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Foreword by

Philip King, FCICM

Chief executive, Chartered Institute of Credit Management

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Understanding Credit Risk

FOR DUMMIES®

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Understanding Credit Risk For Dummies®, Graydon Special Edition

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Foreword

Credit managers are the original multi-taskers. Far from being overlooked as a back office function, the role of the credit manager is expanding – from order to cash. Credit management teams are making tangible contributions to the success of a business at every level, not only tactically but also strategically.

The secret to doing business and getting paid is, of course, knowing your customer. To achieve this goal, credit managers have several tools and tactics at their disposal. Published data is available from Companies House, and more current information is available through professional credit information firms. These firms supplement historic data with more recent payment trends and performance.

You can find other sources of information closer to home. Your sales teams and colleagues may have a track record or even previous employment with a potential customer. These resources provide valuable insight that you cannot get from reading a spreadsheet.

All sources have merit; you can never have enough information. The skill is in understanding and interpreting what you have, and then making informed decisions. Better decisions not only help you avoid the nasty things in life such as fraud, but enable your business to enjoy future growth and prosperity by choosing the right partners.

Credit management continues to grow in stature as a discipline, as demonstrated by the ICM's elevation to Chartered status at the start of 2015. But credit managers never underestimate the importance of getting the basics right. They're happy to embrace anything that helps them learn and improve. I commend this book as a valuable resource to add to your toolbox.

Philip King, FCICM
Chief executive, Chartered Institute of Credit Management

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Introduction

Welcome to *Understanding Credit Risk For Dummies*. Credit risk and fraud are serious problems for businesses. In 2013 the UK economy lost £52 billion to fraud alone, and the problem is on the rise. Today, fraudsters have more ways than ever to do their dirty work. But on the flip side, businesses have more tools to help identify those risks and take proactive measures to minimise them. This introductory guide to credit risk has been compiled by Graydon UK Ltd to explain the intricacies of B2B credit risk and explore best practices for protecting your business from credit risk and fraud.

About This Book

Optimal management of credit risk is vital to companies' success in today's marketplace. Smart businesses recognise this. They also appreciate what their financial group can bring to the table. Instead of waiting for a problem to occur, then going at it great guns, a proactive approach is more effective. Today's credit managers need to be able to implement well-designed strategies to minimise credit risk and fraud.

Easier said than done, you say? Honestly, isn't everything? But you have an ace up your sleeve. You have this book! And you'll glean tons of valuable information that will give you a better understanding of the problem, how to head it off, and how to become a hero in the boardroom!

To be a savvy credit manager you need to do the following:

- Take a holistic approach to credit risk that values your gut feeling as well as a diligent review of a company's annual report.
- Be aware of the potential risks and pitfalls you may encounter.

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- Learn to read between the lines of an annual report to gain a more comprehensive view of a company's financial status.
- Play nice with the sales department. Gain their trust and esteem so you can provide valuable input about the credit risk associated with a potential customer long before the ink is dry on the contract.
- Stay abreast of what's going on with your customers and the marketplace.

Sound like lots of information to digest at one time? Relax. We've packed this small book with the basics in an easily understood format that gives you the head start you need.

Foolish Assumptions

We've made some basic assumptions about you for the purposes of writing this book. We assume three things:

- You are just beginning your career in credit management and are associated with your company's financial group. And, duh, you want to climb up the ladder to success more quickly.
- You want to positively impact your company's bottom line by minimising the risks associated with bad credit and fraud.
- You may not have a financial background – perhaps you're in sales or another area of management – but you want a better (and basic) understanding of how credit risk affects the company.

Icons Used in This Book

Because we know you have a lot on your plate, we've made it easy for you to navigate through this book and quickly capture the most useful and important information. Just look for the following icons:

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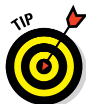

When you see the target, you'll find pithy, easy-to-understand advice.

This icon denotes important information you'll need to revisit time and time again.

Pay attention to this icon! It warns you against common pitfalls or hazards that are best avoided.

How This Book Is Organised

Understanding Credit Risk For Dummies is divided into six chapters. Here's a succinct overview of what you'll find in each:

- **Chapter 1: Delving into Trade Credit.** This chapter provides the history and highlights of trade credit from its origins to the present day. This chapter dispels the misconception that assessing credit risk comes down to a mere mathematical calculation!
- **Chapter 2: Making Nice: Collaborating with Sales.** You'll learn why it's so important to your company's bottom line that credit and sales act as a team – and you'll find tips to facilitate the camaraderie!
- **Chapter 3: Decoding Annual Accounts.** You'll learn how to interpret annual accounts so you can make sound credit management decisions. In addition, this chapter defines the role common sense plays in the equation.
- **Chapter 4: Setting Credit Limits.** This chapter shows you how to factor in additional elements to supplement your credit information and individualise your decision.
- **Chapter 5: Spotting Trade Credit Fraud.** This all-important chapter details why fraud is an ever-increasing problem and provides a plethora of tools for unveiling fraud and guarding against it.
- **Chapter 6: Ten Key Ways to Keep Up the Good Work.** This chapter gives you ten tips for keeping up to date and on the right track, moving forward!

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Where to Go From Here

If you're familiar with *For Dummies* books, you know that where you start is totally up to you. You can devour the book from cover to cover, delve into the parts that are new to you, use the book as a refresher, or use it as a reference book when needed. No matter how you use it, you can't go wrong!

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Chapter 1

Delving into Trade Credit

In This Chapter

- Tracking the evolution of trade credit from its origins to the present
- Gathering additional information to minimise credit risk

Your business received a terrific order from a new customer. Yeah! Everyone scurried around doing their bit to ensure it got out the door and invoiced in record time. Then you waited, and you waited. But the cheque never came. Unfortunately, this scenario occurs every day.

Delivering goods or services without receiving payment upon delivery is risky. Some of your clients are likely to renege and not pay you according to the agreed terms – or ever. But don't despair; you can take steps to minimise those risks.

In this chapter, we discuss how the practice of trade credit began and evolved to where it is today. We also whet your appetite with a sneak peek at the basic information that can help ensure you don't get caught with egg on your face. And, surprise! The information you need doesn't all come from a financial statement!

