# straight talk
## ON CREDIT CHECKS

There's Information
Out There that Could
Make or Break You...

## Are you making credit decisions with one eye closed?

YOU MAY BE JEOPARDIZING YOUR SUCCESS – AND PUTTING YOUR BUSINESS AT SERIOUS RISK.

### WHAT IF YOU:

- ***Extended a substantial amount of credit to a company only to find that their standard terms were 90 days?***
- ***Trusted that a supplier would produce a critical item and then discovered they had several court cases against them for non-delivery?***
- ***Produced a huge order for a new customer in Europe – then learned they had a record of non-payment?***
- ***Were about to grant credit to a new customer whose principal had a history of business failure?***

IT'S TIME YOU WERE INFORMED.

# Foreword

This booklet is designed to help you learn how to protect your company by making informed decisions about extending credit. It's about leveraging information to avoid risk and advance opportunities – enabling you to grow your revenues and keep your business healthy.

Reliable information will empower your decision-making capabilities, enabling you to:

- *Evaluate the risk of extending credit.*
- *Research your customers' payment habits.*
- *Research your customers' legal records.*
- *Qualify new sales opportunities.*
- *Monitor and evaluate your vendors.*

***Let's get started!***

SECTION 1

# When a Handshake Isn't Enough

Today more than ever, it pays to be careful. Times are lean and businesses face greater financial challenges than perhaps ever before.

## 1.1 Protecting Your Business

It's not always easy to find the balance between risk and return. How much credit should you extend? To which companies? Under which conditions? Are you using the best suppliers for your needs? Will they deliver on time? Are they dependable? You want to make smart decisions, to give yourself every opportunity to build customer loyalty and strong supplier relationships. Yet you are concerned. The repercussions for making the wrong choices and credit decisions can be costly, even disastrous, for your business.

## 1.2 Unearthing and Leveraging New Information

The right information can make the difference between smart and poor business decisions, particularly in granting credit. The more you know before you extend credit, the better your chances of getting prompt and full payment.



To elaborate, on the surface a company may appear to be secure and trustworthy. But potential difficulties may not be apparent at a glance. Consider the implications of having – or NOT having – this information about a business:

PAYMENT HABITS – *What's standard – 30/60/90 days – or more?*

LEGAL RECORD – *Are there customer lawsuits outstanding? Have these vendors ever been sued for late or non-delivery?*

CORPORATE FAMILY TREES – *Is a company that appears solid related to another that may not be creditworthy? Is a small company really part of a larger, more prosperous customer prospect?*

COMPANY OFFICERS – *Who manages the company? Do they sit on other Boards of Directors? What are their track records of business success and failure?*

## 1.3 The Increased Vulnerability of Small Business

The reality is, as a smaller-sized company you may be at higher risk to suffer a bad debt. Here's why:

LARGER COMPANIES:

- *Typically have "better" customers – more established.*
- *Have the option of "picking and choosing" debtors.*
- *Have more resources to review customer creditworthiness.*
- *Have policies in place to review customer creditworthiness.*
- *Are not typically targeted by serial bad debtors.*
- *Have a dedicated staff to deal with debtors.*

The more you know before you extend credit, the better your chances of getting prompt and full payment.

Clearly, as a smaller business, effective credit decision-making is even more critical.

SECTION 2

# Risk versus Reward: The Benefits of Extending Credit

Extending credit – to the right people, under the right circumstances – can be a boon to your business. The key is knowing when and to whom.


## 2.1 Cash Flow Equals Profit Potential

It's a fact that cash flow problems are responsible for causing over 70% of businesses to fail within their first year. But what exactly is cash flow – and why is a cash flow crisis so debilitating? Cash flow is the lifeblood of any business; it is the movement of money within the organization, both as income and expenditures. It is key for business survival and growth as it funds all transactions.

So how can you ensure that your business maintains a healthy cash flow?

One important way is to properly manage credit. You need to ensure that debts owed are paid in a timely and efficient manner to bring anticipated funds into your company.
Late payment or non-payment of debts wreaks havoc with cash flow, not to mention the high labour costs of collection efforts.



