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ABSTRACT

This unit on managing customer credit and collections in a small business, the 17th in a series of 18 modules, is on the second level of the revised PACE (Program for Acquiring Competence in Entrepreneurship) comprehensive curriculum. Geared to advanced secondary and beginning postsecondary or adult students, the modules provide an opportunity to learn about and try out entrepreneurship ideas so that students can make a preliminary assessment of how these ideas relate to personal needs. The units on this level contain detailed explanations of small business principles, suggestions on how to find information and use techniques, and encouragement for creating a future business. Students completing this unit should be able to perform these competencies: (1) identify techniques of setting credit limits for credit customers, (2) explain the types of information to be included in a credit record for a customer, (3) describe how an average accounts receivable collection period can be calculated and used to identify credit problems, (4) describe the format that can be used to design an accounts receivable aging system, (5) identify and discuss effective internal and credit collection procedures, and (6) identify and discuss common attitudinal problems managers have about credit collections. The unit is organized into five sections. Following a preliminary section on how to use the unit (with vocabulary and a review of the objectives for this topic on level 1), the unit's information is presented in question-and-answer format. Individual and group activities, an assessment to be completed with the teacher, and sources used to develop the unit follow. A list of the modules of Revised PACE, Level 2 completes the unit. (KC)

UNIT 17

PACE REVISED
Program for Acquiring Competence in Entrepreneurship

- [ ] Level 1
- [x] Level 2
- [ ] Level 3

Managing Customer Credit and Collections

Developed by M. Catherine Ashmore and Sandra G. Pritz

You will be able to:

- **Identify techniques of setting credit limits for credit customers.**
- **Explain the types of information to be included in a credit record for an individual customer.**
- **Describe how an average accounts receivable collection period can be calculated.**
- **Explain how the average accounts receivable collection period can be used to identify credit problems in a business.**
- **Describe the format that could be used to design an accounts receivable aging system.**
- **Identify and discuss effective internal credit collection procedures.**
- **Identify and discuss effective external credit collection procedures.**
- **Identify and discuss common attitudinal problems managers have about credit collections.**

Research & Development Series No. 240 BB 17

THE NATIONAL CENTER FOR RESEARCH IN VOCATIONAL EDUCATION
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BEFORE YOU BEGIN. . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read the Unit Objectives on the front cover. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met at Level 1:

   - Identify reasons for offering credit
   - Consider basic credit and collections policies
   - Determine guidelines for evaluating credit applicants (3 "C's" of credit)
   - Identify features of credit card plans
   - Identify basic types of direct credit plans
   - Determine how cost/benefit analysis can be conducted for direct credit and credit card plans

   If you feel unsure about any of these topics, ask your instructor for materials to review them

4. Look for these business terms as you read this unit. If you need help with their meaning, turn to the Glossary in the *Resource Guide*.

   accounts receivable aging system
   average collection period
   average daily credit sales
   cash discounts
   credit limits
   dating terms
   delinquency charge

MANAGING CUSTOMER CREDIT AND COLLECTIONS

WHAT IS THIS UNIT ABOUT?

Managing credit and collection policies and procedures is somewhat like a balancing act. The manager must achieve a balance between (1) making enough sales, (2) offering competitive customer services (such as credit), and (3) controlling or reducing collection costs and bad debt losses. To do this, the manager must review and evaluate the reasons why a business offers credit, factors for evaluating credit applicants, and methods of evaluating profits or losses from offering credit. (You may wish to review these topics, which are covered in Level 1 of this unit.)

In this level of the Managing Customer Credit and Collections unit, discussion of the above topics will be expanded. This unit will address such questions as—

- How should credit limits be set?
- What basic credit records should be maintained?
- What procedures are available to identify credit problems?
- How can the average collection period be calculated?
- How can the average collection period be analyzed?
- How can an accounts receivable "aging" system be developed?
- What are some effective internal collection procedures?
- What are some effective external collection procedures?
- What are some managerial attitudinal problems associated with credit collections?

HOW CAN CREDIT LIMITS BE SET?

The important question for a business manager generally is not whether to grant credit to an individual customer, but rather how much credit to grant. For this reason, the manager should review the credit application carefully to establish the initial credit limits. Such limits may be changed later, based on the customer's payment record.

