Principles of Business Credit

Eighth Edition

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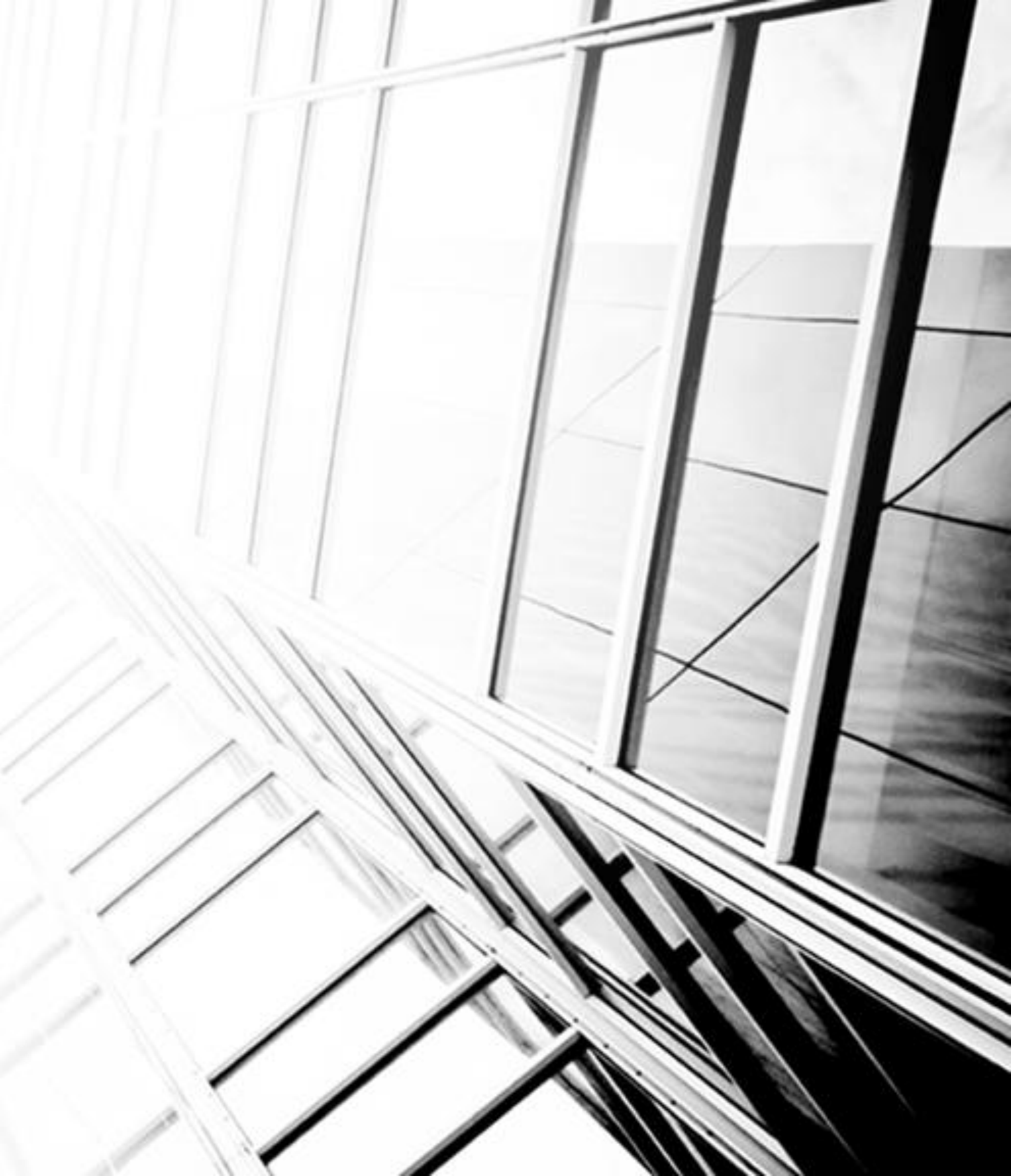
NACM | NATIONAL ASSOCIATION OF CREDIT MANAGEMENT
Driving results



PART IV

VERIFYING CREDITWORTHINESS

Chapter 12: Business Credit Fraud

Chapter 13: Making Credit Decisions

12 Business Credit Fraud

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Hallmarks of bust-out and same name scams.
- Why unsolicited orders are suspect.
- Why a large number of reference requests should be checked out.
- How the credit professional can be used as a reference in a fraud.
- Why unverifiable references, increased orders and unusual product mixes are suspect.
- How to spot misrepresentations.
- How to spot the warning signs of hidden ownership, the principal being unavailable, NSF and counterfeit checks.
- How to spot financial irregularities.
- What assets may be removed from a business.
- How to spot identity theft.

