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Sarbanes-Oxley: Build Compliance Into Credit's DNA

Sarbanes-Oxley Act is this year's hot topic for publicly traded firms because compliance is mandatory and the consequences for not doing so are dire. What does it mean for the credit department? In most cases, it requires "re-mapping the DNA" of credit management's processes and tools. It goes without saying that systematizing the credit evaluation process to meet the SOX standards will more easily enable the firm to fulfill the Act's certification process. But the silver lining to this added regulation, if done thoughtfully, is the improved credit decision-making thereby feeding more profits to the bottom line.

The aim of Section 404 is to ensure accurate representation of assets, requiring receivables to be qualified and quantified. If that task were not tricky enough, it also means providing a justification for those evaluations. While potentially cumbersome, the benefit to the smart organization is a head-and-shoulders improved credit modeling system. A process that ties credit decision-making to projected profits is certain to improve the financial modeling for the entire business. The expediency of tying credit evaluation improvements with Sarbanes-Oxley is made clearer by the fact Sarbanes-Oxley is not going away anytime soon. It is not a onetime event but instead calls for standing systems to ensure ongoing compliance.

The stakes are high indeed. CEOs and CFOs personally must certify all financial information for accuracy. If the credit department was not in central view of the organization's chief management team, it certainly is now. Internal controls must be put into place so that employees across departments and subsidiaries can share information readily and accurately but most important from a shared vocabulary and viewpoint. Heads of credit departments now are in a direct reporting line to the CEOs and CFOs whether it is with a direct or dotted line. As a result, upstream certification is being required by many organizations.

With this need to ensure sound controls and compliance, credit departments must first understand their current genetic material. The self-discovery can include some of the following questions:

- Are credit decisions prone to subjective interpretation?
- Are policies inconsistently applied across departments, locations, or divisions?
- Do decisions lack insufficient justification and rationale? Are conclusions reasonable?
- Are accounts regularly reviewed to truly reflect today's state of the receivables portfolio?
- Is the bad debt reserve reliably forecasted?
- Is the process of auditing data manual? Is the data difficult to compile?

Here is what your peers are saying according to *CIO Insight*, May 2004: Companies are expecting business process improvements (81.5% of respondents) from Sarbanes-Oxley.

	$500 million firm with 500 accounts	$1 billion firm with 1,000 accounts	$1 billion firm with 5,000 accounts
# of credit professionals	3	5	15
# of business units/divisions/regions	1	1	3
Increased staff productivity acquiring data, analyzing, and setting credit lines	555 hours	1,111 hours	5,554 hours
Time saved on reports to mgmt & customers	714 hours	1,009 hours	5,142 hours
RESULTS			
NPV after three years	$786,661	$1,444,231	$2,380,000
ROI after three years	779%	1212%	1023%
Payback period	5 months	4 months	4 months
First year anticipated return	$209,452	$413,406	$680,594
# of person-years saved annually	0.63	1.06	5.35

Moreover, the number one area in which companies expect to make long-term improvements is risk identification and assessment processes (67% of respondents).

Today's credit management systems provide the framework for more efficient credit processes, especially for credit risk identification and assessments. They enable objective decision making along with the reporting to support compliance. Once in place, compliance becomes natural rather than a special activity.

See Real Results That Impact Your Bottom Line

Your receivables portfolio is one of your largest corporate assets. How you manage receivables can have a direct effect on your profits. Cost studies have been performed that have shown payback periods in as little as six months where the payback period includes the implementation time. The following are examples utilizing only measurable results that are possible using a credit management system. Results will vary based on number of credit professionals, sales, number of accounts, divisions/business units, processes in place, etc.

As you can see in the table on page 45, efficiency alone can save on headcount. In addition, these examples include savings in bad debt, DSO, and agency costs thanks to improved proactive credit management processes. The examples do not include intangible benefits such as consistency, timeliness, integration across organization including exposures, SOX compliance and many others.

Make the Right Decisions With Consistency

Today credit professionals must make on-the-spot decisions accurately. A/R systems store past performance data and do not provide any credit decision making support. Credit scoring can assist your organization by quickly transforming your raw credit data into intelligent, reliable day-to-day decisions.

For instance, a rules-based scoring system is based on your evaluation criteria and applies your corporate policies to every analysis performed. Since everyone starts at the same place using the same rules and weights, you get consistent and objective evaluations.

