Credit where it's due

CARRYING OUT CREDIT CHECKS ON CUSTOMERS AND POTENTIAL CUSTOMERS IS PARTICULARLY USEFUL AND IMPORTANT IN THE CURRENT ECONOMIC CLIMATE, WRITES NICK LINNANE

‘A CUSTOMER WHO DOES NOT PAY IS NOT, IN FACT, A CUSTOMER BUT A HOBBY. WE MUST PROTECT OUR BUSINESS AGAINST NOT ONLY BAD DEBTS, BUT ALSO CUSTOMERS WHO EXCEED OUR CREDIT TERMS’

'USING CREDIT CHECKS LEADS TO A REDUCTION IN BAD-DEBT EXPOSURE AND PROTECTION AGAINST FRAUD, AND HELPS YOU TO SET CREDIT LIMITS'

In the ideal world,

all our clients/customers pay cash on delivery and we owner managers don't have to worry about advancing credit. However, we live in the real world and reality dictates that we must advance credit terms to our customers; ideally payment in this situation is received within our credit terms and conditions.

It's my firm belief that a customer who does not pay is not, in fact, a customer but a hobby. We must protect our business against not only bad debts, but also against customers who exceed our credit terms – an essential tool in this area is the use of credit checks. There are many agencies that will carry out these checks on your behalf, but you can collect much of the information quite simply yourself.

Using credit checks leads to a reduction in bad-debt exposure and protection against fraud, and helps you to set credit limits. In addition, you may also use them to determine the financial status of your competitors and even suppliers.

INFORMATION SOURCES

The information to complete a credit check can be sourced through a number of channels:

- Direct from your customer
- From your customer's bankers or providers of finance
- From your customer's financial advisers
- From directories
- Online
- From the Companies Registration Office (CRO)
- From trade journals
- From court records
- From competitors
- From the media.

In addition, from the above information, you or the agency operating on your behalf should be in a position to produce analysis and ratios to provide further information in determining the suitability of your customer.

TYPE OF CUSTOMER

In trying to obtain information for credit checks, you must bear in mind the legal entity the business is trading through as this can be a determining factor in access to information:

Sole traders/partnerships/unincorporated entities

These business forms have no obligation to lodge information and accounts with the CRO and thus a major area of information sourcing is not available.

Small companies

A small company may avail of audit exemption and reduced filing responsibilities if it meets at least two of the following criteria:

Turnover:	less than €7.3m
Gross assets:	less than €3.65m
Number of employees:	fewer than 50

Only abridged accounts are required to be filed, with no profit-and-loss account information necessary.

Medium/large companies

Significantly more information is available, with more profit-and-loss account information and supporting notes accessible.

Public limited companies/banks/regulated businesses

With this category there is a requirement to disclose virtually all financial information irrespective of size and thus there is access to very comprehensive financial data.

COMPANY STATUS AND AGE

Due care and consideration should be given to what stage of its trading life the client company is at.

Newly incorporated:

As no information is filed with CRO or elsewhere, it is thus impossible to attribute a credit limit or rating.

In liquidation/winding up:

Again no credit limit or rating is applicable for obvious reasons.

Not trading/dormant:

These companies still have filing requirements, but due to the lack of activity the information filed will tell us very little and, once again, a very low credit rating will result.

CREDIT REPORT INFORMATION

Credit-report information should include the following (I detail below where the information may be gleaned from):

- **Directory:** Confirmation of address, telephone and fax numbers, and website/email details.

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- **Statutory:** Details of registered name, issued capital, company size, filing dates as well as bankers, auditors and solicitors.
- **CRO:** Details of registered office, directors and shareholders in addition to name changes, mortgage documents and debenture details.
- **Ownership:** Any parent company information, any subsidiaries, what the group structure is.
- **Profit-and-loss account:** Details the past three-to-five years' information, as obtained from the CRO.
- **Balance sheet:** Detailing the past number of years from the CRO with cross reference to notes as appropriate.
- **Supporting accounts information:** Summary of information extracted from accounts, including directors' remuneration and loan accounts, bank overdraft and finance status, geographical group status and sundry group transactions.
- **Ratio analysis:** A summary of all relevant ratios on liquidity, credit given and taken, leverage, performance and gearing.
- **Comparison:** Where relevant, comparison with direct competitors and industry averages.
- **Risk information:** Details of any charges or judgements, with court references as applicable.

KEY CHARACTERISTICS

Having obtained all information available we can thus arrive at the key determining factors in what credit rating and ultimately credit limit will be given to our individual client/customer, namely:

- The industry sector
- How long the company is in existence
- The net worth
- The profitability
- The group structure
- The availability of working capital
- The reputation
- Any historical judgements or charges
- What capital structure exists.

CREDIT RATINGS AND LIMITS

Based upon a collation of the information gathered, customers may thus be divided into seven categories. These categories should be used in determining whether you advance credit to this customer and, if so, how much their limit should be set at.

1 Very low risk	The information indicates confidently that the customer will operate within credit limits.
2 Low risk	There is a low risk that the customer will not operate satisfactorily.
3 Average risk	Be aware, act with caution, but the customer has average-risk status.
4 Above-average risk	There is risk associated with this credit rating and a level of assurance is necessary.
5 High risk	Credit here is risky and a guarantee from the directors is recommended.
6 Very high risk	The information leads to an opinion that the customer shows problem areas in financial management. Risky to advance credit terms.
7 Too risky to touch	Likely to continue poor trading performance and working-capital management. Don't advance any credit.

SUMMARY

In summary, in today's most volatile of climates credit control and the speedy and timely collection of our sales is now more important than ever.

I would recommend that for all customers, both existing and new, you initiate credit checks and set credit limits using the following procedures:

- Appoint a responsible individual in this area
- Determine the entity type the customer trades through
- Collect and garnish information from all sources
- Identify the trading age of your customer
- Compare and contrast the information with your own standards
- Complete a credit rating and thus a credit limit in accordance with your categories
- Operate strictly within these limits.

Finally, it is always worthwhile determining the cost effectiveness of taking out credit insurance on your clients/customers.

Nick Linnane is a chartered accountant and managing partner at Linnane McGlennan. This article does not constitute financial advice and should not be taken as such. Owner Manager *urges you to obtain professional advice when dealing with financial issues.*