confuse 'net' with 'gross' – gross margins of 30% or even 60% still only produce net margins of 3% or 4% in many sectors of business. Understanding their own net margins should lead to an equal understanding of the cost of credit and therefore not be drawn into frittering away the NPBT in 'free' credit concessions. Nor is it ever profitable to 'buy' customers' loyalty by allowing them to defer payments.

Every company that grants credit to customers should have a simple structure of measuring debtors regularly, regardless of their size, and should be in a position to take prompt action to correct problem situations.

INSTITUTE OF CREDIT MANAGEMENT – JANUARY 2002

Introductory Credit Management – Certificate

Question 6
Write short notes on FOUR methods of financing trade credit.

3 Credit policy and organization

Glen Bullivant

A credit policy; The key features of a credit policy; Credit risk policy; Credit policy for export sales; The functions of a credit department; The role of the credit manager; Reporting structure and organization; The qualities of the credit manager; Credit staff and their training

A CREDIT POLICY

The benefits of having a clear credit policy

If we accept that it is simply not good enough to sell, issue an invoice and sit back and wait for the payment to come in, then we must also accept that it is equally unwise to conduct any operation without really understanding its whys and wherefores. In a new business start-up, for example, the bank will ask various questions of the applicant for financial support. Looking at the business plan, high on the list will be 'will you be granting credit facilities to your customers?' If the answer is 'yes', then the next question will be 'how do you propose to assess risk and collect accounts?' In other words, 'have you drawn up a credit policy?'

The very word 'policy' may appear off-putting to some, but in essence all it means is 'this is our preferred way of doing things'. There can be nothing onerous or contentious in that definition, and in many spheres of any business operation, various 'policies' will guide bosses, employees and customers alike. It should go without saying, of course, that any business should conduct its affairs in a lawful manner. There is legislation covering a range of issues, including health and safety, employee rights and benefits, environmental protection and so on. We drive on the left, tyres have a legal minimum tread depth, and the movement of aircraft is under strict control. In other words, guidance exists in many spheres, whether as legally enforceable obligations, or as strong recommendations. To enter into any situation without a plan of action or any guidelines to cover problem situations can only lead to inefficiency, loss and possibly ultimate failure.

The goal of every credit manager is to achieve 'the highest level of profitable sales, over the shortest period of time, with the minimum of bad debts'. It always sounds easy when said quickly! That aim is consistent with the aspirations of every business seeking to succeed by exploring every way of maximizing profitable sales. Both the business and the credit manager know that, to do this, it is naturally preferred that all customers and potential customers will be solvent, there to provide future business growth, and able to meet financial commitments on time. The reality is that in the modern, highly competitive market place where companies vie with each other for sales growth, it is inevitable that sales will have to go beyond the safer customers into the area of those who are a higher credit risk. That requires good drills for checking credit worth, systems for monitoring accounts and procedures for following up slow payers. It also means everyone involved knowing what we are doing, why we are doing it and the consequences for all if it is not done.

Every company does in fact have a credit policy, even if they do not realize it. It may not be written down anywhere, and may simply be passed through the organization by word of mouth, continued as an accepted working practice and operated because the Chairman says so. Having no credit policy, either written or assumed, actually operates as a policy in itself because it says that our policy is 'to let staff do as they like'. Not to be recommended! The range of written credit policies is also quite vast, from one-page documents of intent, to lengthy manuals of detailed policy aims and even more detailed procedures and reports.

It is clear, therefore, that in the environment where competitive pressures require sales wherever and whenever they can be made, a clear and understood credit policy is of paramount importance. If all those sales, the more risky as well as the less risky, are to be turned into cash as quickly as possible, then management must support the credit operation directly, not just with policy words, but also with all the necessary resources, both human and technological. At the highest level, every company management, large and small, should say: 'Our company will grant credit to facilitate sales; will collect sales revenue efficiently; will service customer complaints rapidly; and will use the best people and technology to achieve this – all under the direction of the credit manager (financial director, financial controller, etc.), who will be responsible to the board for the management of the vital debtors asset.'

If this is the declared intention of the board of directors, then it makes sense for the delegated credit manager or director to produce a brief document of policy and procedures, signed off by the Chief Executive and issued to all affected functions, and in particular sales, production, quality control and customer service. The very act of producing (or updating) a credit policy forces people to decide on responsibilities and levels of authority. Knowing 'who does what' in given situations removes any uncertainties and avoids people being left to stew in increasingly unpleasant and damaging juices. It also provides an excellent opportunity for credit and sales to get together on all customer and credit-related issues. There is no better way for a credit manager to explain the credit function than by addressing a sales meeting with the credit policy high on the meeting agenda.

Elements of a company policy for credit management

'Is our cash inflow planned and reliable, or is it uncertain and handled reactively?' is the question that every company boss should ask at least once a year. To know that income can be relied upon, and that planned sales growth can be accommodated by planned revenue, sets the foundation for financial well-being. The following are usually found in successful companies:

1. *Credit policy:*
   - credit as part of our overall objectives
   - responsibilities of credit staff and others.
2. *Credit objectives* (stated criteria and ratios).
3. *Annual budget or plan*, for one year ahead:
   - monthly debtors results
   - monthly credit department expense.
4. *Organization chart* for credit staff and related functions.
5. *Procedures* for credit and collections.
6. *Month-end report:*
   - debtors results (and compared to budget)
   - expenses (and compared to budget).

The concept of debtors requiring management as an asset

There will always be factors outside the control of the credit manager, or of the finance director (see Figure 3.1) whose responsibility it is to manage the above structure, but nonetheless it does illustrate a planned and managed approach to a company's investment in the debtors asset. It also shows an understanding of the components that contribute to the make-up of that asset, and where and when intervention is required.

It is worth labouring the point about 'investment' in debtors. All companies can point to their investments in capital equipment, land, buildings, machinery, etc. For example, as a business progresses it may outgrow its existing premises, and hence need somewhere larger. This would involve finding the right premises, at the right price, and commensurate with the planned needs of the business over the following years. Investigations would consider the location, whether to rent or buy, to build or convert. All the financial factors would cover outlay now against expected return, increased overheads against increased sales volume, not to mention the disruption costs associated with any move. In other words, all the pros and cons of buying, renting and moving would be set against all the pros and cons of not moving at all. The company will determine the cost benefits involved, and finally quantify what it can afford to spend – or not, as the case may be.