To prevent credit sales from exceeding profitable limits, it is necessary to set credit limits for customers. Generally, credit limits are based on several factors: the required payment period, the customer's past payment record, and the customer's potential for future payments. A credit limit is not the maximim amount of credit a customer is allowed at one time. Rather, it is the maximum amount the customer's account is allowed to reach before the account is reviewed. The manager will review the customer's history of payments, the amount of credit still due, and the amount of additional credit requested. Then the credit manager may decide to revise the credit limit.

A credit limit can be established by following three rather simple steps.

1. Estimate the total amount of business you can expect from a customer during the year. Allow for increases or decreases in sales.

2. Divide the total expected sales figure by 12 to determine the monthly sales that you can expect.

3. Multiply the monthly sales figure by the number of monthly payment periods in the credit plan the customer is using. The figure resulting from this multiplication will be the credit limit for that particular customer's account.

An example of this procedure follows:

Last year Charles Gordon purchased $1,200 worth of merchandise from The Baker Firm. The purchases were spread fairly evenly over the year, and Mr. Gordon paid his ninety-day account promptly. The credit manager expects that Mr. Gordon will buy about 6 percent more merchandise in the coming year. The quarterly credit limit for Mr. Gordon should be $318.

$1,200 + 6 percent increase = $72
$1,272/12 = $106
$106 x 3 = $318

To assist businesses in setting credit limits, information about individuals and about their payment records can be obtained from credit bureaus. These inquiries cost money. Yet, when large amounts of credit are involved, such inquiries may save money.

Some smaller businesses will grant direct credit only if the individual customer has a major credit card. The business manager assumes that an individual must be a good credit risk if a major credit card company has approved the individual for credit.

Sometimes with young people, generally sixteen to eighteen years of age, business managers may ask for endorsers, usually the person's parent. The endorser is held responsible for the bill if the individual fails to pay. Another way to reduce the risk is to insist on a substantial down payment for large purchases.

In deciding on credit limits, some banks, credit organizations, and large businesses use a point system. They give a number of points for owning a home in the community, points for having a bank account, points for length of time on the job, and points for the level of income. All these points, when added together, determine the amount of credit an individual is granted.

WHAT BASIC CREDIT RECORDS SHOULD BE MAINTAINED?

Accurate records are essential for reviewing customer accounts and setting credit limits. One good system of keeping records of credit purchases in small businesses is to use a credit account ledger for each customer. The following information should be recorded on this page:

- The customer's name
- The customer's address
- The maximum amount of credit allowed to the customer
- The date each item is purchased
- The item that is purchased
- The amount of each purchase
- The amount of each payment received and the outstanding balance

Such a system is simple and easy to maintain and can provide you with accurate information concerning the amount of money customers owe. An example of a credit record is illustrated below for Mrs. Irma Trask:

CREDIT RECORD

Name: Mrs. Irma Trask — Maximum: $50.00

Address: 873 Vine Street

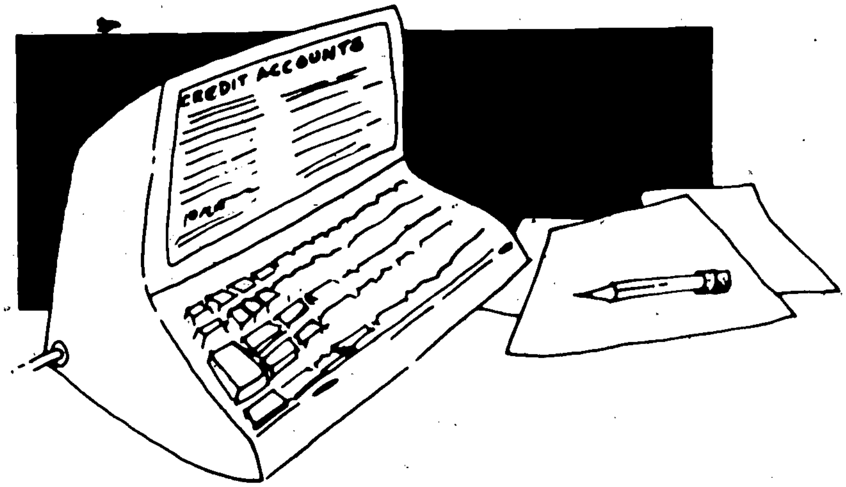
Date	Item	Purchase	Payments	Balance
3/16/77	G.E. Toaster Oven	$30.00		$30.00
4/1/77			$30.00	
4/5/77	Paint and 3 brushes	$15.00	– – –	$15.00
4/9/77	Wallpaper, 3 rolls	$30.00	– – –	$45.00
4/12/77			$15.00	
5/1/77	Clock Radio No. XIX-FM AM	$17.00	– – –	$47.00

