Black Holes and Credit Management

Credit management is an integral and highly visible part of the cash-to-cash business cycle, in which cash invested by shareholders is used to produce and deliver goods and services that are sold for even more cash. As the last step in closing the cash-to-cash cycle, accounts receivable is a valuable company asset that is, at times, not given its due credit.

Credit Management Drivers

Organizations have developed various models for credit management functions. However, for the most part, they revolve around the following drivers:

- ensuring customers live up to their half of the commercial bargain
- predictability of cash inflow in relation to sales
- minimal capital employed in A/R without impairing sales
- minimal expense of operating the credit management function
- minimal losses on extended credit
- achieving and maintaining outstanding customer relations.

As Management Intended

If all of the above are performing within tolerances acceptable to management, then a company could claim that its credit management function is operating as management intended. However, when this is not the case, companies need to look for causes and address them before they become crippling problems.

What inhibits the credit management function from operating as management intended?

Black Holes in Organizations

One significant contributor is black holes in organizations. Black holes involve the failure, at the micro level, of simple, yet essential, basic activities that management has agreed should be executed. The lack of attention paid to these basic activities allows an accumulation of failures to occur unnoticed until, at some point, damage manifests itself on the financial reports, in operations, and elsewhere within the organization and between the organization and its stakeholders.

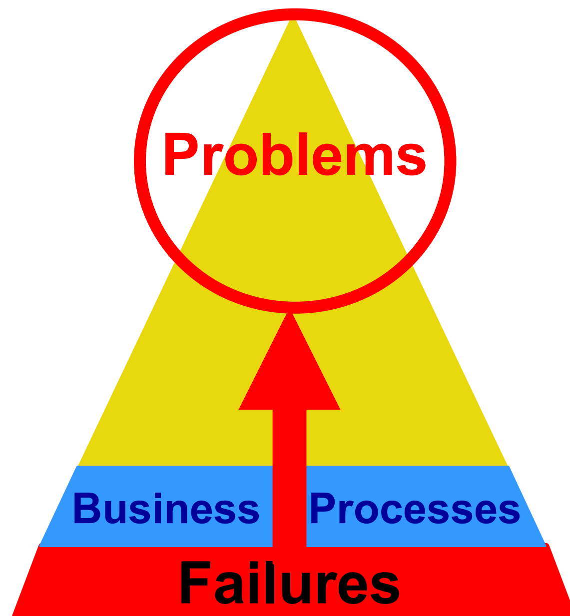
A black hole in an organization can be defined as: “An area of an organization where, unbeknownst to management, an abundance of undesirable activities occur or a lack of desirable activities occur in abundance, both of which destroy organizations.”

In short, poor decisions do not necessarily cause black holes to form. Rather, the formation of black holes is more often caused by poor execution and the inability of decision makers to spot and correct the failure of these basic, yet essential, activities.

Three criteria must be in play for a black hole to exist:

1. *Destruction* must be occurring to the organization.
2. There must be an *abundance* of undesirable activity or a lack of desirable activity in abundance, not merely an occasional occurrence.
3. Management must have an *absence* of awareness of the root cause of the destruction.

Black holes form below business processes, in the area of actions and activities. Numerous failures, not merely an occasional occurrence, need to occur for a black hole to exist. Management may or may not be aware of the *damage* occurring to the organization; however, management does not see the *failure of basic activities* in volume that leads to the damage.



In addition to the direct damage caused, black holes reduce badly needed transparency, increase risk, reduce productivity, reduce margins, drain cash, anger customers, impair data integrity, choke desirable flows within an organization, lower employee morale, and generate or compound difficulties higher up in the organization. Left unhandled long enough, black holes can ruin companies. They have, in fact, caused many companies to go bankrupt, at times without management and analysts understanding the root cause of the failure.

Black holes like to feed on A/R sub-ledgers because they are often an area of high volumes of activity. And being a "near-cash" asset at times, they are subject to challenges by customers. In addition, they are vulnerable to disappearing because electronic and paper files are more susceptible to destruction than steel machinery. As stated in the opening paragraph, "accounts receivable is a valuable company asset that is, at times, not given its due credit".

Since black holes involve the failure of execution of basic activities that management has agreed should be executed, decisions to grant credit to specific companies are not part of the black hole landscape. However, allow me to share a few examples of where, hidden from management, basic activities can fail and cause black holes to form.

Failures of Basic Credit Management Activities

Insufficient credit information collected. Organizations develop successful credit collection procedures that can vary from industry to industry and company to company. These procedures become a routine way of conducting business. Ordering credit reports, requesting and contacting references, reviewing annual financial reports, and meeting with customer management are likely part of those procedures. When established procedures are not followed, failure occurs.

Insufficient security obtained. If company policy requires a certain amount and type of security to be obtained prior to entering into a customer agreement, such as security under the Personal Property Security Act or a pre-lien, and it is not done, then a failure occurs.

