Strategies for More Effective Collections of Aging Accounts Receivable

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Table of Contents

I. INTRODUCTION

The COVID-19 pandemic is placing unprecedented risk levels on some businesses, impacting their ability to stay afloat – and possibly pay their bills. Companies that haven't had to place too much emphasis on business debt collection and concern about bad debt may find their risk landscape taking a turn for the worse as their once low-risk customers may now be at a higher risk of paying late or defaulting altogether.

That means collections is taking center stage, and it's important now for enterprises to consider having documented collections procedures. Many companies may have their collections policy as part of their credit policy, but the collections policy is worth considering on its own. A collections policy is a set of guidelines that govern the accounts receivable team's procedures. When employees follow the company collections policy, there are no gray areas. It creates more consistent, systematic treatment that aligns with corporate goals and business procedures, and that level of consistency makes it easier to implement automation strategies.

The business landscape across many industries has been changing rapidly, and as a result, collections policies and procedures can become outdated. Guidelines and procedures should be periodically reviewed so that they change with the times. In light of current circumstances and with so many unknowns for the foreseeable future, businesses should consider a nuanced approach to collections management. Revising collections strategies to acknowledge an uncertain environment and to create more transparency for both customers and collections team members is crucial for protecting accounts receivable, maintaining strong customer relationships, and motivating employees.

This guide is for credit, collections, and other finance professionals to assist in developing more effective strategies to collect accounts receivable. It will help you answer these questions in creating your own policy:

- What is the purpose of the collections policy?
- What are the goals of the collections department?
- What is the collections process?
- How will the collections process be measured?

II. GOALS OF A COLLECTIONS POLICY

The purpose of having a collections policy in place is simple – to protect accounts receivable. Efficiently collecting payment on current accounts receivable and past-due accounts while maintaining positive customer relationships is the main goal of the collections department.

The first step is deciding to create a written collections policy if one doesn't already exist. Some companies, especially smaller ones, may have never thought about having a formal policy in place if credit and collections are handled by one person. Or perhaps a business that never had a formalized policy has now decided to document the process in order to avoid ambiguity and a risk of bad debt. Consult with your company's legal department as to the best approach for your business.

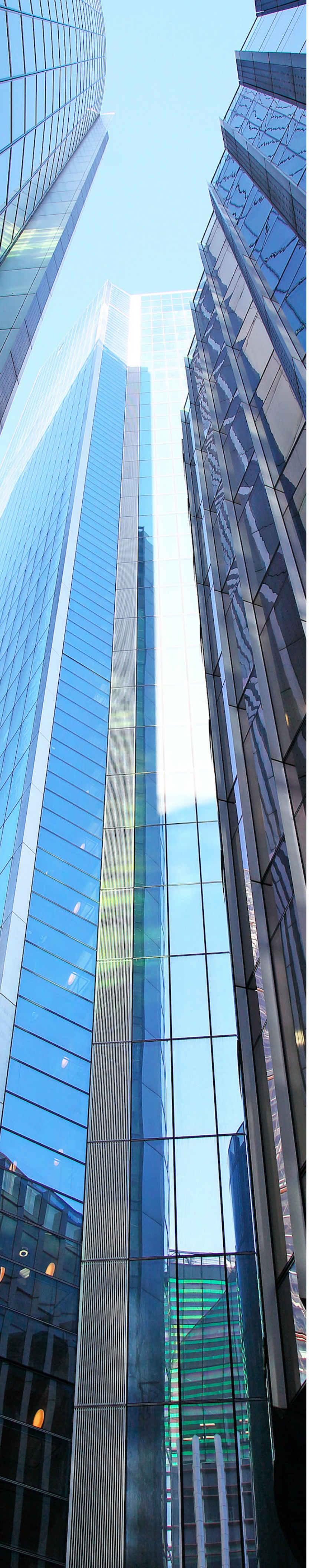
On a practical level, businesses should be proactive with collections and transparent regarding goals and expectations. A thorough collections policy should embody these goals and expectations. Common goals of collections departments include:

- To have your Collections Effectiveness Index* (CEI) be at a defined number or higher
- To have your Days Sales Outstanding** (DSO) be at a defined number or lower
- To reduce your bad debt by a targeted amount
- To reduce the number of invoices sent to a third-party collections agency

Whatever goals an organization decides to include in its collections policy, they must be consistent and attainable, and should aim to improve the quality of work performed by their collections professionals.

The Collections Effectiveness Index (CEI) is a common method for evaluating the effectiveness of collections efforts over a certain period of time. The closer the CEI number is to 100, the more effective the collections effort. CEI = Beginning Receivables + (Credit Sales/N) – Ending Total Receivables ÷ Beginning Receivables + (Credit Sales/N*) – Ending Current Receivables x 100 (Source: Credit Research Foundation)

**DSO, another common method of collections evaluation, calculates the aggregate average number of days that receivables are outstanding. DSO = Ending Total Receivables x Number of Days in Period Analyzed. (Source: Credit Research Foundation)



III. COLLECTIONS PROCEDURES

The set of procedures you define for your collections team to follow will be the core component of your company's collections policy. The rules set forth should be practiced consistently and should aim to apply to all customers – but should also be flexible when necessary.