Similarly, when upgrading plant and machinery, decisions have to be made as to what the company can afford to invest in new equipment and what that investment will bring as a return in the form of improved efficiency, higher productivity, reduced production costs and ultimately increased profitable sales. In other

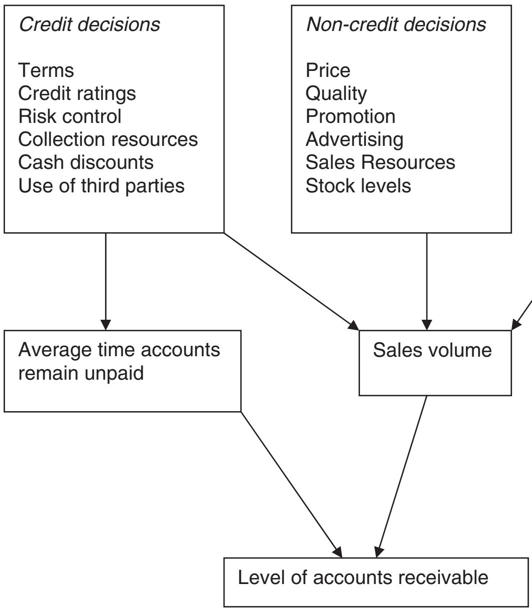

Figure 3.1 Factors affecting the level of investment in debtors

words, before moving premises or buying new equipment, full cost/benefit analysis is undertaken, and the bottom line has to be what the company can afford.

Debtors are no different when viewed as an asset. The company can only support a level of debtors which it can afford – to exceed that level, planned or unplanned, can lead to severe financial problems. Debtors can be planned as a specific investment of a certain amount of borrowed funds, or capital, for a stated period of time, for example, 'we will borrow £5 million to support our debtors asset to cover 60 days sales at any one time'. The total credit possible may be limited by banks imposing limits on borrowings, and the non-credit policy of 'selling all we can and then doing our best to collect the cash' is doomed to fail if the bank puts the brake on subsequent lending. Many a company has failed with a full order book simply because it has not quantified the level of debtors it can sustain and has run out of both funds and time.

Credit has to be on the shortest possible basis, all other factors being considered, because in the context of return on investment, net profit only comes from paid sales. That means that the company only sees the benefit of its investment in debtors when those debts are turned into cash – in the same way that it only sees the benefit of its investment in new plant and machinery when that plant and machinery is up and running efficiently. The time lag between investment and return must therefore be as short as possible.

Another credit investment approach might be that 'debtors should not exceed X% of annual sales'. If credit terms were 30 days from invoice and all customers paid on time, borrowing could be arranged for one twelfth of the planned annual sales value, or 8.33%. In reality, however, not all customers pay on time, sales staff may allow longer terms, some accounts may be in dispute, etc., and therefore the investment of borrowed funds has to be greater. A more sensible ratio would be 16%, or 58 days of sales value. This approach can be more revealing, when debtors clearly exceed planned targets, and it is a useful way to illustrate to both sales and senior management the value of good credit control.

The overall benefits of having a credit policy can be summed up as:

- setting out the company's intentions for the granting of credit
- removing any uncertainties about the authority levels and responsibilities for the setting of credit amounts, payment terms, risk categories and for accepting orders
- providing an operating guide for credit staff
- helping to eliminate 'special' credit deals by unauthorized staff
- demonstrating a positive business attitude towards customers
- simplifying the work of auditors and other visitors (and speeding their departure!)
- recognizing, at the highest level in the company, the importance of the role of credit management and its contribution to sales and profits; and thus the need to support it fully.

THE KEY FEATURES OF A CREDIT POLICY

No credit policy should be drawn up in isolation. Many factors contribute to the policy's actual nature and contents, which are discussed below, but the prime concern is to get everyone on board from the outset. Rules are always much easier to understand, and therefore more likely to be followed, if all participants have been involved in their formulation. A policy drawn up by credit *and* sales staff and then endorsed by the board stands a far greater chance of successful implementation than one worked out in an ivory tower and imposed by an unconnected faceless executive.

The credit policy should always take into account prevailing business conditions, both in respect of the company's own market place, and in the general economic climate.

Normal business conditions apply where:

- the seller is in a good financial condition
- stock is carried at levels which satisfy customer needs
- good profit margins are generally achieved
- most customers pay between 30 and 60 days, with relatively few late payers
- business is expected to continue in the same way.

It is difficult nowadays to define 'normal' business conditions and most of those involved in credit management will experience, through the course of their careers, varying degrees of 'abnormal' business conditions. These may be brought about in a variety of ways, with external influences often gaining the upper hand, not to mention wars and pestilence. They can quite often be self-inflicted, with unfortunate executive business decisions, the wrong product in the wrong place at the wrong time. Whatever the reasons, business conditions will influence the credit policy.

More generous credit is needed when:

- stock is abnormally high
- demand is falling
- the seller is creating a new market for new products
- profit margins are higher than average
- high sales expense has been incurred
- high output is needed to recover overheads or plant costs
- changes in style may risk surplus stocks or obsolescence
- seasonal business leaves surpluses to shift
- a customer is risky, but has a lucrative contract
- a seller wishes to build up outlets
- serious competitors must be followed.

On the other hand, *more restrictive credit* is needed when:

- low net profit cannot afford extra interest expense or bad debts
- stocks are low and demand is high
- products are tailor-made and cannot be re-sold elsewhere
- the production process is very lengthy
- customers have good cash flow (for example, supermarkets).

All these factors have a common thread – they are not solely the preserve of either the credit or sales functions. It is imperative, therefore, that sales and credit between them know all there is to know about:

- the behaviour of existing customers
- the financial status of prospective customers
- the company's future plans in respect of product and market.

