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Protecting Your Assets: A Well-Defined Credit Policy Is The Key

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Abstract
In - Protecting Your Assets: A Well-Defined Credit Policy Is The Key – an essay by Steven V. Moll, Associate Professor, The School of Hospitality Management at Florida International University, Professor Moll observes at the outset: "Bad debts as a percentage of credit sales have climbed to record levels in the industry. The author offers suggestions on protecting assets and working with the law to better manage the business."

“Because of the nature of the hospitality industry and its traditional liberal credit policies, especially in hotels, bad debts as a percentage of credit sales have climbed to record levels,” our author says. “In 1977, hotels showing a net income maintained an average accounts receivable ratio to total sales of 3.4 percent. In 1983, the accounts receivable ratio to total sales increased to 4.1 percent in hotels showing a net income and 4.4 percent in hotels showing a net loss,” he further cites.

As the professor implies, there are ways to mitigate the losses from bad credit or difficult to collect credit sales. In this article Professor Moll offers suggestions on how to do that.

Moll would suggest that hotels and food & beverage operations initially tighten their credit extension policies, and on the following side, be more aggressive in their collection-of-debt pursuits.

There is balance to consider here and bad credit in and of itself as a negative element is not the only reflection the profit/loss mirror would offer.

“Credit managers must know what terms to offer in order to compete and afford the highest profit margin allowable,” Moll says. “They must know the risk involved with each guest account and be extremely alert to the rights and wrongs of good credit management,” he advocates. A sound profit policy can be the result of some marginal and additional credit risk on the part of the operation manager.

“Reality has shown that high profits, not small credit losses, are the real indicator of good credit management,” the author reveals. “A low bad debt history may indicate that an establishment has an overly conservative credit management policy and is sacrificing potential sales and profits by turning away marginal accounts,” Moll would have you believe, and the science suggests there is no reason not to.

Professor Moll does provide a fairly comprehensive list to illustrate when a manager would want to adopt a conservative credit policy. In the final analysis the design is to implement a policy which weighs an acceptable amount of credit risk against a potential profit ratio.

In closing, Professor Moll does offer some collection strategies for loose credit accounts, with reference to computer and attorney participation, and brings cash and cash discounts into the discussion as well. Additionally, there is some very useful information about what debt collectors – can’t – do!

Keywords
Steven V. Moll, Bad debt, Accounts receivable ratio, Credit management, Collections, Consumer Credit Protection Act, Truth in Lending Act, Fair Credit Billing Act, Fair Debt Collection Practices Act, FIU, Beverage
Protecting Your Assets: A Well-Defined Credit Policy Is the Key

by Steven V. Moll

Bad debts as a percentage of credit sales have climbed to record levels in the industry. The author offers suggestions on protecting assets and working with the law to better manage the business.

In this society, people are more conscious of their legal rights than ever before. Litigation has become a way of life for many hotels, restaurants, and clubs.

Because of the nature of the hospitality industry and its traditional liberal credit policies, especially in hotels, bad debts as a percentage of credit sales have climbed to record levels. In 1977, the accounts receivable ratio to total sales was 22.2 percent. By 1983, the ratio had increased to 25.5 percent.

To show further evidence of the use of credit in hospitality establishments, the range for the use of cash as a method of payment in hotels, depending upon the size, location, rate, and availability of food and beverage outlets, was between 19.8 and 41.1 percent; the mean of all establishments was 28.3 percent. The method of payment most used other than cash was credit cards; a range between 9.2 and 18.2 percent was for open accounts, with the mean being 13.9 percent.

To combat these losses, controllers of these various organizations must become more aggressive in implementing policies which tighten the extension of credit and make the collection of debts a more aggressive exercise.

The credit terms a hospitality establishment offers in today's highly competitive business environment are often the only advantage over the competition. Frequently, one property's opportunity to turn a profit is a credit risk the competition would not accept.

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ability to pay and, therefore, the hotel, restaurant, or club must suffer the consequences. According to this rationale, the business with the lowest amount or percentage of bad debts has the best credit management. Reality has shown that high profits, not small credit losses, are the real indicator of good credit management. A low bad debt history may indicate that an establishment has an overly conservative credit policy and is sacrificing potential sales and profits by limiting new accounts. Maximizing income is the result of building sales volume and absorbing some credit losses along the way.

The real measure of a good credit manager is not his or her ability to eliminate credit losses, but the ability to determine how much risk to take in order to maximize income. The following factors lead to the point where it cannot be determined how much to authorize credit.

