Open Account Approval Process

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

EXECUTIVE SUMMARY

Credit policies will vary by industry and from one company to another. Some will tend toward being conservative, while others will be more liberal and everything in between. Choosing one policy or another is entirely within the control of the owners and their chosen management team. What matters is that, regardless of an individual management team's directions to its Credit Department, everyone within that department must work consistently, to achieve its goals. With publicly held companies, there is also a requirement, according to the Sarbanes-Oxley Act (SOX), that policies and procedures be documented in writing, to ensure that there is that consistency. The purpose of this series of FCFP procedural templates is to provide guidelines for the Credit Manager, for use within his or her own company's set of established policies.

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Credit Application/ Open Account Approval Process Template

To begin the process, the Credit Department should reach a credit decision on all new applications within a specified period after the receipt of a properly completed and signed credit application. The Equal Credit Opportunity Act requires a creditor to notify an applicant of its decision within 30 days of receipt. However, customer service and the need to promote sales require a faster turnaround. Also, every effort should be made to reach a positive decision, within the overall policies and needs of your company. To facilitate this, consider the following:

1. If there is an immediate sale pending, consider setting up a temporary automatic Open Account, with a minimal credit availability. This will allow the relationship to begin, while the Credit Department conducts its investigation. This availability can be rescinded later, if the investigation results are negative. In the event of non-payment, the amount extended under this policy should be understood by all within your company to be an acceptable risk. Therefore, senior management should sign off on the process in advance.

2. Determine a minimum credit limit for all approved accounts, with no exceptions to that minimum. The key aspect of this is consistency, so the Sales and Operations people know what to expect.

3. With some exceptions, if you have an applicant who does not qualify for an Open Account, who has been notified of the decision, and who subsequently asks for a minimum account, consider a "convenience" account. The maximum limit can be within any amount the eventual loss of which is negligible. Once again, it is recommended that senior management understands this and accepts its inevitable potential for some losses.

4. Within the confines of your computer system capabilities, establish some sort of risk evaluation. For the sake of this discussion only, consider a range of one to five. The actual value system can be this or any other similar concept. A lower value represents less risk and a higher value a greater risk. This category should be visible within your system.

5. Within those same system abilities, consider a Credit Limit code that identifies the temporary or convenience aspects of the credit availability. One suggestion may be ending the Credit Limit value with a "5" for the temporary or automatic account and a "9" for the "convenience" account. There is an obvious benefit to members of the Credit Department, but these values may also assist the Sales or Operations Departments as well:

   Risk Value 1: This should be used to indicate a sterling credit rating, with its corresponding lack of immediate concerns regarding timely payment. In the case of an automated point-of-sale credit check, this value has no restrictions, other than perhaps the assigned credit limit, plus a specified percentage over that limit. (This could also be used in cases where constant review of the account precludes the need to review and release every order.)

   Risk Value 2: This value represents a sound credit history and rating, with some minimal restrictions regarding the extent of any past due money and the degree to which you wish to control exceeding the Credit Limit for any given sale. Consider the oldest occupied Aging column, as a percentage of the total AR. Any percentage over the Credit Limit should be less than for a Risk Value 1.

   Risk Value 3: This value represents the average account. Consequently, the oldest acceptable Aging/ Credit Limit exceptions will be less than for the first two categories, but still within a reasonable range to continue to allow for sales growth.

   Risk Value 4: This value corresponds to a "2", but in the opposite direction. Restrictions are greater, and more control is needed, with more concern over the risk for non-payment or potential financial issues. For one thing, it is recommended that only minimal past due be allowed, and the assigned Credit Limit is exactly that, rather than a review point or guideline.

Risk Value 5: This should be reserved for the highest risk accounts, with strict adherence to the assigned Credit Limit and disallowing any room for anything beyond the Current column.

6. Note: The "Credit Limit" field in this scenario should simply be a review point or a general availability guideline. Its usefulness is that it represents a point where a human being, within a certain level of authority, actually reviews the order, and then, hopefully, finds a way to approve it.
7. In addition to codes identifying risk levels and whether or not a Credit Limit is temporary, there may also be a need for a different code for a firm Credit hold, at least for stopping orders of any size for an account with any other type of coding or condition. It is suggested that the system have a field that will accommodate a hard-hold code, such as "H". The "H" allows for emergency holds, without an account's parameters changing. It also can be a permanent condition, essentially identifying a Cash account as being a former credit problem. Again, the use of such a thing is subject to management approval, within a given company's policies. For instance, some companies will sell on a COD basis to accounts on Credit Hold, while others will not.

