Risk assessment in trade (commercial) credit

Introduction

No credit manager ever takes anything at face value – it is part of his or her role to look behind the obvious, verify the facts and take informed decisions based upon careful analysis of the results. The impressive premises, complete with the fish tank in the reception area and the flagpoles in the car park, may hide a company with severe financial problems, weak cash flow and a reputation for failing to pay suppliers. Credit managers always look behind the façade, - and certainly never enter into any risk environment without having first weighed up all the relevant and available facts.

Hundreds of businesses close down across Europe every day, their insolvency leaving suppliers and others unpaid. Often those who have supplied without proper checks beforehand seem surprised when failure occurs, never thinking that this could happen to them. Keen to sell as much as possible with eyes focused on volume rather than net profit, such suppliers themselves often pay the high price of failure in turn. Those who have undertaken proper risk assessment, calculated the risk of slow payment and even non payment, enter into transactions with the knowledge of the amount of risk involved and can adjust their terms, collection policy and procedures and their collection activity accordingly.

The simple fact for all to understand in any selling organisation, be they CEO or Sales Manager, is that credit means trust. For trust to have any real value or meaning it requires knowledge, which encompasses all the seller needs to have to make the informed decision. The seller can ask himself three fundamental questions in respect of the granting of credit:

1. Is the customer about to fail? (the *solvency* risk);
2. Can the customer pay our account on time? (the *liquidity* risk);
3. Is the customer growing or declining? (the *volume* risk).

Risk assessment is should it be both structured and logical, with a sequence of events established at the outset. This can be followed by both credit and sales personnel in order to define, from the earliest point in the relationship with the customer, the manner in which such a relationship will be conducted.

- The sequence begins with the *Credit Application Form*: this is the customer's request to borrow the supplier's money.
- The process of *checking on creditworthiness* follows on. The depth of that check will of course depend upon the order value and the extent of the risk exposure envisaged going forward.[1]

[1] MACM provides pertinent data and information on entities registered in Malta with which a seller can evaluate the creditworthiness of the customer requesting credit.

- From both the application form and subsequent credit report, a quantified decision can be made as to *credit rating (limit) and/or risk category.* In other words how much can be allowed and what the perceived level of risk may be.
- From enquiries undertaken, the status of the potential buyer will dictate what *credit terms* will be applied, standard or special.

Many a credit manager has the motto ' a sale is not a sale until it is paid for' engraved on a plaque on the desk as well as on the heart. That could be seen as negative – better would be 'a sale is only a cost to us until it is paid for'. Perhaps the two mean the same thing, the latter, however, has more of a positive ring to it which sales managers could understand. The really positive motto for all professional credit managers should be 'my job is to look for a way to accept every possible profitable order'. In other words, the true role of the credit manager is to seek the highest volume of *profitable* sales over the shortest period of time with the minimum of bad debt.

Credit management is as much concerned with identifying good sales prospects and cultivating strong relationships as it is with standard collection actions and ledger-keeping. The credit manager should be seen by other staff as responsible for the credit policy[2] being carried out, applying commercial sense to resolving customer problems. Risk control does not mean saying 'no' to poor risks, just because the policy allows this. It means looking for ways of saying 'yes' – in other words a constructive attitude which may include various alternatives, such as part deliveries, special credit terms, instalments, discounts, deposits etc.

Risk assessment should begin with all prospective customers being passed to the credit manager to assess for credit. The expense and effort may be wasted if orders do not materialise, but delays are avoided when they do. The credit manager attends Sales Planning Meetings when names of prospective customers are being discussed. He may already know them, and in any event is in a position to move quickly to check them. This involvement can help direct sales plans to the right customers. A joint visit by the credit manager with the sales or marketing person, before the business becomes firm, provides a good opportunity of assessing the people and the premises. This can help in two ways: it adds depth to the written credit reports; and it is the chance to start building strong personal contacts for future collections.

It is of the utmost importance for customers to see sales and credit as a united and money-conscious team, and it is equally important for personnel throughout the selling company to recognise that too. When this team approach is not promoted, the wrong kind of customer can easily play one function against the other in future negotiations, for example, alleging concessions and 'old' agreements.

[2] MACM has developed a framework for introducing an effective credit policy within a firm, focusing on profitable credit sales and long-term customer relationship. This framework is available from the MACM Secretariat.

Opening new accounts begins with the requirement for new customers to complete an ‘application for credit’[3]. The customer is reminded of the terms of payment and his commitment to paying them. The form should also provide the name of a contact for payments. If the business is deemed to be to fast-moving to wait for form-filling, a first order can be taken up to an agreed maximum – that is to say a value that, if lost, would not be too painful for the seller. The credit application form should then be completed before a second order is taken.

