

## **Credit Decisions Without Financials**

A credit investigation to determine the health and potential financial stability of a customer involves numerous steps. Similar to the board game Clue, credit professionals are trying to paint a picture. In the case of the game, players are searching for a murderer, the murder weapon and the location of the murder, asking questions along the way to help connect the dots and fill in the missing pieces. The same can be said for credit departments investigating a new customer or new order—searching for all the information possible to make the best-possible credit decision.

Often, like in the game, not all the information will be available to paint this picture, but it is still the job of the credit department to support and protect the company. Not having financial statements is a gigantic hurdle for credit departments; however, this barrier can still be broken with the right amount of pressure and information during the credit review process.

In a recent NACM webinar, “No Financials, No Problem!” seasoned credit professional Ed Bell, Ph.D., CBA, ICCE, discussed the multi-step process that is making credit decisions without one of the key data points to extend credit. Throw a wrench into the mix like the COVID-19 pandemic and this scenario evolves into another creature. But the philosophy remains the same, gather the best information possible to make an accurate credit decision.

“Things have changed dramatically in the last seven to eight months; this year is a different environment for us when it comes to credit situations,” Bell said. “The information gathering strategy with COVID-19 [is different especially with] limited customer visits and travel restrictions.”

Financial risk analysis is described as an art—decision making with knowledge and experience (gut feeling)—and a science—using math, ratios and calculations. The credit reviews are a very subjective exercise of reviewing the extension of credit to customers based on the 5 Cs and 6 Ps of credit. One of the Cs—conditions—is extremely important right now with the pandemic, hurricanes, fires and political unrest across the U.S. “We’re not just looking at the numbers, if we were, we’d be missing potential customers and business,” which is where character comes into play as well. Capital is the only “C” that is truly looked at on a quantitative level through financial statements.

### **Why have a credit review?**

Having a credit review process in place with or without customer financials helps set the appropriate risk and exposure for the customer, i.e., a credit limit and terms. It also protects assets against bankruptcy and other potential future nonpayment issues or write-offs. Without customer financial documents it is vital to gather as much information as possible. This can come in the form of bank and trade references, information from trade credit groups, information about the customer’s products and industry, and the current economic climate.

How much information is needed and how in-depth it will be depends on the amount of credit being offered. Smaller amounts will likely mean less information, but it’s still important to “Know Your Customer.” There are two ways of gathering this information: direct and indirect. The direct format comes through customer contact and other noncommercial sources like references—think doing this process internally as a credit department through sales reps, public records, speaking to the customer, etc. Indirect investigations involve information from a third-party source—credit data companies and reports such as the National Trade Credit Report and organizations like NACM and FCIB.

Without financials, credit departments need to research performance information about customers, which can come from asking the customer to estimate sales volumes. This is one way to help find the customer's position in the market and industry. A company's size—the number of facilities and employees—can also be an indicator of their financial health. While more difficult in the current climate, customer visits can provide invaluable information like the condition of the facility and overall appearance.

Determining customer financial distress, especially without financials, can be difficult. Bell introduced 10 warning signs.

1. Changing payment patterns: asking for extended terms, but why? Is there a cash flow issue or is this what a competitor is doing?
2. Changing buying or selling habits. Is the customer's business increasing or are they prebuying to bulk up before a bankruptcy filing?
3. Shrinking cash flow, but this is hard to determine without financials.
4. Higher customer demands
5. Large accruals
6. Withholding financial information despite previously being comfortable sharing it.
7. High DSO
8. Changes in management
9. Persistent rumors
10. Tax liens

There is no one-size-fits-all credit option, but there are ways to combat potential problems down the line. Credit departments can reduce or shorten payment terms; require partial payment or prepayment; use letters of credit; have customers sign personal guaranties; use other forms of security agreements; purchase credit insurance policies; sell only on credit cards; or as a last resort, stop selling to the customer.

Having the full picture is the most efficient and effective way to make a credit decision, but some situations don't always allow for that. Like in Clue, asking questions is the best way to get there without guessing if someone is the murderer or if the credit department is making the right decision.

-Michael Miller, managing editor