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Creating a Credit Policy in 9 Easy Steps

June 1, 2002, By Bob Scheufler, Certified Credit Executive

Creating, documenting or reviewing a credit policy has many advantages. A sound credit policy is the blueprint for how the company communicates with and treats its most valuable asset, the customer. The policy also provides for distribution of work or tasks to other associates to increase skill sets (career development), creates a common set of goals for the organization, and identifies the credit and collection department as a contributor to the organization's strategies.

Without a good credit manager, most businesses are unaware of how to profitably manage receivables. Business schools do not concentrate on the importance of receivable management. Nor are they aware of how this same asset account, which can represent up to 40 percent of a company's assets, contributes to profits.

Stock analysts always ask about the sales and earnings per share growth outlook, so management teams focus on these glamour areas. Of course, without sales a company cannot continue to operate, but a sale is not truly a sale until collected. But in the recent economic environment, investor calls include questions concerning Days Sales Outstanding and cash flow from operations.

For most credit managers the laissez-faire attitude towards receivable management has created an environment where the staff operates in a reactive mode rather than a proactive one. Especially with "rightsizing" and being forced to do more with less, now is the time to begin to build the base to become proactive. The best approach is through portfolio management.

However, before you can move to this process, the foundation – your credit policy–needs to be formalized or reviewed.

A well-constructed policy allows the credit professional to begin to lay the bricks for portfolio management. To realize all the benefits of a formalized credit policy nine areas should be addressed. The primary sections to include are these:

1. Mission Statement
2. Goals
3. Define Credit Limit Authority
4. Credit Evaluation
5. Credit Limits
6. Terms
7. Account Monitoring
8. Credit Hold and
9. Collections

One: Mission Statement

The purpose of the mission statement is to clearly outline the function of the credit department. Your mission statement should summarize how the group contributes to sales growth and profitability through risk management and customer relationships. Risk management includes timely processing of credit applications and setting appropriate credit limits and terms. Management of customer relationships includes timely communication with the customer ranging from the status of opening a new account to billing issues.

Your mission statement should be broad, only five to eight lines, and it should not discuss the individual procedures. Other sections of the policy will discuss these procedures more in depth.

Two: Goals

Every credit policy should have stated goals. Where the Mission Statement establishes purpose of the department, the Goals section spells out how to measure the effectiveness of your overall policy and

supporting procedures.

Of course, there are an infinite number or type of goals to choose from based upon your own preferences and industry standards or benchmarks. Our recommendation is to have three high-level goals which are measurable, understandable, challenging but attainable, and reinforcable. Without goals, management can't determine whether or not you're successful. From these goals, you can then develop individual targets for staff members, which contribute to the overall department and ultimately the corporate goals.

Three: Define Credit Limit Authorities

The third section of your credit policy defines authority for the credit approval process. For example, you might want to give credit analysts the authority to set credit limits up to \$50,000. The credit manager might set limits to \$500,000, while the controller might need to sign off on anything above \$500,000.

Two traps to avoid in this section are over engineering the process and not assigning a staggered approval process. There should not be so many steps in the approval process that application turnaround is slowed down which subsequently adds time and cost to the process.

At the same time, you should not be approving all new applications, unless the number of new customers your receive is small. In addition, this section should also include one or two lines outlining who is responsible for approving strategic accounts. These are accounts deemed to be too risky for open terms, but due to the strategic nature, the account must be accepted.

Four: Credit Evaluation

Here your credit policy should clearly outline the sources of data to be used when making a credit evaluation, what data should be collected depending upon the exposure level, and how much weight should be assigned to each element.

To be consistent, you should construct a credit evaluation scorecard so all employees follow the same evaluation procedure. This will allow you to feel comfortable assigning new tasks to staff members and feel assured that the process is followed. It will free you for other duties and enable staff to expand their skill sets.

The goal is to build consistency around the evaluation process. At this point, you can begin segmenting your customers. One strategy is to identify customers as Low, Moderate, or High Risk. Segmentation will help you set credit limits/availability guidelines and prioritize collections. Treating customers differently based upon perceived risk sets the framework for moving to a portfolio management approach.

Five: Credit Limits

The use of credit limits or credit availability guidelines is an area of great controversy. There are as many arguments for setting or not setting as there are for assigning blanket guidelines. Each of these approaches can create as many problems as they are designed to eliminate. The best method is to assign limits/availability based upon the customer's ability to repay their debt as determined during your credit evaluation.

Your best data will come from financial information. Second best are trade references. Of course, most of your guidelines should be flexible. The goal should be to set appropriate limits, providing freedom to lower risk customers with the ability and desire to pay on time and more conservative limits for your slower paying customers. If your limits are set correctly then slower paying customers will pop up for potential credit hold review while strong payers will not.

Six: Terms

The section concerning terms should be relatively straightforward. All companies have typically already defined their terms. However, if you have the ability to develop "other" terms based upon risk then this section should include a discussion of the different types of terms. In addition a statement should be included identifying the responsible party who will approve variations to terms.

Seven: Account Monitoring

Account monitoring is one area most credit professionals neglect. Management teams usually refer to the aging report and feel confident this report can predict potential pitfalls. Unfortunately, the aging report is only one tool which captures one piece of information, namely the payment relationship with your

company.

To be better prepared, you really should incorporate other data sources for purposes of account monitoring. Here are just a few suggestions: sales associates, trade magazines, news wires, and business and credit information companies. In addition, you should implement a process to evaluate customers at regular intervals.

Optimally, all active customers should be evaluated on an annual basis. If this is not possible, a system should be implemented providing for re-evaluation of critical customers (i.e. the top 20 percent or customers with exposure levels >\$100,000). The account monitoring section should summarize sources of information as well as the re-evaluation process.

Eight: Credit Holds

Holding orders can become a major source of conflict with sales but it is an important source of leverage for collections. To really work, your policy on hold orders must have the buy-in of sales. In general, it is important to work closely with your sales force not just in relation to your hold order policy, but for all aspects of your entire policy.

If orders are placed on hold and you are consistently releasing orders (i.e., more than 50 percent of the time) then your credit hold policy should be reviewed. Best practice is to identify customers who have exceeded the credit limit by 10 percent. In addition, you should establish a time frame for how far past due you allow your customer to get before you hold their orders. A conservative policy would be to hold orders immediately after they go past due. A more liberal policy allows a much longer period before you begin holding orders. Your policy will depend upon your company's market conditions and risk appetite.

Nine: Collections

Last but not least is development of the collection policy. Your collection procedure should be prioritized according to both the customer's risk and exposure level. A decision table should be created outlining when customers should be contacted. As most experienced collectors will tell you, the squeaky wheel does receive the oil. Do not be afraid to contact your higher risk customers before the invoice is even due. The best collection process is one which is proactive and consistent.

Creating a formalized credit policy is not easy and it's not a short task. As each of the nine sections is developed, many questions need to be addressed, but as long as you are aware of these essential areas, you can start off faster and on firmer ground. Once completed, the next step is to move to portfolio management.

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