



## PROTECT YOUR REVENUE STREAM: DEVELOP AN AR PROCESS

A successful accounts receivable (AR) process is truly the lifeblood of every business. Without a consistent revenue stream, a business will fail. A common misconception is that the AR process is about placing accounts with a collection agency or with an attorney.

In reality, the best collection results flow from a credit department that has a well-organized, carefully-documented credit and AR process. Proper documentation on the frontend can help minimize or prevent collection problems from arising later. The process of collecting receivables begins before credit is extended.

From the initial decision to extend credit to the ultimate collection of the receivable, credit managers must develop an effective and efficient AR process to protect a business's revenue stream.

### **Have a Written Credit Policy and Follow It.**

Many companies have no written credit policy. That is, in part, a function of the belief that creating a written policy is either not worth the effort or that, once in place, the policy will go unobserved.

Not so. When a business develops and adheres to a written credit policy, it gains the advantages of consistency, continuity, and predictability in both the sales and credit departments. A written credit policy can also be an extremely effective tool to determine credit limits and decide when to impose credit holds.

A written credit policy that establishes parameters for when to place accounts with agencies and attorneys helps improve a company's collection rates. Ultimately, a written credit policy, when followed, fosters the detailed and thorough recordkeeping that makes collection more efficient.

Each business is unique. Likewise, each credit policy should be unique. So it is critical for a credit manager to evaluate his or her company's individual requirements for the extension of credit, and then tailor and follow a written credit policy to meet these requirements. Doing so can help protect the front, middle, and back end of the credit process. That is time well spent.

### **Develop a Strong Credit Application, Use It to Vet Credit Risks, and Always Get It Signed.**

The easiest way to avoid problem accounts is to never open them. Credit professionals should carefully review and analyze the creditworthiness of every new customer seeking to purchase products or services on account. A credit application is a valuable tool in that process, and can help a business identify common red flags such as excessive business debt, increased use of credit to pay basic business expenses, unbalanced asset-to-liability proportions, and high debt-to-income ratios.

A business should develop a well-written credit application that will gather important information for the credit evaluation process. Developing the application is just the first step. The reliability of the credit analysis depends on the quantity and quality of the information gathered.

Robust credit applications include requests for at least one year of business tax returns, year-to-date profit and loss report, business debt schedules, balance sheets, and an accounts receivable aging report. A strong credit application will also appropriately request authorizations to check credit. And knowledge of whom the applicant has done business with previously in your industry, and what their opinion is of the applicant's creditworthiness, can also be highly informative.

The credit manager must follow through by confirming that all of the important information requested on the application is accurate. It can be useful to include a declaration wherein the person signing the credit application swears that all information provided is true and correct under penalty of perjury. But credit managers should still do their homework and vet the information provided.

Once the applicant signs the credit application, the applicant becomes a debtor. The signed credit application constitutes a contract that establishes the terms and conditions between the parties for the purchase of goods or services "on account." This written contract is highly valuable. It establishes and waives rights and duties for the business and the applicant to put the business in the most advantageous position possible, should an account need to be placed for collection.

### **Always Get a Personal Guaranty, If Possible.**

In addition, the credit application may include a signed "personal guaranty," which will reduce the risk of nonpayment where the debtor is a corporate entity. A guaranty is an agreement in which one party agrees to act as a surety for another and provides the creditor with another source of recovery in the event the debtor fails to make his or her payments.

In other words, a guaranty lets you collect against the corporate debtor and the individual that signed the guaranty at the same time. This can protect a business from the inability to collect against a defunct corporate debtor. A credit manager can incorporate the guaranty into the credit application or leave it as a stand-alone document.

### **Obtain Security Agreements Cautiously.**

Credit managers should also consider using security agreements. In a secured transaction, the debtor promises to pay the creditor and agrees that if the debtor defaults in making payment, the creditor may take possession of certain designated property of the debtor, sell that property, and use the proceeds to satisfy the debt.

Before relying too heavily on a security agreement, it is important that the credit manager determines what, if any, superior security interests exist on the property. Fourth in line is usually not a great spot to be in when a debtor becomes distressed.

### **Coordinate the Sales and Credit Departments.**

The sales and credit departments should be united regarding decisions to approve or deny an order request. Remember, the credit department's primary function is to assess the customer's risk factors, while also finding various ways to safely make the sale when possible and prudent.

The most effective order approval process occurs when the sales department assists the credit department to gather as much information about the potential customer as possible. Once the account is open, the credit department can work with sales to follow up if any delinquency arises on an account and to head off small problems before they become big ones.

### **Send Demand Letters.**

Once an invoice is sent, most businesses follow an internal procedure with delinquent customers. The first step typically includes sending a past due or "reminder" notice, reflecting that an invoice remains unpaid.

After the credit department sends a past due notice and perhaps makes a follow-up call, the next step is to send a letter demanding payment. Some businesses prefer to send this letter on company letterhead. Other businesses prefer to hire a third party to assist with this process.

### **Place Accounts Appropriately.**

There are many types of collection agencies and legal counsel available to make demands and prosecute claims in court. Collection agencies handle debt collection, including filing suit by engaging counsel for the creditor. Collection agencies typically operate through a contingency-driven economic model, meaning they seek to receive a percentage of the debt as compensation for their services.

For disputes with larger amounts in controversy, creditors may consider directly hiring an attorney on an hourly basis. A classic cost-benefit analysis drives the decision to hire an hourly attorney versus a collection agency.

You can and should also hire legal counsel to review your credit application before problems arise. Many a litigation dollar could have been saved by spending a few transactional dollars on this step.

### **Monitor Placed Accounts.**

The collection process does not end by placing the account with either a collection agency or a law firm. It is important to monitor these accounts as follows:

1. Obtain written periodic status reports;
2. Review the status reports; and
3. Evaluate recovery results.



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## **Conclusion**

By maintaining a well-organized AR process, the credit manager can effectively ensure a consistent revenue stream for the business.

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