The decision to open the account should be communicated with enthusiasm to the customer’s financial contact by a credit person. This is a good opportunity to firm up the relationship and re-state the payment terms. Only the credit department should be authorised to allocate new account numbers, without which the business cannot go ahead. Newly opened accounts should be placed in a special section of the sales ledger for a period of three months or so. This allows credit management to monitor progress and can then follow up with customer contact accordingly, either as a reminder of terms or as a warning in respect of possible restrictions, according to payment pattern. It is also important to make immediate contact with the customer’s payment person by sending a welcome letter[4].

Customer identity

Many sales ledgers contain errors of name, address, postcode or some other combination. Sometimes these errors are of apparent comparatively minor importance, perhaps a postcode not complete or some spelling mistake in the address. It is easy, especially with verbal orders, to mis-spell or not fully understand, and as such these errors may not have a significant bearing initially on day-to-day dealings with the customer. Having said that, accuracy is indicative of efficiency and professionalism, and customer data should be correct from the outset.

Not acceptable, however, is inaccuracy in customer name. It has a more than significant impact on collection and litigation activity. Many organisations have computer systems which integrate throughout the order, sale, delivery, invoice, statement and ledger process, so that the wrong name at the front end of the operation is repeated throughout. Some organisations even have systems which put a constraint on name and address fields, for example, so that in order to accommodate long names and addresses, some degree of ‘editing’ is required. If possible, such systems should be replaced at the earliest opportunity!

Establishing customer identity is in fact establishing the legal status of the customer. It is therefore important to capture *exactly* the correct legal identity, because the seller should always know precisely who is responsible for the debt incurred. In the United Kingdom, the difference between Smiths on the High Street, John Smith, John Smith & Sons, and John Smith & Sons Ltd. is acute. Customers may well be known by

[3] A sample copy of a Credit Application Form, with suggested terms and conditions, is available from the MACM Secretariat

[4] A sample copy of a ‘Welcome Letter’ is available from the MACM Secretariat.

everybody as Smiths, but is that a trading name used by a limited company, or John Smith & Sons, or is it in fact just Smiths?

The sole trader, or proprietor, in the United Kingdom is an individual and is a legal entity in his or her own right. As such, the sole trader is personally liable for all debts incurred up the full extent of his/her personal wealth. In other words, there is no screen to hide behind, and in the event of business failure, personal insolvency means bankruptcy. Sole traders are not obliged to lodge annual accounts or any details of the business for public scrutiny, though they are required to make tax returns and if registered VAT returns. These are not publicly available in the UK[5]. It can be argued that the sole trader has much to lose in the event of business failure, and for that reason has every incentive to pay debts as and when they fall due. It is also argued, with justification, that it is not possible to distinguish between business debt and personal debt as by definition for the sole trader they are the same, and therefore the personal lifestyle of the sole trader is as significant as the business itself. For credit checking purposes, the sole trader is as much a consumer as any other – his or her home address is perfectly suitable for debt recovery, as are his or her personal assets.

The partnership is, unless otherwise stipulated, a partnership of proprietors or sole traders, each liable for the debts of the business up to the full extent of their personal wealth. Each individual in the partnership is equally liable, jointly and severally (separately) as described, and it is for each partner to be aware of the activities of their colleagues. They cannot avoid liability simply by saying they personally did not order the goods, or they personally did not know what was going on.

To cater for those large partnerships, such as the big accountancy and solicitors practices, as well as others, there is a Limited Liability Partnership, which restricts personal liability in the event of failure. LLPs are more common where partnerships encompass a wide scale of operation, both geographically and physically, and where it would be deemed unreasonable to hold each individual personally liable.

The limited liability company is a legal entity in its own right, just as a person, able to own property, sign contracts and engage in trade. The concept of limited liability was designed to restrict the liability of the owners of the company, the shareholders, to the extent of their shareholding. As such, creditors have no claim on them as individuals (unless it can be shown that they acted fraudulently). The public limited company (PLC) is owned by shareholders and shares can be bought by the public. Liability is limited in the same way as the private limited company, i.e. limited to the extent of the shareholding. Public companies have the advantage of being able to raise capital quickly by the sale of shares. Limited liability, therefore offers a degree of protection to its shareholders, be it private or public, and restricts creditors to pursuing only the legal entity itself, and not its shareholders, for recovery of sums due.

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[5] Similar legislation applies for Sole Traders, Partnerships, LLP, Limited Companies and PLCs in Malta.

