

Setting up or improving a credit control system

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1. The importance of credit control

Granting credit in order to win sales is a fact of life for many small businesses, as is the likelihood that more than 50% of your credit customers will fail to pay on time.

Sadly, no matter how good your product or service is and no matter how adept you are at winning new customers and increasing sales, unless you can convert those sales into cash reasonably quickly, you won't remain in business for long.

The good news is that you don't need to be a passive victim of this so-called 'late payment culture'. If your business struggles with poor paying customers, then by setting up a simple credit control system and injecting a little more discipline into the process of granting credit and recovering cash, your customers *will* start paying you more promptly and you *will* reduce the number of debts which you are forced to write off.

This paper, together with the related tools in the 'Financial Management' section of 'Tools and Tips' on the investors website is designed to help you to set up an entire credit control system from scratch. If you already have a system, you may still want to work through the whole module for ideas on how to improve it.

The module deals with the five key elements of an effective credit control system:

1. Evaluating the creditworthiness of new (and existing) customers, to ensure that the decision to grant them credit is based on a reasoned assessment of their ability to pay.
2. Providing and agreeing standard terms and conditions of trade to ensure that credit customers understand their obligations and to provide evidence for legal and court proceedings if necessary.
3. Setting up a system of invoices, reminders and statements to press for payment in a professional but forceful way.
4. Setting up a system for analysing outstanding debts and identifying those that require action.
5. When all your efforts have failed, using third party legal and debt recovery services to assist you in getting paid.

2. Evaluate customer creditworthiness

Introduction

It seems obvious that you should only grant credit to customers who you are satisfied can and will pay for their goods within an agreed time-frame. However, for a variety of reasons, many businesses do not perform credit evaluations. These reasons include:

- An unwillingness to lose a sale
- Pressure from sales staff (especially those on commission) not to prejudice the sale in any way
- The feeling that prospective customers will be annoyed or embarrassed by a credit evaluation process
- Over-reliance on 'gut-feel' and instinct

None of these reasons should deter you. Evaluating a customer's creditworthiness doesn't guarantee that the customer will pay on time, but it can prevent you from granting credit to customers who may damage and possibly ruin your business by defaulting on payment. These include customers who:

- are insolvent
- are in bankruptcy proceedings
- have outstanding court judgements for non-payment of creditors
- have exceeded their bank borrowing facilities
- have a poor trade reputation for payment

Do you really want to grant credit to these customers?

Customers are more likely to be impressed than irritated if you take a professional approach to credit control. If they are annoyed or embarrassed it may be because they have something to hide - all the more reason to stick to your professional approach.

Remember, you can still do business with customers who fail the credit evaluation process, but you should do so only on the basis of cash or (authorised) credit card payment in advance or on delivery. Once you have established a trading relationship and history with the customer, you can re-evaluate them and offer them credit, if appropriate.

Which customers should you evaluate?

New customers

It isn't cost effective to evaluate all of your new customers. Set a credit limit below which a credit evaluation is not required. It should be low enough that you can easily absorb the cost of a few defaulting customers every year (say, the lower of £1,000 and 0.25% of turnover).

For all your other new customers, you should undertake some or all of the credit evaluation tests set out in the next section. The larger the credit facility being granted, the more tests you should perform.

It may be worthwhile establishing an overall Credit Policy to distribute to sales, accounts and other relevant staff setting out the various types of credit evaluation they should undertake for different amounts of credit requested.

Existing customers

Credit evaluation is an ongoing process. You should continue to credit check your most important accounts at least annually. Rank your customers in terms of average monthly turnover at the end of each year and use the levels set out in the Credit Policy to determine the types of credit evaluation to perform.

Potential problem customers

If you or a member of staff notice a significant change in the payment behaviour of a particular customer then be prepared to credit check them again, immediately, to ensure that their creditworthiness has not deteriorated.

Examples of significant change are increased payment delays, increased, often trivial, querying of invoices and an increase in the number of weak excuses for non-payment.

Granting credit to new customers

You should grant credit formally by way of a Credit Application Form. This notifies the new customer of your intention to undertake a credit evaluation and enables them to provide you with the necessary information.