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Questions for Discussion

THINK ABOUT THIS

Q. What are the key the warning signs of business fraud?

Q. What can be done by a credit professional to identify possible fraudulent activity?

Bust-Out and Same Name Scams

- ***Fraud** is an intentional perversion of the truth for the purpose of inducing another to rely on it to part with some valuable thing. It is false representation of a matter of fact, whether by words or conduct, by false or misleading statements or by concealment of that which should have been disclosed, which deceives and is **intended to deceive** another so that a person shall act upon it to their legal injury.*
- *Bust-Out Scam (sleeper fraud)*
- *Same Name Scam*

Business Credit Fraud

- Unsolicited Orders
- Unverifiable References
- Large Number of Reference Requests
- Being the Credit Reference in a Possible Fraud
- Increased Orders
- Unusual Product Mixes
- Misrepresentations
- Undisclosed Changes in Ownership
- Unverifiable Backgrounds of Principals
- Hidden Ownership
- Principal Unavailable

Comprehension Check

List four basic questions that can be asked about a credit reference to protect from business credit fraud.

Increased Orders

- Here are some things to be aware of:
  - If the order is from a retail store, what is the square footage?
  - How many locations does the business have?
  - Has a sales representative visited any of the stores or the headquarters? What did they find?
  - If the customer is a wholesaler, is the reason for the increase known? Under normal circumstances, a wholesaler knows their sales team. If this is a mystery, try to find out who needs the product.
  - Does the business have the usual signs of permanence?
  - Are the backgrounds of the principals known?

Comprehension Check

Explain how an unusually large number of credit reference requests may indicate a possible business credit fraud.

Hidden Ownership

- Reluctance of principals to make decisions without consulting someone else
- Control change where owners are not immediately disclosed
- Confusing chain of command
- Confusing corporate structure
- Signers on checking account are different than purported owners

Comprehension Check

Why can a sudden increase in orders or an unusual product mix be an indicator of a business credit fraud?

Sources of Information

- Sales force
- Industry credit groups

Comprehension Check

Describe why a change in ownership, unverifiable background of principals, hidden ownership and unavailable principals need further investigation and may be warning signs of fraud.

Business Credit Fraud

- <u>**NSF Checks Received**</u>
- <u>**Counterfeit Checks Received**</u>
- <u>**Financial Statement Irregularities**</u>
- <u>**Assets Removed**</u>
  - Any Asset Can Be Removed
- <u>**Identity Theft and Social Engineering**</u>
  - Business EINs
  - Corporate Identity Theft
- <u>**Fraud on the Rise**</u>

Summary

- Business fraud costs businesses billions of dollars every year. It is critical for a credit professional to be aware of business practices that may seem out of the ordinary.
- Fraud takes a variety of forms, but is normally done through the intentional manipulation of the truth in order to do harm to another party. Common techniques used to commit fraud include:
  - Bust-out scams
  - Same name scams
  - Unsolicited orders
  - Unverifiable references
  - Large number of reference requests
  - Increased orders or unusual product mixes
  - Undisclosed changes in ownership
  - Unverifiable backgrounds of principles
  - Hidden ownership
  - Financial statement irregularities
  - Identity theft

Comprehension Check

List some warning signs of a bad check.

Comprehension Check

Why is it important to keep an eye on a customer's assets and make sure they are not improperly removed?

Summary Continued…

- There are often very reasonable explanations for irregularities in business operations. However, it is very important that, if a credit professional believes something is out of the ordinary, a credit investigation be conducted. This can be as simple as calling the customer in order to prompt an explanation. If a company applying for credit seems to be holding back information that should be readily available, or a principal is avoiding inquiries at all costs, they may be stalling in order to commit fraud.

