

## Fundamentals of Extending Credit

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### You're a Business, Not a Bank

When you as a business extend credit to a customer you are in effect lending them the money to pay for the product or service you sold them. However, unlike a bank, you don't make any money on this loan -- in fact, you lose money on it. Some of your customers may even see this "vendor financing" as a source of working capital for themselves. How can you make the best of this situation? Basically, if your customers treat you like a bank then you need to think and act like a banker.

Key points are:

1. Know who you are dealing with
2. Collect information about the business, its finances and payment history
3. Establish a credit limit for the customer
4. Consider obtaining additional security for large and/or risky transactions
5. Monitor payment performance and review credit terms based on experience and new information

**Know who you are dealing with.** Regardless of the amount of the sale you need to avoid the possibility of fraud, particularly if you are dealing with an out-of-town customer who places an order by email or over the internet. Generally these transactions would be paid for by credit card rather than invoicing the customer. If you must invoice get the required information about a business from a credit application or credit reporting service as described below. If not, at minimum do an internet search for the business and **verify that it exists** by calling the contact phone number provided on the site. If you can't locate the business or if the phone number is non-existent or not answered – beware.

**Collect information about the business.** Get essential information about the business, its finances and payment history from appropriate and available sources.

- **Credit reports** from national reporting services such as Dun & Bradstreet or Experian. You will pay for these reports and it is worth considering a subscription to a service if you review customers frequently. Some credit management or accounting software packages have this capability built in. Small, private companies or those that are newly formed may not have much information available from these sources so you will have to request a credit application.
- **Credit applications** give you the opportunity to collect detailed information as well as permission to contact references. This document can also allow you to get agreement to your terms and conditions. If you want to assess a late fee on overdue

invoices the application is one place to put that notice, giving you legal grounding to do so. It's probably not worth it (or appropriate) to request a credit application from large, public companies but they should have sufficient information available from public sources. Tip: any customer that refuses to complete a credit application in full probably has something in their credit history that they are not proud of. This is a warning signal – look at their situation very carefully.

- Credit references and other pertinent company information are sometimes provided by means of a credit reference statement prepared by the customer in lieu of a credit application. This may be sufficient depending on the amount of credit being requested.
- Reference checks should be performed for all significant credit requests. It is appropriate to fax a credit reference form to a trade reference and expect them to complete it although a phone call to let the credit department know it's coming would be appreciated. Compare what the references tell you with what was provided on the application or credit report. Discrepancies need to be investigated.

**Establish a credit limit for the customer.** Setting a credit limit is a complex and judgmental process of balancing the customer's requirements with their ability to pay and your confidence in that ability

- Credit requirement. The first step is to understand how much credit the customer needs today (for the first purchase) and how much additional credit will be required for future sales. For example a customer who makes a one-time purchase of \$10K requires a \$10K limit but spending this same amount over the course of a year may only require a limit of \$2-3K since the first invoice should be paid before the third one is issued. If not, you have a slow paying problem customer.
- Ability to pay. One of the fundamental principles of credit is the understanding of a borrower's capacity to pay. Compare the amount of the credit request to their cash flow, size of business, existing debt load, etc. Another consideration is their industry. Certain types of businesses (restaurants, for example) have a much higher risk of default than others. Finally, review their track record of paying other vendors according to terms. You may want to be conservative in setting a limit for slow-paying customers or customers in risky businesses to minimize your exposure. Remember, you can always change the limit up or down as new information becomes available.
- Default limit. One way to streamline this process is to establish a default credit line. You can avoid the limit-setting process for customers that need a credit line of less than your default amount and whose existence has been verified through the data collection part of your credit review. You should establish a default credit limit based on your average invoice size, the amount of risk you can tolerate as a business

and your profit margin on a typical transaction. That is, if a customer did not pay an invoice of, for example, \$1,000 would that affect your ability to operate your company?

**Consider obtaining additional security.** For particularly large or risky transactions you should consider obtaining additional security for the transaction. Depending on the situation some options include:

- **Personal Guarantee.** It is common practice to ask the owner of a small business to personally guarantee the debts of the business. The owner will need to sign a document agreeing to the guarantee. You should check the personal finances and credit history of the owner before doing this, however. If their credit is poor and/or they have no significant personal assets then the guarantee may prove to be worthless when you try to enforce it.
- **UCC filing.** If the sale involves tangible property you can record your security interest through a Uniform Commercial Code (UCC) filing with your state's Secretary of State. This is common practice for installment sales or leases but is also applicable to any type of financing and gives you the ability to repossess the property in the event of default. The filing remains in place until the debt is fully paid, at which time you would file a termination.
- **Credit insurance.** This approach is normally reserved for very large transactions where you are concerned that the purchaser might file for bankruptcy. I often see credit insurance for large transactions in the retail sector. Credit insurance is costly (typically one-half to one percent of the amount insured) and requires the insurer to do their own evaluation of the risk before they will issue a policy. However, it protects you from catastrophic effects of default by a customer. Remember, this insurance does not cover slow payments or refusal to pay based on disputes.

**Monitor performance.** Sound business practices dictate that you pay attention to your customers and their behavior. Some of the credit-related activities include:

- **Monitor payment history.** Are your customers adhering to their payment terms? If their payment behavior changed over time that could be a sign of financial stress.
- **Monitor and enforce credit limits.** When customers approach or exceed their limits you need to decide whether it's appropriate to increase the limit or enforce it, placing the customer on credit hold until the outstanding balance is paid down. This is always a tough choice for sales-oriented business owners but you need to cap your exposure in a risky situation.
- **Periodically review large balances.** Concentration of a significant percentage of your receivables in a small number of customers exposes you to risk if one or more of them become unable or unwilling to pay you. Pull credit information quarterly.

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Watch for news about the customer, which can be done easily by setting alerts on Google.

- Take immediate action if something material changes regarding a customer. This could be a news report of impending bankruptcy or mail returned as undeliverable. Time is of the essence in these situations.

Remember – you’re a business, not a bank. But that doesn’t mean you can’t think like one when extending credit to your customers.