Covering Credit Bulletin

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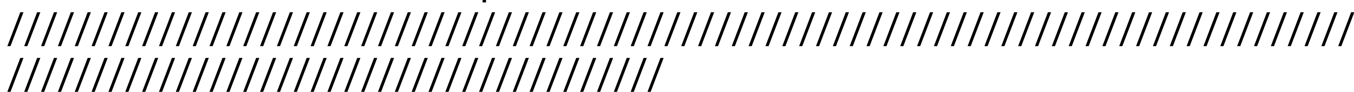
This Month's Topics:

- Risk Management
- How to Keep Your Job
- Questions and Answers
- Keeping Credit Information Confidential
- Account Classification
- Free White Papers
- Free Subscriptions



Risk Management

Credit risk can be defined as the risk of financial loss resulting from the failure of the debtor to honor part or all of its obligations to pay creditors' invoices as they come due. The goal of credit management is to *optimize* the company's sales and profits by keeping both credit risk and payment delinquencies within acceptable limits. Sound credit management involves finding the right balance in the risk/reward relationship between sales and bad-debt losses.

There are a number of ways to actively manage credit risk. Your options include:

- Avoiding risk. This can be accomplished by refusing to extend credit to high-risk accounts. However, in most companies this is not a viable option since so many customers could be classified as high risk that refusing to sell to them would reduce sales to unacceptable levels.
- Controlling risk. This option involves developing a comprehensive plan to reduce credit risk in the company's accounts base, then implementing that plan, and monitoring the credit department's efforts to carry out the plan.
- Accepting risk. A few companies simply accept the risks associated with doing business with customers identified as high risk.

These tend to be companies trying to gain market share, companies with high profit margins, companies with excess inventory, and companies with adequate reserves for the bad debt losses that are almost certain to accompany this policy.
• Transferring credit risk. An example of transferring credit risk would involve purchasing credit insurance. Other examples of transferring credit risk include flooring or factoring of the company’s accounts receivable.

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How to Keep or Get the Credit Job You Have Always Wanted

There is an old adage, “Opportunity only knocks once." I think this a more complete statement… “Opportunity only knocks once and it often knocks very quietly. Opportunity often disguises itself as more responsibility, longer hours, and bigger challenges, and for these reasons opportunities are often missed.”
Keeping a good job is hard work. Finding a good job when you are unemployed is even harder. In theory, any job that increases your income is probably worth considering. In reality, if you don’t enjoy what you do and the people you work with money will probably become less important. In the credit profession, there are a number of skills and attributes that are highly prized by companies looking for credit professionals including these:

Problem solving skills
Creativity
Technical skills in areas such as customer financial statement analysis and interpretation
Excellent verbal and written communication skills
The ability to manage and motivate subordinates
A track record of documented successes and achievements
The skills needed to increase the credit department's effectiveness without increasing costs
A commitment to continuing professional development
The maturity required to recognize that the credit department is a part of not apart from the rest of the company and must be committed to helping the company achieve its sales and profit goals
The flexibility necessary to adapt quickly to changing business conditions as well as to changing priorities

Awareness of the attributes that employers look is critical to keeping a job. If you think that you might be deficient in any of the areas listed above, this is the time to make any necessary adjustments.
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Questions and Answers

Question: How can you assess the reliability of unaudited customer financial statements?

Answer: Some people believe that internally prepared financial statements are better than nothing, but unaudited and internally prepared financial statements can contain deliberate misstatements intended to enable debtors that would not otherwise qualify for open account terms to be offered open account terms. My only advice is to be wary of internally prepared financial statements, especially if the customer’s financial performance is too good to be real.

Q. Do you require customers to provide financial statements?

A. Not always. However, if a customer’s credit needs continue to grow, at some point it will become necessary to receive a copy of their financial statements in order to make an informed decision about whether or not to increase the credit limit.

Q. What are your thoughts about binding arbitration clauses?

A. Creditors usually want to try to preserve the possibility of doing business again with a customer which is unlikely if the creditor sues, but possible if the dispute is submitted to mediation or arbitration.

