Informita

Accounts Receivable Risk

There are two main risks for any accounts receivable manager. The first risk is that of default. Most businesses have processes in place to make sure that there are adequate credit limits in place to ensure that any exposure is limited. Some go as far as insuring their accounts receivable balances. This all helps to minimise the value of bad debt written off and mitigate against the risk that a customer becomes insolvent. To do

this properly will entail employing a team of people to constantly monitor customer account positions, review credit limits on a regular basis and block orders when that credit limit is set to be exceeded. This will often involve purchasing risk data to support the process of reviewing account positions. But these activities do not necessarily guard against the risk of late payment. There are many companies that have extremely robust credit risk processes and still have considerable values of overdue receivables. Many assume that customers with a high credit risk are more likely to be late payers and that this pattern of late payment is likely to be a guide to a possible later default. At Informita, we have heard this argument many times and we decided to put that hypothesis to the test. So we took a real client's data and compared the risk of default to the risk of late payment to try and validate or invalidate the hypothesis.

Credit Risk Focus

Usually credit risk management is focused on minimising the level of bad debt written off. In some cases, there may be demands from credit insurers to guarantee that credit risk procedures are strictly followed. In other situations where banks are granting loan facilities based on the value and quality of the accounts receivable portfolio they may also insist on reviewing the ledger and credit risk procedures so that they can monitor their risk exposure. There are even some who go to an extreme and believe that high rates of blocked orders are the best way of encouraging customers to clear their overdue positions. We would not share that opinion, but it doesn't stop some companies from developing hugely inefficient collection processes that try to execute such a process. In this situation the client had a team of credit risk personnel who were vetting all accounts to review their credit worthiness and credit limit. As part

	Low Risk		Medium Risk		High Risk	
80%	**Large Low Risk**		**Large Medium Risk**		**Large High Risk**	
	Billing	$ 1,575,553,050	Billing	$ 570,777,835	Billing	$ 425,058,880
	Customers	185	Customers	93	Customers	88
	Agreed Terms	50.2	Agreed Terms	36.3	Agreed Terms	36.4
	Average Days to Pay	24.5	Average Days to Pay	27.4	Average Days to Pay	31.7
	February 2017 Debt	$ 124,403,973	February 2017 Debt	$ 35,560,556	February 2017 Debt	$ 38,274,576
	February 2017 Overdue %	13.9%	February 2017 Overdue %	14.0%	February 2017 Overdue %	11.2%
15%	**Medium Low Risk**		**Medium Medium Risk**		**Medium High Risk**	
	Billing	$ 570,777,835	Billing	$ 101,697,386	Billing	$ 129,594,795
	Customers	93	Customers	147	Customers	194
	Agreed Terms	36.3	Agreed Terms	32.6	Agreed Terms	34.4
	Average Days to Pay	27.4	Average Days to Pay	38.2	Average Days to Pay	35.0
	February 2017 Debt	$ 35,560,556	February 2017 Debt	$ 14,826,617	February 2017 Debt	$ 12,003,101
	February 2017 Overdue %	14.0%	February 2017 Overdue %	29.6%	February 2017 Overdue %	20.1%
5%	**Small Low Risk**		**Small Medium Risk**		**Small High Risk**	
	Billing	$ 425,058,880	Billing	$ 41,315,970	Billing	$ 50,404,547
	Customers	88	Customers	425	Customers	870
	Agreed Terms	36.4	Agreed Terms	39.2	Agreed Terms	40.4
	Average Days to Pay	24.5	Average Days to Pay	47.1	Average Days to Pay	40.4
	February 2017 Debt	$ 38,274,576	February 2017 Debt	$ 15,199,117	February 2017 Debt	$ 9,319,603
	February 2017 Overdue %	11.2%	February 2017 Overdue %	30.5%	February 2017 Overdue %	14.8%

of that process they were spending a significant sum of money with credit agencies to pay for accounting information such as balance sheet ratios. As a general statement this company had a good customer base and the perception was that late payment was only a problem at month end due to process bottlenecks. The value of bad debt written off in the previous two years was close to zero. New management had just been appointed and found it difficult to understand how 17% overdues were acceptable, given there was such a robust credit risk process. It would be normal to have overdues of less than 10% and, in best in class situations, overdues of less than 5%. So the new managers wanted to understand why there was such a gap between actual performance and their expectations. Our first step was to segment the ledger between large, medium and smaller accounts, where large accounts account for 80% of gross sales, medium accounts for 15% of gross sales and smaller accounts for the last 5% of gross sales. This showed that the largest accounts were usually paying before term, except at month end and it seemed to back up the story given by credit management staff. But we had never seen such a situation so we applied another approach.

