experian®

Small-business owners and credit evaluation

White paper

Credit managers rely heavily upon external data sources to guide them in the credit decision process. To approve or reject a loan request is a delicate task. A credit manager must evaluate the risk associated with extending credit versus declining an applicant based on numerous factors. All the while, he or she is driven by the desire to generate revenue for the company. This article explores the credit evaluation process, particularly as it relates to small businesses.

The nature of credit evaluation

The need for sufficient and reliable information is the foundation of a successful credit decision. A credit manager may call on references, run background checks, pull a credit report, verify bank accounts or ask questions of the applicant to validate the information on the credit application. Credit managers are challenged with the task of obtaining readily available information to support their decision while sending a timely response to the applicant. A major obstacle in achieving this task is the turnaround time associated with checking references. The process varies from business to business and may include a background check, a verification of a bank deposit or credit references with existing suppliers. Some businesses require written requests, while others may offer to do a phone interview at their convenience. In either case, the "waiting game" is the most challenging aspect.

The nature of the reference check also is skewed to a certain degree. In all likelihood, the applicant will list accounts or business relationships that he knows will produce a favorable statement. For example, consider a business that has an open or closed collection account. It is highly possible that the applicant will withhold this information on his credit application. Such information, however, will appear on a business credit report.

Not having enough information to support the credit decision can be a nightmare for any credit manager. If the applicant owns a large business, chances are the business credit report on his company will suffice. However, if the business is a small to midsize or a start-up operation, it's likely the business credit report will have very limited information.

So what constitutes a robust business credit report? For some, the answer depends on the amount of credit being considered. For instance, if the applicant is asking for $100,000, chances are, as a credit manager, you'll want or expect a credit report with lots of information to help support your credit decision. Conversely, if the amount applied for is only $1,000, you may just want to know that the business exists. A credit report, even if it has limited information, may be just enough to steer you toward the right credit decision.

Following is a list of data elements that normally would populate a robust business credit report. As you look over the list, imagine what you would do if a report on a small business had just one of these items. Then ask yourself, "Is this enough information for me to make a sound credit decision?"

To illustrate this example, we will refer to the company applying for credit as Company A. Here is the information that goes into the process:

- A **tradeline** represents an existing business relationship with a vendor or a supplier. In this case, the vendor is supplying data to the credit-reporting agency with regard to Company A's record of payments for services provided by the vendor.

- A **collection account** represents an account that has gone into major delinquency status. Generally, this involves an account that is at least 180 days late where efforts to bring the balance current by the vendor have been exhausted. In this case, the vendor is relying on a third party, a commercial collection agency in this case, to collect the entire balance or at least a portion of it.

- A **bank relationship** validates the existence of the business from a financial relationship point of view.

- A **leasing relationship** signifies that Company A has leased equipment or tangible goods necessary to operate its day-to-day affairs.

- A **bond or insurance relationship** shows that Company A has strong financial backing from credible firms designed to protect the company's assets should there be a disaster, such as a fire.

- **Demographic data** on Company A includes information such as a telephone number, a Standard Industrial Classification code, employee size and annual revenue. This data reflects the history or background of Company A.

- **Standard & Poor's financials** on Company A represent audited financial statements proving Company A is a reputable and fairly large publicly held firm.

- **Legal data** available about Company A includes liens, judgments, bankruptcies, corporate record or Uniform Commercial Codes (UCCs), which are extremely useful for businesses extending credit in the leasing industry. With the exception of UCCs, all of this data is considered derogatory and indicative of potential financial instability.

Small business in the United States

U.S. businesses are classified as either large, medium or small. Approximately 73 percent of businesses are sole proprietorships. Another 6 percent are legally filed as partnerships, while 21 percent are filed as private corporations. According to a 1997 study conducted by the U.S. Census Bureau entitled *Statistics about Business Size* (including Small Business), 98 percent of sole proprietorships, partnerships and private corporations are considered small businesses based upon employee size and annual sales volume. Here are additional facts on U.S. small businesses:

- In a recent radio ad that ran in the Los Angeles metropolitan area during springtime 2003, a national telecommunications firm said that 95 percent of all U.S. businesses are small businesses

- The Internal Revenue Service reports that the number of sole proprietorships increased by 1.1 percent in 2000 and 1.6 percent in 2001

- In 2001, the Small Business Administration estimated that only 50 percent of new businesses would be open four years after start-up

Given the available information from a variety of sources, it's safe to say that small businesses represent between 95 to 98 percent of all U.S. businesses.

In an effort to manage increasing opportunities for sales to new companies with the increased risk of doing business with them, creditors are looking for alternative sources of information to help them make their business credit decisions. Their dilemma: They are not sure where to turn for help.

What small-business owners are saying

In April 2002, the Orange County, Calif., chapter of the Small Business Administration conducted its first SBA Loan Fair. It was held in Santa Ana, Calif. A second fair was conducted in Ontario, Calif., in October 2002. The SBA Loan Fair was designed to educate and assist small-business owners in their quest to obtain financing through local banks.

On both occasions, Experian® was asked to give a 30-minute presentation on credit reports. After the workshop, we remained on-site for face-to-face interaction with small-business owners to discuss the topic further and to answer their questions. During this time, 80 percent of the conversations we had with small-business owners involved their personal credit history. Some of the questions asked repeatedly were:

- How do I go about cleaning up my personal credit history?

- What is the best way for me to obtain a copy of my Experian credit report?

- My report has a score of _____. Is that good or bad?

- I filed bankruptcy _____ ago. How long does that stay on my report?

- I co-signed on a loan that is now in delinquent status. How can I prove that I am not responsible for making the payments on that loan?

- I applied for a credit card the other day and was turned down due to my debt-to-income ratio. What is that and why is it so important to lenders?

