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PERSONAL PLANNING

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*“We also accept VISA, Master Card
and American Express.”*

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ESTABLISHING A CREDIT POLICY

CREDIT can be extended by your business to your customers in the form of delayed payments, financing, charge cards or checking services.

The first three of these forms of credit can be defined respectively as: trade credit, financing, and charge card credit.

In all cases, a business that offers any of the above credit services is engaged in more than providing a convenient array of payment options; the extension of credit and financing services is a deliberate marketing strategy designed to stimulate business and give a company a competitive edge.

TRADE CREDIT

TRADE CREDIT can be extended to other companies or large organization who usually do business with you on a regular basis. Consider the following: if you are a wholesaler, and a retailer purchases goods for resale from you, that retailer might simultaneously owe substantial mounts of money to other wholesalers, and other creditors such as, telephone, electric and insurance companies. This retailer will likely not have enough cash to pay all their bills at once. Therefore, if you want their business, you must extend them credit.

NOTE In the same manner as trade credit, consumer credit can be given to preferred retail customers who do business with you

In the future, credit cards may replace money as we know it.

FUNFACT

on a regular basis. However presently, the practice of extending personal credit to customers, survives only at prestigious, high-markup retailers.

PROS & CONS of Extending Trade

Credit – The main advantage of extending trade credit is that it will attract additional customers and increase sales volume. In fact, most manufacturers and wholesalers find it imperative to offer credit terms to their customers, simply in order to survive. However, although selling on credit can boost sales, it can also increase direct and indirect costs, which must be weighed against its potential benefits. For example, by offering trade credit, and hence not operating on a cash only basis, you will require more extensive bookkeeping, invoicing, and collection procedures that often demand hir-

ing additional staff just to manage the extra accounts. And what's worse, a definite percentage of the businesses you grant credit to, will not be able to pay.

NOTE Bad debts come in various sizes and conditions. Fashionable stores that sell only to high-income big-spenders need to carry charge accounts because wealthy people rarely carry cash; yet, even the very rich can go bankrupt if their considerable fortunes become deflated in a stock market crash. At the other end of the spectrum are merchants who deal with workers in highly unstable and volatile industries or farmers whose income comes in at the end of a growing season. The percentage of bad debts when dealing with these types of

Open credit is a form of credit where you extend short-term credit to customers without requiring any down payment and without adding either interest or carrying charges to the bill.

business are usually quite high. Extra precautions must therefore be taken.

Types of Trade Credit

There are three basic types of trade credit you should be familiar with:

1. open credit
2. option-terms credit
3. revolving charge

Open Credit – Also referred to as open account, open book, or regular credit, open credit is a form of credit where you extend short-term credit to customers without requiring any down payment and without adding either interest or carrying charges to the bill. It is usually extended for a thirty-day period. This kind of credit is most like the

credit given out in the old days during the great depression by mom and pop grocery stores.

Option-terms Credit – This type of credit permits a customer to charge up to a limit and pay within thirty days of the billing date without penalty. A firm can assign a carrying charge for any amount not paid within that time period and release additional credit (up to a pre-set limit) as payments are made. Thus, the features of both open credit and revolving charge credit discussed below are combined in one plan.

Revolving Charge Credit – Revolving charge credit refers to the continuous re-

leasing of credit to the credit ceiling as payments are made. This type of credit is the most common form of credit given to businesses.

This extension of trade credit is essentially no different than a John Doe running up a bar tab at a local pub and not paying till the end of the month when he gets paid.
POWERPOINT

Guidelines for Extending Credit

Before any credit is extended to any customer, a policy or list of rules must be established by your company in order to weed out potential bad credit risks. To do this:

STEP 1 – Become a member of your local Credit Bureau.

Credit Bureaus provide you with the resources to check out all your applicants, and the latest up-to-date procedures and polices most companies are using. As well, many offer seminars on credit and collection techniques.

STEP 2 – Set policies including standards for measuring each applicant.

The policies and standards you set depend on the type of company you are running. A wholesaler's policies will likely differ from a manufacturer's policies, especially in terms of credit limits. In general, you must set a policy that allows you to make sure that credit is warranted before you grant it. Not all customers should be allowed to apply for credit.