Focus on payment behaviour

Our normal approach is to focus on payment behaviour. So using the same base data as the credit risk situation, we re-ran the analysis focusing on payment behaviour. We know from our experience that every company has customers who pay late, early or on time, but the proportions of these behaviours will differ from one company to the next. For us, reducing overdues is about recognising and then changing certain customer behaviours. In this case, there was a very large proportion of customers who paid early. The overdue amounts were associated with deductions that had not yet been processed and other disputed items. So the focus with these customers was to speed up dispute resolution and to start looking at ways to eradicate certain types of dispute. The next group of customers were those in the middle column who do pay but have payment processes that ensure that payment is received three to five days

	<= 2 Days after Term	2-15 Days after Term	> 15 Days after Term
80%	**A1: Large Good Payer** Billing $ 1,378,658,028 Customers 119 Agreed Terms 54.0 Average Days to Pay 18.4 February 2017 Debt $ 78,999,482 February 2017 Overdue % 6.7%	**A2: Large Average Payer** Billing $ 617,326,658 Customers 107 Agreed Terms 28.3 Average Days to Pay 33.4 February 2017 Debt $ 61,975,066 February 2017 Overdue % 18.4%	**A3: Large Poor Payer** Billing $ 57,743,184 Customers 8 Agreed Terms 40.8 Average Days to Pay 62.7 February 2017 Debt $ 10,344,982 February 2017 Overdue % 46.0%
15%	**B1: Medium Good Payer** Billing $ 85,971,322 Customers 118 Agreed Terms 39.7 Average Days to Pay 30.3 February 2017 Debt $ 8,008,837 February 2017 Overdue % 18.6%	**B2: Medium Average Payer** Billing $ 104,109,512 Customers 145 Agreed Terms 29.8 Average Days to Pay 36.8 February 2017 Debt $ 9,050,789 February 2017 Overdue % 22.7%	**B3: Medium Poor Payer** Billing $ 29,685,311 Customers 48 Agreed Terms 33.0 Average Days to Pay 53.4 February 2017 Debt $ 6,253,791 February 2017 Overdue % 45.6%
5%	**C1: Small Good Payer** Billing $ 24,243,697 Customers 369 Agreed Terms 46.0 Average Days to Pay 37.6 February 2017 Debt $ 3,520,311 February 2017 Overdue % 19.1%	**C2: Small Average Payer** Billing $ 25,972,260 Customers 395 Agreed Terms 35.3 Average Days to Pay 42.1 February 2017 Debt $ 4,531,148 February 2017 Overdue % 21.8%	**C3: Small Poor Payer** Billing $ 15,783,547 Customers 282 Agreed Terms 41.6 Average Days to Pay 70.5 February 2017 Debt $ 4,832,866 February 2017 Overdue % 31.0%

after due date. These customers ensure that they had a very rigid payment process that will not be influenced by the traditional collector call. So there needed to be an account management approach involving both sales and collections that would focus on changing behaviours such as payment method (converting to same day SEPA/ACH) or changing the day of the week payments were scheduled to be executed. For example if payments were made on a Friday and month-end was over the weekend, large overdue positions could be generated at a single point that may well disappear one or two days afterward. The last group were the real late payers. Our experience is that these customers have poor internal processes that slow down invoice processing and payment. The only way to change these behaviours is to be constantly on the phone, as invoices are dispatched, approved and ultimately scheduled for payment. They can fail their process at any stage and total focus by the collector was required. In this instance there were only a small proportion of these types of customers and they had significant overdue percentages. So collection calls needed to focus first on the A3 and B3 segments and these overdue percentages fell very fast.