Factors which might indicate the necessity for a liberal credit policy:

- The economic environment is unfavorable.
- The market is declining.
- Demand for services is higher than the ability to serve.
- The company's financial position is extremely extended.
- Inventories are low and cash flow is restricted to the point where it can be used to service an authorized credit limit.
- The business is declining.
- An order which has been made requires expensive changes. Building sales volume and absorbing some credit losses supports the case for a liberal credit policy. A company's profit margin is one major factor to use as a guideline.

Factors which would lead to a conservative policy include:

- The business is trying to establish new markets and needs accounts.
- The environment is extremely competitive.
- The inventory is very large.
- The market is declining.
- To the next season.
- The business is reaching the end of the season and there would be:

Building sales volume and absorbing some credit losses supports the case for a liberal credit policy.
Credit Policies Should Be Implemented

The implementation of a credit policy which suits a business’ needs is not difficult. It is commenced by determining the number and types of risk categories for the establishment. A manager would monitor the amount or degree of risk within each category by studying annual sales and bad debt losses for each. New accounts would be classified on a “guesstimate” basis according to the information available.

It is imperative, as with all financial information, to have the account classifications up-to-date and timely. Whatever policy an establishment adopts, it is important to keep it flexible. The economic environment in which all business operates is extremely volatile, and what was conservative today may be liberal tomorrow. An excellent guide to follow is a company’s records for total sales and credit sales. Even though a credit policy accepts a certain percentage of high risk accounts and a business may suffer bad debt losses, each individual loss should be treated as an unforeseeable mistake. Never grant credit without having a reasonable certainty that the guest has the ability and desire to pay.

The amount of reasonable certainty of a guest’s ability to pay is a result of investigation of that guest. Management should take the time to perform a credit check of his or her financial statements or should query a credit bureau. This will show if the guest has shown steady financial growth and profits and how much the guest will be able to pay. The most reliable source of information about a guest is a personal impression. It is good idea to meet the guest, if possible, in order to make judgments about the person’s ability and character.

An excellent collection policy is set by management. High powered, aggressive collection techniques are essential. Accounts receivable are frozen assets which tie up the business’ cash flow and can complicate business, reduce profits, and stunt growth. In the hospitality industry this causes thousands of business failures each year. The cure for this unhealthy accounts receivable position is an aggressive collection policy which is strengthened by strong training. High powered, aggressive collection techniques are needed. Sales and marketing managers should be taught how to recognize the characteristics of high risk accounts and how to follow a procedure to collect those accounts. A guest’s financial statements should be examined to discover if the guest’s financial position is strong enough to warrant the extension of credit. Information about the guest’s financial position is the most difficult aspect to investigate because it is intangible. The most reliable source of that information is a personal impression. It is a good idea to meet the guest, if possible, in order to make judgments about the person’s ability and character.

Many managers are skeptical about their salespersons’ abilities to judge the credit standing of a potential sale. It is thought that salespeople are not temperamentally suited nor interested in reporting credit data. They must be taught the importance of credit evaluation because the time spent selling an unworthy risk is wasted. The most comprehensive data available would be financial statements. Management should be careful, however, not to give the guest the idea that it wants these statements because it is gauging the guest’s risk. The guest’s financial condition should be an integral part of his or her overall evaluation. Most companies would be prudent and cautious about doing business with guests whose financial statements indicated an unhealthy financial position. However, the guest’s financial condition should be an integral part of the total evaluation. Management should be careful, however, not to give the guest the idea that it wants these statements because it is questioning his or her credit.

Accounts receivable which are overdue are assets which tie up the business’ cash flow and can complicate business, reduce profits, and stunt growth. In the hospitality industry this causes thousands of business failures each year. The cure for this unhealthy accounts receivable position is an aggressive collection policy which is established by management. High powered, aggressive collection techniques are needed. Sales and marketing managers should be taught how to recognize the characteristics of high risk accounts and how to follow a procedure to collect those accounts. A guest’s financial statements should be examined to discover if the guest’s financial position is strong enough to warrant the extension of credit. Information about the guest’s financial position is the most difficult aspect to investigate because it is intangible. The most reliable source of that information is a personal impression. It is a good idea to meet the guest, if possible, in order to make judgments about the person’s ability and character.
Detractors who suffer seasonal slumps are a problem. When business is slow, cooperation and understanding are required of both parties. This cooperation is essential because the volume of business can affect the cash flow, and each party must work together to ensure that the business runs smoothly. A healthy relationship between the establishment and the customer is crucial for the success of both parties.

