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WHITEPAPER

# Tips for establishing a business credit policy that works

Includes a credit policy that can be adapted to fit the specific needs of your business.

# Tips for establishing a business credit policy that works

Depending on who you ask, the credit profession is either changing rapidly or stuck in the slow lane. New technology has accelerated the pace of digital transformation at some organizations, yet others still like to do things the old-fashioned way – with pen, paper, rubber stamps, and filing cabinets or they are lost in the "modern" world with infinite (technical) possibilities.

If your company has adopted new technology within the past couple of years to streamline its credit operations, has its business credit policy been updated as well, if there was already one present?

A company's credit policy shouldn't be gathering dust with outdated guidelines and often it is: It should be changing with the times, reflecting updated processes for credit and collections as tolerance for risk shifts across the portfolio. It's important to periodically revisit your credit policy to keep it up to date and in line with your credit appetite.

Ideally, this should happen at least once a year. Developing, refining, and evolving an effective credit policy is nothing short of essential. It should align your corporate goals with business procedures and help your company reduce bad debt and write-offs. It should also strengthen your company's payment cycles, liquidity and lead to increased profitability.

The truth is that not all companies even have their policies written down. Credit policies can be "institutional knowledge" at some organizations – seasoned credit professionals seem to know or "feel" the company's appetite for risk. So,the best process to apply toward any account seems to come forward naturally. But is this communicated properly to newer team members in the credit department and is it consistent across the board?

Are salespeople also aware of the credit appetite within the company? Or is it "learn as you go" knowledge? When it comes to the credit policy, there should be no grey areas that lead to misunderstandings or miscommunications with colleagues or customers and ultimately to wrong decisions, costing the company business and therefore money.

Enforcing a sound credit policy will, of course, help reduce exposure to customers who can't pay on time or in terms. And you need to have monitoring strategies in place that will help spot potential issues or even identify new opportunities with existing customers. When you know your data, you know how much you can lend (remember that extending credit is lending, often without charging interest for the service) and still make cash flow.

This guide outlines the necessary steps to establish – and apply – a comprehensive credit policy. It also includes a sample credit policy that can be adapted to fit the specific needs of your business.

# Developing your policy

The Credit Research Foundation (US) established the following six critical questions for developing a credit policy. How these questions are answered lays the foundation for the kind of credit policy that will be most beneficial to your company.

1. What is your mission?
2. What are your goals?
3. Who has specific credit responsibilities?
4. How is credit evaluated?
5. How are collections handled?
6. What are your terms of sale?

1

# What is your mission?

Here we are asking, "What's the credit department's purpose, e.g., what are the tasks and why?"

Consider your answer to be a statement of what you do and why you do it. It can be general or specific, but make sure it aligns with the corporate-level mission statement.
An example: "The credit department defines the requirements for establishing trade credit for new customers and maintaining credit lines and limits for active accounts and returning customers with appropriate payment terms. The credit department also strives to offer optional payment methods to facilitate sales to customers with sub-optimal credit histories or ratings."

2

# What are your goals?

Simply stated, this is a quantifiable and measurable goal for your organization. How do you help ensure your company is paid and optimizes cash flow?

This is a projection and a plan of what you will seek to accomplish with a healthy portfolio of accounts. Perhaps you aim to keep the percentage of past due accounts below a certain figure, or maybe you automatically approve credit requests for a certain amount when the account passes scorecard checks. More definitive goals, such as "reduce DSO by X%," may require more frequent revisions to the credit policy – but then, more definitive goals may be the most effective form of communication across the enterprise to mitigate risk. Again, the credit department's goals need to align with the company's overall goals and will likely need to be adapted or modified as changes to economic conditions and the competitive landscape occur.

3

# Who has specific credit responsibilities?

Roles and responsibilities should be clearly defined to maintain order and enable team members to feel empowered, not diminished. Do salespeople try to escalate questionable credit requests? Does your colleague in accounts payable frequently ask for your team members' help at the end of the quarter? Are your credit managers also responsible for collections? Being clear here can result in reduced redundancy and increased efficiency.

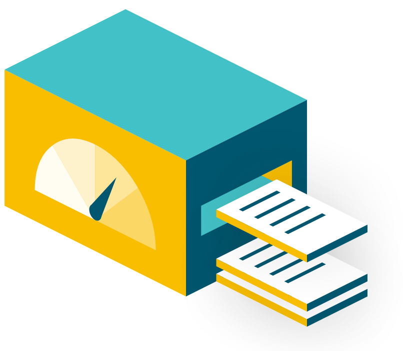
For example, you could dictate that credit managers are solely responsible for assessments and approvals, in order to minimize collections and align with corporate financial goals (e.g., a "pre- check" from sales won't accelerate the deal). Salespeople getting involved in the credit application process has caused problems in the past, you may want to require that only members of the credit department are authorized to communicate with prospects or customers concerning their status and subsequent terms.

