How to make credit pay

RECESSION AND THE MIDDLE EASTERN WAY OF WORKING CAN MAKE CREDIT LOOK PARTICULARLY RISKY. BUT THERE'S NO NEED FOR STRESS IF YOU FOLLOW A CAREFUL STRATEGY, SAYS **PETER BALL**.

Open account receivables are often one of the biggest assets on a company's balance sheet, but one of the trickiest to manage. If receivables grow too quickly because of payment delays, or even strong sales, they easily absorb working capital faster than the business generates it from retained profit. The result can be a cash crisis. To achieve a sustainable and profitable business for owners, business managers need to have strategies for sales and capital but also manage receivables. But there are ways to manage open account receivables.

ESTABLISHING CUSTOMERS' CREDITWORTHINESS

A customer's attitude to making payments and their ability to pay will determine what they do when the time comes to settle invoices. The following steps should be taken by a supplier before deciding whether to take on a new customer or even extend more credit.

First, know who the customer actually is, not just what they are known as. In the Middle East this can be hard because of the absence of credit reference agencies and because customers may be vague in answering the question. However, trade licenses commonly show the name, address and ownership of a business. Also, find out who is behind the customer in terms of management and ownership.

Next, assess where the customer is in the marketplace. Those which are well known and have a positive reputation to uphold are a better risk than a completely unknown company.

Think about the customer's motivations for buying from a new supplier. Buyers only change suppliers when they have a reason. This may be to gain a price or service advantage, but be aware that it could be the last supplier may have been pushed too far on credit and then refused more supplies.

Find out what experience other suppliers have had with the customer. Surprisingly, companies that fight to the wire to secure sales can co-operate when it comes to managing credit. And get the view of a credit reference agency if one is available. Reports can be bought over the internet or through organisations such as Dun and Bradstreet or Coface[1]. Some parts of the Middle East, such as Dubai and Egypt, have plans for credit reference agencies, but none exists yet.

Obtain customer reports from the potential customer's bankers. The responses are rarely overtly negative and the code needs to be understood: for example, "good for X amount" is better than "satisfactory", and "unable to comment" is probably negative.

Ask for audited accounts and assess them.

- Check the information is no more than a year old. Delayed accounts usually indicate a problem and render the information stale.
- See if the company is absorbing or generating cash on the cash-flow statement. Companies that constantly absorb cash will eventually run out and stop paying creditors.
- See if the balance sheet worth is substantial and what the assets are. Are they tangible like machinery, property and stock, or intangibles such as investments or goodwill?
- Check if profit is coming from normal operations and that the trend is stable or positive. A supplier should consider its own history with a customer. If the information is current and payment is for similar amounts, that is an excellent indication of the customer's financial health.
- Finally, decide a credit limit: At the end of the check make a judgement on how much credit to make available and, if possible, ensure that orders are only accepted that do not put the amount owed over the limit.

INSURING RISK As a supplier, companies can also consider trade credit insurance as a means to manage their open account receivables. This has a number of benefits to a supplier beyond indemnity against loss. Insurers will assess the supplier's customers and set credit limits using their own knowledge and information obtained from the policy-holder. In effect, this allows the supplier to outsource part of the

credit control responsibility as well as externalising the risk. Of course, policies require quite a lot of reporting and compliance on the part of the supplier, such as informing the insurer of seriously overdue invoices and getting the insurer's collection agents involved when there is extended default. These controls protect the insurance company but also create disciplines that mitigate risk for the insured.

Insurers want to see a spread of risks which means premiums are paid on whole turnover irrespective of credit limits given. In the Middle East this is often unpopular, and structuring policies can be protracted. However, market acceptance is growing, notably in the UAE and Saudi Arabia.

Three global insurers are active in the Middle East – Coface, Atradius and Euler Hermes[2]. Their identity is not always apparent since, for regulatory reasons, they often trade via "fronting" arrangements with insurance companies and export credit guarantee organisations. They face the same problems as other companies in getting information in the region and are probably at their strongest when dealing with export risk into Europe, North America and Asia Pacific.

IMPLEMENTING METHODICAL CREDIT CONTROL

Regardless of whether a company opts for trade credit insurance, it should establish a firm credit control policy. The best credit control is done methodically and reduces the chance of a customer presenting an unexpected reason not to pay.

A step-by-step credit control process for companies to keep outstanding payments to a minimum follows:

- **Credit limits**: Establish a value-based creditworthiness for each customer.
- **Payment terms**: This is a challenge in the Middle East where credit terms are invariably 90 days or longer (see Figure 1 overleaf). So it is important to be clear about what the credit terms are and when payment is expected. Shortening the terms by 30 days but then being lax about enforcing them does not make payment come quicker – it just creates a lack of clarity and more delay.
- **Order**: Confirm the exact details of the order, in writing if possible, or by fax or e-mail with someone authorised to place the order. This will help to avoid disputes later on.
- **Invoice**: Produce an accurate invoice including information such as order number, delivery address and date to help the customer process payment. If it is international, make sure it conforms to requirements such as Incoterms. Invoice as early as possible after delivery so it is logged into the customer's purchase ledger quickly.
- **Statement of account**: These should be created monthly and sent promptly to the customer. The design of the statement should highlight overdue items.
- **Follow up for payment**: This is sometimes called a "dunning cycle" and is a process of contact with the customer to ensure prompt payment. It might be:
    - Telephone call after the monthly statement to check the due invoices and that the statements are in order and can be paid;
    - Letter one, seven days after due date – politely reminding the customer to pay;
    - Letter two, 21 days after due date – repeating the reminder more firmly, perhaps asking for a response in case there is a problem in paying;
    - Letter three, 30 days after due date – repeating the reminder and setting out consequences of nonpayment;
    - Telephone calls after each letter;
    - Final demand – formally setting out the requirement to pay and the consequences of non-payment. In some jurisdictions this is required before legal action is taken;
    - Referral to solicitors for legal action – the last resort.

