WHITE PAPER

COMMERCIAL AFFORDABILITY FOR FINANCIAL PROVIDERS

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Commercial Affordability for **Financial Providers**

Being able to quickly and effectively assess the affordability of loans is a critical issue within the commercial lending market. It helps meet the increasing demands from regulators – especially with respect to responsible lending – and it also improves margins. At the heart of this is the need to automate the lending process as much as possible. The needs of SMEs must also be met quickly and cost-effectively, with low referrals and underwriting, whilst at the same time keeping bad debt at an acceptable level.

Assessing loan affordability: **the lending imperative**

When applying for a commercial loan, the requirements of small and medium enterprises (SMEs) tend to be both simple and clear. For these kinds of customers, a slick and efficient borrowing process which enables them to quickly understand how much they can borrow – and how much it will cost – is very important. Time, after all, is a precious commodity, and credit borrowing is regarded as a necessary inconvenience. Consequently, if a process is too onerous, the SME will naturally follow the path of least resistance and perhaps go elsewhere.

Because of this, lenders need to be able to ensure that the journey they provide to their SME clients is convenient and streamlined. Where additional information is required, it should be relevant and proportionate to the customer's needs and should make the lending decision process as smooth as possible.

Although the regulatory demands in commercial lending are lower compared to consumer lending – the FCA's Consumer Credit Sourcebook (CONC) – for example, needs to be applied for sole traders and elements of consumer duty apply as well, there is much more complexity in the commercial space. There are, for example, a multitude of products available, including: working capital; investment; trade finance; purchase of materials; and asset finance. Moreover, payback periods can vary and there can be larger fluctuations in income streams and, for some businesses, the effects of seasonality need to be taken into account.

SHORT VS LONG TERM BORROWING

Short

For short-term borrowing, such as an annual overdraft, the key affordability considerations typically include 12-month revenue and expenditure predictions, short-term debt obligations and seasonality.

Long

For longer term lending, however, the type of product, its term, and its repayment schedule, can all affect the level of insight that is required by the lender in order to understand the underlying strength of the business and its ability to service any proposed debt obligations. A 5-year loan, for example, needs to be considered in the context of core business profitability, long-term debt obligations, and the macro-economic environment.

When it comes to asset finance and secured lending, then, the information that is required – and the process of getting it – generally acts as a way of mitigating risk, improving recoveries and, therefore, reducing losses created by credit default.

Increased affordability complexity
due to uncertain economic conditions

Many of the cost of living factors that are currently impacting consumers are having either a direct, or knock-on, impact on the financial health, or otherwise, of businesses applying for lending products.

During the COVID-19 pandemic, the government quickly put measures in place to protect UK businesses from negative economic impacts. However, the strategy for reducing the impacts of the cost of living crisis on businesses is more uncertain. This is leading to increased demand for commercial credit, but also to increased financial stress and, potentially, reduced affordability in the near term at least.

Several of the key factors currently impacting businesses, and which therefore need to be considered by lenders in all affordability analyses, are:

Inflation in raw materials, fuel costs and energy costs
These are increasing the cost of doing business, stifling growth ambitions and increasing the need for cheap credit. The impacts are especially pronounced in sectors such as farming, logistics and high-energy industries such as manufacturing.

Reduced consumer confidence and levels of spending
This is negatively impacting business revenues, especially in 'luxury' sectors, hospitality, and even in clothing and food retail.

Brexit challenges to free flow of goods
These are increasing workloads and costs and impeding normal business activities with negative impacts on revenues and margins.

Increased staffing costs
These are related to both a lack of skills and available employees, as well as higher wage demands related to the consumer cost of living crisis.

Slowing economies around the world
These have a negative impact upon UK businesses that export goods or services overseas.

The rising cost of credit
This is due to interest rate rises.

Understanding affordability: **Net Free Cash Flow**

There are four key elements that are used to determine affordability. These include business income (turnover), costs, depreciation, and dividends (drawings). For more information about this, please see the box [next page]. These values are used to calculate what's known as the 'Net Free Cash Flow' or 'Servicing Surplus' (see diagram on the next page).

A factor of this is then utilised – maybe 50% to 60% (depending upon risk) – to arrive at what an individual businesses' maximum annual debt repayments should be. As a rule of thumb, if the total cost of borrowing (new and existing facilities) is less than the Net Free Cash Flow then the loan is fine from an affordability standpoint. If it is greater, however, the loan should at the very least be referred on for expert underwriting.

It is important to note that within Commercial Lending there are many different types of business looking for borrowing. The ability to use these standard affordability approaches needs to be compromised somewhat depending upon different circumstances, Sometimes, for example, income might be long-term, future projections (this is typical in development finance). On other occasions, income might be linked to a Specialist Purpose Vehicle (such as a Buy-to-Let mortgage) and thus the facility will, by definition, need to be provided in advance of income being received. In this case, 'affordability' must be linked to future rental income and the ability of the business to manage an empty property and afford to keep it maintained. Business complexity could mean that multiple entities would need to be assessed.

Alongside the use of Net Free Cash Flow, other measures such as Debt Service Ratio (the monthly cost of Credit Average as a proportion of Average Monthly Income), and Debt-to-Income Ratio (the total outstanding balances/limits versus Annual Income), can also be used to understand the ability of a business to service a particular debt and to assess whether the business is over leveraged or not.

The affordability approaches covered later in this paper, however, all utilise the Net Free Cash Flow method outlined here. To some extent the issue for lenders to consider becomes whether enough of the data points are readily available and how important are they relative to the loan amount being proposed.