- The best sources of information for a credit professional who suspects fraud are the sales force and industry credit groups.

- Due to a creditor's need for the free flow of information, businesses are often not afforded the same protection as individuals. Credit reports and business **EINs** may make it easy for a thief to steal a business's identity. Over 30 types of fraud have been identified with the top three complaints being identity theft, debt collections schemes and imposter scams. It is critical that a credit professional be aware of these scams and remember that, "If it seems too good to be true, it probably is."

Comprehension Check

Explain how **EINs** make identity theft easier.

13 Making Credit Decisions

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Approval of credit for new customers.
- Establishing credit limits for customers.
- Available security devices.
- How credit scoring is used to help manage credit.
- Credit approval for marginal credit accounts.
- Making credit decisions using limited customer information.
- Conducting reviews of credit limits.

CHAPTER OUTLINE

1. Accounts for New Customers 13-2
2. Credit Availability and Limits for New/Existing/Repeat Customers 13-3
3. Handling Marginal Business 13-13
4. Decisions Based on Limited Information 13-14
5. Review of Credit Limits 13-16

Questions for Discussion

THINK ABOUT THIS

Q. What influences when or how often a customer's credit file should be reviewed?

Q. When can it be beneficial to take on marginal business?

Q. What should be taken into consideration when approving credit for new customers?

Q. What factors influence the introduction, use and review of credit limits with customers?

Q. What constitutes marginal business, and how can marginal business be an essential component of a credit portfolio?

Accounts for New Customers

- Issues to consider:
  - How much credit is required?
  - What is the profit margin on the product being sold?
  - Does the customer have the resources to pay? Is the use of trade credit for convenience as designed, or is the trade creditor being used as a substitute for a bank loan?
  - When will the customer pay? Does the customer's history suggest that, regardless of creditworthiness, there might be a potential risk of slow-pay, dispute or litigation?
  - If the customer does not currently have resources to pay timely, is it likely that the customer will have them by the time payment is due?
  - How much credit do other vendors offer this customer, and is the request in line with like suppliers?
- Approval of Small Initial Orders

Accounts for New and Existing Customers

- Approval Based on Credit Reporting Agency Rating Scores
  - This method of approving orders provides the following advantages:
    - Documentation of actions taken.
    - Little or no need for exhaustive investigation for each account when it falls within set criteria.
    - Efficient use of time for other, more exacting duties.
    - Exceptions to the policy or marginal cases are more easily identified and can be examined carefully by the credit department.
- Non-Routine First Orders
  - Is the order large enough to warrant the cost of investigation?
  - Is the potential for future sales large enough to merit a full credit analysis?
  - Is the treatment of non-routine orders covered by company policy?
- Terms Other than Open Account

Comprehension Check

Some companies establish a way to automatically approve small orders. Supply a justification of this policy.

Credit Availability and Limits for New/Existing/Repeat Customers

- Purpose
- Credit Line vs. Credit Limit
- Underlying Factors
  - Financial information.
  - Agency ratings, reports and credit scores.
  - Bank checks.
  - Trade clearances and other data as warranted.

Influences on Credit Decisions

Profit Margin

1. If the profit margin on a particular product is high, the seller can afford to accept a greater credit risk and make more credit available.
2. If the company's credit policy is conservative and profit margins are slim, credit limits may be more restrictive.
3. If demand for a company's product is greater than its production capacity or if there is an industry-wide supply shortage, sales may be made primarily to the most select class of customers, with credit limits to marginal customers curtailed.

Greater credit risks may be taken when a credit grantor operates under one or more of the following:

- High overhead which demands increased production for profitability.
- A highly competitive market which affects profit margin by meeting the competition.
- Introduction of a new product line or expansion into a new territory/market means higher expenses.
- Product sales that require major capital investment such as equipment and/or fixed assets.

Terms of Sale

Comprehension Check

What is the difference between **credit line** and **credit limit?**

Figure 13-1 **Lost Profits**

The table below demonstrates what happens when a company with a net margin of profit of 2% does not collect $5,000 in accounts receivable. The sales force must make up that loss by selling $250,000 in products or services in order for the company to "break even" on the loss of $5,000. This means more time and expense are associated with staying even than can be exercised in getting ahead. This does not take into account the necessary efforts to collect each new sale within credit terms. In common vernacular, this scenario could be called "spinning your wheels."