  The process can vary to accommodate the sensitivities of the customers. In the Middle East, personal relationships can be more important than in the West, but the customer is likely to expect to be asked to make payment. A good communicator works out the right contact, the best time and method for approaching, makes a relationship with the contact so they want to help and knows how far to push without upsetting important personal relationships.
- **Dispute handling**: The most common reason for not getting paid is a query or dispute. A difference in price, error in the invoice details, delay in delivery or problem with the goods – the value involved can be relatively small but the payment withheld proportionally large. Identify and resolve disputes promptly. For spurious disputes the handling approach is the same: quickly identify and resolve the issue so that any excuse can be exposed.
- **Management control**: The credit controller needs to be able to escalate problems and managers need a monitoring tool. The aged debtor report showing all the customers and the profile of what they owe for each month is invaluable. The credit controller can annotate it with comments about payment promised or disputes so that management actions can be taken such as stopping supply or referring to their personal relationship with managers in the customer's business.
- **Stop list**: Creating a process that withholds supplies to customers who delay payment is one of the most effective ways of releasing payments.
- **Enlisting the help of sales staff**: Sales staff may be able to leverage their relationship with the customer to help the credit controller solve a payment dispute.
- **Remittances**: Allocate remittances promptly and against the information provided by the customer. Delay makes

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chasing ineffectual and makes it harder for the customer to agree what to pay. Avoid allocating remittances to the oldest invoice first unless the customer has agreed, because it disguises disputed invoices and creates havoc with the reconciliation of payments and invoices later on.

ACCEPTING POST-DATED CHEQUES This practice is common in many Middle Eastern countries. Cheques can be dated for the due date of the invoice, but are often dated after it. The company needs to decide if the benefit of getting an acknowledgement of debt and the instrument to collect payment is worth having to wait longer for payment. In some jurisdictions the enforcement of bad cheques is strong, making them more valuable, although claiming a cheque is "lost" can negate this.

USING FACTORING This is when a "factor" – usually a bank – buys an accounts receivable (invoice) from a company at a discount, and is a long-established financing service in Europe and North America. In the Middle East however, factoring is a relatively new concept and should not be confused with the short-term loans that are sometimes described as "invoice discounting".

The UAE has the most established factoring market in the region, and Pakistan has a few providers. The three service components are:

- **Finance**: The "factor" (often a bank) pays 80-90% of the invoice value to the company's supplier in advance of being paid itself by the customers.
- **Protection**: If the customer does not pay because of business failure, or inability to pay, the factor does not have recourse to the company's supplier.
- **Collections**: The arrangement is disclosed to the company's customers and the factor undertakes credit control to secure payment from the customers.

The finance service can be used in combination with one, two or none of the others. In all cases this is a very controlled and structured facility that links the finance directly to the receivables themselves.

For companies, the key benefits of using factoring from best-in-class providers are:

- Cash flow ahead of payment from the customer;
- Advances recovered from the customers without disrupting the company seller's cash flow;
- Receivables are taken as security to support bank facilities;
- Collections resource is provided to improve credit control;
- Transfer of default risk that may allow the advance payment and trade credit to be "off balance sheet".

HSBC provides factoring services in 24 countries and has been voted "Best Factor" by the readers of TradeFinance magazine for six consecutive years. In the Middle East it is the largest provider with the most comprehensive range of services in the market, with factoring offered in the UAE, Oman, Bahrain, Qatar and Pakistan.

CONCLUSION Making a payment is a decision for the buyer of goods and services but that does not mean open account receivables cannot be managed by the supplier. By being proactive, managing relationships and using factoring, the company's working capital can be improved and risk reduced, and any benefits can be passed to the customer in the form of lower prices.

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1. See www.dnb.com (Dun and Bradstreet) and www.coface.com (Coface Group) for more information.
2. For more information about each of these companies, see www.coface.com (Coface Group); www.atradius.com (Atradius); and www.eulerhermes.com (Euler Hermes Group).

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Figure 1: Credit Terms – The Middle East versus Worldwide

Credit terms in the Middle East	
Domestic transactions in the Gulf	Terms of 90–120 days from delivery are the norm.
Supply of building materials	Terms may be longer to accommodate the flow of payment from main down through sub-contractors.
Supply into the retail sector	Larger stores may pay at 60 days, while small stores frequently require longer and will delay payment.
Supply to governmental customers	Terms may vary and can exceed 180 days if there is no understanding of who should release payment.
Supply of commodities (eg steel)	Terms can vary, but thin margins mean sellers often cannot afford to see delay and where the market is in their favour they will try and push to 60 or even 90 days.
Exports	Expect to have to extend the terms for any delay in shipping and then apply typical local terms.
Examples of common credit terms outside the Middle East	
Germany and northwest Europe	30 days following the invoice or delivery date
UK	End of the month following the invoice or delivery date
France	60 days
Asia Pacific	60–90 days
North America	30–60 days

Source: HSBC