The 4 key elements

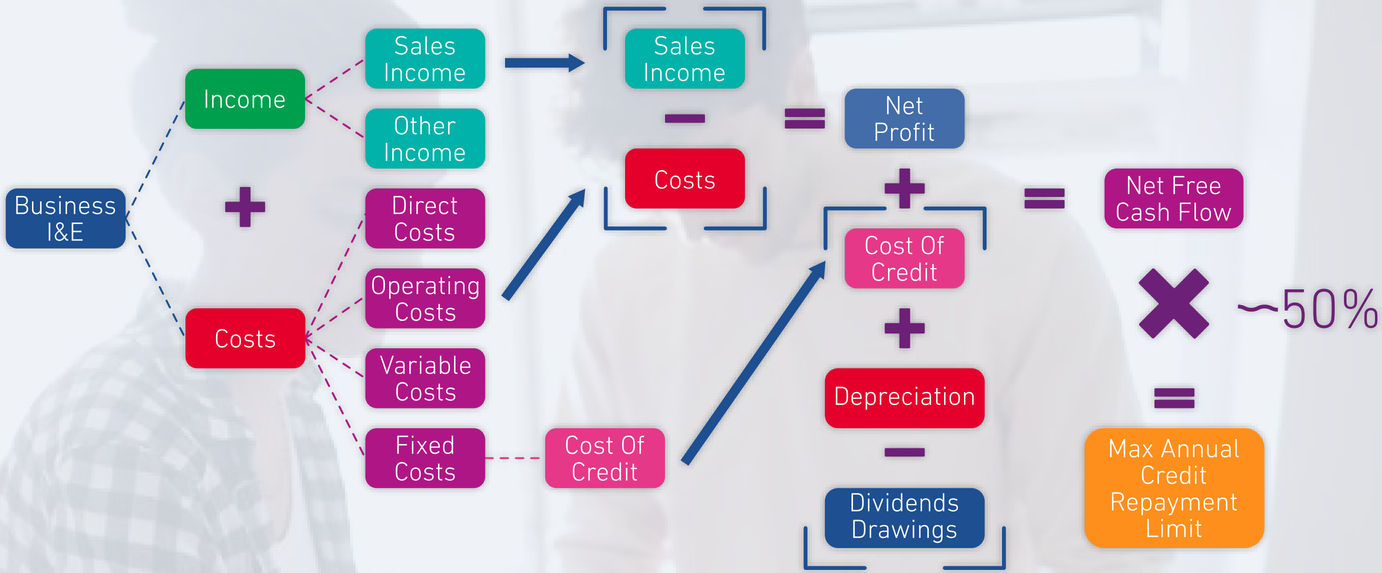
The four key elements that are used to determine affordability. These include **business income (turnover), costs, depreciation**, and **dividends**

As a rule of thumb

If the total cost of borrowing (new and existing facilities) is less than the Net Free Cash Flow then the loan is fine from an affordability standpoint. If it is greater, however, the loan should at the very least be referred on for expert underwriting.

The four key elements that **determine affordability**

To work out how much a business can afford to repay and, therefore, whether it can afford a proposed loan, means considering the following four key elements, with a particular emphasis on business income (turnover) and costs:



#1

Business Income/turnover
How much money is the business making each year; how stable is that income, and is seasonality an issue? This, in turn, means considering two key types of income:

- **Sales/turnover Income**
  This is income from sales of products and/or services.
- **Other Income**
  This is income not directly related to 'goods' sold, such as sales of unused equipment; materials; rental income; interest on savings; investments; bank accounts; money invested in the business; etc.

#2

Costs
What are the total costs each year, and how variable or fixed are they? This breaks down into four types of cost:

- **Variable costs**
  Expenses that vary depending on business needs, such as additional expenses incurred to build up goods to meet future seasonal demand.
- **Operating costs**
  Expenses associated with the daily operations of a business, such as equipment to manufacture goods.
- **Direct costs**
  Also known as 'Cost of Sales', these are expenses directly related to the manufacturing of a product, such as employee wages for the staff creating goods.
- **Fixed costs**
  Expenses that don't change despite business activity, such as monthly rent, utility bills and insurance. This also includes the cost of credit.

#3

Depreciation
This is the reduction in the value of business assets over time.

#4

Dividends/drawings
This refers to the proportion of profits paid to the owners of the business.

The **cost benefits** of **automation**

Automation is a key way in which lenders can start to offer their customers a more streamlined commercial lending experience. However, it also makes great commercial sense for the lenders themselves.

Like their clients, margins and profitability are to a large extent determined by income and costs. In their case the income is driven by the interest they earn from loans augmented by their fees (these vary, of course, from lender to lender depending upon their cost base).

Their costs, meanwhile, will be determined by a combination of factors. The first is their funding business model. All of these – deposit base funding, interbank borrowing, hedge funds, peer-to-peer, etc. – have different costs associated with them. Bad debt is another variable which affects individual lenders differently. It will reflect different risk appetites, the segments that are being targeted and also the mix of loan products that they offer. Operational costs (people, systems, processes, and data) can also differ massively from one lender to another reflecting different levels of underwriting, systems costs, people numbers, and so on.

Automating the commercial loan affordability calculations can greatly assist in reducing costs and, therefore, increasing margins. There are two ways in which this happens:

Automation reduces bad debt
Automation improves the assessment of the customers' capability to service its debt obligations, both now and for the foreseeable future. In some strategy exercises that Experian has undertaken, we have seen a reduction in bad rates utilising a CATO/CAIS based affordability strategy over and above the credit risk strategy of circa 20%.

Automation reduces operational costs
This happens because automation lowers referral rates. If the average cost to underwrite a case is £75-£125 per application this can represent a significant saving per application.

Three methodologies for **assessing financial data**

To be able to understand if a business can service its debts and to automate the assessment of affordability then using the correct data is critical. Getting this information, however– especially up-to-date data – is not always straightforward.

For example, Non-Limited Businesses often don't provide Profit and Loss (P&L) data. Following recent changes to Companies House filing requirements, small Limited Companies (with a turnover of less than £10.2M) also no longer need to file this information. Moreover, where this information is available, it is typically between 10 and 22 months out of date.