It can therefore be appreciated that having the exact customer name is of the utmost importance, and that exact customer name should exist on all of the seller's documentation throughout his computer system. Distorting a name to fit a computer field radically alters the whole picture – in the event of litigation, it would be disastrous, not to say costly to issue a writ against the wrong business

Sources of information

Risk is determined by calculating the likelihood of prompt, slow or non-payment from as much information as it is both possible and feasible to obtain. The level of potential risk exposure will dictate the extent to which information is sought, but a wide range of information is available.

Sales - Sales staff should be the credit manager's first insight into the potential customer, and indeed also a source of information about the existing customers. They talk to, and visit, customers regularly, are aware of industry developments, and keep their ears to the ground for information which could be useful to them in the competitive environment, but also useful to the credit manager. Naturally, they prefer not to waste their time with declining customers, or those going into liquidation – but do they know who these are? Sales are constantly learning about their customers and it is this which helps them to sell successfully. Their input of data to the credit area must be reliably organised: what are their impressions of the customer; what are they like to deal; are they well organised; do they reply promptly to phone calls, letters and emails; are the premises and plant in good order; does it feel like a hive of activity, or are people standing about looking aimless; do staff look cheerful or morose? Bad impressions can be a warning sign. Is the customer's product or service in demand; is the market expanding or contracting; is it seasonal; what is the level of competition; who are their customers; and does the customer's management ability inspire confidence???? All these questions can be answered by Sales simply observing and listening when they visit their customers and prospective customers.

Account experience- Monitoring the payment performance of existing customers reveals trends and gives early warning of trouble ahead. Payments getting later every month, calls not answered or the named contact becoming increasingly more difficult to actually contact are all signs of a deteriorating situation. The ledger shows valuable trends in payment performance, sales value and disputes, both getting worse and getting better. If payments are made later as sales increase, this may indicate stretched resources. Customers who begin to raise an undue proportion of disputes and queries may be trying to delay payment – assuming, that is, that all remains efficient and organised in the seller company. If there is no reason for a high level of dispute from an existing customer as far as the seller is concerned, the obvious answer lies with the customer and his need for more time.

Industry credit circles **-** Industry credit circles in the UK often form part of trade associations and can be extremely useful sources. Many credit managers find it productive to join the relevant credit circle for his industry, but the approach and use must be professional. The benefits depend upon input; and it should be treated as an opportunity to exchange accurate customer information and keep up to date with industry practice. UK legislation covering both data protection and competition has made some companies wary about allowing their credit managers to join credit circles in recent times, but there is nothing illegal about credit circles. They are in fact no more than a form of personal trade reference, providing discussion is restricted to past facts and there is no collaboration, intended or implied, to restrict future trade. It is recommended that credit application forms include an acceptance section for completion by customers relating to shared information.

Press reports **-** Press reports disclose useful interim company results of publicly quoted companies, and reports of resignations and appointments of key people. The financial pages of the quality financial press should be standard reading for all involved in credit management, together with those industry magazines and journals relevant to their own particular market sector. The great benefit of the press is that information is highly topical, and 'local' press may be even more topical in respect of plant closures or 'downsizing'. Sales staff will no doubt also read the trade publications, as well as local and national press, and they should be encouraged to pass on any pertinent data on existing or prospective customers to the credit department.

Customer visits - For many credit managers, customer visits are more common after problems have occurred (and are often seen as collection visits), but it is extremely valuable to visit large accounts on a planned and regular basis. An on-site customer meeting is a very effective way to evaluate creditworthiness, with the credit manager looking out for all those signs as discussed above in connection with the sales force. A visit to sort out payment problems may be a good way in, and can lead on to more detailed financial matters. Quite often, the customer is keen to show the credit manager around the whole operation to encourage confidence and to facilitate a satisfactory outcome from his standpoint. No credit manager should ever turn down such an opportunity. It can set his mind at rest or confirm his worst fears – either way, some of the uncertainty will have been dispelled. The first visit may be with the salesperson, to ease introductions and allow him to find out more about his customer, but out of both courtesy and professional integrity credit should always both inform sales of the intention to visit and give sales the opportunity to accompany or not.

Credit agency reports - Credit agency reports are the most comprehensive form of data. Either the stated credit ratings can be taken, or the data used by the credit manager to calculate his own ratings. Reports vary in form and content, ranging from

a brief summary of main details to a full-blown financial analysis of the customer and industry, with a recommended credit limit. Agency reports are still available by post, phone or fax, but most are now delivered on-line direct to the credit manager's desk top PC, and as such information on prospective customers can be delivered in seconds rather than days[6].

