IMPLEMENTING AN INITIAL TRADE CREDIT POLICY FOR AN EMERGING CANNABIS RELATED BUSINESS

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INTRODUCTION

The cannabis market is evolving and more and more companies in all segments of the market that have previously operated only in a cash/COD environment are now starting to extend credit terms to their customers either by choice or due to market competition. This is not an unusual situation. Accounts receivable is often the largest asset on a company's balance sheet.

Implementing a formal process for managing credit & collections and accounts receivable is commonly referred to as a Trade Credit Policy or just a Credit Policy. In this White Paper, we will detail the steps required to implement a Trade Credit Policy. This process may assist with placing your company on a sound financial basis by giving better control of a major asset and making it easier for you to secure external financing.

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HIRING A CREDIT AND COLLECTION MANAGER

The Credit & Collection Manager of a small business is typically going to be, at the start, a solo operator who will be responsible for the entire credit granting and collection process. This includes developing and consistently applying the company's Credit Policy as well as managing and collecting the accounts receivable. The Credit & Collection Manager will also periodically review the credit status of existing customers and be responsible for evaluating the credit worthiness of potential new customers. Having someone in this role may facilitate in increased sales, fewer bad debts, and a more profitable business.

The Credit & Collection Manager does not operate in a vacuum. It is his/her responsibility to interface with sales personnel and communicate credit decisions as quickly as possible for both existing and, in particular, for new customers. If credit is not evaluated on a timely basis the business may suffer.

The Credit & Collection Manager is the fulcrum around which the Trade Credit Policy is organized. Some basic qualifications include:

- Strong computer skills – Aside from knowledge of basic packages (Word, Excel, etc.) ability to install and integrate credit & collection applications
- Degree in accounting, finance or a related field
- At least five years' experience in a credit & collection related function
- Experience with using credit reporting agencies & credit analysis
- Able to communicate effectively both in writing and in person
- Good management skills
- Good interpersonal skills

DEVELOPING A CORPORATE CREDIT POLICY

The Credit & Collection Manager should develop a Trade Credit Policy that lays out how your company will manage its credit and collection process and evaluate credit risk. The new Credit Policy will likely affect the way the company does business and it is important that management understand the consequences of moving from a cash-based environment with no accounts receivable to an organization with a strong focus on managing the accounts receivable.
There are several important objectives for a Trade Credit Policy. According to the Institute of Credit Management, a Credit Policy's objectives should include:

1. To help promote sales
2. To help build good customer relationships
3. To establish standards for obtaining information on which to extend credit
4. To determine profit potential of sales to marginal risks
5. To determine policy and procedures for unusual sales terms
6. To encourage maximum sales – safely
7. To foster cooperation with the sales department
8. To establish full responsibility for all collections
9. To maintain the shortest possible collection period as well as minimum bad debt loss

If these are the overall Credit Policy objectives, then how are they implemented? The Credit Research Foundation suggests that a Trade Credit Policy should identify answers to the following questions:

What is the company's mission?

The mission statement can focus on many different areas depending upon management's main concerns with granting trade credit. Sales is the area of the company that is most affected by the Credit Policy. Not every potential customer will meet your credit granting requirements. So, defining the level of credit risk that you are willing to accept is a major component of a mission statement as it directly affects your revenues and cash flow.

What are the company's goals?

This requires that you specify just how much risk you are willing to assume. The amount of risk you are willing to take places a limitation on the companies you are willing to sell on credit terms. Some of the measures of risk that can be set as goals are:

a. Bad debt as a percentage of sales
b. Days sales outstanding (DSO) – measures the average time in days that receivables are outstanding
c. Percentage of receivables that age beyond a specific number of days (usually 60 or 90)
d. Minimum FICO score of a business owner accepted in lieu of a personal guarantee
e. Frequency of credit limit review
f. Unauthorized deductions as a percentage of sales

An applicable statement in the Credit Policy would put numbers to the above measures; for example, our goal is to limit bad debts to "X%" of sales, DSO to "X" days, etc.