A more serious problem is the delinquent debtor who suffers from a shortage of money or a lack of desire to fulfill an agreement. These debtors fall into the delinquent category. They do not owe the establishment the money due, but they could have their problems. They do bring in the needed cash, but they could also lose customer confidence and sales volume in the long run. Collection strategy should be flexible.

Management should develop an appropriate collection policy so that the system works effectively. The system once developed should not be changed. Changes in the system should be minor and should require only minor adjustments. A systematic approach to collection ensures that the establishment is not penalized by late payments. The establishment must be flexible and understanding.

Many times a guest's payment is late because of an honest misunderstanding. This highlights the need for the salesperson to educate the guest as to the type of credit being extended, the terms, the rate, the discount, and the due date. Once properly educated, the honest guest will usually pay on time. Salespeople are usually the cause of this problem. The typical salesperson has a single motivating interest - to sell the service or product. When a potential guest asks how long payment terms may be, the salesperson usually replies "no problem" or "don't worry." This is a battle against human nature. To sell the service or product, the salesperson must educate the guest about the establishment's credit policies.

A letter of credit explanation, which should go to every new guest, would streamline teaching sales personnel and guests. The detail of the letter depends upon the type of guest and the nature of his or her business with the establishment. A willingness to help, the ability to serve, and integrity should be emphasized.

Many receivables become overdue because of inefficiencies, indifference, or carelessness. A signal this is occurring is a patternless lateness, payment coming anywhere from one to four weeks late. Usually the way to receive payment from this type of account is to send a firm, polite letter explaining the importance of prompt payment. If you start receiving excuses more than two or three times, a firm, polite letter should be sent explaining the importance of prompt payment. If you start receiving excuses more than two or three times, a firm, polite letter should be sent explaining the importance of prompt payment. If you start receiving excuses more than two or three times, a firm, polite letter should be sent explaining the importance of prompt payment.

A more serious problem to an establishment is the delinquent debtor who suffers from a shortage of money or a lack of desire to fulfill an agreement. These debtors fall into the delinquent category. Disasters or a strike may cause a delinquent debtor to become a delinquent debtor. If a case like this is verified, it is wise to be very lenient. Offer the debtor a grace period, and, if the debtor fails to pay within the grace period, let the debtors know that no further leniency will be granted.

Debtors who suffer seasonal slumps are a problem. When business is slow, cooperation and understanding are required of both parties. This cooperation is essential because the volume of business can affect the cash flow, and each party must work together to ensure that the business runs smoothly. A healthy relationship between the establishment and the customer is crucial for the success of both parties.
ness is booming, they pay their bills on a timely basis. When the slump occurs, you wait and wait. These types of debtors can develop into prime accounts if given time. Management must be alert to the seasonal debtor who is severely undercapitalized and is probably not going to survive the off-season.

**Attorneys Can Be Useful**

There will be times when the credit department discovers the reason a guest has fallen behind in payments is because his or her business is going bankrupt. This is an urgent situation. Management must do everything in its power to collect the debt immediately. It is important to use the strictest methods available; the establishment's attorney should be consulted.

Another situation where use of the attorney would be necessary is in cases of fraud. When this occurs, gather all documentation and evidence of the fraud but discuss the case with no one because it may open management and the establishment to charges of slander and libel. Once the evidence has become definite, turn the entire affair over to company attorneys.

Many circumstances have been discussed as to why guests fail to pay their bills on time. There are just as many reasons why they would take an unearned discount. It is possible they misunderstood the terms or discount procedures. If taken innocently, a simple note will solve the situation. However, guests who deliberately take an unearned discount are testing the business and the way management reacts will be the determining factor for future dealings. When responding to such a challenge, have a variety of strategic options prepared. Management may be lenient and allow the discount; it may also be lenient but firm, allowing the discount this time but sending a letter indicating it will refuse any future attempts at taking the discount. Management may strongly adhere to its policy and refuse the discount.

There are strengths and weaknesses to each of these options. If a business really needs volume, allowing the discount may be the correct approach to this situation, although it is a poor long-range strategy. There are cases which support the other methods, but the best approach is to let theguests know the discount is a poor long-range strategy.