If you have an actual loss of:	and your net profit is: 2%	3%	4%	5%	6%
	you will require this amount in additional sales to offset the loss:				
$300	$15,000	$10,000	$7,500	$6,000	$5,000
500	25,000	16,666	12,500	10,000	8,333
1,000	50,000	33,333	25,000	20,000	16,667
3,000	150,000	100,000	75,000	60,000	50,000
5,000	250,000	166,666	125,000	100,000	83,333

Establishing Credit Limits

- Competition
- Formula
- Payment record
- Period of time
- Expectation of use or expected volume of sales
- Agency scorings and ratings

Comprehension Check
Explain how the profit margin and terms of sale of the selling company influence credit decisions.

Figure 13-2 Agency Scoring and Ratings

NTCR Predictive Score

Predictive Score is based on the unique tradelines gathered by NACM Affiliates. The scoring model predicts late payments and severe delinquency looking forward six months. The predictive variables include current aging status, historical aging (including trends and variance in payment trends) and other business characteristics. From the data on hundreds of thousands of businesses, common characteristics are examined on the business subject and, depending on how closely or remotely that subject matches the characteristics, the score is assigned a range, from high risk to low risk. In cases where not enough data exists, no score is assigned. If the business subject is already delinquent to the degree that the score is trying to predict, no score is assigned in the low to high range because there is no need to predict something that has already occurred. Each report contains a complete credit score explanation. The Predictive Score ranges from 450 (high risk) to 850 (low risk). The Risk Class includes 1 (low risk), 2, 3, 4A, 4B and 5 (very high risk). The score leverages 12 months of historical trade data to predict future behavior.

D&B Viability Rating

Viability Score assesses the probability that a company will no longer be in business within the next 12 months compared to all U.S. businesses within the D&B database. The Viability Score is best used when ranking all businesses within a portfolio especially for identifying the most valuable prospects for sales and marketing. The score ranges from 9 (high risk) to 1 (low risk).

Portfolio Comparison compares a company to businesses assigned a similar D&B "model segment" classification which is determined by the amount and type of data available. The four model segment types include: Available Financial Data, Established Trade Payments, Limited Trade Payments and Firmographics (a set of characteristics of organizations which are most likely to spend money on your product or service) & Business Activity. This score analyzes the risk level of a business for credit risk management purposes. The score ranges from 9 (high risk) to 1 (low risk).

Data Depth Indicator represents the level of predictive data available for a company. This indicator is based on a scale from A to G where A indicates the greatest level of predictive data, such as financial statements, and G reflects a minimal level of data, such as firmographics only.

Company Profile describes a company based on a combination of five categories: Financial Data Available, Number of Trade Payments, Company Size, Years in Business and Firmographic Data. The five categories are rated based on: not available, available (3+ trades), medium and established.

Credit Scoring Models: Types

- **Behavioral Models**
- **Rules-Based Models**
- **Neural Models**

Comprehension Check
Discuss three common methods used to establish a credit limit.

Credit Scoring Models: Pros

- Increase speed and reduce response time
- Quantify risk and improve management control
- Consistency, accuracy and objectivity
- Reduce personnel and credit investigation costs
- Decision support and planning tools
- Prioritization of collection activities and reduce bad debt loses
- Comply with audit mandates
- Knowledge transfer mechanism
- Ease of implementation

Credit Scoring Models: Cons

- Qualitative factors and situation-specific judgment
- Dependency and lack of judgment
- Insufficient and / or heterogeneous pool of customers
- Obsolescence of historical information
- Statistical difficulties

Other Factors to Consider in the Credit Decision Process

- Country risk.
- Appetite for risk.
- Willingness to pay.
- Age of credit and financial data used for credit scoring.
- Potential of customer.
- Competitor’s action.
- Notes to financial statements.
- News reports, periodical articles, etc.
- Weather patterns.
- Credit insurance.

Comprehension Check

Explain credit scoring techniques and the pros and cons for their use.