Formalising the granting of credit in this way also sets the right tone for your future relationship. Poor-paying customers tend to abuse accounts which they deem to be a soft touch and you can reduce late payment simply by adopting a firm and professional approach from the outset.

Types of Credit Evaluation

In relation to your new customer you should now have:

- A completed Credit Application Form; and
- A decision on what level of credit evaluation to undertake (in accordance with your established Credit Policy).

You should now use one or more of the following types of credit evaluation

1. Credit Report from a Credit Referencing Agency

Credit reports provide an objective assessment of credit from a specialist third party credit referencing agency. You will have to pay a modest fee, but a good credit report is an integral part of the credit evaluation process.

In addition to providing you with details of financial performance, the payment experience of other suppliers and any outstanding court judgements for non-payment, good credit reports will also give a credit rating and a credit limit recommendation.

2. Bank Reference

You can ask the customer's bank to give some indication of the customer's ability to pay by asking them to complete and return a standard Bank Reference. There is likely to be a bank fee associated with this.

The bank's obligations and loyalty are to its client (i.e. your prospective customer) and not to you, so the bank will only provide the reference if it has written permission from its client. For the same reason, you should treat the information provided with some caution and use it mainly to back up other information which you have obtained.

3. Trade Reference

Information from other suppliers about their credit relationship with the customer can be extremely useful. However, where the customer has suggested which suppliers to contact, the information may be of little value since the customer is unlikely to put forward the names of suppliers with which it has a poor credit relationship.

If you do not know the names of any suppliers yourself, then contact the suppliers provided by the customer (on the Credit Application Form) and ask them if they can provide the names of other suppliers (this tactic may or may not work).

If you are satisfied that the selection has not been unduly influenced by the customer then the results obtained from the Trade Reference should be analysed and followed up with a phone call or visit if necessary.

4. Personal visit

Personal visits either by you or a member of staff to the customer's premises can yield useful information. Although time-consuming, this tactic should certainly be used for large accounts.

Try to talk to as many members of the customers' staff as possible to get an indication of how the business is doing and to identify any areas of concern. You may also be able to get the names of other suppliers in passing which may be more useful for Trade Reference purposes than those provided in the Credit Application Form.

5. Company accounts from Companies House

If your customer is a company, a Credit Report should give you a summary of the most recently published financial statements which have to be filed annually at Companies House.

If you want the full financial statements, you can obtain these online for a small fee at the [Companies House website](#). This is really only useful if you have a good understanding of company accounts and their interpretation.

Obtaining a copy of the most recent financial statements may be particularly useful for larger public limited companies (PLCs) which are obliged by law to state in the directors' report the average time they take to pay suppliers (in days).

The decision to grant credit

Having assessed the results of your credit evaluation, you can now decide whether or not to grant the customer credit.

Answer: Yes

If you are satisfied that the customer is creditworthy, you need to decide how much credit to allow. You can either do this by accepting the recommendation of the Credit Referencing Agency in the Credit Report, or by setting your own credit limit. In the latter case, you may want to set the credit limit, say, 50% higher than the anticipated monthly sales from this client.

As sales grow, you will need to review this limit regularly and decide if you are prepared to increase the credit limit. Don't forget, increasing the credit limit is simply lending the customer

more money, so at each increase, you need to re-evaluate whether or not they can repay this larger amount.

If you feel that a particular credit limit is becoming too high for a particular client you may be able to agree a compromise solution, such as 50% payment in advance or on delivery, with the balance payable 30 or 60 days after invoice.

Answer: Yes - deciding on the payment period

You also need to agree the payment period, i.e. the period between the invoice date and the due date for payment. Many businesses use 14, 30 or 60 days. Alternatively, there may be an industry standard for your particular sector which you will be under some pressure to follow in order to remain competitive. If the customer does not accept your initial offer, it may boil down to a simple negotiation.

Whatever period you use, you need to know whether or not your business has sufficient liquidity to allow this delay in payment. In other words, will the business have sufficient cash or access to borrowing facilities to meet the business's costs until each customer pays.

Answer: Yes - notifying the customer

You should notify the customer of their successful credit evaluation by adapting the following letter.