Assessing Creditworthiness

The word 'credit' is based on the Latin *credere*, which means 'to trust' or 'I believe'. You extend credit to a business and trust they will pay you at a later date. But sometimes businesses don't pay their debts. Perhaps they went belly up or maybe they never intended to pay. The result is the same: Customers who don't pay jeopardise the health of your business.

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That's why in 1841, Lewis Tappan, a wealthy American merchant, created a methodology for assessing a customer's ability to pay. Within ten years he had hundreds of clients and more than 2,000 correspondents all over the U.S. Soon, credit bureaux began opening worldwide, beginning with Western Europe in the 1850s. Eastern Europe followed suit in the late 990s and most recently, the Middle East.

By the 1970s credit bureaux were the norm for checking the creditworthiness of customers or prospects. Correspondents in the UK used data from Companies House, the government body responsible for processing all filed data, including:

- Company officers: directors, company secretary
- Registered office address
- Annual accounts and annual returns
- Charges or secured borrowings

Based on their findings, correspondents made subjective value judgments and assigned a company a credit rating.

Today, empirically derived scoring systems are the gold standard for assessing credit risk. This methodology provides modern-day credit controllers and managers like you with the predictive outcomes you need to make these difficult calls.

The key ingredient for assessing creditworthiness, then and now, is the annual account. Under penalty of law, private limited companies and public limited companies must file nine months and six months from year-end, respectively.

Digging Deeper

If you think your work's finished after scrutinising the annual account, think again! That's just one part of the overall investigation into a company. It isn't only about the maths!

The next step is to learn everything you can about the company. The story behind the numbers is just as revealing as the numbers themselves. And to make informed decisions, you need a comprehensive perspective.

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Put on your reporter's hat and adopt the five *W*'s – who, what, when, where, and why – as your investigative tools.

The Internet makes it easy to search for information not necessarily included in financial reports, such as the directors' backgrounds – are they blemish free or questionable – and whether the industry as a whole is thriving or declining.

Knowing your customers

You may think you're trading with John Smith, but are you? 'John Smith' can actually be any of these:

- John Smith Ltd
- John Smith trading as John Smith Engineering (sole trader)
- John Smith and Julie Smith trading as John Smith Engineering (partnership)
- A ginormous company Ltd trading as John Smith Engineering (division)

Why does the type of business matter? Sole traders and partnerships are personally liable for *all* debts, while private limited companies are liable for only the company's debts, limited to assets realised against liabilities.

Getting familiar with sectors

You also need to bone up on your customers' industries and their customers' industries. In particular, you want to know:

- Who are the market leaders?
- What are the growth prospects for the sector?
- What challenges lie ahead for the sector?

Your customer's problem can become your problem. If they don't get paid, you don't get paid.

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Questioning Changes

Although you vetted a company thoroughly before extending credit, your job still isn't finished. Things change. Review customer accounts regularly for information such as:

- New directors or resigning directors
- A change of address
- A change of bank
- Deterioration in the company's payment record

Investigate the reasons behind those changes – question your customer, too – then reevaluate their creditworthiness.

A customer's website showcases the positives, but for information such as the loss of a key contract, closure of a site, or layoffs, you need to turn to other sources.

For prospective customers, the question is: Why did they leave a competitor to come to you? Perhaps your competitor wasn't responsive enough. But maybe the customer was late making payments!

Keeping It Simple

Don't drown in a sea of figures. When starting out, stick to the basics. Look at the key figures and the most basic ratios. Dig deep to unearth trends. Ask these questions:

- Are sales increasing or declining?
- Are profits rising or falling accordingly?
- How much of the profit is being reverted to the business?
- How much has the company borrowed, and how has its borrowing affected cash flow?

You're just beginning your career in credit management. Don't attempt to run before you can walk! Getting a handle on the essentials now will make your work easier down the road!

So there it is, an introduction to trade credit and some teasers of what's to come. Are you ready to dig deeper?

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Chapter 2

Making Nice: Collaborating with Sales

In This Chapter

- Recognising the need for cooperation and collaboration
- Employing tactics to develop stronger relationships
- Taking the lead in providing innovative, win–win solutions

In many companies, the sales department and the credit department spend lots of time in their respective corners getting prepared to square off – against *each other!*

Why? The competition to make a sale has never been more fierce. And from the sales manager's perspective, when the credit department puts the brakes on a hard-earned sale, it's time to come out fighting!

Protecting the company from credit risk has also become more difficult – and more crucial to a company's very survival. From the credit manager's perspective, the sales department should be more discriminating. Not every prospect's signature on the dotted line is cause for celebration!

So the lines are drawn. And when everyone's in fight mode, no one benefits, least of all, the company.

In this chapter, we show why in-fighting between the sales department and the credit department is detrimental to the company. We cover some steps credit can take to break the ice and involve the sales department in the credit process. And we discuss the responsibility the credit department has in helping make a sale – a good sale!

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Taking the Boxing Gloves Off

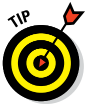
Sometimes the credit department may feel a good right hook is called for to make the sales department get the message – and vice versa. But no one wins in that scenario.

How can you turn that situation around? A collaborative relationship between credit and sales, one based on mutual respect and understanding, is key to successful trading.

When each department respects and honours the role of the other, and works together in the company's best interests, it's a win–win for everyone!

Nourishing the Partnership

When each department knows the role the other plays within the company, the goals each department strives for and the challenges each faces, they can more easily understand why each department reacts in the way it does. Along with these insights comes respect. And when respect replaces distrust, the tone is set for future cooperation.



Small steps can yield big results. Try throwing an interdepartmental party to ease the tension and put a little fun into the getting-acquainted process.

Both departments need to understand there's a natural connection between them and that they need one another to operate optimally. If the sales department doesn't sell on credit, the company doesn't need a credit department. But if those credit sales aren't solid, the company's bottom line and solvency are threatened.

The sales department really is the lifeblood of the organisation. That isn't just sales hype! Without a continuous stream of new sales, the company won't survive.