This step-by-step process begins when an account first becomes past due. The process needs to continue until one of the following events occur: payment is collected, turned over to a third-party collections agency or legal counsel to pursue, or written off as bad debt. The policy should include account prioritization and clearly defined timeframes for contacting customers and escalating issues, strategies to be used, and tone and behavior to be exhibited throughout interactions with customers and internal departments.

An important consideration to keep in mind when defining your company's collections procedures is the size of your organization. Smaller companies often have tighter profit margins and can be catastrophically impacted by delinquent accounts. These risks should be reflected in the steps of your collections process, such as by tightening timelines of customer contact and escalation to senior management, in order to closely guard accounts receivable and optimize your cash flow. On the other hand, larger companies that have access to greater sources of capital may implement a more relaxed collections policy, concentrating more on the customer relationship and future business than on shorter timeframes for collecting payment.

Below are sample guidelines to help you build out your company's collections process. Timelines and strategies can be customized to reflect different levels of risk with respect to both your company and your customers.

1. WHEN TO CONTACT CUSTOMERS

- **DAYS 1-3 PAST DUE:** Confirm invoice was sent, confirm there are no disputes, and send automated email reminder including account statement.
- **DAYS 4 -7 PAST DUE:** Contact customer by phone and/or email attempting to secure payment. Ensure any discrepancies or disputes have been resolved.
- **DAYS 8-14 PAST DUE:** Send second automated email and follow up with a professional, scripted phone call. Notify sales representative that payment is now one week late.
- **DAYS 15-30 PAST DUE:** Send third automated email stating account will incur late fees after 30 days. Follow up with a phone call to confirm receipt and remind customer of late fees.
- **DAYS 31-45 PAST DUE:** Mail letter on company letterhead stating payment is now 30 days late. Apply late fees to account.
- **DAYS 46-60 PAST DUE:** Begin calling and emailing customer every 3-5 business days. Place account on credit hold and notify sales representative and customer of credit hold.
- **DAYS 61-90 PAST DUE:** Notify senior management and prepare to send account to collections agency and/or legal counsel and/or write off as bad debt.

2. HOW TO HANDLE DISPUTES

A comprehensive collections policy should include guidelines on how disputes and discrepancies should be handled. Before initial contact with a customer, the collections professional should ensure that any internal issues are cleared up. These might include unapplied checks, unused credits, or any special terms offered by the sales representative but not applied to the account. If a dispute arises during interactions with the customer, handle it quickly to avoid slowing down the receivables process. For example, if you wait a week to send the customer a corrected bill, you've just put off getting paid by a week.

COMMON REASON CODES FOR DISPUTES

- Customer Claims Pre-Bill
- Wrong Goods Shipped
- Damaged Goods
- POD Required
- Customer Returned
- Invoicing Error
- Discount Not Applied

Handling disputes should be a clearly articulated step in your collections policy that will empower your team to resolve such situations in accordance with the stipulated schedule and process.

However, some companies may choose not to include written procedures for handling disputes in order to allow themselves to treat accounts on a case-by-case basis. This custom approach may be more time-consuming for all parties involved, but depending on the size and industry, your company may benefit from this tailored customer service approach.

3. WHEN TO INTRODUCE PROMISSORY NOTES

A method of binding a customer to pay their delinquent account balance is by means of a promissory note. A promissory note, similar to an IOU, is a legal document that states that the customer promises to pay a certain amount of money within a certain timeframe. This creates a legal record that sets out all terms of the pending payment as agreed upon by both parties. Depending on guidance from your company's legal team, issuing promissory notes can be incorporated into the steps of your collections policy as another strategy in the efforts to collect outstanding debt. The benefits of having a customer sign a promissory note are that it is a legally enforceable document and acts as another touchpoint and reminder to the customer of their past-due balance.

While having a promissory note in place gives your company a legal document obligating the customer to pay the delinquent account balance, it could create unfavorable client relations. Given the current environment in which some companies are in financial crisis due to the COVID-19 pandemic (but have otherwise been prompt payers), it may be more appropriate in certain circumstances for collections teams to choose a softer touch with past-due accounts. An understanding and compassionate collections process on certain customers would not go unnoticed during these crucial times.

4. WHEN TO SEND ACCOUNTS TO COLLECTIONS AGENCIES

When all internal means of collecting on a past-due account have been exhausted, some companies choose to turn the delinquent account over to a third-party collections agency. A collections agency is a company used to recover funds that are past due or from accounts that are in default. This step in a collections process usually occurs when the account is 60 or more days past due.

