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Chardon, OH 44024
(866) 903-1430
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Credit Risk Management Guide

Credit management has become critical in the new normal. Many companies are delaying payments to suppliers to conserve cash because of the uncertainty. Credit rating information has become less reliable. Procedures for granting credit and setting credit limits are often out of sync with the realities of the new normal.

Many companies need to revisit the way they handle credit management. Although traditional methods of credit management can still be used, they should be paired with other best practices to best protect your company from cash flow risks. In this whitepaper, we will address the basics of credit management, tools to use to protect cash flow, what you need to know about business credit reports, business credit scoring strategies, how to calculate customer credit risk, how to set credit limits and how to continually monitor customer creditworthiness.

The Basics of Credit Management

We all know this to be true, the longer an invoice goes unpaid, the less likely it is that the invoice will ever be paid in full…or at all. If you're like the average company, you're accounts receivable situation looks something like this:

- 39% of invoices are paid late
- 17% of customers do not adhere to credit terms
- 48% of customers delay payments
- 52% of businesses ask for extended payment terms
- Average days sales outstanding (61 days) is more than 2X the payment terms (28 days)

By implementing best practices and proven tools to help you identify and reduce credit risk, you can change those numbers, and start putting your accounts receivable assets to work.

Credit Policy

Credit management should start with a sound policy that addresses the framework of how to manage credit including:

- Risk – The amount of bad debt losses and credit exposure that is consistent with your company's goals.
- Approval process – Guidelines for approving credit
- Credit limits – Process for setting credit limits
- Credit terms – Terms of payment
- Collection procedures – Process for collecting accounts receivable
- Bad debt procedures – Process for dealing with uncollectable accounts

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With uncertain business conditions, new approaches may be needed to deal with each of these elements.

Risk

The amount of bad debt losses and credit exposure that your company can risk may need to be reduced. It is not clear how long it will take for the economy to recover and whether certain industries and companies will recover.

Approval Process

It may be necessary to tighten up your approval process for a number of reasons including:

- Increased risk for certain industries and companies
- Credit reports, which have a number of drawbacks to begin with, may be unreliable.
- Bank and trade references may be of limited value because of rapidly changing business conditions.
- Company financial statements and ratio analysis may be based on information that is stale and of little value.

Credit approval is typically based on historical information, which is of limited value in a rapidly changing economy. It may be necessary to rely on anecdotal information from conversations with banks, suppliers and competitors until the economy recovers.

Credit Limits

It may be advisable to reduce or eliminate credit limits for riskier customers, so that all orders come up for credit review.

Credit Terms

Many companies offer credit terms common to the industry they are in. This may not be practical in the current economic environment. You may need to offer alternative terms to riskier customers such as:

- Shorter payment terms
- Cash discounts
- Deposits or cash in advance

Make sure there is buy-in from all stakeholders before changing a customer’s terms. When the economy recovers, customers will remember who supported them or not.

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Collection Procedures

More aggressive collection procedures may needed including:

- Earlier and more frequent reminder emails or texts
- More collection calls with emphasis on personal relationships

Bad Debt Procedures

Delays in bad debt actions increase losses. Give your collectors authority to work out payment plans. It will probably be less expensive than using a collection agency.

Protecting Your Cash Flow by Practicing Credit Management

The purpose of credit management is to provide a process for extending credit and collecting accounts receivable consistent with your company's commercial and financial objectives. The goal is to achieve cash flow targets. If you're not already practicing an active plan for credit management, here's a few reasons you should be.

Credit Exposure

Credit management includes managing your overall credit exposure. If accounts receivable grow because of a business recession, cash flow will decrease. In a business slowdown sales decrease but accounts receivable can balloon due to customers conserving cash by stretching accounts payable. Accounts receivable can turn into a cash trap just when you need cash the most. You need to monitor overall credit exposure to make sure you don't get snared in a cash trap, and take corrective action if necessary.