Both sales and credit can help each other for the overall good of the business. There will be disagreement on some issues from time to time, but minor friction can be resolved by the senior board member. There should never be any circumstance where some disagreement at a relatively low level is allowed to fester and grow into open warfare. Friction between sales and credit damages the business and only benefits the competition. No company should *ever* allow non-communication between sales and credit, which is little more than a state of war between the departments. It is often the credit manager who has to work the hardest in this scenario, and running fast just to stand still is no real incentive to progress.

At the outset, it is important to remember all the ramifications of allowing goods or services on credit, and how, why, where and when credit is to be granted. It is also equally sensible to know all there is to know about the goods and services, the price structure, the way business is usually (or intended) to be conducted and how marketing is carried out. For example:

- Does the price include the costs associated with granting credit facilities, in particular the interest cost of payment terms and/or the average DSO for all accounts?
- Is it necessary always to grant credit in every sale, or would it be possible for some customers to pay deposits, or pay in full in advance, or on delivery?
- Does competition mean that not only must credit be allowed, but that it may be possible to gain marketing edge by offering longer or cheaper credit than competitors? If that is the case, is it possible to accommodate the cost?
- Must credit offerings to customers be uniform, or will it be possible to negotiate non-standard terms with specific customers? If the latter, what will be the circumstances, the criteria and the control?
- On the basis that 80% of sales revenue usually comes from 20% of customers, will the full financial standing of those major customers be fully investigated?
- Will senior people be designated, perhaps reporting to a senior manager, responsible for planning the overall investment in credit and will the senior manager himself/herself be controlling that plan personally each day?

The credit policy is designed to answer all these questions in full. Drawing it up involves input from finance, sales, marketing and general guidance from the board. All manner of plans, and related costs have to be taken into account, as well as the nature of the product (and its shelf life) or the scope of the services provided. If starting from scratch, or if indeed reviewing an existing credit policy with the object of updating it, those involved should set out the criteria by which they will operate:

1. What is the extent of available borrowing, or likely available borrowing? This will indicate the scope for allowing credit.
2. What will be the intended level of debtors? This means, in effect, what is the planned level of sales, and therefore (in connection with (1) above), what level of debtors as a proportion can be supported?
3. What is the company's market strength? The position of a leader in the market will be far stronger than that of any of the many followers in the market.
4. What are competitors doing? In a normal competitive environment, to succeed requires not only knowing what others are doing, but also avoiding being markedly out of line.
5. What are the current and likely business conditions and business prospects? Interest rates and regulations are subject to change, and the prospects for a manufacturer of steam engines in 2004 is not what it was in 1904!

6 What is the make-up of the customer base, both in the mix and the quality (small, large, blue chip, sole traders, well established, new, etc.), and the possible volume of sales and customers to be handled? A limited number of very high value customers will require disciplines which may well differ from those needed when dealing with vast numbers of small value customers.
7 What will be the availability of good quality staff and the costs associated?
8 What will be the process for credit checking? This covers the extent of information required, and the costs of obtaining that information. It should also take into account:
   - customers
   - countries (for exports)
   - action at order acceptance
   - action at pre-delivery.
9 What are the credit objectives?
10 What will be the required level of collaboration between sales and credit? This will extend beyond the basic 'who does what?' to the more detailed 'who will be responsible for what?'
11 What will be the targets for customer service, returns, disputes, etc.?
12 What will be the cost of overdues and bad debts, and what will the effect be on net margins? Put another way, what are the bottom line margins taking *all* costs into account, *including* overdues and bad debts?
13 Will the credit control function be centralized or decentralized? There may well be a measure of centralized control at a certain level, with regions left with particular responsibilities, or fully controlled from a central location.
14 What will be the line of command for credit responsibilities?

A typical credit policy is shown in Figure 3.2.

It will be seen from the sample credit policy in Figure 3.2 that the policy does not have to be extensive or complicated by hard-to-follow equations – all that is required is a straightforward statement of aims and intentions:

1 The company's business and aims
2 Types of customers and business sectors
3 Conditions of sale, as issued to customers
4 Selected conditions of sale, requiring credit management:
   - payment terms
   - cash discounts
   - special arrangements, extensions, instalments, etc.
   - interest charges
   - reservation of title
5 Bad debt level
6 DSO objective
7 System of vetting customers
8 Collection methods and timetable
9 Staff responsible for implementation of policy
10 Responsibility of other departments to help achieve firm's credit objectives.

This policy is designed to improve the debtors asset and to meet the company's wish to arrange sound terms for every possible sale. It is the company's aim to gain financial benefit whenever possible from every profitable revenue source.

Assessment of risk

Every customer will be given a *credit rating* and a *credit code*, established by the credit manager with the cooperation where required of sales personnel.

To achieve meaningful ratings and codes, the credit manager will use financial and other data obtained from specialized credit reference agencies (Experian, Dun & Bradstreet, etc.), together with trade and bank references when required.

The credit ratings and codes assigned to each customer will be reviewed annually, or sooner if deemed necessary.

Credit rating

This is the assessment of the liquidity of the customer. It is the maximum amount a customer can settle within the specified credit terms. If a credit rating is exceeded, the account will in all probability become overdue, which will reduce profitability and may even lead to a loss for the company.

Credit code

This is the assessment of the solvency of a customer. Each customer will be coded A, B, C or D, according to its financial strength and perceived risk as follows:

- *Code A:* Negligible risk. All inter-company and government accounts, and large companies considered extremely unlikely to fail.
- *Code B:* Average risk. Customers who are not A, C, or D.
- *Code C:* High risk and /or bad payment record. Small companies with little financial stability. New companies with no track record established – up to two years old.
- *Code D:* Cash only. No credit allowed.

(Note: Customers who are coded 'C' are marginal credit risks with little future, so sales efforts should be focused on B and A customers. Customers can move between codes following review by the credit manager based upon experience of payments, trading history and specific events, such as dishonoured cheques, etc.)

New accounts

No deliveries can be made on an 'open terms' basis until a credit rating has been established. Where the prospective customer has requested immediate delivery, cash in advance is required.

A credit application form will be completed by the prospective customer. The credit manager will attempt to establish a line of credit appropriate to the volume of orders expected from the customer.

After credit has been approved, an account number will be assigned by the credit department and used in all transactions.