NOTE Before you establish your credit policy, check out what your competition is doing. If they are not offering a credit service such as yours, either they don't have the time, manpower, or expertise, or have lost money on it and no longer offer it. However, if they are offering a service like yours, try and get a copy of

Before you establish your credit policy, check out what your competition is doing.

their policy, copy what is working for them, and then try and innovate on a few key issues, particularly, the terms of sale.

STEP 3 – Devise a credit application form to be completed by the person or company applying for credit.

Before granting anyone credit you should have them fill out an application form. A lawyer can provide valuable help in preparing this form.

NOTE A simple credit application form could be outlined as follows: list the customer's name, address, telephone number, place of employment, bank and credit references.

STEP 4 – Verify the data on the application form. The information provided in the application form should then be checked carefully by mail or telephone,

and/ or with a bank, credit bureau or mercantile agency, such as Dun & Bradstreet.

STEP 5 – Evaluate the application. A decision to extend credit to any specific client or company is generally based on what is called *The Five C's of Credit*:

- character
- capacity
- capital
- collateral
- conditions

Character – Since an individual's character, in the sense of personality or behavior patterns, is extremely difficult to appraise, much less define, character is usually translated to mean the

A decision to extend credit to any specific client or company is generally based on what is called The Five C's of Credit: character, capacity, capital, collateral and conditions.

applicant's willingness to pay bills when they are due. Hence, credit records must be studied to determine what kind of behavior was evidenced by the applicant in the past with respect to debts i.e., do they pay their debts as promised. Relevant information may be requested from the customer's bank, previous suppliers or from credit reporting agencies.

Capacity – This criterion refers to a person's or company's ability to pay debts out of current income. Obviously, if a company is suffering serious cash flow problems and may not be able to pay you for quite some time, you would think twice about extending them credit. An examination of the credit buyer's financial statements and business plan may aid in mak-

ing a correct judgment. As well, an analysis of their debt-to-asset and current ratios will also help in measuring their ability to repay.

Capital – Another indication of the credit applicant’s ability to pay is his or her financial resources (or net worth). A company with substantial financial assets, and a temporary cash flow problem, may not concern you that much, especially if they have been around for a long time, and are likely to continue doing so.

Collateral – When deciding whether to extend credit to a customer, it is also important to look at any collateral which they may offer as security

Having a cash-only policy or charging only on no-recourse charge cards will prevent bad debts and limit the many of the problems associated with extending trade credit. However, this will also likely lead to a reduction in total sales.

SUPERTIP

or you may ask them to pledge.

Conditions – Finally, when deciding whether to extend credit to a customer, you will need to take into consideration the general economic as well as specific geographical and industry conditions which might speak positively or negatively about granting credit to any customer.

STEP 6 – Set a credit limit. If the application is approved, you must then set a credit limit for the customer. It is necessary to set a credit limit to control your losses in case the account goes south. The limit you choose will depend upon your research and company policies.

STEP 7 – Establish terms of sale.

When a firm offers trade credit, it usually offers a discount off the purchase price for early payment (to reduce its average collection period and improve cash flow) as well as state a limit or credit period as to how long the customer has until the bill must be paid. For example, in the case of a wholesaler who ships goods to a retail firm, a typical terms of sale might be marked on the shipment's invoice as 2/10, net 30. This means that the retailer is permitted thirty days of credit from the date of invoice. If the bill is paid promptly – that is before ten days have passed – the retailer is entitled to deduct 2 percent from the face amount from the bill. A typical terms of sale policy also deals with issues like:

In business, one way to obtain credit is to create the impression that one already has it.

**MIGUEL
UNAMUNO**

- DO you offer a discount for *cash* payments?
- DO you encourage COD sales or require an advance deposit for a large orders?
- DO you charge interest on overdue accounts and how much?
- DO you have a late payment penalty charge? This charge is usually this is in the form of interest and sometimes even automatically calculated out e.g., after this date pay \$11 instead of \$10, and before ten days pay \$9.
- ARE your payment terms competitive? Before you establish your terms of sale, check out what your competition is

doing if you haven't already done so. In the least, you should be doing the same as them.