4

# How is credit evaluated?

It's safe to say that organisations will issue trade credit to applicants who have a history of paying on time and who share financial data that shows they can continue to pay on time.

But if an applicant shows below-average risk scores from a third-party credit data provider like Altares – Dun & Bradstreet or is unable to provide trade references or financial statements – is that a deal-breaker for your company? Many organizations are also using credit scorecards (scoring models) to evaluate high-volume applicants at scale. Should applicants fail the scorecard's criteria, what is the re-decisioning process? Here you determine what is or is not acceptable. While this may seem basic to a credit professional, creating and maintaining the company's credit evaluation and re-decisioning process is necessary to ensure fair, unbiased, and consistent treatment of all applicants.

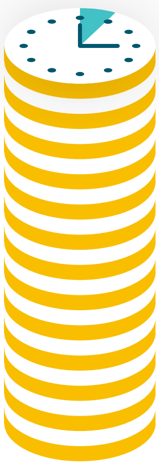


5

# How are collections handled?

Disputes and collections can be considered the dark side of trade credit. Most credit professionals would love never having to chase a customer for payment. However, when the agreement to pay is not honoured, even unintentionally, collections procedures must come into play. What consequences does your company want to enforce for breach of contract?

At its most customer-friendly, the collections process can be as follows: After a payment is missed (and you can confirm the invoice was sent), an auto-generated email gets sent to the customer with a request to call or pay immediately. The collections staff follows up with a phone call within 24–72 hours (depending on whether you want to allow for a grace period), sticking to a script to maintain a professional tone. At the same time, a letter on the company's letterhead is sent through e-mail or more conventional by post. Each company may have a different tolerance for how often they want to start or repeat this process; some companies may do this three times, taking up to 90 days, before they turn the account over to a collections agency.



Other factors to consider when establishing the frequency and length of the collections process include the overall profitability of the product or service, risk profile of the account, and amount of the invoice.

6

# What are your terms of sale?

It may not be as simple as "Net 30 across the board!" Different types of orders for different products require different terms of sale.

Here, as in the credit evaluation phase of the business relationship, it's important to have a clearly stated policy in order to remain fair and impartial and provide consistent terms to all accounts. In addition, it's the law – familiarity and compliance with trade and anti-trust laws is critical for every credit professional.

# Credit policies: reducing risk, strengthening cash flow, and giving you peace of mind

By explicitly documenting processes and procedures, a clear credit policy will ensure consistency across your account portfolio and help lead to stable and predictable cash flow. It should be grounded in the deep knowledge you have about your company, its risk tolerance across the portfolio, and your experience with customers, their industries, and their payment behaviour. With that, here are three steps you can take to build a credit policy that works.

1

## Know how much credit can you afford to extend

The first step in establishing the parameters of your credit policy is to understand just how much credit your company can afford to extend, in the context of your customers' ability to pay. Here, an analysis of the portfolio is crucial. Once you have a deep understanding of the accounts receivable – e.g., company size, industry, location, average credit extended – you can begin by setting a standard for certain criteria and milestones.

2

## Learn who pays on time – and who doesn't

This leads to the next thing you'll want to examine: Which accounts pay on time, pay late, or don't pay at all. DSO (days sales outstanding) is a ratio measuring the average number of days that a company takes to pay its invoice. It's calculated for a given period by dividing accounts receivable by total credit sales and multiplying the result by number of days. (DSO differs from DBT, days beyond terms, which is focused on the average number of days that a company takes to pay its invoice once it's past due, or beyond terms.) It's also helpful to compare Paydex scores with industry averages, you will find the Paydex in Altares – Dun & Bradstreet Credit Risk Products.

You might find out that your riskiest segment of accounts takes more than 90 days to pay, but the majority of your accounts pay within terms. You might find out that your largest customers are the worst offenders, and due to the size of the invoices, they impact monthly cash flow. Many businesses tend to be more lenient on their larger customers because they don't want to lose that big contract, but you may discover that those larger customers are costing money in the end. You may also find out that your newer accounts have a lower DSO than your established accounts because you've made better credit decisions than you did previously. Building an explicit credit policy is a good way to standardize those "better credit decisions."

For example, you might want to define that credit requests over € 250.000 must pass certain checks, such as favourable credit scores, and that credit requests under € 25.000 can be offered a payment discount. You also might realize that you need separate credit policies for customers in different countries, due to local regulations and market standards.

