

# Managing the Credit Function in Today's Business World

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To grant and manage credit is expensive and carries risk.

Due to the international economic and financial turmoil, banks are being more cautious when granting loans and overdraft facilities to businesses. Insurance companies are being reluctant to cover credit risks. Maltese importers are finding it more difficult to obtain or extend their credit from their foreign suppliers.

Therefore, why do businesses continue to grant credit themselves to their customers?

Statistics show that:

- **80% to 90% of B2B transactions involve payment at a later date and credit terms are often extended;**
- **Accounts Receivables (A/R) or as it is commonly known 'Debtors' is one of the largest liquid asset representing on average 40% of the total assets of an organisation;**
- **More customers are demanding and expecting credit from their suppliers.**

Being faced with such demand for credit from customers, can businesses compete without granting credit to them? Can they gain and maintain market share if they don't satisfy fully their customers' needs and expectations?

All the strategies and tactics that businesses adopt should be focused on how to attract more customers and how to maintain market share. And the credit function is by no means an exception.

Granting and managing credit to customers can serve as a useful tool to gain and sustain competitive advantage.

Businesses are aware that due to the current commercial scenario, unemployment has increased, the economic feel good factor is practically inexistent, and demand has decreased considerably. Products and services are becoming more homogenous with very little scope for differentiation. Besides, the world has become one big market with no commercial barriers. We are living in an era where from the comfort of our sitting rooms or offices, we can shop around the world for our product needs, compare product features and prices, make our purchases and pay bills on line. Purchased products will then be delivered to our door steps in no time! All this has increased the level of competition.

Therefore, being faced with such a hostile commercial scenario, can businesses ignore customers' needs and expectations? Can they afford to loose sales? What can businesses do to stand out of the competition? The Credit function can help to combat such hostile business environment.

Credit can be used to differentiate products in order to improve long-term business relationships with customers!

If businesses grant and extend credit to meet their customers' expectations, the latter would be satisfied and willing to continue buying from the same suppliers. The scope of granting credit should therefore be that ***'to close profitable sales that would otherwise be lost!'***

Hence, businesses should grant credit to increase or maintain sales whilst protecting their cash flow and profit by means of minimising risks associated with credit. This implies to focus on the major components of the credit function.

## **1. Credit Sales Approval**

The approval of credit sales should be the priority of the credit function and therefore, the resources required to carry out this activity should be allocated as appropriate. This would result in taking effective and efficient credit decisions in order to close sales profitably and in a timely manner.

The Credit function exists primarily to assist in the selling process, to complete a profitable sale - therefore, the credit function should be customer-focused. It should strive to provide proficient customer care by which long-term customer relationship could be built.

Providing good customer service when approving credit sales will support competitive advantage. But obviously, businesses should balance the credit risk with credit rewards. Businesses should strive to get to know their (prospective) customers. A detailed Credit Application Form should always be completed. A template of a Credit Application Form is made available to all members of MACM – *Malta Association of Credit Management*. Using such Credit Application Form, MACM Members are able to learn more about their prospective customers whilst inform them of their credit terms and conditions at the onset of the business relationship with their customers. *Patti chiari, amicizie lunghe!*

Once businesses get to know their customer, they will be able to evaluate the risk involved in that particular credit sale, and therefore, take the appropriate credit decisions in a proactive manner.

## **2. Invoicing**

Another critical activity of the credit function is issuing invoices to customers. An invoice is a request for payment made to a customer.

Can a business expect to get paid on time if the invoice itself is not sent on time to the customer? Can a business expect to get paid if the invoice is not clear, incomplete or inaccurate?

Invoices should be:

- *properly dated and addressed;*
- *clear, providing description of goods and delivery address;*
- *accurate, showing exact quantities, prices and any discounts applicable;*
- *complete, incorporating the agreed payment terms and conditions of sale;*
- *informative, making reference to any matter pertaining to the sale or payment, as agreed in the conditions of sale.*

A template of a proper Invoice document is also made available by MACM to its members.

### 3. Past Due A/R Management

The third vital activity of the credit function is the management of past due accounts receivables (A/R).

