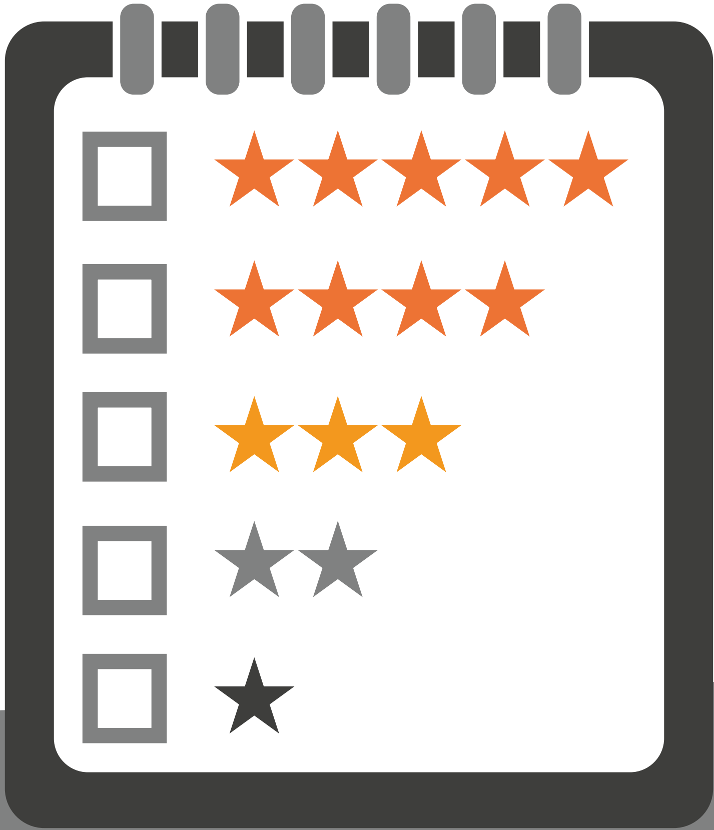
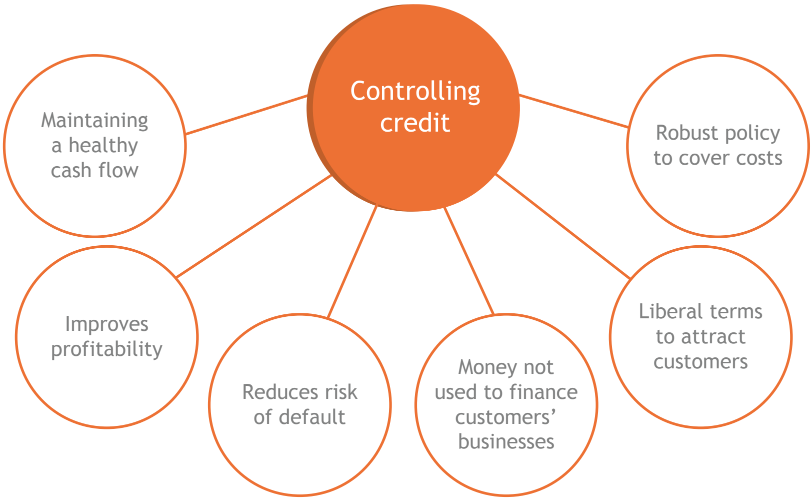


Chapter 18

Controlling Credit and Bad Debts

How do I control credit and recover bad debts to maintain a healthy cash flow and improve profitability?

Controlling the credit an organisation gives to its customers is a vital part of maintaining a healthy cash flow and good profitability. This is because there is a risk of default, or non-payment, as well as a cost in terms of the time for which the business will not have the cash to use for other purposes. Rather, the business' funds are being used to finance their customers' operations rather than their own, while it still has to bear the cost of raising this money. So the business must ensure that its credit policy is liberal enough to attract and retain customers, whilst being robust enough to ensure that the costs of any instances of extended credit are covered.



To effectively control the credit your organisation grants, you should make sure that your credit terms are clearly stated on all quotes, invoices and statements that you issue to customers. Check that they are not replaced by your customers' own credit terms on the purchase orders they send to you. You will need to regularly assess the risks of your customers defaulting on the amounts they owe, by running credit checks to help examine their levels of indebtedness and cash flow positions. This will help you to set appropriate credit limits.