Credit Limits

- Implementing Credit Limit Decisions
- Credit Limit Management
- Communication Credit Limit Decisions

Real World Perspectives

RWP 13-1

FIVE BIGGEST MISTAKES B2B CREDIT MANAGERS MAKE

Credit managers must balance the conflicting needs of revenue and business credit. But there are core best practices which are universal to all our efforts to bring the money in. Below are five mistakes credit and collection professionals make and how to fix them.

1. **Not giving reasons for your credit decisions.** Credit professionals should verbalize their well-thought-out, sound reasons to the stakeholders when presenting the bad news. Too many credit professionals impose, rather than sell their credit and collection decisions. When someone simply says "no," even if they have the authority, their credibility and reasoning can be questioned. If decisions are always supported with facts, data and experience, then stakeholders will come to understand that the decisions are based on sound judgment.

2. **Not meeting folks halfway.** Rarely are credit decisions black and white. There are situations where credit professionals need to stick to their assessment and give solid reasons for the decision. However, most day-to-day credit decisions exist in a grey area where company exposure can be controlled by limiting credit lines, modifying terms of payment, or allowing other functional groups to take a portion of the financial risk. Collaboration with other stakeholders can make all the difference between a new business partnership and no revenue.

3. **Operating in a silo.** No department or function can operate in a vacuum. A company is made up of individuals who work in groups, and they must rely on each other as if it is a living ecosystem. Hold weekly meetings with staff; have weekly meetings with direct stakeholders. Get out of the office/cube and visit with internal customers, who know who and what problems may emerge.

4. **Focusing solely on bottom-line savings, while ignoring top-line growth.** Credit and collection managers have a reputation for wanting to collect all of the receivables on every sale, at the expense of not making every sale. Credit professionals must find a balance between the two: develop a certain appetite for risk that is based on historical bad debt expense, as well as current data and information regarding the true financial health of the customer in both the short and medium range; long-term financial health is something that can be managed throughout the life of the customer relationship. It is dynamic and always changing. To keep it all in check, put strong processes and procedures in place to monitor exposure and periodically evaluate current and future risk.

5. **Not identifying the root cause of collection issues.** What's stopping the money from coming in the door? There's always a reason invoices aren't getting paid. Typically, the least common of these reasons is a customer's cash flow; the most common reason for non-payment (or late payment) is that the invoice is incorrect or not in a "format" that the customer can use. The ultimate goal of any order-to-cash process is to make the customer happy and to allow them to be a self-payer. In other words, don't provide customers any excuse not to pay the bill; this needs to be a constant driver for every organization and is one that requires a great deal of collaboration and diplomacy between the various order-to-cash stakeholders.

George Waters, Global B2B Credit Professional, Published on LinkedIn July 2016

Informing Customers of Credit Limits

- Advantages
  - Opportunity to discuss and possibly adjust the limit in order to sell more.
  - Opens discussion about payment expectations and to obtain more information.
  - Reduces embarrassment of holding orders when/if customer is over limit.
  - Creates a chance to help a marginal customer become more solvent.
- Disadvantages
  - Possibly damages goodwill.
  - May restrict purchases to the credit limit imposed.
  - Customer may be offended/insulted by what it perceives to be an insufficient credit limit.
  - Raises questions as to how or why the credit limit was determined.

Security Instruments and Actions Against Default

- Guarantee
- Cross-Corporate Guarantee
- Irrevocable Letter of Credit
- Subordination Agreement
- Security Agreement
- Financing Statement
- Mechanic's Lien
- Notice to Owner (NTO)
- Payment and Performance Bond
- Bond Claims
- Joint Check Agreement
- Real Estate Mortgages (Deeds of Trust)
- Job Contracts
- A/R Insurance

Handling Marginal Business

- General Considerations
  - Management can be either inexperienced or lack depth and succession planning.
  - Finances are inadequate. Companies are not adequately capitalized for their transaction volume or are not generating sufficient profits.
  - Payments are slow. Terms of sale are not observed, requiring extra collection efforts.
  - Merchandise is bought in too small quantities and/or provides low profitability.
  - Orders often exceed predetermined credit limits.
  - The customer has a low composite credit score.
- Profit Issues
- Other Decision Factors

Comprehension Check
List some available security devices.

