Paul Robbins training and consultancy

Credit Management

Credit Scoring

Exercise 1 Model Answer

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

	Year 1 (£000)	Year 2 (£000)
Sales Revenue	654	703
Cost of Sales	479	515
Current Assets	368	377
Current Liabilities	312	325
Inventory	127	141
Trade Receivables	133	152
Trade Payables	164	159
Profit from Operations	47	50
Interest Paid	24	24
Net Profit	23	26
Long Term Debt	100	100
Equity	230	230

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 Tennis Supplies Ltd.

	Indicator Year 2	Rating Year 2	Indicator Year 1	Rating Year 1
Operating Profit Margin %	*7.11%*	*5*	*7.19%*	*5*
Interest Cover	*2.08 times*	*0*	*1.96 times*	*-10*
Current Ratio	*1.16*	*-10*	*1.18*	*-10*
Gearing %	*53.63%*	*0*	*51.88%*	*0*
Total Credit Rating		*-5*		*-15*

We should not grant trade credit to Tennis Supplies Ltd. This is because their total credit rating represents a medium level of risk and, although this is consistent in Year 1 and Year 2, 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*	*(50 / 703) x 100* *= 7.11%*	*(47 / 654) x 100* *= 7.19%*
Interest Cover *Operating Profit / Interest Payable*	*50 / 24* *= 2.08 times*	*47 / 24* *= 1.96 times*
Current Ratio *Current Assets / Current Liabilities*	*377 / 325* *= 1.16*	*368 / 312* *= 1.18*
Gearing % *(Total Debt / Total Debt plus Equity) x 100*	*(166 + 100) / (166 + 100 + 230) x 100* *= 53.63%*	*(148 + 100) / (148 + 100 + 230) x 100* *= 51.88%*

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***