STEP 8 – Set up an effective invoicing system. Invoices should be prepared and mailed promptly on a regular basis (usually monthly or bi-monthly) with all payment terms clearly stated. To do this you need to set up an accurate, efficient and organized system for rendering these statements.

NOTE In general, try and send an invoice with each shipment or invoice within two working days of filling the order.

STEP 9 – Monitor credit usage carefully. Monitoring your accounts receivable allows you to identify problems before they

Failing to regularly keep track of your bad debts ratio can give you a false sense of net worth and eventually threaten the profitability of your business.

become serious credit risks. This is accomplished by setting up a system for aging all A/Rs (see Guidebook #28). Pay particular attention to overdue accounts, not only to make sure that your customers have received their bills, but also to stop giving them credit in the future, or until their account has been brought up to date. When monitoring you A/Rs, also make it a habit of comparing your average collection period (ACP) with industry averages, past experience, and changes to payment terms, as well as your monthly bad debt percentage.

NOTE Failing to regularly keep track of your bad debts ratio can give you a false sense of net worth and eventually threaten the profitability of your business.

Calculating Your A/R Dollar Value – If you know your average volume of credit sales per day and your average length of time between sales and receipt of full cash payment (your average collection period), you can calculate your A/R dollar value using the following simple formula:

A/R Dollar Value = average credit sales per day x average collection period

For example, if a business has credit sales of \$500 per day and ACP of 20 days, it will have a total A/R Dollar Value of: \$500 x 20 days = \$10,000 invested in receivables at any given time.

NOTE If you are missing the values of certain variables, when using the above A/R formula, you should be able to make rea-

sonable projections using industry averages.

Calculating Your A/R Average Collection Period – If you know your A/R dollar value (often referred to as your A/R position) and your A/R annual total, you can calculate your average collection period (ACP) based on the following simple formula:

ACP = A/R Position/Daily Sales

For example, if a business has an A/R position of \$2,000 (i.e., how much its customers owe at one particular point in time) and annual credit sales of \$40,000, its average collection period is $(\$2,000)/(\$40,000/365)$ or approximately 18 days.

NOTE As a rule of thumb: if your ACP is

Credit: The life blood of commerce.
FRANK MCKINNEY HUBBARD

more than one-third larger than your credit period (e.g., if your credit period is 30 days and you have an ACP of more than 40 days, you have a problem.

STEP 10 – Establish a bad debts collection policy.

Timely and effective debt collection is essential to generate positive cash flow and to increase profits by diminishing the need for short-term operating loans. Therefore, all companies need to implement a systematic collection procedure to follow up on slow accounts. The purpose of this procedure is to help reduce “delinquency” to an appreciable degree without destroying the good will of good customers. You don’t want to avoid losing potentially good customers by giving them a nasty or insensitive collections notice. To

Timely and effective debt collection is essential to generate positive cash flow and to increase profits by diminishing the need for short-term operating loans.

help develop your collections policy, use the following guidelines:

STAGE ONE – Once an account has been red-flagged or aged beyond a certain length (over 30, 45, 60 or 90 days or a greater or lesser amount as decided by company policy), mail a duplicate invoice – stamped *past due*, *second notice*, or some similar phrase – to the customers shortly after discovering that the account is over due. Or call the company in question to make sure it just wasn’t an oversight or mix up on their part before you Fax or mail a duplicate copy of the invoice. If you call the company, make sure you record or make notes on the conversations that take place for your own records.

STAGE TWO – After several weeks without receiving a response, send out the first in a series of form letters (prepare these long in advance). The first letter should be pleasant in tone and suggest that the customer may have accidentally overlooked payment of such-and-such an amount (you might consider placing a telephone call in between the first and second letters to find out what is happening).