Credit Terms

If you experience a drop off in collections, you may need to change credit terms to protect your cash flow. In the new normal it may not make sense to follow industry credit terms or your past practices. With many businesses struggling to survive until the economy recovers, it may be wise to shorten credit terms, offer cash discounts, and in risky situations require deposits or cash in advance. This will increase cash flow and help to reduce bad debt losses.

Credit Limits

Credit limits may need to be reviewed to protect cash flow. If you only do credit reviews once a year, you may not be aware of unfavorable changes in a customer's financial situation. In industries heavily affected by the new normal, it may be advisable to reduce or eliminate credit limits to avoid unwelcome surprises. This will create more work for your team, but it will protect cash flow and reduce time spent on collections.

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Credit Procedures

To protect cash flow you may need to send payment reminders earlier and more frequently. However, text and email contact is not as effective as a personal call where collectors can leverage personal relationships. Phone calls take more time so you need to make sure collectors are not tied up in clerical collection activities.

Bad Debts

If you experience more uncollectible accounts, you can minimize the damage to cash flow by giving your collectors the authority to work out payment plans. This will probably yield faster results and a larger recovery than if you use a collection agency.

Practicing credit management will help to protect your cash flow, but it will require more time of you and your AR team. Automated credit and collection solutions can help you stay ahead of the curve and increase cash flow.

Tools for Credit Risk Management

Since new methods of credit management can take more time than simply checking a credit report, there are tools out there that will help to make this job a little easier. There a few different tools available to stay on top of your customers' potential credit risk and using them all together will help to protect your cash flow.

Credit Apps

Credit ratings are available on apps from credit rating agencies such as Experian and TransUnion. It is easy and convenient to obtain credit rating information with credit apps. They are available online anywhere and anytime you need them, which provides the flexibility you need, particularly if you are working from a remote location.

Credit apps can also provide alerts for changes in credit rating information so you can be aware of new developments with your customers, and take action if necessary.

Trade References

Trade reference information on customer payment history is an essential part of evaluating credit risk. Information on customer payment history is available from credit rating agencies or you can obtain it by contacting references directly.

Payment history information reported by credit rating agencies is easy and convenient to obtain online, but it has drawbacks. The information reported is often stale, and may not be reliable. In addition, the reports do not include the background information or nuances that you may obtain from calling a reference directly.

Contacting references directly can be very helpful, but it is time consuming and references need to be updated regularly for them to be useful.

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Credit Applications

Credit risk management for a new account begins with a credit application. The application should include all the information needed to make a credit decision, and establish credit terms and a credit limit. It should include company information, bank and trade references, financial information and other relevant items. Your application form should also include any relevant information related to the cost of credit, and all associated fees if applicable.

Manual credit applications can take a lot of time for customers to complete, and more for your team members to enter in your system. As part of your onboarding process you should provide an online application. It will enhance your customer's experience in dealing with your company, and increase the efficiency of the credit review process.

Dashboard

With automated credit management solutions you can provide your team with a dashboard for each account, which incorporates the key data needed to manage credit decisions. With the dashboard solution by Anytime Collect, your collectors can see at a glance a customer's account status, credit score, whether payment is usually late or on time, and by how many days. A color scaling used to rank credit quality will pop up when searching for a company in Anytime Collect.

Tools are essential for managing credit risk and protecting cash flow. Automated credit management solutions provide the tools your team needs and free up time to be spent contacting customers to increase cash flow.

The Risks and Rewards of Using Business Credit Reports

Business credit reports from companies such as D&B, Experian and TransUnion have traditionally been a major resource for payment history and credit ratings. However, the new normal has changed the economy, and you should consider the risks and rewards of using business credit reports before relying on them for credit management.

Risks

The business environment is constantly changing as companies and the economy struggle to recover from the recession. Virtually every day there are announcements of major company layoffs, closings and bankruptcies. News headlines report actions taken or contemplated by the Federal Reserve and the Federal Government to assist companies and individuals, and bolster the economy.

