

# **Credit and Collections Management**

## **Critical Business Function Misunderstood and Underutilized**

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### **Abstract**

The credit and collection function which is responsible for creating and managing Accounts Receivable may be the most misunderstood, underutilized, and undervalued area of business.

### **Introduction**

Accounts Receivable is one of the largest and most liquid of corporate assets. Unfortunately effective management of the process is still often wrongly seen as being part of accounting and therefore as a cost center.

Many organizations view credit and collections as a necessary evil designed to protect against bad debts. In actual fact credit and collections should be an integral part of the sales process; helping establish an initial framework for a long and mutually beneficial relationship between buyer and seller and completing the final step in the sale-to-cash cycle. If viewed from this perspective, credit and collections becomes a sales enhancement function and a profit center, not an administrative cost center that inhibits the sales process.

There was a time not so very long ago when there were valid reasons for the extension of credit being viewed as a privilege, a favor to some and not others. Following World War II pent up demand, commercial shortages and earnings from work in the war effort precipitated unprecedented growth.

Much of the rest of the industrial world had been badly damaged or destroyed by the war and had to be rebuilt creating even more demand.

The 1950s were a time of limited competition; there were no big box stores, cyber competition or aggressive foreign competition. Companies with little or no competition controlled the buying process, including credit. Credit was a privilege; given, but only as a last result. Credit terms were tightly controlled and were designed to limit a company's risk. If you did not pay on time, you were given no further credit. Most companies were operating at capacity and had no problem finding customers willing to pay quickly.

The natural outgrowth of this economic climate was the view that credit management was aligned with "risk management" and the key performance indicators were DSO. (Days Sales Outstanding) and % Bad Debt. This view was therefore appropriate for the times.

In the 50s credit was defined as "the ability to pay and the willingness to pay".

The current economic climate is radically different. Rather than shortages there are more goods and services available than ever before in human history and more on the way. Today quality in products and services is a given and for businesses to be competitive they must also have quality in their business processes.

Today many businesses still track DSO and % Bad Debt and in so doing they are missing an opportunity to increase sales, improve cash flow, control losses, elevate customer service levels and customer retention, and decrease their cost of doing business; all of which contribute to profit enhancement.

The notion of "risk management" ruled in the 1950s but this is 2007. We must rethink the role of credit.

## The Purpose of Credit

Credit terms are extended when products and services are sold on the basis of payment at a later date. This simple act will generate incremental costs of doing business. Pre-sale incremental costs could be the additional administrative cost of information gathering, credit checking, account establishment, and even the billing process itself. Post sales costs are past due A/R management, the cost of carrying A/R, the time value of money and of course the risk of non-payment.

The question that must be answered is simple. "What is the purpose of credit?"

Some people will tell you that costs are incurred because customers require time to ensure they got what they ordered and more time to process the invoice. Others will tell you that customers need time to add value to the products/services they are buying, and to make sales to their own customers. Finally, some will tell you that they must incur the costs of credit because it's the customary way of selling in their industry, and that if they don't extend credit their competitors will.

The only reason for any business to extend credit is to generate a profitable sale that would otherwise be lost. Not just sales but profitable sales...any fool can make sales and lose money doing so.

The purpose of credit is sales support....it is not an accounting function.

## Major Components and Goals

In most cases the credit-to-cash function can be broken down into four major components:

- Credit/sales approval
- Billing
- A/R management (what some erroneously call "collections")
- Monitoring and improvement

Each component must have a goal which compliments the purpose of the credit-to-cash function itself.

## Credit/Sales Approval

If the purpose of credit is to secure profitable sales which would otherwise be lost, then it follows that the goal of the Credit/Sales Approval process should be to seek ways to say yes while being confident of payment. In some cases a substantial investment is made to guide the customer to the point where they want to buy. It's such a waste to then look for reasons to reject the sale or to quite possibly alienate the customer to the point where they will reject you.

- Wrong Message: The credit approval process has at times been described as finding ways to say no and the credit department has been referred to as the sales avoidance department. Considering that the credit people are being told, via performance measurements, that risk avoidance is the goal; it's surprising that any customer gets approved.
- Right Message: The goal of the credit approval process should be to maximize sales opportunities wherever possible while minimizing risks. Working to find ways of saying yes to every possible sale while remaining confident of payment better complies with the sales support mission.

