



# ***Credit Analysis***

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## *Who Should Care About the Credit*

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- Corporate
  - Financial Controller
  - Credit Control Manager
  - Sales and Marketing Manager
- Banking
  - Credit Lending Manager
  - Risk Manager
  - Investment Portfolio Manager
- Investment
  - Investment Manager



## *Some Concerns Credit*

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- Different businesses have different requirements of credit control
- Credit can impose significant costs and expenses for the firm
- A minimal credit loss leads to a large amount of required compensation in sales
- The character of credit granted by the bank has changed significantly over time and is of global concern
- Banks incur additional risks with more complications
- Even investment world is exposed to credit risk



# ***Credit power and Business Development***

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- Why Grant Credit ?
- Customer Risk
- Country Risk



# *Why Grant Credit ?*

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- **Executive belief**

“A certain level of receivable balances outstanding permanently is an inevitable cost of doing business and credit management is nothing more than a housekeeping task that incurs costs”

- **Old style executives** : Business needs to give credit and hire some business prevention officers and pay less
- **New style executives** : Credit is a powerful strategic tool that can be aligned with the strategic interest of the business



## *Why Grant Credit ?*

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- Businesses have significant amount of the accounts receivables on the balance sheet and growing more weight.
- A/R impacts balance sheet, liquidity, cost of capital and business policy.
- It is a significant investment.
- Better hire receivables portfolio strategists.
- No business has to give credit, it is a choice.
- Decision on the credit should be made from the top level with clear strategy.



## ***Strategic Reasons for Granting Credit***

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- Product Offer Enhancement Credit Strategy
- Comparative Cost of Money Credit Strategy
- Credit Strategy for Administrative Efficiency
- Credit Strategy to Build Trust
- Credit Strategy for Business Development



## ***Product Offer Enhancement Credit Strategy***

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- This strategy aims to use credit to enhance competitiveness of the product beyond price quality and delivery (to match or to make it better)
- This emphasizes good quality and aggressive commercially minded credit management
- Successful companies are those with better quality credit analysis, less risk averse and credit risk minimization



# ***Comparative Cost of Money credit Strategy***

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- This strategy aims at the better position of suppliers to borrow money than its buyer to add competitive advantage
- It is appropriate for the buyers in the countries with relatively high borrowing rate
- This also represents cost minimization and risk transfer



# *Credit Strategy for Administrative Efficiency*

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- Granting trade credit may be motivated by a need to capture certain administrative efficiencies and reduces operating cost
- This is achieved through reducing number of invoices, reducing cash handling, reducing number of shipments, reducing storage cost and increasing sales volume
- Terms such as CAD or COD
- Example: Agricultural fertilizer market



## *Credit Strategy to Build Trust*

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- Granting credit can signal that the supplier has confidence in the quality of the goods and services and that the supplier wants to establish a long-term relationship with the buyer



# *Credit Strategy for Business Development*

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- Potential distributors without significant working capital may not be able to afford the venture capital or short term bank finance.
- They can ask for assistance from suppliers which in turn can use them as the distributors to develop the business.
- The assistance in terms of working capital can be done through extended supplier credit



