collective szabo wisdom®

SZABO ASSOCIATES, INC. VOLUME 19, ISSUE 3, SEPTEMBER 30, 2004

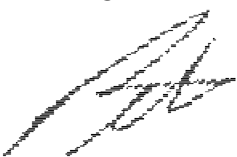
Dear Friends:

Without risk, there would be no such thing as credit management. Every day credit managers must make determinations about what constitutes an acceptable level of risk and what needs to be done to successfully manage it. This issue's feature article focuses on dealing with those high-risk accounts which, as we know, often carry the greatest opportunity for profit.

An important upcoming event on our fall calendar is the Advertising Media Credit Executives Association convention on October 16-20 in Washington, D.C. Then, we'll celebrate the holiday season at the Szabo Holiday Party on December 11th here in Atlanta.

We at Szabo wish you all a wonderful fall and holiday season!

Best regards,



Pete Szabo, President
Szabo Associates, Inc.

Managing High-Risk Customers—The Personal Side

Credit management is risky business. Assessing risk, choosing whether or not to accept the risk, and managing what is deemed to be an acceptable level of risk are integral parts of doing business. The reason for our willingness to deal with risk is, of course, that opportunity for profit trots happily alongside it.

As defined by Webster, risk is simply the possibility of suffering loss. Since none of us wants that to happen, we do our best to evaluate or quantify the risk and weigh it against the opportunity that accompanies it. Over time, sophisticated approaches to this quantification process have been developed. New technology tools enable companies not only to attach a numerical value to customers' and potential customers' creditworthiness but also to evaluate the "collectability" of accounts and even model strategies for customer contact based on group behavioral data.

While such innovations may offer value in an increasingly complex credit and collections environment, what remains at the end of the day is somebody trying to get paid by somebody else for goods or services. Improved modeling may facilitate the targeting of accounts for proactive attention; it is then up to credit and collections to deal with the customer.

Credit managers who extend credit only to customers with impeccable credit histories and high credit scores may find themselves with low DSO's and reduced losses against sales—as well as lower company profits, many disappointed prospective customers, and disgruntled sales personnel. Good credit managers do not avoid risk. They manage it, knowing that high-risk customers can also be among the most profitable.

Sound credit policy forms the foundation for effective risk management. With a good credit policy in place, credit managers can successfully engage in the activities essential to high-risk customer management: watching carefully for change and responding quickly when it occurs.

The Watch

We identify high-risk customers as such either on the basis of existing data or on the basis of having insufficient data. In either case, high-risk customers must be carefully monitored to determine change in circumstance—positive or negative—that warrants assessment and response on the part of credit and collections. Because such change can occur quickly, constant diligence is necessary to effectively circumvent disaster or to reward a customer on a timely basis for good business practices. Simply stated, the goal of monitoring the high-risk customer is to determine—as early in the game as possible and at any given time—who will pay, who cannot pay, and who will not pay.

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One important key to an effective "watch" is frequent monitoring of order and collection activity and changes in the customer's business. Collection activity includes not only payment history but also calls, promises, and broken promises. Have there been any postdated or NSF checks? Requests for a hiatus or premature cancellation of a contract? Complete documentation of all customer contacts and results help establish a pattern of behavior and "psychology" of the debtor.

Staying abreast of changes in the advertiser's industry can also help forecast trouble down the road. Financial magazines, newspapers, and financial Web sites are good ways to track industry trends. More specifically, watching the advertiser's general business behavior can provide clues to business health. Is merchandise priced unusually low? Is inventory turning over slowly? What is the reputation of the business in the community? Is the business growing too fast? Have there been changes in operations or management?

While many credit managers track how a customer company is doing by examining ratios having to do with assets and liabilities, many experts point to cash flow as the most valuable predictor of a company's health. A company's EBITDA number (earnings before interest, taxes, depreciation, and amortization) is one practical measure. EBITDA margins (EBITDA as a percent of sales) can be used to measure profitability. If sales are going up but the EBITDA margin is going down, the company is losing profitability and may be heading toward trouble.

The second key to the watch is communication—with internal and external information sources, and with the customers themselves. By making a determined effort to open the lines of communication with sales personnel, credit managers can pick up a wealth of information about customers' ability and willingness to pay. Communication with outside sources, such as other credit managers, can also bring information to light prior to credit approval or before an existing account is in serious trouble. Other media credit managers are particularly valuable, since they are the ones who know first-hand how customers treat their media creditors. Active involvement in trade organizations is a worthwhile investment of time, offering credit managers the opportunity to develop a network of colleagues with whom they can exchange policy, procedure, and customer information.