‘Quick start’ limits
Intended for use in fast-moving sales operations, such as with telephone orders. An immediate rating of £x will be established to enable same day delivery to the customer up to that value. No further orders will be accepted or delivered until the appropriate credit rating has been established and the credit line approved.

Existing accounts
It is the responsibility of the credit department to persuade all customers to pay their accounts within the specified credit terms. Collection activity will include letters, telephone, fax and email and customer visits in association with sales if required. With the exception of major accounts, all accounts becoming 30 days overdue will be subject to delivery suspension. Any orders on hand, or subsequently received, will be placed on ‘stop list’ until the overdue account has been paid.

If overdue invoices are known to be in dispute, the credit department will ensure that disputes are resolved within seven days, by credit notes to the customer if the dispute is genuine, or by payment if not. (Note: All sales managers will ensure that sales personnel are aware of the commitment to swift resolution of disputes and will instruct *all* sales staff accordingly.)

Pre-delivery, order values will be added to account balances and compared to the customer’s credit rating. Orders for delivery to over-limit accounts will be referred to the credit manager for review.

Order entry
All new orders will be added to existing orders plus the account balance for comparison with the credit rating.

Orders in excess will be referred to the credit manager, who will urgently seek ways of accepting such orders (part payment of the account, guarantees, etc.).

No order acknowledgement will be sent to the customer unless and until that order has been credit approved. In most cases, this process will be automatic, but referral to the credit department may be essential in some instances.

Credit/sales relationship
The credit manager will undertake to inform the sales manager of any changes in customers’ status which may affect sales to those customers.

Monthly meetings will be held between credit and sales staff to exchange recent experience with problem customers, to decide action assignments, to discuss the credit activities of competitors, and to discuss any changes that may be required to credit policies or procedures.

Figure 3.2 A sample credit policy document

Thus the policy will explain to all staff and management just how the company does its credit checking and uses the resulting credit ratings and risk categories, as well as its approach to late payers. There should be no confusion or dispute between departments, in particular sales and credit. Nor should anyone be under any illusion about company policy in respect of use of the stop list, legal action or interest charges. The company will send reminder letters, it will make telephone collection calls, it will use ethical collection practices – it says so in the policy.

What will give the credit policy its merit and its authority will be the fact that it has been approved and issued by the board. Senior management have endorsed its contents, and it is now to be effective the length and breadth of the organization. Dated when issued, showing pre-arranged review dates, the document now has universal recognition – it should be part of any new starter's induction process in the organization to be made just as aware of the credit policy as they are of any other significant company policy.

If it is remembered that the credit department is *not* the 'stop all orders' department but is the 'try to find a way of accepting all *profitable* orders' department, it follows that some customers carry a higher risk factor than others. Not all customers are 'no problem and not to be touched with the proverbial barge pole'. A large proportion of any customer base is made up of those in the middle range of risk, neither very high nor very low risk. At one end of that middle spread, however, are the risky customers, with whom trading can be profitable over a limited period of time, provided strict controls are in place. By definition, high risk customers are those still able to place orders today, but likely to fail over the following 12 months as indicated by financial reports, ratios, excuses, broken promises, etc. For such customers, a policy tailored to the risk that they represent is a sound addition to the general credit policy.

CREDIT RISK POLICY

There are two ways of looking at risk policies for all customers:

1. *Maximum sales and no credit checking:* Higher sales, and therefore higher profits, are certainly possible, but so is high interest expense because of more overdues. There is a much greater risk of losses due to bad debts, and it is not rocket science to calculate the volume of extra new sales required to recoup the losses from one bad debt, particularly in a low margin environment. Add to that the expense of employing extra resources to collect ballooning debts on the ledger and dealing with myriad unknown customers with little or no knowledge or previous experience, and it is apparent that such profits as can be obtained from higher sales can soon disappear.
2. *Selective sales and credit checking:* Sales may be lower, but profits from those sales will be much more *reliable.* Fewer bad debt losses will be incurred, there will be more accounts paid to terms and less in the way of interest costs on overdues. Rather than throwing the sales net out as far and wide as possible, targeting of known better customers and reducing sales to

bad risks ultimately leads to fewer collection resources and a general reduction in overheads.

To achieve profits from high risk customers, it is necessary to have strict controls in place, from risk assessment until collection. That much is obvious, but it is just as important to know how much should be at risk as a percentage of total debtors as a maximum. In other words, the total value of high risk debtors should be kept within known and decided limits. For example, a company may decide that 15% of debtors can be in the high risk category. If average debtors are £6 million, then the high risk limit should be £900 000, that is, 15% of £6 million. If credit assessments are accurate, then bad debt losses should only come from accounts in the £900 000 sector, apart from the totally unexpected collapse, which is quite rare. Both credit and sales staff know from this simple formula what efforts are required, both in selling and collecting, as far as high risk customers are concerned, and the company is working within acceptable high risk bounds. It would soon become apparent if the limit were exceeded, with drastic remedial action instantly required.

As a further precaution, it would be prudent to accrue additional provisions for bad debts, and to ensure that sufficient resources are allocated to monitor the high risk accounts. As the purpose of a high risk strategy is to be able to squeeze extra sales from customers identified as risky, it would be pointless to use up the high risk limit with delinquent overdues or by extending terms in other areas. It also follows that collection procedures and/or application of the stop list must be firmly and swiftly enforced to ensure minimum exposure.

The credit manager should also study and report on the progress of the strategy, looking for variation or deterioration, with revision when needed. The selling price in the high risk area *must* be commensurate with the fact that such sales *are* high risk – extra profit is necessary to offset extra losses and higher credit and collection expense. Losing sight of the objective is losing sight of the profit, and if it is not done properly, it is not worth doing at all!

CREDIT POLICY FOR EXPORT SALES

Chapters 17, 18, and 19 concentrate on credit matters relating to export, but it should be part of the company credit policy in much the same way as the policy and process for home sales. It is even more important to have a properly worked out export credit strategy because the pitfalls in export are additional to those in the home trade. There are differences in banking, currency, documentation, payment terms and credit cultures throughout the world, which all add to both risk and cost.