NOTE Whether you call or send a letter will depend upon how serious the aged account is (how much) or which method you find achieves the best result of ensuring customers loyalty and getting the money owed. If a customer is delinquent, you also might first try to obtain a promise of payment on a definite date. If payment is not received on

Your last letter in the series should emphasize the fact that you're about to turn the delinquent account over to your attorney or a collection agency.

the date promised, ask the customer to explain why and get a new promise or move on to the next stage of your collection policy.

STAGE THREE – If you hear nothing further, send out additional letters, each of which becomes progressively stronger. These should be spaced so that they reach the addressee about every ten days or two weeks. Your last letter in the series should emphasize the fact that you're about to turn the delinquent account over to your attorney or a collection agency (indicate at exactly what point their credit rating will become damaged and your results filed with the credit bureau).

STAGE FOUR – Turn the matter over to

your attorney, a collection agency, or both. For some people a few nasty letters from a lawyer or collections agency can be particularly motivating. As well, make sure information about the delinquent offender is passed on to your credit bureau.

NOTE At this point, you may consider selling some of your delinquent accounts to special agencies at a considerable discount. They will pay you a certain percentage of the face value and then take over full responsibility for the collections.

Trade credit will typically increase your sales by 30%.
SUPERTIP



What You Need to Do to Develop an Effective Company Credit Policy

- ❑ **Monitor** A/R dollar amount (A/R position) on an ongoing basis as well as calculates the percentage of total sales sold on credit
- ❑ **Send** invoices immediately after the sale, rather than waiting for the end of the month
- ❑ **Offer** a discount for quick payments to improve its cash flow position
- ❑ **Assess** a late payment fee from customers
- ❑ **Age** your A/Rs monthly
- ❑ **Monitor** your average collection period and bad debts ratio
- ❑ **Project**, monitor and write off your bad debts percentage
- ❑ **Evaluate** the “Credit Worthiness” of your customers, using the 5 C’s of credit
- ❑ **Develop** and effective collections policy
- ❑ **Have** on file a series of increasingly pointed letters to collect from late or delinquent accounts
- ❑ **Identify** prompt-paying customers and search for more like them
- ❑ **AND** most importantly, be able to show that the costs of granting credit are offset by the benefits of higher sales

FINANCING

LIKE ALL forms of trade and consumer credit, financing is essentially a service that a company provides in order to bring in more business. The single rule to follow when establishing your customer financing policy is that there are no rules. In fact, many companies have distinguished themselves among their competitors by offering innovative financing or payment options, keeping in mind that ultimately financing is a game of numbers. The risk of bad debts is balanced with the increased revenue creating by financing and the increase in overall sales.

PROS & CONS of Customer Financing – The advantage of granting financing

The advantage of granting financing to your customers, like trade and consumer credit, is the resulting increase in business.

to your customers, like trade and consumer credit, is the resulting increase in business. The disadvantages are also similar. Not only will you have to create a finance department and establish collection procedures, but you will likely further inflated your bad debts ratio. These factors could turn your business into a record keeping nightmare.

Types of Financing Options

There are many kinds of financing options ranging from rent-to-own schemes to no interest and no down payment blitzes. In fact, the options available to you are limited only by your imagination (and possible a few legal restrictions if you tactics become TOO creative). Below are a few of the more prominent financing strategies:

Direct Financing – In direct financing, or straight financing as it is often called, you refer your customer to someone else for financing, such as a preferred local bank or credit union. Although you don't provide any of the financing yourself, you assist the bank in screening out risky customers, you know based on their criteria, would be rejected anyway.

Don't Pay for a Year Financing

– This type of financing is usually reserved for large furniture companies who understand, to the penny, how much money they will lose from bad debts compared with the resulting increase in sales. To them, it's all a game of numbers. This type of financing is not realistic for the mom & pop type hardware store.

If it takes longer than 60 days to collect payments, you need to examine your credit and collection policies.
SUPERTIP

Installment Plans – Here, your customer is required to place a down payment on merchandise and then pay the balance in full over a period in regular installments. Most often, the buyer signs a conditional sales contract and is charged for the service about 1.5 percent per month on the unpaid balance.

Leasing & Renting Options –

Renting and leasing is a service your company can provide for businesses and consumers who are short of capital and cannot pay for more expensive items up front.

