Chapter 21
Managing Customer Credit to Reduce the Company's Risk and Overdue Credits

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ABSTRACT

Most companies give credit to customers when selling products or providing services. It has advantages as more customers may be willing to negotiate with the company, but it increases the company's risk. Therefore, the company must analyze the pros and cons of giving credit. This chapter summarizes all information needed for a company to establish credit policy for each customer or group of customers. First, credit risk and customers' credit risk are explained to call the attention to the need to manage it. Then it shows how a company can manage credit to maximize its value and reduce its risk. The inputs needed to determine a customer credit policy are explained. Credit risk models are presented. And finally, a recovery method to collect overdue credits is presented. This chapter aims the help the company to solve liquidity and solvency problems and to stablish long-term relationships with customers.

INTRODUCTION

In a competitive world, companies need to sell differentiate products or provide singular services to survive. Although it is not enough, and thus companies need to have a strategy and management techniques to assure economic and financial sustainability. Moreover, risks should be avoided as they are related with uncertainties and the probability of negative events. Some risks the company cannot foresee, as for example changes in policies, while others the company can try to forecast and avoid or reduce it. Credit risk is one of this risk that the company can manage to decrease it.

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Some companies receive the payment of the products sold or services provided in the moment of delivering or before, in the moment of the order. Although, most companies give credit to customers, not only because their competitors also do it, but also to appeal their products and services to customers. The problem arises when customers do not fulfill the contract obligations, it means, when customers do not pay in the contract period, delaying payments, or do not pay at all. If customers delay or fail their payments, the company must deal with costs, as cost of materials, workforce costs, supplies and services costs, among others, but have no revenue (income) to support it, leading to some financial distress, and to losses.

Managing customers' credit is not a new issue, but it has gained prominence in the last years specially after the financial crisis of 2007/2008. Diverse companies went to bankrupt or had solvency problems. This has led to a snowball effect: customers have not payed to suppliers, suppliers who are also customers of other companies have failed their payments, and in the end diverse companies have deal with financial problems, and some went to failure.

Moreover, not only customers financial problems are relevant. Some problems arise due to countries' financial problems. For example, some customers give authorization to pay their obligations to foreign suppliers, although the country government did not allow the bank to transfer the money and thus, the customer failed its contract obligation, but not due internal causes. Likewise, it is important not only to understand customers financial situation, but also the industry and the market situation.

Managing credit risk nowadays is crucial to almost every company but is even more relevant when the company sell or provide services to external markets due to the country risk, and the difficulty to solve divergences when it happens since the legal system is different.

This chapter aims to explain how the company can manage credit risk, from the moment of the decision to grant credit till the moment the amount in debt is collected. How the company should manage credit? Which information the company should collect? Where the company can look for that information? How the collected information should be related and supported? Which factors should be considered in the moment of credit decisions? Should the company look for additional protection to avoid risk? Which procedures should be used to collect the money? How to deal when the customer does not pay even if the company have used all the ways to receive the amount in debt? How to reflect bad debts and doubtful accounts in financial statements? This chapter provide answer to these questions, helping companies in their decision of granting credit.

Using the information provide in this chapter, companies can draw customers' profile and understand if should or not give credit to them. Moreover, they will understand which procedures should be following to act proactively instead of solving existing problems. The main aim is to avoid bad debts, increase company's return, solvency and liquidity, and decrease company's risk. This chapter is relevant to practice but is also relevant to theory since it is an in-depth study that provides all information needed to deal with this thematic.

The chapter is organized as follows. After this introduction topic, in topic 2, a definition of risk is provided, as well as risk's classifications to frame the thematic. Then credit risk and its relevance to companies its explained. Topic 3 explains how to manage customer credits and the steps companies must follow to deal with it. The conclusion is in topic 4, some recommendations in topic 5 and the chapter ends with suggestions for future analyses.