From a business point of view, it is wise to lay out a monthly reporting form that shows either the number of accounts that are 30 days unpaid, or the dollar amount unpaid, or the percentage of total credit volume that is on such unpaid overdue credit. Some retailers maintain all three figures on a month-to-month basis. An example of a monthly reporting form is presented on the following page.

As you can see in this example, the first line indicates that in March, a particular retailer issued $800 in credit. During the month, $850 was received in payment. There remained $150 in unpaid bills in the 30- to 60-day column and $50 in the 60-day category. The next line indicates that in April the retailer advanced $634 in credit, but received only $500 in payments. This increased the overdue amount to $334. The credit picture became even worse in May, when more overdue payments moved into the 60-day column. The June balance began to improve somewhat.

MONTHLY REPORTING FORM					
Month	**New Credit Issued**	**Payments**	**Outstanding Balance**	**Balance over 30 days and less than 60 days**	**Balances 60 days or more**
March	$800	$850	$200	$150	$50
April	634	500	334	205	29
May	750	600	405	285	120
June	400	350	305	250	55

All of the credit accounts, ledgers, and monthly credit reports we have discussed can be easily adapted to several of the microcomputer programs available from commercial suppliers. It is recommended that a business manager/owner consult various businesses using computerized credit systems.



WHAT PROCEDURES ARE AVAILABLE TO IDENTIFY CREDIT PROBLEMS?

A successful credit and collection policy requires that problems be detected and acted on as early as possible. The sooner a problem is detected, the sooner it can be corrected. This is particularly critical in customer accounts receivable management, where the passage of time can aggravate any problems that may exist.

An important indicator of the effectiveness of a credit and collection policy is the average collection period. The average collection period is a ratio that expresses the total amount of accounts receivable that are outstanding in terms of an equivalent number of average daily credit sales.

The average collection period is calculated as follows:

Accounts Receivables/Average Daily Credit Sales

HOW CAN THE AVERAGE COLLECTION PERIOD BE CALCULATED?

For example, if a business had average monthly credit sales of $6,000 and outstanding accounts receivable of $9,000, the collection period would be calculated as follows:

Average Daily Credit Sales	= Average Monthly Credit Sales			÷	Days in Month
Average Daly Credit Sales	= $6,000	÷	30 days		= $200
Average Collection Period	= Accounts Receivable			÷	Average Daily Credit Sales
Average Collection Period	= $9,000	÷	$200		= 45 days

HOW CAN THE AVERAGE COLLECTION PERIOD BE ANALYZED?

The average collection period can be compared with any of the following bases to determine whether or not a collection problem exists.

- **Payment terms**. If your terms of sale specify payment within 30 days and your average collection period is greater than this, it indicates that creditors are not complying with your terms, and a problem exists.
- **Past history**. Comparison with your experience in previous periods indicates whether or not collections are improving or declining.
- **Industry averages**. Comparison with the experience of other firms in your line of business will determine whether or not your credit and collection policies are as effective as those of your competitors. (Business/industry averages are usually available at your library or trade association.)

Compare your actual receivables with a target level to find the extent of the accounts receivable in excess of the target level. For example, assume that your terms of sale specify payment within 30 days. Your average collection period is approximately 30 days. A suitable target for your receivables would then be 30 days, average credit sales. If your average daily credit sales are $200, you can calculate a target for receivables as follows:

Average Daily Sales	X	Collection Period	=	Receivables

$200 X 30 = $6,000 (Desired Receivables Target)

If your actual receivables were $9,000, you would then know that you have an excess of $3,000 ($9,000 - $6,000) in receivables and that they require attention.

A relatively high average collection period indicates that a problem exists and corrective action must be taken. Prompt attention should reduce the collection period, speed conversion of receivables to cash, minimize your capital tied up in accounts receivable, and, at the same time, reduce the risk of uncollectible accounts. Prompt attention requires that accurate credit records be kept, a system be developed to identify overdue accounts, and customer contacts be made to determine causes for overdue accounts.

