WHITE PAPER

Credit Management Processes That Pay Off

As many Canadian companies have learned, the ability to offer credit and favourable payment terms to your foreign customers can offer your company several advantages as well. Offering credit may help tip sales decisions in your favour, encourage repeat purchases, and help you establish and build long-term relationships and loyalty from customers.

At the same time, however, defaulted payments from your customer can seriously hurt your bottom line and curtail company growth. Even late or sporadic payments can in turn disrupt your ability to cover day-to-day operating costs or meet your financial obligations – which could potentially harm your credit capacity.

While it's impossible to say with certainty which customers will never default on a payment, there are ways that you can mitigate the risks through strong credit management. This white paper is intended to equip you with some key information and tools that can be used to establish or strengthen credit management practices for your business.

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HOW TO IMPLEMENT CREDIT MANAGEMENT INTO YOUR BUSINESS

Credit management is an effective way to protect your revenues, reduce your bad debts, and ultimately strengthen your bottom line. Managing credit involves having clear processes and internal controls in place for determining whether to extend credit to existing and prospective customers, and how to collect your receivables.

1. The Credit Application

The first rule of thumb for managing your credit is to ensure that, for all sales contracts, you verify the company's creditworthiness to establish an appropriate credit limit and reasonable payment terms.

This means asking each company to complete a credit application form, and using the information they provide in this form to do further credit analysis. You can use EDC's **credit application** form as a guide to create your own form.

The most effective credit applications include the following elements:

- Company information – Legal name, trade name(s), headquarters address, name and contact information of the employee(s) with whom you will be communicating, and the contact information for the employees who have the authority to purchase goods and issue payment. **Note: Getting the correct legal name of the company is very important**. In the event of non-payment, you need to know exactly who owes you money. To ensure you have the correct legal name, you can cross reference the credit application with the purchase order, contract, shipping documents, or other such documents.
- Bank information – Legal bank name, account manager contact information, the amount of cash that is accessible by the company, how much the company is able to borrow from the bank (through loans, lines of credit, etc.), and how much they currently owe.
- Commercial trade information – Ask for a minimum of three business names from which the company has purchased. The commercial trade information should also include contact information, dollar value of the credit limit, date of last sale, and payment record.
- Provisions that may protect you in the event of non-payment – These provisions are not standard to all credit applications, but it is advisable that you include them in case there is no written contract or purchase order that includes this information:
    - Maximum number of days after receipt of goods to report a quality/quantity issue.
    - Terms of payment.
    - Description of how disputes will be resolved.

- Your rights to terminate credit terms (i.e., if the account is more than 30 days past due, you would have the right to stop selling or providing product, without being in breach of contract).

- Contact signature – Be sure to include this; without it, the above-noted provisions cannot be relied upon.

2. Credit Assessment Tools

Once you have the basic information provided in the Credit Application, it is recommended that you use one or several of the credit assessment tools outlined in the table here. These tools will allow you to assess whether the limit requested is acceptable to your company. The tools have been presented in order of the depth and breadth of information provided by each – the higher the limit requested, the broader and deeper your analysis should be. For example, extending only a small amount of credit may warrant that you rely only on commercial trade references. As the limit requested increases, you may wish to consult the company's bank, source financial statements, or order a credit report from a reporting agency.

Tool	Suggested Use
Commercial Trade References	Written references are more reliable than verbal ones. Contact a minimum of three references; use a lower amount of credit as a guideline for establishing your own limit.
Your own past payment experience with the customer	Assess the level of credit you have given to the customer in the past, as well as the experience you have had collecting payment. You should rely on an additional tool if: • The last credit sale was not recent; • The customer is asking for a higher credit limit than you have previously given; • The payment terms requested are longer than what you have agreed to for past transactions with the customer.
Bank Report/ Recommendation	A written report or recommendation is more reliable than a verbal report. Bank information should provide: • An indication of the strength and longevity of the banking relationship; • A description of the borrowing facilities that are accessible to the company; • The level of the company's borrowing capacity; and • The level of debt utilization. In regard to debt utilization, consideration should be given to operational cycles (e.g., seasonality), as in some industries, companies will typically borrow more during their peak production season. If bank information is the main source of credit information, it should be updated every 6-9 months.

Financial Statements	Financial statements will provide a view of the company's liquidity, profitability and cash flow (ability to make short-term payments). The turnover of their accounts payable will also provide insight into how quickly you can expect to get paid and the company's leverage (ability to service long-term obligations). There is a higher quality of information in financial statements that have been audited, and where there are no qualifications made in the audit report. Financial statements that are more than one year old may not provide a reliable picture of the company's current financial position. Annual financial statements with year-over-year comparables are ideal, as these will allow you to see the trends in financial performance. Interim financial statements (covering a period of less than a year) provide only a snapshot of activity, and are not as reliable as a full year (or several years).
Credit Agency Report	As a one-stop solution, credit agencies can provide the most reliable and comprehensive information. This may include trade payment experience, bank information, financial statements, and historical information regarding the company and its principals. A credit report that is more than one year old may not provide a reliable picture of the company's current financial position or creditworthiness.

3. A Clearly Worded Contract

The importance of a clearly worded sales contract cannot be exaggerated. It is the best preventative tool for managing credit. A clear contract will identify the obligations of each party, and will minimize the risk of dispute. For tips on some of the terms to include in your next contract, download our free **Commercial Contract Terms Reference Guide**.

4. Reasonable Payment Terms

Establish payment terms that are common for your industry, and that your customer is capable of managing. If you are unsure about your customer's creditworthiness, mitigate the risk of the sale with upfront payment (partial or full), or by using letters of credit. Another way to mitigate the risk is to set a shorter payment due date, or provide for a certain percentage rebate to encourage your customers to pay earlier.

5. Update and Reevaluate on a Regular Basis

Be sure to update credit information about your customer regularly to ensure their creditworthiness has not deteriorated. The time when an update is most relevant is when:

- your customer needs to increase their credit limit;
- your customer is asking for payment terms that you have not provided in the past;
- you have not sold on credit to this customer within the past year;

- your past experience with the customer has been less than favourable; or
- your customer has undergone a change in structure or ownership.

Also watch for red flags that suggest your customer's creditworthiness may have changed – red flags include a change in payment habits or a change in the principals of the company. Being aware of these changes means that you need to build strong relationships with your customers through trust and open communication – especially with the person who pays your invoices. Visit your customer often to see their operations. What does it look like? Does it feel well managed? Don't rely on information from the Internet which can be misleading.

6. Structuring Your Credit Department

To follow best practices in your credit department, you need to establish appropriate internal controls:

- Define the division of responsibility between your credit manager and sales staff to avoid conflict of interest.
- Define who in your organization has the authority to approve credit limits.
- Maintain accurate records, including purchase orders, invoices, and correspondence.
- Create a credit manual that defines your credit management process, and be sure to share it with staff and all new employees as appropriate. Update the manual as your processes change. Guidelines on how to establish credit limits are described in Step 1.

For more information, please visit **edc.ca**

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