Typical sections of agency reports are:

- *Full name and address*: including trading names and styles
- *Legal status of the business*: sole trader, partnership, limited company. It should be noted that information on sole traders and partnerships may well be less available than in respect of limited companies.
- *Ownership of the business*: the names of the shareholders and the extent of their shareholding may be significant. Limited companies are subsidiaries when owners hold over 50% of the shares, and a parent company is not obliged to pay the debts of a subsidiary. In practice few parent companies are willing to give guarantees in respect of their subsidiaries. Often the only connection is in a group overdraft facility, which may have a cross-guarantee to the bank from all the members of the group.
- *Time in business*: this is also significant, and a good report will show the customer's previous trading activities, perhaps as a proprietor or partnership, or as a company with different owners. If there is a year in the company title, e.g. XYZ (2004) Ltd, this can indicate the revival of a previously failed business, often with the same owners or directors.
- *Activities and industrial sector*: The company's financing will differ according to its activity, as manufacturer, distributor (wholesale or retail), services or a mixture of all three. The customer's industrial sector affects the credit risk. Some are highly competitive (engineering), have high failure rates (construction, motor trade), many new and small companies (computer software, electronics), or must be in good high street positions, such as department stores and retailers generally. Some industry sectors have tiny profit margins (commercial vehicle makers), while others need very high margins (fashion retailers). It is useful to know also if the customer exports to risky markets, which may indicate sluggish cash inflow.
- *Financial information*: good reports provide three years of balance sheet and profit and loss information, allowing simple comparisons and trends to be seen. Some reports provide ratios already calculated and explained, and some compare them with industry norms.
- *Background information*: number of employees, size and ownership of premises, trade marks and product names, associated companies and directors other directorships can be useful.
- *Legal action and collection information*: many agencies have their own collection divisions, so are aware of accounts passed by client to them on the subject of enquiry. Any county court judgments show that other suppliers have had to sue to obtain payment. There may also be comments on major court cases, such as product liability claims in process or pending.

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[6] MACM is the distributor of Graydon International Reports in Malta

- *Payment experience*: some reports give calculations of the payment times experienced by suppliers to the subject company, with an average of the delay for all payments.

Bank references – in 1994, banks in the United Kingdom radically overhauled the reference process. Express written consent must be obtained from the subject of the enquiry. This must be signed by an authorised signatory under the customer's bank mandate. Normally, the authority of the customer is specific to a particular enquiry, known as 'specific authority'. However, the customer could also give his bank 'blanket authority', which is his consent for his bank to reply to each and every enquiry, from whatever source, without further reference by the bank back to the customer. The customer can also give his bank 'continuing specific authority'. This is where the relationship between supplier and customer is likely to be ongoing, and the supplier may require further bank references on that same customer as business develops and grows and where credit reviews are carried out regularly as part of the monitoring process. The bank is able to reply under this authority without further reference back to the customer. If so desired, the subject of the bank enquiry can receive a copy of the reference supplied by his bank. The request for a bank reference is sent to the supplier account holding bank on a standard form supplied by his bank and recognised by all clearing banks. The bank receiving the enquiry will reply directly to the enquirer. The fee (which varies from bank to bank and includes VAT at the standard rate) should accompany the request for the reference, and the replying bank should issue a VAT receipt with the reference. If the subject of the enquiry refuses to consent to his bank supplying a reference, the fee is returned to the enquirer, together with a note of explanation. (It will be for the enquiring credit manager to form his own opinion as to the significance of such a refusal).

Trade references - Trade references were once quite but have long been considered to be of limited use, and not recommended if supplied by the customer himself – it is hard to imagine a customer providing names of dissatisfied suppliers. There is also a great danger of 'cultivated' suppliers always being quoted for trade reference purposes – those suppliers which the customer pays well at the expense of the majority of his other suppliers. Referees are busy and have no obligation to an enquirer, but most credit managers act professionally and respond to each other. It can also be a useful way of making contact with others in the industry where, for example, there is no established credit circle. It can save time and avoid inaccuracy if the enquirer makes it easy for the referee to respond by having boxes for ticking Enquiry by telephone may produce more information, on a confidential basis.

Financial statements – United Kingdom - balance sheets on all limited companies registered in England and Wales are required by law to be filed at Companies House[7], Cardiff and are available for public scrutiny (Scotland is covered by Companies House, Edinburgh, and Northern Ireland by Companies House, Belfast). The balance sheet is the company's financial statement and can be obtained from Companies

[7] In Malta, companies are required to file their audited accounts at the Registrar of Companies.

