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

by
Steven V. Moll
Associate Professor
School of Hospitality Management
Florida International University

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 cognizant 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, hotels showing a net income maintained an average accounts receivable ratio to total sales of 3.4 percent.[1] 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.

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 percent and 18.2 percent was for open accounts, with the mean being 13.9 percent.[2]

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.

Credit managers must know what terms to offer in order to compete and afford the highest profit margin allowable. They must know the risk involved with each guest account and be extremely alert to the rights and wrongs of good credit management.

Many managers feel bad debt is a signal that someone has made a mistake, that a clerk did not take the time or trouble to verify a guest's

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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 management policy and is sacrificing potential sales and profits by turning away marginal 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. There are many factors to consider when deciding to adopt a conservative or 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 would be:

- The economic environment is unfavorable.
- An order which has been made requires expensive changes before it can be placed into service.
- Business is slumping badly.
- The company's financial position is extremely extended to the point where it cannot assume even an average credit risk.
- Demand for services is higher than the ability to serve the market.
- Inventories are low and cash flow is restricted to the point where business cannot be built up immediately.

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

- The business is reaching the end of the season and there is the feeling that it is not financially sound to make it to the next season.
- The market is declining.
- The inventory is very large.
- The environment is extremely competitive.
- Marketing costs are extremely high.
- The business is trying to establish new markets and accounts.
- Overhead is so high that the business must maintain high sales volume in order to prevent losses.

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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 also how much the guest will be able to pay.

Finally, it is important to research the moral fiber of the guest, the most difficult aspect to investigate because management is trying to discover the guest's personal reputation. This data is available from a number of sources. Much can also be learned from a personal interview of the guest and from guest-supplied references or credit agencies. Reliance on a Dun and Bradstreet credit rating is another popular method. Other sources might be accountants, lawyers, or banks. The source chosen depends upon the credit information requirements.

The most reliable source of information about the guest is a personal impression. It is a good idea to meet the guest, if possible, in order to make judgments about the person's abilities 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 it wants these statements because it is questioning his or her credit.

Accounts receivable which are overdue are assets which are frozen. They 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 set by management. High powered, aggressive collection techniques

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have their drawbacks. 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

Collection strategy, therefore, should be kept flexible. Detecting late payments requires constant checks through the receivables file. A systematic aging of receivables at frequent intervals is necessary. Computer assistance in this area facilitates this mundane function with speed and accuracy, freeing personnel to perform the "people functions" of actually collecting the money.

Management should develop an appropriate collection policy so the effort works efficiently. The system, once developed, should alert management to accounts as they become overdue, remind them of previous collection efforts, and inform them of the next step that should be taken.

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, but credit managers must educate the sales force, with strong cooperation from the sales manager.

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 reminder. If you start receiving excuses more than two or three times, a firm, polite letter should be sent explaining the importance of prompt payments. Guests who see they can take advantage of credit will continue to do so, thus becoming a negligent debtor. If the guest says the billing department failed to mail a statement on time, accept it. Check the matter with the billing clerks. Be cautious if the customer uses this excuse a second or third time.

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 serious collection category. Disasters or a strike may cause a client to become a delinquent debtor. If a case like this is verified, it is wise to be very lenient. Offering cooperation and expressing concern for his or her situation can generate a tremendous amount of good will.

Debtors who suffer seasonal slumps are a problem. When busi-

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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. If, however, guests took the discount deliberately, they 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 stating it will refuse any future attempts at taking the discount. Management may also 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 be firm but polite in implementing long-range policies.

Depositing a check when a customer has taken an unwarranted discount only confirms the deduction when the guest has written "paid in full" or "in full satisfaction" or some similar saying. People who try to do this are called "terms chiselers."

During the 1970s, many credit managers felt that the cash discount lost its appeal, but the 1980s and new interpretations of credit laws have brought the cash discount back to popularity. In the hospitality industry, especially in hotels, encouraging payment as close to the immediacy of the transaction as possible is desired. This form of transaction has become very popular at gasoline stations across the nation. If an establishment offers discounts for cash payments, simply educating the guest may speed the collection rate.

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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 2/10 net 30 discount, payment within the first 10 days would save a 36 percent 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.
- Costing analysis would be simplified.
- 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, as an example. A hospitality company may be in violation of this act by giving in to terms chiselers.

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, stressing the importance of the matter or the importance to the client. Calling guests at too early a date may turn them off, so having a written policy as to when the campaign begins is important.

Collection Letters Are Effective

The most popular method of credit collection is the collection letter. There are many manuals and books which can suggest dozens of varieties of letters to send to clients, depending upon the severity of the amount and length of time the debt has been outstanding. Compiling a list of these letters and a manual for the credit staff to use will provide consistency of application of policies and allow for a smooth transition if personnel leave the credit department.

Regardless of the method chosen to communicate with guests, there are important points to remember when doing so:

- Collect all information.

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- 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.

There are many times in the collection process when drastic measures are called for. In these cases it is imperative to make and stick with the decision to collect the funds even though it may mean losing the future sales volume of that client. It may be imperative to do so if the word gets out on the street 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 the business is responsible for its actions. With this in mind, it is of utmost importance to take great care in choosing the right agency. A good idea is to verify if agency personnel are bonded.

