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GUIDE

How to set credit limits: a guide for business to business payments

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Introduction

Setting credit limits is a critical part of effective credit control and, for many small and medium businesses, credit control is vital to ensuring that all important consistent cash flow.

Simply put, a credit limit is how much credit you are willing to offer a customer.

If your credit limits are too small, they can restrict your business opportunity and prevent customers from placing larger orders.

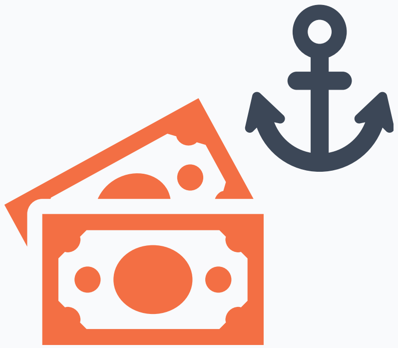
If your credit limits are overly large, the amounts owed, but not paid, can cut off your cash flow.

With one in every ten invoices in the UK being paid late, the threat of late payment can significantly impact businesses that don't have considered credit limits in place.

Many businesses offer credit by operating on finance themselves. Assuming a turnover of £1 million and an average interest rate of 7.5%, the standard 30-day payment terms will cost a company £6,164 in interest alone.

If that invoice is paid 15-days late, which is not unusual, that interest amount goes up to £9,247, highlighting the importance of both carefully considered credit limit and effective credit control.

So, how do you set effective credit limits?



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Run a business credit check

The first step in setting up a credit limit on a customer is to run a credit check on their business. Credit checks are part of your due diligence when onboarding a new customer and offering them credit. A business credit check will provide vital information on your customer's payment history, current revenue, and outstanding obligations, giving you greater insight into whether to offer them credit.

There are a number of credit platforms, such as Dun & Bradstreet, Equifax Business and Experian Business, that are able to run a business credit check on your behalf.

As we noted in our previous article on setting credit limits, in order to run a business credit check, you'll need certain details from your customer, including:

Signed consent to conduct credit checks with the customer's bank, credit reference agencies, and their trade suppliers.

- Details of the business owner.
- The specific legal status of the business.
- The businesses address.
- Their bank account details.
- If the company is a limited company, you'll also need their business registration number.
- The exact amount of credit being requested.
- Full contact details for whoever deals with your customer's finances.

The best way to obtain those details is to create your own business credit policy in writing and, as part of the process, require a customer to fill out a business credit application.
A customer refusing to provide this kind of information should be considered a red flag.

The average SME is owed around **£63k** in late payments

35% of businesses experience cash flow challenges due to late payments

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Selecting the right credit limit

Once you've run a business credit check on your customer and determined that it's viable for you to offer them credit, the next step is to work out the right credit limit for them.

There are two important external factors you need to consider when doing this, including:

The context of the application

Context is important when it comes to establishing credit limits.

If the customer in question is a long standing client with a history of paying you promptly and placing large orders, then it makes sense to be more generous with your credit limits.

On the other hand, if the customer in question is a new customer who hasn't been trading very long, or one you've had some payment issues with in the past, you may want to consider starting at a lower credit limit and adjusting it later.

Your risk appetite

Your risk appetite represents your willingness to risk the credit you've extended not being paid back to you.

There is a balance to be struck between increasing your risk appetite and potentially attracting new customers and getting existing customers to place larger orders and keeping your risk within acceptable limits to avoid bad debt.

How to strike that balance will largely depend on your individual circumstances.

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What to base credit limits on

An effective credit limit is always based on hard numbers, and there are few ways to determine what credit limits you should be offering.

Net worth calculation

A business's net worth calculation can be determined by the sum of its liabilities from its assets. As a general rule, you want to set credit limits that are around 10 percent of a potential borrower's net wealth.

For example:

If a prospective borrower has assets of £750,000 and liabilities of £250,000, then their net worth would be £500,000 and a reasonable credit limit would be around £50,000.

Trade References Model

Instead of a mathematical model, the trade references model requires you to connect with other companies that have extended credit to a prospective borrower, determine if the borrower has made those payments on time, and construct a credit limit from that information

For example:

If a prospective borrower has three other credit agreements in place with limits of £50,000, £75,000, and £100,000 and all the payments on those agreements are being made promptly, then an averaged out credit limit of £75,000 would be reasonable.

