Look for the Warnings Signs of a Distressed Customer

Being able to discern the warnings signs of a financially distressed customer is critical. Although a decline in cash flow is the most important bellwether of financial distress, about 80% of all companies are privately held and don't provide detailed financial information. As a result, creditors must rely on their customers' payment patterns, competitors' experience with the customer and customers' actions as indicators of their financial health. Operational and managerial signals can serve as a warning of impending problems.

Whenever a company dramatically changes its business model, financial analysts should become wary—especially if the system moves from one easily understood by investors to one that is obtuse and difficult to evaluate and monitor. The use of special purpose and other off-balance sheet entities can be used to create phantom profits and hide liabilities. The absence of detailed disclosure about such entities raises additional red flags. Other warning signs include numerous related-party activities and self-dealing by senior executives; large stock sales by directors and officers; and resignations by top management.

A more thorough list of warning signals include the following, which can be categorized into three subcategories:

Operational Signals

- change in senior management
- high employee turnover
- board of directors resignation
- strike or unusual fire or theft
- market changes
- a change in suppliers or payment to suppliers
- pricing issues and quality control problems
- one-time events such as a large bad debt claim

Managerial Signals

- reliance on one individual for decision-making
- inexperienced management team with weak financial and organization skills
- frivolous spending
- not returning phone calls
- personal problems
- working long hours

Financial Signals

- decline in sales
- lower profit margins
- sustained losses
- growth at faster rate than inventory and accounts receivable
- increased debt
- highly leveraged balance sheet
- reduced cash flow or negative free cash flow
- working capital decline that turns negative as A/P grows faster than inventory and A/R

- change in company's bank relationship—reduced availability on operating line or change in borrowing patterns without a change in the business
- increase in loan security or a bank's request for security on a previously unsecured loan
- breach of loan covenants or missed loan payments

Source: *The Art & Science of Financial Risk Analysis: The Analyst's Guide to Determining a Company's Financial Strength and Creditworthiness*.