Successful exporting is a team effort involving sales and credit working in harmony. Support by export sales staff, in terms of account issues, possible terms of payment and collection processes to be employed, is essential. Equally, credit staff should be fully aware of all the difficulties encountered by sales people in overseas markets, and avoid treating foreign customers to UK-style strident collection methods. Much is different in export, not just in language or culture, and an understanding of international business methods is essential to effective professional export credit management. A company usually has good commercial reasons for entering or expanding a particular export market, and the export credit manager should seek profitable ways of supporting those reasons.

The questions that follow obviously apply to a first time exporter, but are also valid for exporters at all stages of experience. They carry an implication of what should be done, and discussing them can be very useful in producing good policy decisions. The right working procedures then become clear.

- Has the figure for working capital needed to support debtors been calculated by multiplying planned sales by the average *collection* period? (Note: *Not* the credit terms. The time between shipment and payment is usually much longer than in the home trade.)
- Has one individual been delegated to build up the company's export credit expertise? (Sharing it between functions can seriously fragment the experience needed.)
- Are there written procedures for order approval, credit terms, collections and financing methods, and do all affected departments have a copy of it?
- Who is authorized to visit, telephone, fax, email and write to overseas customers on credit and collection matters?
- Before assessing the credit worth of actual customers, is the ability of the foreign country to remit hard currency checked? In other words, is there a need for secure terms, regardless of the individual customer's own credit rating?
- Has the range of allowable credit terms for each market been specified, and where credit insurance exists, does the policy permit those terms?
- Is pricing quoted and billed in sterling or a specified convertible currency?
- Are payment terms shown on all quotations and acknowledgements?
- How are new customers checked for creditworthiness and is a list of essential credit questions given to the salesperson?
- Is there reliable local representation in each market to obtain credit data and help with accounts collection if required?
- Have credit agencies been signed up to provide rapid credit reports on markets as well as customers?
- Are all customers given credit ratings to avoid risky excesses? Are they reviewed regularly to adjust up or down for latest results?
- Will security or extra controls be required for extra risky accounts?
- Who authorizes credit extensions?
- Does the sales ledger system show on-line data plus payments history and are problems and worsening trends reliably exposed?
- Does the system produce accurate invoices which clearly show payment terms and standard international data?
- For bank collections (cash against documents, bills of exchange and letters of credit), can all the essential documentation be gathered rapidly?

- Have good payment methods been arranged with each customer, utilizing bank sort codes and account numbers?
- Is an export debtors report reviewed critically each month, leading to action assignments to improve problem situations?
- Are all accounts contacted just before due date, just after if needed, and soon after that if promises are not kept?
- Is the policy clear on when to charge interest on overdues, how to use agents and associates, when to protest bills of exchange and how to act on bank advices of dishonour?
- Has the total cost of credit staff, documentation and export finance been budgeted in relation to sales and profits?
- Will the export receivables position be discussed regularly with the bank to ensure that the best possible finance is made available?
- Is factoring a cheaper credit management alternative?

International credit requires expertise to influence all the company activities which affect export payments and to bridge the gap between commercial and financial interests. Skills also have to be developed in the legal, documentation, shipping and banking areas. The export credit manager fulfils this role, as well as running all the daily credit and collection tasks. The role may simply be part of the credit manager's duties generally (many credit managers are responsible for both domestic and export), but particular expertise applies to export. The aims of debtor quality and the maximization of profitable sales are the same in both home and export, but good export management involves more focused responsibilities for the export credit manager. For example, they should:

- in collaboration with sales management, arrange suitable payment terms for new and existing customers, in line with market risks, the status of the buyer and the cost of the resultant credit
- maintain up-to-date status files on all active accounts
- maintain up-to-date information files on all markets into which the company sells or intends to sell
- set credit ratings for all buyers according to status, in line with the terms of payment and the level of sales, and review them at least once a year
- check orders and shipments against credit ratings and take action in the event of excesses
- monitor the payment performance of all buyers, with prompt contact to collect where needed
- arrange transfer of foreign funds to ensure that cash inflow is as fast as possible
- be thoroughly conversant with credit insurance facilities
- have knowledge of the types of export finance to be able to advise sales and take part in negotiations if required
- have knowledge of foreign currency to be able to advise sales on the use of currencies and to protect against exchange losses

- maintain contact with overseas agents and representatives, to obtain credit status information and follow up outstanding accounts
- prepare reports on the level and quality of export debtors as required
- review, at regular intervals, debts needing bad debt provisions
- ensure that staff receive good training in topical export credit developments.

THE FUNCTIONS OF A CREDIT DEPARTMENT

For many years, credit control or credit management was regarded in many firms as simply collecting debts. The less well informed may still hold this view, but in recent years the role of credit management has become significantly more extensive. Although collection of funds remains one of the most important parts of the credit function, it is only a part.

The aim of good credit management is the maximization of profitable sales over the shortest acceptable period and with the minimum of bad debt losses. To put it another way, the basic objective is to protect the company's investment in receivables or, in yet other words, to provide the best possible return for the company from the borrowed funds invested in accounts receivable (the debtors ledger).

The five main areas of operation cover:

1 *assessment of credit risk:* trying to find ways of accepting and controlling all business, including high risk opportunities
2 *establishment of credit terms and limits:* taking into account the risk involved and liaising closely with sales
3 *monitoring and control of debt:* ensuring that agreed terms are adhered to, all high risk customers are kept under control, and action is taken promptly to resolve any queries or disputes
4 *maintenance of the sales ledger:* ensuring that the customer master file is up-to-date and accurate, and that payments and other adjustments have been applied promptly and accurately, and
5 *collection of payment:* in a manner which creates the optimum cash inflow while at the same time ensuring continuity of business.

It will be seen that, while item 5 (collection of payment) remains the prime credit task, close attention to items 1 to 4 greatly improves collection prospects. It is usually seen in successful firms that the greater the attention at the 'front end' (1 and 2), the less activity is needed at the 'back end' (5).