HOW CAN AN ACCOUNTS RECEIVABLE "AGING" SYSTEM BE DEVELOPED?

Analysis of your average collection period will help you identify and measure receivables problems in total. However, immediate corrective action requires identification of individual problem accounts.

Problems in individual accounts can be detected through analysis of your receivables by "aging." A receivables aging system involves dividing each customer's account into amounts that are 0-30 days old, 31-60 days old, 61-90 days old, etc.

For example, examine the receivables aging system below. The first account shown, for L. Brown, has a total outstanding debt of $775.02. Of this amount, $317.91 is in the group of accounts 0-30 days old, $222.63 is 31-60 days old, $156.32 is 61-90 days old, and $78.16 is over 90 days old. Prompt action directed toward collecting the outstanding balance seems required.

ACCOUNTS RECEIVABLE AGING REPORT

March 31, 1977

	Total Amount Due	Amount Due for 0–30 Days	Amount Due for 31–60 Days	Amount Due for 61–90 Days	Amount Due over 90 Days
L. Brown	$ 775.02	$ 317.91	$ 222.63	$ 156.32	$ 78.16
A. Charles	426.58	426.58			
B. Doherty	507.19				507.19
F. Eagle	1,871.67	736.12	617.02	518.53	
R. Francis	896.15	896.15			
L. Gillis	1,343.41			716.48	626.93
M. Holloway	271.42	271.42			
TOTAL	$6,091.44	$2,648.18	$ 839.65	$1,391.33	$1,212.28
PERCENTAGE	100%	43.5%	13.8%	22.8%	19.9%

Totals are entered for each age group. It is often useful to calculate the percentage of total receivables in each age group to alert you whenever overdue receivables become excessive. For example, if you know from past experience, or from industry averages, that receivables more than 90 days past due are seldom more than 5 percent of total receivables, the 19.9 percent would alert you to a situation that requires immediate action.

WHAT ARE EFFECTIVE COLLECTION PROCEDURES?

The fundamental rule of sound receivables management is to minimize the time between the sale and collection. Any delays that lengthen this time cause receivables to build to unnecessarily high levels and increase the risk of uncollectible accounts. This is just as true for delays caused by your internal billing and collection procedures as it is for external delays caused by the customer. Several effective collection procedures relate to—

- **Proper invoice preparation.** Proper collection procedures begin with invoice preparation. Invoices should be prepared promptly and accurately. Promptness eliminates one possible source of delay. Accuracy prevents those delays that occur when the customer disputes the invoice and returns it for correction, which can be time-consuming and costly.

  Invoices should clearly state payment terms. Is payment due within ten days? Thirty days? Are the days measured from the receipt of goods? Receipt of invoice? End of the month?

- **Wise use of cash discounts.** For large accounts such as commercial, industrial, institutional, and governmental buyers, collection is often accelerated by the offer of a cash discount. The discount, usually 1 or 2 percent, is offered for payment within ten days. Most large organizations take advantage of all such discounts. In so doing, they can help to reduce your commitment of capital to accounts receivable. If your competitor offers cash discounts, it may be necessary for you to do so to maintain your competitive position.

- **Understanding payment terms.** Payment terms usually include *discount terms* and *dating terms*. Discount terms describe the discount available, if any, for prompt payment. Dating terms specify the time when payment is due.

  Discount terms are usually described on the bill. A number before the slash shows the discount percentage, in this case 2 percent. The number following the slash is the number of days within which payment must be made in order to take advantage of the discount. For example, assume that a customer receives a 2 percent discount for payment within ten days. This leads to the question, "Ten days from when?" "If the customer lets the discount period pass, when is the net amount due?" The answers to these questions are specified in the *dating terms*, which might might be expressed as follows:

  2/10 - n30

  The "n" is the abbreviation for net. The "30" indicates that payment is due within 30 days. If no other date is specified, the 30-day period begins with the invoice date. For example, if the terms above appeared on an invoice dated September 2, the customer would be entitled to a 2 percent cash discount for payment by September 12. If the customer does not pay within this period, the net amount is due within 30 days, or by October 2.

- **Meeting special conditions.** Certain accounts specify unique requirements for invoice preparation. They may require certain ways of preparing a purchase order, proof of delivery, or a certain number of copies. Be certain that these conditions are met when the invoice is first prepared and submitted, in order to avoid delays and duplication of effort.