# Extend credit on your terms (and make it possible to always say yes)

You must decide how long you will allow for payment, what early payment discounts you may offer, and whether to extend credit at all. Here are a few example questions to consider when it comes to payment:

- Will you set terms at 30 days? Or 15? Remember that in order to comply with local trade laws, exceptions to standard terms may be subject to legal restrictions.
- Will you offer 2/10, net 30 (whereby you give a 2% discount when the invoice is paid within 10 business days instead of 30)?
- Do you accept payment at delivery or in advance for customers who don't qualify for trade credit?
- What about cryptocurrencies?

When it comes to payment, your credit policy should very clearly outline the penalties you are prepared to impose on your customers should you find yourself chasing late payments.

Generally, a credit hold is placed on a delinquent account in case the customer tries to re-order. There are many options to then consider, such as late fees, lowering the credit limit (in the case where a hold is not placed), establishing a prepay schedule, or requiring a deposit so you don't have to stop shipping altogether.

You can also consider requesting a promissory note for past due items, ask for collateral to secure the note, or ask for a corporate or personal guarantee. Referring to roles and responsibilities, you may want to clarify who is approved to communicate with customers about resolving credit holds and delinquent accounts when the customer does initiate contact, as these can be sensitive issues.

In the current economic climate, it may simply seem impossible to say no to a prospective or returning customer. The good news is that credit policies which require obtaining detailed information about the customer may in the end make it easier to say yes.

Even marginal customers – from newer companies with insufficient credit histories to those that have indeterminable risk for a variety of reasons – even they may have potential. The key is to manage against that reality to make the sale successful and provide a basis for mutually profitable future transactions.

When managing marginal customers, it's important to maintain a mindset that every customer has potential. Recognize which opportunities come with risk, and then use strategies to limit your exposure, including:

- Require progress payments to mitigate part of the risk
- Limit exposure by shipping only one order at a time
- Employ security instruments such as deposits, guarantees or letters of credit.

# A brighter future

Establishing a credit policy and developing a systematic and scalable way to evaluate customers' stability – and their ability to consistently pay for the goods and services you provide – is incredibly beneficial.

**With sound credit policies in place, you may see:**

- Larger sales volume: Customers may buy more if they know they have attractive payment terms.
- More sales from existing customers: When you know which customers are good financial partners, you have a clearer view of which ones to invest more time with to win more of their business.
- New customers: Credit terms may attract customers who hadn't done business with you to try your goods or services.

The credit policy you create will no doubt serve as the anchor for your entire business operations. With the right safeguards in place, it can guide your business toward streamlined processes and procedural insights that reduce your exposure to risk, ensuring your company becomes more profitable than ever before.

# Sample credit policy

A company's credit policy can vary in length, from a couple of pages to hundreds of pages. Starting below is an example of a sample business credit policy that can be adapted to fit the needs of any company.

## Mission

The credit department defines the requirements for establishing trade credit for new customers and maintaining credit lines and limits for active accounts and returning customers with appropriate payment terms. The credit department also strives to offer optional payment methods to facilitate sales to customers with sub-optimal credit histories.

## Goals

Each year, the credit department works with executive management to establish new goals for the coming year. These goals are based on many factors – including the company's credit policy, sales and financial requirements, competition, our desire to move into new markets, and the condition of the domestic and global economy.

The credit department's main goal is to maintain a Days Sales Outstanding (DSO) of 60 days or less, however, that is dependent upon programs established in conjunction with the sales department.

Receivables should remain at least 75% in the current category and less than 5% in the over 60 days category, with bad debt write offs not to exceed 0.5% of annual sales.

All past due customers should be contacted when invoices are 15 days past due. All customer credit lines should also be reviewed every two years; however, all customer credit lines exceeding x amount shall be reviewed annually. Any order flagged will not be shipped until the order is reviewed by the credit department.

## Roles and responsibilities

team leader – The Credit Leader has overall credit and collections responsibility for the credit department. Employees in these roles have authority to approve credit lines up to x amount. Anything exceeding this amount needs approval from the Finance Director.

Credit Manager – The Credit Managers are responsible for managing the credit evaluation, review, and approval process, as well as managing overall risk to the portfolio. Only credit managers and leaders are authorized to issue communications with customers concerning credit-related issues.

Accounts Receivable – This position/team reports to the Credit Manager(s) and is responsible for daily accounts receivable activity, including invoicing and processing incoming payments.

Collections Manager – This position/team oversees collections and works with contracted collections agencies if the collection manager is not successful in collecting the outstanding amount.

## Credit evaluation policy

The credit department establishes and maintains credit lines and payment terms for all new and existing customers. Credit is extended to customers who can demonstrate their ability to repay a debt. Creditworthiness is determined via third-party credit information from Altares - Dun & Bradstreet, trade references, and the customer's financial information (when required).

Our company uses credit scorecards to determine creditworthiness and assign credit limits. The credit department evaluates the scorecard result alongside other information provided in the online credit application and will determine if the customer has the ability and willingness to pay at the required level. In the absence of any red flags, such as bankruptcy or a documented case of fraud, appropriate credit limits will be set.

