Managing Receivables in the Midst of Today's Economic Environment

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- Given the fact that there is limited profit to be had, with limited capital to lend, the banks are curtailing their working capital lines and or sharply increasing the cost to borrow against them. The net effect is that the supplier is now being thrust into becoming the bank for the majority of its customers.

- This paper offers an insight into the economic situation and how it might impact us, puts forward suggestions on what you may do to cope with the credit crisis and reveals what others are doing to meet the issues brought about by today's economic environment.

Introduction

We are in the midst of a credit crisis and a resulting economic downturn. As credit professionals we need to gain a thorough understanding of this situation and how it could potentially impact our business. Strategies should be devised to anticipate and overcome the potential financial hazards that could become a by-product of the current economic state of affairs. This is the time for credit professionals to rise to the challenge.

In mid October, CRF at its forum in San Diego questioned credit professionals and service providers from businesses throughout the country on their views relative to the extent of the credit crisis, how it might be impacting their respective business and what methods they were adopting to counter the issues brought about by the credit crisis. CRF has also reached out to over 6,000 credit managers and B2B credit service providers via survey to attain their take on the situation.

This paper is reflective of CRF's findings. It offers an insight into the economic situation and how it might impact us, puts forward suggestions on what you may do to cope with the credit crisis and reveals what others are doing to meet the issues brought about by today's economic environment.

Economic Overview

The root of today's economic problem lies within the banking and financial services industry but spills out into the entire world economy. The banks grossly overextended themselves by making reckless loans against real estate and securing the loans with highly inflated real property. Little attention was paid to the borrower's ability to satisfactorily retire the loan as it was felt that asset values more than offset the potential of loss brought about by default on the loans. Needless to say as the real estate bubble burst and asset values declined to levels well below outstanding loan values and as borrowers began to default at record levels, banks were confronted with major write-downs that all but exhausted their available reserves. The end result is that banks have simply run out of money to lend. The Federal Government out of necessity has come to the rescue by infusing $750 billion back into the banking system, but at this point it looks like the banks are more concerned with replenishing their reserves with these funds rather than passing them through to the economy in the form of increased lending.

Impact on Credit Management

How does this situation impact us as credit managers engaged in supplying our customer base with goods sold on open terms? Typically goods sold on open account terms carry a relatively short payback period. There is generally insufficient time before the invoice matures to afford your customer the opportunity to sell his inventory and collect money from the end-user in time to meet his obligation in line with your selling terms. To address this issue, businesses make arrangements with their banks for lines of credit that allow them sufficient working capital to overcome the obvious ebbs and flows of cash brought about by the cyclical nature of their business operations.

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For the banks, working capital lines of credit extended to their business customers offer limited financial return because of their short-term nature and their relatively low rates of interest. These loans are offered by the bank to their business customers as an accommodation to entice them to establish and maintain depository accounts and buy pricey services such as lock boxes etc. Given the fact that there is limited profit to be had, with limited capital to lend, the banks are curtailing their working capital lines and or sharply increasing the cost to borrow against them. Nearly seventy percent of respondents to a recent CRF survey indicate that their customers are experiencing a general tightening of working capital lines by the banks.

The net effect is that the supplier is now being thrust into becoming the bank for the majority of its customers. Ninety percent of the respondents to the CRF survey are reporting that their customers are relying on them for their working capital needs. Over two-thirds of the respondents are experiencing a general slowdown in payments. This places the supplier in double jeopardy as in many cases the supplier's bank is restricting working capital availability thus strapping the supplier for cash.

How should we as credit professionals react to this situation?

As a result of the credit crisis, the sharp decline in real estate values, the stock market crash and significant increases in the price of staples such as food and transportation, consumers have sharply curtailed spending on non-essentials. The impact of this on business has the potential to be devastating. Most economists are now predicting recession. The American automobile industry that either directly or indirectly provides employment to 1 in every 30 Americans is on the verge of collapse. Not only are we as credit professionals confronted with a slowdown in customer payments as a result of the bank induced cash crunch but we can anticipate that businesses within our customer base are likely to succumb to the economic pressures and fail.

Risk Assessment

Under these circumstances careful scrutiny should be applied when assessing customer risk. For the credit professional the first step is to determine the organization's appetite for risk. In most cases, given economic circumstances, one would assume that the appetite for risk would be relatively low. However, survey results indicates that nearly 40% of credit professionals have made no change to policies pertaining to the extension of credit and 3% have actually relaxed credit granting standards.

Recognizing a need for the customer to rely at least in part on the supplier to satisfy its working capital requirements, the credit manager in consultation with senior sales, treasury and financial management should make a determination as to how aggressive actions should be in addressing slowness in payment on the part of key customers. In many cases a middle of the road approach is likely to be adopted. The majority of customers within the company's account base are going to survive the economic downturn. Some will become stronger and more viable as a result; however, some will succumb to the pressures of today's economic situation and fail. When assessing risk

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under these circumstances it is important to be able to segregate those businesses with a higher probability of failure and manage them accordingly.