Payment behaviour versus credit risk

We then decided to compare the two approaches. If the approaches were compatible we would expect that low risk would be aligned with good customer payment behaviour and that high risk would correlate with poor payment behaviour. The boxes highlighted in yellow would show the highest percentage of customers in this group if the hypothesis was true. But this is not what we found. In only two segments did the level of risk and the payment behaviour seem to match in any way. In the large good payer segment, 52% of customers were deemed to be low risk while 48% of customers were deemed to be medium or high risk. In the medium good payer segment, 56% of customers were deemed to be low risk while 44% of customers were deemed to be medium or high risk. For large average payers only 27% of customers were deemed to be a medium risk while 49% were deemed to be low risk. In the large poor payers, only 22% were deemed to be high risk and a whopping 56% were deemed low risk. The least level of correlation was amongst small customers. There was clearly no

	<= 2 Days after Term	2-15 Days after Term	> 15 Days after Term
80%	**Large Good Payer**	**Large Average Payer**	**Large Poor Payer**
	Low Risk 52%	Low Risk 49%	Low Risk 56%
	Medium Risk 25%	Medium Risk 27%	Medium Risk 22%
	High Risk 24%	High Risk 25%	High Risk 22%
15%	**Medium Good Payer**	**Medium Average Payer**	**Medium Poor Payer**
	Low Risk 54%	Low Risk 48%	Low Risk 36%
	Medium Risk 19%	Medium Risk 23%	Medium Risk 27%
	High Risk 27%	High Risk 29%	High Risk 37%
5%	**Small Good Payer**	**Small Average Payer**	**Small Poor Payer**
	Low Risk 41%	Low Risk 40%	Low Risk 32%
	Medium Risk 16%	Medium Risk 19%	Medium Risk 27%
	High Risk 42%	High Risk 41%	High Risk 41%

alignment between payment behaviour and credit risk for these customers. This should be a concern since most new customers start off as small customers and then grow over time. For these new customers credit checking is essential since there is no previous history of trade, but the numbers would suggest that the worst performance of credit agency information is in these areas. This may be because they are new companies with little credit history or that they are private companies where the credit agencies find it difficult to obtain any meaningful data. But this comparison would suggest that in the majority of cases with small new customers that there is more to be learned from trading on a limited basis so that payment history can be understood rather than basing an approach purely on credit risk assessments. Some of this also applies to large customers. Some of the largest companies in the world are private companies. In many credit risk assessments that would automatically make them a high risk customer. But our experience is that payment behaviour will tell you a lot more over the first few months of trading. In the best circumstances there will be meaningful information on both credit risk and payment behaviour and then a comprehensive assessment can be made.

Conclusions

Different methodologies with different goals

Does this analysis suggest that the credit risk scores are wrong? Does the analysis mean that analysing payment behaviour is a better methodology than credit risk? The answers to both of these questions is a resounding no. They are different methodologies that are trying to achieve different things. Minimising bad debt written off does not necessarily mean you will have low levels of overdue. Equally having low levels of overdue doesn't protect you from bad debt write off. The data simply shows that minimising bad debt is not a compatible goal with minimising overdues and promoting good payment behaviour. This does not invalidate either approach. It just says that they are different approaches with different outcomes. This only becomes a problem where the methodologies are confused. Many companies focus on credit risk to the detriment of collection calling and vice versa. Neither are right. The balance of activity will be different in different industries since the risk of default can be so much higher e.g. construction subcontractors. So the best possible scenario is to have both effective credit risk procedures and good collection processes.

Methodology

This analysis is built up from paid customer invoice transactions over a 12 month period to February 2017 and the outstanding receivables as at 28 February 2017 for one of Informita's clients. In each case we have used the credit risk rating applied by the client's credit risk team. Their algorithm had components involving availability of financial information, financial ratios, insolvency history and payment samples supplied by their credit information provider. Customers were regularly re-assessed at least on an annual basis. We then overlaid the payment behavior statistics. Agreed terms represent the weighted average by value of the contracted terms with customers and the average days to pay represent the weighted average by value of the actual number of days to pay invoices in each segment. The table on page 4 represents the percentage of customers by number of customers that fall into each risk category split by size and payment behavior.

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