In this frenetic environment, it is not possible for business credit reports to be kept up to date and be reliable. Even before the new normal, payment information on credit reports was often stale because of the time lapse in reporting by creditors. Now with the business landscape changing daily, business credit reports may no longer be reliable.

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Rewards

Business credit reports are easy to access on line. Many credit reporting agencies also have credit apps for obtaining the information you need from anywhere and at any time. This is particularly helpful for working from a remote location. Since credit reports do not involve contacting references directly, they save time which can be spent contacting customers. However, credit reports should be used in addition to contacting trade references, not in lieu of them.

Credit reports have more information on customer payment history than you can gather from contacting a few references directly. The number of creditors reporting to the credit reporting agencies provide a broader sample, and can include a variety of credit terms other than the terms your company offers. This information can provide insights into customer payment history, which you may find helpful in managing credit risk.

There are risks and rewards to using business credit reports. They should be just one of the tools used to manage credit risk. With automated credit management solutions, you can provide your team with a dashboard for each account, which incorporates the key data needed to manage credit.

Using the dashboard solution by Anytime Collect, your collectors can see at a glance a customer's account status, credit score, whether payment is usually late or on time, and by how many days. A color scaling used to rank credit quality will pop up when searching for a company in Anytime Collect.

Business Credit Scoring Strategies

Credit scoring can be a useful and efficient tool for assessing business credit risk. There are several business credit scoring strategies that you can use. Here are some things that you should consider in deciding which credit scoring strategy is best for your company.

Traditional Credit Scoring

Traditional scoring focuses on trade references. Trade reference information typically includes:

- Length of business relationship
- Amount of credit
- Terms of credit
- Payment history

Trade references are important for assessing credit risk, but they should be used in conjunction with other references and financial and legal information to make well-informed credit decisions. Trade references are usually limited to a few suppliers, so they may not provide a broad enough sample to get a clear picture of a customer's credit worthiness.

Credit Rating Agency Scoring

Experian, D&B and other credit rating agencies provide statistical credit scoring on businesses. The scale is 1-100 with higher being better as compared to the scale of 250-900 used by FICO for individuals.

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Business scoring considers trade references, balances outstanding, payment history, credit utilization and trends. In addition, public records are reviewed for liens, judgements and bankruptcies, and consideration is given to years on file, Standard Industrial Classification (SIC) code and business size.

Credit rating agency scoring provides a broad range of factors, and includes a larger sample than traditional scoring, but the information can be stale and unreliable due to the rapidly changing business environment in the new normal.

Best Practices

Ideally, credit scoring should match your company objectives, customer base and business processes, and use data from as many sources as possible. Information should be kept up to date and organized. Automated credit solutions will help your team be more efficient and effective at managing credit risk.

Custom Scoring

The one-size-fits-all approach to credit scoring may not be the right solution for your company. Automated custom scoring can provide the flexibility to incorporate a number of information sources to reflect the right mix of data needed to measure the credit risk of your customers efficiently and effectively.

With the credit scoring solution by Anytime Collect you can customize the information that best fits your customers, and assign a value and weight to the components based on their importance. Custom credit scores are also displayed on the dashboard solution by Anytime Collect for easy access and use by your AR team. Automation of custom scoring frees up your collectors so they can make more customer contacts and increase collections.

How to Calculate Customer Credit Risk

Customer credit risk has become a major concern in the new normal. Even companies that were financially sound before the start of the recession are struggling to survive until the economy recovers. In this challenging and uncertain environment calculating and monitoring customer credit risk is essential to protecting your company’s cash flow.

Calculating Credit Risk

Credit risk is directly correlated with a number of factors including:

- Years in business
- Financial strength
- Supplier payment history
- Loan payment history
- Bankruptcies, liens, judgements
- Available credit

The best way to distill these separate but related pieces of information into a tool for calculating credit risk is to develop a custom credit scoring model.