Here are some tactics the credit department can initiate to make the partnering process run more smoothly:

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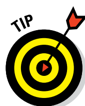
- Strive to get buy-in from the sales department to ensure credit applications are fully and accurately completed the first time round. Be sure to explain the consequences, which range from inconvenience – having the application returned for correction or completion – to disaster – bad debt or non-payment.



  Don't cave under pressure! If the application isn't up to scratch, don't begin processing it. Politely send it back to the sales department and request that it be corrected or completed. After a while, they'll get the idea!

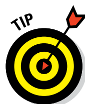
- Take the mystery out of the credit process by facilitating a presentation for the sales department. Keep it blame-free while shedding light on pertinent issues.
- Encourage the sales department to pre-vet prospects. Pre-vetting saves time and money for everyone involved. And it's less disappointing to both the salesperson and the potential client to find out early on that the sale can't be approved. Be sure to give sales the tools they need – no holding back on access to financial databases and quality forecasts! Sure, you may have to give the sales department additional training, but that's another good opportunity to build a better relationship!

  Pre-vetting a client keeps everyone's expectations in check early in the sales process.

Taking a Proactive Stance

Sales representatives initiate contact with potential customers, so they're naturally involved at the beginning of the sales cycle. Often, credit isn't consulted until later in the transaction.

But an effective credit manager doesn't wait to jump into the ring at the end of the sales cycle. The credit department's goal is to prevent a problem from happening in the first place or to minimise potential problems. To do that, credit needs to be involved at the beginning of the sales cycle – especially for the company's biggest and most important clients.



You may have to get out of your comfort zone and be more assertive to reclaim credit's place at the table. But the results will be worth it!

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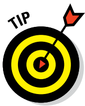
Being a credit problem-solver

Savvy credit professionals devise creative approaches to ensure a good sale goes through.

For example, if a potential customer's credit limit is £10,000 and the order is for £20,000, you have several options:

- Deny credit. This is the easiest option, and the facts support it, but it's lazy. No one wins with this one.
- Ask the customer for a 50/50 transaction – £10,000 up front and £10,000 on credit – to bring the sale in line with the credit limit.
- Consider using discounts for cash as an enticement. If profit margins allow, a settlement discount can get you ahead of the competition and give the buyer a big incentive to settle accounts promptly. This approach improves your cash flow as well! Offering a small but significant percentage discount is commonplace in many sectors, but it need not apply to all customers unless it is written in your credit policy. Utilise a discount where it benefits your business most.

Pointing out potential problems with the sale isn't enough. You've got to offer solutions!



If a sales representative has a potential sale with a customer who pays after 90 days instead of 30 days, advise sales to charge a slightly higher rate to offset the losses entailed by a late payment!

So break with the old traditions, get out of your comfort zone and make a real difference. Your relationship with the sales department will improve and the credit process will go more smoothly. And that will give you more time to deal with other important issues such as interpreting annual accounts – coming up next!

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Chapter 3

Decoding Annual Accounts

In This Chapter

- Interpreting annual accounts
- Supplementing annual accounts with additional information
- Learning which ratios to master first

Now we're getting down to one of the credit manager's most valuable tools – the annual account. This mysterious report boils a company's essence down to one neatly packaged bundle of figures.

By law, a company's annual account must contain the following items:

- Balance sheet
- Profit and loss account (with the exception of small or medium companies)
- Auditor's report
- Director's report

Now that you have all that information, the big question is what do you do with it? As a credit manager, your role is to put on your wizard's hat and decipher what these figures mean. The job may sound intimidating, but if you take it a step at a time, you'll soon impress your colleagues with your wizardry and your wise decisions!

In this chapter, we discuss the key components to consider when reviewing an annual account and how to interpret those numbers to get the most accurate and comprehensive information. We also look at other factors that can help you get a more comprehensive financial picture of the company.

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Taking a Holistic Approach

An annual account is much more than historical data from public records. If you take the information it contains at face value, you'll shortchange yourself. And that skewed interpretation will likely lead to your making wonky credit decisions. Now, that isn't going to help you get ahead in your career, is it?

When interpreted correctly, a company's annual account can do these things:

- Give you guidance about the amount of credit to extend to a company
- Help you predict a company's willingness to pay
- Help you predict business failure

Discovering the Trends

A company's year-end figures may look strong, but if you make a value judgment based solely on year-end figures, you may be sorry!

To get a better grasp of a company's financial health, look at a company's accounts over the last three to five years. Your goal is to spot trends.

Are sales trending up or down? How about the company's profits, net worth, and shareholders' funds? These are key indicators of a company's financial health, so you need to know if they're increasing or decreasing. Ideally, you should see a steady upward line in each category.

For example, at £1 billion, Company ABC's annual sales figures may look strong – until a comparison of previous sales figures shows they've been steadily declining over the past five years. Numbers don't lie, but interpreted in isolation, they may not give you the real picture, either.

Year-end figures viewed in isolation can be deceiving. Try to view the figures for the last three to five years.

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Table 3-1 shows a financially healthy company. Look for year-on-year sales growth and increasing profits.

Table 3-1 Snapshot of a Healthy Company

Number of weeks	*52*	*52*	*52*	*52*
Accounts date	*13/09/2014*	*14/09/2013*	*15/09/2012*	*17/09/2011*
Currency	*GBP*	*GBP*	*GBP*	*GBP*
SALES	***2786250***	***2583515***	***2297946***	***2096422***
Cost of goods sold	2253549	2089637	1930835	1739249
GROSS PROFIT	***532701***	***493878***	***367111***	***357173***
Wages and salaries	312730	257986	231284	197488
Directors' emoluments	923	806	994	689
Auditors' fees	228	165	75	120
Trading profit	380416	339142	273022	250833
Depreciation	96943	91030	88751	69645
OPERATING PROFIT	**283473**	**248112**	**184271**	**181188**
Non-trading income		(10318)	5	8
Interest payable	9521	647	16769	13134
PRE-TAX PROFIT	**273952**	**237147**	**167507**	**168062**

The balance sheet extract in Table 3-2 shows year-on-year growth in net worth/shareholders' funds. For a financially healthy company, the net worth should be a positive number that has been growing over a period of years in tandem with sales and profits.