Most people treat credit approval as a fixed point in time with a fixed set of operating characteristics. Once a prospect has overcome all of the credit approval hurdles that inhibit their desire to place an order (we can really make the simplest of acts incredibly complex), they are assigned a credit limit that in most instances acts more as a deterrent to new business than a protection against increased risk.

- If a customer likes your products/services and wants to order more than either party had originally anticipated, the credit limit places a temporary cap on their ability to do business with you. What's wrong with this picture?
- If you are operating below capacity, the only expenses that matter are the variable costs of production (product acquisition). The actual profit margin for these incremental sales is therefore higher, sometimes substantially higher. In order to fill this excess capacity you can adopt very aggressive pricing models and/or relaxed credit terms. The write-off rate may be higher, but the incremental profit more than makes up for the added risk. This concept is called "Product Value at the Time of Sale" and works for any type of business with excess capacity.

One last comment should be made before we move forward. If A/R Management is in fact a sales support function, then the people working in this area may need to adopt a different attitude. Credit is not a privilege offered to only the few. Prospects and customers should not be made to jump through hoops in order to do business with you. Customer contact to discuss overdue invoices should be a positive experience where buyer and seller are working together to achieve a mutually beneficial relationship. In short, A/R Management personnel should be well versed in the fine art of selling.

### **Billing**

Companies sell products in order to generate revenue. That revenue cannot be turned into cash until two key milestones have been reached: the customer must receive the invoice and the invoice must be approved for payment. Therefore the purpose of the billing process is to facilitate payment.

It may not sound like a significant problem, but let's look at an example where it takes three days to generate an invoice. Let's also say that this company generates \$20 Million in annual revenue. That's \$100,000 in revenue per day. Therefore for every day that an invoice is not completed and mailed a company must invest an additional \$100,000 in receivables. Looking at it the other way round, for every day a company can reduce the time required to actually generate and mail an invoice they will receive a one-time cash flow of \$100,000.

The invoicing function is a critical link in the order-to-cash cycle. At a minimum companies should

- Monitor and reduce the time required to generate a typical invoice.
- Monitor and reduce invoice defects (format, pricing, terms, etc.).

### **A/R Management**

A/R Management is not "collections", the enforcement of payment. Collections is what collection agencies and attorneys do, and they deal with "debtors", not customers.

A/R Management is "the completion of the sale". The goal is to keep customers current and buying and in the process achieve one of the most important underlying goals: the stimulation of repeat sales. The last thing smart companies want to do is create an impediment to lucrative repeat business.

The purpose of A/R Management is keeping credit customers current. The benefit is enhanced cash flow. The secondary purpose of A/R Management is the early identification and control of the small percent of business that represents a potential for loss.

### **Monitoring and Improvement**

The last and most important component of credit management is the process of continuous improvement. Goals need to be established. Information needs to be generated to compare actual results against the established goals. This then leads to the identification of opportunities for improvement and the creation of specific steps to either overcome the identified problems (that's the

reactive approach) or take advantage of the new opportunities (that's the proactive approach). Finally, the circle is closed as new goals are established and information gathered to monitor the revised processes.

Please keep in mind that this is both an internal and external process. The internal component is an analysis of the efficiency and effectiveness of business processes themselves as well as individual employees (or work groups). Efficiency is tied to the cost of a business process (or one of its components), while effectiveness is tied to whether the specified goals are being achieved. You could spend great quantities of cash to make a business process work, but that would not be cost effective. Conversely you could make the business process less costly and not achieve the goals of the process. Somewhere between these two extremes is the best suited path and that path will depend on your industry and the way you have decided to run your business.

Having said all of this, what then needs to be measured and why? The following list is certainly not all inclusive but intended to help establish a framework to help measure efficiency and effectiveness.