Effective Credit control	
1	Clearly state credit terms on all quotes, invoices and statements
2	Check these are not replaced on purchase orders received
3	Regularly assess the risks of customers defaulting
4	Run credit checks
5	Examine customers' levels of indebtedness and cash flow positions
6	Set appropriate credit limits
7	Question unexpected increases in orders - is the customer having trouble securing credit elsewhere
8	Reduce the time between supplying products and issuing invoices
9	Monitor the average length of credit granted, or debtor days, on a monthly basis
10	Identify where the problem lies

Question any unexpected increase in orders from a particular customer by checking whether it is due to their growth and success, or because they are having trouble securing credit elsewhere. The latter might indicate there is some information that you have missed, which could result in a more negative view of their credit worthiness. Look at your internal accounting processes to see if you can reduce the time between when you supply products and when you issue invoices, because the receipt of invoices often determines when customers make payments. You should also monitor the average length of credit you are granting to you customers, or debtor days, on a monthly basis. Is this in line with your credit policy? If it isn't, then you need to identify exactly where the problem lies, perhaps by conducting an aged debtors analysis.

An aged debtors analysis shows all the customers who owe you money in a list, together with the total amounts they owe. Next to this, we list how much they currently owe that is not overdue, before detailing the overdue amounts, sorted by the number of days for which they have been overdue. For example, Cubitz may be particularly slow to pay, so we should investigate whether this is a regular occurrence or a one-off event. Has their financial health deteriorated? Or are we at fault for not following our own procedures for controlling debts?

Aged Debtor Analysis						
Amounts overdue						
Customer	**Total due**	**Current**	**Aged 1 - 30**	**Aged 31 - 60**	**Aged 61 - 90**	**Aged > 91**
Burlington	12 000	8 000	3 000	1 000	0	0
Cubitz	57 000	16 000	14 000	11 000	12 000	4 000
Diamara	7 000	5 000	2 000	0	0	0

When recovering debts, focus on large debts first, because on average 20% of your debtors will account for 80% of your business' debts. Unpaid debts may be simply caused by administrative errors or oversight, so start with a call to see if

Recovering bad debts

1. Focus on large debts first
2. Check it’s not an administrative error
3. Send a firm, clear and polite letter to insist on immediate payment
4. Highlight why paying the debt is attractive:
    - it protects their reputation
    - extends credit terms
    - avoids debt collection agencies
    - prevents legal action
5. Send further letters to support potential legal action
6. Recovering bad debts
7. Withdraw credit, and sell products only on payment-in-advance or cash-on-delivery
8. Consult the Late Payment of Commercial Debts Regulations 2013 to charge interest and add debt recovery costs
9. Appoint an FCA-licenced debt collection agency
10. Consider legal action

you can resolve the matter informally. If this doesn't work, then send a letter that is firm, clear and polite, to insist on immediate payment. Make paying the debt more attractive than not paying it, by highlighting the advantages of protecting their reputation, continuing to be able to purchase items on credit, and avoiding debt collection agencies becoming involved or legal action being taken. You will need to follow this up with further letters of increased severity to support any potential legal proceedings in the future.

For continued non-payment, withdraw any credit previously offered to this debtor, and sell products only on a payment-in-advance or cash-on-delivery basis. When the debt has been outstanding for some time, consult the Late Payment of Commercial Debts Regulations 2013, which sets out provisions for charging interest and adding reasonable debt recovery costs. The next step is to appoint a debt collection agency that has been licenced by the Financial Conduct Authority, to try and recover the debt on your behalf. Find one that will only charge you a percentage of the amount they successfully recover, so you do not pay fees without results. Finally, consider legal action as the last resort, but this will be expensive regardless of success.

Because of the time and effort involved in managing debtors, and the risk of incurring bad debts, many organisations use debt factoring. This is where the business sells all of its current invoices to a debt factoring agency at a discount on their full value. The business receives slightly less money, but it gets it straight away. The factoring agency then incurs the cost of administration, and bears the risk of some of these debts defaulting.

Debt factoring: the business sells its invoices to a debt factoring agency at a discount on their full value