RWP 13-2

Real World Perspectives

THE ONE THAT GOT AWAY

I had worked for a company as credit manager for less than a month when we received an order for $3.1 million from a customer with a credit limit of $500,000 and a high credit of less than $400,000. I updated the credit report and went to meet with my boss, the division CFO, and his boss, the general manager (GM). I explained that there was not enough information on file to justify releasing the order pending. I was told to make arrangements to fly out the next day—if possible—to meet with the customer to try to qualify the account for a $3.1 million credit limit.

After meeting with the customer's CFO and reviewing the customer's financial statements, which were weak and showed a significant downward trend, I was convinced that there was no way that the order pending could be released on open account terms. I shared my insights, observations and concerns with the CFO and GM as soon as I returned to the office. They thanked me for my efforts and my input, and then the GM instructed me to release the order anyway. In response, I sent him an email with a copy to my manager. In part, it said:

> *"As you instructed in our meeting this morning, I have released the order pending for $3.1 million for production and shipment. I remain concerned about the possibility of default and will keep you informed of any problems involving this customer."*

Approximately 50 days later, the customer filed for Chapter 11 bankruptcy protection still owing the $3.1 million—making our company the single largest unsecured creditor. On a dotted line basis, I reported to the corporate treasurer, and when he was notified of a potential $3.1 million loss, he told me to fly out and meet him ASAP to discuss this problem—and to bring the credit file.

The treasurer started the meeting by telling me that this was one of the largest bad debt losses the company had ever incurred. He added that he was disappointed and deeply concerned that the loss had occurred less than three months after I was hired. In response, I produced from the credit file my trip summary memorandum, which read in part:

> *"There is no safe way to make this sale. The only reason to do so would be if our need for this $3.1 million in sales exceeds our concerns about a potential $3.1 million loss."*

The second document I handed him was a copy of my email confirming the general manager's verbal instructions to release the order pending. In total, the meeting lasted about 10 minutes. The treasurer thanked me for making the trip, and instructed me to leave the credit file with him and to take the next day, a Friday, off. The following Monday, the general manager was fired and the CFO was given an opportunity to accept early retirement. I continued to work for that company for more than five years before leaving for greener pastures, but this incident was never discussed with me again.

What is the moral of the story? **Document, document, document!** Document your decision-making process, and *always* document management overrides. You never know when adequate documentation might save your job.

Michael C. Dennis, MBA, CBF

Decisions Based on Limited Information

- Reasons for Limited Information
- Other Factors

Comprehension Check
List and discuss the characteristics of a **marginal account.**

RWP 13-3

Real World Perspectives

ASK AND YE SHALL RECEIVE

I worked for 12 years at a small manufacturing business. When it was sold, I found myself looking for another position in credit. I was open to trying something new and different, and I went to work at a Big 7 accounting firm managing its receivables. I found myself in a different world!

This company had offices all over the country and internationally as well. I had a lot to learn. It became obvious that accountants are a little different in the way they think about and collect their receivables. The ones with the largest clients became partners, and these partners would do nothing that might offend their clients.

My first challenge was the New York office—the largest billing office of the firm. I had heard horror stories about how the partners there would allow no one to collect their money. So I booked my flight (Did I mention I live in a small town in North Carolina?), pulled out my best black business suit and headed to the "Big Apple."

The office on Madison Avenue was very impressive; the partners were so nice and seemed to welcome my help. Okay, not all of them, but one in particular had a major client that brought in millions. I gasped when I looked at the receivables and found that $500K was over five years old! In my old job, no money went uncollected, much less $500K.

When asked, the partner confessed that he had inherited this client, and that they were unlikely to pay because of the age of the invoices. Of course, this drove me crazy. Can you imagine my frustration? I humbly asked if I might try to collect this money. Literally, he wrung his hands, agreed, but made me promise not to upset them. UPSET *them*!

I began to prepare for my meeting with this important client, gathering time records, billing information—everything I could put my hands on. This went on for a couple of months. The information was professionally bound into a beautiful book—I was going in armed with everything I needed. Finally, the appointment was made.

The partner declined to attend the meeting. Big surprise; he had such *pressing matters* that day. For backup, I decided to take the tax administrator instead. I painstakingly briefed her on how we would handle it—who would present the information, what kind of deal we would cut and so on.