Who in the company has specific credit responsibilities?

You will also need to establish the level of authority for setting credit limits, i.e., the credit manager can grant up to $10,000 in credit, but above that the treasurer, CFO, or owner is needed, etc. Additionally, the criteria for holding up a sales order can be specified, and who can release an order if credit has put a hold on it. Also, the accounts receivables condition (how seriously past-due the account is) that is necessary for enhanced internal collection efforts and the circumstances necessary for turning an account over to an external collection agency should also be specified.

How will credit be evaluated?

Before doing business with a prospective customer, you will need some information on them to help you make your decision on whether you want to extend credit. This will require that the customer complete a "Credit Application" which we will discuss later in this paper. Essentially, you are trying to determine whether the customer will pay their bill promptly and on your terms. If you are comfortable with the customer's perceived risk, you will set a credit limit and start doing business. The initial credit limit may not be as high as the customer requests, depending on your findings. If a high credit limit is requested, you may need to review certified financial statements to meet the customer's needs, In any event, credit limits should be reviewed periodically and if the account becomes overdue you may need to revoke their credit limit.

What are the company's terms of sale?

Your customers need to know what your terms of sale are. The terms should be specified on every invoice. Additionally, if there are penalties for not meeting your payment criteria, they need to be identified. Usually, payment is due in full on a specified date, typically between 7 and 30 days after the customer receives the merchandise (Net 7 or Net 14 or Net 30 on an invoice). In addition, terms may include a discount for early payment; a typical inducement cuts the bill by 2 percent for full payment within 10 days – usually described as “2% 10, Net 30.” You may also require an additional amount (interest or penalty) if a due date is missed. And, if the customer doesn’t pay you, your credit application should detail that the customer will be liable for legal fees and collection costs, and you have the right to establish the jurisdiction if legal action is required to get the debt paid.

How will the company handle collections?

Collecting your accounts receivable as quickly as possible is important for your financial success. Therefore, having a documented collection strategy is a major requirement. The two critical factors in such a strategy are: (1) When should you consider an account severely delinquent, and (2) What are you going to do about it when it occurs? Your approach to this problem needs to be considered in your Credit Policy.

Additionally, a Credit Policy must be in writing and it should be dynamic. As business conditions change the Credit Policy needs to be reviewed and modified, as required.

SELECTING THE SOFTWARE FOR MANAGING CREDIT AND COLLECTIONS

The key to any successful credit & collection operation is having the right “Order to Cash” (OTC) software in place to help manage the credit & collection process. There is a myriad of software options available both in-house and cloud-based at various price ranges. This is not a replacement for QuickBooks, which many cannabis based business use to run the financial side of their business or any ERP system that you may have implemented. Order-to-Cash systems are bolt-on application that sit on top of either QuickBooks or whatever ERP system your company uses to manage your business. To implement an Order-to-Cash system you will need to document your requirements, and then evaluate the numerous software alternatives with respect to how closely they meet your needs. If possible, try to minimize system modifications. If an existing system meets over 90% of your requirements, try to live with it. Software modifications are expensive and require extensive testing before they can be put into production.

Order to Cash systems are a set of integrated programs that allow a company to efficiently manage their cash flow from the time they take the order to the time they receive the payment. Fully integrating order entry, billing, payment processing and cash application eliminates the possibility of human error and can cut days or weeks off the order to cash process. A typical OTC system consists of the following modules:

- Customer master file
- Order entry (creation of order / booking of order)
- Invoicing
- Customer payments
- Cash application
- Deductions (If invoice short paid by customer)
- Collection (dunning letters, etc.)

Lack of cash control has put many companies into bankruptcy. By prioritizing and refining the order to cash system, you are setting your company up for long-term success.

