Interview / **Bottom Line Business**

How to Avoid the Many Costly Traps in Managing Customer Credit

It is always tempting to sell to a customer who promises to pay promptly. Unfortunately, even so- called "good" customers delay payment-and some default-on trade credit. The unpredictable nature of today's business climate wreaks havoc on the finances of even the best-run businesses.

It is possible, however, for sellers to protect themselves from customer credit problems. It just requires a bit more work than was the case in earlier years.

Rule of thumb: Customer credit has two basic components…

- Assessing risk, which involves checking the credit status of a customer to decide whether to extend credit in the first place.
- Guaranteeing payment from the customer-when and if the decision to extend credit is made.

RISK-ASSESSMENT TOOLS

These days, companies need more than the standard three trade references and one bank reference to verify a customer's credit. If a customer is pressing for a credit limit that seems high, ask for the following…

- **Bank statements from the last three months.** These statements will reveal a complete quarterly picture of the company's cash flow, detailing cash in (deposits) and cash out (disbursements). They will also provide a snapshot of the company's average balance cycle-the times during the month when the company has its highest and lowest balances, and its largest check written within the last 90 days. It will also indicate whether the company's credit request is out of line with other bills it has incurred.

Bank statements will also reveal whether there were any NSF (not sufficient funds) checks, and whether the bank covered them.

Important: Even if the bank did help the customer pay a bill, NSF checks should be a red flag that indicates a company can't manage on its current cash flow.
In addition, bank statements can provide information about a customer's operations that might not be found elsewhere.

Example: A customer requested a $20,000 credit limit and we were inclined to grant it But the bank statements revealed that the customer had never written a check for more than $6,000, and its checking account balance was only $5,000. So we decided we needed a financial statement before making a decision.

Other options in such an instance: Insist on a cashier's check (which segregates and protects your payment from other checks drawn on the customer's account)...or ask the risky customer to pay for merchandise up front and ship the goods after the check clears.

- **Financial statements.** These documents are more accessible than many people realize. One easy way to get hold of such statements is to include a box to be checked off next to a line that reads, "Financial statement available upon request," on your company's credit application form.

If this box is checked, you know the statements are available. But even if the box isn't checked, don't give up. If large orders-over $20,000, for example-are involved, you can press the customer to provide them.

Make sure that the financial statement provided is current. Ask for the most recent year-end statement. If it is more than eight months old, also ask for the most recent quarterly statement. That way, you will be able to track trends, such as a slowdown in accounts payable...increases in bank debt... unusual fluctuations in expenses.

PAYMENT GUARANTEE TOOLS

Even if your company can't get all the credit information it needs from a customer, there are approaches that may allow you to do business with that customer and still reduce the risk of not getting paid. Consider the following techniques…

- Joint-check agreements. These agreements are useful for companies that don't qualify for high credit limits but happen to have a big order from a respectable customer. Example: If your client's customer is a Fortune 500 company that pays your client with a check made out to both you and your client, you have the leverage to make sure that you get - paid, too. Why? Because your name is on the check and you must endorse it before it can be cashed.

Important: A joint-check agreement must be set up in writing, in advance of the sale. The agreement should state that it cannot be changed after the deal by just one party.

- **Letters of credit.** These are very useful if your company has a customer that is not creditworthy and that is dependent on one large buyer-and that buyer must pay the customer before the customer can pay you.

Ask your customer to give you a "domestic standby irrevocable letter of credit." This guarantees that if the customer doesn't pay within 90 days, the bank that issued the letter of credit will. As its name implies, the letter of credit is good in the US, is good any time after the due date of the receivable up to the expiration date of the letter and can't be canceled.

If your company already does business with a large commercial bank, the cost of a letter of credit should be approximately 1% of the face value of the letter. So the cost of a $20,000 letter of credit would be just $200. You could offer to split the fee with your customer. For $100, you would get a $20,000 order and a guarantee of payment. Pretty cheap peace of mind.

- **Credit cards.** These can be a great way for brokers, sole proprietors or small companies with limited assets and lots of small orders (from $75 to $300), to finance their purchases.

Consider opening a merchant Visa® or MasterCard® account. Then have these smaller customers pay for their orders with credit cards. You get your money up front and they have months to pay off the balance-to the credit card issuer. Having the credit card issuer- rather than your company-finance the transaction is a great way to cover credit risk. Your cost for this "insurance" is anywhere from 1.5% to 3% of the transaction.

Example: It might cost $45 at a 1.5% rate to let a customer charge a $3,000 order. That's not a bad price to guarantee payment. But you don't have to bear the entire cost. You could bill the customer $3,045 to reflect your additional fee. If the customer balks, you could explain that paying by credit card gives him 30 days, if not more, to pay the bill. You could also offer to split the cost of the credit card transaction with him.

CREDIT CAUTIONS

Insuring receivables is great, but it is no substitute for keeping track of the financial health of customers.

Important: Keep in regular phone contact and be on the lookout for such warning signs as a slow-pay pattern that no longer qualifies for a discount...a request by the customer's bank that it find another lender...a sudden increase in the customer's borrowing up to its credit limit...a divorce in the works for a key principal...and a slowdown in the customer's own accounts receivable.

Also, the best credit policies in the world can't protect against disputes-the biggest reason for nonpayment. To protect the company from such disputes-say, a customer is 89 days late on payment, and on day 90 suddenly announces that he doesn't intend to pay the full amount because the shipment was short or because the product was damaged-rubber-stamp invoices with the following message: "Unless we are notified within 10 working days, we deem the merchandise to be clean and acceptable."

Some disputes are unavoidable, but simple steps such as these may reduce the number of disputes to a manageable level.

Bottom Line/Business interviewed Eric Shaw, president of New York Credit, an independent consulting service that helps companies in the manufacturing, wholesaling and distribution industries improve the management of their accounts receivable portfolios. He is the author of The Game of Credit, a book and board game designed to help small businesses better manage their receivables, New York Credit, 929 Howard St., Marina del Rey, California 90292, (310) 827-0076 $29.95.