To achieve optimum results, the duties of the credit department are many and varied:

- risk assessment
- credit ratings
- credit risk categories

- opening new customer accounts
- maintaining and updating the customer data file
- over-limit situations
- order referrals
- credit insurance
- bad debts and insolvencies
- legal action
- customer meetings
- support for marketing information
- cash collection
- cash allocation
- planning levels of debtors
- planning departmental expense
- reporting, departmental and corporate.

THE ROLE OF THE CREDIT MANAGER

Below the level of the board of directors, somebody has to be responsible for running the credit function on a day-to-day basis. Although that task requires someone with full management responsibility, the reality in some organizations is that there is no one who fits the bill, so the finance director – the board member nearest to the 'action' – has to take on the role. 'The credit manager's job is one of the few jobs in a company where the responsibility exceeds the authority' – so said Dennis Williams, one-time Credit and Treasury Manager for Texas Instruments and a very experienced authority on credit-related matters. Not a flippant remark, since it is true that a credit manager has the responsibility for an asset (debtors) worth, possibly, many millions, but does not have the actual authority to do what is expected. The difference between responsibility and authority is therefore a 'gap' which has to be filled by a talent for persuading other managers to do the right things all the time.

This can be illustrated by listing the company's expectations of the credit manager:

- contribute to increasing profit
- contribute to obtaining sales
- speed up cash flow
- reduce borrowings
- improve customer relations
- use cost-effective systems
- develop motivated staff.

The list shows that the expectations encompass every aspect of credit management in its most professional sense. Not all people can have these abilities (see 'The qualities of the credit manager' below). There has long been confusion over job titles and related responsibilities, often brought about by employers not appreciating what they were actually expecting their credit people to do, and by some credit people themselves attaching some status, mythical or otherwise, to what is merely a job title.

It is now generally accepted that 'Credit Controller' is usually a job which is subordinate to a Credit Manager or Credit Control Manager. For example, a credit manager may have six credit controllers, each handling a different section of the ledger and each with specific authority and responsibility limits. The credit manager is in overall control of the credit function, though in smaller organizations it may be the finance director who is responsible for credit management and has credit controllers to undertake the ledger work. There are Group Credit Managers, running regional credit functions up and down the land, each regional office having its own credit manager and credit controllers. There are many other variations, such as: Credit Sales Manager; Manager, Credit and Collections; and General Credit Manager. Some Customer Service Managers have credit as an integral part of their duties and responsibilities – credit is increasingly being seen by many large organizations as a customer service function.

Whatever the job title, the duties of the person in charge of the credit function are:

1 running the credit department
2 analysing credit risks and obtaining security when needed
3 collecting accounts
4 dealing with collection problems beyond routine stages:
   - devising special letters to customers
   - discussing debts with sales offices
   - using third parties such as collection agencies
   - handling compromise settlements
   - processing insolvency cases
   - recommending write-offs
5 applying payments to accounts; approving cash discounts; banking cheques; maintaining cash book records
6 maintaining customer data files, including credit ratings and payment trends
7 checking customer creditworthiness to establish suitable credit ratings and risk codes, and country status reports for exports
8 fixing payment terms for export customers
9 supervising credit activities of branches and depots
10 coordinating credit activities with other departments
11 developing good relations with banks, credit organizations, etc.
12 training staff as required
13 keeping top management fully informed via reports and analysis
14 setting cash targets to meet company plans
15 contributing to sales conditions
16 contributing to company business planning
17 achieving targeted DSO and aged debt plans
18 contributing to debtors budgets and forecasts

19 measuring and reporting debtors results
20 budgeting and controlling annual departmental expense
21 recruitment, training and motivation of staff
22 arranging a job succession plan.

Duties are aimed at achieving objectives and those objectives for the credit manager can be more easily broken down into:

- the assessment of the creditworthiness of customers; helping sales staff to obtain maximum business within acceptable limits of risk
- protecting the investment in debtors via daily credit and collection controls
- achieving the planned intake of cash by competitive methods to achieve cash targets
- keeping within an acceptable level of bad debts by closely monitoring risky sales
- improving the return on assets by reducing the debtors ratio to sales over agreed time-scales, and
- increasing customer loyalty via personal contacts and constructive attitudes.

A truly motivational objective for the credit manager would be: 'Achieve planned debtors/sales ratios – at the planned cost of doing so!' This can then be applied firmly to separate targets, including specified reductions in:

- DSO
- values overdue totals
- overdue percentage
- credit terms

and improved:

- payment methods (for example, more direct debit accounts)
- security for the more risky accounts
- age analysis quality.

REPORTING STRUCTURE AND ORGANIZATION

The reporting lines for credit management have been the subject of heated debate amongst credit managers for many years. As a function which on the face of it handles money, it has long been held that credit management sits more comfortably within finance or accounting. There are some who argue that promoting profitable sales places it squarely in the sales area, and that reporting to the sales director is more natural. Others see it as important that reporting lines are separate from both sales and finance, and thus go directly to the managing director or chief executive. Another view is that asset control is a treasury function, especially if a large proportion of receivables is generated from export sales.

A further aspect involves customer service, which may be more sales-oriented than finance, but which defines credit control as very much part of the overall customer service sphere of operation.

Because of different company cultures, it is not possible to be definitive over the best 'home' for credit management, though undoubtedly the credit manager is the bridge between finance and sales. As such, he or she has a degree of comfort under either umbrella, but as credit is regarded by most as a financial function, it should report to the finance director, financial controller, chief accountant, etc.