House, credit reference agencies or directly from the customer. In the case of non limited company businesses, the likelihood is that accounts have been prepared (for Tax and VAT purposes), so it is possible to ask the customer direct for copies so that credit terms and amounts can be assessed.

The set of financial statements is a very readable picture of the health of a company, giving the credit manager the opportunity to calculate credit levels by the use of ratios. However, a balance sheet is an historical snapshot of a company at a moment in time now past. They are therefore out of date before they are issued, can be subject to a degree of 'window dressing' and can carry auditors' 'qualification'. Nevertheless, the vast majority of accounts are straightforward, and analysts can develop experience in studying their customers' accounts, spotting inconsistencies or identifying misleading parts. Except when the actual page called the 'balance sheet' is being discussed, the term 'balance sheet' covers the complete set of financial statements as required by the Companies Act 1985 to be filed annually at Companies House (within 10 months of the financial year end for private companies, and within 7 months of the financial year end for public companies).

The statutory set of documents is submitted in a wide variety of style and quality, from glossy publications with photographs from the large corporations wishing to impress the market and investors, down to basic typed pages from accountants representing small companies. Whatever the style and presentation, the content still consists of the key documents listed below:

1. Cover page (showing name of company and date of balance sheet).
2. List of directors, registered office, auditors and bankers.
3. Report of the directors to the shareholders.
4. Auditor's report to the shareholders.
5. Profit and Loss account, for the year (usually) up to the balance sheet date.
6. Balance sheet, as at the date shown.
7. Source and application of funds statement (or 'funds flow' statement).
8. Notes to the accounts.

There are useful points for credit managers to look at when assessing potential credit:

Report of the directors: This presents the accounts to the shareholders and shows the principal activities and a review of the year (often just by referring to the later accounts). It also states the export content of the turnover, says whether dividends are being paid or not, shows directors' interests as shareholders and in any holding company, shows the arrival or departure of any directors, gives a table of fixed assets (or refers to its being in the notes to the accounts), and names the auditors and whether or not they are to be reappointed.

Analysts should note the tone of the report for any optimism. It is reasonable to pay dividends to reward shareholders, but not if large losses have been sustained, or if the company is less than three years old, when profits are better retained to strengthen the new business. Resignation of directors may be significant – they may have advance knowledge of bad news which only becomes public later. Auditors normally continue, so not reappointing them may indicate a serious disagreement over the true results, or

simply over audit fees. In the wake of the Enron scandal, and the involvement of Arthur Andersen, the question of auditors, their relationship with the client company, and their reappointment or otherwise remains the subject of ongoing debate and review. Directors' connections with other companies may be interesting.

Auditor's report: This should simply state that the figures add up and are legal ('give a fair and true view' and 'comply with the Companies Act'). Often there is a qualification, where the auditors are not totally happy (e.g. ' where complete figures were not available to us, we have accepted the assurances of the directors'). A more serious qualification would be 'the company has not complied with the Companies Act, Section XXX'. Where auditors say that the 'going concern basis depends upon continuing finance from Anybank Ltd' or that 'new finance is being sought', this is a distinct warning of credit risk and deserves clarification.

Notes to the accounts: These refer to numbered items in the accounts and items of particular interest to credit managers are details of the parent company and 'contingent liabilities' which show possible debts which may hit the company later. For example, cross-guarantees may bring down the subject company if the bank calls on all group members to repay a loan to one of the group's companies in trouble.

The profit and loss account: Sales less costs equal the profit for a stated period up to the date of the accounts, normally the financial year end. Four different stages of profit are shown: *gross profit, operating profit, net profit before tax* and *net profit after tax.*

> *Gross profit* is the difference between total sales and the cost of raw materials, wages and overheads in producing the sales. (Sales less cost of sales = Gross profit.)
> *Operating profit* is what is left from gross profit after operational expenses, such as office costs, sales commission, etc. (Gross profit less operating expense = Operating profit.)
> *Profit before tax*: includes items after the operating profit level, e.g. interest paid on loans or received on deposits, non-standard profits or losses such as sale of investments or fixed assets. (Operating profit less non-operating expenses = Net profit before tax – NPBT.)
> *Net profit after tax:* Tax must be paid on final profits, reducing the total available for dividends or to be retained in the business. (Net profit before tax less income tax = Net profit after tax.)

A further calculation normally shows the retained profits from previous periods , plus the net profit after tax for the year, less any dividends paid. The balance is the new retained profit figure carried forward on the balance sheet (as shareholders' funds in the net worth section).

