Paul Robbins training and consultancy

Credit Management

Credit Scoring

Exercise 2 Model Answer

You have been provided with a summary from the Financial Statements for the last two years of Rugby & Cricket Ltd, a new customer requesting trade credit.

	Year 1 (£000)	***Year 2 (£000)***
Sales Revenue	***705***	***824***
Cost of Sales	***512***	***633***
Current Assets	***658***	***782***
Current Liabilities	***554***	***765***
Inventory	***87***	***41***
Trade Receivables	***176***	***285***
Trade Payables	***284***	***336***
Profit from Operations	***39***	***11***
Interest Paid	***31***	***45***
Net Profit	***8***	***(34)***
Long Term Debt	***150***	***175***
Equity	***200***	***250***

Note that Current Liabilities includes short-term debt and trade payables only.

Tasks

1. You should calculate the performance indicator ratios shown in the table below for Year 1 and Year 2, expressing your answers to two decimal places.

2. You should then complete the credit scoring for each ratio, using the scoring criteria provided, in the table below for Year 1 and Year 2.

3. You should then calculate the Total Credit Rating in the table below for Year 1 and Year 2.

4. In the box provided below, state the level of risk for Year 1 and Year 2 and advise whether we should grant trade credit to Rugby & Cricket Ltd.

	Indicator Year 2	Rating Year 2	Indicator Year 1	Rating Year 1
Operating Profit Margin %	***1.33%***	***0***	***5.53%***	***5***
Interest Cover	***0.24 times***	***-20***	***1.26 times***	***-10***
Current Ratio	***1.02***	***-10***	***1.19***	***-10***
Gearing %	***70.73%***	***-20***	***67.74%***	***-20***
Total Credit Rating		***-50***		***-35***

We should not grant trade credit to Rugby & Cricket Ltd. This is because their total credit rating represents a high level of risk in both Year 1 and Year 2. In addition, the total credit rating is worse in Year 2 and almost a very high level of risk. We should only look to grant trade credit to businesses with a low or very low level of risk.

Performance Indicator Ratio	***Year 2***	***Year 1***
Operating Profit Margin % ***(Operating Profit / Sales) x 100***	***(11 / 824) x 100*** ***= 1.33%***	***(39 / 705) x 100*** ***= 5.53%***
Interest Cover ***Operating Profit / Interest Payable***	***11 / 45*** ***= 0.24 times***	***39 / 31*** ***= 1.26 times***
Current Ratio ***Current Assets / Current Liabilities***	***782 / 765*** ***= 1.02***	***658 / 554*** ***= 1.19***
Gearing % ***(Total Debt / Total Debt plus Equity) x 100***	***(429 + 175) / (429 + 175 + 250) x 100*** ***= 70.73%***	***(270 + 150) / (270 + 150 + 200) x 100*** ***= 67.74%***

Credit Rating (Scoring) System	*Score*
Operating Profit Margin	
Losses	***-5***
Less than 5%	***0***
5% and above but less than 10%	***5***
10% and above but less than 20%	***10***
20% and above	***20***
Interest Cover	
No cover	***-30***
Less than 1	***-20***
More than 1 but less than 2	***-10***
More than 2 but less than 4	***0***
4 and above	***10***
Current Ratio	
Less than 1	***-20***
Between 1 and 1.25	***-10***
Between 1.26 and 1.5	***0***
Above 1.5	***10***
Gearing (total debt / (total debt plus equity))	
Less than 25%	***20***
25% and above but less than 50%	***10***
More than 50% but less than 65%	***0***
Between 65% and 75%	***-20***
Between 76% and 80%	***-40***
Above 80%	***-100***
Risk	***Aggregate Score***
Very low risk	***Between 60 and 21***
Low risk	***Between 20 and 1***
Medium risk	***Between 0 and -24***
High risk	***Between -25 and -50***
Very high risk	***Above -50***