



Credit-to-cash briefing:
**How to conduct a risk
assessment of your
receivables**

Your company's accounts receivable is an important indicator for assessing business health.

Credit-to-cash briefing:

How to conduct a risk assessment of your receivables

An assessment of outstanding invoices and the risk of non-payment will help you identify any weak points and guide you to take decisive action to minimise risk and protect your business.

Assessing your receivables has become more important than ever during the COVID-19 pandemic, with increased levels of insolvency and other factors such as the interruption of supply chains negatively impacting businesses throughout the world. During such periods of economic uncertainty you should assess your receivables regularly. Early detection of risk will help you avoid or minimise potential losses.

Below is a range of tasks you can do to complete a risk assessment of your accounts receivable and secure your cash flow during this time of economic uncertainty.



1. Sort your customers into groups

Sorting your customers into groups will help you identify patterns and establish a risk profile. For example if a customer stands out in a group for demonstrating poor payment practices, they may present a higher payment risk. Or you may find indications of stress in a specific geography or sector.

You can use this exercise to note how evenly your customer base is spread. If a high concentration of your turnover is limited to a small number of customers, you may be at a higher risk of insolvency if that key source of income is lost. Conversely, customers that represent just a small part of your overall receivables should not make a great impact if they fail to pay you.

Examples of possible groupings to assess include:

- Domestic customers
- Foreign customers (you could further differentiate this by country or region)
- Trade sectors
- Product categories
- Size of customer
- Percentage of your overall receivables the customer represents
- Debtors with and without payment guarantees

2. Limit your exposure to bad debts

In addition to identifying which customers or areas pose greater risk to your cash flow, it is useful to identify and list what security arrangements and guarantees your business uses. These may include:

- Bonds
- Comfort letters
- Credit insurance
- Factoring
- Letters of credit
- Lien
- Retention of title
- Transfer of assets
- Transfer of receivables

Analysing your security arrangements and guarantees can help you shed light on how high the share of total losses could be and what percentage of your portfolio is protected.

3. Assess your history of unpaid invoices

Looking at the history of losses incurred through insolvencies allows you to draw conclusions about general default risks. Is there a pattern? For example, are the bad debts clustered in a particular sector or geography? Can you identify a group that has a greater need for security arrangements and guarantees than other customer groups? In addition to helping you identify areas to approach with caution moving forward, analysing past bad debts can also help you assess the quality of your company's receivables management. Can you identify areas for improvement within your own company's policies and processes?

- Plot out the history of bad debts over the past five years
- Differentiate individual insolvencies, e.g. according to sector, size, region
- Assess future potential risks inherent to individual segments and put in place processes to minimise the risks

It is also worth paying attention to any insolvencies in your sector. Has there been an increase in insolvencies and is your sector more vulnerable following the outbreak of the coronavirus pandemic? It may be worth seeking guarantees to help protect your accounts receivable from the risk of customer insolvency.

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4. Calculate DSO – Days Sales Outstanding

The average time in terms of days between invoicing and payment is your DSO and is a good indicator of the efficiency of your receivables management.

To calculate your DSO first divide your total accounts receivable by the total value of your credit sales. Then multiply this figure by the number of days in the period you are assessing. Many businesses calculate their DSO on a regular basis, monthly, quarterly or annually.

DSO formula

$$\text{DSO} = \frac{\text{Accts receivable}}{\text{total credit sales}} \times \text{no. of days}$$

DSO calculation example

$$\text{DSO} = \frac{100,000}{150,000} \times 30 = 20$$

Regularly checking your DSO will help you check:

- How the ratio has changed within the past years/months
- How the ratio stands compared to your industry's average, if your company's DSO is much higher or lower than the industry average are you offering payment terms that are more or less risky than your competitors?
- How many customers pay within the agreed credit period and how many fall in arrears
- How successful your business is at cashing in invoices

It may be that the greatest risk to your accounts receivable is not a customer, but rather your business's internal collection processes. An improvement in this area could result in a lower DSO and reduced risk.

5. Complete an aging report

You can use the report to:

- Assess the financial health of each customer
- Review your own business – is your sector slowing down?
- Explore your sales practices – is your sales team extending longer credit terms?

6. Identify future risks to your cash flow

When assessing your debtors' creditworthiness, future developments and planning processes should be taken into consideration.

Aspects to be taken into account include:

New products/target groups

Moving into a different customer base, or launching new products or services can give rise to new payment risks. You can try to minimise these with - for instance - credit insurance, factoring, or bonds, at least until the new service or customer has become established.

New regions

Entering a new geographical market can be fraught with risk including unfamiliar trade laws or practices, varying rules on imports and customs duties and potential political instability. A thorough risk assessment for each market you trade in will help you identify and take steps to minimise risk.

Expanded sales

If your business has experienced growth in sales, it is wise to investigate whether your debtor structure base has remained unchanged or whether market changes or new products have affected the rise in sales. Does your sales team operate with due diligence parameters? Does sales growth represent higher risks to your business?

New customers

Completing thorough due diligence and seeking letters of credit or trade credit insurance on every proposed new customer will help you minimise the risks associated with taking on a new customer. It is also a good idea to consider each customer individually when assessing the risks posed to your

accounts receivable. For example, an individual customer may present very little risk despite being located in a region regarded as high risk. If you dismiss them because of their location, you could miss out on a valuable sales opportunity.

7. Assess the impact of your payment terms on your receivables

Make a critical assessment to find out if your payment terms meet your company's requirements or if they need to be adjusted. Often, many individual clauses can result in too many variations and lead to delayed payments. You could seek to reduce the number of clauses in your payment terms or find ways to enhance their attractiveness e.g. with the help of payment incentives like bonuses, discounts, period of payment.

8. Enhance the skills of your credit management team

The risk of losses can be reduced by qualified credit managers and related staff. In times of economic stress, such as the current situation caused by the COVID-19 pandemic, you can help protect your company's cash flow by appointing a team dedicated to monitoring your accounts receivable through weekly reviews and empowering the team to act quickly.

Start with an audit of the skills of your credit management team and then build on this with additional staff as needed and a programme of professional development to plug any skills gaps and support your team's knowledge and motivation. In addition you could encourage your receivables management team to become involved in cash flow focused events such as:

- Seminars and conferences
- Networking events
- Credit management organisation membership
- Technical literature
- Internet forums and webinars.

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