Depositing a check when a customer has taken an unearned discount is to be firm but polite in implementing long-range policies. The discount arrangement may also suggest a check to the guest and provide a letter stating it will take precedence any future deposits at checking the situation. However, guests who take an unearned discount are testing the business and the way management reacts will be the determining factor for future dealings.
Informing guests that they are borrowing money at very high rates of interest when they do not take the offered discount may encourage prompt payment. If you offer a 21% net 30 discount, payment within the first 10 days would save a 36% annual rate of interest.

Advantages to a cash discount are:
- Immediate cash on hand
- Lesser needs for borrowing from banks
- The ability to take cash discounts from purveyors.

Disadvantages to offering a cash discount are:
- Guests take unearned discounts.
- Some guests may feel they are being slighted because they do not have the ability to pay within the short period of time required, but can within the 30 days required. Cash discounts give no real economic value but are a source of encouragement to guests to pay when they should.

Cash discounts are allowable under the Robinson-Patman Act as long as they are allowed uniformly to all guests of all classes, not discriminating against business versus social guests, for example. A hospitality company may be in violation of this act by granting to groups of otherwise equal classes of guests, not discriminatorily, a reduction in price or other financial advantage.

Collection Letters Are Effective

The most popular method of credit collection is the collection letter. There are many manuals and books which suggest dozens of letter types. The credit manager must establish a strategy for collecting the debt. If a telephone campaign is launched, the person or persons doing the calling should be firm and polite and have a strong voice. In the case of large accounts, the manager should make the call. When the telephone campaign is launched, the position of personnel doing the debt sale of outstanding balances should be firm and polite and have a strong voice. The credit manager must establish a strategy for collecting the debt.

The credit manager must establish a strategy for collecting the debt.
Make sure to communicate with the right person.

Use the correct title.

Get and keep the person's attention.

Get the response you desire.

Avoid arguments.

Keep control of the situation.

If promises are made, keep them.

Keep control of the situation.

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Get and keep the person's attention.

Use the correct title.

There are many times in the collection process when drastic measures are called for. In these cases it is imperative to make and stick to the decision to collect the funds even though it may mean losing the future sales volume of that client. If the word gets out that a company's collection practices have no teeth, thereby attracting marginal credit risks. This practice might even offend good customers if they discover a company's leniency.

When collection is so delinquent that management has run out of options, it may be time to turn to a collection agency. In many hotels, restaurants, or clubs, a specific 90 through 180-day cycle mandates turning receivables over to a collection agency. As a credit manager, it is important to establish the specific timing when receivables are turned over. This determination should analyze the probability of collecting the debt and the costs incurred in collection. It is important to remember that the collection agency is a company's legal agent and to remember that the collection agency should guard the probability of collection and the costs incurred in collection. The collection agency has a greater sense of urgency to its methods. The people who work for a collection agency can be blunt and tough and can sometimes do more harm to your company's reputation. A credit manager should carefully review the collections agency's methods and determine if they are appropriate for your company.

Because hotels, restaurants, or clubs have the right to charge interest on amounts owed does not mean they actually do. Many hesitate because of the potential loss of sales. Some people feel charging interest encourages late payments, but it is all right as long as they pay the interest on time. A hotel, restaurant, or club's main purpose is to collect while generating good will and fostering more sales. A collection agency may have a greater sense of urgency to its methods. The people who work for a collection agency can be blunt and tough and can sometimes do more harm to your company's reputation.

When a company intends to charge interest, however, it is a very smart idea to have the conditions printed on all statements. The way to keep the conditions printed on all statements is to make sure the person's attention

If promises are made, keep them.
interest costs by deferring payments. By paying on time, they will save themselves high interest costs. One of the most effective ways of encouraging the payment of debt is to allow partial or split payment. This should be allowed as an exception to the rule rather than as a set policy. It shows a company's willingness to work with a client who may be having a cash flow problem, fostering goodwill and encouraging future sales volume.

When accounts have been delinquent for some time, it is important to go through a management checklist to analyze and evaluate the type of delinquency. This list should reflect:

- What is the amount due?
- How long has it been overdue?
- What has been the client's pattern of payment?
- How long has this account been a client on the books?
- What have been the previous experiences with this client?

Computers Aid in Collection Management

Collection management has been brought into the modern era with the advent of computers. The speed and accuracy of the collections process is magnified with the reports available to management. Management must not forget, however, that the collections process in this industry is a humanistic one. It must not allow the mechanically generated materials to take the place of human thought and reason. Credit managers must have the qualities to judge human nature and a vast knowledge of financial matters. They must also do a good job of keeping the client abreast of the progress of the collection process. The client must not lose sight of the human element in the interaction.