Let me set the scene as it was on that fateful day. In my best black suit again, I grabbed a taxi and headed down to the client's office. We rode the elevator and stopped on the top floor—the penthouse, no less. We were ushered into the main conference room and offered a wide selection of beverages. As we waited for the VP of Finance, I gazed out the window at the Statue of Liberty. What a view!

The VP arrived, and I told him we had $500K outstanding and that we would like to get that paid. He asked a few questions. (I had my hand on the beautiful, professionally bound book, ready to spring it on him.) Then he looked at me and said, "I will have my accounting department write you a check. You should have it by the end of the month."

My mouth must have dropped open—could it really be that easy? I thanked him for his time and for making this so easy. He just looked at me and said, "If we owe it, we will pay it. It's just that simple."

My heart was pounding as I got into the elevator. I looked at my co-worker and told her that we couldn't tell anyone how easy it was! Needless to say, I was the hero of the day, adding $500K to the bottom line—that money had been reserved as bad debt. The Partner was ecstatic but mystified. What kind of magic powers did I have??? I never did tell him!

I've since moved on, but I keep that story close to my heart. After nearly 20 years in accounts receivables, I always remind myself and those who work beside me: *"Sometimes, all you have to do is ask!"*

Amy D. McGuinn, CICP

Review of Credit Limits

- Regular Reviews
  - A thorough and complete review should include the following steps, with particular attention to trends:
    - Secure from the sales department an estimate of the customer's current and near-term needs.
    - Request from the sales department an estimate of the customer's potential growth.
    - Review the customer's recent payment record with the company.
    - Review the latest agency reports to check for changes in ownership, operation, payment record, rating and financial information.
    - Review and analyze latest financial statements, whether received directly or contained in an agency report. Obtain current figures if necessary.
    - Review the most recent trade credit data and compare it with previous reports.
    - Review the latest information from the customer's bank and obtain new information if necessary.
    - Review notes resulting from direct contact with the customer.
    - Make a personal call, if considered advisable, on the customer.
    - Appraise historical information on the new principals when important changes in management take place.
    - Decide whether the credit limit and payment terms are reasonable for the customer's financial strength and credit standing, in line with company credit policy, and adequate to supply the customer's needs.

Review of Credit Limits: Circumstances

- Improved Credit Situations
- Changes in Business Conditions
- Exceeded Credit Limit
  - Answers to these questions must be answered in order to increase credit
    - Do current liabilities exceed current assets on the customer’s balance sheet?
    - Are trade payments prompt?
    - What is the experience of other suppliers on the risk?
    - Are other suppliers placing undisputed claims for collection?
    - Is there any evidence of careless or unreliable performance by the customer?

Comprehension Check

Why can selling to a marginal account be important to a business?

Review of Credit Limits: Extraordinary Credit Needs

- Reasons for Unusual Needs
  - Expanding sales.
  - Initial or seasonal buildup of inventory.
  - Special contracts.
  - New or recently established business. In a highly competitive economy, buyers frequently count upon credit from suppliers as the principal source of operating capital.
  - Continuing credit for normal needs when there is a moratorium on previously incurred debts.
- Probability of Collection
- Seller Consideration

Comprehension Check

When should credit limits be reviewed?

Review of Credit Limits: Extended Terms

- Establishing the Necessity for Extended Terms
- Terms Offered by Competitors
- Determining Whether Extended Terms Are Realistic
  - Will temporary assistance from the supplier give adequate financing?
  - Does available information, including sales forecasts and cash inflow forecasts, indicate that funds will be available to meet obligations as they mature?
  - Will there be adequate funds to resume normal payments as agreed?
  - Does close analysis indicate that such aid would serve no long-term purpose and that the actual need is for equity capital or long-term debt?

Review of Credit Limits: Other Reasons

- Overdue Accounts
- Other Reasons for Reviews
  - Receipt of a new financial statement.
  - A change in the accounting method for reporting sales and income.
  - New auditors.
  - The death of one of the principals.
  - The admission of a new partner or other change in management.
  - A change of banks.
  - A change in the legal structure of the entity (e.g., from a proprietorship to a corporation or LLC).
  - A merger or an acquisition.