Automatic (Temporary?) Credit:

This option obviously requires Management's understanding and approval, and it may not apply to all circumstances. However, when timing is a factor and the sale may already be pending, even before anyone obtains a Credit Application and Sales Agreement, it may be beneficial. There is also a risk that the applicant may not ultimately qualify for open account credit. Therefore, it is important that all concerned understand this. The policy should be in writing, and the applicant should also be notified with a letter or other communication.

1. Minimal information: Approve $3,005, Risk Value 3

   -This should be an absolute limit without a credit application.

   -Follow up for the application each 30 days & close the account at 90 days. Exceptions may be made for accounts that pay on time and continue to purchase within the credit limit. There should generally be no credit limit above $3,000 that is not supported by a Credit Application. Balances exceeding this threshold should be exceptional and temporary in nature.

2. Completed & signed application, pending the investigation: Approve $5,005, Risk Value 3

   -If subsequent payment history is satisfactory, then treat as below

   -Conduct investigation & adjust limit accordingly.

   -Rescind or qualify limit if necessary.

   -If the application is fully completed, but it is not properly signed, then it is best to revert to #1.

Automatic Approval Guidelines:

Within certain restrictions, many Credit Applications and Sales Agreements can be processed and accounts established without a full review by a Credit Manager. The advantage is timing, with additional credit availability for the customer without further delay. Of course, this must be acceptable to Management.

Definitions:

High Credit (HC): This is the highest amount of open account credit actually extended to the customer, without regard to the assigned Credit Limit. Typically, Credit Departments will not divulge the Credit Limit, because it may be construed as influencing the inquiring party, beyond Federal Government anti-trust regulations. However, it could be assumed that, if a customer can properly handle a High Credit with someone else, he/ she could do the same with you.

Industry Credit Group (Group): The Federation, NACM affiliates, Reimer, DAL and some other organizations have these groups, which meet regularly to share payment experiences. They are strictly monitored by these organizations, to comply with Federal Government regulations. The requirement is that the member submits businesses that are past due, but there are also list of regularly reviewed accounts and new applications as well.

Commercial Credit Reports: Commercial reporting agencies, such as Dun & Bradstreet, Credit2B and others, compile full reports, containing public record information, trade payments, usually anonymously submitted, plus biographical and other historical information.

Consumer Credit Reports: Under certain strict Government regulations, these consumer reports may be used in conjunction with making business credit decisions. The party, even if the Credit Application is signed on behalf of the business, must provide a separate written approval for the specific purpose of obtaining a consumer report(s).

The following are suggestions, to be altered to suit your own policies:

Sole Proprietorships and Partnerships:

1. In business > 2 years--

    -Check references-if at least two with adequate HC & payment history…

    -Pull last 3 Group reports. If not listed, or report is OK...

    -Pull Consumer & Commercial Credit Reports, if no negative information…

    -Approve with an amount equal to the HC ($5K min), not to exceed $15,000.00, Risk Value 2 or better.

2. In business < 2 years--

    -Pull Consumer & Commercial Credit Reports. If no negative information...

    -Pull last 3 Group reports. If not listed, or report is OK...

    -Approve with minimum $5,000 credit limit, Risk Value 3

3. If requesting higher credit line--

    -Call references until sufficient HC, with satisfactory payment record.

    -Refer to the appropriate Credit Manager

Corporations & Limited Liability Companies:

If Personal Guaranty signed, then process as above. (See special section below)

-Check last three Group reports. If not listed, or report is OK...

-Check D&B rating, if used & the rating is trusted, and then assign appropriate Credit Limit & Risk Value

-Pull Commercial Credit Reports. If no negative information…

-If no negatives, approve minimum $5,000 credit line, Risk Value 2 or better.

-Follow up with investigation to consider raising the credit limit or if higher availability was requested.

-When completed, refer to the appropriate Credit Manager.