In this context, then, lenders need to look at more effective ways to assess affordability. There are three main alternative approaches for assessing loan affordability for simple- and medium-complex businesses under these circumstances. These are:

#1

Use of **Current Account Turnover (CATO)** and **Commercial Credit Account Information Sharing (CAIS)** credit data along with typical business sector margins – typically for lending under £100K but predominantly sub £50K.

#2

Use of **Categorised Bank Account** data to arrive at a pseudo Profit & Loss report for the business.

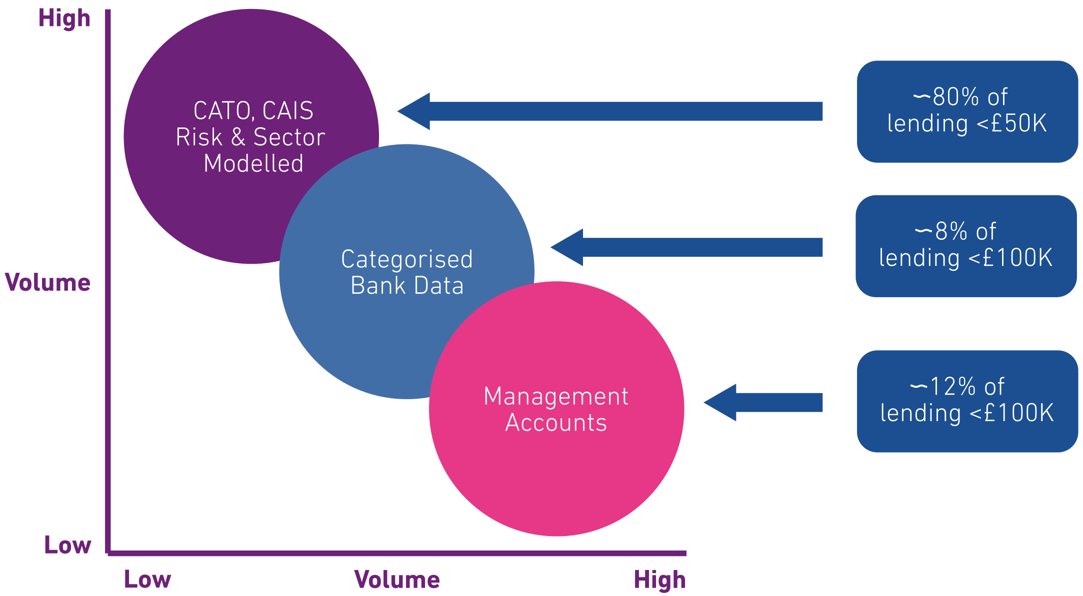
#3

Use of **Management Accounts** data including financial cash flow forecasts to gain an in depth view of the business, its long-term health and future expectations.

The choice of which methodology to use is often a question of judgement and balance. This is because each of these approaches to assessing loan affordability either has its own regulatory framework to enable access to the data, or requirements for specific consent and credential-based access to be considered. These, in turn, impose different levels of friction and complexity on the customer journey. Lenders need to balance the burden on the document requirements and/or bureau data demands made on the SME with the level of risk and then make a value judgement about the value that the data will bring, compared to the costs associated with getting it.

Method	Typical Limits	Coverage	Retrospective Analysis	Access	Regulatory
CATO & CAIS	Up to £50K	~90%	Yes, back to 2017	Via CRA Reports (legitimate interest	SCOR & CCDS (membership)
Categorised Bank Data	Up to £150K	~90%	No (except for banks)	Customer consent and credentials	Open Banking Regs
Management Accounts	Any Amount	~50%	No	Customer consent and Credentials	N/A

We can see how often these approaches could be utilised by creating a graph which overlays the number of applications by the size of borrowing (i.e. all products on Commercial CAIS) over the last 5 years (excluding BBLs). Please note that these figures will also be dictated by organisational risk policies and lending criteria.



As part of the customer journey, potentially all approaches could be used to assess affordability. The judgement about which one (or which ones), to choose depends upon the risk associated with a particular customer, the availability of data, the quantum of borrowing and the type of loan product that is being considered.

In specific cases – such as Pre-Assessed Lending/Advertising Limits in banking and eligibility journeys elsewhere – CATO/CAIS is a methodology that can be used without creating much friction. In practice, this approach can often be used to facilitate both a limit that customers can borrow up to under a simple journey, through to higher limit which is 'subject to' additional checks and potential conditions on borrowing (such as collateral requirements, for example).

'Subject to'

Displaying 'subject to' limits is important so that a customer is aware of what they could potentially borrow. There is a commercial danger to the lender here: if a customer sees an initial limit for £50K (based on what they can borrow immediately using bureau data including CATO/CAIS), but they require more they may be under the impression that the organisation won't help them. Without using the all-important phrase 'subject-to', they may, therefore, simply decide to look elsewhere.

The importance of **seeing the full picture**

The underlying importance of assessing Commercial Affordability has been highlighted recently in several cases, some high profile, where lenders have been left with large write offs due to the proliferation of lending across many organisations. In these cases, the businesses were assessed without having the total picture of borrowing available to them. It is why data sharing initiatives such as CAIS are so important as they shine a light on the ability or an organisation to repay new facilities.

A recent example we came across recently illustrates this very well. The organisations' business turnover was around £30M according to their annual accounts and confirmed by CATO. They were servicing over £90M of active debt on CAIS which, it turned out, was understated in the company's reported liabilities. All of these were on either 3 or 4 year terms. The debt-to-income ratio was over 300% – a particularly worrying figure considering the average term of the debt was about 3 years. Finally, the Debt Service Ratio was over 100% which meant, quite simply, that all income was required to support the debt repayments.

Although this example ended up being the result of first-party fraud, the significant losses here could have been stemmed had the lender's affordability assessments taken account of existing debt obligations. It is also a great example of the importance of sharing credit data.