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A custom credit score can be tailored to include the factors which give the best reading of your customers' credit worthiness. Some things to consider in developing a custom credit scoring model include:

- Factors that give the best picture of your customers' credit health
- Value and weighting to be assigned to the factors in scoring model
- Ease of updating the factors to keep credit scores current
- Convenient display of credit scores for easy reference by your team
- Automation of credit score calculations to increase efficiency

Monitoring Credit Risk

Monitoring credit risk is done more efficiently and effectively with automated credit and collection solutions. Anytime Collect has a number of solutions which can help you monitor credit risk including:

- Custom Credit Scoring Model: Calculates credit score based on values and weighting assigned to factors you think are the best indicators of your customers' credit quality.
- Dashboard Reporting: With a glance your team can see a customer's account status, custom credit score, days past due, available credit, D&B, Experian, TransUnion; and whether the account usually pays on time or late and by how many days.
- Color Scale Ranking of Credit Quality: A color scale of credit quality which pops up when searching for a company in Anytime Collect.
- Automated Customer Communications: Automated emails or text reminders based on the status of customer invoices.
- Activity Management with Smart Activities: Prioritizes activities for your team based on account information.

How to set Customer Credit Limits

Credit limits are an essential tool for managing credit risk and protecting your company's cash flow. Orders in excess of credit limits are automatically placed on hold for credit review. If credit limits are set too low, your team will be tied up needlessly reviewing and releasing orders. If they are set too high, you risk overextending credit. The recession caused by the pandemic is a real-life reason for the need for credit limits, and the necessity of reviewing and adjusting them as circumstances change.

Here are some suggestions for setting credit limits.

Net Worth

One approach to setting credit limits is to use an amount equal to 10% of a customer's net worth. This may not work for all customers if their financial strength will not support the credit limit needed for order volume.

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Working Capital

Another approach is to use 10% of a customer's working capital, but as with net worth it may not support the credit limit required for orders.

Average Monthly Sales

Using 10% of average monthly sales can be a good alternative, but keep in mind that it is based on past sales and may not be adequate for future orders.

Trade References

An average of credit amounts reported on trade references can be a good approach, but make sure that the limit you set is consistent with your company's appetite for risk. Following the crowd can be dangerous, if the credit limit amount is more than your company can afford to lose.

Customer Request/Need

Customers may request or need a certain amount of credit to handle their anticipated order volume. You have to decide if you are comfortable with the amount of credit needed.

There is no perfect way to set credit limits. The objective is to find a happy medium between commercial requirements and your company's capacity to absorb bad debt losses. That is why it is important to keep track of credit limits and adjust them up or down as needed.

When a customer is constantly exceeding its credit limit, it is obvious that a review is needed to set an appropriate credit limit. What is not always obvious is when it may be necessary to reduce a customer's credit limit because of an unfavorable change in payment behavior.

Anytime Collect has a number of solutions for tracking and monitoring changes in a customer's behavior and credit which can alert you to review a customer's credit limit. Conveniently displayed on a dashboard are credit measurements including:

- Days past due
- Available credit
- Custom credit scoring
- Credit scoring from TransUnion, D&B and Experian
- Whether the account pays on time or late and by how many days

A color scale of credit quality pops up when searching for a company on Anytime Collect, and automated emails or text reminders are sent based on the status of customer invoices.

The Cost of Credit

The cost of offering credit to customers is made up of three components:

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- Time value of money
- Bad debt losses
- Cost of credit and collection functions

The cost of NOT offering credit to customers is lost sales and the gross profit that would have been earned on the lost sales. Most companies offer credit because otherwise they would not be competitive.

The cost of credit can be substantial. It is important to understand and manage the components of the cost of credit to minimize the cost of your credit and collection activities. Here are some suggestions for managing the cost of credit.