The balance sheet: This is a statement of the assets and liabilities of a business at a certain date, usually the financial year end. Larger companies produce half-yearly, quarterly or even monthly balance sheets. Assets are owned by the business: liabilities are what the business owes. The total assets must always equal the total liabilities

(hence ‘balance’). The liabilities indicate the money made available to the business and not repaid at the date shown, e.g. bank overdraft and trade creditors. The assets show the business has used the money made available to it, e.g. in debtors and stocks.

Group accounts: A company with subsidiaries (i.e. owning more than half their share capital) is required to produce accounts covering the whole of the group, usually comprising a consolidated Profit and Loss account and balance sheet. Associated companies are usually those in which the investing company holds 20% or more (up to 50%) of the shares in a company which is not a subsidiary.

Types of liabilities: There are three groups of liabilities: current liabilities; fixed liabilities; and shareholders’ funds (or equity). Shareholders own the business, so their funds are listed separately from ‘outsiders’, such as banks and creditors. Current and fixed liabilities are referred to as ‘outside’ or ‘external’. Fixed liabilities represent long-term finance and normally carry interest charges. Current liabilities represent short-term finance, repayable within 12 months, e.g. bank overdrafts, short-term loans and accounts payable (or trade creditors).

Shareholders’ funds (equity): When a company is formed, part of its funding is provided by investors who buy shares. In return, the shareholders expect to receive dividends each year from the profits made. The balance sheet also shows profits retained in the business and not paid out as dividends. Every limited company is authorised to issue a stated amount of shares, called the authorised capital. Until it requires it all, it only invites shareholders to subscribe to the amount needed. Thus, the issued capital cannot exceed the authorised capital. Many companies are formed with £100 authorised capital and operate for years with only £2 issued capital. The company itself has a liability to shareholders for the capital subscribed, only repaid when a company is wound up, and only then if there are sufficient funds when all other debts have been paid. As both the investment by shareholders and the retained profits are owed by the business to the shareholders, they are known together as shareholders’ funds, or equity. Profits earned and kept in the business are called retained earnings, or earned surplus. Increased value from revaluing assets is capital surplus. Earned surplus and capital surplus on the balance sheet are cumulative totals built up over the past years up to the balance sheet date.

Net worth: The worth of a business is said to be the stated value of its assets (short-term or current plus long-term or fixed) minus all external liabilities (short and long-term). The result is the total shown for shareholders’ funds. In other words, the net worth of a business is the amount owed to its internal lenders, i.e. shareholders. It should be noted, however, that in a break-up situation, such as insolvency or acquisition, assets are rarely found to be worth their balance sheet figure, whereas liabilities always are!)

Funds flow statement: This compares the current balance sheet with the previous one and uses data from the profit and loss account to show the changes in funds available to the business and how they were used, i.e. where new money (sources) has come from and where it has gone (uses). Sources of new money include net profit (after depreciation), depreciation, new issued share capital, sale of fixed assets and new loans (including increases). Depreciation itself may not be actual new money, but since it has reduced profits without funds physically leaving the business, it is not unreasonable to add it back as a source of funds. Uses of funds, on the other hand, include an increase in working capital (more debtors/stocks and less overdraft, creditors, etc.), purchase of fixed assets, payment of dividends, and repayment of loans. As sources must equal uses (back to 'balance' again), funds not used for the aforementioned will produce changes to working capital. Not too many analysts use the funds flow statement, as the most useful ratios are calculated from the balance sheet and the profit and loss account.

As previously stated, private and public limited companies are required to file statutory documents at Companies House. At one time, there were few exemptions granted to companies, however small or large, but in recent years exemptions have been granted by UK governments to small and medium sized companies. These are currently as below:

	Small companies	*Medium-sized companies*
Balance sheet	Abbreviated content	No concession
P&L account	Not required	Can start with gross profit
Notes to accounts	Very limited requirement	No need to show turnover/ profit by activities or markets
Directors' report	Not required	No concession

The definition of small and medium-sized companies and therefore the qualification for exemption is any two of the following three factors (from 6 April 2008):

	Small companies	*Medium-sized companies*
Turnover not exceeding	£6.5m	£25.9m
Balance sheet total not exceeding	£3.26m	£12.9m
Average employees not exceeding	50	250

[8]*Vide Foot note 8*

The most important of these provisions for the credit manager is the absence of a profit and loss account for a small company. If the assessment is important enough, it is worth approaching the customer directly to request the missing data in order to decide on the credit level.