300%

The debt-to-income ratio was over 300% – a particularly worrying figure considering the average term of the debt was about 3 years

Assessing affordability using **Commercial CATO** and **CAIS**

The Small Business, Enterprise and Employment Act 2015 brought in new data sharing principles (CCDS) designed to help facilitate greater choice in the commercial lending market, specifically for SMEs (businesses in this case with a turnover of less than £25M). It did this by forcing banks to share not only all their lending data (previously this had only happened on a voluntary basis under SCOR rules), but also summary Current Account data (CATO) on a monthly basis.

The CCDS regulations aimed to create a level playing field for data. The plan was to foster competition and to increase choice for SMEs by allowing organisations to utilise the CATO data if they would, in return, share their lending data with the CRA's, even if they don't have a Current Account product (which restricts access to CATO data in consumer lending).

Within banks, this data has been used for many years to facilitate Risk Assessment and Limit Setting, enabling them to develop powerful scoring models and effective affordability assessment (based on loss rates), thereby giving them a considerable competitive advantage when lending. This data is now available as part of the standard bureau data process, so can be retrieved at the point of application or in batch for existing customers.

Furthermore, this data is also open to trade creditors who are not financial providers as long as they contribute their ledger data to Commercial CAIS.

The CATO data, then, provides an in-depth and up-to-date picture on a business through monthly snapshots from banks. It includes Credit and Debit Turnover, balance data (high, low, average & End of Month) as well details on Returned items and days in excess.

This detailed picture of their cash flow health **helps in a number of ways:**

#1

Lenders can create more predictive scoring models

These are shown with both Experian's new Commercial Delphi Gen 6 and Cash Flow Delphi scores and the big improvements in scorecard performance and Gini.

#2

Lenders can create policy rules to refine score decisions

Examples might be: no income for x months; declining income; Debit Turnover in excess of Credit Turnover; signs of stress in balances; excesses and returned items.

#3

Lenders can calculate affordable limits for SMEs

See below.

Banks have for many years used CATO data to calculate automated lending limits for their customers as it provides an in-depth view of SME cash flow, including their income and likely expenditure, and therefore the capacity to take on debt and thus to successfully offer pro-active limits to their customers. This success was one of the primary reasons the government mandated the release of this data.

To enrich the income and cash flow view from CATO, CAIS data provides a detailed view on the Financial Credit products used by a business and includes data on Loans, Overdrafts, Asset Finance, Commercial Cards, Commercial Mortgages, Telco and Payment Acceptance data. CAIS holds around £150 billion of active commercial debt, mainly in the SME segment, providing details on type of facility and age, limits and balances, any arrears including the history, term and monthly repayment as well as additional card details.

This allows us to see the level of debt, monthly debt servicing cost and performance in meeting their obligations – important in both calculating affordable limits and assessing risk.

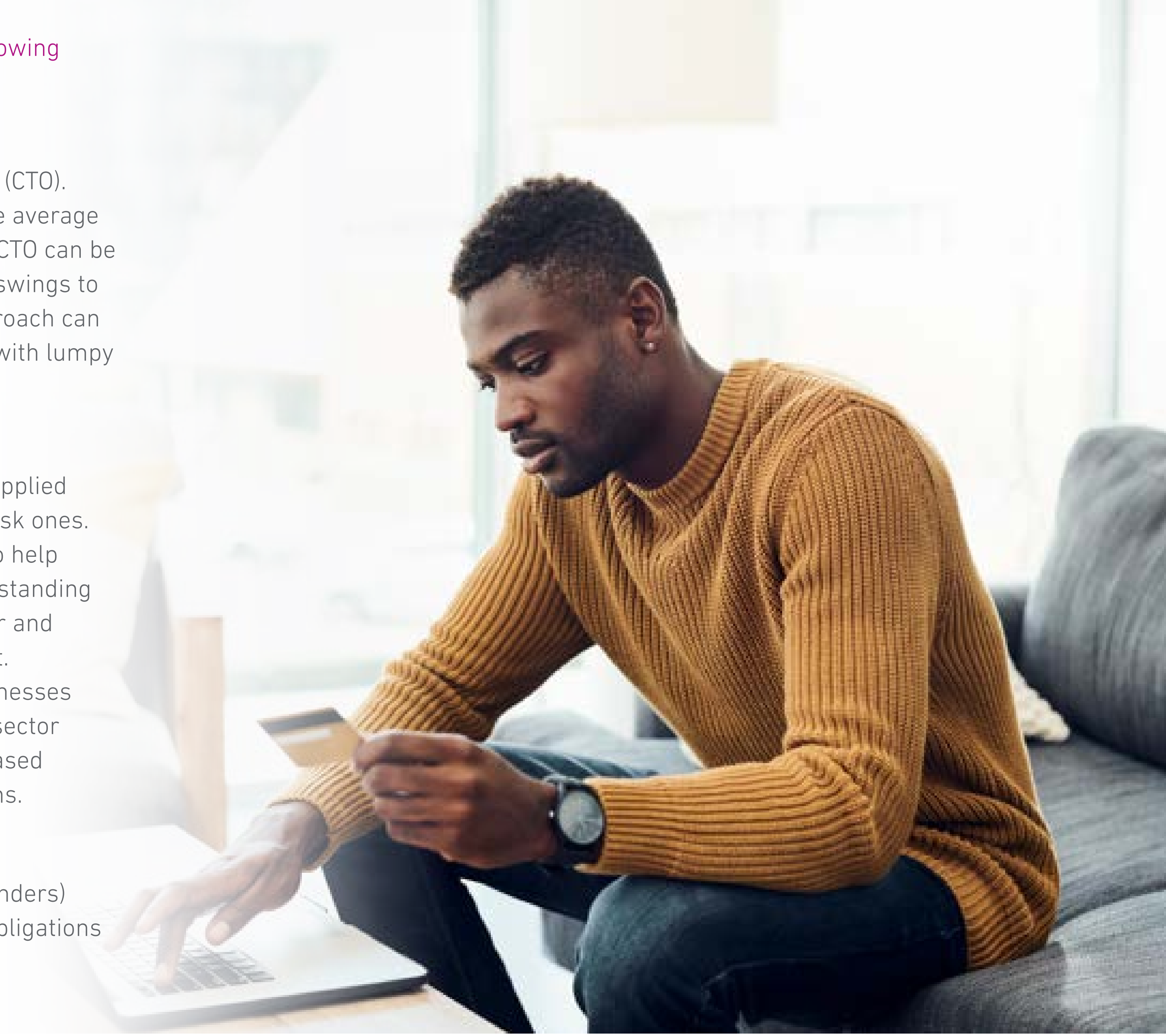
CATO Credit Turnover × Factor (based on Risk Grade & Profit Margin) − CAIS Debt = Affordable Limit

