



CPAs & Business Advisors

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Not knowing your clients' financial health may cost you

In 2004, 34,317 businesses filed for bankruptcy in the United States, according to the Administrative Office of the U.S. Courts. These filings resulted in millions of dollars of lost payments to manufacturers.

And even though there is risk involved when extending credit, you can mitigate that risk by establishing policies that help identify and deal with customers in financial distress. By doing so, you'll help keep your company's cash flow healthy.

Monitor credit files

Despite the fact that most manufacturers perform routine checks to determine a potential new customer's creditworthiness, many fail to review and revise this information over time, resulting in credit files with outdated data.

Bear in mind that even dependable customers can run into financial hardships. A company's past payment record doesn't indicate its future ability to pay on time. For this reason, regularly update customer files and monitor payment activity to look for suspicious changes in financial information or payment patterns.

A common warning sign of financial problems is falling behind on paying bills. Of course a slow payment may not mean a company is ready to file for bankruptcy — it could be just a temporary cash flow setback or a computer glitch. But slower payments should be investigated because they could signal a bigger problem.

In addition to monitoring payment activity, update credit application information and keep financial statements on file. An immediate red flag should be raised if financial statements are late or if the auditor is changed during an audit.

Examine customers' financial statements

It's important to regularly review your clients' financial statements — specifically accounts receivable — for possible clues of financial mismanagement or fraud. Compare the current and prior years' sales and accounts receivable balances. The accounts receivable balance should follow the sales trend. If receivables are rising at a faster rate than sales, this could signal that the company is recording revenue before it's earned.

You'll also want to review the inventory balance. A company with financial difficulties may not have the resources to update its product line. To determine if that's the case, calculate inventory turnover — how many times the inventory is sold and replaced with new inventory — by dividing the cost of goods sold by the inventory balance. If the number is low compared to



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industry standards, this could mean that inventory is selling poorly or is obsolete and possibly worthless.

Cure with communication

If you have reason to believe that a customer is having financial problems, you need to take prompt action. Good credit management calls for managing slow-paying accounts before they become nonpayments.

The best way to deal with this situation is to communicate directly with the customer. You'll need to assess whether he or she is forthright about acknowledging there is a problem and whether the company is capable of finding a solution.

If a customer is slow paying or is a potential credit risk, you may have to reduce credit limits or take other measures, such as having the customer pay at the time of the sale or staggering the order by sending a partial shipment and not shipping the rest of the order until you receive payment.

Make a diagnosis

Proactive credit management means taking action now to avoid problems later. By developing procedures to monitor and investigate your customers' financial health, you'll be able to more quickly recognize a customer in financial distress and have more options for keeping credit risks within tolerable limits.

Sidebar: Check for other symptoms

If a company's financial statements aren't available, look for other symptoms of financial distress. Trade or business publications may offer subtle indications, such as resignations or layoffs in the accounting or finance department, or a reorganization that puts an inexperienced management team with little or no financial skills in charge.

Other useful methods for gathering information include site visits and even industry gossip. Although these methods can't provide conclusive information, they may provide clues, such as a business not making much-needed facility repairs or a company suddenly cutting back on advertising or marketing budgets.