Effective high-risk management also involves developing relationships with agents and advertisers. Regular communication not only can uncover a problem looming on the horizon but also can help set the stage for constructive action to mitigate the problem. Many credit managers do not hesitate to do business with certain advertising agencies, regardless of who the advertiser is, because of the reputation of the agency and the relationship they have developed with it over time. With all due respect to the integrity of the parties involved, we recommend viewing this practice with caution. Thirteen years ago, the AAAA began recommending that agencies adopt a sequential liability position, whereby agencies will not pay media unless and until they are paid by the advertiser. Since that time, the number of agencies who have not adopted the sequential liability position has been steadily dwindling. While the liability issue continues to be hotly debated, it has become increasingly important to monitor the health and payment practices of both agencies and the advertisers they represent.

Some credit managers are successful in getting sensitive financial information from customers simply by asking them for it. Good information to know includes how the customer is using its line of bank credit and if there have been any loan violations. If the relationship is not such that asking is an option, information regarding any loan violations can be found in the footnotes of financial statements (for privately held companies) and in 10-K reports (for publicly traded companies).

The Response

Data is just information until something is done with it. Good behavior must be rewarded; bad behavior must be dealt with. If a customer is having problems, proactive measures should be taken before the situation becomes irreversible.

If a high-risk customer shows consistently that it respects media's terms and conditions and pays according to the agreement, the payment behavior should be recognized, acknowledged, and rewarded in a timely manner. Continuing to insist on the initial payment terms with a high-risk customer that has shown good faith for several months does nothing to grow a healthy business relationship and foster a partnership atmosphere.

Let us say, for example, that a new business with no credit reputation has nonetheless been deemed to be an acceptable credit risk. Perhaps the owner has solid ties to the community and a good personal credit reputation. Or there are tangible assets available to satisfy the obligations of the business. Even so, initial credit limits are wisely set at a level that does not overburden the new business with an inordinate amount of debt. After a specified time, perhaps a few months, during which the cus-

tomer proves its ability and willingness to meet its obligations, the situation should be reassessed, and credit limits should be adjusted.

In the absence of both a credit reputation and tangible assets, it may be decided that cash in advance is the only acceptable way to do business. More flexible solutions might be partial cash in advance with the balance due within 30 days, or weekly credit extension with payments to picked up by the salesperson. Again, after a specified time, the customer's consistent adherence to terms and conditions can be rewarded with more standard terms of payment.

On the other hand, let us suppose that the advertiser's behavior points to a cash flow problem. Phone contact with that customer should be initiated as soon as that assessment is made. First of all, is the problem temporary, cyclical, or permanent? A conversation with the advertiser can provide the answer to that question while minimizing any potentially negative impact on the relationship.

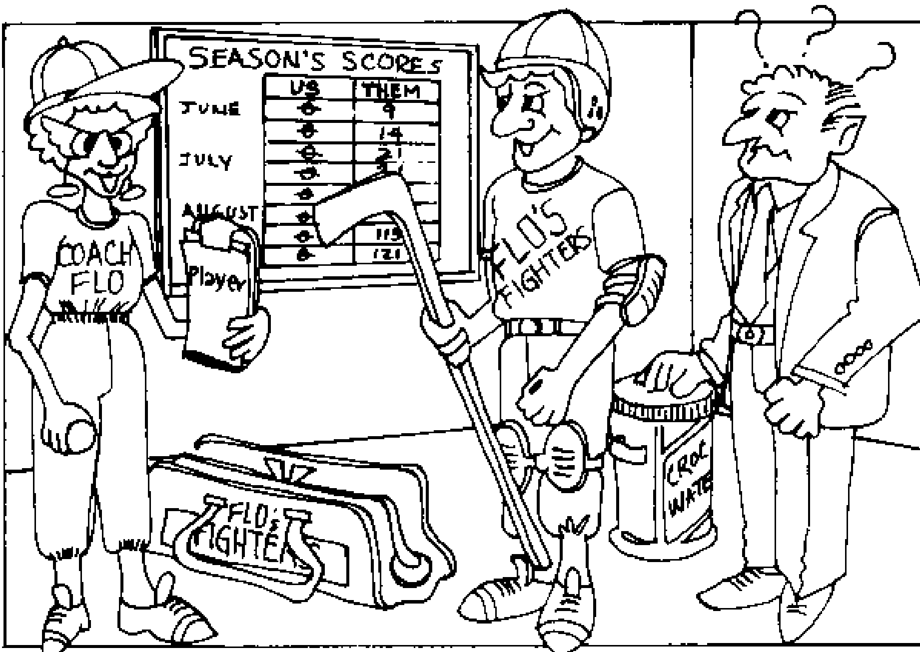
Obviously, advertisers who cannot pay should be handled with delicacy and sensitivity to their situation. Indebtedness has a psychological as well as a financial component. An inability to pay is often a source of shame for the debtor, an indication that the debtor has lost control and relinquished that control to creditors. Because most debtors would like nothing more than to eliminate the source of shame and stay eligible for new sources of credit, collection efforts that are handled with a sincere attitude of helpfulness will have the most positive outcome.