To calculate an automated affordable limit the following information are used:

Income
This figure is taken from the CATO Credit Turnover (CTO). This provides both an Annualised view but also the average monthly Credit Turnover of the business. Average CTO can be calculated after topping and tailing to remove big swings to get to a more stable monthly income, but this approach can adversely impact seasonal businesses and those with lumpy turnover patterns.

Risk and Sector Factors
This allows restricted limits (or zero limits) to be applied to high-risk businesses and larger limits for low risk ones. Business margin is used alongside the risk view to help understand spare cash flow to pay off debt. Understanding Business Margin is difficult as only Credit Turnover and Debit Turnover can be seen on the current account. However, Companies House data on >£10.2M businesses provides indicative EBITDA/Gross Profit levels by sector which can be utilised to set conservative sector-based margin factors to feed into affordability calculations.

Existing Debt Obligations
This comes from CAIS (own company and other lenders) and enable us to understand current repayment obligations and levels of debt (short- and long-term).



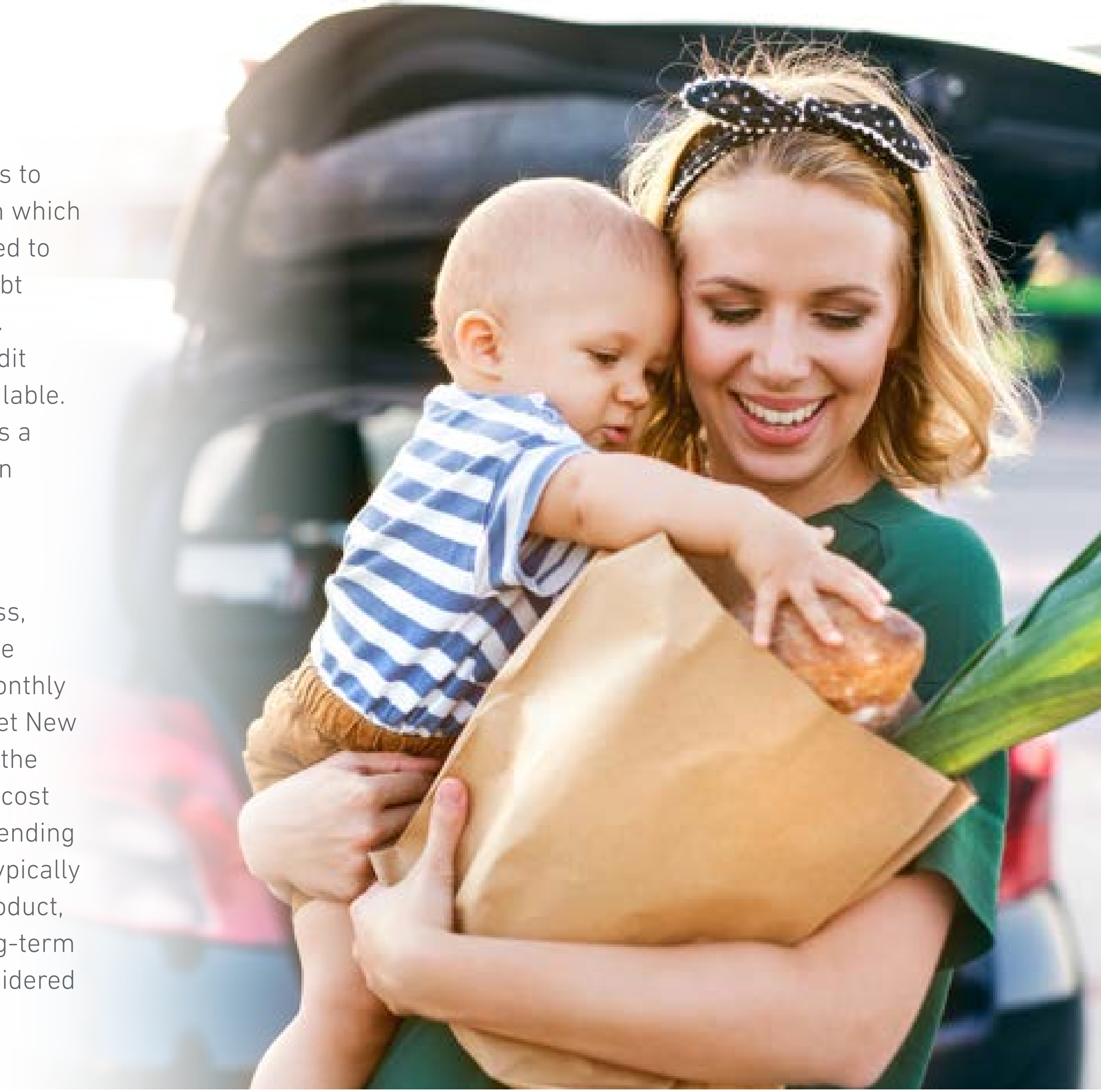
This data is then used to calculate affordable limits.
There are two main approaches which can be taken here:

Overall Debt Limit

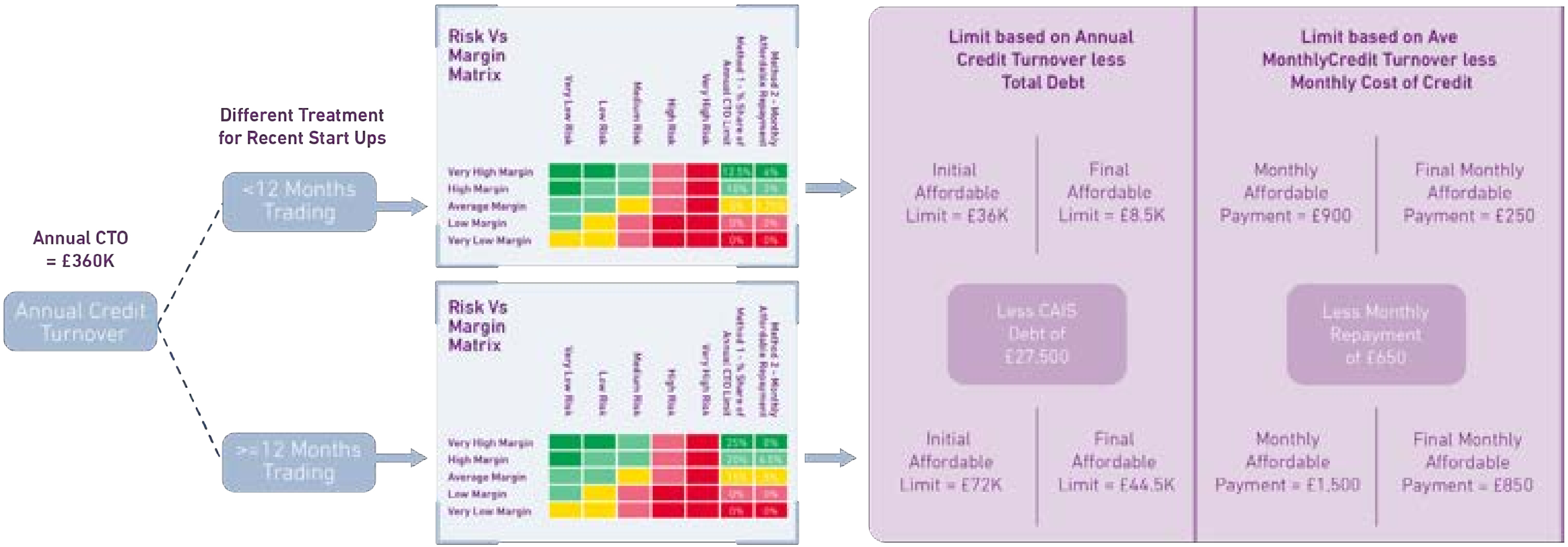
This utilises Annual Credit Turnover and the Risk/Margin factors to set an overall affordable Unsecured Limit for the business from which existing debt (Term Balance plus OD & Card Limits), is subtracted to provide a Total Net New Borrowing Limit. As part of this, any debt repayment on existing facilities needs to be taken in to account. With this approach caps may be applied on total unsecured credit new borrowing reducing the Total Net New Borrowing limit available. Where a business has long-term lending commitments (such as a commercial mortgage) or is applying for this type of facility then this method is not, however, ideal.

Monthly Repayment Limit

This utilises the Average Monthly Credit Turnover of the business, coupled with the Risk/Margin factors to set an overall affordable Monthly Repayment Amount for the business. From this, the monthly cost of existing credit commitments is subtracted to create a Net New Monthly Repayment Limit. Within this approach a proportion of the OD and Card Limits is typically utilised to feed into the monthly cost of existing credit commitments. (This is different to consumer lending calculations where a proportion of the outstanding balance is typically utilised.) Again, lending is possibly capped for the customer/product, etc., based on risk, product, and exposure. In this approach, long-term lending commitments such as commercial mortgages are considered in the initial repayment calculation.



The diagram below shows an example of both approaches:



In the examples above the actual product limit depend on the term of the facility and the type of product. For example, a working capital facility – like an overdraft – may be based on 3 to 4 times the monthly affordable payment (or equivalent to circa 8% of annual income on the principle of covering a month's Revenue). A term-based product, on the other hand, will be linked to both the Term and APR of the product.

In strategy exercises that Experian has carried out to create affordable limits using this approach we have seen around 75% of business receiving an affordable limit which accommodates their borrowing request. The performance overall on this population was a bad rate of circa 1.2% for Asset Finance and slightly higher for loans (though this does depend on segments and clients risk appetite).

The importance of **sustainability**

One consideration that does need to be overlaid on top of affordability is sustainability and ensuring a business can continue to pay in the future. The CATO history can help here by showing if the business has a stable or growing income as opposed to declining income and worsening balance. With CAIS we can see the trend in debt and payments. Combining these measures on the track record of the business a view can be formed on the future stability or growth of the business to provide a level of comfort on its future capability to afford the facility.

Another area to consider is the impact of the people running the business and their personal debt; this is especially true for Sole Traders but can be applied to Sole Director Limited companies too. However, personal CATO data cannot be used within Commercial Lending due to regulatory restrictions. To enable affordability checks on Sole Traders, Small Partnerships and potentially sole Director Limited companies and meet CONC rules on affordability assessment, clients often look at both business and consumer debt. Within the models above the debt can also include Consumer borrowing via CAIS alongside the business debt (Consumer CAIS is accessed through the SCOR cross-over rules). The principle being that the 'Business Income' is realistically paying both the commercial debt directly, but also the consumer debt indirectly via the income paid from the business to the owner.