## 2.2 Is It Still Worth It?

With cash flow risks, and the prospect of potentially never collecting money you are owed, it may almost seem that extending credit simply isn't "worth it". With the associated risks, some small businesses may ask "why bother"? The answer is that granting credit – prudently – is a must for success.

At the same time, it is not sufficient to provide credit to your customers just because "everyone else gives credit", although it is vital to keep your customers' needs in mind as you develop a credit policy. An excellent starting point is to evaluate how your company might gain by allowing credit sales. Any or all of these benefits can result:

INCREASED SALES – *Customers enjoy being able to delay payment, encouraging them to buy more. For many industries, providing credit is, in fact, an important business norm.*

IMPROVED PROFITABILITY – *Higher sales mean a healthier bottom line.*

NEW CUSTOMERS – *Individuals who may not have purchased from you before may be enticed to try (and become a loyal customer) when an attractive credit plan is offered.*

INCREASED MARKET SHARE – *If your credit policy offers more attractive terms for customers, they may be persuaded to buy from you rather than your competition, enhancing your market share position.*

Granting credit – prudently – is a must for success.

Now with your strategy in place as to why you should extend credit, you are better equipped to develop policies and procedures to ensure that credit granting produces profitable growth for your business. You're ready to learn how to make better credit decisions and learn about ways to reduce the risk of non-payment.

SECTION 3

# How to Make Better Credit Decisions Using the “4Cs”

The starting point for determining who should or should not receive credit privileges from your company is assessing the prospect’s ability to pay you back – if he can and when he can.

4Cs
CHARACTER
CAPACITY
CAPITAL
CONDITIONS

## Introduction: Assessing a Customer’s Ability to Pay

If you’ve done a good job of selling your business’s strengths, it will inevitably lead to this situation: “The customer wants to buy more of our product but doesn’t have the cash flow to pay us right away. He’ll be able to pay in a few weeks – after he fills his orders and his customers pay him. Can we, should we, sell to him on credit?” The answer is, it depends.

There are four key attributes to consider when deciding a potential customer’s creditworthiness. As a business owner, it is wise to measure how the customer rates on each factor before coming to a final conclusion.



## 3.1 Character

Getting a sense of the character of the business and its principals is critical in assessing a company’s ability to satisfy obligations. What is the experience of its management team and principals? How long have they had control? Who is the owner – and ultimately responsible if a problem arises? What is his financial worth? What is the background of the company’s officers? Check into the business itself as well. What is its history? What is its exact name and legal form? Any litigation or bankruptcy issues? What products does it sell? On what terms? Does the business have major seasonal fluctuations? How well does it benchmark against its competitors?

## 3.2 Capacity

A company’s capacity to operate productively on a day-to-day basis is also an important consideration in your credit decision. In smaller businesses, principals are often forced to wear many hats, potentially diluting their ability to manage effectively. If they are spread too thin through the various business functions – sales, production, finance, etc. – efficiency and business performance could deteriorate. Keep an eye on management and the business’s facilities.

The financial ability of an organization to meet its obligations in a timely fashion should be thoroughly analyzed.

## 3.3 Capital

The financial ability of an organization to meet its obligations in a timely fashion should be thoroughly analyzed. There are two variables to address: the willingness of a company to pay and its ability to pay. Conducting business with customers unable to pay is quite different than with those unwilling to pay. You may be able to work out terms with a customer who is unable to pay immediately, but customers simply unwilling to pay on time perhaps should be denied altogether, or required to pay a premium for their increased risk.