There are several factors that influence a company's decision to turn past-due accounts over to a collections agency. One factor is the company's risk tolerance for bad debt. If positive cash flow would not be greatly impacted by a certain level of bad debt, a company may choose not to outsource collections efforts. On the other hand, a company with tighter profit margins would likely be more risk averse and may set forth in their collections policy the transfer of past-due accounts to a collections agency at a designated number of days past due.

5. WHEN TO PURSUE LEGAL ACTION

Companies may opt for pursuing legal action to recoup past-due accounts receivable over collections agencies. There are multiple reasons why this course of action may be taken, but the most common reason is that the total debt owed is substantial. While you can legally sue for any amount, the actual amount owed should be worth the time, effort, and cost of retaining counsel. This step is generally decided on by the legal department, not the finance department.

6. WHEN TO WRITE OFF BAD DEBT

If it has been determined by the collections team, in congruence with the collections policy, that the debt has become worthless (because it can't be collected), then it can be written off. Writing it off means adjusting your books by removing it from the accounts receivable balance so that it is not represented in the total amount of your current accounts.

IV. MANAGING EXCEPTIONS

Of course, there are always exceptions to established procedures, even with a collections policy. Your policy should be structured and consistent but also flexible, so it can adapt to changing times and uncertain environments.

NEGOTIATING TERMS

Customers who are aware of their inability to make timely payments may want to renegotiate terms or arrange a payment plan. Now, more than ever, is the time for businesses to try and practice compassionate collections based on their threshold for appropriate risk. A balance between showing compassion and protecting accounts receivable needs to be established. Remember, extending terms disrupts your cash flow. Perhaps the customer is offered an extended payment plan, but with the extension they agree to forfeit discounts. If payment is still late after renegotiating terms, the customer forfeits the right to renegotiate for an extended period of time.

If these are formerly low-risk customers currently experiencing hardship and financial distress due to COVID-19 and now considered high risk, you should consider continuing to treat them as upstanding customers. Of course, all high-risk accounts should be monitored closely and handled on a case-by-case basis.

AUTHORIZATION

Another example of an exception is who is on the approval list. Different situations will require different approaches and will sometimes need to involve senior levels of management. Can the credit manager extend terms or does he or she need a leader's authorization? What is the maximum invoice size that can be authorized by the credit manager? Can that amount change depending on the customer? Who has authority over deducting late fees? Policies should clearly identify hierarchy and be structured to achieve the best resolution for every situation.

Striking a balance between consistency and flexibility in order to safeguard your accounts receivable while demonstrating superior customer service is the outcome your collections procedures should aim to accomplish.

V. MEASUREMENT

Once goals are established and procedures best practices are defined, it is important to identify metrics to help measure and evaluate the effectiveness of your collections policy. Regularly monitoring performance helps identify process issues that could be slowing down collections on your accounts receivable.

Specific benefits of using meaningful measures of collections performance include:

- Increased productivity and quality of work
- Reduced errors or defects
- Reduced costs of collections
- Shortened lead time
- Reduced bad debt
- Increased cash flow
- Increased customer retention and satisfaction
- Identification of potential areas of growth
- Improvement of policies and procedures
- Improvement of employee morale
- Performance of fair and informed individual and team evaluations

The metrics you choose for measurement should align with the goals you have set for your collections policy, be consistent, and aim to improve the quality of work performed by your collections professionals.

As mentioned earlier in the context of setting goals, (DSO) is a common metric used in the collections process. DSO is widely used as an overall measure of accounts receivable relative to credit sales. If your goal was to keep your DSO below a certain number, did you achieve it? If not, what can you do to get there? If you find that the targets are not being hit, consider adjusting your collections policy accordingly.

As an added measure, by calculating DSO for those customers with extended terms and comparing them to all other customers, you can better determine the impact of extended terms on your receivables performance, which may be affected greatly during uncertain times. Further, the receivable balance for customers with extended terms should be closely monitored to provide insight into any trends and as a point of comparison with standard-term customers. This will help determine whether your extended-term approvals are being honored, and whether your monitoring and collection efforts are effective.

As a reminder, extended terms are a customer courtesy. In some cases, it is a tactic to preserve sales, while in others the hope is for increased sales. With this in mind, the profits generated by extended-term sales should be tracked at least quarterly as well as year to year, and perhaps even more frequently during times of financial uncertainty.

In addition to DSO, there are a number of other measures you can use to evaluate your collections process. You should choose the ones that are effective and consistent and that meet the needs of your organization.

VI. CONCLUSION

The collections policy is often overlooked but is an essential part of a sound and comprehensive credit policy. Having an effective collections policy in place promotes consistency and efficiency and aligns corporate goals with business procedures.

As businesses continue to face uncertain times, by reprioritizing collections based on your company's changing risk landscape, teams are empowered to practice more nuanced collections strategies. Not only will this create sustainable customer relationships, but it also will help motivate and encourage employees to do their best amid trying circumstances.

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