Within the consumer CAIS data there can be 'joint' lending products such as Mortgages and these could be paid by two parties. Likewise, the sole trader may have income from other sources, monies paid in to the business and personal accounts.

This approach will, therefore, be conservative in nature but it does mean that credit approvals will have passed affordability measures and those that fail affordability will need to provide additional information from the credit underwriters to check affordability.

The benifits of CAIS

With CAIS we can see the trend in debt and payments. Combining these measures on the track record of the business a view can be formed on the future stability or growth of the business to provide a level of comfort on its future capability to afford the facility.

Assessing affordability using **Categorised Bank Account Data**

Traditionally, lenders have had to use their own internal current account data. Open Banking, however, has changed all that, and has opened up a world of granular bank account data which can be used in affordability calculations.

The **Open Banking Directive** was born out of the Payment Services Directive 2 (PSD2) regulations, implemented in the UK in 2017. It mandating the largest banks to make their current account data available at a transactional level, based on a consent-based regime and underpinned by new security measures to keep the data safe.

This has made available extremely granular, transactional data on income and expenditure items for both consumers and businesses. With the end user's consent, this information can be shared via APIs and integrated into other services. Consent is not only required but it needs to be reconfirmed to continue using the data; moreover, data use must be proportionate and relevant. Data can then be categorised by Experian and others to make it useful in. For example, affordability calculations.

Categorised bank account data (whether from existing customer accounts in a bank or via open banking), enables a more detailed view of an SMEs Income and Expenditure than the aggregate Credit and Debit Turnover and balance data available under CATO. It enables a granular view of their income streams and can exclude non-income sources (such as a loan paid into the bank account, internal account transfers, etc.). It can also provide an in-depth view on the costs of the business.

Categorised account data provides a 'pseudo' management accounts view. Because of this, it is possible to ascertain the actual level of Net Free Cash Flow within the business. It can also ensure that affordability better aligns to the capability of the business to repay debt. This is much better than utilising sector-level views on typical margins because, by their nature, these cover all businesses and, as such, there needs to be a level of conservatism applied to these in order to ensure a sensible risk-based approach.

Having a specific view of both the cost and income of a business means elements of this conservatism can be removed. Also, having a granular view of the Income and Expenditure enables specific elements to be better understood, such as types of revenue, nature and make up of their cost base, what income the directors take from dividends, and fixed costs versus variable costs. These produce a much richer picture of the business and help ascertain aspects of fixed versus variable costs, likely breakeven points, levels of residual income, and so on.

When it comes to calculating affordability, this more granular view means a more business 'personalised' affordability approach can be taken as the true nature of the business costs are understood. It means that the lender knows what their actual margin is as opposed to relying on sector-level assumptions. Taking these figures into account along with the trends in income and costs, lenders get a much better insights into whether a business is growing or declining. It can provide views into measures such as income, cost and profitability, changing efficiency, issues concerning how the business is run and so on. This greatly benefits affordability calculations and helps make assessments concerning business risk.

Open Banking Directive

Mandating the largest banks to make their current account data available at a transactional level, based on a consent-based regime and underpinned by new security measures to keep the data safe.

Experian's **categorisation engine**

In our categorisation engine, Experian has created an affordability-based aggregate model. It includes the following high-level categories to provide a breakdown of Income and Expenditure for a business. A further 48 sub-categories (Vehicle; Utility; Software, etc.) sit beneath these.

Income

- Sales
- Loan Receipt
- One-Off Credit
- Finance Income
- Uncategorized Income

Expenditure

- Finance Costs
- Dividends
- Wages and Staff Costs
- Other Tax Expense
- Facilities and Insurance Costs
- Accountancy, Legal and Other Professional Fees
- Other Admin Costs
- Costs of Goods Sold
- Sales Refunds
- Operational Costs
- Uncategorized Expenditure

This breakdown provides a more in-depth picture on a business and enable some of the issues within CATO data to be removed on credit turnover (such as a new loan/investment in the business looking like income).

More importantly, however, it provides an accurate view on costs. Debit turnover on CATO does not provide this level of resolution. To see why this is important, consider a business operating on, say, a 30% margin but which pays the owner a handsome salary. In this case the two might cancel each other out with debit turnover equalling credit turnover through the year.

Having the granular view of cost and an accurate view of income, then, enables a business-specific Free Cash Flow value to be calculated. This can be utilised to ascertain the affordability of any facility. This would be akin to the CATO/CAIS method outlined above but instead of using a sector factor it utilises either the actual business margin or the data as pseudo management accounts as outlined in the following section but without the balance sheet items (which could instead be taken from statutory accounts).

With this more in-depth view it enables higher and safer lending limits to be calculated. Of course, it is still important to understand the view from CATO and CAIS alongside this to confirm the picture is accurate. One can imagine an example where open banking is viewed on a single account of a multi-banked business, thus potentially leading to an inaccurate interpretation by ignoring the other accounts. Similarly, business borrowing may not all be paid out of the categorised account and so CAIS will provide a view on all facilities they have as well as the total level of borrowing, maturity dates, arrears, etc. to fill in the gaps from the current account.

Assessing affordability using
Management Accounts

Unlike CATO and Categorised Bank Account Data, Management Accounts provide a more in-depth and detailed picture on the business including not just Profit and Loss figures but also Key Ratios, an up-to-date view of Assets and Liabilities (as opposed to the year-end view from Companies House), as well as Sales ledger and monies owed as well as key suppliers and outstanding invoices.

Management Accounts provide a valuable and detailed insight into a business. This is a brief summary of the key critical documents which are available:

Profit and Loss (or income) statement

This provides a summary of revenue, expenses and profit/loss, showing a company's ability to generate sales, manage expenses and create profit.

Cash flow statement

This reports monies in and monies out each month, account balances and indicates the ability of a business to weather short-term financial emergencies. Cash flows help identify the difference between success and failure.