- **Payment Terms:** Cash flow can be impacted if payment terms are too liberal. While more lenient payment terms may be a reflection of competitive realities, they may also be used as a quick fix to gain business.
- **Invoicing Delays:** If there is a delay between the time an order is shipped or a service provided and the invoice date, this may be an opportunity for improvement. Users should track both the average delay (general improvement) as well as investigate billing delays for specific invoices that exceed a specified limit (specific improvement).
- **Procedural Errors:** The failure to meet a customer's business process requirements (Purchase Order number, invoice formats, pricing, even number of invoice copies) will lead to payment delays. These procedural errors need to be segregated by type, tracked, and continuously improved.
- **Service Disputes:** If a customer does not pay on time due to an identifiable dispute/problem (goods or services are not provided on time, poor quality, or any other reason that can be tracked), cash flow will be negatively impacted. These specific problems need to be resolved as quickly as possible (another measurement standard) and they need to be tracked over time to determine if general improvement is being achieved. When an invoice is disputed, a specific dispute type needs to be assigned. Each dispute type (both instances and value) need to be monitored.
- **Average Days Late:** DSO (Days Sales Outstanding) is relevant to cash flow forecasting, but not A/R Management simply because it (DSO) is not tied to the payment terms you can elect to offer customers. Average Days Late (ADL) measures a customer's payment history as it relates to the payment terms offered for each invoice. If a customer's ADL is increasing or is higher than average, this should be a trigger to contact the customer, not about a specific invoice, but their payment history in general. ADL may also indicate that a specific A/R rep is not quite as effective as they could be (when compared against other A/R reps). Finally, a customer's payment history should be one of the factors sales people consider when discussing future pricing with customers.

### **A/R Management Software**

The goal of A/R management software is to facilitate the order-to-cash process by providing the structure and tools necessary to improve both effectiveness and efficiency.

Effectiveness measures the success of efforts to encourage customers to pay their obligations sooner than they are currently.

Efficiency measures the cost of these activities against the incremental improvement in Days Sales Outstanding.

Goal: Invest time designing a system that ensures that there is no reason why a customer should delay payment.

- Order Entry: Make sure that the order itself reflects both the customer's requirements (items or services) and their desires (delivery date, handling, packaging, method of delivery, payment terms, etc.). This could be as simple as repeating the item name, quantity, price, delivery date, and payment terms. For service oriented companies this means making sure that all aspects of the service to be performed are clearly understood before the service is delivered.
- Invoicing: Make sure that the invoice is understandable (the invoice format is easy to read), correct in all aspects (pricing, matches the customer's Purchase Order), timely (the invoice is printed and mailed as quickly as practical) and above all else is mailed to the correct person at the correct address.

Why are invoices not paid on time?

- Damage
- Dispute: quality (product and service), timeliness (too late or too early), quantity, price or procedural (sent to the wrong person or address, lost in the mail, etc.)
- Processing inefficiency: both buyer and seller
- Policy: Customer does not pay invoices on time
- Cash flow problems.

There are several types of customers and each should be handled differently.

- Good customers who pay on time.
- Good customers who would like to pay on time but cannot due to cash flow problems.
- Marginal/poor customers who do not pay on time as a matter of policy.

### **A/R Management Procedures**

While all companies will have to rely on "force" from time to time to facilitate payment, one must remember that A/R Management is an integral part of the sales process and therefore all contacts with customers should be positive in their nature, not negative or threatening. Customers should be encouraged to pay overdue invoices or improve their payment history to enhance the likelihood of profitable sales in the future.

In the past and to some extent even today the only tool available was an Aging Report. While the Aging Report does list overdue invoices by customer and therefore helps people identify which invoices are overdue, it does not identify

- which customers may have already been called,
- who has already talked to the customer,
- which customer contacts have already been called,
- which invoices have already been discussed,
- what these contacts may have said,
- if there is some impediment to invoice payment (technical, procedural, quality, price, etc.),
- when these customer contacts promised to pay and
- when these individuals should be contacted again.

The Aging Report may be acceptable for small companies with a limited customer list or limited invoice activity, but it is inefficient and ineffective for everyone else.

A/R Management should be a software assisted process. The software application itself should not drive the process, but facilitate it, helping people do their jobs more effectively as well as more efficiently.

### **A/R Management Tools**

The objective of all tools utilized to control A/R balances is the reduction in the time required to complete the sale (receive payment). The real question is which tool is most effective under what circumstances.

### **Integrating A/R Management into CRM**

The key to an effective A/R Management process is treating it as if it were an integral part of Customer Relationship Management (CRM) which in fact is precisely what it is. The people who control payment processing are just as much customers as those people who make the initial purchase decision and the last thing you want to do is give your customer a reason not to buy (or in this case not to pay).

An integral part of the sales process/cycle should include some form of contact with the people responsible for payment processing. After all; friends look each other.

- If your relationship with a customer's CFO or other administrative people is cordial, not adversarial, they will give you higher priority when it comes time to selecting invoices for payment.
- If you establish friendly relations with your customer at all levels, they will notify you if there is a problem with an invoice.
- If you establish a true business relationship with your customers, you may be able to switch to e-mail requests for payment (the most efficient alternative) and they will in fact respond whereas they would not if your relationship was typically adversarial.