Additional Approval Guidelines:

As mentioned above, levels of authority, to correspond with specific job titles, are essential for maintaining a consistent approach to credit and collection management. Again, the actual dollar amounts will vary according to a company's individual circumstances. What is presented here is meant to guide the senior credit executive through the process:

1. FCFP's credit application template recommends including a place for the customer to request a specific level of credit availability. At the very least, this provides a starting point for the review process. Of course, whatever the Sales Department may propose will also impact things, perhaps by creating the circumstances where additional information is required to even consider the potential sales volume.
2. Credit approval needs vary between the initial credit application approval and subsequent orders that "fail" the automated credit check process. The word "fail" simply refers to reaching and exceeding the review point. It should not, in nearly all circumstances, mean that the customer is not creditworthy beyond that point.
3. For the sake of this discussion, an assumption is made that there will be three levels of authority, not counting the senior credit executive:
    a. Level One may bear a title similar to Regional or Area Credit Manager, usually responsible for a given geographical territory, a special product group or something similar.
    b. Level Two may be titled as an Assistant to the Level One person, as in Assistant Regional Credit Manager.
    c. Level three may be a Credit Associate, Credit Correspondent or Credit Representative.
4. For credit application approval purposes, the authority to approve or decline beyond the automatic guidelines above would normally be limited to a full credit manager level, the RCM or ACM. The Assistant RCM/ ACM would serve as back-up, with limitations. For discussion purposes, the RCM/ACM level may be $100,000, with

the Assistant limited to $50,000. When circumstances require, as in the absence of the RCM/ ACM, the assistant be need to consider a higher amount, so a referral to another RCM/ ACM, with a recommendation for an amount, would be recommended.

5. Anyone faced with an amount higher than $100,000 would be required to go to the senior credit executive, usually titled as Director of Credit or similar. When doing so, it is best to recommend a credit availability amount, aka Credit Limit, with the supporting information and arguments ("Argument" is a rhetorical reference to justification, not a fight or disagreement.)
6. For day-to-day order approval, the Credit Associate/ Correspondent/ Representative should have both an individual order amount threshold and a total exposure limit, beyond the already established Credit Limit, even if within that order threshold. Such a limit is more for the protection of the person than a reflection on their abilities. Furthermore, SOX calls for such limits, intended to reflect the accuracy of the AR asset and the fact that responsible policies and procedures are in place. RCMs and ACMs, plus their Assistants may not have the order amount limit, but would still need to stay with the exposure limits above. The order limit for the CS/ CC/ CR may be something like $20,000.
7. Within the construction industry, where specific jobs may have lien or bond rights at stake, it may be a good idea to require a review of the job information vs. the individual state's compliance requirements. This could be as simple as having the Sales Associate or Representative submit a completed Job Sheet tailored to those requirements.
8. For the sake of customer service, but within the established policies of an individual management team, it is recommended that all "negative" credit decisions be presented to the customer in a more positive manner. For one thing, a conditional approval (see below) provides the opportunity to save a sale and keep a customer. Be prepared, though, to justify the conditions and the decision to require them. (It is highly recommended that the Credit department provide some advance training for the Sales and Operations Departments, either by way of presentations in meetings, written documents, or both.) See #4 below.

Credit policies are at the discretion of each individual company and its management team, of course. There are, however, a few so-called "rules of thumb" that may apply:

1. Establish a credit availability threshold that will require the applicant, or an existing customer, to submit at least two years' worth of annual Financial Statements. This should include both Balance Sheets and Income Statements. Why both? A Balance Sheet is a snapshot in time, while the Income Statement, also known as a Profit and Loss Statement or P&L, shows activity over a period of time, broken down by individual business activities, which then "feeds" the Balance Sheet
2. The Balance Sheet shows the values of the customer's assets, liabilities and net worth. Without going into all of the details, which are quite complex, the relationship between the assets and liabilities will show the extent of, or lack of, a customer's liquidity, and thus his ability to pay his debts. Most importantly, Current Assets, which are what can be turned into Cash within 12 months, should be sufficient to pay all Current Liabilities, as they become due within the same 12-month period. This is the translation for the Current Ratio calculation in financial analysis. Divide Current Assets by Current Liabilities and the value should be "1" or higher. (Inventory, as a Current Asset, may convert more slowly to Cash. Subtract it from the total and repeat the calculation, called the Quick Ratio. The same value of "1" is the optimum result.)
3. The difference between Total Assets and Total Liabilities provides the customer's Net Worth, which should be a positive value. While a negative value is cause for concern, considerable concern, there may be extenuating circumstances. That can be determined by the review of several sets of statements, other information, plus a conversation with the customer. A "standard" does exist for using the Net Worth to determine a credit availability number, which is equal to 10-20% of the NW. Another "standard" says to avoid extending unsecured open account credit to a customer with a negative NW. However, there can be circumstances in which other elements may justify doing so. These fall within your prerogative and that of your company's management team. (At the extreme, yours truly has experienced a combination of factors that justified extending open account, successfully, to a company with a negative NW but good cash flow, as well as setting a credit availability equal to another customer's Net Worth. Both situations required careful analysis of numerous other factors, which would require much more time and space to explain, not to mention some additional education.)
4. Additional education is required to fully understand the various security options available. The importance here, though, is to understand the concept of saying "yes, if…", rather than fully declining an application for open account, or even a specific order. For one thing, declining an application for new open account credit or a request for additional credit allows the customer to avail himself or herself of the right to know the reasons by submitting a written request per the Equal Credit Opportunity Act. Offering options or suggesting alternatives

as a condition for approval is not the same. Probably more importantly, it offers the customer a more positive approach, even as he or she must now contemplate those alternatives. Common security options include:

a. Standby Letter of Credit: This is a bank-issued document, whereby the customer's bank guarantees the debt, upon submission of a request, usually with some conditions. The key to successful use of the Standby L/C is to ensure that those conditions are yours, or at least agreeable to you, not the bank's requirements. Another advantage is that the L/C covers a specific period of time, both allowing you to make some protected sales and for the customer to establish a good payment history. The recommended minimum is 12 months, with the option to require an extension.

b. Purchase Money Security Interest: This is usually a security interest in the customer's inventory purchased from your company. If properly perfected, it puts your company in front of a secured creditor holding a blanket interest in assets, to the extent that your material is still there.

c. Documentary Letter of Credit: This is transaction specific, and is most common internationally.

d. Personal or Corporate Guaranties: Entities are people with a financial interest in a company, as in the principals, may guarantee the debts of that company. Of course, it is critical that the Guarantors have the financial ability and the credit history to compensate for the applicant's lack of it. Also, the ECOA forbids requiring the personal guaranty of a spouse that is not also a principal in the business. You can require the principal to do so, but that Guaranty cannot be embedded in the Terms and Conditions. Instead, offer it as a separate option. To entice, not require, a spouse to offer a P/G, ask the principal to submit personal financial statements. If the only useful assets are jointly held, then the spouse can offer to present them for consideration by signing the P/G. Note, whereas one of several General Partners can encumber the others, jointly and severally, the other spouses enjoy the same protections.

e. Mechanic Liens: If you are in the construction industry, there may be the opportunity for lien rights. Each state and the District of Columbia have different and very distinct requirements for enforceability, so it is important to understand where the specific job is located. It is also important to understand the full enforcement of a lien may put your company in the real estate business.

f. Payment Bonds: This is a similar option as "e" above, except that most bond scenarios involve public projects, although it can occasionally include private jobs. It should be understood that, even when the rules are followed to the letter, there would almost always be a lawsuit to extract payment from the Surety. There is also a separate Federal law, the Miller Act, for projects receiving Federal funding.

g. Consignment: Sometimes, a customer may wish to hold more material in his possession than he needs immediately. With a Consignment Agreement, and the understanding that there is still a risk, the customer can be obligated to pay when he uses or sells the material. You retain ownership of the unused material. Care still needs to be taken, since he or she may use or sell all of it and, therefore, owe for all of it. Additionally, make sure that the customer provides a certificate of insurance, and that your field personnel are willing and able to conduct regular inventory counts, to ensure that you can bill the customer and replenish the material.

h. Cash in Advance: This may seem obvious, and perhaps a little comical. However, there is a convenience factor for the customer's benefit, even as you are protected. Putting cash on deposit allows a non-creditworthy customer to purchase on short notice, without having to provide checks or credit card information each time.