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What to base credit limits on

Days Sales Outstanding

The days sales outstanding method divides the customer's income received by their outstanding credit, then multiplies this number the number of days in a given month.

If the resulting amount is high, around the 45 days mark, this could indicate that the customer has issues maintaining a consistent cash flow and may have issues paying back any credit you offer them.

For example:

If a prospective borrower has an income of £75,000 and outstanding credit of £25,000, then their days sales outstanding over a 30 day month would be 10-days.

So it takes them, on average, 10-days to collect payment on outstanding accounts receivables, indicating good cash flow.

If a prospective borrower has an income of £75,000 and outstanding credit of £100,000, then their heir days sales outstanding over a 30 day month would be 43-days, indicating poor cash flow.

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Credit risk management

Credit limits should never be set in stone and active credit risk management is important in stabilizing your own company's finances.

If your customer's payment behaviour changes, you should be in a position to notice that change and adapt your credit limits accordingly.

How to monitor and manage credit risk

The key to monitoring and managing your credit risk is to have access to the right reporting.

A central credit control tool, like Chaser, allows you to draw on insights generated from the payment information of your customers.

Using Chaser, you can monitor the payment behaviour of your customer and compare it to historic data to determine if there have been any significant changes that could indicate a shift in your customer's creditworthiness.

You can then use that data as the foundation for any credit decisions you need to make.

Red flags

Red flags to look out for include:

- A sudden request to increase a customer's credit amount or to extend their payment terms.
- A shift from reliable payment behaviour to unreliable, inconsistent payments.
- The customer's primary customers suddenly go out of business.
- The customer operates in a traditionally high-risk sector or industry.
- Communication between you and your customers is patchy, with emails not being answered and calls not being returned.

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Adjusting your credit limits

When it comes to adjusting your credit limits, risk and context become critical again.

If a customer with a consistent payment history and a stable business model that consistently places high orders with you asks for increased credit, then you might consider the extra business from a trusted client to be worth the risk.

Other factors include the current state of the economy, it's generally a bad idea to take on more credit risk during a recession, and the state of your customer's particular industry.

You should always feel free to adjust your credit limits in order to generate new business, as long as you are doing your due diligence to ensure that the credit risk to your company is within tolerable limits.

Decide, set and track customer credit limits with ease in Chaser'
Accounts receivable software

