Paul Robbins training and consultancy

Credit Management

Lesson 1 – Introduction to Credit Management & Financial Analysis of Customer Accounts

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Liquidity

- **Liquidity** (or solvency) is the **ability of a business to meet its financial obligations** (pay its debts) **when they fall due**
- For a business to meet its financial obligations when they fall due, it **needs to have enough cash available at the right time**
- As well as cash, a business will usually have a range of liquid assets that it can convert into cash at fairly short notice
- These are (in decreasing order of liquidity) cash in hand, cash at bank, trade receivables and inventory. It may also have some short term investments

Liquidity and Trade Receivables

- There are several ways in which a business can improve its liquidity in relation to trade receivables:
- **Debt Factoring** – a factoring company lends a business money on the basis of its trade receivables and takes over the running of the sales ledger function
- **Invoice Discounting** – a finance company effectively buys specific debts from a business at a discount to their face value
- **Credit Insurance** – insuring against irrecoverable debts, whether individual customer accounts, key accounts or all accounts

The Credit Control Function

- The Credit Control function of a business covers several key areas:

- Assessing potential credit customers, deciding whether or not to grant trade credit terms and, if trade credit is granted, how much trade credit to allow

- Monitoring and reviewing existing credit customers to ensure that they are still creditworthy and assessing applications for increased credit limits

- Taking action to collect overdue debts and dealing with irrecoverable debts

External Customer Information Sources

- **Bank References** – obtain information from the customer's bank
- **Trade References** – obtain information from the customer's current suppliers
- **Credit Circles** – businesses in the same sector share information
- **Credit Reference Agencies** – e.g. Dun & Bradstreet or Equifax
- **Companies House** – information on company finances and directors
- **Other Information** – e.g. Google search, management accounts or internal information such as reports from sales representatives

Performance Indicator Ratios

- **Before granting trade credit, a potential customer should provide their financial statements, ideally for the last three years, so that a range of performance indicator ratios can be calculated**
- Whilst there are many different individual performance indicator ratios that can be calculated, these fall into three main areas:
- **Liquidity** – measures the ability of the business to repay its short term debts when they fall due
- **Profitability** – measures whether the business is profitable
- **Gearing** – measures how much of the business is financed by debt capital

Liquidity Ratios

- Current Ratio
- Quick Ratio (also sometimes called Acid Test Ratio)
- Accounts Receivable Collection Period (days)
- Accounts Payable Payment Period (days)
- Inventory Holding Period (days)

Profitability Ratios

- Gross Profit Margin
- Operating Profit Margin
- Net Profit Margin
- Interest Cover (can also have EBITDA Interest Cover)
- Return on Capital Employed (ROCE)
- EBITDA to Total Debt

Using Credit Scoring

- Credit scoring (credit rating) is the process where numerical values are given to performance indicator ratios covering profitability, liquidity and gearing
- The credit scores for each ratio are totalled to give a total credit rating score which shows the overall level of credit risk
- A high credit rating score normally indicates a low risk and a low credit rating score indicates a high risk
- A business should only grant trade credit to businesses which have a low or very low level of risk

Overtrading

- **Overtrading is a situation where a business grows too quickly, resulting in the business running out of working capital (cash)**
- Whilst it is good for a business to grow, it should be done gradually so that the growth of the business and its working capital are broadly in alignment
- Overtrading can occur in profitable businesses and sometimes very profitable businesses can be ‘victims of their own success’ through overtrading
- Additional sales result in greater inventory levels and higher trade receivables balances. As the increase in trade payables is not enough to compensate for this, the cash balance of the business reduces until it runs out of cash

Signs of Overtrading

- Rapid growth of the business (significantly higher levels of sales and purchases) without a corresponding increase in working capital
- Significant increases in trade receivables and trade payables balances, especially in overdue balances
- Higher levels of irrecoverable debts and reduction in the quality of credit control, as staff struggle to deal with higher number of accounts to manage
- Regular cash shortages and constantly using the bank overdraft, in many cases requesting higher overdraft levels, and instances of exceeding the authorised overdraft limit

Dealing with Overtrading

- Adopting a policy of reducing sales levels to more manageable levels
- Improving credit control procedures and considering employing additional credit control staff to deal with higher levels of trade receivables and reduce the instances of irrecoverable debts
- Considering introducing debt factoring or invoice discounting, which will improve cash flow through receiving part of the sales value upfront
- Introducing additional capital into the business and consider converting long term bank overdrafts into bank loans which can be repaid over a longer time