Atradius
Managing risk, enabling trade

Credit-to-Cash Briefing:

Checklist: Early detection of default risks

Insolvencies often happen when an important business partner folds. Particularly small and medium-sized enterprises with capital ratios of less than 20% can fall victim to this domino effect. They find it difficult to weather losses caused by a customer's insolvency and can fast end up in dire straits, with liquidity constraints threatening their very existence.

However, businesses almost never go into insolvency over night. Therefore, a timely identification of vital factors is indispensable to protect oneself. A 100% accurate prognosis is hardly possible. It is not uncommon for companies to be successful despite showing negative indicators.

On the other hand, it is not uncommon for businesses that in the past did not show unfavourable signs to file for insolvency. But practical experience shows that the chance for a future insolvency will grow with the number of negative characteristics and indicators.

This checklist typifies the most important indicators you should monitor. It thus enables you to adapt your business policy accordingly. The credit risk goes up with the number of indicators that are fulfilled. And uncertainty grows with the questions that do not lead to concrete answers (n.i. =no input.).

Payment behaviour

A customer with a bad payment record is an unmistakable early warning sign, particularly if negative changes occur. Be sure to adapt your terms of payment and security measures accordingly.

Keep close tabs on the following indicators:	YES	NO	N.I.
Does your customer frequently fail to pay on due dates?	☐	☐	☐
Do they permanently take advantage of the full credit lines you have granted?	☐	☐	☐
Have constant reminder notices been necessary of late?	☐	☐	☐
Does your customer at times ask you to prolong overdue bills?	☐	☐	☐
Has your customer suddenly changed the bank?	☐	☐	☐
Has your business partner offered bills of exchange when invoices become overdue?	☐	☐	☐
Have cheques recently been returned unpaid or bill of exchange dishonoured?	☐	☐	☐
Were insufficient funds in the account when debited?	☐	☐	☐
Did unwarranted rescission of direct debit authorisations occur?	☐	☐	☐

Senior management

The managerial capabilities of senior staff undeniably play a crucial role in company's strategic development. You need to be informed about some of the following criteria above all in the case of larger credit volumes.

Qualification

Particularly the management of small and medium-sized businesses often lacks the relevant expertise to generate a sustainable level of profit. You should closely monitor the following potential weak points in the senior level:

	YES	NO	N.I.
Insufficient management expertise?	☐	☐	☐
Lacking experience in the relevant sector?	☐	☐	☐
Lopsided technological orientation?	☐	☐	☐
rather unrealistic business planning?	☐	☐	☐

Human resource problems

Human resource problems that have not been resolved often have potentially serious consequences:

	YES	NO	N.I.
Have there been problems with the issue of succession?	☐	☐	☐
Was there a frequent change of partners in the past?	☐	☐	☐
Is there a high turnover among senior management?	☐	☐	☐
In your eyes, has the senior management made errors in assessing situations and developments in the recent past?	☐	☐	☐

Financing

Return on sales is often at a low level. Therefore, adequate liquidity and financing capacity are crucial. Moreover, Basel II now obliges companies to commit themselves to an optimal financing scheme.

Capital structure

The risk of insolvency rises with unfavourable figures, in particular:

	YES	NO	N.I.
Do you perceive your customer's equity capital to be insufficient?	☐	☐	☐
Is there a marked reluctance to increase their equity capital?	☐	☐	☐
Do you believe the debt level to be overly high?	☐	☐	☐
Are there high loss carry forwards on the balance sheet?	☐	☐	☐
Does the interest to sales ratio exceed the sector's average?	☐	☐	☐
Are fixed assets predominantly short-term financed?	☐	☐	☐

Internal financing

	YES	NO	N.I.
Is the rate of return on capital employed too low?			

Accounting

More than in other areas, weak spots in the accounting department can lead to grave financial problems. Moreover, an accounting that is flawed and not based on the latest data is often the reason that a company's management fails to identify serious problems in time.

Collections

	YES	NO	N.I.
Do you believe that your customer has a flawed collections management?	☐	☐	☐

Every delay in time costs money. If collection services fail to operate inefficiently, DSO (days of sales outstanding) ratios are high and cut profits because of increased financing costs.

Invoicing / billing

	YES	NO	N.I.
Is the rate of return on capital employed too low?	☐	☐	☐

Unnecessarily late invoicing implies additional need for financing as customers are kept from making timely payments.