Balance sheet

This provides details about the Assets and Liabilities of a business, including depreciation and amortisation to calculate the net worth of the business.

Ratios and KPIs

Key financial ratios to illustrate current financial performance include Creditor and Debtor Days; EBITDA; Liquidity Ratio; Current Ratio; Acid Test; revenue-per-employee; etc.

Sales and Purchase Ledgers

These provide details about orders and who owes what (and when), as well as suppliers and their associated costs including, again, monies owed to them, and when.

Unlike statutory accounts, management accounts provide a view of the business at a particular point in time as well as in a historic context. As such, they can illuminate what is really happening within the business. They highlight key trends and changes within the business, and can show how it is performing financially, its costs and how money is being spent. Management accounts reveal the revenue that is being received and where it is coming from. This provides insights on both margins and profitability in a clear, insightful, and well understood way which can inform both business owners and other interested third parties. This is also helpful to those maintaining bank risk policies, particularly if they don't want to be engaged with businesses in certain sectors or geographies that might have been sanctioned or put on a risk register.

As Management Accounts can be updated regularly, they create a clear monthly view on performance, enabling owners to be better informed about their business, how it is meeting their commercial goals and, importantly, enabling them to make predictions on the future which, in turn, helps them make better, more informed business decisions today.

Without this clarity, business owners are often relying on their perception of business performance which may not be borne out by the facts. The lack of such insights, therefore, can make it harder to effectively manage a business, its cash flow, and spending so that it aligns to revenue-generating activities.

Perks of a Management Account?

Management Accounts can be updated regularly, they create a clear monthly view on performance, enabling owners to be better informed about their business, how it is meeting their commercial goals and, importantly, enabling them to make predictions on the future

Management Accounts are clearly important when making lending decisions, especially higher value loans are being considered, due to the level of information they provide on business performance, its costs, revenue, cash flow position and forecasts for the future. Detailed management accounts make it much easier for organisations to gain confidence in providing funds as they can clearly see the ability to pay. This visibility also makes it possible to see opportunities for providing more varied products.

Though Management Accounts provide the most detailed view of a business this is only the case if they are accurate and up to date, have data properly input and are not misrepresenting the true picture of the business. Unlike CATO/CAIS and Bank Account Data, Management Accounts are, after all, open to manipulation as they are based on data input from the business.

There is, therefore, a need to validate Management Accounts. This is possible by comparing their information with data from other data sources such as CATO and Open Banking Data. It is possible, for example, to confirm whether the Sales Revenue information ties up with actual Income and that payment/reconciliation of invoices ties up with the ledger. Liabilities linked to lending should match information held on the CAIS database, and the accounts narrative should be consistent with previously published 'official' accounts. Bill payments, for example, should be in-line with Payment Performance.

Loan Limits in practice

Find out more about **calculating loan limits** on the following page.

In practice: calculating loan limits from Management Accounts

There are a variety of ways that Management Accounts can be used to calculate if a business can afford its lending commitments, both current and future.

EXAMPLE #1

Using Management Accounts to calculate Working Capital Limits

One approach taken here is to use the balance sheet and the Assets and Liabilities report to calculate the Net Working Capital for the business. Assuming short-term values, this is worked out as follows: Inventory + Receivables + Short Term Financial Assets - Payables - Short Term Financial Liabilities. The working capital limit will then typically be a factor (between 0.7 and 1.3) based on segmentation linked to: business age; risk; sector; income variability; and utilisation. This is similar to the CATO & CAIS/Open Banking Approach.

An alternative approach is to use the turnover and multiplying that by a factor – typically 10% to cover just over one month's turnover.

This factor is again linked to business age; risk; sector; income variability; and utilisation.

EXAMPLE #2

Using Management Accounts to calculate Loan Limits

Another approach is to use the Management Accounts to calculate Net Free Cash Flow (this, as discussed earlier in this paper, is the cash left after a company pays operating expenses and capital expenditures). Once again, factors are applied to take account of business age; risk; sector; income variability; and utilisation. Consequently, only a proportion of the Net Free Cash Flow is used to make the decision.

The limit that is then set is based on the Net Free Cash Flow, product APR and Term and is decision based, essentially, on the ability of a business to cover the monthly repayment.

In this context, Total Debt Service Ratio is an important consideration to bear in mind, in order to understand the cost of all obligations versus the Net Free Cash Flow.

Conclusion

The commercial lending market is evolving at pace. There is a push towards automation in order to reduce operational costs whilst lenders need to reduce bad debt through ensuring better serviceability of repayments. The legislative burden continues to become more onerous, and lenders have to contend with the increasing variety of revolving finance products, such as Buy Now, Pay Later (BNPL), that are coming to the market.

In this constantly evolving market, calculating loan affordability is becoming an increasingly important issue. Being able to get an accurate real-time/short-term affordability view is key, as is the ability to provide a better service and lending journey for SME customers.

As the need for adopting better affordability checks has developed, new methods for calculating affordability and new data sources for making those decisions have emerged. Regulatory and technological improvements have been matched by ever more valuable data availability regarding SMEs.

These have combined to enable lenders to better meet the challenges in assessing debt serviceability. They are now able to use the most appropriate methodology based on the type of business, its history, how much data is available, as well as the level of borrowing they require and the type of facility that best suits the business need.

This paper has shown there are now a number of approaches that can be taken to enable affordability assessment to be automated. This is particularly straight forward in the majority of commercial lending situations which have a lower value loan requirement. Here, lenders can now simply take into account the risk and affordability perspectives thanks to the availability of readily and easily available data following the CCDS regulations.

For larger value lending, both categorised bank data and management accounts can be brought into play. These give a broader view which can also be useful with lower lending values.

Find out more

To find out how Experian can help you assess affordability for your commercial clients, please visit the **website**, or **contact us today** for a personalised demo.

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