

Prepayment: Payment Term with Supplier Security before Goods Are Made Available

Prepayment is a payment term under which the buyer pays the purchase price or a down payment before the supplier ships the goods or delivers the service. It shifts the payment risk entirely to the buyer and is the most secure form of payment for suppliers overall. For buyers, however, it means tied-up liquidity and a certain supplier risk, which should be limited through contractual and procedural measures.

Key facts

- Prepayment means payment before delivery or before performance begins, typically by bank transfer or as a down payment on a project.
- For suppliers, prepayment virtually eliminates the risk of default and noticeably improves their own liquidity.
- For buyers, it creates pre-financing without possession of the goods, which increases the risk in the event of the supplier's insolvency, payment difficulties or delivery problems.
- In practice, advance payments are frequently between 20 and 50 per cent for capital goods, custom-made products and initial orders with new suppliers.
- Alternatives such as documentary letters of credit, buyer protection models or supplier strength through Supplier Rating can partially replace or reduce prepayment.
- Legally, the payment term should be clearly regulated in the contract; in individual cases a review by Legal and Tax is advisable.

Definition: Prepayment

Prepayment denotes a payment arrangement in which the buyer pays the amount due before the goods are made available or the service is rendered. It is the counterpart to purchase on account or buying on credit and represents the most secure protection against payment defaults for the seller. In industrial procurement, prepayment occurs primarily in new supplier relationships, custom-made products and international business.

Distinction from Down Payments and Partial Payments

A down payment is frequently a partial payment with the remaining balance due after delivery, whereas prepayment in the strict sense means full payment before shipment. In practice, the terms blur: many suppliers demand an advance payment of typically 30 per cent as material pre-financing and the remainder on delivery or with a payment deadline. Buyers should define this structure unambiguously in the contract, including due date and performance triggers.

Prepayment in the Procurement Process

Prepayment is a component of the procurement strategy and closely linked to Digital Contract Management, as payment terms form part of framework agreements and ordering conditions. In the

operational process, incoming invoice verification after receipt of the order triggers payment release; deadline monitoring ensures that the payment date is met before the shipping date. In indirect procurement and for small volumes, prepayment is often acceptable; for strategic materials, usually not.

Methods and Approach: Managing Prepayment in Procurement

Handling prepayment follows a clear logic: the weaker the supplier's dependence and the higher the order risk, the more readily the buyer accepts pre-financing. Conversely, the stronger the buyer's negotiating position, the easier it is to enforce payment terms or alternatives. The approach is systematised in four steps, from risk assessment to payment approval.

Credit and Risk Assessment before Payment

Before any advance payment, a structured assessment of the supplier should take place: credit report, commercial register extract, references and, where applicable, a Supplier Rating from previous business. For new suppliers or higher amounts, it is also advisable to examine operational capability, for example through supplier approval or serial approval for production-related parts. A Risk Mitigation Plan records measures for the event of default.

Contractual Protection

The contract should regulate when payment is due, what consideration it is given for and what happens in the event of non-delivery. Sensible measures include repayment agreements, contractual penalties and, for international business, clear Incoterms regulations such as Incoterms FAS, so that transfer of risk and transport responsibility are unambiguous. For sea freight, a Bill of Lading can additionally secure the availability of the goods as a document; in air transport, the Air Waybill (AWB) performs a comparable role.

Procedural Implementation and Payment Release

In the operational process, the prepayment is recorded and reconciled in a traceable manner via the accounts payable department and the account statement reconciliation (AP). A four-eyes approval is important: the specialist department, procurement and finance jointly approve the advance payment. Digital Contract Management and purchase order workflow systems support the automatic transfer of payment terms from purchase order and contract.

Key KPIs Relating to Prepayment

Prepayment itself is not a metric, but it influences several standard procurement and finance KPIs. Those who systematically measure prepayment volumes and share can identify negotiation potential and address liquidity risks at an early stage. The most important variables are the share of prepayment volume in procurement volume, supplier payment morale and the impact on Working Capital.

Prepayment Ratio and Working Capital

The prepayment share of annual procurement volume indicates how much liquidity is pre-financed. In practice, this share is typically in the low single-digit percentage range for established procurement organisations; higher values indicate weak negotiating positions or new-supplier risks. Since every pre-financing burdens Working Capital, the value should be considered in conjunction with the early payment discount ratio: early payment discounts can be more attractive than prepayment, as the discount at least partially compensates for the tied-up liquidity.

Supplier and Delivery Reliability Metrics

Because the buyer performs in advance under prepayment, on-time delivery and delivery quality are particularly important. Metrics such as Carrier Performance and Supplier Rating show whether the pre-financed supplier delivers reliably. Deadline monitoring and inventory management complete the picture: anyone who pre-finances has a heightened interest in punctual, complete deliveries and a low need for alternative sourcing.

Cost and Risk Indicators

The overall assessment of a pre-financed procurement should also include Total Landed Cost (TLC), as pre-financing can generate additional costs through capital commitment. Savings Realized and Supplier Rating feed into the periodic review. A measurable risk indicator is the default rate on pre-financed orders; in healthy procurement organisations it is typically close to zero in practice.

Risks and Controls in Prepayment

The central risk of prepayment is obvious: the buyer pays without having ownership or possession of the goods. In the event of insolvency, fraud or refusal to perform by the supplier, the advance payment may in the worst case be lost entirely. Controls therefore focus on supplier selection, contractual protection and procedural approval.