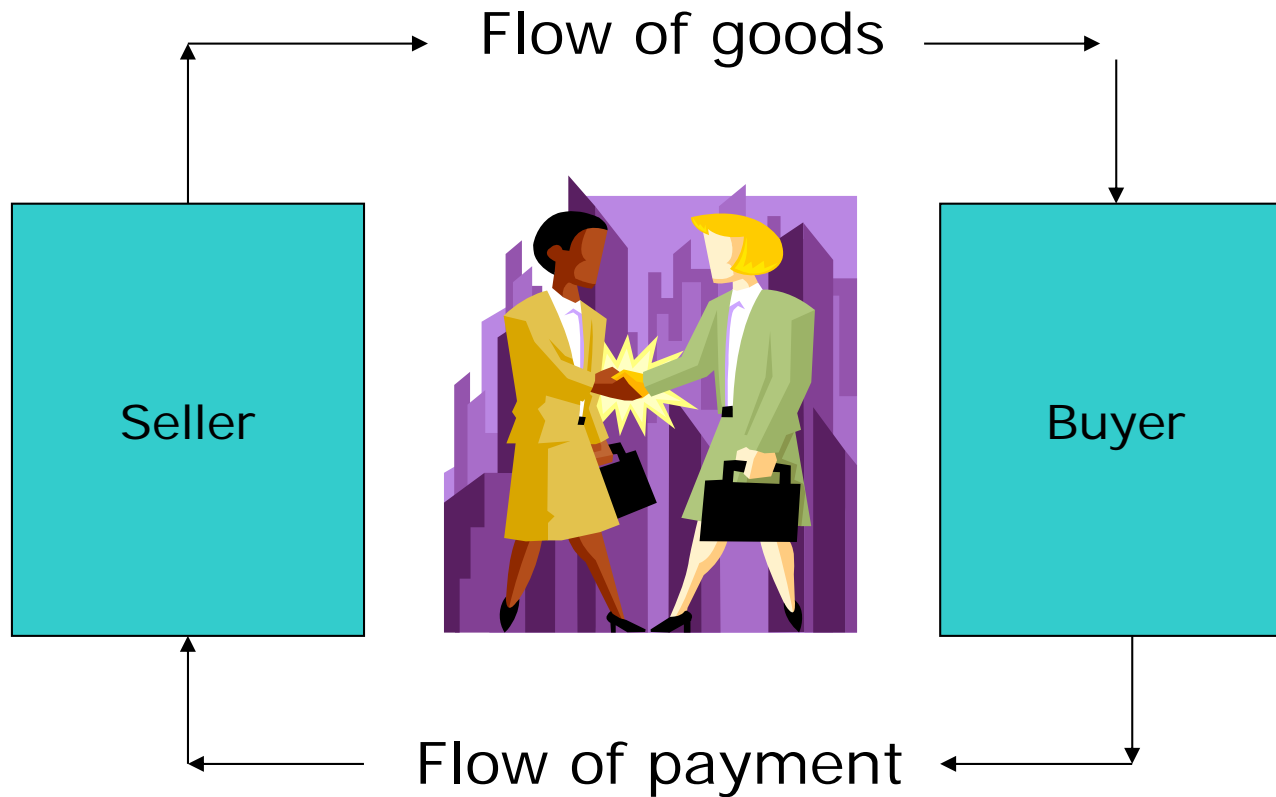
# Customer Risk

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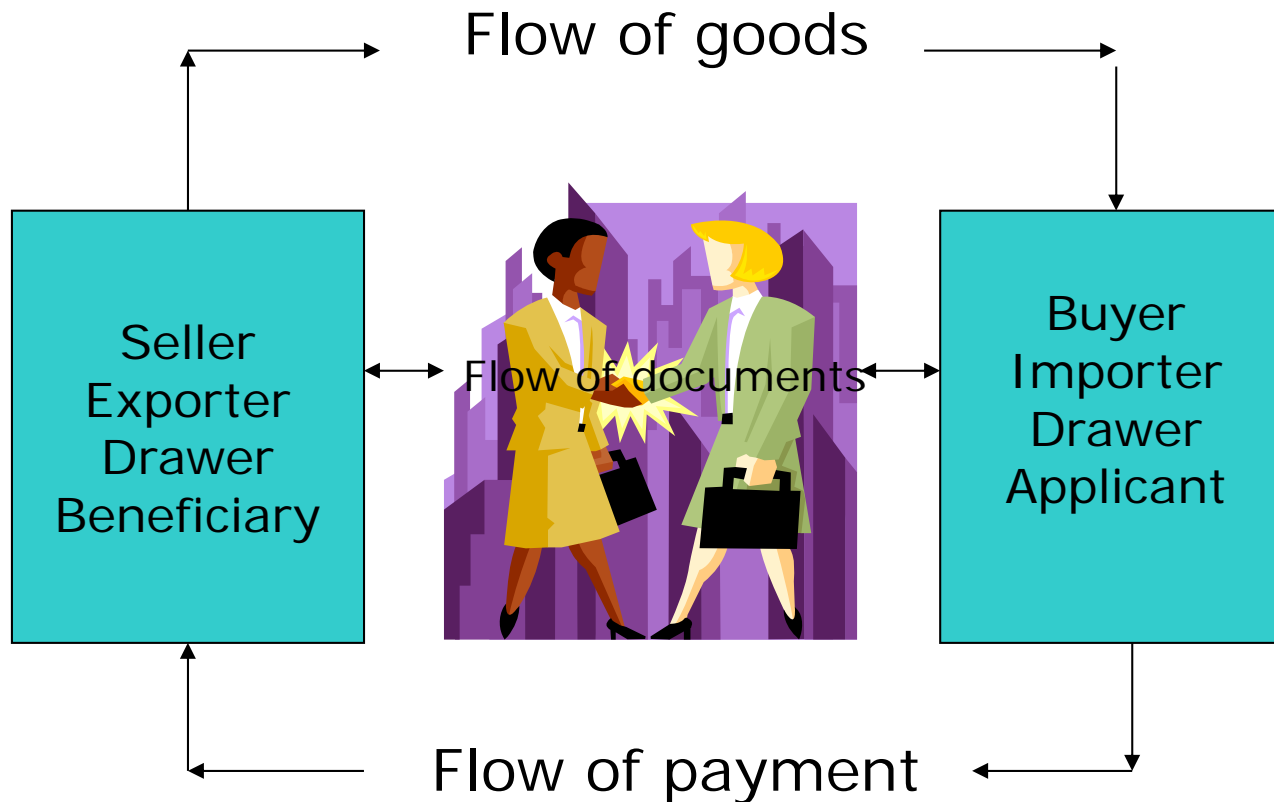
- The customer is the risk that the buyer fails to pay either due to financial constraints (bankruptcy or illiquidity) or due to dishonesty (indefinite delay without good reasons)
- The analysis goes beyond the balance sheet and ratio analysis but includes “Character, Premises, Business, Competitive Advantage, Credit policy, Management”

# *Customer Risk in Local Trade*

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# Customer Risk in International Trade





# *Due Diligence*

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- A process of gathering data, summarizing data and analyzing the data of a company
- Usually, the investigation will be done in depth and across disciplinary including legal, tax, financial, accounting, operating, human resource, management credentials, relationship with stakeholders and system
- It is to ensure customer existence thorough personal visit
- Due diligence is used to investigate the credit fraud



# *Credit Fraud*

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- Careful study of traditional methods used in reaching credit decision
- Three types
  - Shell Company fraud
  - Bust-out fraud
  - Theft of corporate identity



# *Customer Payment Risk*

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- The customer is the risk that the buyer fails to pay either due to financial constraints (bankruptcy or illiquidity) or due to dishonesty (indefinite delay without good reasons)
- Liquidity and honesty are under direct control of the management of buyer so the analysis of management is crucial
- High-quality trade credit analysis can provide competitive advantage while protecting losses



# *Customer Risk Analysis Tool*

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- Financial information as to the condition and achievements of the customer (Financial Statement)
- Information related to future and strategies of the customers
- Payment and Operational performance information from other suppliers, banks, company record, credit reference agency, internet, etc.
- Generally available information regarding the customer's industry, market environment and tax and legal environment
- Personal visits



# *Analysis of Financial Information*

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- The use of financial statement such as balance sheet, income statement, cash flow statement together with the financial statement based ratios to determine the credit decision.
- Cash flow is regarded as the most reliable source as it reflects actual cash movements during the review period and it helps to understand
  - The customer's ability to generate cash
  - The customer's strategy for utilization of cash generated
  - Sources of cash
  - The cash flow cycle of the customer's business
  - The customer's defensive interval (days)  
(Quick asses / Daily Cash Operating Expenses)
  - The customer's cash flow cycle



