Credit Management for Small Businesses

Ormsby Street

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Credit management is the process of controlling and collecting payments from customers. This is the function within a bank or company to control credit policies that will improve revenues and reduce financial risks.[1]

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[1] http://en.wikipedia.org/wiki/Credit_manager

Why is credit management important?

Every business lives and dies on whether or not it has enough funds to continue with its operations. Those funds will typically come from the sale of goods and services. However, if you sell to people who aren't in a position to pay for their purchases, then you won't have any funds to continue. You should make sure you sell to people who can pay, and then put yourself in the best position possible to get the money you are owed.

Research by the Credit Management Research Centre[2], reported that the average small business incurred £14,000 worth of bad debt write off every year.

The recent Small Business Bill[3] is a welcome step to ensuring tighter regulations in relation to business debt, and allowing small businesses to flourish.

Government minister, Matthew Hancock, writes about the importance of the UK's first ever small business bill after growing up with parents who dealt with the strains of running a small business- especially managing cash-flow[4]: the new bill is designed to pull down barriers to small businesses and give them the freedom to become the dynamic driving force of our economy thatwe all know they can be.

To put it in context, if you are forced to write off a £1,000 bad debt and your sales margin is 10% then you'll need to find a further £10,000 of sales just to cover this shortfall.
And what's the missed opportunity cost of this £1,000? That could be the new shop refit, or a new website, or the pay rise for your most consistent sales person to stop them leaving.

So what can you do to ensure you're taking all the necessary steps to running a successful and pain-free business?

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[2] *http://www.businesswings.co.uk/articles/The-Cost-of-Late-Payment-to-SMEs*
[3] *https://www.gov.uk/government/collections/small-business-enterprise-and-employment-bill*
[4] *http://www.telegraph.co.uk/news/politics/conservative/10917431/Matthew-Hancock-My-parents-struggles-and-strains-behind-bill-to-help-small-business.html*

Access your Customers

A sales person will tell you a sale is a sale when they get someone to sign on the dotted line. A financial person will tell you a sale is sale when you get your hands on the money. That's quite an important difference and one that as a small business is important to learn.

There is always the clamour for new business, because new business means growth and opportunity. It means that someone believes in what you're doing, it provides some validation for all your efforts and is a promise to pay you some money.

But promises can be broken and in reality, all of this positive feeling isn't going to drive your business forward unless it is backed up by cold hard cash.

So to avoid the scenario where you sell to a customer and then find out that they don't have the money to pay for what they've purchased, or they do but they won't give it to you for another 4 months, the first step should be to look into their finances before you put in too much effort to win the work.

Check their credit status and check their payment performance to give you an indication as to how secure a business they are and what you'll be letting yourself in for if you do business with them.

How to run a credit check:
There are a range of services out there, either directly with Credit Reference Agencies (such as Experian or Dun & Bradstreet) who gather the data on companies' trading and financial performance, or via third party providers (such as CreditHQ) who present this data alongside a range of tools to support you in checking and monitoring companies and subsequently chase any outstanding debts.

CMRC research[5] indicates that SMEs currently have to wait a further 20 days after an invoice's due date to get paid, which compares badly to larger organisations who only have to wait an average of 10 extra days.

If you're still not sure, then seek references from their regular clients or their bank. If they don't like the idea of you doing this, then wouldn't you be interested in what they've got to be worried about?

Important data:
Credit Score - A value provided by a Credit Reference Agency (CRA) which indicates the risk of a company going out of business. The values and ranges vary across each CRA.

Payment Beyond Terms:
The amount of time before/after the length of agreed credit terms that a company will pay an invoice. E.g. a PBT of 30 will mean that the company will pay 30 days AFTER an invoice is due

[5] *http://www.theguardian.com/business/2008/oct/26/small-business-recession-credit*

Set your terms of trading for each customer

Not all customers are the same, so you shouldn't treat them all the same. However, Sage Pay's research in August 2013 found that for 1 in 10 SMEs, a third of invoices are paid late - so make sure you follow some simple steps before you hit the stage of chasing invoices.

For customers whom you have seen have a stable financial situation, you can happily provide them with payment terms of 30 days or longer, safe in the knowledge that they'll appreciate it and you'll get your money on time.

But for those customers who you aren't too sure about, adjust their payment terms to something more suitable. Whether it be paying fully up front, paying a deposit, or only having 14 days' payment terms, it all goes to help you control your finances in the most effective way.

Once you've agreed the terms, this will need to be communicated to the customer so they know what they're dealing with.