Releasing orders when an account exceeds credit limit. A credit limit can consciously be placed on an account by a credit committee or authorized personnel. Should this limitation be overridden by non-authorized personnel, perhaps by releasing orders that cause the limit of the account to be exceeded, then a failure of a simple yet essential basic activity would occur.

Failures of Basic A/R Management Activities

Credit notes due customers not issued. If customer returns are not entered into the management information system, then credit notes will not be issued to customers. If Marketing does not notify Invoicing that a customer delivered on his part in a co-op advertising campaign, then Invoicing would not issue the customer a credit note. If the customer charges back the company for damages to its premises during a company installation and the A/R clerk fails to notify Finance, then a credit note would not be issued. Such omissions are failures of basic activities.

Misapplied cash. Clearing the oldest items from the customer account – even with the customer's permission – instead of allowing the customer to state which invoices are being paid with which payments, is a risky way to manage A/R. Inevitably, there will be disputes over arbitrarily cleared items. Because the arbitrary clearing of invoices leaves a blurry trail, resolution will become difficult. Customer A/P personnel change, customers hire consultants to find errors, memories fade. This mix can lead to unresolved customer disputes.

Unable to apply cash. When credit notes due customers are not issued, A/R clerks will not be able to apply customer payments properly because customers will be claiming credit notes that do not exist on the A/R sub-ledger. For example, if a customer submits a cheque for $200,000 and a list of invoices being paid totaling $300,000, along with charge-backs for unissued credit notes for $100,000, the A/R clerk has four payment application choices.

The options, none of which are positive, include:

1. Clear $200,000 of invoices listed by the customer, leaving the remaining $100,000 invoices listed outstanding.

2. Clear $200,000 of the oldest invoices in the customer account.
3. Clear the $300,000 of invoices listed by the customer and set up customer charge-backs for $100,000.
4. Apply the payment to the account as an on account payment leaving all invoices outstanding.

Bad debts not acknowledged. Unacknowledged bad debts sitting on the A/R sub-ledger, a basic failure, will overstate the A/R asset and possibly waste the time of A/R clerks who must continually try to collect and report on dead accounts.

Inaccurate invoicing. Complicated or ambiguous pricing arrangements, as well as simple human error, can lead to inaccurate pricing of invoices. No matter the reason for inaccurately pricing invoices, the inaccurate pricing of invoices is a basic failure.

Faulty computer programming. Errors in computer programming can cause errors in invoice pricing, application of incorrect tax rates, application of incorrect interest and late fee charges, and errors in cash application. Such errors are the result of the failure of the basic activity of computer programming.

Interest and late fees on phantom A/R. If A/R is overstated because credit notes due customers are not issued, for example, then the overstatement increases due to unsubstantiated interest and late fees. This is a failure of the basic activity of maintaining an accurate A/R sub-ledger. Also, the number of open items that must continually be managed increases. This places a burden on A/R clerks and possibly increases the cost of credit management.

Charges to wrong customer accounts. Whether at the data entry level or sales order taking level, wrong customer accounts can be charged. This risk of basic failure increases when customers have more than one account with a company.

The key to the formation of black holes is volume. The failure of basic activities in volume *causes, or at a minimum irritates, larger problems higher up the hierarchy of activities, to the point that the organization's survival is threatened.*

Pay Now or Pay Later

Excessive employee workloads can increase the frequency of failures of basic activities. Ironically, if the frequency of failures increases, there will be even more work to perform. This additional work can lead to additional failures. In this way, an unaddressed black hole can snowball.

The Effect on "as management intended"

Let's look at some effects that failures of basic activities have on our objective of operating the credit management function as management intended:

- If insufficient credit information is collected or insufficient security obtained, or orders are released when accounts exceed established credit limits, then the organization risks experiencing losses on credit extended.

- If credit notes properly due customers for things such as returns, co-op advertising, and price protection are not issued, then the A/R sub-ledger is overstated. In addition, customers become unhappy when basic credit activities are not executed properly.

- If customer payments are misapplied to the A/R sub-ledger or the A/R clerk is unable to apply customer payments, then the A/R sub-ledger becomes fouled and write-offs will likely ensue.

- Unhappy customers will delay future payments until their account is corrected, contrary to the goal of minimal capital employed in the A/R sub-ledger.

- The confusion caused by a fouled A/R sub-ledger and the efforts required to handle individual failures and terminate their root causes is contrary to the goal of minimal expense of operating the credit and A/R management function.

All of the failures of basic activities that occur harm the goal of "predictability of cash inflow in relationship to sales" and put into question the goal of "ensuring customers live up to their half of the commercial bargain". The goal of "minimal losses on extended credit" was shattered at two companies. One wrote off $19 million from its A/R sub-ledger and the other wrote off $17 million —all due to the types of black hole-creating items mentioned here.

Is your credit department functioning *as management intended*? Or are black holes impeding the credit department's performance? As this article demonstrates, more than cash flow may hang in the balance.

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