Some of the more obvious pros and cons may be:

Responsible to	*Advantages*	*Disadvantages*
Sales	Credit becomes sales-minded; more aware of company goals	Credit sense may give way to higher sales
Accounting	Can influence cost and profit priorities	May not receive adequate sales data or cooperation
Treasury/ Finance	Close identity of interests	Isolation from daily sales and finance activities

The number of people to be employed in the credit department and how they are organized will depend on the number of customer accounts and what tasks are required. Many companies expect each credit person to perform a variety

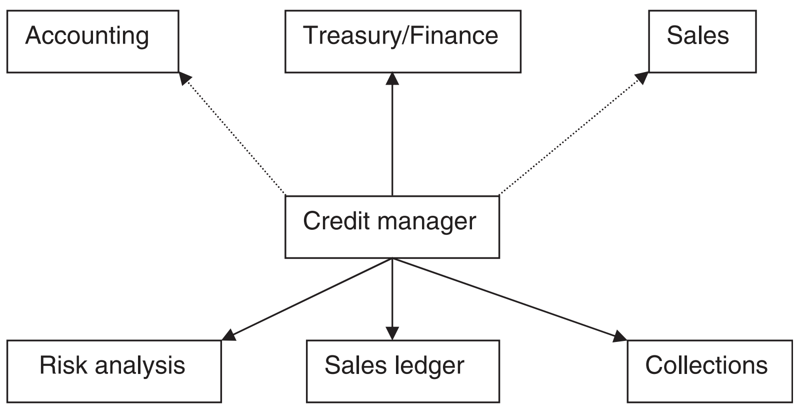

Figure 3.3 Example of credit department reporting structure

of roles, while others will have specific staff for specific duties. In general, the department will:

- maintain the customer data file
- operate the sales ledger
- allocate the cash received
- analyse risk
- approve orders and despatches for credit
- operate the credit insurance policy
- undertake collection activity.

If the sales ledger is divided up, say, alphabetically, then some companies would put credit controllers in charge of each section of the ledger and would expect them to be responsible for all aspects of their section. A typical controller's day in such an environment would begin with cash matching and allocation, updates to the customer file from correspondence received, including amendments to names and addresses, followed by opening new accounts in their section and notifying all concerned. When all the 'housekeeping' was complete, collection activity would be undertaken. This scenario is by no means unusual, even in large companies.

It is quite normal for the activities of sales ledger management (housekeeping) and risk analysis to be split, with specialist staff to carry out the risk assessment tasks without any involvement in other duties.

In other words, credit staff could be 'generalists' or 'specialists'. Generalists do everything on their accounts, while specialists do only the credit checking, or the collections, or the sales ledger work.

On average, generalists cannot adequately cope with more than 600 accounts without results suffering, and to attempt more in most circumstances would be a false economy. In today's climate of 'downsizing', companies find it almost irresistible to expect more out of less, but to overload the generalist and then expect the same accuracy, attention to detail and high level of customer service and involvement would be unrealistic. Quality will inevitably suffer. It is also easy to forget that in trade credit (there are different criteria for both consumer and export credit) a trained telephone collector can usually only effectively handle about 20 to 30 calls per day. This assumes that about 50% of all calls made require a call back (messages left, follow-up on promises, etc.). With an average 20 working days in a month, this equates to about 400–600 accounts per month. Organization and staffing levels are therefore very closely allied to numbers (and quality) of customer accounts.

The credit manager must also establish where the authority and responsibility lie for resolving customer disputes and queries. Some disputes may be quite simple – errors in delivery, for example, or pricing – but resolution finally comes with the production of the credit note to correct the errors. Speed is vital, because collectors can only collect that which is collectable. Unresolved queries cost money directly (financing the debtors ledger) and indirectly (customer satisfaction). Once resolved, who raises the credit note? If not agreed, who tells the customer?

A final note on the reporting line for the credit manager and his/her place in the total organization structure. Reference has already been made to those circumstances where, for example, the task of cash allocation is separated from that of risk assessment or collections. It is growing business practice, chiefly in large national or international companies, to operate centralized 'shared service' functions, where the cash matching and posting is undertaken for a variety of member companies, separate from any risk assessment or collection operation. Whilst not in itself a bad thing, there is a danger that the credit manager will lose sight of some aspects of what has hitherto been regarded as their own responsibility. It is important, therefore, for the credit manager to have absolute confidence in any shared service and ideally have a direct reporting connection with the head of that individual function.

THE QUALITIES OF THE CREDIT MANAGER

The credit manager must:

- be able to influence others
- have good communication skills
- have top-level support
- perform consistently
- be experienced in successful credit techniques.

Not everyone will make a good credit manager, just as not everyone can be an airline pilot or a brain surgeon. There is more to success in any role than knowledge, or experience, more than just technical competence or even personal drive. Traditionally, the credit manager has been seen by many as 'a Jack of all trades, and a master of most of them'! That may be something of an exaggeration, but it is true that some of the roles expected of the credit manager require a level of commercial expertise and understanding which goes beyond the boundaries of some more specialized professions, such as the tax accountant or the matrimonial lawyer. Risk assessment involves balance sheet analysis, as well as interpretation of factors such as market position and trade experience. Collection activity requires both interpersonal skills and commercial awareness. When the managing director hears that customer X has 'gone bust' it is almost certain that they will turn to the credit manager to find out what to do next, so knowledge of insolvency is required. Issuing a summons or a writ means knowing not just a good solicitor, but also the ramifications of taking one action as opposed to another.

A good place to start would be to look at personal qualities, because much of the credit manager's daily role will be dominated by matters of personality. Tact, – knowing when and when not to, how and why. Diplomacy – being right, being sure of the facts and convincing others who disagree at the outset, for whatever reason – requires careful persuasion and also patience and understanding. The authors of reminder letters to be sent to customers know they must be 'firm, but fair' – so too must the credit manager – and be seen to be so by his or her staff..

Good organizing skills are essential, as is the ability to handle people. No credit manager will want to do every job in the department (even though they should be able to), but they must know and encourage the different capabilities of staff, to get the best out of each of them in each task they perform. Good judgement of people does not stop with staff. It is a prerequisite for believing the customer or not when they promise to pay, or makes a complaint.

Persistence and tenacity, accounting ability and a good telephone manner are in there somewhere together with a pleasant personality and, above all, integrity. It goes without saying that the credit manager should know all the techniques, ancient and modern, of credit management itself and not be afraid to make judgements and take those risks which calculation and analysis have shown to be worth taking. Not every one will be a winner, but the good credit manager is usually right far more often than wrong. When all is said and done, credit granting is all about calculating the risk, making the judgement, and going with the decision. For anyone connected with export, some linguistic talent is an advantage because, in spite of popular opinion, not everyone in the world speaks English. Besides, the impression gained by the customer when spoken to in their own language is one of a supplier who cares about customers. That can deliver an important PR advantage.