Book a demo

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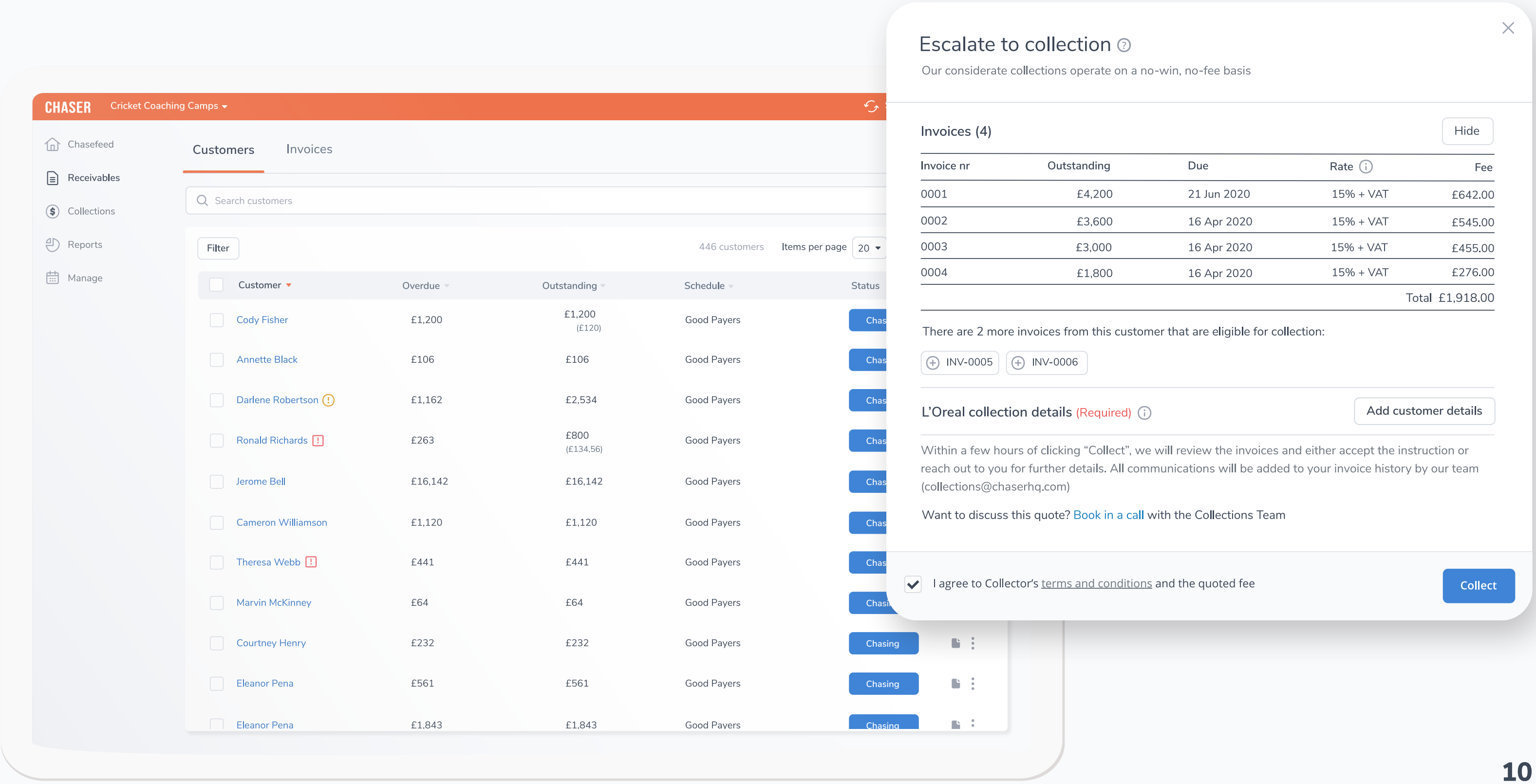
Ensure ongoing effective credit control

Data is the bedrock of setting effective credit limits and generating new business while minimising your risk.

With Chaser's award winning receivables software, that data is always at your fingertips, allowing you to get the insights you need to make data driven business decisions on whether to grant credit, what limits to set and when to change those limits.

In the instance that invoices aren't paid, you can escalate to Chaser Collections, our friendly, ethically-trained debt collections team, who work with your customers collaboratively to reach an agreeable solution whilst protecting your customer relationships and reputation.



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About Chaser

Chaser helps businesses get paid sooner with its award-winning all-in-one accounts receivables automation platform, debt collections agency and outsourced credit control services.

Users can credit check, monitor debtors, chase late invoices via SMS and email, collect payments, recover debt and reconcile accounts, all in the same unique platform.

Within Chaser's software you have access to a centralised hub that helps you keep track of your accounts receivables activity. You can see at a glance all reminders sent and replies received for each invoice and customer. This saves time spent searching through inboxes, and allows other people in the business to keep up to date on communications. You can easily log call notes or any other important updates which ensures that you are fully prepared for any accounts receivables phone calls you have to make.

Chaser was named B2B Supplier of the Year at the CICIM British Credit Awards (2022), won Best Use of Technology at the Credit Awards (2022), was Xero's 'App Partner of the Month' {August, 2021), and the Accounting Excellence 'Cloud App of the Year' three years in a row (2017, 2018, and 2019).

Contact us for more information about our pricing

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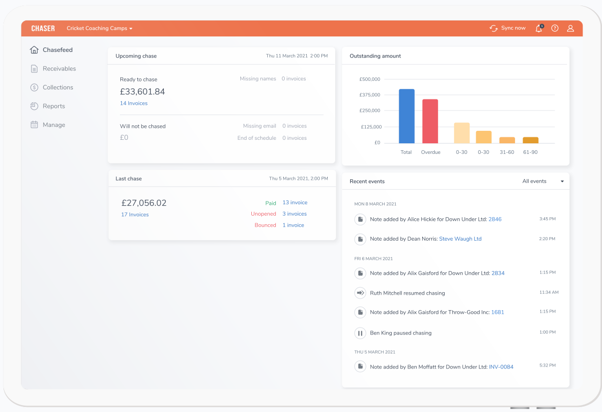

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