How a Credit Policy Can Stop Cash Flow Problems Before They Start

6 min read

To survive in business, you need to have money coming into your company accounts before you have to pay cash out (or you need cash reserves to cover cash flow shortfalls or cash flow gaps).

Key Takeaways

- **When a Client's Cash Flow Problem Turns Into Your Cash Flow Problem:** One important way to manage your cash flow and prevent shortfalls is not to let your…

- **How to Improve Your Cash Flow With a Client Credit Policy:** we suggest that business leaders handle clients the way a bank or landlord would. Minimize your business's risk by checking the…

- **Avoid Shortfalls and Close Your Cash Flow Gap With a Credit Policy:** regardless of your business's situation, running credit checks to screen new clients and having a written credit policy that you personally makes sure…

When you have bills to pay, and your clients aren't paying you, this can result in a cash flow shortage that can seriously impact your operations and ability to stay afloat.

What Is Cash Flow?

- **Cash Flow Definition -** Cash flow is defined as the movement of money.

In a business, cash flow is defined as the movement of money into and out of the company and the timing with which it does so. A cash flow statement is a financial report that documents the movement of money over a set period of time. A business's cash flow can be:

- Positive (more money coming into the business than going out)
- Negative (more money leaving the business than flowing in)
- Zero (equal money flowing into and out of the business).

When a Client's Cash Flow Problem Turns Into Your Cash Flow Problem

If any of your clients have financial issues, then their cash flow problems can quickly become your cash flow problems, spelling trouble for the health of your business.

One important way to manage your cash flow and prevent shortfalls is not to let your clients' cash flow problems turn into your cash flow problems – and that means saying no to deadbeat clients. When your dollars are on the line for a contract of service, it would be irresponsible not to review a client's creditworthiness before you start paying people to work on the account.

How to Improve Your Cash Flow With a Client Credit Policy

While each business is different, these credit policy suggestions can help you prevent new cash flow problems that stem from clients before you start new work.

Review Your Clients Before You Have Them Sign

If you pay payroll before you get paid, then you are lending the client money. Banks run credit checks and have underwriting guidelines that help them determine when lending money is prudent. Additionally, landlords check out their applicants' credit histories and references before entering into lease contracts with them.

So, we suggest that business leaders handle clients the way a bank or landlord would. Minimize your business's risk by checking the creditworthiness of your clients before extending them credit (i.e. starting work on their contract).

Spending a little time investigating a potential client before they sign on the dotted line is a good way to identify any obvious cash flow red flags and help keep payment issues at bay.

To review your client's creditworthiness, take the following three steps:

1. Check Your Client's Credit References

Require that your clients complete an application and list credit references. Then, it's essential that you take the time to check their references. By talking with their references, you should be able to get a sense of your new client's creditworthiness as well as some personal insight into who you will be dealing with if you do in fact take them on as a client.

Ask your credit references about the payment habits of your potential clients before 2020 and about how they have performed since. While some people encountered financial struggles during the pandemic, it's important to note that people who were bad at paying their bills before the global crisis will not be better now!

2. Run a Background Check

Running a background check on a potential client helps you understand their history – whether they represent a business or are an independent contractor.

Use background checks to make sure that the company looking to buy your services is in fact a well-run company and doing real business. Poorly run companies don't normally have stellar bookkeeping and cash management skills.

Read More: Save Your Small Business With These Cash Flow Strategies

3. Check Their Credit Rating

Both potential renters and potential borrowers have credit checks run on them before they are able to lease real estate or take out a loan from a bank.

So, why shouldn't your business run a credit check on your potential client before you enter into a contract and extend veritable credit to them? Exactly! There's no reason why you wouldn't.

Your business should run credit checks on your potential clients for multiple reasons:

- You'll be able to see if they have a history of not paying off their debts.
- You might discover they have a perfect history of repaying their debts.

Plus, by running a credit check, you'll also be able to see if your potential clients have any outstanding debts, how much they owe, and how much they have to pay monthly which will help you better understand whether or not they can actually afford to pay for your services.

Make Sure You Have a Written Credit Policy

In addition to screening new clients before entering into business, you also need to have a written credit policy. A written credit policy is key for ensuring that your clients are aware of your payment terms. This policy should be included in their contract as well as referenced in every invoice you send them.

Take the time to review the credit policy with your clients before they sign any contracts with you. This will help you avoid the "Oh, I never knew that" excuse that frequently comes up when clients pay late or otherwise break their payment terms.

Remember that even if you personally give them copies of your credit policies, there is no guarantee that they will read the documents, so it's your responsibility to ensure both parties are on the same page.

A basic credit policy should include:

- **Terms** - Terms should include details such as when the balance is due and when it is considered late.
- **Late Fees** - Explain how much you charge clients for paying late. To move your bill to the top of their priority pile, we recommend 18% (1.5% per month).
- **Legal Fees** - Clearly write out which party is responsible for legal fees should you have to deal with the court to collect money that is owed to your business.

Additionally, if your profit margins permit, you can take your credit policy a step further to encourage your clients to pay early by offering an early payment discount.

Read More: Why Profits Don't Equal Cash Flow

This early payment discount can help encourage clients to pay you well before their invoices are due, giving them an incentive to prioritize your bill over the others they need to pay. As a result, you'll receive payment sooner from more clients and start to close the gap between outflowing cash and inflowing cash.

Avoid Shortfalls and Close Your Cash Flow Gap With a Credit Policy

Every industry is different, and every business is unique. However, regardless of your business's situation, running credit checks to screen new clients and having a written credit policy that you personally make sure your clients understand can help you avoid falling victim to your clients' cash flow problems.