The credit manager needs to motivate staff. The prerequisite for this is to find out what drives each and every member of staff and find ways of encouraging each one according to those individual needs. To get the best out of people requires *knowing* them – not all respond to the same stimulus, and not all will be capable of doing every task. A prime example is in collection activity – he is nervous and uncomfortable using the phone, but his ledger work and letter writing is flawless; she cannot cope with ledgers and columns of figures, but has a telephone manner that wins every time. Who does what is no contest, then, except that if training is required, it is clear who needs what.

A team is made up of people with different abilities and motivations – those who can or cannot use the phone effectively, those who can or cannot readily reconcile accounts – and the aim of each is to succeed in whatever it is that they are doing. Mix the group, and the team benefits from the success of each. The team has an objective, for example a collection target set by the credit manager. It should be a tough but achievable target; and achieving that goal brings rewards to the team, the efforts of each participant being recognized for the value of their contribution.

The manager must have the ability to support as well as motivate. In fact, strong support from the leader is itself a motivating factor for each member of the team. Staff want to believe that the manager can resolve those problems that lie within his or her domain, and would also respond to a manager who has earned the support of senior management. Managing staff is never easy, and there are as many textbooks on people management as there are football club managers who last a season. Fundamentally, however, it is a matter of personality, observation, motivation and awareness of anything that might act as a stumbling block or a source of encouragement. The credit manager should be able to lead from the front, push from behind and scrum down in the middle. But mainly, to lead.

CREDIT STAFF AND THEIR TRAINING

Staff numbers depend on volumes but also on systems in operation and the support that can be expected from today's computerized environment. Sadly, not all credit managers are properly consulted when new systems are installed, which may explain why some are reluctant to become involved in specifying their requirements when such consultation does take place. Chapter 10 looks at computer systems for credit management in some detail, so we shall confine ourselves here to examining computer support in so far as it concerns staff.

Computer systems serve to remove all the deadly chores from the day-to-day operation of a credit department. The computer is a great help in risk assessment, payment history, records of promises kept and broken, production of invoices, statements and reminder letters, cash allocation and other features of the daily grind. Whatever is done by the computer, it represents something that was previously done by a person, thus freeing that person's time for something more expert. Long gone are the days when it took weeks to open a new account and set up the ledger details. Long gone, too, should be the days when cash was updated weekly, or even overnight. Now, if the screen display says that the account has not been paid then it has *not* been paid.

What is now needed are people who are computer literate, able to find their way round keyboards and systems, as well as having the personal communication skills for collection activity, customer contact and inter-departmental cooperation.

Implicit in all staff management is staff development – enhancing those skills which exist, introducing those that do not, and developing those that may become necessary through changes in work patterns or even company ownership. Training is the key to all success, and the pity is that many companies do not see investing in their staff in the same light as investing in new equipment or new processes. Staff represent an expensive outlay, but they are also the company's greatest asset. As such, they have to be worth the same measure of care and attention as that lavished on the new lathe or the new R&D facility. The returns will far outweigh the investment.

External training is available from a variety of sources, with foundation courses run by commercial organizations such as Dun & Bradstreet, Credit Management Training Ltd, and ATC. The Institute of Credit Management itself now provides a Foundation Course in credit management, delivered through colleges or in-house, as well as in-house training in specific areas such as telephone collection techniques.

The above organizations, and others, hold seminars on many credit management topics throughout the country (the ICM alone runs over 100 such seminars and one-day courses each year). The topics range right across the credit perspective, with a wide selection of speakers and presenters, many of them practising credit managers with many years' experience in consumer, home trade and export. Details of some of the courses available can be found in the Appendix.

The ultimate aim for any credit professional has to be membership of the Institute of Credit Management, the only professional institute for credit managers in the UK, with membership in excess of 9000. The ICM has 26 branches throughout the UK and Northern Ireland, each one holding its own series of meetings, and some (notably Merseyside & North Wales, Wessex, and East Midlands) additionally holding Annual Conferences. The various Scottish branches of the ICM hold an Annual Conference at Hampden Park, to focus on particularly Scottish aspects of credit management, of which there have been a number since devolution.

Perhaps the most thorough training in credit management available today is the personal study necessary for the ICM examinations to qualify as a Graduate Member of the Institute (MICM(Grad)). Tuition is available through a number of local colleges, as well as by distance learning, together with the growing availability of web-based support.

'On-the-job' training also has great value, provided that it is part of an overall training programme. A sustained period of on-the-job training in credit assessment and balance sheet analysis is useful, since these skills are not acquired quickly or by theory. Some credit functions can only be learned by experience, but are learned faster if the credit manager is on hand to give support and encouragement, evaluate and advise. No new recruit should ever be sat alongside a busy member of staff and simply left to get on with it, just as a learner driver should be taught by a driving school – father can provide practice but should not be passing on bad habits!

When the credit manager identifies specific needs, then relevant training can be arranged – telephone collection techniques, effective letter writing, interpretation of balance sheets, the dos and don'ts of Emails, etc. Companies and organisations that run credit seminars in hotels, conference centres and in-company (on site) can be asked to tailor their sessions to individual client needs. Where several staff are available for training, in-company sessions can be much cheaper than external courses and benefit from being tailored to specific company requirements. However, external courses and seminars expose staff to people from other companies and can open eyes to better ways of doing things.

A mixture of internal and external training is ideal, but whichever methods are used, the credit manager should hold a de-briefing session with the delegate(s) and generate action assignments to use the knowledge gained. A manager is well defined as a person who achieves the required results through other people. A credit manager, therefore, is only as good as his or her team and it is a sensible manager who ensures that the team is thoroughly trained and equipped.

INSTITUTE OF CREDIT MANAGEMENT – JANUARY 2002

Introductory Credit Management – Certificate

Question 4

(a) Name four functions of a credit department and outline what is involved in carrying out these functions.
(b) Outline the main duties of a credit manager.

Advanced Credit Management – Diploma

Question 5

You have recently become Credit Manager of a chain of retail outlets that have their own in-house finance facilities available for their customers.

The company does not have a credit policy and your Financial Director has suggested you use the same credit policy document you used in your previous company, which was a manufacturing company.

State whether or not you believe this to be appropriate and give reasons for your views.