### **Measuring Performance and Initiating Improvements**

Bringing the payment side of A/R Management under more effective control is an important step, but it certainly is not the only step you should take. There is an underlying reason why invoices are not paid on time. That's why managing and improving performance is so critical. The following suggestions may assist.

- A cause must be assigned to every overdue invoice.
- Each cause must be associated with either the customer or an internal process.
- Each cause must be clearly segregated into a specific category (billing delay, incorrect pricing, quality, invoice lost in the mail, delay in contacting the customer, customer's internal inefficiency, customer cash flow problem, customer payment policy, etc.).
- Take steps to investigate each cause and either eliminate or reduce the likelihood of it happening in the future.
- Work with customers to improve their invoice-to-payment cycle, or at least improve it from your perspective.
- Initiate contact sooner.
- Establish performance goals for each process that has an effect on the invoice-to-payment process (invoice creation, billing errors, disputes in their various forms, customer payment history, etc.).

- Measure performance on a regular basis.
- Establish specific improvement goals.

### **Managing the Invoice-to-Payment Process**

The process of improving the invoice-to-payment process must start with the assumption that the Aging Report as the primary management tool must be replaced with a software-supported process. Specifically the process should mimic the functions found in a contact manager. The only difference is that this application should support the invoice-to-payment process (the completion of the sale) rather than the prospect-to-customer process (the initiation of the sale).

While there is no doubt that bringing receivables under control will require some effort and expense (mostly time), the goal is getting customers to the point where they are thinking about you when they are selecting invoices for payment. If you can reach that point with most customers, the time required to keep receivables in line will be more reasonable.

Your approach has to be positive, not negative. *“He who screams loudest gets paid first”* does not work in the long run. Screaming at customers or threatening them does not contribute to repeat (highly profitable) business. This does not mean that you should not encourage customers to alter their behavior. That is precisely what you have to do: permanently alter the way customers treat you. You do want them to give you payment priority because they want to, not because they have to.

#### Why Doesn't a Contact Manager or CRM System Work?

The key to the successful management of A/R is consistency. That's why an application with contact management capabilities would work so well. You could take a typical contact manager or CRM system and modify it so that a contact event would be created when an invoice became past due, but what do you do when you actually make first contact. Contact managers and CRM applications are sales oriented. You need information that relates to overdue invoices and a customer's payment history. Although you could open a separate screen to view invoice details or sales order details, that's inefficient. If you needed to see only the contact history (for one invoice or for all invoices), would you be able to do so using a generic contact system?

The management of A/R requires access to specific information without having to filter out information that is not required. It is a highly specialized process and therefore the software that supports it must also be highly specialized.

### **The Ideal A/R Management Tool**

What we are going to do now is create a set of specifications for a full-featured middle-market A/R management software application. Since the process itself is driven by people who are supported by the software application, we will also discuss the business process itself. Although collections is a negative term and has been avoided to this point, we will use that term here simply because it flows better.

#### Setup

- Specific collections responsibility must be assigned to people within the organization. No business process will achieve optimum performance levels unless people are actually assigned responsibility and by assigning responsibility their performance can be measured.
- In some cases responsibility can be shared between two or more people in a work group setting.
- If required, individual customers should be assigned to specific collections reps. This fosters a positive relationship by which subtle pressure can be applied just as it is in the sales process.

- Some form of hierarchy should be created to facilitate management oversight as well as the transfer of responsibility. A prime example here would be the transfer of responsibility for an invoice from a collections rep to the CFO or other senior manager if legal action is the next logical step.
- In some cases sales representatives can be brought into the process with full contact responsibility or with read-only access (meaning they can view a customer's payment history, but cannot actually record collections calls).

### Trigger Points

While dates drive a typical contact manager and certainly dates will drive an A/R Management application once first contact has been made, the trigger that will drive the first contact with a customer (concerning a newly identified overdue invoice) will be an event. Smaller companies could get by with a very limited number of event types, while larger organizations may want to take full advantage of the fact that any one of several event types could drive the first contact.