MAINTAINING THE CORPORATE CREDIT POLICY

Implementing and Using a Credit Application

A credit application is more than just a form for requesting credit. A credit application is a contract between the seller and the buyer. A good credit application will benefit the seller, a bad one the buyer. Therefore, it is important to your company that your credit application, whether electronic or on paper, contains all the safeguards and guarantees available to reduce customer risk. Securing a credit application does not guarantee payment, but it is one of the more significant documents you can obtain to assist you in making a good credit decision and ultimately collecting your past-due accounts receivable and associated collection fees.

A typical credit application requires that at least the following information be provided:

- Name and address of the applicant
- Name and address of any parent company
- All contact information (i e: phone #'s, e-mail addresses etc.)
- Type of entity (i.e., corporation, partnership, proprietorship, etc.)
- Names of principals/directors/officers
- Bank references
- Trade references - at least three
- Tax ID and DUN & BRADSTREET number
- Availability of financial statements
- Credit limit requested
- Applicant's agreement to payment terms
- Applicant's agreement to interest on past-due amounts
- Applicant's agreement to pay for legal and collection costs
- Applicant's personal guaranty(s) with spouses if possible and authorization to pull personal credit report with SS#.
- Right to verify data on application from external sources (banks, trade references, credit bureaus, etc.)
- Signer(s) is an officer or authorized to bind the buyer

Once you have the credit application in hand, you should verify the information it contains. The first thing you should do is pull a commercial credit report from one of the leading credit bureaus such as Dun & Bradstreet, Experian or Cortera. Cortera has created a cannabis specific database and now has credit reports available on more than 20,000 cannabis related business. We recognize many of your prospective customers will not have a lengthy credit history, but this will change as the cannabis industry moves forward and more credit bureau data becomes available. In a perfect world you would look to get the following; at least three trade credit references that you can contact as well as their banks to verify the existence of their checking account(s). You should be sure that all their references are legitimate. If for some reason you can't contact one - be sure that at least they exist. Any false information on the credit application is a strong sign not to do business with that potential customer. If the buyer is looking for a substantial credit line, you will want to review their financials (if you can get them), especially a statement of cash flows. If they are operating in a negative cash position you need to be sure that they will have enough cash available to pay you. Limit their credit line or at the very least change their terms if it looks like they may have a cash flow problem.

Periodic credit reviews are a necessity. More account defaults come from existing long-term customers than from new customers. Customer credit limits should be reviewed periodically, at a minimum once a year. Additionally, obtaining current credit bureau reports on your largest customers annually is a good idea. Stay on top of your accounts receivable aging. If a customer is always 30 to 60 days past-due on some part of their balance, they are only one period away from being a problem.

Determining and Managing Credit Limits for New Customers

One of the best uses of the generic credit scores provided by credit bureaus as well as their company data is to help you review new applicants for credit. The bureaus have reports that are specifically designed to help you review new applicants. In most cases, you will likely only provide a small line of credit to a new account until you have been doing business with them for a reasonable period and are happy with their payment pattern. Once you increase their credit line, you'll have to protect yourself against the possibility of the account's credit deterioration, over time, which means purchasing additional credit bureau information in the future.

Deciding what type of credit evaluation system to use with new applicants is a function of the volume of new applicants and the credit limit requested. The various credit evaluation systems available range from: (a) using only bureau data for a low number of monthly applicants possibly supplemented by financial statements and bank references, if a large credit line is requested to; (b) using a judgmental rule-based system supplemented by financial statements and possibly bureau generic scores and bureau reports to; (c) using a custom statistical-based system enhanced with bureau data, if there are a large number of new applicants each month.

Determining and Managing Credit Limits for Existing Customers

For evaluating a request for additional credit or determining the collectability of a past-due account for an existing customer, as a SMB, you are probably not going to invest in building a robust credit scoring model that analyzes your portfolio. Most of your decisions are going to be manual and based on the historical payment performance of your customers as well as whatever data you can get your hands on to help you in your decision.