When examining the financial risk of major customers, one should consider more than year-end results. Financial detail should be sought on an interim basis as economic volatility in today's business environment may lend to rapid and significant deterioration in a company's financial viability. A customer's reluctance to providing the financial information more frequently should serve as a red flag to the credit analyst.

When reviewing a customer's financial situation the focus should be on short-term liquidity. Is there sufficient cash flow in the short term to meet maturing obligations? The cash position should be assessed as well as receivables and inventory. The analyst should ascertain how long it takes for the customer to convert its receivables and inventory into cash and factor that into the liquidity equation. If there is insufficient liquidity to meet maturing obligations then the customer's banking situation should be examined. Are working capital lines in place? Is availability on these lines coupled with available internal cash flows sufficient to meet maturing obligations? Is there a clean up provision tied to the line that might occur during the period of exposure? When are these lines of credit up for renewal? Are there covenants tied to the line that the customer is in jeopardy of breaching that would nullify its ability to draw on the line? In most cases the information to answer these questions appears in the financial statements. However, if it is necessary for you to contact your customer's bank for additional information it should be done with the customer's consent and the customer should contact its banking officer and encourage him or her to openly share the requested information. Once again a customer's reluctance to do so should be viewed as a red flag.

In addition to taking a short-term view of the customer's financial strength, given today's set of circumstances it would be prudent to take a longer-term view when assessing future financial strength. Those customers that pass the long-term financial viability test should be identified as strategic partners and credit in accord with sales should act to develop a strong supplier/customer bond that would carry beyond the current economic downturn. Credit should be prepared to concede reasonable payment slowdowns to these key customers in an effort to support constraints put on working capital by the banks. The customer should be assured that what is in his best interest is in your best interest. A strategic trading partner arrangement should be developed and nurtured with the notion that this arrangement might carry forward once we have realized economic recovery and the investment in developing and nurturing the relationship will pay dividends in increased future sales growth.

Market conditions must be understood. It is important not to focus specifically on your customers business but to gain a thorough understanding of its industry and the climate in which it is trading. Obviously if you sell to the building trade you might take a different look towards a contractor engaged in residential home building versus a contractor that is engaged in commercial construction or if you sell to automobile parts manufacturers you would view the customers who are distributing new parts to the U.S. automobile manufacturer differently than those that are selling aftermarket parts to retail auto parts

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distributors. The key is to understand the economy that directly impacts your customer's business and look downstream and secure an understanding of his key trading partners. Insure their financial viability and gain an appreciation for their ability to meet their obligations to your customer in a timely fashion.

It is essential to determine whether your customer is employing the right strategy for the prevailing market conditions. For example, a customer who is focused on growth in a shrinking market place should be questioned.

Automating Risk Assessment and Portfolio Analysis

In most scenarios it becomes physically impossible to closely monitor the entire battery of active accounts. Fifty-five percent of the respondents to the CRF survey indicate that they have an account base of over 2,500 accounts. To monitor 2,600 accounts per year nearly 100 accounts would have to be reviewed on a daily basis. Constraints on available resources make this a daunting if not impossible task. The potential for a considerable increase in bad debt loss is significantly elevated given today's business environment. An investment in automating the risk assessment process under these circumstances carries the likelihood of yielding immediate returns in savings related to creating efficiencies and thwarting bad debt losses.

In addition to monitoring individual accounts, processes should be adopted that reflect a macro view of the entire account base. By evaluating the entire receivable portfolio for potential of slowness and overall customer default, management decisions can be made to tweak credit procedures that help to assure that cash projections can be attained and profitability goals realized. Statistical models designed to monitor the receivable portfolio are readily available for this purpose and should be considered as a key tool in receivable management.

Other Key Considerations

Credit policies and procedures should be reviewed to assure that their content and intent are in harmony with corporate objectives and the prevailing economic business environment. If a policy is outdated or there is none in place a concerted effort to establish a current policy and set of procedures should be pursued.

The credit professional should become thoroughly familiar with the variety of security devices available to mitigate receivable risk. Armed with a familiarity of the various risk mitigation tools available to diminish risk of loss from marginal customers, credit management can enhance revenues by negotiating with customers who may not otherwise be eligible for open lines of credit and drive sales that represent limited down side risk.

A key issue to be considered at this time is reserving for bad debt. Care should be taken to assure that reserves are consistently adjusted to accurately reflect annual bad debt write-offs. The economic impact on today's volatile business environment and a steady stream of unexpected news impacting business creates a situation where reserving for bad debt is like trying to hit a moving target. It is forcing credit managers to maintain an

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ongoing vigilant watch on conditions lending to bad debt write-downs. CRF's survey reveals that over fifty percent of those reporting acknowledge adjusting reserves upwards as a result of the economic downturn. Nearly fifty percent are reevaluating their reserves on a monthly basis while an additional 33% are doing an analysis at least quarterly.