Q. In response to a question about risk, you responded that every company’s tolerance for risk is different. Aren’t all companies risk averse? Would you expand on your response?

A. Sorry if I was unclear. Here are some examples that might help explain why some companies are more risk averse than others. Companies in a highly competitive environment, or a market in which total sales are stagnant, are likely to need a more liberal credit policy than companies with less competition. When industry-wide sales are stagnant, companies must sometimes adopt a more liberal credit policy to differentiate their company from the competition to attract new business. Companies tend to be less concerned with credit risk when

demand for their product is expected to slow dramatically due to the introduction of a new product that is better, faster, or cheaper. A seller's financial condition could also impact credit policy. A financially stable credit company or one with high gross profit margins should be more willing to accept marginal credit risks and the associated risk of payment delinquency or default.

Q. In my new position, every member of the credit department can and does approve and release orders and establish credit limits. This seems unusual. What are your thoughts?

A. It is unusual. Anyone who is given the authority to extend open account credit terms should have extensive experience in credit management, financial analysis, and risk management. In most companies, only one or two people in the credit department are given authority to approve open account credit terms and/or to increase credit limits, and everyone with this authority must be assigned a specific dollar limit on his or her credit granting authority. Either your entire staff is exceptionally well trained or one or more of them should not be making these decisions unilaterally.

Q. What are my obligations relating to trade references?

A. Creditors have no duty to provide credit references. Many creditors recognize that an open exchange of credit information benefits creditors and participate on this basis. Your legal obligation is not to misrepresent your credit experience with a debtor company.

Q. I have been invited to join an industry credit group. I am concerned about confidentiality. What are your thoughts?

A. Unfortunately, some companies use credit group meetings to prospect for new accounts. This may be unethical, but it is easy for attendees to come back with a list of prospective customers for their sales department.

Q. One of the companies we sell to is owned by the son of the President of our company. Is this a conflict of interest?

A. No employee should engage in any activities which place them in a conflict of interest between their job duties and personal interests. In this scenario, a conflict of interest would occur if the company President

exerts influence on the credit department to extend more credit to this customer than it deserves.

Q. I have been asked to offer open account terms to a new distributor, our first foreign buyer that has demanded open account terms as a condition for doing business. The sales department tells me they have open account terms with one of our competitors in Asia. I cannot verify this information. I am concerned that offering open account terms could be a serious mistake. What are your comments?

A. You have good reason to be concerned. The obvious and serious risk involved with offering open account terms to a foreign buyer is that if the buyer defaults on payment, you may be forced to pursue payment through a foreign court system. Commercial laws vary from country to country, and in certain countries it may be difficult for the creditor company to find legal representation that is competent, experienced, and honest. FYI, many U.S. based credit managers are finding that exports are shifting from the traditional markets in Western Europe, Canada, and Japan toward the rapidly emerging markets in places like Latin and South America. The rapid growth in these emerging markets makes them inviting to U.S. exporters regardless of the risks and difficulties associated with exporting to these countries.

Q. What is a consular invoice?

A. This is a document issued by a foreign government's consulate or embassy prior exporting. The foreign consul issues the document describing the goods to be exported. This document typically shows the consignor, the consignee, and the value of the shipment. The document is used by the importing countries' customs officials to verify the value, quantity, and nature of the shipment being imported.

Q. Can you describe the process for amending a customer's letter of credit?

A. Beneficiaries do not amend letters of credit. Amendments must be initiated by the buyer. Any required change made after the letter of credit is issued is referred to as an amendment. Amendments are required when the letter of credit does not conform to the seller's requirements. Note: The seller should never rely on a commitment from the buyer that a letter of credit can be or will be amended. The seller should wait for the amendment to arrive before releasing the

order. The rationale is fairly straightforward: If the goods have been shipped, the buyer may refuse to amend the letter of credit hoping that the seller will not pay the cost to have the goods returned.