Time Value of Money

The credit your company extends to customers creates accounts receivables which must be collected to be converted into cash. The time value of money is the cost to your company of financing accounts receivable until they are converted into cash.

The cost to finance accounts receivable during allowed terms such as Net 30 should be evaluated based on your company's cost and ability to finance accounts receivable. The cost of financing accounts receivable paid late or beyond your allowed terms, which can be expressed as: (cost of money APR%/365) x (amount late) x (days late), should be minimized with credit and collection practices.

Automated credit and collection solutions can help you minimize the cost of credit. Anytime collect has a number of features which can alert your team to customers costing you the most including:

- Credit dashboard with the cost of credit and days past due displayed for easy reference
- Alerts which can be programmed for:
- Cost of credit more than X
- Average days late is now more than X
- Customer is on credit hold
- More than X broken promises in past six months
- More than X disputes in past 6 months

Bad Debt Losses

Bad debt losses can be minimized by monitoring credit risk and effective collections. Anytime Collect has credit management solutions which can help you minimize bad debts including:

- Custom credit scoring of factors that are the best indicators of your customers' credit quality.
- Dashboard reporting of custom credit score, days past due, available credit, credit agency scores, and whether an account pays late or on time and by how many days
- Color scale ranking of credit quality which pops up when searching for a company in Anytime Collect

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Cost of Credit and Collection Functions

Automated credit and collection solutions can help improve efficiency and reduce the cost of credit and collection activities. Anytime Collect has automated credit and collection solutions that span the accounts receivable transaction cycle including:

- Automated invoicing
- Credit management with dashboard reporting
- Automated customer communications
- Activity management to assist collections
- Business intelligence tools
- Online collections and customer payment portals
- Automated accounts receivable sequences

How to Continually Monitor Customer Credit Worthiness for Improved Collections

The rapidly changing business environment in the new normal has made it more important than ever to continually monitor customer creditworthiness. Under normal conditions, many companies only reviewed customer creditworthiness on a quarterly or annual basis; unless they hit their credit limit, changed payment habits for the worse, or something else major happened. Today, this approach can leave you exposed to more credit risk than your company can afford. Customer creditworthiness needs to be monitored on a continuous basis, so credit limits and terms can be adjusted as necessary to minimize bad debt losses.

Anytime Collect has credit management solutions which can help you continually monitor customer creditworthiness including:

Customer Credit Dashboard

The credit dashboard conveniently displays the information your team needs to monitor creditworthiness including:

- Custom credit score – based on factors that are the best indicators of your customers' creditworthiness
- Payment habits – whether an account pays late or on time and by how many days
- Days past due
- Available credit
- Credit agency scores – D&B, TransUnion and Experian

Color Scale Ranking of Credit Quality

Five credit score rankings in color from Very Poor (red) through Poor (red), Fair (orange), Good (green) and Very Good (green), which pop up when searching for a company. This provides an easy way to identify accounts with higher credit risk for credit review.

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Alerts

Alerts can be programmed for important credit factors such as:

- Customer on credit hold
- Average days late now more than X
- Change in credit score

With the rapidly changing business environment making it difficult for credit reporting agencies to provide up-to-date information, it is also a good idea to pay close attention to economic news of changes that may affect your customers and the industries your company serves. Companies in heavily impacted industries may need to have credit limits reduced.

Credit limits are very important but should be only one of the tools you use to monitor and control credit risk. If credit limits are set too low to avoid bad debt losses, your team will be needlessly tied up reviewing and releasing orders on credit hold. Conversely, if they are set too high, you risk exposing your company to avoidable bad debt losses.

With automated credit solutions you can continually monitor customer creditworthiness, and adjust credit limits and terms when you detect that a customer's credit profile is deteriorating.

"Our DSOs are down, and we have beaten our collections targets for two quarters in a row. I attribute that to ramping up on ATC and it's automation."

– Bridget Santagate
AR and Collections Manager, Cantata Health

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