Collection Strategies

Your collection approach is critical in today's trying times. Once again it is imperative to have a clear understanding of your companies' tolerance for customer slow pay. Slowness in payments can be anticipated, but the level of aggressiveness in the collection of past due monies should be strategically weighed. Needless to say a zero tolerance policy for past due invoices can weigh heavily upon future sales potential. Over two-thirds of those surveyed by CRF indicate that they have tightened up on the collection cycle. No doubt issues related to restricted cash flows are driving this strategy by so many.

As is always the case in a collection scenario, awareness of what is contributing to the customer's inability to pay timely is essential. The root cause for the slowness should dictate the collection strategy adopted for individual accounts. An account whose liquid assets have been depleted due to extended and ongoing losses should be treated entirely differently than one whose bank lines have been curtailed and the slowness is prompted by a problem related to converting liquid assets to cash.

It may be prudent to consider relaxing terms in a case where a key customer, who is otherwise financially sound, is seeking relief in the form of extended terms due to short-term cash flow problems. As part of the concession your customer should be asked to agree to two conditions. First you should seek a firm commitment from the customer that the agreed upon new due date would unequivocally be honored and second the customer should be asked to compensate you for the additional cost you are incurring in carrying the receivable thru the extended period. It would not be unreasonable to have the customer sign a promissory note detailing the terms of this arrangement. It is certain that if the customer were seeking this arrangement from his bank he would expect to pay interest and sign a written contract detailing the terms of the agreement.

Two thirds of the respondents to the CRF survey have indicated that they are experiencing a general slowdown in customer payments. Nearly 50% report that they are experiencing more bankruptcies than a year ago. There is no reason to believe that this trend will reverse anytime soon and in fact there is every reason to believe this situation will continue to get worse. As collection problems continue to mount, obviously resources become strained. There are several solutions to this issue.

Maintain the Status Quo by Working Harder and Smarter.

It is conceivable that this approach might work, but the downside risk is that of slower pay and accelerated bad debt write-offs that more than offset the cost of paying for additional resources to devote to the collection effort.

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Hire Additional Staff to Address the Increase in Delinquent Accounts.

Generally an economic slowdown prompts management to curtail expenses, frequently by eliminating jobs. It would be difficult despite the potential positive impact on cash flows and profitability to convince management that hiring in the midst of cost cutting initiatives is an appropriate strategy to employ. To incur the expense of hiring and training new employees only to have them reach peak efficiency at a time the economy is correcting itself, collections are down, and you are overstaffed in the collection area may not be prudent.

Automate the Collection Process

Models that point the collection effort to the accounts that require the most attention have become quite successful and are being used more widely to create efficiencies in the management of large account portfolios. However, expenses related to building these models and validating them routinely become an issue, particularly at a time of cost cutting.

Outsource the Collection Effort

As resources become strained seeking assistance from third party collection and deduction resolution services represents a practical solution. It makes a tremendous amount of sense to surrender smaller, less meaningful accounts to these services thus freeing up internal resources that can focus on larger more strategically viable past due accounts. Savings related to accelerated cash flows and reductions in bad debt can more than offset service fees paid to the third party service provider. It is vital to consider that if you choose to adopt this strategy that you move expeditiously in getting your past due accounts to the collection service provider. A recent survey conducted by the Commercial Collection Agency Association reveals that account placements to the collection agencies are up significantly, but recoveries as a percent are down. The survey also reveals that the longer the past due is allowed to age the less likely the opportunity for recovery. A procedure that assures a timely delivery of past due receivable to the collection service provider can pay dividends in elevating the probability of recovery.

Conclusion

It is important to understand that the future of your respective organization lies heavily upon the shoulders of those managing the company's receivable portfolio. The investment in A/R is typically the largest of the liquid assets on an organization's books. Mismanagement of this key asset is certain to lend to the unraveling of the organization's fabric and has the potential of bringing the business to its knees given today's economic situation. We must realize that cash is, in fact, king. The ability to accelerate the turn of non-cash liquid assets into cash is imperative if a business wishes to gain or maintain a competitive edge.

A thorough understanding of the customer's business is necessary in evaluating risk. Key customers should be identified with an eye on their long term financial viability. Once identified, sales management should be made aware of these customers so that they may

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direct their sales effort accordingly. In the interest of building a lasting customer relationship, if financially viable to your organization, one might consider making concessions in payment terms to otherwise financially sound customers that may be experiencing temporary cash flow issues as a result of a curtailment in bank lines. This should be done only after you have obtained a firm commitment from the customer for timely payment and compensation for the cost of carrying the receivable.

A misguided credit decision has the potential of costing the business thousands if not hundreds of thousands of dollars in either bad debt loss, if the customer fails, or lost future revenues, if the customer is turned away and ultimately survives.

A credit and collection strategy designed to meet the needs of the business should be crafted with input from senior sales, treasury and financial management. Prudent assessment of risk and an adherence to policies and procedures designed to conform to organizational objectives should be pursued as a strategy to enhance productivity and create efficiencies in the receivable management process.

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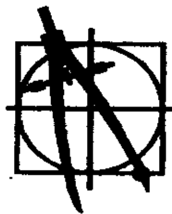

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