The Entrepreneur's Guide to Financial Maturity ®
Know your Customer Before Extending Credit

In light of the recent accounting scandals and the increase in bankruptcy filings, it is of paramount importance that you, as a business owner, know your customers, especially their financial condition. Recent headlines highlight some of the financial "games" companies "play" in order to create the illusion of financial strength when, in reality, the companies are failing. There is no way of knowing how prevalent this practice is, however, in all likelihood, we have not heard the last of it.

Many small and mid-sized companies aggressively pursue the business of large and prestigious clients. Generally, small and mid sized companies leverage prestigious clients to gain other clients. Sometimes, however, these clients become nightmares, demanding preferential treatment such as, more senior personnel on the account and immediate service, while stretching out payments terms. Unless those accounts are managed properly, the customer can cause significant human resource and cash flow problems.

Although each of the highly publicized accounting frauds involved publicly held companies private companies can be motivated when the stakes are high. For example, companies may utilize aggressive accounting, or worse, in order to:

- Obtain a favorable loan or other financing
- Disguise failure to meet established benchmarks
- Maintain minimum financial ratios pursuant to loan agreements
- Conclude a merger
- Sell a business or division
- Disguise excessive officers compensation
- Survive another day

Although none of us expect to be the victims of these frauds or financial games, it can occur.

It is important to understand what can occur and how you can protect yourself. For example, several years ago a prestigious publishing company abruptly stopped paying its trade vendors and filed for Chapter 11 bankruptcy protection. One of its vendors, a small business, was owed in excess $175,000, an account receivable balance what was not unusual on this account. Prior to the bankruptcy filing the vendor kept in touch with the executives of the publisher. There wasn't much news beyond the constant assurances that a "white knight" will be rescuing the company and the vendors will be paid in full.

Under the auspices of the bankruptcy court, an investor, who owned both secured debt and equity in the bankrupt publisher completed a foreclosure action and acquired all of its assets. The investor was able to continue operations and publish the magazine to the same subscription base as the bankrupt publisher. Since the bankrupt company had no remaining assets, the unsecured creditors (including the vendors) were left with write-offs. Several of these vendors filed for bankruptcy.

Many sophisticated investors utilize the above methodology to acquire troubled companies, at a fraction of its cost to build. Investors also utilize other strategies such as "pre-packaged bankruptcies" ("pre-packs"). In a pre-pack, the major creditors negotiate the terms of bankruptcy reorganization with the troubled company prior to the troubled company filing bankruptcy. These investors will try to carve out enough creditors to get the pre-pack approved, even before the trade creditors become aware of the magnitude of the troubled company's problems. There has been an increase use of pre-packs.

How can you as a business owner protect yourself against these or other uncertainties? The first step is by changing your paradigm. It is true that your customer base is extremely valuable and you would not be in business without customers, however, **you are your customers' bank.** Your bank will cease operations if it originates too many bad loans and so will you if your credit policies are too lax. You must know if and how your client can repay its obligations.

With so much attention now focused on the subject of accounting and financial statement reporting, most business owners understand they have to provide more information so as to allow potential business associates (including vendors) to conduct due diligence. Accounting policies and practices impact

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the health of companies, including companies we conduct business with.

In the past, when credit managers reviewed customers' financial statements and if it showed losses the customers might have been able to "explain" that the losses were to reduce income taxes, or other reasons. Although this rationale may still hold true, we must investigate it further and continue to monitor the reevaluate the risk of maintaining the account. The reevaluations must focus on the customers' ability to repay all its obligations.

In the past, many companies did not thoroughly review its clients' financial statements, especially those of public companies. By understanding your clients' financial realities you are better able to manage your risks. Your customers' financial situation impacts your company's gross income, operating expenses, profitability and cash flow.

For most companies, accounting issues will have no impact on its ability to carry on day-to-day operations. However, for companies that are in marginal condition, accounting issues may cause you, an unsecured creditor, anxiety.

Whether your customers are public or private companies, at a minimum, the following steps should be taken:

- Develop credit screening and monitoring policies and procedures and adhere to it
- Review the way your credit department analyzes financial statements and determine its adequacy
- Review the way your credit department analyzes the questions they ask your customers or potential customers
- Make sure the person approving credit has a thorough understanding of your customers' financial situation
- Conduct reviews of your customers' financial situation frequently
- Continually evaluate your customers pay history
- Evaluate trends in your customers' industries
- Professionally collect the money due to you

In summary, the more you know about your customers the less likely you will make a bad credit decision. By the time you get this point you might be thinking:

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- Should I continue to conduct my business as usual?
- Can I afford to conduct business as usual?
- Do I have the right people approving credit?
- Is my credit management department properly trained?
- Can I afford to make the investment in my credit management department to properly manage my accounts receivable?
- Can I afford not to make the investment in my credit management department?
- Is there a way to relieve myself of these burdens and operate my business effectively?

Many business owners have turned to professionals that:

- Screen potential customers' credit
- Monitor customer credit
- Insure against or reduce bad debts
- Provide professional collections
- Provide invoice processing
- Provide detailed management reports

In other words, many business owners have turned to factoring accounts receivables as a risk management tool and as a means to reduce company overhead, even then their companies' qualify for less expensive financing. Factors act as an early warning system. Frequently factors are privy to information that your credit department is not.

Needless to say this past year has been a very difficult for many small and mid-sized companies that service telecom, travel, retail, insurance and computer hardware, software industries, to mention a few. Not even 24 months ago, accounts relievable from major companies in these industries were viewed as good as cash. Today receivables from many of those companies cannot be factored. If you have an early warning system and your company is agile, your company's likelihood of survival improves. If you are unprepared and get blindsided, your chances of survival diminish. Just remember if you loose a sale, you lost profits. If the receivable goes bad, you may have given the goods or services away for free, and you still have to pay your suppliers.

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