Financial, cost and liquidity planning

	YES	NO	N.I.
Do you find that financial, cost and liquidity planning are unsatisfactory?	☐	☐	☐

An adequate planning process is precondition for responsible corporate management. Without it, the possibility of financial problems occurring is definitely higher.

Procurement

Your customers' procurement policies allow you to draw important conclusions as to their creditworthiness.

Dependence

	YES	NO	N.I.
Does the company depend on too few suppliers?	☐	☐	☐

Depending on only few suppliers can be potentially dangerous. If one of them should file for insolvency or experience difficulties in delivering ordered goods, the buyer, i.e. your customer, might face a predicament.

Suspension of deliveries or immediate collection by other suppliers

	YES	NO	N.I.
Have you been informed of suspension of deliveries or immediate collection by other suppliers?	☐	☐	☐

Caution is advised should you be informed to that effect. Payment problems or lacking lines of credit with credit insurers or factoring institutions might be the reason.

Recurring change of suppliers

	YES	NO	N.I.
Have you found out that your business partner often changes suppliers?	☐	☐	☐

This can imply problematic relationships with suppliers.

Complaints

	YES	NO	N.I.
Has your customer made unwarranted complaints?	☐	☐	☐

Repeated complaints that turn out to be unwarranted or based on mere trifles are usually used as a pretext to delay payments.

Ordered quantities

	YES	NO	N.I.
Have there been extreme changes in ordered quantities?	☐	☐	☐

A decline in ordered quantities can in certain cases indicate that a customer has stopped receiving goods from other suppliers. Furthermore, fraudulent ordering can be the reason for an unexpectedly large order.

Manufacturing

Critical weak points in the provision of goods and services can have serious financial implications for a company.

Stock on hand

	YES	NO	N.I.
Are your customer’s stock levels comparably high?	☐	☐	☐

A strong hike in stock on hand can indicate falling sales.

Production capacities

	YES	NO	N.I.
Does your customer have excess production capacities?	☐	☐	☐

Facilities that do not operate at full capacity in most cases imply sales problems. This also has an adverse effect on the cost structure.

Manufacturing facilities

	YES	NO	N.I.
Are the manufacturing facilities in a bad shape?	☐	☐	☐

Poorly maintained facilities as well as lack of investments into new fixed assets or the replacement of old ones may indicate a deficit of funds. The closure of complete product lines could be because of problems with the market. On the other hand, it might also signify a market-driven and sensible decision.

Product quality and product range

	YES	NO	N.I.
Do your customer’s competitors boast superior product quality / product range?	☐	☐	☐

If competitors are superior in both product quality and product range, this can suggest a flawed product management as well as not adequately qualified senior management levels. In the medium term, this carries a particular risk of insolvency.

Sales

Sales and turnover are decisive factors in securing a company's financial standing. Negative developments can lead to insolvency within only a short period of time

Customer structure and credit rating

	YES	NO	N.I.
Do your clients depend on a few customers?	☐	☐	☐
If yes, do these buyers have a rather low creditworthiness?	☐	☐	☐

The risk that you have to file for insolvency due to bad debts is larger if your accounts receivable are dominated by only few customers. In this case, the likelihood of having to deal with potentially dangerous situations is obviously higher. Frequently the default of one major customer can already lead to the creditor's insolvency. Therefore, it is advisable to closely monitor your client's customer base and – if possible – their buyers' creditworthiness.

Market behaviour

	YES	NO	N.I.
Does your customer offer products or services at unusual prices?	☐	☐	☐

In a desperate effort to raise cash, a customer's "last stand" might be to resort to aggressive sales techniques, e.g. special offers with extremely high rebates.

Market development

	YES	NO	N.I.
Is there a greater competitive pressure on your client?	☐	☐	☐
Do you believe that your customer fails to adapt adequately to market changes and innovative customer demands?	☐	☐	☐

Your customers' market environment plays an important role. Unfavourable risk factors, e.g. a slump in sales, recession in the relevant sector, as well as aggressive competitors need to be taken into account too when rating their creditworthiness.

You cannot always identify impending dangers. This makes it all the more important to prepare yourself for worst case scenarios.

Atradius offers a range of comprehensive credit insurance solutions geared to protect you against bad debts in the followup of customer insolvencies. Please don't hesitate to contact us. We will be glad to help you.

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