A robust credit management system allows you to score accounts with information from both internal A/R and external systems (application forms, multiple credit agencies, references, etc.) while accommodating differing levels of information available on accounts. The system should also have the flexibility to tailor scoring models dependent on multiple business situations such as channels and regions. The resulting scores then can be used in adapted credit limit models for decision recommendations. Hence, your credit decisions can then be delegated to the lowest possible level knowing that your decision process has been cloned for consistency and reliability. And of course, a system will store this decision information for the audit process.

If you only use a generic credit report, you still require manual effort since it will not apply your business policies. Therefore, you will be prone to inconsistent decisions and get little Sarbanes-Oxley compliance support.

The robust credit management system results in a reproducible decision process. Not only do you have greater control, validating decisions for Sarbanes-Oxley compliance to auditors is simplified.

Easily Manage Receivables Portfolio

SOX's goal is to report the TRUE quality of your receivables. How do you determine the quality of your receivables portfolio? Historically, most credit executives used the Days Sales Outstanding (DSO) figure to measure the quality of their accounts receivable. This assumes, of course, that customer payment trends are related to risk. Actually, how a customer pays your firm is often a poor indicator of risk. Many high-risk customers pay promptly or within acceptable terms. Conversely, low risk customers often are given longer terms to accommodate special inventory programs.

A credit score that uses many types of credit information to evaluate a customer's risk is a better measurement than one single factor such as how that customer pays your firm. If this is true when evaluating a single customer, it is also true when evaluating all of your customers.

It follows, then, that a better measurement of the quality of your accounts receivable portfolio is to use the credit score for each customer along with the amount owed by that customer at the end of each month. By combining the total amount owed by customers in each risk category the credit executive will have a picture of how much of their portfolio is high quality, how much is high risk, and everything in between. For instance, you may want to look at Overall Risk, Financial Risk, and Pay History Risk as it relates to receivables and open credit.

While the portfolio analysis can look at the entire customer base, the credit executive may also want to segment their portfolio by product line, customer type, or sales region to determine if certain groups of customers carry more risk than others. With this type of portfolio reporting, you have more control to plan appropriately for developing trends and to see a more accurate portfolio picture.

In addition, performing regular ongoing account reviews and credit line re-evaluations also becomes mandatory to reflect the current portfolio condition. With an automated credit management system, portfolio reviews can be run in seconds. Reporting tools can help you efficiently identify accounts requiring immediate attention and isolate accounts requiring intervention in the risk review process.

What if your portfolio's risk composition changes over time? No problem. Forecast bad debt reserve accurately by using risk category experience rather than basing it only on a percentage of projected sales. Bad debt reserve becomes a much more reliable figure and can be explained more confidently to the auditors.

Suppose that bad debts over the past several years had averaged 0.001% of annual sales. Using just that single variable, the Bad Debt Reserve would be forecast at $270,000 or 0.001% of projected sales of $270 million.

However, if the credit executive forecasted the amount of bad debts by using projected accounts receivable and the past bad debt experience for each risk category, a much higher or lower amount might be set aside if appropriate. For example, poor quality and high-risk accounts use higher bad debt likelihood in the forecast computations. This highly developed methodology is similar to using actuary tables that are tried and true in the insurance industry.

Document Decisions for Straightforward Audit Process

Now you have the evaluation process under control and you can quantify the true value of the portfolio. Reporting this information can be time consuming if data capture methods are manual and must be compiled from disparate systems across business units and/or regions. We have all heard the stories of how individuals or teams are spending time just compiling reports rather than performing value-add duties.

Many businesses will rely on Word and Excel files to document internal controls but that approach would generate hundreds of files. It may be fine for the first year of Section 404 compliance. But on an ongoing basis, it will be difficult to maintain controls using those products. Using a database approach, you can automate and simplify reporting necessary for compliance so you don't waste your valuable time creating and managing documentation.

A properly implemented credit management system delivers reporting that highlights key information quickly and accurately. A system should allow you to see justification of individual accounts credit lines and terms in credit summary reports rather than the typical piecemeal approach from disparate systems and paper files. Detailed financial reports using comparative supporting data help you better grasp a firm's financial health.

Lastly, credit information and decisions can be tracked and stored in the credit management system. A robust credit management system can integrate information from disparate systems so tracking across the organization is less complicated. Then you can create audit logs showing who approved, when approved, why, etc. What could be easier for reporting to the auditors?

In summary, a credit management system can improve your credit department's ability to consistently make objective decisions. Consequently, you will have greater control of the credit decision process for confidently reporting the true value of your receivables and certifying for compliance. Moreover, internal controls will be documented as well as the supporting materials for justifying decisions. In the end, compliance becomes part of your everyday process so you can meet Sarbanes-Oxley mandates today and into the future.

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