- In most cases the trigger point should be based on Due Date + "x" days. As an example an invoice will be passed through to the A/R Management application five days after the Due Date.
- That invoice will be assigned to a customer-specific collections rep. or to a default collections rep.
- Users should also have the ability to define customer-specific Trigger Points.
- Trigger Points can be negative so that the process can begin before the Due Date. This would allow users to make first contact prior to the Due Date and therefore remind a customer to pay their invoice in a timelier manner.
- A separate Trigger Point could be assigned to invoices that exceed a certain dollar value. This recognizes the fact that high-value invoices should receive higher priority.
- Customer-specific trigger points could be dynamic rather than fixed, tracking a customer's payment history and assigning a Trigger Point based on their payment history. Therefore as customers improve their payment pattern, they will be contacted less frequently.
- Other types of Trigger Points could be utilized in certain circumstances. As an example if a customer partially pays an invoice, that may be an indication that there could be a problem with the balance of the invoice. Another example would be if a customer calls to say that an invoice is in some form of dispute. In both cases the invoice should be passed over to the A/R Management system even though it may not yet be overdue.
- Other safeguards should be in place as well. As an example small value invoices should not be passed through because the cost of the call would exceed the invoice value or exceed the invoice margin. However, once a group of invoices reaches a collective target value, all would be transferred simultaneously as the cost to discuss a group of these low-value invoices would be more reasonable.

### Statements and Dunning Notices

We have assumed to this point that the driving force behind the A/R Management system is personal, repetitious contact with customers. What about statements and dunning notices (letter and e-mail)?

This is certainly the least costly alternative, particularly if e-mail is utilized as the delivery vehicle. The problem is that statements and dunning notices do not work in all instances.

- In the past some customers would pay only by statement, but that is the past. Most companies have software driven payment processes that are keyed to an invoice's Due Date.
- If an invoice has been lost in the mail, a good customer who wants to pay will initiate contact and ask for a copy of the missing invoice.

- If an invoice is incorrect (format, price, incorrect PO, etc.), some customers will initiate contact immediately without waiting for a statement or dunning notice. Other customers will do nothing because it's not their problem.
- Some customers (actually the people responsible for processing invoices) are "too busy" to take notice. This is particularly true for companies in which the invoice processing function is not efficiently organized.
- Customers that cannot pay on time or elect not to pay on time as a matter of policy will ignore any form of faceless communication.

The conclusion that we can draw here is that statements and dunning notices will work under a limited set of circumstances. The most significant drawback is that when this alternative does not work (and that's apparently most of the time) it only delays payment even further. If a customer responds to dunning notices, then it makes economic sense to utilize that as the first contact. If a customer does not react to dunning notices, then their first contact should be personal.

### Daily Operations

Now that the system has been created, let's describe how it should operate. Remember that we have elected to not use a standard contact manager to manage this process. The reasons will become obvious as we discuss the process below.

- Each person responsible for collections will open their Call List just like they would in any contact manager.
- All invoices posted to the system for the first time would be assigned the current date.
- All other invoices would be sorted by Next Contact Date, again just like a contact manager.
- Although calls should be made based on Next Contact Date, users should have the flexibility to sort the Call List by customer, invoice amount, or any other field associated with the Call List.
- Once an invoice is selected, the system will display the contact screen itself and this is where it becomes necessary to have a specialized application. Users should be able to access via smart buttons and lists (meaning the user does not have to specify Customer ID, invoice number, etc.) every piece of information that will facilitate the payment of this invoice.
- Once a call is made, contact notes recorded, and promised payment date recorded, the user will record the next contact date (usually a few days after the promised payment date).
- Hopefully the initial contact will encourage the customer to settle their account, but if required users should be able to record an unlimited number of contacts, share this file with other people (even if that is just to cover vacation time), reprint invoices and statements, access e-mail from within the application, and even pass responsibility to another person.

As you can see, many of these functions are identical to those available in a contact manager. However, you can also see that users need to access multiple sources of information and multiple functions that are very specific to the collections process. The contacts themselves make the process effective (the customer extends higher payment priority) and that is the primary goal. The customer-specific and invoice-specific information and functions make the process more efficient. Both goals must be achieved.

### **Summary**

Accounts Receivable can represent the single most valuable liquid asset any company possesses and yet many companies and certainly many accounting software vendors do not seem to understand the potential business benefits of credit and A/R management. A modest reduction in A/R can generate a huge one-time cash flow. A credit management philosophy that is associated with sales enhancement rather than risk aversion can generate more profitable sales. All of this is possible, but

only if companies scrap business processes that were created 40 years ago under different economic conditions. Credit and A/R Management can and should be an integral part of the sales process (prospect to customer to order to cash), not a defensive posture that inhibits the sales process.