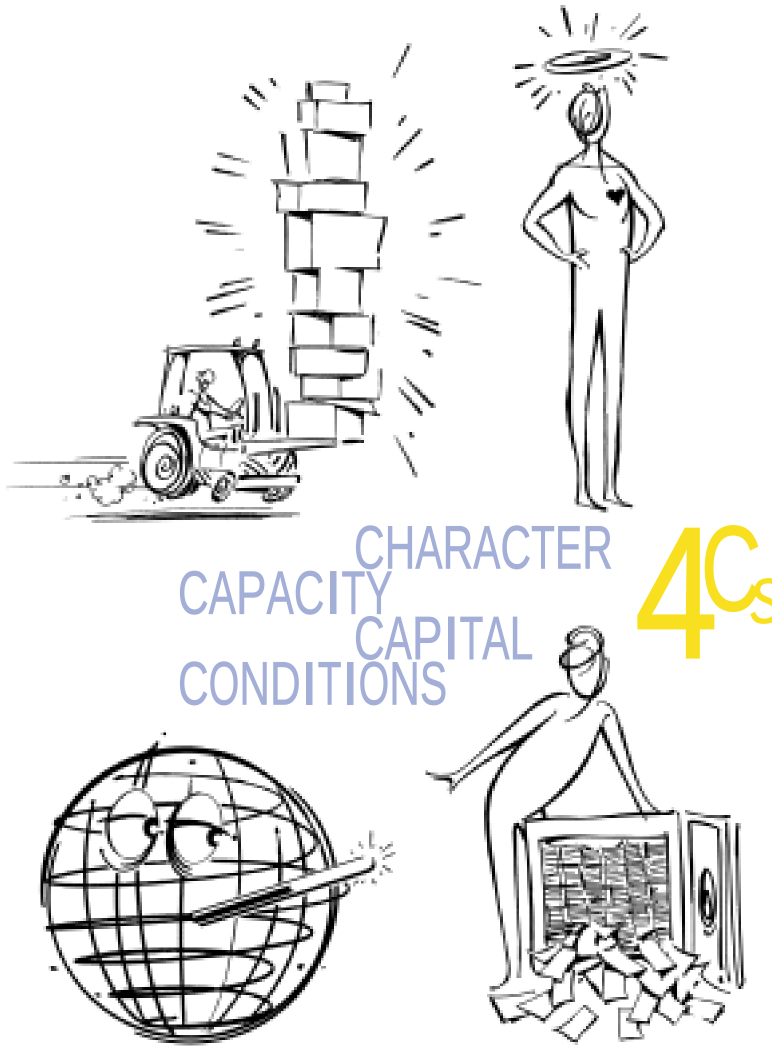
There are a number of ways to learn about a customer's financial solvency and payment background. The best approach is to find a credit information partner that can provide up-to-date information on key business variables, giving you the data you need to make sound judgments. You might also consider reviewing bank and trade references, as well as reviewing any pending litigation or contingent liabilities. Is there a parent company? A guarantee may be available. Keep in mind that inter-company loans might also affect financial solvency. Always check agency ratings that predict slow payment or default. In addition to working with a reputable credit information provider, remember that one of your best indicators is watching customer payment habits over time.

## 3.4 Conditions of the Times

Analyzing the big picture can also reveal valuable insights. Overall conditions may have an effect on a company's financial picture, and hence, ability to pay. What is the general economic climate across the country, within the community, within the industry? Is the company in a growing or shrinking industry? Is this considered a prosperous or more depressed economic time? Are there any happenings in the news that affect this company?



Working together, the 4Cs provide an excellent snapshot of a company's ability to repay credit. They can help provide some of the guidance you need to make informed credit decisions.



SECTION 4

# Easy Ways to Minimize Your Credit Risk

Analyzing a customer's ability to repay credit is vital – but there is much more to plan and organize. The points below will help you formulate a comprehensive strategy to make the most of your credit opportunities while managing your risk.