Q. One of our customers asked for our Letter of Credit instructions. Are there standard instructions?

A. I think you should always provide the buyer with specific instructions about the terms and conditions that may be included in the letter of credit. These instructions should eliminate any terms and conditions that may prevent you from being paid under the letter of credit. For example, you would want to be sure that the expiration date of the letter of credit permits sufficient time to correct, if necessary, any mistakes found when the documents are presented for payment. Given the high failure rate of initial presentations of letter of credit documents, having sufficient time to correct errors is critical.

Q. This is a follow up question: One of the terms that the customer is insisting on is that they must acknowledge receipt of the goods before the issuing bank is required to pay the Letter of Credit. I am not sure why they require this – but I am tempted to think that the customer just wants to make sure they get the goods they are going to pay for. Comments?

A. If the buyer is uncomfortable, they have the option of requiring and arranging for an inspection of the merchandise prior to shipment. I recommend against allowing this condition to be added to the L/C. It takes very little imagination to envision a scenario in which a creditor would not be paid because the customer never presented this required document to its bank. Remember that unless the Issuing Bank receives all the necessary documents it cannot fund the L/C even if the seller's shipment was correct in every other way without the buyer's approval.

Q. What techniques can be used to actually get someone of authority on the phone when they are avoiding your call?
A. Here are some ideas: Call daily until you receive a return call. Ask to speak to the AP manager, and failing that the Controller, CFO or business owner. Ask the operator to have the person you must speak to paged. Call another department and ask them to transfer you to the person you need on the assumption that someone avoiding your calls is likely to answer an internal call even if they will not answer calls from outside the company.

Q. My new boss suggested we send "coming due reminders." Do you have an example of this?
A. There is at least one in my book "Credit and Collection Forms and Procedures Manual." Here is an example:
"We appreciate the opportunity to have provided products to you and hope you are completely satisfied with your purchase. If you have not received our invoice, or if there are problems that would prevent you from paying the invoice listed below promptly, please contact me immediately at 800 xxx-xxxx.
Invoice # Invoice Date PO Number Due Date Balance Due
Thank you for your cooperation."
Etc.
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Keeping Credit Information Confidential

Credit personnel should carefully safeguard the confidentiality of the sources of the credit ratings they receive. For example, creditors should never reveal to an applicant which creditor(s) they contacted and what specific information was provided to them. (See Exhibit I-A.) Similarly, credit professionals should never reveal what specific credit bureau reports were used in the credit-evaluation process, and what, if anything, those reports might have said about the applicant's creditworthiness.
Equally important, credit professionals should never share confidential credit information with their salespeople. Many credit professionals have done so, and learned from bitter experience that this is a serious mistake and a breach of professional ethics.
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Account Classification

Customer accounts can be classified in a variety of ways. For example, they can be ranked on a scale from one to 10 (from lowest to highest risk) on the basis of their credit risk characteristics. One of the simplest ways to categorize accounts involves as (1) Low-risk, (2) Moderate-risk; or (3) High-risk accounts. Customers classified as low-risk accounts are normally large, financially stable, publicly held companies or government accounts. Large credit limits are normally assigned to these accounts so that orders are never delayed unnecessarily—or these accounts are sometimes coded so that orders entered bypass the order review cycle altogether.

The majority of customers are likely to be moderate risk. Credit limits on these accounts are normally set high enough to accommodate the customer’s normal requirements, but low enough that credit risk can be properly managed. Orders for moderate risk accounts will be referred to the credit department for approval when the credit limit is exceeded or when the account is past due.   For most creditors, a small number of customers will be classified as high risk. High-risk accounts are identified by a number of factors or indicators including poor financial performance, poor payment history, tax liens, a previous bankruptcy, or a history of slow payments.

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encouraged to use your judgment in deciding which of the ideas to accept or adopt, and which to reject and ignore.

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On Sale: “*The Credit and Collection Manager’s Concise Desk Reference*” published by the Institute of Credit Management and written by Michael Dennis. This book retails for $44.95 and is on sale for $19.95 including shipping and handling. For more information, or to order this book, please contact me at:
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