Table 3-2 Growth in Net Worth/Shareholders' Funds

SHARE CAPITAL + RESERVES	***293718***	***287336***	***188219***	***179018***
Share capital + sundry reserves	52539	51719	50966	50546
Issued share capital	50000	50000	50000	50000
Sundry reserves	2539	1719	966	546
Profit and loss account	241179	235617	137253	128472
SHAREHOLDERS' FUNDS	**293718**	**287336**	**188219**	**179018**
CAPITAL EMPLOYED	**321969**	**324616**	**233866**	**225677**

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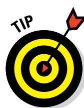
Look at the profit margins as well. If Company ABC recorded sales of £50 million and pre-tax profits of £1,000, what does that tell you? Profit margins are slim!

Knowing Your Industry

How you interpret the numbers also depends on the industry involved. Get to know the peculiarities of your industry. The Internet is a great place to start.

These questions can help you get a feel for an industry:

- Is it a thriving sector, in general?
- Do earnings fluctuate with the seasons?
- Is its success dependent upon another industry?
- What are its prospects for growth?
- Is its market share expanding or declining?
- Is it an antiquated industry that hasn't kept up with the times, or an innovative, fledgling industry?
- How well is it anticipated to fare in the current economic climate?



Profit margins vary from industry to industry, so compare companies within the same sector. For retail, a 1-per cent profit margin is typical. Even a giant of a business like Tesco makes only modest profit margins – when it makes a profit at all!

The more you know about an industry, the more likely you are to make good decisions about businesses in that sector.

Considering Liquidity

Liquidity – the difference between current assets (monies accrued or due to be received within one year) and current liabilities (monies due to be paid within one year) – is just as important an indicator as a company's net worth.

Liquidity ratios can provide information about a company's ability to meet its short-term financial obligations. They can determine whether you're likely to be paid, and when!

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This is a simple but powerful concept. For example, if you earn £2,000 per month and your expenses total £1,000 per month, you have £1,000 to play with. Life is good!

But if you earn £1,000 per month and your expenses total £2,000, your world looks different. You'll have to be miserly until you've worked your way back to positive liquidity!

When businesses are short on accessible funds, they have to consider supplementing their income by borrowing.

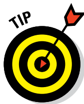
Factoring in Borrowed Funds

These days, many companies borrow funds at some point. It may be a loan, an overdraft, or asset-based lending, which is increasingly becoming the norm.

Asset-based lending is borrowing funds against a security. If you've ever borrowed against your mortgage, you know the basic concept. Book debts (monies a company's invoiced but hasn't yet collected) can also be used as security.

No matter what the form – a loan, an overdraft or asset-based lending – borrowing money always comes at a cost in the form of interest payments.

Look at the level of funds a company has borrowed and how much interest it's paying. Then take another look at those trends to see how this changes the picture.



Raise a big red flag when a trend shows a decline in sales and profits combined with an increase in borrowing!

Ensuring the Account's Current

Are the accounts filed with Companies House up to date with regards to the company's legal obligations? Specific rules govern filing requirements for public limited companies and private companies. And they're different for each entity.

- **A private limited company** must file 21 months from its incorporation date, and thereafter within nine months after its year-end. For example, if a private limited

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company's year-end was in December 2014, it must file its results no later than the end of September 2015.

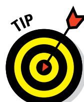
- **A public limited company** must file 18 months from its incorporation date, and thereafter within six months after its year-end. For example, if a public limited company's year-end was in December 2014, it must file its results no later than the end of June 2015.

Filed reports are historical data. Always supplement them with current results from your own research.

Investigating the Directors

Don't forget to dig up info on the guys who're calling the shots. Do the directors have a track record of managing successful businesses, or mismanaging failures?

By company law, a director is obligated to list all other directorships he or she held within the last seven years.

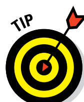


Although not listed as directors, shareholders can run the company. In that case, they're called *shadow directors*.

If the company is a new limited entity, look at their business experience. For example, if a director's prior work experience focused on retail, you should do a double-take if he or she is listed as director of an engineering company!

It's more likely that a director with experience in one industry parlays that expertise to found his or her own business. That's how most businesses get started today.

A new business seeks credit opportunities. Find out the complete story behind its formation, and whether it's a sole trader, a partnership, or a private or public limited company.



The risk status of a non-limited business (sole trader or partnership) is different from that of a limited business. With a non-limited business, the owners' personal assets can be tapped to pay off debt, but the owners' personal assets are protected with a limited business.

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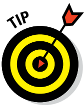
Looking at Post-Filed Accounts

Management accounts offer more timely information about the company's financial status than the annual account. Typically, they're prepared to show a company's progress to date, which can be compared to the filed annual report. They provide managers with the latest cash-flow statistics on which to base short-term decisions, and are often used for a company's presentation to banks when it's trying to procure additional funding.



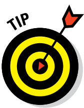
Management accounts invariably omit taxation and potential dividends until the trading figures are audited internally or externally.

A draft account is a second type of post-filed account. This account is typically very accurate and is often used as the basis for the next filed report.

Both types of accounts – management and draft – are helpful to credit controllers because they provide a more up-to-date picture of the company's trading figures.

Mastering the Basic Ratios

Many ratios are available for credit managers to use in assessing a company's accounts. You can measure how quickly a company turns over its stock, how quickly it collects on invoices and a whole slew of other measurements, including performance ratios, liquidity ratios, and solvency ratios.



Your credit reference agency generally highlights the most meaningful ratios in its credit reports.

But until you're a seasoned credit manager, stick to the basics. After you have them down pat you can add more sophisticated assessment tools to your toolbox.

The *current ratio* is quite simple – current assets divided by current liabilities – but it's one of the most important ratios to master. Table 3-3 is an example of a balance sheet with a 2:1 current ratio. A 2:1 current ratio is ideal and indicates a healthy liquidity position, but a 1:1 current ratio is acceptable.

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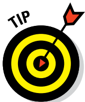
Table 3-3	Liquidity/Working Capital		
CURRENT ASSETS			
	Stock	£1,000	
	Debtors	£10,000	
	Cash at bank	£9,000	
	TOTAL ASSETS		**£20,000**
CURRENT LIABILITIES			
	Trade creditors	£5,000	
	Bank overdraft	£4,000	
	H Purchase	£1,000	
	TOTAL LIABILITIES		**£10,000**
NET CURRENT ASSETS			**£10,000**

The balance sheet shows that the company has £20,000 available in current assets to cover £10,000 in current liabilities, leaving the company with a balance of £10,000 in liquid assets. That's a pretty good financial position!



The *quick ratio* – current assets, minus stock, divided by current liabilities – gives a more accurate measurement of cash flow and liquidity. Why? Because you won't have the conversion rate dollar amount until the stock is sold.

By themselves, most ratios aren't highly meaningful. To get the real picture, compare them to historical data. A 2:1 current or quick ratio looks great until you discover last year's ratio was 3:1. And the year before that it was 4:1!

Putting It All in Perspective

So, even when you're working with annual accounts, it isn't all about the maths!

Common sense and a desire to uncover subtle nuances are also critical to making credit decisions. Learn how to finesse that information to set credit limits – coming up next!

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Chapter 4

Setting Credit Limits

In This Chapter

- Evaluating creditworthiness
- Learning why the 'why' behind a credit request is so important
- Utilising third-party reporting to your advantage

When you've mastered the basics of reading a credit account (and reading between the lines), you may think you have everything you need to set credit limits. But don't be so hasty. Remember when we said it isn't all about the maths? Rather than glibly basing your final decision on the annual account alone, keep investigating to give your report more depth.

In this chapter, we discuss additional ways to supplement your credit information and help you determine not just whether to extend credit, but how much credit!

Assessing the Credit Request

As a credit manager, you want to open new accounts. After all, increasing sales (and revenue) is key to your company's financial health. But the quality and profitability of that revenue are what really matter.

Good credit assessment helps to reduce bad debts and increase profitability. You need a great deal of insight into your client's situation and requirements to make solid decisions.

The good news is there are no hard and fast rules! The bad news is there are no hard and fast rules!

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Honing in on creditworthiness

If the potential customer has been pre-vetted and found creditworthy, that's great! If not, you need to analyse the annual accounts, looking beyond the obvious and considering:

- Are sales and profitability figures trending up or down compared to the last three to five years?
- Is the industry thriving, with potential for future growth?
- How reputable and experienced are the directors?

Comparing the amount of credit a company is requesting to its annual total sales can also provide insight into the company's purchasing requirements. If it requests a figure that represents 75 per cent of its annual sales, you wouldn't approve that credit limit, would you? We hope not!

That brings up another question. How large a supplier do you want to be to this company? A huge contract can be tempting, but you have to weigh that against the risk that the company may not pay you! Is their business worth the risk?

Better to take a lesson from XYZ Steel Company, which sells its steel to multiple companies in different industries. If one company or market falters, XYZ has relationships with many others, allowing it to more easily absorb those losses.

Having all your eggs in one basket is dangerous – even if that basket is sporting a beautiful blue bow!

Keeping everything in balance

Another factor that influences the credit limit is the price of the product or service your business has to offer versus the monetary amount or terms your potential customer has requested. The two need to be in sync – and realistic.

For example, if your business supplies fuel cards, you won't grant a credit limit of £10 million to a one-man taxi business. Likewise, if your business supplies oil rigs to oil exploration businesses, you won't set a credit limit of £2,000. In both examples, the credit limit is inconsistent with the price of the product or service.

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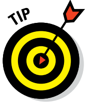

Aim for the proper balance. Set a limit that benefits both your customer and your company!

Investigating purchase patterns

Sometimes, seemingly out of the blue, a business breaks from its normal purchase pattern.

For example, one of XYZ Steel Company's customers has been purchasing 100 tonnes of steel bar per month, and then suddenly increases the order to 100,000 tonnes per month.

What's the first thing you'd want to know if you were the credit manager of XYZ? If you asked, 'Why is the customer ordering so much steel this month?' you get a gold star. You need to know what's driving the request.

Your first step is to contact your friends from the sales department. They tell you that the customer was just awarded a contract to construct a skyscraper taller than The Shard at London Bridge. That puts the customer's request in a whole different light.

This is where all the time you spent building a collaborative relationship with the sales department pays off. The sales department is closer to potential customers and regular customers and should be able to answer your questions on the spot – or find out for you.

Savvy credit managers find out the 'Why?' behind their customers' business requirements.

Take your investigation several steps beyond simply learning about your customer. Find out about your *customer's* customer and if need be, *their* customer as well. One break in the supply chain – be it goods or services – can lead to the whole project collapsing in a heap. Ask detailed questions, or get your friends in sales to ask.

Utilising multiple reference points

Trade references can give you an idea of the credit limits your competitors are trading to and how promptly they're being

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paid. You may discover a business typically pays within 90 days – even when the credit terms are 30 days. Do you want that business as a customer? Probably not!

Or you may find out that a potential customer has been denied credit by the competition. If you extend credit to them, you'd better be strategic in setting a limit and terms that protect your company, and aggressive in account management.

A good customer is one that not only pays, but pays on time! Profit is reduced by slow payment or non-payment.

Credit reports are another source of detailed information about businesses. Just be sure you use a reputable credit reference agency and one that uses sophisticated scoring and analytics to rate the amount of overall risk.

A 21st-century credit report should do three things:

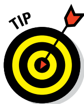
- Predict the risk of business failure
- Predict the willingness of a business to pay to terms
- Detect unusual patterns in a company's activities

Realising it isn't as easy as 1-2-3

No hard and fast rules can guide you through the process of setting credit limits. Each case is unique, with its own set of circumstances. Those circumstances are often in flux.

You can't take shortcuts. Setting credit limits calls for extreme due diligence – impeccable intelligence-gathering skills, a dash of good common sense, and strategic analysis. After that, you can set those credit limits with confidence.

Setting a credit limit isn't a once-and-done activity. Situations can change overnight. Keep tabs on your customers on a regular basis to update their information (and your credit limit assessment).



Make sure your customer's request or limit increase ticks all the boxes on your assessment form, not just some of them!

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Chapter 5

Spotting Trade Credit Fraud

In This Chapter

- Understanding the prevalence of fraud
- Shedding light on why fraud often goes unpunished
- Unveiling fraud: tools for your toolbox

Welcome to the Digital Age! The Internet has made huge changes in the way we do business. Some are welcome – such as the ease of looking up information online rather than poring over stacks of paper. And some are not so welcome – like when corporate fraudsters use the Internet to create a seemingly legitimate business that's really a scam.

Like it or not, dealing with corporate fraud is the reality of doing business these days – and it's on the increase. Fraudsters are using more sophisticated measures to appear legitimate, making them more difficult to detect. And they're expanding their product lines.

Ten years ago if you asked a group of people if they'd been affected by fraud, most would have replied in the negative. That's because back then, fraud typically involved small items of high value such as mobile telephones or laptops. But these days, fraud can involve any and every product line.

Let's not forget the reason fraudsters continue to thrive. Although no one would admit they'd purchased an iPad from a bloke in the pub for £50 or that their business had snagged a hot deal on a truckload of plumbing fittings, the reality is, it happens. A lot! Fraudsters have a ready marketplace in which to sell their ill-got goods.

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In this chapter, we'll discuss what fraud is, why it often goes unreported or unpunished, and ways you can protect your business from it.

Grasping How Fraud Flourishes

Fraud can be defined as an artifice by which the interests of one party are injured by another party, or a stratagem intended to obtain undue advantage over another party by imposition or immoral means. It can also be defined as a deception deliberately practised to secure unfair or unlawful gain or a piece of trickery. It's theft!

In 2013, the National Fraud Authority reported that the UK economy lost around £52 billion to fraud. And while you might think the biggest targets of fraudsters are major corporations worth gazillions of pounds, most corporate fraud victims are SMEs (small and medium enterprises). Of the £52 billion in reported frauds, almost £16 billion related directly to the SME sector.

The numbers become even more staggering when you include unreported loss. Some financial experts say this brings that £52 billion figure closer to £80 billion!

Why would a loss go unreported? Well, some companies don't want to admit they've been duped. They'd rather write the loss off than reveal publicly that they've been fleeced! (You probably know a few people like that, too!) Other companies don't want to take the time to report fraud because they doubt the fraudsters will ever be caught and they'll be able to recoup their losses.

With only a laptop, a fraudster can disguise himself or herself as a multi-billion-pound corporation.

Knowing the Government's Role

You're probably wondering why the police haven't done more to stop those fraudsters in their tracks. Sadly, police departments have limited resources and other top priorities, like solving murders!

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So if your local Bobby doesn't have time to investigate, where does that leave you? Government intervention, perhaps? But is the government serious about tackling corporate fraud? Opinions are divided, and here's why.

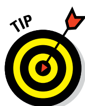
In December 2013, then Home Secretary Theresa May announced the National Fraud Authority would be closed in March 2014. A new entity, the National Crime Agency, was created to bring a single focus to the fight against all crimes. Its mission is to reduce 14 types of serious or organised crime, of which fraud is just one. Time will tell if this new approach will be effective.

And if you think you needn't worry about fraud if the companies you're doing business with are registered with Companies House, think again. That would be nice, but that isn't the case.

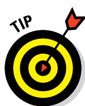
These are the two main functions of Companies House:

- To incorporate and dissolve limited companies
- To store company information and make it publicly available

Companies House doesn't guarantee the accuracy of the information submitted to it. False documentation is often filed with Companies House to give a fraudulent business an aura of legitimacy. In fact, a large proportion of frauds are generated from false documents being filed in the public domain. Fraudsters create fictitious credit ratings, install false directors and change address details to lull credit managers like you into a false sense of security.



Creating a false company at Companies House is easy. A company formerly based in Peckham, South East London, listed three directors – Bin Laden, Gadaffi, and Mubarak!



Fraud is more likely to be committed under the guise of a private limited company than under a non-limited entity.

Is Companies House to blame? Not really. It's just following protocol by receiving documents, scanning them into the system, and filing them for public viewing. It files thousands of documents daily and can't verify each one.

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So who is responsible for the gigantic job of protecting companies from fraud? You guessed it: credit managers!

Protecting Your Business

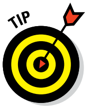
If the police and even the government have been ineffective at stopping fraud, what chance do you have?

You'd be surprised. You can use many tools to combat fraudsters. Here are some to put in your toolbox!

Validating VAT numbers

If you have the business's VAT number (Value Added Tax ID) and you know the country of origin, validating the VAT number online is incredibly simple. Here's how:

1. Go to the VIES VAT Number Validation – European Commission – Europe site (`http://ec.europa.eu/taxation_customs/vies/`).
2. Select the alleged country of origin in the Member State drop-down box and enter the alleged company's VAT number.
3. Select your country from the Requester Member State drop-down box and enter your VAT number.
4. Click the Verify button.



For easy reference, bookmark the European Commission VAT Number Validation site!

Another way to determine if a VAT number is genuine is to use this simple, three-step calculation:

1. Write the number vertically, as shown in Figure 5-1.
2. Multiply the first of the 7 digits by 8, the second by 7, the third by 6, and so on. Then sum the total.
3. Deduct 97 from the number you got in Step 2, until you obtain a negative figure. This negative figure should match the last two numbers of the VAT number.

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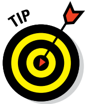
Step 1	Step 2				Step 3				
GRAYDON UK LIMITED									
VAT Number: GB 238 7491 29	VAT Number: GB 238 7491 29				VAT Number: GB 238 7491 29				
2	**2**	*8	=	16	**2**	*8	=	16	
3	**3**	*7	=	21	**3**	*7	=	21	
8	**8**	*6	=	48	**8**	*6	=	48	
7	**7**	*5	=	35	**7**	*5	=	35	
4	**4**	*4	=	16	**4**	*4	=	16	
9	**9**	*3	=	27	**9**	*3	=	27	
1	**1**	*2	=	2	**1**	*2	=	2	
2	**2**				**2**				
9	**9**			**165**	**9**			**165**	**-97**
								68	**-97**
								-29	

Figure 5-1: How to find a legitimate VAT number.