## 4.1 Set-up a Credit System

Before developing a credit policy, you need to know how extending credit will affect your key business variables and what processes are necessary to ensure any changes are properly handled. Ask yourself these questions as a starting point:

- ➜ *Do you have the required cash flow? (Cash flow is defined in Section 2.1.) What is sufficient?*
- ➜ *Do you have a system in place for receivables?*
- ➜ *How will you assess a customer's ability to pay? (See Section 3.)*
- ➜ *What credit information organization will you use to assist you?*
- ➜ *How will you collect accounts that become overdue?*
- ➜ *Is your product priced accurately to reflect the cost of granting credit (i.e. to protect your income)?*
- ➜ *What terms will you use in extending credit?*

## 4.2 Create a Credit Policy

Your credit policy should determine how and when to sell on credit, what kind of terms to offer, the conditions under which those terms should be changed, when to resort to collection efforts and what those efforts should be. The only real objective of a credit policy is that it should turn credit sales into paid



credit sales. In developing a credit policy that meets your company's needs, consider these questions:

- *How much credit can you afford to extend? What will be the maximum credit you extend per customer?*
- *How long will you allow for payment?*
- *Will you offer early payment discounts – and what will be the penalty for late payment?*
- *What will you include on your credit application form? (See exhibit below.)*
- *Who will be your credit contact? Who will it be within your customer's company?*
- *How will you delegate credit responsibilities among your staff?*

### Suggested Questions for Credit Applicants

Most if not all of the following categories should be included to obtain the complete picture on a corporate credit applicant:

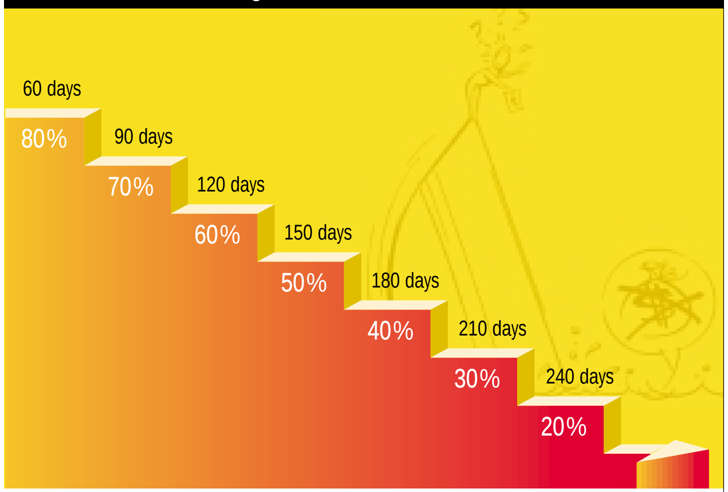
- ➜ *Full legal name and address.*
- ➜ *How long the company has been in business?*
- ➜ *The form/type of business.*
- ➜ *The company's bank.*
- ➜ *A listing of the applicant's suppliers (to gather trade references).*
- ➜ *A listing of current assets including: inventory, cash on hand, accounts/notes receivable, etc. and fixed assets including buildings, land, fixtures and equipment.*
- ➜ *A listing of current liabilities, including accounts/notes payable, accrued taxes, payroll accrued, etc. and long-term liabilities.*
- ➜ *Total net worth.*
- ➜ *Value of machinery or equipment held under lease.*
- ➜ *Most recent audit and dates of latest inventory count.*
- ➜ *Dollar totals of insurance, including liability, fire, etc.*

## 4.3 Evaluate Ability to Pay

The most fundamental way to minimize your credit risk is to know your customers – the company and the owners. A reliable credit information service can be an excellent resource, providing corporate, legal and financial information. The “4Cs” of assessing a customer’s ability to pay will also help you better understand the factors that influence a customer’s creditworthiness. Please see Section 3 for a more complete discussion of the 4Cs – character, capacity, capital and conditions of the times.

*To see the effect time has on your ability to collect an overdue account, please review the chart below.*

### Chances of Collecting an Account




Example: After 60 days, the odds of recovering an account are 80%; after 90 days this declines to 70%.

Conclusion: For each month added to a delinquent account, the odds of collecting decrease by 10%. To increase your chances of collecting accounts, collect them early!

*Source: “Advanced Collection Techniques” D&B Seminar (Quebec), Trainer: François Beaulieu*



**For effective accounts receivable management, it’s essential to minimize bad debt.**

## 4.4 Protect Yourself from Financial Loss

Sometimes, diligence on your part is not enough. Things can still go wrong; for example, your customer may go out of business or refuse to pay. For added security, you may want to consider accounts receivable insurance.

