

# Better Business

TIPS, IDEAS AND KNOW-HOW

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# Credit reports are valuable and revealing resources

It looks like you are about to win that new client. It's a deal you have been cultivating for a long time and you could really do with the revenue. Nothing will stop the champagne corks popping now. Or will it? There may still be one difficulty remaining – the credit report.

There is the option of avoiding a credit check altogether. Very much like not opening bills, we would often rather bury our heads in the sand than stare bad news in the face. But as tempting as that can be, it is not the best policy in this time of record corporate failures at all levels. We need to be careful.

The climate has changed not just because of the credit crunch but also because of the relative ease of prepacked administrations and, perhaps, a culture where business failure does not carry the same stigma as in past times. This has certainly led to larger corporations dissolving unprofitable subsidiaries while leaving creditors high and dry. Of course, a vibrant, fast-moving economy is essential, but we need to be aware of the risks.

## Credentials of a credit report

So how do we evaluate those risks? The credit report is the starting point and, given the unreliability of bank and trade references, your most worthwhile resource. It is certainly more dispassionate than your salesman's assurances that "they are loaded!"

Credit reports vary in quality. Ratings will also vary considerably and if you wish to rely solely on these then make sure your credit report provider examines the business carefully rather than simply processing its most recent accounts through a computer program.

The very high-profile providers will also provide information over and above the basic accounts and legal information. Perhaps the best they can offer is the payment habits of your future client, but this will still not be a substitute for the actual balance sheet.

What do we look for in the balance

A good starting point in getting to know a business is through its credit report, and this is a vital tool if you plan to do business with it, says Clive Pacey.

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**'At the risk of being ageist, a board comprised entirely of inexperienced directors can be seen as a concern'**

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sheet? The first and perhaps most crucial question you will ask is whether or not the client has the resources to pay. The indicator for this will be the working capital.

Simply put, this is the balance of the client's liquid (referred to as 'current') assets and liabilities and, naturally, you will be wanting to see the assets outweigh the liabilities. In fact, it is a rule of thumb that anything other than a positive balance will probably indicate a fairly high credit risk.

However, when we dig a little deeper, the ratio of the working capital as well as the nature of the industry with the resulting transactions, are also factors.

## Business assets

It is the assets that are most important and, being largely made up of debtors, stock and cash, remember that cash is king. No one can question the level of cash (although Parmalat creditors may disagree), whereas debtors and (especially) stock, have elements of risk.

There are various indicators that can help form a fuller picture of a firm's credit-worthiness. Among these would be how efficient the client is at collecting its debts and the level and turnover of its stock.

Another indicator is the firm's net worth. This takes the balance of all assets and liabilities, including fixed assets

such as property, and liabilities such as long-term loans, as well as the infamous balance sheet item, 'intangible assets'.

Again, you will want to see a positive balance and, because this is an overall indicator of the value of the business (sometimes referred to as the shareholder value), it could be argued that this would be the first area to look at.

But remember how difficult it can be to convert fixed assets into ready cash and how their realisable value can be quite different from that stated on the balance sheet (I have seen a £2 million fixed asset item realise £15,000 upon liquidation).

## Company history

Although this may seem a little complicated, it is vital to look at the profitability of a business. It is perfectly possible, for example, for a business that is making losses to be a sound credit risk. Less likely, but also possible, is for a business trading profitably to go bust. Put simply, profits or losses strengthen or weaken the balance sheet. In summary, the ideal scenario is:

- ➔ Positive working capital.
- ➔ Positive net worth.
- ➔ Profits.

Of course, the balance sheet and profit and loss are a snapshot of the business's status at its last accounting point, and there will always be an element of guesswork surrounding the current position.

To gain a fuller picture, it is helpful to look at the history of a business over the past three to four years. Most credit reports will include this information and you will be hoping to see a steady pattern. The nature of the sector will have some bearing on the volatility of progress, but as a rule it is desirable to see a steady increase or little fluctuation in profits and net worth over the period.

Fortunes can change rapidly for any business and generally the smaller the





business the greater these fluctuations will be.

Before you leave the numbers, make sure that the business's accounts are not overdue. If more than a year has passed since the date of its last filed accounts, then questions should be asked. Anything significantly longer than this is a serious negative. Businesses do not wish to disclose bad information in the public domain unless they have to.

### Legal information

Once you are reasonably happy with the business's assets and history, it is on to other factors – the most significant of which is the legal information.

Frankly, if there is any negative legal information detailed on the credit report I would stop there. For this information to appear on a credit report it would mean that the full process of obtaining a judgment or fully progressing a winding-up petition has taken place, and at that stage the client is possibly beyond recovery. However, if there are county court judgments of relatively small value, this may not be significant. It is quite easy for a large corporation to let a few of these slip through the net.

Some credit managers put a premium on the past record of directors, although it is not overly concerning if they have been involved in a failed business in the past. But do look at the profile of the directors. At the risk of being ageist, a board comprised entirely of inexperienced directors can be seen as a concern.

The better credit reports detail the payment record of the client. You would not want to see a declining pattern, but at

## 'If there is any negative legal information detailed on the credit report I would stop there'

the same time, take note of the sample used.

### Ownership

We now come to the question of ownership. Generally speaking a fully owned subsidiary of a well-known and highly rated corporation will probably be backed, regardless of the state of its accounts. However, this is not always the case, as creditors of ITV Digital and others will confirm.

If your client is registered overseas there is a whole range of issues to consider, but these are too many to mention and would require an article dedicated entirely to the subject.

### Other sources

There are traditional tools that you can use to find out information about a new client, such as trade references and bank references, but frankly I would pay little attention to them. I spent time at a business that could provide glittering bank and trade references until the very day it went into administration.

Websites are an interesting source of data. Of course they will not tell you that

the business is struggling to pay the bailiffs, but if you know what to look for, they can offer clues.

All credit has an element of gamble about it and you are looking to maximise the win potential. Many reports will be fine. Most businesses are not in trouble. And occasionally some reports will be so poor that the decision is easy to make.

Furthermore, there is the difficulty of judging a new business that has yet to file its accounts. This can often be the most difficult decision of all because while it has not incurred significant positives, it is equally the case that there are no real negatives. Some credit agencies will downgrade new businesses simply because they are new, which is not always fair.

Ultimately, your aim is to form an overall picture of the risk profile for the business. This is often a highly significant decision for any enterprise to make, with possibly serious financial implications. It is therefore worthwhile to elicit an opinion from a credit professional. They will often have the experience of having examined thousands of clients and will have monitored their progress. Don't be afraid to ask. ❖

### Infobank

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