## Credit review policy

For existing customers, the credit department reviews credit limits as needed. All limits may be subject to change based on changes in customer creditworthiness. Individual orders are referred to the credit department when an account is over their credit limit, and/or the customer is past due and every attempt has been made to seek payment. If satisfactory arrangements can't be made, the account is placed on a credit hold and the order will be held or cancelled.

## Terms of sale policy

Terms of sale are determined based on current sales programs and promotions. The credit department works closely with sales to institute and modify appropriate terms that maximize sales outcomes. Advance payment discounts may be used to close new business, if needed. Standard payment terms are net 30; net 45 for sales over x amount, or four equal quarterly equal payments due on days 1, 90, 180, and 270.

Terms for orders already shipped cannot be altered or modified without approval from the credit department. Any changes from standard payment terms requires a variance request form.

Variances are the rare exception, as non-standard terms have a negative impact on cash flow and DSO; they also increase the cost of carrying the accounts receivable.

## Credit card policy

Our company accepts credit cards as a method of payment for all customer purchases and open cash invoice customers who want to pay the remaining balance by credit card. All major credit cards and debit cards are accepted. Credit cards can be charged for any monetary amount – it's not restricted to sales and/or orders under or over a certain amount, nor limited to customers with certain payment terms. Customers paying by credit card will not incur any additional fees, such as merchant fees, nor will they receive a discount. When a charge is disputed by the customer, our company policy is to individually review and then issue a chargeback or refuse the refund if the dispute is found to be invalid. Our company currently does not use mobile payment systems or contactless payment systems for credit card purchases.

## DELINQUENT ACCOUNTS POLICY

This policy establishes the procedures to be followed should an account have an open receivables balance more than 90 days past due. In congruence with the D&B Paydex, it's labelled as "severely delinquent." The credit team alerts the sales team to the outstanding balance, and the credit team will send a letter marked Final Notice to the customer. The account is placed on a credit hold; stopping future orders from being processed or shipped. The sales and credit team will work with the customer to resolve the issue. If the outstanding balance is not resolved with payment, the revenue is cancelled, and the account now must be treated in adherence with the company's Bad Debt Policy.

## BAD DEBT/COLLECTIONS POLICY

When a severely delinquent account (91+ days past due) is not resolved with a good faith effort of payment, the expense may be written off to bad debt. Our company's definition of bad debt is an uncollectible balance owed from a customer experiencing financial hardship such as bankruptcy. Non-paying accounts can be written off to bad debt only after the customer has gone out of business, has filed for bankruptcy, or has been placed for collections and payment has not been secured after six months (180 days). Financial hardship can include, but is not limited to:
a company that shows a D&B Delinquency Score of less than 20,
a D&B Paydex of less than 40,

and a D&B Risk Rating of 4. If every attempt at collection fails, otherwise outstanding balances are turned over to our company's collections agency (a third party) if approved by both the Finance Director and the Sales Director.

## MERGERS & ACQUISITIONS POLICY

When one customer buys another customer's business, the acquired business is transferred to the account of the acquiring or surviving entity. The surviving entity's Dun & Bradstreet D-U-N-S Number is established as the master. It is the responsibility of the acquired business's sales and credit representative to ensure the acquired account is in good standing. Issues such as bad debt, outstanding balances, purchase orders, etc. must be completed prior to transfer. These issues should be documented, and a treatment determined and/or resolved during planning between the two teams.

# Checklist:

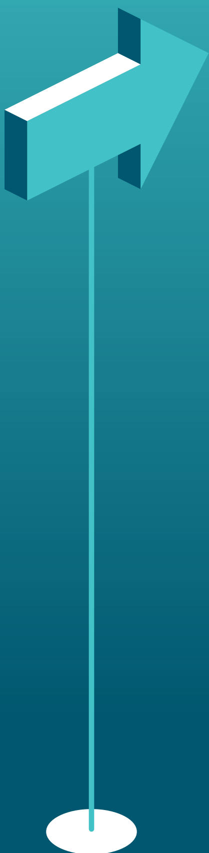
## For a complete picture of a credit applicant

The credit policy should state the required information your company collects as part of the application. You'll want to make sure you're capturing all the data needed to provide a complete picture of the applicant to help you make the most informed business credit decision and provide the best possible terms. Remember, even if the applicant can't provide everything, you can still extend credit, as long as the terms comply with the credit policy and corporate risk tolerances.

- Full legal and trade name(s)
- Dun & Bradstreet D-U-N-S® Number
- Billing and shipping address
- Tax ID
- Local registration number
- Principals/ownership
- Contact information
- Trade references (customer provided or D&B payment experiences)
- Date of founding
- Financial statements
- Type of business/legal status

OUR VISION

# Smart insights to shape your future



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