Accounts receivable insurance helps protect your business against non-payment. If your buyer doesn’t pay, you can file a claim and receive up to 90% of the insured loss. This is especially important when you are selling to the United States or overseas, where collecting on problem accounts can be complicated and expensive.

## 4.5 Devise a Plan for Collection

No matter how carefully you choose your credit customers, late payments will sometimes be an issue. How will you collect them? Your first consideration is to ensure you have a system in place to alert you to aging receivables. Then, before you take action, investigate your customer’s situation. There may be circumstances that caused the delay in payment. If that isn’t the case, there are four suggested steps to follow. And remember – always address your communication to the right person – the person with the authority to pay.

1. A REMINDER (PERHAPS AT 5 DAYS TO A WEEK LATE)
   *Assume at this point that the bill has somehow been overlooked. “Your payment of $1,000 has not yet been received. Please check on it promptly. Thank you.”*

2. ENGAGE IN A CONVERSATION (15 TO 21 DAYS OVERDUE)

*Assume the customer knows of the bill, but won't or can't pay.*
*"Your payment of $1,000 is overdue. Is there a problem where we may help? As you know, we cannot provide further product until the overdue amount has been submitted. When can we expect your payment?"*

3. A DEMAND (45 DAYS PAST DUE)

*Assume the customer can't or won't pay because of a serious problem.*
*"Your account is overdue. You have not responded to our earlier requests. This is our final reminder. If payment is not received in 7 days, we regret that further action will be taken."*

4. A FINAL EFFORT (60 DAYS OVERDUE)

*Assume that you have lost this customer and want to recoup as much as you can.*
*"We have made several requests for payment without a response. We have referred your account to a collection agency."*

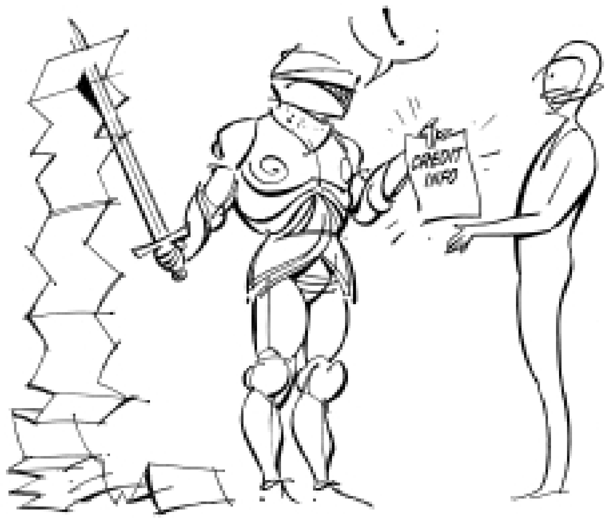
*For suggested best practices to apply in collecting bad debt, please see the exhibit below.*

### Collection Best Practices

When collecting bad debt, these best practices can help maximize the results of your efforts:

- *Follow your established credit policy.*
- *Always be polite and respectful, but also firm.*
- *Don't argue with your customers.*
- *Don't suggest an action that you won't carry out.*
- *Attempt to understand your customer's situation and work through problems cooperatively.*
- *When appropriate, mediate.*
- *Turn to the legal process only as a final resort.*






## 4.6 Minimize Bad Debt

For effective accounts receivable management, it's essential to minimize bad debt. Here are a few "best practice" recommendations:

- *Monitor your customers' credit histories. Use a reliable, professional credit agency to help you – and to ensure that you are always working with "fresh" credit information.*
- *Keep your credit policy updated. This is especially important during trying economic times when a business's situation can be more volatile.*
- *If you accept personal cheques, insist on two pieces of identification.*
- *Always have a customer fill out a credit application. (See exhibit in Section 4.2 to help you decide what to ask.)*
- *If the risk is too high, deny credit.*
- *Watch for red flags.*
- *Mediate problem accounts carefully.*
- *Get a down payment if a customer plans to pay in installments.*
- *Stipulate credit terms clearly on invoices.*
- *Consider purchasing accounts receivable insurance to help protect you for up to 90% of your loss, if your U.S. or foreign customer can't or won't pay.*