However, once you have enough customers on credit, say 150 or more, a credit evaluation system may be beneficial. These systems may be more or less robust, from: (a) using bureau credit reports supplemented by an analysis of customer payment patterns to; (b) using bureau generic credit reports together with customer financial statements to; (c) using judgmental-rules based systems enhanced with bureau data to; (d) using a statistical-based credit and collection scoring system that utilizes internal data to; (e) using a custom designed statistical-based system enhanced with bureau data.

Developing an Internal Collection Strategy for Managing Accounts Receivable

No matter how good you are in evaluating customer credit, some accounts to which you have extended credit will not pay you on time, and others will not pay you at all. You need to be prepared for this eventuality and have a policy in place to handle it. Collecting your accounts receivable as quickly as possible is important for your financial success, so having a documented collection strategy is a major requirement. As noted before, the two critical factors in such a strategy are: (1) When should you consider an account severely delinquent, and (2) What are you going to do about it when it occurs?

Here are some specific customer account characteristics that indicate you may have a collection problem:

- Your terms are net 15 and the account is over 60 days past due.
- You have called the account several times and they haven't returned your calls. Additionally, they haven't responded to your emails or your collection letters.
- A review of their AR shows very erratic purchasing activity.
- The account has stopped buying.
- All recent payments, when they have paid you, have been from different banks.
- You get negative information from an

independent credit reporting service or you belong to a trade group and one of the members provides you with negative information on the account.

- The account refuses to settle certain disputes which you feel should be easily handled.

Typically, the Credit & Collection Manager/Department is responsible for internal collection activity. This can mean collection letters/emails supplemented with telephone collection calls. To maximize internal collection effort, sales should work with credit. When there is a problem with a customer, sales should help in collecting past due monies owed. Additionally, if the situation escalates and you are still not getting paid, the sales rep who handles the account should personally visit the customer to discuss a possible payment arrangement. In any event, if the customer is seriously past due, it is not responding to your calls, and communication attempts fail, there should be no further shipments until acceptable payment arrangements are in place.

It is the responsibility of the Credit & Collection Manager/Department to determine if all internal collection efforts have been exhausted, and what to do once they have. Most uncollectable accounts are still operating businesses, and if they are refusing to pay it is probably time to bring in a third-party collection agency to assist in your collection efforts. Collection statistics indicate that once an account goes over 90 days past due, to maximize the probability of collection, it should be turned over to a collection agency as the chance of collecting in-house significantly decreases once the customer is 90 days or more past due.

UTILIZING A THIRD-PARTY COLLECTION AGENCY

There are at least three good reasons to use a third-party collection agency to help collect past due accounts:

A collection agency will collect from accounts that you could not.

Your past-due accounts won't talk to you, but they will talk to an agency or the collection agency's attorney. The agency knows that to collect, it must make contact with the account and it won't stop trying until it does. A good collection agency will make 10 to 15 attempts to reach your former customer in the first 30 to 45 days it has the file. This is typically about 3 times the number of attempts your internal staff will make. As the agency's fee is based on what it collects, an agency will be more persistent and assertive than your internal collectors are at this stage of the customer lifecycle. Remember that the collection agency does not get paid unless it collects your money.

Using an agency frees up the time and resources needed to manage your current active business.

Collecting money is very time consuming. You need to send letters, emails, possibly make customer visits and make phone calls, lots of phone calls. This takes time away from the things you and your employees need to do to manage and run your business on a day to day basis.

A collection agency utilizes technology that you do not have.

This makes the agency far more proficient at collecting money than their clients. The agency possesses advanced tools that help it locate and contact debtors. This technology is costly and unless you are in the collection business you won't have it. Additionally, their personnel are professional debt collectors.

CONCLUSION

In this paper, we have tried to lay out the rationale for a cannabis related business to implement a formal Trade Credit Policy, which may assist you in properly evaluating your customer's credit worthiness and collecting your accounts receivable on a timely basis. It may improve your bottom line and accelerate your growth.

In the development of this White Paper we used information from the Institute of Credit Management and The Credit Research Foundation.

If you have any questions about anything in this White Paper, you can contact Sam Fensterstock SVP of AG Adjustments at samf@agaltd.com