The above definitions are an increase on previous qualifications for exemption and there are currently proposals to increase these further from 2010. The Institute of Credit Management has consistently opposed exemptions on the grounds that limited liability is a privilege, protecting directors and shareholders in a way not accorded to sole traders and proprietors. The ICM has also vigorously contended that exemptions equate to restrictions available to creditors of information necessary to reach sensible credit decisions. It is stated that the latest proposals are to keep the UK in line with EU law, but the opposition, led by the ICM, has strongly argued that a turnover of £6.5m and a balance sheet total of £3.26 is hardly 'small' by any reasonable definition – constant increases have a negative impact on the whole credit granting process, and hence on business generally.

An exemption for the requirement for a company to have a statutory audit was first introduced by the UK government in 1994, at which time the turnover threshold was £90,000. Over the following years, the threshold has been raised at regular intervals, reaching a turnover not exceeding £6.5m (and gross assets not exceeding £3.26m)[9]. Combined with actual account filing exemptions, the result is far less 'accurate' and 'audited' figures being available to assist credit managers in making sensible balanced credit decisions. This cannot make commercial sense by any measure and since the banking fiasco of 2008, it has fallen more and more upon trade creditors to support businesses ongoing by granting credit facilities - it is utter nonsense on the part of the authorities therefore to constantly reduce and dilute the information available and necessary for credit managers to make the right decisions. What is more ridiculous is the contention that such exemptions 'reduce red tape' and 'encourage entrepreneurs' – companies still have to prepare accounts for their bankers and for the tax authorities, and full audited accounts remain the best weapon in their armoury in the battle for

[8]

	Small companies
Turnover not exceeding	€5.124m
Balance sheet total not exceeding	€2.562m
Average employees not exceeding	50

There is no definition for Medium-sized companies under the Maltese Companies' Act

[9] Every company should file its Accounts at the Registrar of Companies. However, small companies, as defined by Law, may file Abridged Accounts.
Micro Companies satisfying two out of the following three criteria and may not file Audited Reports:

Balance Sheet Total	€46,588
Total Turnover	€93,175
Employees	2

funding support from whatever source. The credit management profession, through the ICM in the UK and throughout Europe through FECMA will continue to lead the fight against constant erosion of information quality.

Interpretation of accounts

It is worth deciding a 'pain' level, i.e. an amount which would really hurt if it were lost and then organise an ongoing view of the financial status of all debtors above this level, using an analysis of key balance sheet items. Even when analysis is not made in depth, most credit managers would at least check the basic solvency and liquidity of customers with significant exposures. Much time and expense can then be saved by not giving as much deep analysis to small value (i.e., not too painful if lost) accounts.

Solvency - solvency is calculated as a percentage or a number of 'times'. It indicates the proportion of shareholders' funds in the total liabilities and is sometimes called the *creditors' protection ratio*. The higher the proportion of shareholders' funds, compared to external debts, the more comfort is provided for creditors. The expression *gearing* has different definitions and can be misleading. For credit analysis, it is best used to show assets financed by shareholders' funds versus interest-bearing borrowed funds. A high solvency ratio (high proportion of shareholders' funds) represents low gearing, low risk and the customer's capacity for borrowing more external finance, or credit. A low solvency ratio indicates high gearing, high risk and less scope for further borrowing in the event of credit difficulties.

Liquidity - Current ratio = current assets divided by current liabilities. Quick ratio = current assets less stock divided by current liabilities. There should be sufficient current assets to turn into cash with which to settle current debts. A current ratio below 1 indicates a credit risk because of insufficient cash-producing assets, depending on the due dates of liabilities. A very high ratio, over say 3, although comfortable for creditors, indicates inefficient use of assets. The quick ratio, also called the *acid test,* measures the more immediate liquidity, to meet current liabilities (i.e., cash and debtors). A quick ratio of 1 or above is good, although many companies these days survive with a quick ratio of about 0.8.

Sales comparison - this is sales for the current year compared to previous years. A reduction leads the analyst to see how other ratios have been managed in a decline.

Profit comparison - this is the profit for the current year compared to previous years. The percentage should match or exceed the percentage of sales growth or decline. Lower growth in profits than sales indicates lack of management control and should be investigated further.

Sales compared to net assets - this refers to the use of assets to produce sales. Increased ratio year on year is desirable as long as profit growth keep pace.

Sales compared to working capital (i.e. net current assets) - this shows the efficiency in use of working capital to produce sales. An excessively high ratio, or sudden increase, may indicate overtrading, where profits are not retained in the business. Where sales race ahead of liquidity, the company may have to delay payment to suppliers.

The following ratios are also widely used in credit analysis:

Net profit before tax as a percentage of sales: Shows overall efficiency and control of costs. It is difficult when sales decline to reduce costs in the same proportion, and serious trouble can follow.

Net profit before tax as a percentage of net assets (current and long term): Shows the efficiency in using assets to produce profits.