Answer: Yes - but beware...

It's easy, as sales to a particular client grow rapidly, to start letting your credit control procedures slip. Credit evaluation ceases and credit limits are ignored as amounts owed by that particular client start to represent a significant percentage of total debtors and working capital.

Apart from the potentially disastrous consequences of default in these circumstances, it is also common for the client to take longer to pay as the amounts owed increase (as a bigger and more important client, they feel that they can take more liberties).

Many otherwise successful small businesses are bankrupted every year because of the increasing credit risks and cashflow problems associated with rapidly growing credit sales. In fact, it is sufficiently common, that there is a special name for it - 'Over-trading'.

Don't relax your credit control procedures as sales increase. If anything, you need to be more, not less, rigorous.

Answer: No

If you are not satisfied that you can grant the customer credit then you should trade on the basis of cash in advance or on delivery until you have established a trading history and can re-evaluate the customer's creditworthiness.

You may have to accept granting credit to customers who have only an average credit rating, but you should be prepared to lose a sale if a customer with a very poor credit evaluation is unwilling to pay in cash in advance.

Again, you should notify the customer of your decision to trade with them on the basis of cash in advance or on delivery only using the New Account Welcoming Letter.

3. Establish Terms of Business

Introduction

You should ask every customer (cash or credit) to read sign and return your standard Terms of Business. These set out your contractual relationship with the customer and provide the basis for settling any payment (or other) disputes which may arise in the future.

Many small businesses proceed without written terms. This often leads to debt recovery problems in the event of a dispute, due to the difficulty in proving the commercial relationship between the parties.

Some customers may insist that you use their Terms of Business rather than yours. This is often the case where the customer is a much larger business than you. You may have no option but to sign the customer's terms. This is fine, in that the most important thing is that written Terms of Business exist between the parties. In the case of complex terms for large customer accounts, you should consider asking a lawyer to review the terms for you.

To ensure the Terms of Business stand up in court, you must draw the purchasers' attention to the terms prior to starting to trade with them. It is too late sending the terms on the back of the purchaser's invoice. You must make them aware of the terms prior to trading e.g. in the credit application process.

Drafting the Terms

There are a number of issues to consider when drafting the Terms Business. We have covered some of the basic points in the Terms of Business tool, but because each business is unique, it is essential you should seek legal advice to ensure you cover the issues relevant to your business.

Some of the more general points that could be included in the Terms of Business are outlined below:

- Definitions. Specifying who the contract is between.
- Price and price reviews. Whether the price is specified in the contract or taken from a published price list.
- Payment terms. Either payment in advance, on delivery or within 30 (60, 90 or other period appropriate to your business) days of invoice date.
- Delivery. Specifying the time and means of delivery.
- Returns. Procedures for returning goods.
- Title. When is the ownership of the goods passed from the seller to the purchaser.
- Warranties and conditions. Any guarantees associated with provision of goods/services
- Cancellation. The rights of either the purchaser or the seller to cancel an order.
- Force Majeure. What happens if delivery is delayed as a result of issues outside your control e.g. civil disturbances or national strikes or 'acts of God'.
- Jurisdiction. The law of which land used to resolve of disputes (particularly important when dealing with overseas trade).

The terms in your Terms and Conditions of Business should be fair and reasonable from the perspective of both yourself and the purchaser. Even though you can design the terms as you see fit, they may be subject to a test of reasonableness in law.

4. Send out invoices and statements

Good invoices and statements are an important part of the credit control process. They should be clear and unambiguous and they should reinforce the professional approach established during the credit evaluation process.

However, you shouldn't use these documents in isolation. You should also use personal contact, by phone or visit, at each stage of the collection process.

With new customer accounts you should establish contact by phone with the person to whom invoices will be addressed to introduce yourself and offer your assistance with any queries which they may have.