Rentals are based on month to month agreements. Leases are based on a longer fixed period of commitment (usually a year or more).

Rent-to-Lease Plans – In a rent-to-lease plan, you offer daily, weekly and monthly rental rates which can later be applied to a leasing plan, if the client desires to use the piece of equipment for a longer period (short-term rental rates are higher than long-term leasing rates).

Rent-to-Own Plans – In a rent-to-own plan, you offer daily, weekly and monthly rental rates, which can later be applied to purchasing a piece of equipment outright, if your client so desires. This type of plan is essentially a heavily financed installment package. Musical instruments and furniture suites have been successfully sold this way for years.

In a rent-to-own plan, you offer daily, weekly and monthly rental rates, which can later be applied to purchasing a piece of equipment outright, if your client so desires.



CHARGE CARD CREDIT

OVER THE past 20 years, many businesses have switched to utilizing charge card credit as a simpler, surer, quicker way of getting their money. In fact, most small business consultants advise that you must have a credit card service, otherwise you are giving up too much business.

NOTE In some ways, offering charge card credit is not much different than offering customer trade or consumer credit, being that the customer must usually wait until the next paycheck before being able to pay their bill. However, unlike trade credit, using charge card credit you don't wait for the money, the credit card company does.

Most small business consultants advise that you must have a credit card service, otherwise you are giving up too much business.

PROS & CONS of Charge Card Credit

– The advantage of offering your customers charge card credit, is like trade credit, consumer credit and financing, it generally results overall increased sales. North

Americans love to buy on credit. In fact, customers will have more buying confidence and be more comfortable in your store if they know they can afford to buy. Credit makes this possible.

The popularity of credit cards also stems from the convenience they give to customers (they don't have to carry cash), the faster business owners can get their money (they don't have to wait thirty days or more), and the elimination of bad debts (business owners can usually collect from a credit card company even when the customer

turns out to be a deadbeat.

However, this assurance, convenience and reduction of risk comes at a price. A charge card arrangement requires the business firm to yield a percentage of sales volume to the agency. This percentage varies between 2% to 6% based on the dollar volume of sales (some larger companies can negotiate rates as low as 1%). As well, there usually is a hook-up charge and either the rental, lease, or purchase of a credit card handling device. When offering this service, business operators need to take these extra costs into consideration.

NOTE Many small businesses choose to charge the agency fee on top of there

When working in a business activity that sells directly to customers, it is advisable not to extend store credit but to use charge cards.
SUPERTIP

regular price in order to negate this drawback, believing that the money they lose on customers who are not willing to pay the agency fee and thus take their business elsewhere, is much less than the extra profit they make.

How Charge Cards Work

Every time a customer orders by credit you have to deposit the sales slip in your bank the same way you would do when depositing money in your checking account. The bank will automatically credit your account for that amount less a service charge of 2 to 6 percent depending on your agreement. The sales slip must include a credit card number, expiration date and signature (in special cases the signature is not needed).

NOTE Don't be afraid to try and negotiate your credit card terms with the issuing bank.

The “Big 5” Charge Cards

All large credit card companies would like you to think there is a huge difference between them and their competition, but when it comes right down to it, as a business person it really doesn't matter to you. All you want to do is making it easier for your customers to buy from you and thus increase your total sales. Visa and Master Card are the world leaders, having more worldwide acceptance than all other cards combined. It is essential to accept both these cards. American Express is also important, especially if you plan to cater to travelers and big spenders.

Merchant status is a term banks use to designate businesses they feel deserve their credit card.

American Express

800-522-4503; 800-526-7443

Diner's Club

800-322-4566

Discover Card

800-322-4566

Visa

800-322-4566

MasterCard

800-322-4566

What is *Merchant Status*

Merchant status is a term banks use to designate businesses they feel deserve their credit card. Getting merchant status is pretty much routine, especially if your business is stable, has a good credit record, and is a type of business already known to offer charge card services to their

customers.