- **Preparing customer statements.** To keep customers advised of their account balances, you should submit monthly statements to all open accounts. Statements should summarize the amount owed and any activity in the account within the month.

- **Review outstanding credit balances.** Once a month, review any outstanding balances that are more than 30 days old to see what problems might exist. Follow up on any bill not paid within 30 days. Send a statement to the customer to inform him or her of the overdue amount. Indicate that finance charges have begun, as well as the rate at which they are being charged.

- **Send a follow-up letter.** For all accounts more than 30 days overdue, send a follow-up personal letter with the statement. Ask the customer whether he or she has overlooked the bill and whether there is any problem. You could ask the customer to please come in to your place of business and discuss any problems.

- **Assessing delinquency charges.** In some businesses, a delinquency charge for late payment is used to discourage customers from allowing their accounts to become long past due. The delinquency charge normally involves a finance charge or service charge of 1-1/2 percent per month on all balances more than 30 days past due. For example, if a customer's statement at the end of June indicates a total balance due of $630, of which $417 is more than 30 days past due, the finance charge for June would be calculated as follows (assuming a 1-1/2 percent delinquency charge):

  $$\$417 \times .015 = \$6.25$$

  Most customers recognize that a charge of 1-1/2 percent per month represents an annual interest expense of 18 percent (12 x .015).

- **Initiate forceful collection activities.** Once a bill is 90 days old, more forceful collection activities are essential. Make a personal phone call between the 60-day and 90-day point. If the customer still does not pay, send a strongly worded letter, preferably over a lawyer's signature or on a lawyer's letterhead, indicating that legal action will be taken if payment is not made. Lawyers fees vary between 20 to 40 percent of the outstanding credit due. Be sure to have a clear understanding in writing when using lawyers' services. Turning collection activities over to lawyers and collection agencies should be considered a last resort.

If your own collecting efforts fail, there are two courses of action that are left to you—the collection agencies and the courts.

HOW CAN COLLECTION AGENCIES BE UTILIZED?

Collection agencies are businesses established to collect past-due accounts receivables on behalf of creditors. The primary advantage that collection agencies offer is their superior knowledge of persuasive collection techniques. Additionally, creditors are usually anxious to clear their invoices referred to collection agencies rather than further damage their credit ratings.

A collection agency's fee is usually based upon a percentage of each account collected. The percentage ranges from 25 percent to 50 percent, depending on the size of the account or the total dollar volume of accounts referred to the agency for collection. This approach, while often effective, can be expensive.

HOW CAN THE COURTS BE UTILIZED?

If the collection agency fails, your final recourse is through the courts. The matter may be resolved in a small claims court if the amount owed is small. This may be a time-consuming process. For larger amounts, you may have to hire a lawyer and file suit to collect. In such a case, you are faced with a costly and time-consuming procedure. Remember that going through small claims court, however, is not that costly in terms of money, but may take up great deal of your time.

The best way of avoiding these time-consuming, costly procedures is to take prompt, strong action on your own as early as possible. In the long run, you will be doing both yourself and the creditor a favor. While your creditors may be unhappy at the time, you will have spared them costs, time, and the loss of their credit ratings. (Legal rights and recourses are covered in Level 3 of the PACE series.)

WHAT ARE SOME MANAGERIAL ATTITUDINAL PROBLEMS?

Many managers may at first have attitudinal problems with credit collection and are reluctant to enforce strict collection procedures. Some people simply are embarrased to ask for money, even though it is owed to them. Others are concerned that they might alienate a "good customer" and perhaps lose an account. The opposite is true. How good is a customer if the bills are not paid? Even more important, the customer owing you a large balance is reluctant to do more business with you until the account is cleared. You have not only lost your money, you have also lost a customer.

Some managers think that rigorous enforcement of a collection policy can damage their reputation. Do you think that a person who owes you money is likely to tell others about it? Effective credit and collection policies and procedures begin with objective and rational attitudes by the manager toward this important customer service.

ACTIVITIES

Do you know enough about managing credit and collections to put some of your skills into practice? The following activities will help you experience some of the real-life situations of entrepreneurs.

INDIVIDUAL ACTIVITY

This individual activity is designed to assist you in using and analyzing an accounts receivable aging report.

Refer to the accounts receivable aging report on page 10. Answer the following questions on a separate piece of paper.