## 4.7 Understand the Laws

You need to know the laws governing credit and how to apply them before you start extending credit. You should know the legislation that protects your rights and the rights of your customers. The Federal Government publishes the *Bankruptcy and Insolvency Act*. You can request a copy. Provincial Governments are responsible for the *Consumer Protection Act*, another publication available to you. Finally, it's important to familiarize yourself with what you can and can't do during the collection process. Obtain a copy of the *Collection Agencies Act* to learn more.

## 4.8 Learn to Recognize Warning Signals

A customer who is creditworthy today may not stay that way. Can you recognize the signs of a customer's deteriorating creditworthiness? The number one indicator is the obvious – late or non-payment – a situation you should always take seriously. The reality is that the older a receivable is, the less chance you have of collecting it.

Be alert when your customer:

- ➜ *Stops buying from you.*
- ➜ *Frequently suggests changes in payment schedules.*
- ➜ *Makes only partial payments.*
- ➜ *Dramatically alters his ordering pattern.*
- ➜ *Frequently says the cheque is in the mail.*
- ➜ *Cannot be reached.*



## 4.9 Learn from Competitors

How is credit typically extended in your industry? The answer can provide insights as to how you should set your standards. Find out how your competitors grant credit – through cheques, credit cards, letters of credit and payment terms. There are resources to help you including trade associations and bankers, credit information agencies/providers, accountants and other financial professionals. Advertising may also reveal information about your competitors' credit offerings.

SECTION 5

# Managing Accounts Receivable: The Real Cost of Bad Debt

As money that's "promised" to your company, accounts receivable indicates your organization's financial strength and the strength of your customer relationships.

## 5.1 Accounts Receivable Overview

Accounts receivable is one of your business's most powerful assets; in fact, it's likely to be the number one asset on your balance sheet. Of course like any asset, accounts receivable must be carefully managed to stay healthy – and that may be challenging. You need to have controls and processes in place to ensure you put "good stuff" on your books (i.e. A/R that is collectible).

## 5.2 Why Having Some Uncollectible Accounts is Good

Any business that sells its products or services on credit will inevitably find that some of its accounts receivable are not collectible. Regardless of how thoroughly you investigate prospective customers, some uncollectible amounts will arise as a result of an error in judgment or because of an unanticipated development. This is to be expected. In fact, a limited number of uncollectible accounts is evidence of a sound credit policy. If you are too cautious in rating customers, you may avoid all credit losses, but in doing so also reject many acceptable accounts (and profitable business). It's a question of balance.

## 5.3 The High Cost of Uncollectibles

The cost of carrying too many bad debts is high. Consider how much it costs your business when you write off an account as uncollectible. There is the obvious amount of the unpaid debt, but there are other costs as well:



- *The cost of labour to pursue the funds (your staff's time is valuable and could be used to earn income).*
- *The cost of a collection agency, should you choose this alternative.*
- *The cost of generating invoices and past due letters and of posting them.*
- *The cost of income lost that might have been generated through investing the uncollectible amount elsewhere.*
- *The negative effect on cash flow and the ability to maintain and grow your business.*

**The Impact of Bad Debt:** *EXTRA SALES REQUIRED TO REPLACE A LOSS*

| Actual Loss | Net Profit Percentage | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2 % | 3 % | 4 % | 5 % | 6 % | 10 % | 15 % |
| $100 | $5,000 | $3,333 | $2,500 | $2,000 | $1,666 | $1,000 | $667 |
| $500 | $25,000 | $16,666 | $12,500 | $10,000 | $8,333 | $5,000 | $3,335 |
| $1,000 | $50,000 | $33,330 | $25,000 | $20,000 | $16,660 | $10,000 | $6,670 |
| $5,000 | $250,000 | $166,660 | $125,000 | $100,000 | $83,330 | $50,000 | $33,350 |
| $10,000 | $500,000 | $333,300 | $250,000 | $200,000 | $166,600 | $100,000 | $66,700 |