For newly established companies with VAT numbers beginning with the number 1, you must add 55 to the number you get in Step 2 before deducting 97 from it.

Going online for info

You can utilise the Internet to check out other details that will give you an idea if the company is legitimate or not.

Looking at the company's street view

Sometimes you can find out about a business simply by looking at its physical location. Follow these steps:

1. Go to Instant Street View at `www.instantstreetview.com`.
2. Enter the street address of the business in the fill-in box.

You can view the building in which the business is located, as well as the surrounding neighbourhood. If the business is supposed to be a manufacturing facility, but it's obviously in a residential area, you may want to do some more investigating!

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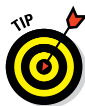
On the other hand, don't be paranoid about every business that operates from a residential address. Many small businesses do, especially one-man bands. Alarm bells should ring, however, if the order value is above what you would expect from a small business trading from a home.



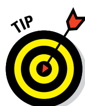
This probably goes without saying, but beware of delivering large orders to a residential address!

Determining if the address is physical or virtual

Sometimes an address is a virtual address as opposed to a physical address. A *virtual address* is often an address, usually in an upscale or well-known area, utilised by many businesses. The problem is that none of them are actually located there! Mail and phone calls are forwarded on to – well, who knows where! Fraudsters love the credibility of a virtual office. They can appear to have genuine offices, whilst remaining outside the jurisdiction in which the fraud is being perpetrated.

You can verify business addresses at the Royal Mail site by following these steps:

1. Go to: `http://www.royalmail.com/postcode-finder`.
2. Enter the name of the alleged company to see what address comes up, or enter the entire address to see if it matches the Royal Mail search.



Virtual offices can be rented by phone or over the Internet without the criminal ever setting foot at the location.

PO Box addresses aren't valid addresses on their own and fraudsters often hide behind them. They aren't permanent and can easily be changed without the change going on the public record.

Finding the registration date of its web address

Be sure to find out when the company registered its web address. If the company claims to have been in business for a decade and its website was registered last May, that should raise a flag. Whois-Search.com can help you find the registration date. Follow these steps:

1. Go to http://`www.whois-search.com`.

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2. Enter the company's URL in the text box.
3. Click Go.

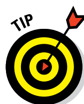
Checking the documentation

The Internet is a godsend for quick fact-checking and information gathering, but you need to delve into paperwork as well! Pay close attention to the following:

- **Signatures on documents filed with Companies House.** Do the signatures from the previous year's accounts match the current signatures? Have there been recent appointments at the director level? If so, compare the directors' appointment dates to the dates on the submitted documents.
- **Accounts figures.** In particular, look at the first year's accounts. If the company reported making a 20 per cent profit in its first year, that should raise a flag! Look to see if a revaluation reserve was included in the first set of accounts. A company shouldn't use a revaluation reserve in its first year. Also, does the share capital stated in the accounts match the amount stated on the annual return?

Anything that sounds too good to be true probably is!

- **Unusual filing patterns.** Companies generally file around the same time of the year every year. Has the company changed its office address several times in a short space of time? Has it filed dormant accounts followed by an amended trading set for the same period? Has it submitted accounts shortly after year-end? Are accounts filed for different trading periods within a short period of each other? Does the stated level of issued share capital in the accounts match that recorded in the annual return?
- **Application versus credit report.** Does all the information match – the VAT number, telephone number, email address, business activity, website URL and other data?



Hotmail, Yahoo or Gmail used for a business email address should raise a red flag!

- **Trade references.** You may be tempted not to bother checking references. After all, no company lists a reference that's going to say anything bad about it, right? But

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that's what fraudsters are counting on! Fraudulent businesses usually use fraudulent references. And if they use a genuine reference, chances are you'll get an earful!

- **Orders.** Fraudsters often change the mode of delivery on the order from 'deliver to' to 'will collect'. They also may schedule orders for delivery early in the month to give them more time to disappear! If your credit terms are 30 days or monthly, they'll be long gone by the time you start to collect!

Never let new customers collect their order unless they've prepaid!

Wrapping it up

Due diligence is the key to avoiding fraud. Check everything thoroughly. And don't let a sales representative or anyone else pressure you into giving an order the green light until you've thoroughly investigated the potential client. You don't want to be put into the position of explaining how you got snookered by a fraudulent company, now, do you?

You're the one who'll take the heat if you approve credit for a sham company. So be thorough. A comprehensive check can help you beat fraud in most, if not all, cases!

Who said it?

Here are some interesting statements about crime and fraud from three totally disparate sources: the notorious criminal John Dillinger, American business magnate Warren Buffett and comic book villain par excellence Lex Luthor. Can you guess who said what?

A. 'It's only when the tide goes out that you learn who's swimming naked.'

B. 'Because that's where the money is.'

C. 'Evidence is sometimes all that separates the criminal from the successful businessman.'

A: Buffett. B: Dillinger (when asked why he robbed banks). C: Luthor

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Chapter 6

Ten Key Ways to Keep Up the Good Work

In This Chapter

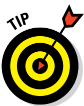
- Rolling with the changes
- Keeping current
- Sharing your expertise
- Moving forward

If you've scrutinised the preceding chapters (or at least honed in on the parts of particular interest to you), you've learned new skills or sharpened old ones. And that's great! But don't stop now. Back in the '60s, legendary songwriter/artist Bob Dylan told us 'the times they are a-changin'. His lyrics are even truer today. Our world is in a constant state of change, and to stay at the top of your game, you need to keep up!

Here are ten ways to keep your expertise current.

Stay Abreast of New Legislation

As a credit professional, you need to be aware of new legislation that governs business conduct so you understand how it affects your job and your businesses. Credit management associations often provide valuable education on legislation and other relevant topics.



Check out the Chartered Institute of Credit Management (`http://www.cicm.com`). It keeps members up to date on new legislation, changes to existing legislation, and other hot topics through publications, training, and other resources.

