Insecurity rules

***Clive Pacey** highlights the need for careful interpretation of data when conducting credit checks*

Clive Pacey

Why credit check? What difference does it make? These are questions that I have been asked on a number of occasions, often by relatively senior finance staff.

Of course, to those of us involved in both lending and brokering-lending, questioning the need for credit checking is a ridiculous scenario. The very idea of lending your cash or assets to a completely unknown entity, without insisting on a comprehensive character assessment beforehand, is bordering on madness but, time and time again, businesses are dazzled by the potential of the sale and they, frankly, lose their heads.

Last year I was involved in attempting to find a solution for a business that lost £800,000 to a debtor which had not been credit checked because the client was a plc, and was clearly not a risk in the eyes of both them and the accountant.

Unfortunately, this plc was managed by a director who had a string of recent badly-failed businesses to her name, and this new enterprise had been trading for all of two months. Of course, being alerted to this by a simple credit check would have saved the business and 200 jobs.

Simple information was readily available and we are all reliant on the quality and timeliness of the data and news stories to help us make good decisions. Yet, how reliable are our sources? Companies House information has to be taken as it is found and the skill can lie in its interpretation, which is not as straightforward as might often be imagined. This is where problems do arise.

The simple fact is that, if you are relying on interpretation and credit scoring of company financials, without applying your own analysis, you are likely to find the scoring you are provided with will vary enormously depending on the agency.

In my experience, the major agencies all have different criteria to which they add varying weights. That is understandable, but the overall quality can also be an issue and this will often be in line with budgetary expectations.

Sadly, poorly assessed ratings, and interpretation of data that is sloppy or too mechanical, can destroy confidence. Allow me to provide you with an example.

Late last year, I advised a client that it had to move quickly to collect from a £500m turnover telecoms business which possessed a most disturbing balance sheet. The firm had been making small profits but was extremely vulnerable, with frighteningly high gearing. The negative net worth of the business was in the region of £50m. My client collected and, early this year, the telecoms business collapsed. Needless to say, my client was ecstatic to have avoided a costly bad debt.

> “Good clients can be lost due to overly negative assessments”

Subsequent to our successful collection and before the collapse, it had been widely reported that the business was close to breaking bank covenants and had appointed new directors possessing turnaround experience. The writing was on the wall. However, clearly not to everybody.

A good contact at an asset-based lender ran a credit report on that very business on the very morning it went into administration. What did the report state? That it was good for credit of £3.6m. A chronic balance sheet had somehow been misinterpreted and not a single national news agency picked up on it. I shall not state the name of the credit check agency but, let it be said, you only get what you pay for.

The first concern is that some businesses might well have been relying on that rating in the weeks up to expected collapse and they were, therefore, putting their own balance sheets at very serious risk. Yet, just as concerning in my view is the resultant complete lack of confidence in the whole process.

If an agency cannot highlight such widely-reported difficulties, with such a high-profile struggling business, then what use are they at all? It needs to be highlighted that this was not an isolated incident. As well as the risk of bad debts, the other side of the coin is that good clients can be lost due to overly negative assessments; poor ratings of subsidiaries of strong overseas firms are a good example.

As inexcusable as a refusal to check clients will always be, in this instance, “Why credit check?” and “What difference does it make?” are perhaps understandable questions. However, that in itself is just not acceptable.

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