If you work alongside other people, set out your credit policy so that everyone is following the same rules and guidance that you are. Set out the factors that you deem relevant to making a decision for setting credit terms, such as credit ratings, payment performance or references.

Default payment terms:
If you don't set up anything differently, your customers will automatically have 30 days to pay their invoices.[6]

[6] Late Payments of Commercial Debts (Interest) Act 1998, the Late Payment of Commercial Debts Regulations 2002 and the Late Payment of Commercial Debts Regulations 2013

Manage your invoice process tightly

Once you've got people signed up to appropriate payment terms, you'll need to ensure that you stay on top of your invoicing.

It's often convenient to say "I'll do all the invoicing at the end of the month when I've got a few invoices to do". However, in reality what this really means is that the customer who gets your service or buys your product on the 1st of the month, gets a whole month's free credit because you won't even raise their invoice until 30 days after the sale or work completion, and then they have 30 days to pay it. Great for them, not so great for you.

Make sure you put time aside to invoice as soon as you can after you've done the work or sold the goods, because the sooner your customer gets the invoice, the sooner they have to pay it.

Invoices are an area where detail matters, as any inconsistency or confusion provides an opportunity for the customer to raise a query which takes time to resolve, and thus extends the time it takes the money to get into your hands.

Address the invoice to an individual so that you have someone to talk to directly. Include appropriate descriptions so that your customer knows exactly what is being invoiced. Double check your values to ensure the invoice is for the right amount, and make sure you have information on payment terms and how to pay the invoice on or at least with the invoice so they know what they have to do to pay the invoice. Many of the cloud based accounting packages will do this automatically, and even include online methods of payment within the invoices so payment is just a click away.

Know what to chase, when to chase, and how to chase

Once your invoices are out there, you'll need to know when you've been paid for what and when, so that you're able to act if it looks like you aren't going to get paid on time.

This requires regular reconciliation of payment received to outstanding invoices, and then preemptive chasing of outstanding debt.

Set up reminders that prompt you to take action, especially if your working week doesn't follow a fixed pattern. Find a method that works for you, whether it be items marked on a calendar or scheduled actions within your bookkeeping package.

Chasing up payments

What?

invoices that will soon become overdue or are overdue

When?

five days before due, and then every day after due

How?

phone persistently, and then send correspondence so that there's a record of what you've said

Keep monitoring & adjusting to reflect changes in circumstances

Having said all of this, it isn't just a one off activity. You should look to do all of these tasks regularly.

Monitor your customers' financial performance so you know when something happens that might affect their ability to pay you.

If you have customers who you invoice regularly, you'll have built up a history of the invoices you've raised and the dates that these invoices get paid. If you're lucky, the invoices will be paid as per the payment terms (e.g. 30 days), but they might be more. However, if the number has been consistent but starts to increase, then this might be a sign that the business doesn't have access to the cash needed to pay your invoices so they are waiting for funds to come in before they can go out in the form of a payment to you.

Services such as CreditHQ will monitor payment performance for you and alert you to any changes that may occur, so that you can take immediate action without having to do the analysis yourself.

Review your payment terms to reflect how well a company is trading and how they are handling your invoices.   If their credit status improves and they pay you on time, then extending payment terms might be a nice bonus to throw into the next deal you're negotiating, but if things start to get worse then you could look to reduce payment terms so that you get your money sooner.

And keep track of your invoices, ensuring they are going out in a timely manner and any follow ups are being done to help the cash-flow back into the business.

Summary

1. Research

2. Set your terms

3. Invoice on time

4. Chase promptly

5. Monitor & adjust

REPEAT

Credit management is key to the success of your business so it should be treated with the same commitment as sales and the actual delivery of the service.

Good credit management starts before an order is even received by assessing the risk of a potential customer, establishing its identity and status, ensuring that it is good for the sums of credit likely to be incurred, submitting invoices correctly and promptly, understanding its invoice processing and approval systems so that they can be met, and taking swift action if payment isn't going to arrive when it's expected. [7]

Philip King, CEO, Institute of Credit Management

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[7] http://www.icm.org.uk/ceoblog/better-late-never-blog-philip-king-ficm-chief-executive/

About Ormsby Street

Ormsby Street is a Shoreditch based digital software-as-a-service company which helps small businesses make big decisions. Our team of high-performing product innovators and software engineers are quietly taking sophisticated financial information and turning it into a next-generation digital tool to help businesses make good decisions about customers, suppliers and themselves. You can find more information at www.ormsbystreet.com, and more small business opinion at blog.ormsbystreet.com.

The small print: