

MINIMIZE YOUR CREDIT RISK

SUMMARY

Granting credit requires careful examination of your customers' ability to pay. Even some of the nation's largest companies experience financial difficulties from time to time. It is therefore important to make regular reviews of the credit worthiness of your major customers, as well as to investigate the bill-paying ability of companies seeking credit for the first time. Extending credit always involves a risk. However, obtaining key information and keeping that information up-dated will help minimize your credit problems.

YOU NEED RELIABLE INFORMATION

Bad debt losses don't happen frequently, but when they do occur, they can have a serious negative effect on your profit. And, in some cases, such losses could actually threaten your company's survival. For a company earning a five percent pre-tax profit, a \$10,000 bad debt loss will wipe out the net profit from \$200,000 of work. However, rather than outright bad debt losses, your credit problems will generally be in the form of slow payment by your customers. While you are waiting for your money, you may experience difficulty in paying your own bills; you may have to miss trade discounts; or you may be forced to borrow funds at a high interest rate to meet your own obligations.

To minimize your credit risk, you should investigate your customers' bill-paying habits. If the amount of credit is substantial, you should check their overall financial condition as well. A good rule of thumb is this: if you can't afford to lose the amount of money involved, make a credit investigation.

Many owners and managers discuss customers' credit with other metalworking executives. Although members of your local NTMA chapter—and NTMA members you know in other cities—may be able to alert you to certain problem situations, you should not rely strictly on that credit advice. An account that pays in 120 days may be considered satisfactory by a company which desperately needs the work, but that same account might have little appeal for another company that has a heavy work backlog and is tight on cash.

CONSULT YOUR BANKER

Your banker can be an excellent source of credit information. The use of the term "banker" instead of "bank" is intentional, since a personal relationship at the bank is far more valuable than an account number, even if your balance is substantial. To obtain maximum cooperation, you should be able to provide your banker with the customer's exact name, correct mailing address, amount of credit involved, an estimate of potential annual business with this customer, any previous experience you may have had with the company, and, if at all possible, the name of the customer's bank. In many cases, your banker may be able to give you an indication of the company's general credit standing quickly, but more detailed information—such as actual payment patterns and approximate bank balances—may take several days. All credit information provided by your banker should, of course, be treated as confidential.

Although there is no guarantee that a company's previous payment pattern will continue indefinitely, reports of prompt payment by current suppliers is a positive sign. Be sure to check the credit terms, since payment within terms on a net 60-day basis is obviously different from prompt payment on net 30-day terms. Also, check to see whether the terms include a prompt payment discount and, if so, whether the company takes such discounts regularly. A company with a sound working capital position will ordinarily take most prompt payment discounts. However, when interest rates are above ten percent, some companies will pass up discounts of one percent or less and stretch their payments to 45 days or longer in order to reduce their interest costs.

When a credit request is particularly large in relation to your volume of business, you should make every effort to learn about the customer's overall financial situation, as well as the company's payment record. Your banker may be able to obtain that information for you; but in some cases, you might find it necessary to ask your customer for a current financial statement. Most companies will comply with such an inquiry if the amount of credit is significant. If you don't have current financial information, you can only gamble and hope that the customer will continue to pay its bills in the same manner it has in the past.

FINANCIAL ANALYSIS

When requesting a financial statement, you should also insist on at least a summary operating statement or a reconciliation of net worth so that you can ascertain whether a profit was earned during the last fiscal period. The customer's financial statement should ordinarily be prepared by an accountant. You should recognize, however, that only an audited financial statement insures that the figures have been prepared in accordance with generally accepted accounting principles; otherwise, the figures might have been prepared from the company's books without further analysis by the accountant. If notes to the financial statement are included, study them closely. If none were furnished, you should ask your customer to provide them, because those notes could indicate operating problems or contingent liabilities not readily apparent from the financial statement.

Owners and managers who understand the fundamentals of financial management or are trained in credit analysis can evaluate such information without outside assistance, but most metalworking executives will benefit from the advice of their banker and/or accountant in ascertaining a company's credit worthiness. Perhaps, at first glance, the company looks satisfactory because its net worth is greater than the amount of credit sought. But if current liabilities far exceed net worth or if the company's working capital and its net worth are highly dependent on assets of questionable value—such as unsalable inventory—the company may, in fact, be in serious financial difficulty. Outside advice will help you interpret the story told by the financial statements.

PRECAUTIONS

Because business conditions change very rapidly, it is important to maintain up-to-date credit information on your major customers, not just your new accounts. Talk with your banker about establishing a system for updating your credit files on a regular basis. If your company uses a line of credit, your banker should be particularly willing to assist you because he has a direct stake in your company's financial health and future progress.

Take special care when you are approached to do subcontract work, especially by another tooling and machining firm or an engineering company. Because your invoice will be collected from the contractor, not the company for which the contractor is working, you should make a systematic effort to find out whether the contractor is reliable and financially sound. An impressive customer list or prior reputation does not guarantee payment from a contractor with a marginal financial structure.

When you are uncertain about a company's credit standing after reviewing available information, you should consider requesting a substantial cash payment with the order and regular progress payments thereafter. You should expect, however, that some potential customers will take their work elsewhere rather than make a down payment.

If you generate a significant number of credit inquiries, you should possibly consider using a national credit agency, provided that you can justify their annual fee. The most prominent national credit agency is Dun and Bradstreet, although the Credit Interchange, sponsored by the National Association of Credit Managers, is useful for a continuing update on major accounts.

This BMA was prepared by Barry E. Miller, Financial Management Consultant, Reading, PA. The Barry E. Miller Company prepares the Operating Costs and Executive Compensation Report and the Wage and Fringe Benefit Report for NTMA. Mr. Miller serves as a consultant to NTMA members and has appeared as an expert witness on behalf of member companies.