Credit Application Guidelines:

1. Refer to the FCFP publication on Credit Application and Sales Agreements, to ensure that you have the proper form, and that a legally authorized individual executes it.
2. Exceptions for business decision purposes:
   a. Management may require that applications be waived for certain larger companies where purchasing is authorized through purchase orders and/or credit applications are made using standard information sheets. While not recommended, it may simply be a fact. The downside is that it is wise to review each Purchase Order, to ensure that their Terms and Conditions do not place an unfair financial burden on your company. You may wish to train sales and operations people to recognize the dangers, if you can rely on them. If not, then make sure that the risk is "transferred" to those areas. Of course, the Credit department will still be tasked with collecting the money.
   b. The lack of a legally authorized signature on a Credit Application and Sales Agreement is, indeed, a concern. However, an argument can be made that, in these limited special circumstances, certain of the customer's positions, by the nature of what they do, can encumber the customer. Again, make sure that their T&Cs are not potentially dangerous for your company.

Supporting Documents Guidelines:

It is recommended that every approved account receive a Welcome Letter, to advise them of the approval itself, the initial Credit Limit and the opportunity to ask for an increase. There will also be occasions where additional actions or information will be necessary to proceed. Lastly, there will sometimes be an occasion where an initial "denial" of open account credit is called for, even if it is a conditional approval.

Beginning with the second scenario, a letter should be prepared, to advise that something is missing or incorrectly done and to offer the opportunity to correct the error or to provide the missing information. Also, under the Fair Credit Reporting Act, a consumer credit report may be accessed ONLY with the written permission of the individual. (Note: It should also be said that this permission must require a separate signature, apart from any other Terms and Conditions within the Credit Application and Sales Agreement, which means that it cannot be embedded within those Terms and Conditions.) See the next page, for the FCFP A_1 letter. This letter can be used as shown, as a so-called All-in-One Letter, or each concept may be separated into its own letter. See the second page after that, for an example of a Welcome Letter and then the third page, for a Conditional Approval or Denial letter. The final page of this document is a template for an automated credit checking process.

To summarize, the purpose of this document is to provide a template for the credit review and approval process. As such, it is a guide, which must relate back to established policies and goals within your organization. The amount thresholds and percentages can, and should be, modified to suit your own circumstances. As mentioned, the operative word is "consistency", within both the credit application process and the daily review of incoming orders. This will satisfy SOX documentation requirements, and it will provide standards for the Credit Department, whether in a public or private environment.

FEDERATION of CREDIT and FINANCIAL PROFESSIONALS

July 4, 2016

Name

Address

City, St ZIP

Reference: Account Number _______

Dear Valued Customer (Use signer's name, if desired):

In reviewing your application for open account, we found that more information is needed. Please help us to assign an appropriate credit availability, by providing the following, where indicated:

__ A. Authorized signature (copy of application enclosed), generally limited to the owner (Sole Proprietor), an officer (Corporation), General Partner (Partnership), Managing Member (LLC).

__ B. Complete the sections indicated (copy of application enclosed). This information is needed for our review. Without it, we may be unable to meet your open account needs.

__ C. Please sign this separate agreement:

The undersigned applicant acknowledges and agrees that Creditor may utilize outside consumer credit reporting services to obtain information on Applicant. In the event that Applicant is/are individual (s), the signing of this agreement shall constitute authorization to Creditor to utilize consumer credit reporting agencies to provide reports on said individual (s) in order to permit Creditor to appropriately evaluate the extension of any business credit. Additionally, should any individual (s) guarantee the debt of Applicant, said individual (s) shall be provided with a copy of this Credit Application, and upon the signing of separate Guaranty, shall consent to Creditor's use of consumer credit reporting agencies' reports to assist in the evaluation of the credit of said Guarantor (s).

(Please Note: Without your permission to use consumer credit reporting agencies, this application may be delayed. Unfortunately, trade reference sources are not always timely, or even available)

Print Full Legal Name: ____

Signature: ____ Date: __________

A postage paid envelope is enclosed if you to return this via U.S. Mail or please return to us via facsimile at 410-555-1234 or email to _______________.