If a hotel, restaurant, or club has a good credit office, why use a collection agency? A hotel, restaurant, or club's main purpose is to collect while generating good will and fostering more sales. A 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 enrage the client. The hotel, restaurant, or club can blame the agency if this occurs, but the credit office of your company did not commit the blunder, providing, hopefully, a saving grace.

Because hotels, restaurants, and 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 is all right as long as they pay the interest. This puts the hospitality operator in the credit or loan business, a position none wants to be in.

If a company intends to charge interest, however, it is a very smart idea to have the conditions printed on all statements. The way to encourage faster collection is to remind clients they are incurring high

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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 good will 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?[3]

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 be tough and thorough. Without these qualities, they would be in an untenable position to make decisions regarding the extension of credit.

In the past 25 years, a number of new laws regarding debt collection have come about. These laws have been established on the local, state, and federal levels and cover almost every area of credit collection. Because they are primarily statutory in nature, interpretation is limited; therefore, it is necessary to comply specifically. The majority of federal laws in the credit area deal with individual consumer credit. State laws do not always relate to federal law; therefore, it is important to always obtain state laws before making a decision on the applicability of a regulation or law.

The federal consumer proceedings are known as the Consumer Credit Protection Act. Title 1 is known as the Truth in Lending Act, Chapter 4 as the Fair Credit Billing Act, Title 6 as the Fair Credit Reporting Act, Title 7 as the Equal Credit Opportunity Act, and Title 8 as the Fair Debt Collection Practices Act.

As one reads through this myriad of laws, one realizes the need for assistance in selecting the appropriate forms to use on specific occasions. The Federal Reserve System has prepared sample forms to use which conform with the requirements of the law. The local office

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of the Federal Reserve will assist in securing them.

While it 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

Failure to comply with the Truth in Lending Act is a civil offense. A debtor who successfully sues a creditor for failure to comply with the act may collect attorney's fees and costs of the suit, as well as real damages.[4]

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; inquire about child support or alimony; inquire about marital status (except in community property states); require a spouse's signature as a condition of the loan (except in special circumstances); and request information about child-bearing intentions or birth control practices.

As the creditor, a company may request information about a spouse or former spouse if he or she will be allowed to use the account or be liable for payment and if the applicant is relying upon community property or the spouse's income for repayment of the debt. In addition, the creditor may use the applicant's age as a factor in a demon-

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strably 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 Credit Reporting Act is a very important part of consumer credit law. Its purpose is to protect consumers from penalties caused by incorrect information which may be contained in a company's credit files. A company should not include information in credit reports which are shown to be incorrect or cannot be verified.

The Fair Debt 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 specifically creates prohibitions and limitations on what may be done by debt collectors by defining unfair collection practices, validating procedures regarding debts, specifying allowable actions regarding multiple debts, and stating actions taken by a debt collector who brings legal action against a debtor. This act prohibits the use of misleading or false information and the abuse or harassment of the debtor in the collections process. It also limits acquiring information regarding the location of the debtor and communicating with the debtor in the collections process. For example, a debt collector may not:

- communicate that the consumer owes any debt;

- communicate with anyone other than the debtor more than one time;

- communicate by postcard;

- communicate any language or symbol on an envelope or

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telegram which would indicate they are in the debt collection business or that the communication relates to the collection of debt;

- communicate with anyone other than the attorney, if the debtor is represented by one, unless the attorney does not respond within a reasonable amount of time;

- communicate at any unusual time or place which would be inconvenient to the consumer;

- communicate directly with the consumer if it is known that the debtor is represented by an attorney unless the attorney consents in writing to the communication;

- communicate at the consumer's place of employment if the collector has reason to believe the consumer's employer prohibits the consumer from receiving such communications.

Naturally, exceptions to these strict regulations occur when the consumer or a court of law gives you express permission. It is imperative to have a copy of the law and its annotated interpretations in order to be an informed credit manager. This law is not to be taken lightly. Federal agencies enforcing it are now taking violators directly to court, and winning.

Another law which affects collections managers is the Uniform Consumer Credit Code, which is very similar to the Truth in Lending Act and controversial because it has not been adopted by a majority of the states. It was supposed to unify and simplify laws governing consumer credit. If there is ever a conflict between the Uniform Commercial Code and the Uniform Consumer Credit Code, the Consumer Code prevails.

Commercial debt is covered by an entirely different set of laws, compiled in the Uniform Commercial Code (UCC). It is extremely thorough and has been adopted by all states with the exception of Louisiana. With few exceptions, all credit transactions are covered in Article 9. Unfortunately, Article 9 was revised in 1972, 10 years after the original preparation, to correct some ambiguities of the earlier version, and not all states adopted the revision. This leaves some states using the 1962 edition and some states using the 1972. It is important for the credit manager to be familiar with rulings from both versions on questionable matters.

Familiarity with the new bankruptcy laws is another matter for the credit manager. Having a copy of the law with its interpretations on hand is essential. Knowing the rights and procedures for a client's bankruptcy will enable a company to maximize the collection of receivables.

The credit manager must be aware of the maze of procedures, controls, and laws which affect the hospitality industry. An intelligent

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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.

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