The Difficulty of Getting Merchant's Status for Mail Order and Home-based Businesses –

You would think that if your business was willing to pay a percentage of each sale to Master Card or Visa, banks would be eager to grant your Merchant Status. However, in the case of mail order and home based businesses, even though they won't divulge their criteria for granting credit – for the record – many banks don't like granting merchant status to these businesses.

It is obvious that their prejudice stems from the fear of fraud and canceled pur-

American Express is better at weeding out good and bad clients, and is more open to granting charge cards to businesses that otherwise might be overlooked, especially if the business in question caters to the typical American Express customer.

FUNFACT

chases or charge backs. They consider home-businesses too unstable and over the years they have found them significantly riskier (particularly mail order).

Credit card issuers also claim that those who sell products by phone, obviously don't have the user's card in hand. Without it, they can't verify the signature, check it against other ID, or swipe it through a machine, which checks the data on the magnetic strip on the back.

Your only recourse, if you are having difficult getting merchant status is to try another bank or contract out an ISO service (more on ISO's later).

To get merchant status for your mail order or home-based business, first, try banks that have involved credit card applications much like that of getting a loan. If your business is basically sound, the more research they do, the less likely their final decision will be prejudiced.

Credit Card Bureau

Boynton Beach FL
407-737-5800

(Call this number to get a
VISA or MasterCard Mer-
chant Status report)

NOTE Home-based businesses often have more success getting Merchant approval through American Express. The differentiating factor is that American Express is a company that issues only one

Home-based businesses often have more success getting Merchant approval through American Express.

card. It is centralized unlike Visa and MasterCard, and thus has systems which make it easier to verify addresses and, resolve card member disputes, and deal with charge-backs more easily.

American Express also, rather than lumping all mail and phone order businesses into one category, pays more attention to whether a given company is a good match with their own interests. Their card members typically spend lots, are heavy travelers, and are business people. Therefore if your product or service appeals to their card members, they will more likely consider you.

American Express can usually be approached through chambers of commerce or national trade associations if the busi-

ness is a member.

What is a Merchant Service Provider?

As a last resort a small business, particularly a mail order home based business, may decide to resort to an independent sales organization known as an ISO or merchant-service provider. These organizations contain registered agents who represent one or more banks, which authorize their cards. ISOs are intermediaries or brokers. Most ISOs are reputable, but some have gained a shady reputation – many are less than five years old.

How much do ISOs charge? ISOs can charge more than \$300 for application fees, outlandish markups on sales, and

ISOs can charge more than \$300 for application fees, outlandish markups on sales, and high leasing costs for the use of their terminals, which all merchants need to process charges.

high leasing costs for the use of their terminals, which all merchants need to process charges. For example, the standard

Tranz 330 credit card processing terminal, which costs the ISO \$250 wholesale to purchase is often sold to the retailer by the ISO for \$330 to \$1500 or leased for the outrageous cost of \$30 to \$90 per month (and there are no clauses that the rates won't go up next month either). Sometimes after the application fee has been collected the ISO disappears or tells you the bank denied your application.

NOTE *Preferred Card Services* is a reputable ISO organization. One owner paid \$125 to apply, \$250 to have a used processing terminal reprogrammed for his business, and \$45 a month to lease

the used terminal. For each customer credit transaction, he pays 2.31 percent of the retail price plus 11 cents.



Retailers and many service firms, who generally in the past have operated on a cash basis, nowadays, are frequently extending credit to customers. Some larger department stores which have their own credit cards, boast that as many as 70 percent (or more) of their clients are charge account customers.

FUNFACT

PERSONAL CHECKING SERVICES



ALTHOUGH granting a checking service, is not in the true sense of the word, a credit option, it does pose a series of problems every businesses must consider.

Check fraud is on the increase and businesses must protect themselves. It therefore is wise, if you decide to offer personal checking services, to also contract with a check verification service, especially if dealing with many new and unknown clients.

NOTE Other payment options worth considering to offer you customers include: C.O.D. purchases; money orders; and cashier's check orders.

*He that takes
too much credit
is really in as
much danger, as
he that gives too
much credit.*

DANIEL DEFOE