Extending Credit to Small Businesses and Contractors

FEDERATION of CREDIT and FINANCIAL PROFESSIONALS

EXECUTIVE SUMMARY

Having had the opportunity to work in several different industries over the years, it quickly became obvious, to me at least, that the most difficult challenge for the credit professional is working with small businesses. Of course, extending credit to anyone is challenging, even to Fortune 500 companies, and not everyone has the aptitude to do it successfully. Credit management is more than collecting money. It is a combination of factors, only one of which is making a collection call. The purpose of this article is to present some of the other issues.

Tom Gannon, CCE
Director of Research & Education
Federation of Credit and Financial Professionals

Having had the opportunity to work in several different industries over the years, it quickly became obvious, to me at least, that the most difficult challenge for the credit professional is working with small businesses. Of course, extending credit to anyone is challenging, even to Fortune 500 companies, and not everyone has the aptitude to do it successfully. Credit management is more than collecting money. It is a combination of factors, only one of which is making a collection call. The purpose of this article is to present some of the other issues.

First, it is important to understand that businesses are run by people, not machines and software. Those are also important, of course, but it is the human factor that plays a huge part. Entrepreneurial thought processes do not always include purely business management, for instance. Some people may only consider their own technical skills. As their business grows, they may lack the understanding of financial issues relative to that growth. The next thing they realize is that they are receiving collection calls. They believe that no one should expect to be paid until their customer pays them, or that it is OK to pay cash for expensive equipment, to avoid interest charges, since the supplier will understand the motivation. Should that supplier accept it?

Not necessarily, but understanding is not acceptance. It allows for an altered course of action, even if that simply means changing the argument. After all, a credit professional has a job to do. That job, though, goes beyond a script or a requirement to reduce DSO at all costs. How do you balance things?

Go beyond the script. When a customer provides the reason, or excuse, for delayed payment, maybe even the inability to pay at all, listen carefully. In some cases, it may simply mean following up again later. In other cases, the customer may be providing alternatives that will allow you to be proactive with getting him paid, so he can pay you, or you could bypass him altogether. At the very least, you may hear or say something that will debunk the customer's excuse, uh, reason, sufficiently that he may need to re-prioritize. When deciding whether to set a credit limit, or to provide open account at all, there can be factors beyond requiring a minimum Current Ratio of 1 or better. Some real-life examples follow:

1. Immediately after starting a new job as a Regional Credit Manager for a major manufacturer, you are instructed to reduce a key customer's credit limit from $1,000,000 to $500,000, due to some slower payments and a concern over their Net Worth. So, you visit the customer, a regional distributor of sophisticated electronic equipment, to deliver the bad news. Upon arrival, you observe that, while the business is not huge, it is well organized and very professionally operated. You ask for and receive current financial statements, and while listening to the customer explain the operation, you compare that to the statements, asking questions as the discussion continues. Sometimes, the conversation drifts to some details of his personal financial worth, such as vacation homes and such, plus that of his partner. While the financial value of the business is centered in inventory that moves quickly and his facility is rented, there is substantial personal worth, so you discuss the possibility of a Personal Guarantee from both partners. To shorten the story, your product is key to the business, and you manage to get the PGs from all parties, including their spouses. (Be careful with discussing spousal PGs, which is another topic altogether) You wind up actually doubling the credit limit to $2,000,000, based on all factors combined. The latter includes the customer's fear of losing a market advantage, so he manages to pay more timely.

2. As a credit professional in the construction industry, you visit a customer who suddenly slowed down payments considerably, which is totally out of character and prior history. The first thing you notice is that his office is in his home, actually in half of a 2-car garage! Then again, you already know that he is always in the field and all product is delivered to job sites. As the conversation goes on, the reason for the sudden decline becomes readily apparent. He is not being paid himself, and with little in the way of assets, he cannot get a bank line of credit. He is entirely dependent on cash flow, which is common in the industry. What became suddenly apparent? You see a large stack of your invoices on the neighboring desk. Does he need the costs on them to bill his customer? Yes. It dawns on him that his bookkeeper is out on extended leave, and he hasn't had time to enter them into AP, so he hasn't billed his customers! How can that happen? He is too busy on the job, and his GC is not going to remind him to issue invoices. You suggest a temp, and everything goes back to normal.

3. Still in the construction industry, although the issue can come up anywhere, you have a customer with increasing needs, or so your sales rep says, so you investigate for a credit line increase. After an extended review, including new financial statements, credit reports, references, and so on, you cannot justify what the sales force requires. In fact, they appear to be overselling their ability to pay, although senior management likes that idea. Being a national company with a centralized credit operation, you review the address on Google Maps. They look physically impressive enough, plus you notice two cabin cruisers in the parking lot. (?) Still, your decision stays the same. The customer then calls you directly, and you arrange a visit. Upon arrival, you notice that the boats are gone. During the conversation, the truth comes out. The customer needs your company to provide "financing" by allowing slow pay, out to 90 days, on an increased credit availability. Why? Well, you may have noticed the boats, but he didn't. They belonged to his father-in-law, who just happened to be his AP person. Those boats, plus a third and larger one on a nearby river, were the result of a multi-million dollar embezzlement. His need for extended terms and increased credit availability were due to an IRS audit and his bank calling all loans!

4. Lastly, you visit a slow-paying customer, but he's not there. His spouse is, and, without going into all of the circumstances, you learn the reasons for the slow pay. Your coworker asks about a substantial multi-carat diamond ring on her finger. Several years later, they file Chapter 7. The Automatic Stay stops everything, but you file suit on your PG. They file personally as well, but you remember that ring, which is not listed as an asset. A ring that size will surely be listed separately on a homeowner's insurance policy, so you ask your attorney to subpoena the police. It is listed there, providing a basis for bankruptcy fraud! The petition is thrown out, so they suddenly have a reason to work out a payment plan.

Vigilance! It's necessary on both ends. Being aware of the limitations and advantages in small businesses is key. It's also beneficial to have a true understanding of your company's product, and how it may affect your customer. This is especially true if you sell functioning equipment. Well-intentioned small business owners can be significantly impacted by equipment failures.

Are there ways to protect your company when bad things happen? That is another article.

A Primary Source

for

Order-to-Cash Best Practices

www.federationofcredit.com

Printed in the United States of America

FEDERATION of CREDIT and FINANCIAL PROFESSIONALS

Federation of Credit and Financial Professionals
51 Cragwood Road, Suite 200
South Plainfield, NJ 07080
www.federationofcredit.com