Comprehension Check

Explain the statement:
The longer the credit period, the greater the risk.

Figure 13-3

	NEW CUSTOMER RISK REVIEW CHECKLIST	Comments	Completed?
1	Completed and signed credit application (or written approval from management if requirement is waived)		
2	Sales-initiated customer form is completed and approved		
3	Financial statements (Full set if purchases are expected to exceed a certain level. If lesser volume, obtain written or verbal information to calculate key ratios.)		
4	Resale tax certificate (if a U.S. entity) is sent to tax department (dated copy retained by credit deptartment)		
5	Legal name verification via Secretary of State websites		
6	Third-party credit reports, including key scores		
7	Bank references		
8	Trade references (3)		
9	Review customer's website and online presence		
10	Generate internal credit score		
11	Credit limit determination		
12	Security instruments		
13	Evaluation and approval		

Figure 13-4

	EXISTING CUSTOMER RISK REVIEW CHECKLIST	Comments	Completed?
1	Completed and signed credit application (or written approval from management if requirement is waived)		
2	Sales-initiated customer form is completed and approved (if requesting additional credit limit)		
3	Financial statements (Full set if purchases are expected to exceed a certain level. If lesser volume, obtain written or verbal information to calculate key ratios.)		
4	Resale tax certificate sent to tax department (if a U.S. entity and if the previous certificate has expired)		
5	Legal name verification via Secretary of State websites		
6	Third-party credit reports, including key scores		
7	Bank reference to update availability and relationship		
9	Review customer's website and online presence		
10	Generate internal credit score		
11	Credit limit determination		
12	Security instruments		
13	Evaluation and approval		

Summary

- The basic objective in making credit decisions is to find ways to approve an order with reasonable expectation that the customer will pay in accordance with established credit terms.
- New orders should be processed as quickly as possible in order to ensure continued sales. When processing new orders, consider:
  - How much credit is required?
  - What are the profit margins on the products being sold?
  - When will the customer pay?
- Credit investigations may not be necessary for all sales. Credit policies that establish terms for automatic credit approvals and approvals based on a creditor reporting agency's rating or score can save time and money for a credit department. Some, but not all, benefits include:
  - Documentation of actions taken
  - No need for exhaustive investigation
  - Efficient use of time
- When first orders cannot be streamlined by using an automatic credit approval system or credit ratings, an organization may sell on other terms such as cash in advance or certified check.

Summary Continued...

- Profit margin of a product can have serious implications for a credit decision. For example, high profit margin can allow a seller to accept a greater credit risk.

- Financial exposure is greater when credit terms are longer.

- Factors to consider when **establishing credit limits** are:
  - Competition
  - By formula
  - Payment record
  - Payment performance
  - Period of time
  - Expectations of use
  - Agency scoring and rating

- **Credit scoring** is a popular tool of credit analysis. A credit matrix can be used to assign certain credit bands to specific terms. Credit scoring models are also popular tools when making credit decisions. They can take into account various factors like the NAICS code, payment history and financial data to make an appropriate, unbiased credit decision.

- Many companies advise their sales department of credit limits. It also may be appropriate to inform the customer of credit limits. However, there are advantages and disadvantages to this practice including an opportunity to discuss and possibly adjust the limit in order to sell more, or the potential to damage goodwill between a customer and the seller.

Summary Continued…

- There are various security devices that may be used during a credit decision. Some include: guarantees, irrevocable letters of credit and subordinate agreements.
- Marginal risks may be essential to a business' receivables portfolio allowing for increased profit if the risk is justified.
- Credit managers may need to make credit decisions with limited information because of limited time or increased cost. There are many factors to consider when making decisions with little information, one being the overall economic environment at the time of the decision.
- **Credit decisions** should always be done on a specific timeline based on when certain information becomes available for that particular business. However, the frequency of review may be subject to change based on the business as well as other factors that include:
    - **Improved credit situations**
    - **Changing business conditions**
    - **Exceeded credit limits**
    - **Extraordinary credit needs**
    - **Extended terms**
    - **Overdue accounts**
  - Other reasons for **review** include, but are not limited to, the following:
    - **New financial statements**
    - **New auditors**
    - **Merger or acquisition**
    - **Death**

Principles of Business Credit

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