Developing an affordable payment plan shows concern for the advertiser's position, allows the advertiser to weather a temporary storm, and promotes a loyal business relationship. The customer will most likely remember a willingness to work with it during both good times and bad, effectively counter-balancing any negative feelings about the present situation. Conversely, waiting until the advertiser reaches its highest stress point—after numerous missed payments with no credit line remaining—will most likely bring an unsatisfactory result for both media and advertiser.

If the advertiser's behavior indicates an ability but not a willingness to pay, a phone call can validate that perception and help arrive at the most effective plan of action—clearing up disputes, reducing credit lines, canceling the account, and/or fast-tracking the debt-recovery process. Payment history, advertiser behavior history, and advertiser attitude about the present problem will most likely indicate whether a dispute or discrepancy is legitimate or simply a stalling tactic. If it is legitimate, prompt engagement and resolution can soothe ruffled feathers and salvage a good relationship. If the advertiser is identified as not profitable, the cost of collection can be managed to a minimum. Since every stage in the collection process carries cost, the value of early intervention cannot be overstated.

Just as communication with salespeople can aid in monitoring the high-risk customer, cultivating an atmosphere of mutual respect and assistance with sales can also assist with management of high-risk customers who become delinquent. One effective cooperative procedure that has worked well for some media credit managers is the following: The credit and collections department calls the account 35-45 days following the invoice date. The department makes a second call if the payment has not arrived as promised. If the second call is unsuccessful, the credit manager sends a memo to the salesperson listing the account and payment history. The salesperson must then respond by describing the action taken.

Generally, a problem account shows itself as such within the initial 60-75 days of being invoiced. Particularly with high-risk accounts, the first phone call should be placed <u>no later</u> than the 45-day point. By 90 days, if multiple joint efforts by the sales representative and



"THIS 'HIGH-RISK MANAGEMENT' STUFF IS KINDA TRICKY. THE GOOD NEWS IS, OUR COMPANY SOFTBALL TEAM HAD NO INJURIES All SEASON. THE BAD NEWS IS, WE CAN'T SEEM TO GET TO FIRST BASE."

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credit and collections have not resolved a discrepancy or recovered enough money to roll the account back to a 60-day or better status, the account should be placed with a third-party collector. If at <u>any</u> point in the collection process the debtor breaks promises, skips, makes unfounded claims of disputes, or shows offense at requests for money, the account should be immediately turned over to a third-party collection service. Given the cost of the collection process, including time that could be spent on more profitable credit and collection efforts, as well as the depreciating value of an aging receivable, the use of a third party can substantially reduce aging losses. Rather than indicating failure, either in a credit or collection sense, the judicious use of a third party indicates that a company is taking advantage of opportunities for profit. Companies that never need third-party assistance most likely are overly cautious and miss out on such opportunities.

And finally, what if a company files for bankruptcy? Whether the bankruptcy falls under Chapter 7 (liquidation) or Chapter 11 (rehabilitation), we recommend filing a Proof of Claim. (Chapter 11 usually does not require creditors to file a Proof of Claim if the creditor recognizes its claim, listed in an indisputable amount on the schedule of liabilities filed by the debtor. Regardless, it is <u>always</u> a good idea to file a Proof of Claim.) It is also important for creditors to respect the automatic stay provision of the bankruptcy law. Once the bankruptcy has been filed, all collections activity on the account must cease, and contact with the debtor should take place only through an attorney.

Before deciding to continue to extend credit to a Chapter 11 debtor, creditors should study the legal aspects of the case. Court orders vary regarding the terms upon which purchases may be made. Additionally, the debtor's assets may be encumbered. (For a more complete discussion of the implications of bankruptcy and resources for information, see Collective Wisdom, March 2002*.)

Credit management may be risky business, but where would we go in life without taking risks? In order to understand risk, we need to get close to it. We need to look at it critically. If the opportunity it offers justifies a relationship, we then need to embrace it with a commitment to watch, assess, and act quickly. By managing risk, we maximize profit—the only way to do business in today's competitive marketplace. ♦

*All past articles of Collective Wisdom are available on the Szabo Web site, www.szabo.com

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