

Run the numbers before you extend customer credit

Funny thing about customers: They can keep you in business — but they can also put you out of it. The latter circumstance often arises when a company overly relies on a few customers that abuse their credit to the point where the company's cash flow is dramatically impacted.

To guard against this, you need to diligently assess every customer's creditworthiness before getting too deeply involved. And this includes running the numbers on entities you do business with, just as lenders and investors do with you.

Information, please - A first step is to ask new customers to complete a credit application. The application should request the company's:

- Name, address, phone number and website address,
- Tax identification number,
- General history (number of years in existence),
- Legal entity type and parent company (if one exists), and
- A bank reference and several trade references.

Depending on which industry or industries you serve, there may be other important data points to gather, as well. If you haven't updated your credit application form in a while, consider doing so — especially if you've gotten burned on the same type of credit failure multiple times.

Financial data - When dealing with private companies, consider asking for an income statement and balance sheet. You'll want to analyze financial data such as profit margin, or net income divided by net sales. Ideally, this will have remained steady or increased during the past few years. The profit margin also should be like those of other companies in the customer's industry.

From the balance sheet, you can calculate the current ratio, or the customer's current assets divided by its current liabilities. The higher this is, the more likely the customer will be able to cover its bills. Generally, a current ratio of 2:1 is considered acceptable. Again, there may be other metrics that are particularly important for the types of businesses you work with.

An evolving challenge - Reviewing financials is only one key step in determining whether a customer is creditworthy. It's also important to contact the references the customer provided, and you may want to purchase a credit report. Finally, be sure to look at coverage of the customer both by traditional media and on social media. Doing so could reveal information that will impact your decision on whether to extend credit.

When competing to win and keep customers, it's easy to get carried away with credit. Approach this task carefully and bear in mind that, for most businesses, extending customer credit is a learning process and an evolving challenge. For further help and info on assessing customers' creditworthiness, please contact our firm.