1. Which accounts are current (0-30 days old)?
2. What percentage of total receivables are past due (more than 30 days old)?
3. What action should be taken with L. Brown. Explain.
4. What action should be taken with P. Doherty? Explain.
5. How would you interpret the account of L. Gillis?
6. What are your impressions of the credit collection policies of this firm?
7. What changes would you make to reduce the age of the average accounts receivable?

COMBINED INDIVIDUAL AND GROUP ACTIVITY

This activity is designed to help you better understand various collection policies and procedures. You will be then be able to determine the more common internal and external collection practices used by businesses in your community. It is recommended that you investigate collection policies and procedures used by businesses that you are interested in managing or are presently managing.

1. On your own, prepare a list of commonly used collection procedures described in this unit or from other sources identified by your instructor.
2. Assemble in small groups of three to four persons per group. Review the different types of collection policies and procedures identified by each individual. As a group decide on the specific types of businesses that each group member will investigate. Prepare a list of questions on such topics as common reasons for collection problems, procedures commonly used, legal rights and recourse, external collection services, collection trends, follow-up procedures, and so forth.

COMBINED INDIVIDUAL AND GROUP ACTIVITY

1. On your own, visit a local business. Ask the manager to respond to your group's questions and add other pertinent information. If possible, obtain copies of collection policies and procedure?

2. Meet with your group to discuss differences and similarities in the manager's responses to certain questions. What new information was obtained about collection policies and procedures?

CASE STUDY

A need for cash caused Jose Garcia to examine his credit sales and compare his store's average collection period with those of similar dress shops. He found that the average collection period was 40 days and that his average monthly credit sales were $15,000. His accounts receivable currently totaled $25,000. Answer these questions—

1. What are Jose's average daily credit sales? (Assume that the store is open for business 30 days per month).

2. What is the average collection period?

3. How does Jose's average collection period compare with those of similar businesses?

4. What should Jose's next step be in finding the cause of the problem?

5. After identifying the problem, what should he do then?

ASSESSMENT

Directions: Review the following statements to check your own knowledge of these topics. When you feel prepared, ask your instructor to assess your competency on them.

1. Identify three factors that are used to set credit limits.
2. Explain what types of information you would include in a credit record for an individual customer.
3. Describe how an average accounts receivable collection period can be calculated.
4. Explain how the average accounts receivable collection period can be used to identify credit problems in a business.
5. Describe the format that could be used to design an accounts receivable aging system.
6. Identify and discuss six effective internal collection procedures.
7. Identify and discuss four effective external collection procedures.
8. Identify and discuss attitudinal problems managers have about credit collections.

SOURCES USED TO DEVELOP THIS UNIT

Dible, Donald M. *Business Start Up Basics.* Fairfield, CA: The Entrepreneur Press, 1978.

Rosenberg, R. Robert, Whitcraft, John E., and Brown, Gordan W. *Understanding Business and Consumer Law.* 6th ed. New York: Gregg Division, McGraw-Hill Book Co., 1979.

U.S. Small Business Administration. *Business Basics, Consumer Credit. A Self-Instructional Booklet* 1013. Washington, DC: U.S. Government Printing Office, 1980.

U.S. Small Business Administration. *Business Basics, Credit and Collections: Policy and Procedure, A Self Instructional Booklet* 1014. Washington, DC: U.S. Government Printing Office, 1980.

For further information, consult the lists of additional sources in the *Resource Guide.*

Level 2

PACE

Unit 1. Understanding the Nature of Small Business

Unit 2. Determining Your Potential as an Entrepreneur

Unit 3. Developing the Business Plan

Unit 4. Obtaining Technical Assistance

Unit 5. Choosing the Type of Ownership

Unit 6. Planning the Marketing Strategy

Unit 7. Locating the Business

Unit 8. Financing the Business

Unit 9. Dealing with Legal Issues

Unit 10. Complying with Government Regulations

Unit 11. Managing the Business

Unit 12. Managing Human Resources

Unit 13. Promoting the Business

Unit 14. Managing Sales Efforts

Unit 15. Keeping the Business Records

Unit 16. Managing the Finances

Unit 17. Managing Customer Credit and Collections

Unit 18. Protecting the Business

Resource Guide

Instructors' Guide

Units on the above entrepreneurship topics are available at the following three levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business

OSU

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