In relation to each invoice or statement always:

- address an invoice or statement to a named person, if possible. You should have obtained the name of the appropriate person in the Credit Application Form.
- give each invoice or statement a unique identification number
- include the customer's purchase order number or other reference number
- state the payment terms (e.g. 14, 30 or 60 days after the date of the invoice) and calculate and state the actual due date for payment (e.g. ..payable by 30 June 20xx)
- indicate that interest is charged on overdue amounts (this is either as set out and agreed in your Terms of Business or in accordance with the Late Payment Of Commercial Debts (Interest) Act 1998) and show the applicable rate
- indicate who cheques should be made payable to
- use first class post to set a tone of urgency and avoid late receipt of invoice excuses

Invoices and statements should be sent out in the following order:

Invoice Incorporating Terms

Statement incorporating terms

First reminder letter

Letter informing interest will be charged

Second reminder letter

Commencement of County Court Proceedings

If payment still has not been received within, say, 14 days of the Second Reminder letter, you should consider obtaining a county court judgement for payment. This is particularly quick and cost-effective where the debt is not disputed by the client.

Before commencing a county court action, you should read the leaflet prepared by the Lord Chancellor's department, **A guide for small businesses to debt recovery through a county court** . If you do decide to proceed, you can use the **Letter Notifying County Court Proceedings**.

5. Collect cash from customers

Set up a monitoring system

You need to monitor your outstanding debts regularly, once a week at least, to ensure that overdue amounts are identified and followed up with the appropriate action.

Every time you generate an invoice, statement or reminder letter you should diarise the next course of action. If you use a software package such as Outlook, use the tasks function to generate a reminder on the next due date to check for payment and, if it has not been received, to proceed with the next course of action.

In addition to diarising the progress of each invoice, you can also get an overall picture of your outstanding debts by setting up an 'aged debtors analysis'. This shows a list of all your outstanding customer invoices and the number of days since each invoice was raised. Invoices are then categorised into time periods. For example if your contractual payment period is 30 days, then the outstanding invoices will be classed as either 'current' (less than 30 days old and not yet due for payment), between 30 and 60 days old, between 60 and 90 days old and over 90 days.

The aged debtors analysis is useful to show how well your credit control system is operating. As each month goes by, you are obviously aiming to reduce the percentage of outstanding debts which fall into the various overdue categories.

If you use an accounting software package to generate your invoices, then the aged debtors' analysis will be generated automatically by the software. In addition, the software may contain a 'Task Manager' to assist you in diarising the progress of each invoice.

Dealing with account queries

If there is a dispute about a particular invoice, then you should clarify whether or not the dispute relates to some or all of the invoiced amount. If parts of the invoice are undisputed, then it should be made clear to the client that these are due and payable as normal.

You should then aim to settle the disputed amount promptly. This is not just a question of collecting the cash as quickly as possible, it also helps to discourage poor paying customers from raising spurious queries in the hope of delaying payment

Dealing with late payment excuses

Don't be fobbed off by weak excuses for late payment such as

- 'You'll have to wait until the next cheque run as we cannot raise cheques manually'
- 'We posted you a cheque last week'
- 'There is no-one here who can sign cheques at the moment'

- 'We can't pay you until someone has paid us'

Stick to your schedule of letters and reminders and make it clear in communications with the customers that these excuses will not prevent you charging interest on overdue amounts or seeking recovery of the debt through court or third party action.

6. Recover overdue debts

If a customer debt remains outstanding after the final demand letter, then there are a number of courses of action open to you. Do not worry about losing future business with that customer. A customer who refuses to pay is one you can live without.

The most important overriding factor in recovering overdue debts is to do what you have threatened to do. If your final letter threatens court action within seven days, then this is what you must do if payment is not received. Otherwise you will be seen as a soft touch.

Debt Collection Agency

A debt collection agency will take over the recovery. They will charge a success-based fee of between 5% and 15% of the debt.

Debt collection agencies have high success rates and are particularly useful for smaller debts where the time involved in pursuing payment is not cost-effective.

Solicitor's letter

A solicitor can issue a strongly worded letter demanding payment and setting out the consequences of non-payment.

Statutory winding-up letter

These can be issued by you, your solicitor or a debt collection agency. They threaten that an application to the court will be made for the winding up of the business if payment is not received within 21 days.

Court action

You can seek a county court judgement for payment of the debt. This is a simplified procedure designed to be used without the services of a solicitor if you wish, although you should ensure that the debt is not in dispute before proceeding (see [above](#)).

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