It is important to keep in mind that past due A/R management is not collections, or enforcement of payment but it is simply part of ***the process to complete the sale.***

Collections, even collections of past due accounts is part of the A/R Management and the attitude of the credit practitioners should remain positive at all times. This Asset (*past due A/R*) needs to be managed effectively in order to gain more profitable business, whilst keeping losses to a minimum.

One has to keep in mind that repeat sales from existing customers are the most profitable sales as they reduce administrative and marketing costs. Studies contend that the cost involved in selling to a new customer is three times greater than the cost involved in selling to an existing customer. Therefore, customers should be provided with good service at all times in order to maintain good customer relationship. Thus, encouraging repeat sales.

Nevertheless, selling on credit to existing customers would entail identifying potential losses at an early stage and closely monitoring past due customers to keep losses to a minimum.

Members of MACM have a facility whereby they monitor each and every account on a daily basis.

#### 4. Communication

The fourth major component of the Credit Function is Communication.

During the course of approving credit customers and managing A/R, the credit function interacts with almost every aspect of the business. The credit function's role has to relate to customers, salespersons, finance people, lawyers, distribution, warehouse team, and other business units that collectively make a sale happen.

Therefore, the credit function is perfectly positioned to communicate effectively with these stakeholders and have a birds' eye view of the whole business process. Hence, it can detect internal inefficiencies and identify areas of opportunity for improvement.

Communication in this context also means measuring the credit function performance and report the results to the top management team.

The business world has changed and is continuously changing. Managing change has become a critical role of every manager.

- *But what has changed in the credit function to meet today's changes?*
- *Are the credit functions still measuring their performance by means of DSO (days sales outstanding) Ratio and Percentage Bad Debts?*
- *What other tools are being used to measure the effectiveness and the efficiency of the credit function in terms of cash flow and customer relationship management?*

In today's commercial world, if a credit department uses only DSO as its measuring tool, it will be neither effective nor profitable to the business organisation.

The DSO ratio on its own has little or very limited value because it does not account for customer retention, nor does it measure customer satisfaction, which is required to sustain long-term customer relationship in today's business environment where demand is shrinking!

Therefore, it is suggested to make use of measuring tools that would assist the firm

- *to gain and sustain competitive advantage in the market;*
- *to continuously improve the internal systems; and*
- *to provide good customer service.*

One of the suggested tools is surely the Balance Score Card developed by Norton & Kaplan in 1992, as it takes into consideration both the financial and the non-financial aspects in order to satisfy the expectations of all the stakeholders and meet today's changing market needs.

Constant improvement of processes and procedures would result in better efficiency and lower cost of doing business. This is another critical issue of the credit function under the communication component.

But how can a business achieve constant improvement?

The secret lies in motivating employees, in building and sustaining a strong Team. This would entail introducing the concept of '*internal customers*' within the business organisations.

All employees should understand the role of the different departments and business functions and appreciate while respecting the importance of each.

One cannot imagine a successful business organisation without an effective sales team and an efficient distribution department – likewise, one cannot conceive a profitable and sustainable business organisation without a proactive credit management department.

Therefore, the internal conflicts between the sales and the credit teams should stop.

It should be appreciated that the Sales Team triggers the Sale, and the Credit Practitioners compete the Sale in a profitable manner.

Therefore, treating employees and peers as internal customers – satisfying and meeting their needs - should help to improve the internal systems and procedures; it should help to enhance the internal relationship and team building and this would in turn reflect in better customer service and in sustained competitive advantage - ***which is the name of today's business game!***

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**The Malta Association of Credit Management (MACM)** is a not-for-profit organisation, providing a central national organisation for the promotion and protection of all credit interest pertaining to Maltese businesses.

MACM represents the credit profession across all economic sectors. It is a centre of expertise for all matters relating to credit management in Malta. MACM offers a range of services to the local creditors, including, credit management information systems, credit management education, training, conferences, seminars, and lobbying activities. It is the ICM (UK) accredited Training Centre for Malta. MACM is a member of the Federation of European Credit Management Associations – FECMA.

**MACM is the distributor of Graydon International Credit Reports in Malta.**

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