

8

Grant credit – assessing the customers

this chapter covers . . .

Credit control is the process of managing customers who pay on credit so that settlement of debt is made on time.

Efficient credit control is essential for maintaining the liquidity of an organisation; money not received may mean that money will have to be borrowed.

This chapter takes an overview of the whole credit control process – from credit application to debt collection, and then concentrates on the ways in which an organisation assesses applications from customers to trade on credit terms. This assessment process involves:

- *examining the external sources of information – banks, credit rating agencies, other suppliers – which enable the organisation to evaluate the customer*
- *examining the internal sources of information available to help with the assessment decision – reports from colleagues (eg sales records, notes on visits) and analysis of financial accounts*

The next chapter describes how an account is set up, or, if the customer fails the assessment test, is refused.

NVQ PERFORMANCE CRITERIA COVERED

unit 15 OPERATING A CASH MANAGEMENT AND CREDIT CONTROL SYSTEM

element 15.3

Grant credit

- A *Agree credit terms with customers in accordance with the organisation's policies.*
- B *Identify and use internal and external sources of information to evaluate the current credit status of customers and potential customers.*

KNOWLEDGE AND UNDERSTANDING COVERAGE

- 6 *Legal issues: basic contract; terms and conditions of contracts relating to the granting of credit; Data Protection legislation and credit control information.*
- 7 *Sources of credit status information.*
- 8 *External sources of information: banks, credit agencies and official publications.*
- 18 *Interpretation and use of credit control information.*
- 30 *Understanding that practice in this area will be determined by an organisation's credit control policies and procedures.*
- 31 *An understanding of the organisation's relevant policies and procedures.*

AN OVERVIEW OF CREDIT CONTROL

importance of credit control

Credit control is the process of managing customers who pay on credit so that settlement of debt is made on time.

As we saw in the last two chapters, liquidity management in an organisation involves the timing of cash inflows and outflows – including financing and investing – so that the organisation has sufficient working capital and remains solvent. An important element of liquidity management is therefore the efficient functioning of the sales ledger – or in basic terms, customers paying up on time. If customers do not pay up, on time, or – worse still – become insolvent, this can be the result of:

- credit terms being granted to customers who are not creditworthy (a failure in the system when the customer applied for credit), or
- the payments of the customer not being monitored effectively and warning signs of customer financial problems not being picked up (a failure of the sales ledger management system)

The result is likely to be the same: a bad debt and a consequent loss of profit.

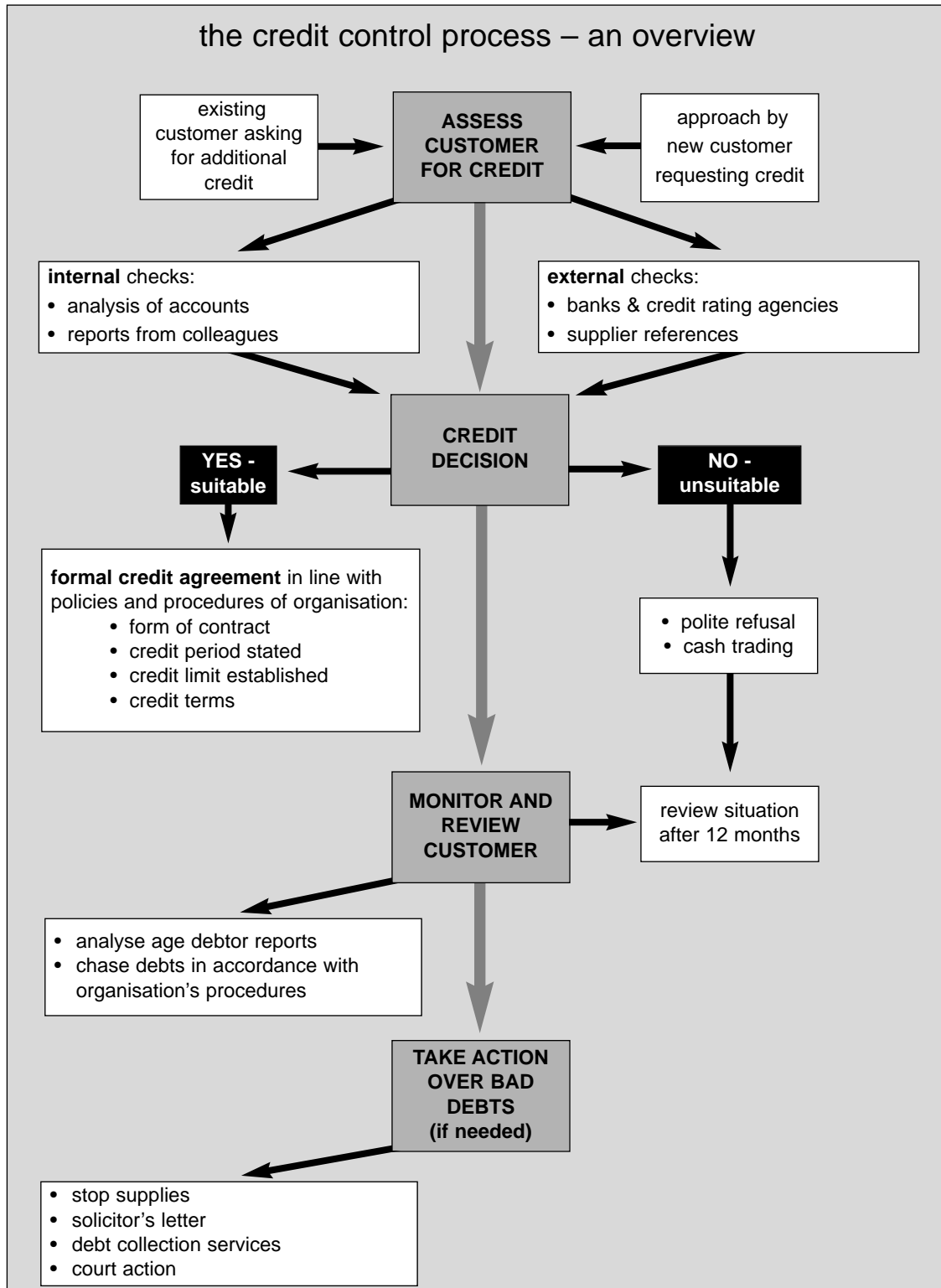
the credit control function

Credit control is part of the accounting and finance function of an organisation. The number of people employed in credit control will depend on the size of the organisation. It may be a whole department, a section, or in the case of a small business, the accounts assistant or even the proprietor. The credit control activities carried out are summarised in the diagram on the next page, which you should study carefully. They include:

- assessing new applications for credit (either from new customers or from existing customers looking for an increased credit limit)
- monitoring sales ledger accounts by using reports such as the aged debtors summary
- chasing overdue debts and dealing with bad debts

Larger organisations are likely to have a **credit control policy**, a written set of procedures detailing issues such as assessment methods, credit terms granted, chasing of debts, dealing with bad debts. An example is shown on page xx. It will normally be accompanied by documentation such as credit application forms, sales contracts and chaser letters.

People who work in credit control need to be highly experienced in communication skills: they are negotiators and persuaders, but should also be able to take on the role of rotweillers.



the credit control process

The diagram on the previous page illustrates the processes involved in the credit control process. These processes will be explained in detail in this and the following three chapters.

In this chapter we examine in detail the credit checks and analyses that are made when assessing the creditworthiness of a new or an existing customer. The sources of information are either external or internal.

EXTERNAL SOURCES OF INFORMATION ABOUT CUSTOMERS

Organisations can consult a variety of sources of external information:

- bank references
- supplier (trade) references
- credit rating agencies

The credit control policy document of the organisation (see page xx) is likely to provide guidance about establishing the creditworthiness of a new customer and indicate what external sources should be approached. It is common practice for an organisation to send out a letter to a new customer along the lines of the following:

Dear Sirs

Ref : Application to Open a Credit Account

Thank you for your request to open a credit account in our books.

So that I can consider your request I shall be grateful if you will supply me with:

- details of your bank account - bank, bank branch address and account name, plus your written authority to your bank to release information
- details (contact names, addresses, telephone numbers) of two trade references

Thank you.

Yours faithfully

S Gerrard

S Gerrard
Credit Control

Alternatively the organisation may have a credit application form which it sends to customers who are applying for a credit limit. This would request details such as:

- the registered name, and address of a limited company, or
- the names, business and home addresses of partners, or
- the name, business and home address of a sole proprietor
- any trading name used
- at least two trade references
- bank details, plus an authorisation to obtain a bank reference
- credit requirement
- signature of the applicant(s)

An example is shown below.

APPLICATION FOR CREDIT	
Please open a credit account in the name of	
Address	
.....	
Telephone..... Email.....	
Trading name(s) where applicable	
Amount of credit required £ monthly, in total £	
Please accept this as authority to release information to the parties below for reference purposes.	
signed capacity date.....	
signed capacity date.....	
Bank name.....	
Bank address.....	
Trade reference 1	Trade reference 2
Name.....	Name.....
Address	Address
.....
.....
.....

bank references

Banks have traditionally been a valuable source of information about the credit standing of prospective customers.

One problem with bank references is the language in which they are written. Banks are masters of understatement. Just as school reports need interpretation – eg ‘she is a quiet student’ means ‘she is asleep most of the time’ or ‘she is lively in class’ means ‘she talks incessantly’ – so bank reports also need interpretation.

A request for a bank reference is normally worded along the lines of

‘Do you consider Dodge E Builders Limited to be good for the figure of £10,000 trade credit per month?’

The replies that might be received are shown below, both in bank language and also in plain ordinary English. The replies are listed from top to bottom in order of creditworthiness.

bank reply	plain ordinary English
<i>‘Undoubted’</i>	<i>‘A good risk for the figure quoted.’</i>
<i>‘Good for your figure and purpose’</i>	<i>‘A reasonable risk and most probably OK.’</i>
<i>‘Should prove good for your figures and purpose.’</i>	<i>‘Not so sure about this one - well worth investigating further before making a decision.’</i>
<i>‘Although their capital is fully employed we do not consider the directors would enter into a commitment they could not see their way to fulfil.’</i>	<i>‘This business has cash flow problems and should not be allowed any credit.’</i>

When translated into plain English, bank references are limited but useful indicators of the prospective customer’s creditworthiness.

trade references

It is common practice for organisations to ask for two trade references when assessing a customer's credit risk. These are not always reliable because the prospective customer might give as references suppliers who are not strict about credit control, and avoid quoting the suppliers who are red hot in chasing debts.

A standard letter asking for information from a trade referee is shown below.

Fine Dowl Limited 88 Station Road Newtown NT6 9GH Tel 01707 767188 Fax 01707 767022 www.finedoubt.co.uk	
Credit Control Manager Esloy Engineering Unit 16 Forest Estate Bath BA2 4JP	
We have received a request for credit from our customer Parsons Printers. They have quoted you as referee. We shall be grateful if you could answer the following questions.	
How long have you been trading with the customer?years months
Terms granted	amount per month £.....
Total limit	£.....
Period of credit granted
Payment record (please indicate as appropriate)	prompt / occasionally late / often late
Have you ever suspended credit?	Yes / No When?.....
Other relevant information
Thank you for your assistance. We will be happy to reciprocate at any time.	
Yours faithfully	
N Igmer	
Nigel Igmer Credit Controller	

A reply to a trade reference may take a long time to process. The enquiring organisation can avoid delay by telephoning the enquiry to the ‘sales ledger’ staff after sending off the credit enquiry letter.

A dubious alternative adopted by some businesses is not to make the enquiry through the quoted referees but to telephone one of their own competitors (who are likely to deal with the customer) and speak to the sales ledger staff directly and informally – often receiving a very honest appraisal. This could result in a breach of the Data Protection Act (see page xx) by the replying organisation, however, and so is not to be recommended!

credit reference agencies

Organisations which frequently process new applications for credit often subscribe to **credit reference agencies**. These are commercial organisations which offer an on-line service for checking the credit rating of companies and individuals. They have extensive databases which provide a wealth of material which can be provided on demand, enabling an instant credit decision to be made. They do, of course, charge for the service, and there is the risk that some of the information may be out of date. Examples include:

- **Dun & Bradstreet** (www.dnb.com)
- **Experian** (www.experian.co.uk)
- **Equifax** (www.equifax.co.uk)

Reference enquiries can be made either on limited companies or on individuals. Reports from credit reference agencies on **limited companies** will provide details such as:

- three years’ accounts
- payment history
- directors details
- any insolvency proceedings

Credit reference agencies are widely used for providing reports on **individuals** for organisations such as banks, credit card and hire purchase companies. Sole trader and partnership businesses are enterprises run by individuals. These reports will not produce much in the way of financial data (only limited companies have to file their accounts) but will provide information such as:

- names and addresses
- credit risk – based on any default on credit (including not paying credit card bills on time)
- county court judgements for non-payment of debt
- bankruptcy orders



credit references available online from Dun & Bradstreet and Experian



Reports on individuals are sometimes requested to check up on the credit rating of directors of limited company customers. A director with a bad credit record can often be found to be running a company which is a poor credit risk.

The handling of personal data by credit reference agencies is governed by the Data Protection Act (see next page).

Companies House

Another source of information about limited companies is Companies House, the Government agency to which all larger limited companies are obliged by law to send their annual accounts and to which all companies send information of directors (www.companieshouse.gov.uk). This data is publicly available (at a cost), but financial data may not be completely up-to-date, as many companies file accounts well after the balance sheet date.

other published sources

If a credit control department wishes to find out about the creditworthiness of a large organisation it may find references and articles in the press, trade journals and online. The internet is a powerful tool here. Try doing a search on a well-known company name in www.google.co.uk, for example, and see what information and up-to-date news articles are produced.

a note on the Data Protection Act 1998

When an organisation asks for a reference from a company, bank or credit reference agency, it is asking that organisation to disclose data it holds which relates to a third party (someone else). The law is very strict on this point as there is a real danger that the information may be incorrect or the person or organisation to which it relates does not want it to be released.

The current legislation covering this area is the Data Protection Act 1998, which has reinforced existing rules for the processing of personal data. It follows the guidelines of a European Directive and brings the UK in line with European legal principles. The Act applies to:

- data about individuals (eg sole traders, partners) but not about companies
- records held on computer – eg a computer database of names, addresses, telephone numbers, sales details of each customer ('data subject')
- manual records – eg a card index file system of customers details

All organisations which process personal data should register with the Data Protection Commission and should follow the eight guiding principles set out in the Data Protection Act. These principles require that personal data is handled properly. They state that personal data must be:

- 1 fairly and lawfully processed
- 2 processed for limited purposes
- 3 adequate, relevant and not excessive
- 4 accurate
- 5 not kept for longer than is necessary
- 6 processed in line with the data subject's rights
- 7 kept securely
- 8 not transferred to countries outside the European Union unless it is adequately protected in those countries

Individuals have the legal right to know what personal details about them is held by an organisation such as a credit reference agency. They should apply in writing to that organisation for a copy of the personal data held on file; they are likely have to pay a small fee (£2, for example).

INTERNAL SOURCES OF INFORMATION ABOUT CUSTOMERS

External sources of information are often used when the individual or organisation applying for credit is not known to the enquirer. If an organisation needs to assess the credit risk of an existing customer – eg when an increase in credit limit is requested – much of the information needed may already be available within the organisation. This **internal** information includes:

- internal conversations, records of meetings and visits by employees of the organisation – eg by sales ledger and sales teams
- ratio analysis of the financial accounts of the customer

internal records

Suppose two existing company customers (A and B), each with a credit limit of £10,000 ask for an increase to £15,000 because of increased trading. The credit control staff could make enquiries within the organisation . . .

Company A: Go-A-Head Limited

feedback from sales ledger team

'Yes, they always pay on time. Never go over their limit. No problems there.'

feedback from the sales team

'Yes, we went to see them last month. They seem well-organised and there is a good market for their product. They are well positioned for expansion. They find our prices very competitive. They are good to do business with'

conclusion of credit control team

'On the face of it a good credit risk, but we will need to see their accounts.'

Company B: Going-to-the-Wall Limited

feedback from sales ledger team

'Not sure. They always seem to be up to their limit or slightly over. The money comes in, but it is often late, and we have had to send out chasers.'

feedback from the sales team

'We asked to visit them, but they didn't seem keen. They have a high turnover of staff - we always seem to be dealing with someone different. I personally think that they have been overordering from us as I am not sure that their sales are up to target. I wonder if they need the higher limit to help fund their liquidity?'

conclusion of credit control team

'There appear to be problems here, so we will need to see their accounts. We may struggle to recover what is owed!'

analysing customer accounts

As we have seen on the previous page, feedback from within the organisation is a valuable source of information for credit assessment. It is essential that it is backed up wherever possible by an analysis of past and up-to-date financial statements of the customer. If up-to-date financial statements are not available, draft accounts or internal management reports should be requested for analysis. Ideally, at least three years' accounts should be analysed in order to show the trends in three key areas:

- **liquidity** – the ability of the business to repay debts as they fall due
- **profitability** – the ability of the business to maintain its capital and to provide funds for repayment of debts in the future
- **gearing** – the financial risk taken on by the business shown by comparing interest bearing liabilities and total capital employed

You should be familiar with ratio analysis from your other studies, so for the purposes of this book we will list the basic performance indicators which you should be able to apply. If you are unsure about this subject, you are recommended to study Osborne Books' *Limited Company Accounts Tutorial*, Chapter 7, 'Interpretation of Financial Statements'.

What is a good indicator?

The question is often asked: what is a 'good' current ratio or a 'good' liquid capital ratio? The answer is that it is impossible to give a fail safe answer. Businesses vary widely in the way their assets and liabilities are structured – compare a TV manufacturer and a supermarket, for example. There are some guidelines, however. These are shown below as notes, and should be used for guidance purposes only.

liquidity indicators

These indicators show the ability of the business to repay short-term debt from liquid or semi-liquid assets, and also to turn over its current assets such as stock and debtors.

INDICATOR	FORMULA	WHAT IT SHOWS
current ratio	$\frac{\text{current assets}}{\text{current liabilities}}$	working capital expressed as a ratio <i>ideally 2 : 1 or higher</i>
liquid capital ratio	$\frac{\text{current assets} - \text{stock}}{\text{current liabilities}}$	a ratio comparing liquidity with short-term debts <i>ideally 1 : 1 or higher</i>

stock turnover	$\frac{\text{stock} \times 365}{\text{cost of sales}}$	the number of days on average that stock is held – <i>this will depend entirely on the nature of the stock; the figure should not increase over time</i>
debtor turnover	$\frac{\text{debtors} \times 365}{\text{sales}}$	the number of days on average that it takes for a debtor to pay up – <i>this will depend on the nature of the business; 30 to 60 days is common</i>
creditor turnover	$\frac{\text{creditors} \times 365}{\text{purchases}}$	the number of days on average that it takes to pay a creditor – <i>this will usefully show how promptly the business pays its debtors</i>

profitability indicators

These indicators show the ability of the business to generate profit which will enable it to repay its debts in the longer term.

INDICATOR	FORMULA	WHAT IT SHOWS
operating profit %	$\frac{\text{operating profit} \times 100}{\text{sales}}$	profit made before deduction of tax and interest – <i>this should remain steady and in line with the industry average</i>
net profit %	$\frac{\text{net profit} \times 100}{\text{sales}}$	profit made after deduction of all expenses – <i>this should ideally increase over the years, and not fall</i>
return on capital employed (ROCE)	$\frac{\text{operating profit} \times 100}{\text{capital employed}^*}$	profit made related to the capital employed by the company – <i>this should also remain steady over the years</i>

* ordinary share capital + reserves + interest bearing capital + long-term loans

financial position

Financial position measures the strength and long-term financing of a company. Two ratios are calculated: interest cover and gearing.

Interest cover measures the ability of a business to pay interest on borrowing from its profits.

interest cover	$\frac{\text{operating profit}}{\text{interest}}$	the safety margin of profit over interest payable – <i>the higher the figure the better</i>
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The proportion of long-term debt to capital is known as **gearing**. This shows the extent to which the company is financed by debt. Gearing can be calculated in a number of ways. The formula below is commonly used.

gearing %	$\frac{\text{long-term debt}^* \times 100}{\text{capital employed}^{**}}$	relationship between long-term debt and capital – <i>this should ideally be less than 50%, the higher the figure, the less secure the company</i>
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* interest bearing capital + long-term loans
** ordinary share capital + reserves + interest bearing capital + long-term loans

The Case Study which follows shows the credit assessment process in action.

Case Study

FIRTH ELECTRONICS: CREDIT ASSESSMENT PROCEDURES

situation

You work in the credit control section of Firth Electronics. You have been approached by a new customer, Bridge Trading Limited for credit of £10,000 a month. You have sent out your normal enquiries – a bank credit status request and two trade credit reference requests. Bridge Trading have also sent you their last three years' accounts for you to analyse.

The replies and accounts summary are show below.

You have been asked to prepare notes summarising your assessment of this company.

National Bank PLC

status report: Bridge Trading Limited

Request: £10,000 trade credit per month

Report: Good for your figure and purpose

Response to trade credit enquiry, received from A Jones & Co**Re: Bridge Trading Limited: £10,000 trade credit per month**

We have been trading with this company for five years and allow £15,000 credit per month on 30 day terms. The company can sometimes take longer to pay than allowed by these terms.

Response to trade credit enquiry, received from A Patel**Bridge Trading Limited £10,000 credit per month**

We allow this customer £5,000 credit per month on 60 day terms. The account is usually paid on time, although sometimes payment can be late. The figure you quote is higher than the credit given by us but we know of no reasons why this customer should not be able to fulfil its liabilities.

SUMMARY OF FINANCIAL ACCOUNTS: BRIDGE TRADING LIMITED

	<i>Year 1</i> <i>£000</i>	<i>Year 2</i> <i>£000</i>	<i>Year 3*</i> <i>£000</i>
Sales	1,000	1,200	1,400
Cost of sales	600	800	1,000
Current assets	880	1,040	1,200
Current liabilities	620	710	750
Stock	200	220	280
Debtors	102	115	127
Creditors	150	161	195
Operating profit	80	94	112
Interest paid	20	34	32
Net profit	60	60	80
Long-term debt + interest bearing capital	200	200	250
Capital & reserves	400	460	520

*Year 3 was last year and the accounts were made up to 31 December.

solution

You process the data from the bank report, the two trade references and the three years' accounts, and set out the results in a table:

ANALYSIS OF FINANCIAL ACCOUNTS: BRIDGE TRADING LIMITED			
	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>
Current Ratio	1.42 : 1	1.46 : 1	1.60 : 1
Liquid Capital Ratio	1.10 : 1	1.15 : 1	1.23 : 1
Stock turnover	122 days	100 days	102 days
Debtor days	37 days	35 days	33 days
Creditor days	91 days	73 days	71 days
Net profit %	6%	5%	6%
Return on capital employed %	13.3%	14.2%	14.5%
Interest cover	4.0 times	2.8 times	3.5 times
Gearing	33%	30%	32%

You draw the following conclusions:

bank report

This indicates that the bank considers Bridge Trading Limited to be a reasonable credit risk, which, as far as bank reports go, is a positive response.

trade references

Both references draw attention to the fact that Bridge Trading Limited does pay up, but is often late in doing so. The analysis of the three years' accounts will therefore need to concentrate on the liquidity ratios. Late payment can either result from inefficiency or from illiquidity.

analysis of three years' financial accounts

The profitability ratios (net profit and return on capital employed) and gearing percentage all suggest a company with manageable debt and a consistently sound profit record. The interest cover shows an ability to cover interest costs from profit.

The current ratio and liquid capital ratio have both improved over the three years, although the current ratio does reflect the high level of creditors (see below). Debtor days at around 35 shows that the business is collecting its trade debts efficiently. It is the payment period (creditor days) that gives cause for concern, although there has been some improvement. The reason is not a lack of liquidity, but is either a conscious policy of delaying payment to help with short-term financing, or just a lack of efficiency. Whatever the reason, Firth Electronics should not accept similar treatment.

recommendation

Bridge Trading Limited should be allowed the credit requested, as there is sufficient liquidity in the company, but on strict 30 days' terms. Payments should be carefully monitored and the company advised that any late payments could result in withdrawal of credit and an insistence on trading on cash terms only.

THE ORGANISATION'S CREDIT CONTROL PROCEDURES

It is important to appreciate that the credit assessments carried out in the Case Study and also on pages xx to xx are likely to form part of the organisation's credit control procedures, often set down in a formal written policy document.

Where there is such a document, there will be operational requirements, set terms, standard documents, all of which will ensure that the administration of credit control runs smoothly and in line with the organisation's 'standard' procedures.

Another reason that standard procedures have to be followed is a legal one. The relationship between seller and buyer is one of contract, ie legal agreement. If that contract is broken – eg the buyer does not pay up – the seller may need to take the buyer to court. The law is very particular and if the seller is to be successful, it is very important that all the procedures have been carried out 'to the letter'. This is particularly important in relation to terms of payment. This will be dealt with in full on pages xx - xx.

Set out below is an example of a typical Credit Control Policy Document. Note that Sales Department – who will be dealing with the customer on a day-to-day basis – will need to be notified of any default procedures.

CREDIT POLICY & PROCEDURES

New Accounts	1	One bank reference and two trade references required.
	2	Analysis of minimum of three years' accounts for limited company customers.
Credit Terms	3	Standard terms 30 days of invoice. Any extension to be authorised by Credit Controller.
	4	2.5% settlement discount at Credit Controller's discretion.
Debt Collection	5	Invoices despatched on day of issue.
	6	Statements despatched first week of the month.
	7	Aged debtors analysis produced and analysed first week of the month.
	8	Reminder letter sent first week of the month for accounts 30 days overdue (Letter 1)
	9	Telephone chaser for accounts 45 days overdue. Meeting arranged if required.
	10	Customer on stop list if no payment received within 15 days of telephone chaser (unless meeting arranged). Sales Department notified.
	11	Letter threatening legal action and stop list notification sent if payment not received within 30 days of first letter (Letter 2).
	12	Legal proceedings set in motion if payment not received with 30 days of Letter 2 – subject to authorisation by Finance Director and notification of Sales Manager.

Chapter Summary

- An effective credit control policy is essential in an organisation if bad debts are to be avoided.
- The extent of the credit control function depends on the size of the organisation. The same basic functions will be carried out:
 - assessing applications for new credit from new customers
 - assessing applications for increased credit from existing customers
 - monitoring the sales ledger
 - chasing overdue debts
 - dealing with bad debts
- Organisations use a variety of external sources and internal sources to provide information when assessing credit risks. External sources are likely to be used more for new customers and internal sources for existing customers.
- External sources include bank references, trade references, credit rating agency reports and other publications. Some organisations ask the customer to complete a credit application form which will provide the data it needs.
- When using external sources of information the organisation will need to be aware of the restrictions of the Data Protection Act 1998 which regulates the disclosure of information about individuals (not companies) to third parties.
- Internal sources of information include records of meetings, conversations and visits by a variety of employees of the organisation, including the sales ledger staff and sales force.
- Another valuable exercise in credit assessment is the ratio analysis of financial accounts – preferably from three consecutive years. This is an important exercise for new customers and also useful for existing customers. Ratio analysis will provide information about the trends in:
 - liquidity
 - profitability
 - the financial positionAll of these will provide information about the customer's ability to repay invoices when they fall due.
- An organisation's credit control policy will often be formalised in a written Credit Policy document which ensures that all procedures are carried out correctly.

**Key
Terms**

credit control	the process of managing customers who pay on credit so that settlement of debt is made on time
bank reference	a credit report given by the customer's bank to supplier; the information is reliable but requires some interpretation
trade reference	a credit report authorised by the customer and given by an organisation which already provides the customer with credit facilities; this information may not be as reliable as a bank reference
credit reference agency	an organisation which provides a wide variety of credit data about companies and individuals on a commercial basis – often online – including financial accounts, payment histories, details of court proceedings and insolvencies; this information is very full but can be costly
Companies House	the Government agency which holds details of all limited companies and directors; larger companies file their annual accounts at Companies House
Data Protection Act	the legislation which regulates the disclosure of information held by individuals and organisations about third parties; it covers data held on computer and in paper-based records
liquidity indicators	performance indicators which show the extent of the liquidity of a business; for example the current and liquid capital ratios, stock turnover, debtor days and creditor days (see page xx for formulas)
profitability indicators	performance indicators which show the ability of the business to generate the profit needed to provide liquidity; for example operating profit percentage, net profit percentage and ROCE (see page xx)
financial position	the extent of the reliance of the business on long-term debt; interest cover shows how well interest payments can be met from profit and gearing shows the reliance on long-term loans and interest bearing capital

Student Activities

answers to the
asterisked (*)
questions are to
be found at the
back of this book

- 8.1*** You work for GML Importers Limited, an importer of toys from the Far East. The Credit Control Manager has received a letter from Toppo Toys Limited which operates a chain of 20 shops in the London area. Toppo Toys wishes to purchase stock from GML Importers Limited and is requesting credit facilities. You are to draft a reply using today's date and your own name. The company Credit Policy Manual states that to assess any new proposition you will initially need a banker's reference and two trade references.

Toppo Toys Limited

71 Clerkenwell Avenue

London EC1R 5BC

Tel 0207 8371199 Fax 0207 8371192 Email sales@toppotoys.co.uk

D Brinkwell, Credit Control Manager
GML Importers Limited
29 The Greenway
Slough SL2 7GH

Dear Mr Brinkwell,

Request for credit facilities

We have purchased stock from you over the last six months and would now be grateful if you could consider providing us with credit facilities. We would initially be looking for a facility of £10,000 on thirty days terms.

As we have been trading with you on a cash terms basis for six months we hope that this can be arranged with the minimum of formality.

We look forward to hearing from you.

Yours sincerely

B Attman

Bart Attman
Director

8.2* Your company, GML Importers Limited, is processing a new credit application for S Low Limited. Steve Low, the customer's MD is anxious that the facility be set up as soon as possible. You find, however, that one of the trade references has not yet been received. You telephone the company concerned, but the manager who normally provides the references is away on holiday in Spain for the next two weeks. Your colleague suggests using a credit reference agency to obtain a back-up reference. Describe:

- (a) the data that a credit reference agency will be able to provide about a limited company
- (b) one major advantage and one major disadvantage of using a credit reference agency

8.3* A sales ledger assistant at your company, GML Importers Limited, receives a telephone call from a competitor business, Pronto Importers, who ask if the sales ledger assistant can provide some information about a mutual customer, Hal Johnson. They would like to know if you provide Hal Johnson with a credit limit, and if so, how much it is and whether the customer pays up on time. The sales ledger assistant is unsure how to deal with this request and asks you for advice. What would you advise? Give reasons for your recommendations.

8.4 You are assessing an application for a credit limit for £15,000 from a new customer, Stylo Limited. You have received a bank reference and two trade references. Stylo Limited has also provided you with a summary of its accounts for the last three years (see data below and on the next page).

Your company Credit Policy Manual requires that credit terms should initially be offered for a maximum of 30 days.

You are to:

- (a) write comments on the bank reference
- (b) write comments on the trade references
- (c) Analyse the accounts summary and draw up a table showing for the three years the following performance indicators:
 - the current ratio and the liquid capital ratio
 - debtor days and creditor days
 - net profit percentage
 - interest cover and gearing
- (d) write comments on the performance indicators
- (e) write a conclusion, stating your recommendations for the granting of the requested credit of £15,000 a month

Centro Bank PLC

status report: Stylo Limited

Request: £15,000 trade credit per month

Report: Should prove good for your figure and purpose.

Response to trade credit enquiry, received from B Ruckner Ltd**Re: Stylo Limited: £15,000 trade credit per month**

We have been trading with this company for five years and allow £10,000 credit per month on 60 day terms. The company normally meets its commitments on time.

Response to trade credit enquiry, received from V Williams**Stylo Limited £15,000 credit per month**

We allow this customer £5,000 credit per month on 60 day terms. The account is usually paid on time.

EXTRACT FROM FINANCIAL ACCOUNTS: STYLO LIMITED

	<i>Year 1</i> £000	<i>Year 2</i> £000	<i>Year 3</i> £000
Sales	750	781	720
Cost of sales	350	363	348
Current assets	720	705	684
Current liabilities	680	656	663
Stock	200	220	280
Debtors	88	93	95
Creditors	58	63	62
Operating profit	80	86	94
Interest paid	60	71	80
Net profit	20	15	14
Long-term debt	121	150	175
Capital & reserves	125	145	160