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Know Your Client's News

Credit management isn't a once-and-done deal! Historical information is essential, but you need to know what's going on with your client today. Gather information about how well (or not!) your client is performing in today's market as well as its prospects for the future – at least in the short term. You don't want to be bushwacked by your boss asking, 'How did we not know that XYZ Ltd was going to fail a month after they signed the contract?'

Keeping current isn't just a preventive measure. Learning that a company is expanding or has gained a lucrative contract, and then alerting your sales department to potential opportunities, can make you a hero!

Maintain Customer Contact

Communication is key to maintaining good relationships with your customers. And calling them every month to find out where that cheque is doesn't count! Make your customers feel wanted and valued by making regular courtesy calls. You may be able to pick up on early warning signs that portend potential problems on the horizon. Or, you may find out that the company wants to increase its business with you!

Talk to The Competition

You may compete against a business for sales, but that doesn't mean you shouldn't interact with your competition. They may have the scoop on a customer that can help you decide whether to extend credit or not – and vice versa. Sharing experiences benefits everyone. If you advise a competitor about the impending failure of a business, chances are he'll reciprocate next time round. Plus, you'll earn a reputation for being an expert!

Credit circles and forums are also a great source of information. You can share your concerns with like-minded individuals and take advantage of learning opportunities.

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To avoid potential legal pitfalls, choose a credit circle or forum carefully. Make sure it has the right credentials and follows strict guidelines. Ensure that your forum or circle adheres to legislation, particularly the Data Protection Act and the Competition Act.

Keep Your Paperwork Up to Date

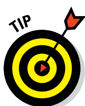
Are you still using the same application form you used 20 years ago when you started working with the company? Remember what we said about change? Changes in legislation may make forms outdated. Ensure all your paperwork, not just the forms, is relevant and meets the legal specifications for today's market. Even better, have a lawyer or a member of your own legal team review your paperwork. It's for your own protection.

And while we're on the topic of credit applications, it's imperative that they're 100 per cent complete. Ninety-five per cent isn't good enough. Complete applications help you avoid future headaches such as slow payments and bad debts.

Peruse the Press Regularly

The press releases on a company's website are a great, and often the first, source of 'good news' information. You can find notices of contract awards, expansions, and new products. Everyone loves to announce good news to the world!

The general press – business journals, newspapers, trade magazines – is also a great source of information, especially 'now' information. And that's the kind you're looking for, right? The press offers a more balanced view of a company, reporting adverse news as well as good news. And online forums and chat rooms often discuss specific problems businesses and individuals have encountered with businesses. Simple research can uncover a plethora of information that can help you make better credit decisions.



Use Google Alerts (`https://www.google.com/alerts#`) to keep tabs on particular businesses or topics. You'll receive email alerts about them when they make the news. (Set the frequency of alerts so you don't get overwhelmed!)

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Monitor Customers with a CIP

Top-notch credit information providers have monitoring systems for clients' use. Many credit information providers have a monitoring system that automatically alters a rating (either up or down) based on an event change – perhaps the filing of new accounts or changes in directors. Using that system can let you know if the credit limit you set for a customer six months ago is still relevant. If your credit information provider doesn't have a monitoring system in place, shop around for a new one! And if you don't have a credit information provider, get one!

Loop in Line Management

Don't keep that new information you've collected all to yourself! Liaise with your boss and other senior management and keep them apprised about the company's clients. Voice your concerns. No one likes nasty surprises! Here's your chance to become a hero – or at least to say, 'I told you so!'

Continue to Fight Fraud

Despite all your due diligence, you may still be taken in by a fraudster. Fraud happens all the time, and no one is immune. Commercial fraud is a multi-billion-pound threat that shows no signs of abating. And it covers every industry sector, not just fast-moving consumer goods (FMCG). Don't become complacent. Ensure detection methods are in place or, better yet, utilise a credit information provider (such as Graydon UK Ltd), which features a specialist fraud-detection team.

Stick to Your Guns

As a credit professional, you hold a great responsibility for the good of your company. Never forget that! Refuse to be rushed into opening an account – even if you have the head of sales breathing down your neck. Be diligent and thorough, ensure that everyone follows the procedures, and don't agree to credit account facilities until you're 100 per cent sure. You won't totally avoid bad debts, but you'll avoid most of them!

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Mitigate Credit Risk

graydon.co.uk/credit-risk-management

Graydon has a rich history in helping companies minimise risk and maximise opportunity by offering them specific business information. At the heart of this is Graydon's belief in transparency; the belief that openness paves the way for confidence and trust in business.

Companies rely on Graydon to enable them to make accurate, realistic assessments about credit risk. That's because we use the most current information available and funnel it into real-time, sector-specific credit risk data.

We provide credit reports on both companies and individuals, from quick snapshots through to highly detailed risk assessments and we do it both UK-wide and internationally.

Graydon is owned by Atradius, Coface, and Euler Hermes, Europe's leading credit insurance organisations. We offer a comprehensive network of offices and partners worldwide ensuring a seamless service.

For more information
call 0208 515 1400 or visit www.graydon.co.uk/credit-risk-management

GRAYDON
open in business

A guide to understanding credit risk for better business decision making

What does it take to become a modern-day credit manager? Take action against the increasing problem of fraud by learning how to safeguard your business and mitigate credit risk. Trade with confidence and make informed decisions about the companies you choose to do business with. Learn how to become a valuable asset to your business by taking a holistic approach to credit risk and looking beyond a company's annual report.

- ***Paint the big picture* — take a holistic approach to credit risk beyond a company's annual report**
- ***Play nice with sales* — gain their trust so you can provide valuable input about associated credit risk**
- ***Spot fraudulent behaviour* — be aware of the potential risks and dangers of corporate fraud**

Open the book and find:

- **How bridging the gap between credit and sales provides you with valuable insight for better decision making**
- **How to demystify annual accounts so you can make sound credit management decisions**
- **How to set credit limits by factoring in additional elements to supplement your credit information**

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By gathering and analysing big data about companies and markets, **Graydon** can provide its clients with vital business information. Graydon's data intelligence gives clients better insight into the present and the future so they can make sound business decisions.

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