Sincerely,

Credit Department

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

Welcome Letter Template

July 4, 2016

Name

Address

City, St ZIP

Dear Valued Customer (Use Signer's name, if desired):

Welcome to the _________________________ family. We look forward to being your (supplier/ manufacturer/ whatever) of choice for years to come. (Consider adding contact information for your Sales and/ or Operations Department personnel) To learn more about us, visit our website at ______________________.

I/ We have assigned an initial credit availability of $_________ on Account Number _________. This amount may be adjusted from time to time, at the sole discretion of the Credit department. However, if you feel that you need additional open account credit, call me, to discuss this and any additional requirements that I may need to consider that increase. In the event of any future adverse action, the provisions of the Equal Credit Opportunity Act allow you 60 days to submit a written request for the reasons for that decision. This Credit department will respond to you within another 30 days. In any event, we do accept major credit cards as well.

Again, thank you for your interest in our company and its products (services).

Sincerely,

____

Regional Credit Manager

<u>Denial Template:</u> This, of course, can be altered to reflect other conditions, such as the submission of Financial Statements, business/ personal or both. The important thing is to provide positive alternatives, rather than simple declining the request for open account credit.

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<u>Conditional Approval/ Denial Letter Template</u>

July 4, 2016

Name

Address

City, St ZIP

Dear Valued Customer (Use Signer's name, if desired):

Welcome to the ________________________ family. We look forward to being your (supplier/ manufacturer/ whatever) of choice for years to come. (Consider adding contact information for your Sales and/ or Operations Department personnel) To learn more about us, visit our website at _____________________.

Unfortunately, I am not able to assign unsecured credit availability, as requested. However, I can re-consider open account, upon receipt of a Standby Letter of Credit, issued by your bank. Such a document, valid for at least 12 months, will allow time for you to establish a sound payment history. Prior to its expiration, I will review the account circumstances, to determine if the Letter should be renewed. In the meantime, I did establish a COD account, Number _________, for your convenience. The provisions of the Equal Credit Opportunity Act allow you 60 days to submit a written request for the reasons for this decision. This Credit department will respond to you within another 30 days. In any event, we do accept major credit cards as well.

Again, thank you for your interest in our company and its products (services).

Sincerely,

____

Regional Credit Manager

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Automated Credit Check Template

This is a tool, to be used as a guide to the design of a computerized credit check, as orders are submitted through an order entry process. The specific parameters can, and should be, altered to suit the credit management guidelines of your company. For the sake of consistency in the general document, the same Risk Values, as described in the main template, are used here:

Past Due Test	**Credit Limit Test**
Risk Value 1:	
No past due test	150% of Limit
Risk Value 2:	
Hold, for review, if $ in 90 day column >20% of total A/R bal	125% of Limit
Hold, for review, if $ in 60 day column >25% of total A/R bal	
No 30-day test	
Risk Value 3:	
Hold, for review, if $ in 90 day column > 15% of total A/R bal	120% of Limit
Hold, for review, if $ in 60 day column > 25% of total A/R bal	
No 30-day test	
Risk Value 4:	
Hold, for review, if $ in 90 day column > 5% of total A/R bal	110% of Limit
Hold, for review, if $ in 60 day column > 10% of total A/R bal	
No 30-day test	
Risk Value 5:	
Hold, for review, if $ in 60 day column > 5% of total A/R bal	100% of Limit
Hold, for review, if $ in 30 day column > 10% of total A/R bal	

Note 1: The parameters for R4 & R5 can also be the same, except, perhaps, for the variance over the Limit. The separate codes are otherwise useful to the Credit Department, as an overall indication of risk.

Note 2: Orders below $250 are automatically passed through the credit check, unless the account is coded with an “H”. The use of this code is to be very limited, unless otherwise approved by the Director of Credit.

Note 3: The aging columns will vary according to the actual calculations used in a given system. Some systems also age invoices daily, while others do so only at month-end. Also, the actual fiscal closing can vary by calendar month or number of days or weeks per period. All of this should be taken into account, when determining these credit check parameters. For the sake of this discussion, the aging method used included a general re-aging of invoices at a calendar month-end, regardless of the terms extended, so long as the first Due Date had passed:

90 days = 120+ days from invoice date

60 days = 90+ days from invoice date

30 days = 60+ days from invoice date

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A Primary Source

for

Order-to-Cash Best Practices

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