Our intention was to discuss business credit reports. We wanted the participants to focus on making sure that their business credit report reflected how they dealt with vendors and suppliers. Yet, in the end, the conversation focused primarily on their consumer credit reports.

It was obvious that most of them were not aware that a credit report on their business existed. From this, one can draw two conclusions:

1. Most small-business owners mix their personal finances with that of their business finances.

2. Many small-business owners are more concerned about their personal credit history than they are about their business's credit history.

What credit managers should know

An increasing number of credit managers now realize that many small-business owners are financing their operations with their personal credit. This is based on a study completed by the Federal Reserve Board that found 33 percent of small businesses financed their business operations through personal credit cards. Consequently, many credit managers have considered using consumer credit information but are unsure how it can be used in light of the Fair Credit Reporting Act (FCRA) legislation and recent Federal Trade Commission (FTC) opinions.

Before a credit manager can use owner credit data in a commercial credit risk assessment, an understanding of the latest FCRA legislation and FTC opinions is essential.

At Experian, we subscribe to the following set of guidelines, which describe the acceptable and unacceptable use of consumer credit data in a commercial credit transaction.

The use of consumer credit data in a commercial credit transaction is acceptable to:

- Extend commercial credit (i.e., credit that is not for personal, family or household use)

- Review an existing commercial account

- Collect on an existing commercial account

In each case, however, the above apply only when the individual involved is a:

- Sole proprietor

- General partner in a partnership that is the account debtor

- Individual who has signed a personal guaranty on the subject debt

- Individual who has provided a written authorization specifically approving the review of his or her personal credit history

An example of unacceptable use of consumer credit data in a commercial credit transaction includes reviewing the personal credit history of the following:

- Principals of corporations or other limited-liability entities (*Note: Identifiers of corporations and other limited-liability entities include Corp., Inc., LP, LLC, LTD and LLP.*)

- Employees of a company a credit manager is researching

- Yourself, your co-workers, friends, family members, names in the news, celebrities, government officials or any other individuals with whom you have no commercial credit relationship

Having this information gives credit managers confidence in knowing that they are acting within the guidelines of the law. Once they have an understanding of what they can and cannot do under the law, they feel more assured in looking at owner reports and indicators, which may show that the business owners are leveraging their personal credit for business operations.

This valuable insight helps credit managers interpret how owner data may positively impact their credit approval process.

Obtain a 360-degree view

In bringing this all together, a credit manager must look beyond just a business credit report when evaluating the risk associated with a small business. Consider the facts. At least nine out of every 10 businesses are classified as small businesses. Most small-business owners mix their personal and business finances. Therefore, in order to obtain a true 360-degree view of a small business's creditworthiness, we recommend that credit managers obtain a personal credit history on the business owner in conjunction with a business credit report. Having both will provide the "big picture" regarding the risk associated with extending credit.

Experian's Business Owner Profile is available as a complement to our commercial credit reports such as Business Profile or Commercial Intelliscore℠. Business Owner Profile allows credit managers to view a business owner's personal credit history in conjunction with the credit history of the business.

Some key indicators available on a Business Owner Profile include:

- **National Risk Model —** a score developed by Experian to determine the likelihood that an account associated with the individual will enter delinquent status within the next 24 months. Delinquent status is anything beyond 90 days late.

- **Negative account profile —** the section of the report with details on open or closed accounts that are or were in delinquent status. In this section, any account that is at least 30 days late is considered delinquent.

- **Positive account profile —** the section of the report with details on open or closed accounts that are or were paid satisfactorily.

- **Neutral account profile —** the section of the report with details on open or closed account where there was some sort of a dispute involved. One example would be a co-signer who is not the person paying on the account disputing the charge that the account is being paid slowly.

- **Fraud Shield℠ indicators —** an added value on the report. These indicators will list warnings such as the Social Security number being associated with a deceased individual or an inquiry address identified as nonresidential. There are 22 Fraud Shield℠ indicators. This is a great tool to identify possible identity theft.

- **OFAC warning —** another added value on the report. The Office of Foreign Assets Control (OFAC) is a U.S. government entity that enforces economic and trade sanctions based on foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. The organization produces and maintains a list of Specially Designated Nationals (SDN) and Blocked Persons, which contains names of individuals identified by the U.S. government as having direct or indirect ties with such groups. When a name matches the OFAC list, the report will make a notation under the heading "OFAC warning."

Experian's Small Business Intelliscore℠ is a score-based credit report that blends a business's commercial credit information with that of the small-business owner's personal credit history. Businesses with annual revenue of less than $10 million and fewer than 50 employees made up the population for developing the model for Small Business Intelliscore℠. So, what does the model predict and what does it mean to you, the credit manager?

- **Score range —** The score range is 0 to 100. The higher the score, the lower the risk.

- **Future outlook —** The model predicts the likelihood of a business entering 90-day-plus delinquency status within the next 12 months.

- **Key factors —** Up to four key determining factors are listed to support the score associated with the report.

In summary

Risk management is an art developed by credit managers from years of experience on the job. Most will rely on third-party information to validate the authenticity of a credit application. For due diligence purposes, it is imperative that credit managers have a reliable source of information that is readily available. What makes it even more challenging is when information is lacking, especially when the credit applicant is a small-business owner.

The need to obtain information from credit reporting agencies, such as Experian, is vital. Quite simply, whether the applicant is seeking a business loan for $1,000 or $100,000, risk is risk. To ensure that the proper credit decision is reached, credit managers need to subscribe to the kinds of services discussed here. Only with the right information will you have a 360-degree view of the small-business applicant at your fingertips.

475 Anton Blvd.
Costa Mesa, CA 92626
800 333 4930

8130/2012 07/03

www.experian.com