Net Profit Percentage is Calculated as:
Total Sales – Total Expenses – Income Tax if Any / Total Sales x 100

*Source: "Advanced Collection Techniques" D&B Seminar (Quebec), Trainer: François Beaulieu*

## 5.4 Accounting for Bad Debts

There are a couple of methods to estimate bad debt expenses on your books. You should investigate both the Percentage of Credit Sales method and Aging Accounts Receivable method to see which is best for your company. When an account is ultimately determined to be uncollectible, it no longer qualifies as an asset and should immediately be written off your books.

Rather than estimating bad debts and putting money aside to cover them (also known as "provisioning"), you may find it cheaper and more accurate to purchase accounts receivable insurance. See Section 4.4 for more information.

Prudent management of your accounts receivable is vital. The repercussions for errors can prove disastrous for your company. Clearly, choosing the "right" customers to receive credit – based on accurate, reliable information – is essential.

SECTION 6

# Finding a Dependable Credit Information Partner

A credit reporting agency can provide you with valuable insights on the creditworthiness of potential customers and suppliers.

## 6.1 Which Attributes are Most Important?

Deciding which customers should be extended credit is, as we have seen, not always easy. The only way to have a measure of certainty is to obtain complete and up-to-date information on prospective accounts – and then to use those facts to distinguish between financially solid businesses and potential bad debts.

Credit reporting agencies can be very helpful in this process. Be sure you choose one that will provide information you can trust. You should evaluate these factors:

- ➜ *Is this a reputable credit information provider?*
- ➜ *How long has this credit information provider been in business?*
- ➜ *Can this company provide me with the intelligent products and services my company will need as it grows?*



- ➜ *Does this information provider take the necessary steps to continually offer quality data? These three points are key:*

1. IS THIS SUPERIOR DATA? *Data superiority is judged on: breadth (actual qualified number of company records); depth (number of fields in each company – history, company officers, etc.); integrity (accuracy) and freshness (how often data is updated). You should seek a company that ranks strongly on all these factors.*
2. IS THIS UP-TO-DATE DATA? *To maintain data accuracy, a reputable credit information provider will take the initiative to regularly confirm/validate a company's information. This should be considered a positive attribute, enabling the provider to be a source of intelligent information business across multiple industries.*
3. IS THIS VERIFIABLE DATA? *A sound provider will only accept audited financial statements on behalf of a company, rather than estimates. This ensures you get credible, reliable information on every organization.*

## 6.2 Credit Information Sources for Small Business

Smaller businesses may have special requirements in a credit information partner. Trust, reputation and proven experience remain key, but other attributes should also be examined:

AFFORDABILITY. *Can you buy what you need – and only what you need – at a fair price that's within your budget?*

NO OBLIGATIONS. *Does this credit information provider offer a no-contract option that enables you to pay-as-you-go?*

EASY PAYMENT. *Can you pay by credit card for convenience?*

CONSISTENT, GLOBAL INFORMATION. *Today, businesses don't recognize geographical boundaries. Does this credit information provider have a global database? Is data consistently reported from country-to-country?*

Choose your credit information provider as you would your credit customers – wisely!

## Epilogue

Today, building your business means extending credit to customers who have the ability and willingness to pay. There are many ramifications to granting credit. It affects all aspects of your business, but can be a major boost to your profitability when managed properly. This handbook is a starting point in helping you understand credit fundamentals and in developing appropriate policies. Moreover, it is intended to show you the value of using all the information at your disposal to grant credit to those who are creditworthy – beginning with finding a capable credit information provider.

## Did you enjoy reading *Straight Talk on Credit Checks?*

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Your comments will help us better inform business people like yourself. Please let us know what sections of the booklet you liked, where you were hoping for more information or clarification, or even just general opinions.

You can share your thoughts by emailing:

**straighttalk@dnb.com**