# *Caveat when using Operating Cash Flow*

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- Operating cash flow is not immune to the creative practices of the financial wizards
- Generally accepted accounting practices requires the attention, investigation and careful analysis
- Followings need to be paid attention
  - Income generated by discontinued businesses
  - An income tax paid (partly from investing or financing act.)
  - Cash flow generated as a result of securities trading activities that are sporadic
  - Expenditure that is treated as an asset on a company's balance sheet



# *Analysis of Information about the Future*

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- The future is less and less likely to resemble the past
- Credit analysts need to assess the customer's business environment and its competitors' possible strategies, to understand the customer's resources and strategies and to reach a reasoned decision as to the probable efficacy
- To start, the past record may provide reliable clues as to the customer's abilities to deal with the future



# *Credit Scoring*

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- Some Companies or banks use credit scoring but suffer from some limitations such as
  - The statistical problem due to small sample size
  - Financial data are prone to manipulation
  - The past is not a good indicator of the future
  - All models are subject to the assumption and the subjective decision
  - Country differences



# *Trade Credit Risk Scorecard*

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- This techniques use the Balanced Score Card concept to create scoring models that require analysts to give due weight to non-financial factors when assessing the credit risk
- The objectives of developing a Score Card is to
  - Make credit limit decisions in a standardized way
  - Make credit decisions that align with company strategy
  - Speed up credit decisions and enable the use of technology
- The credit risk scores are useful in terms of receivable portfolio with risk consideration



# *Customer Limit*

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- One important component in granting the unsecured trade credit is to decide on how much exposure to allow, credit limit
- A useful guideline should be proportion of company equity or should be consider together with the purchasing power and credit term
- The factors to consider
  - The normal pattern of customer business
  - Normal purchase level
  - Usual credit term in the market
  - Relative size of customer's business
  - Relative financial strength



## *Authority to Approve Credit Limits*

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- The company must have designed processes and delegate with adequate training and experience to deal with the decision to grant credit.
- The delegation of authority to grant unsecured credit limits should be approved by the Board of Directors.



# *Power Collections*

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- The Collection process is very important
- The most effective way to obtain payment from past due invoices is to simply ask the customers to pay promptly with regular update.
- Especially for the disputed invoices requires a special attention.
- For high-value invoices the follow-up should be done in advance politely to ensure that the invoices has been received, is not disputed and payment be made within the due date.



# *Country Risk*

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- Country risk is the risk that something may happen in a foreign country that will stop or discourage state-owned or privately owned customers in the country from paying debt



# ***Transfer or Sovereign Risk and Local Factors Risk***

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- Receipt of foreign A/R requires
  - Foreign currency exchange regulations of the country allow the transfer of fund freely
  - Foreign country has sufficient currency available
- The risk that one or both conditions is not satisfied is the transfer risk or sovereign risk
- On the other hand, local factors risk includes all elements which could have a simultaneous negative effect on the financial well-being of the business operating in the country such as new tax law, reduction in currency value, national disaster, outbreak, civil war or sharp rise of interest rate



# *Country Risk Management*

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- The situation in each country is dynamic and subject to rapid changes
- Consider countries independently and interdependently
- Individual country limits should be reviewed formally and on a regular basis
- It is vital to gather information regularly as to assess risk exposure and compare to limits



# *Country Risk Rating Agencies*

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- Several international renowned agencies that produce regular country risk analysis reports and risk ratings for subscriber using criteria such as
  - Economic indicators
  - Political factors
- These organizations provide the rating for each country and each agency has its own way of expressing ratings



# *Unique-Company-Product-or Service Country Factors*

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- Additional elements should be considered and each could be assigned a risk weighting]
- Elements to consider
  - The strategic position of your goods within the country being analyzed
  - Your company's influence with decision makers in the country
  - Your company's strategy in the geographic area in question
  - The strategy of your company's competitors
  - The availability of payment risk cover from bank or the credit insurance market