Sales compared to stocks -shows how long stocks take to be sold, e.g., a ratio of three times means that it takes four months to achieve sales. A higher than average ratio for the particular industry indicates competitive success. Slow moving stocks can be a major reason for slow payments.

Stocks compared to working capital (net current assets) - shows how much of the working capital is tied up by raw material, work in progress and finished goods. It should be steady in relation to sales growth, subject to seasonal trade. An increasing level may indicate obsolete stocks or weak stock control.

Current liabilities compared to net worth - if short-term debts are well covered by net worth, there is a good chance of creditors being paid. Secured creditors are paid before unsecured creditors receive any payment at all; so information is needed on the proportion of the debtor's secured outstandings.

Sales compared to trade debtors - shows the average time taken by the company to collect debts from customers. A ratio of 3:1 indicates one-third of a year's sales unpaid, or 120 days. If terms are 30 days, this is excessive and indicates a lack of credit control and a shortage of liquidity to pay creditors.

Current assets cover for current liabilities - shows the assets available to produce cash to meet current debts. A ratio of 2:1 may be regarded as comfortable, but it has to be said that in recent years a ratio of 1:1 has been seen and regarded as not abnormal. Some current assets are not very liquid and a high stock figure can mean excessive stocks, whether raw materials, slow-moving finished goods; or work-in-progress

which is blocked for technical or customer reasons. Current liabilities differ also in their urgency. Most trade creditors expect to be paid within 60 days but a bank overdraft, although repayable on demand, may be allowed to run on without pressure to repay or reduce it.

Quick assets cover for current liabilities - known as the 'acid test', this is the most useful guide to the customer's ability to pay its way in the short term. It excludes stocks from current assets and assumes that the customer's own trade debtors will become cash soon.

In general , the following seven ratios are recommended for risk assessment:

1. *Current ratio*: Current assets cover for current liabilities. This shows the ability to meet debts from assets becoming cash in the short term.
2. *Acid test*: The more available cover for debts after excluding stocks. A company should be able to meet most of its debts without selling more stocks.
3. *Stock turnover*: Stocks x 360 days divided by annual sales gives the rate at which stocks are sold. This is especially useful when added to DSO to show how long the purchase-to-cash process takes.
4. *DSO (days sales outstanding or collection period)*: Debtors x 360 divided by sales, to show how long sales are unpaid.
5. *External debt/net worth*: Either all debt, current and long term, divided by net assets, or just the current liabilities. This shows how reliant the customer is on lenders (trade and bank) compared to its own investment.
6. *Interest burden*: Interest payable as a proportion of profit before tax and interest. Obviously, interest expense should not exceed profit. Even 50% is a warning sign. When a bank sees its income (i.e. interest) not being covered by earnings, it tends to mention receivership.
7. *Profit on sales*: NPBT (net profit before tax, often referred to as the 'bottom line') as a percentage of total sales. This shows how much is left from sales after total costs, and is thus available to pay out as dividends or retain in the business; 5% is typical for many industry sectors, with firm varying within them.

It is always better to compare any one ratio with the same ratio for the previous year, or better, two years. Three successive years of financial ratios are a reliable indicator of the progress of a company and it is worth devising a standard worksheet to record a customer's ratios and trends. The worksheet is then available at a glance, instead of having to remember the basis for previous credit decisions.

Key ratios for a simple credit assessment worksheet would be

LIQUIDITY

1. Current ratio (times) $= \frac{\text{Current assets}}{\text{Current liabilities}}$

2. Quick ratio 'Acid test' (times) = Current assets less stocks / Current liabilities
3. Stock turnover (days) = Stock x 365 / Sales
4. Collection period – DSO (days) = Debtors x 365 / Sales

DEBT

5. Creditor protection ratio (%) = Net worth x 100 / Current liabilities
6. Interest burden ratio (%) = Interest expense x 100 / Profit before tax + interest
7. Net margin (%) = Profit before tax x 100 / Sales
8. Net worth growth (%) = Net worth current year less less previous year x 100 / Net worth previous year
9. Sales growth (%) = Sales current year less previous year x 100 / Sales previous year
10. Profit growth (%) = NPBT current year less previous year x 100 / NPBT previous year

Conclusion

Credit managers should not become obsessed with balance sheets – many factors point to credit *ability* as well as credit *worth.* On the other hand, not to utilise every piece of financial data available would be selling risk assessment short. All information is valuable, and every piece of a jigsaw ultimately completes the big picture. Credit worth can either be calculated from data, or purchased via credit reference agency reports. An agreed policy is needed to decide how much time and effort it is worth expending to match sales values and the amounts of possible losses