In the past 25 years, a number of laws and regulations have been enacted that deal with the collections process. The federal consumer proceedings are known as the Consumer Credit Protection Act. Title 1 is known as the Fair Credit Billing Act; Title 6 is known as the Equal Credit Opportunity Act; Title 7 is known as the Fair Debt Collection Practices Act; and Title 8 is known as the Fair Credit Reporting Act. The federal consumer proceedings are known as the Consumer Credit Protection Act. Chapter 4 is known as the Truth in Lending Act.

The federal consumer proceedings are known as the Consumer Credit Protection Act. Chapter 4 is known as the Truth in Lending Act.
While it is impractical to review the entire extent of the consumer credit legislation, it is important to review where the hospitality credit manager must go to find the credit legislation which pertains to the situation. Compliance with the Truth in Lending Act involves anyone who grants consumer credit. Only consumers are covered, which is to say the credit is used for personal, family, or household credit. All such credit transactions are covered up to $25,000, except real estate transactions, which are covered to any amount. The definition of a creditor, the one to whom the customer must make initial payments, is a person or business which extends credit more than 25 times a year which is payable by written agreement in more than four installments, or which is subject to a finance charge. The Truth in Lending Act takes precedence over state laws except where the Federal Reserve deems those statutes to be “substantially similar” to the act and to have adequate enforcement provisions backing them.

Credit managers should determine which laws apply in every area in which they do business. The substitution of state regulations applies only to disclosure (terms of credit disclosed before the credit is extended) and rescission (specifying the right to repeal a transaction by a specific date). The sections regarding garnishment, advertising, and loan-sharking apply to all instances.

Where federal and state laws differ, the credit manager must make two disclosures to satisfy the requirements of both, unless the state laws are preempted by the federal law. If management is unsure, the Federal Reserve Board can be contacted to determine if state laws are inconsistent with federal laws.

Debtors Also Have Rights

Inconsistent with federal laws, inconsistent with federal laws.

The requirements of the Equal Credit Opportunity Act of 1977 take effect as soon as an application for credit is received, or even earlier if a company advertises. This act is prohibitory in nature. It prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, and age. A company may not make statements which would discourage a reasonable person from applying for credit. It may not request information about the applicant's race, color, religion, and national origin except for monitoring purposes. It may not request information about the applicant's age, religion, and national origin except for monitoring purposes. It may not request information about the applicant's race, religion, and national origin except for monitoring purposes. It may not request information about the applicant's race, religion, and national origin except for monitoring purposes.

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A sound credit determination system, except that an older applicant may not be assigned a negative factor. The creditor may also ask about marital status in community property states, and in other states unless the application is for separate unsecured accounts. Within 30 days of receiving a completed application, the creditor is required to notify the applicant about what action has been taken on the application.

The Fair Credit Billing Act protects consumers against inaccurate or unfair practices of open-end credit. The act requires the creditor to inform debtors of their rights and the responsibility of the creditor under the act. The principal responsibility of this act is to provide for prompt settlement of billing disputes.

The Fair Credit Reporting Act is an area many hospitality management establishments feel they never are responsible for learning. This is not necessarily true, however, if one of the following circumstances occurs:

- If a business sometimes or regularly tells other businesses what has been learned about a guest's credit worthiness.
- If a business shares data of this type with others in the business or location.

The Fair Deed Collection Practices Act refers to one of the most pertinent areas which relates to the hospitality industry: the unfair, deceptive, and abusive practices in the collection of debt. It specifies the responsibilities of debt collectors and defines prohibited actions. The act prohibits:

- Communicate any language or symbol on an envelope or
- Communicate by position;
- Communicate with anyone other than the debtor more than once time;
- Communicate that the consumer owes any debt.

Business or Location:

If a business shares data of this type with others in the business or regularly tells other businesses:

- Occurs:
- The Fair Credit Reporting Act is an area many hospitality management establishments feel they never are responsible for learning. This is not necessarily true, however, if one of the following circumstances occurs:
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Credit procedure starts with a well-thought-out strategy, followed by strict control systems intertwined with compliance with federal and state laws. Following all these procedures will enable a hospitality company to enjoy continuing profitability.

References

4. Ibid., p. 27.