Default and Fraud Risks

Typical risk scenarios are the supplier's insolvency between payment and delivery, fraud cases involving fictitious companies, or deliveries that fail to meet quality or quantity requirements. Particular caution is advised in international sourcing without any prior personal history. A Supplier Rating from historical business, supplier approval and checks of the commercial register and creditworthiness significantly reduce the risk.

Liquidity and Opportunity Costs

Every pre-financing ties up capital that could otherwise be used for early payment discounts, early payment terms or investments. The opportunity costs are part of the Total Landed Cost (TLC) and should be included in the price comparison calculation. In practice, it is often cheaper to accept a slightly higher unit price with a payment deadline than an apparently cheaper price with prepayment.

Controls and Approval Processes

Effective controls include: amount thresholds for prepayment (typically approval by management or the CFO above a defined volume), the four-eyes principle for payment release, documented contracts in Digital Contract Management and ongoing deadline monitoring of the promised delivery dates. In the event of deviations, alternative sourcing or a Risk Mitigation Plan should be activated at an early stage.

Current Developments: Prepayment in Transition

Prepayment is losing importance in established supplier relationships but remains relevant in niches. Digitalisation, international sourcing and supply chain volatility are changing the approach to pre-financing. Three developments are shaping the picture.

Digital Payment and Protection Models

Digital Contract Management and automated purchase order workflows make payment terms more

transparent and renegotiations more traceable. For international business, document-based protections are gaining importance: documentary letters of credit, documentary collections and payment release based on shipping documents offer security equivalents to prepayment without fully pre-financing the buyer.

Supply Chain Stress and Pre-financing

In phases of material scarcity and long lead times, buyers more frequently accept advance payments to secure capacity – for example for semiconductors, EMS services or Toll Manufacturing, when the contractor has to pre-finance material. Here, prepayment is less a sign of a weak negotiating position than an instrument of procurement strategy for securing capacity. A Sales Forecast from the customer can make pre-financing easier for the supplier and reduce the advance payment amount.

Sustainability and Compliance Requirements

For pre-financed orders, the review of sustainability and compliance requirements is gaining importance, particularly with international suppliers. Supply-Chain Due Diligence and confidentiality agreements complement the classic credit check. Cross-Functional Sourcing brings procurement, finance, legal and quality management together to assess payment terms holistically.

Typical metrics

Prepayment ratio (share of procurement volume): < 5 %

Higher values indicate a weak negotiating position or high new-supplier risks

Default rate on pre-financed orders: 0 %

Close to zero in stable organisations; deviations reveal control gaps

Early payment discount ratio: > 50 %

A high early payment discount ratio can partially replace prepayment as a liquidity instrument

On-time delivery rate for pre-financed orders: > 95 %

Important, as the buyer performs in advance and depends on reliability

Practical Example

A medium-sized mechanical engineering company sources a custom-made gearbox housing from a new foundry supplier in Southern Europe. Because of the high tooling costs, the supplier demands a 40 per cent advance payment. The buyer accepts this only in return for several protective measures and documents the agreement in Digital Contract Management.

- Credit report and commercial register check as well as supplier approval based on sample part evaluation before the first payment
- Contractual repayment agreement with a contractual penalty for non-delivery and a clear Incoterms regulation of the transfer of risk
- Deadline monitoring of the promised pre-series delivery with escalation levels and a prepared Risk Mitigation Plan including alternative sourcing
- Inclusion of the supplier in the Supplier Rating with reviews after serial approval, in order to negotiate the advance payment amount for follow-up orders

Conclusion

Prepayment is a legitimate and, in certain constellations, sensible payment instrument – for new suppliers, custom-made products and capacity reservations. For buyers, however, it means performing in advance without possession of the goods and therefore a risk that can only be managed through careful supplier selection, clear contracts and structured approval processes. Measured systematically – for example via the prepayment ratio and Total Landed Cost – it becomes apparent where pre-financing is necessary and where it wastes negotiation potential. Anyone familiar with alternatives such as early payment discounts, payment terms or document-based protections negotiates from a stronger position. In practice, an annual review of all prepayment agreements is worthwhile in order to deploy liquidity more efficiently.

Frequently asked questions

What does prepayment mean in procurement?

Prepayment (Vorkasse) means that the buyer pays the purchase price or a down payment before the supplier ships the goods or delivers the service. The buyer thus performs in advance and bears the risk of default. In B2B procurement, prepayment is common primarily with new suppliers, custom-made products and international sourcing.

What prepayment amounts are common in industry?

For capital goods and custom-made products, advance payments of typically 20 to 50 per cent are common, often as material pre-financing. For small volumes in indirect procurement, full prepayment before shipment is also usual. The specific amount depends on bargaining position, the buyer's creditworthiness and the risk profile of the order.

Is prepayment risky for buyers?

Yes, because the buyer pays without having ownership or possession of the goods. In the event of the supplier's insolvency, fraud or refusal to perform, the advance payment may be lost. Risks can be reduced through credit checks, supplier approval, repayment agreements and a Risk Mitigation Plan.

What is the difference between prepayment and a down payment?

Strictly speaking, prepayment means full payment before the goods are made available, whereas a down payment is usually a partial payment with the remaining balance due after delivery. In practice, the two terms are often used synonymously. What matters is the contractual regulation of due date, subject matter of performance and repayment terms.

When should a buyer accept prepayment?

Prepayment makes sense when the supplier provides pre-financing services, for example for tooling costs, customer-specific materials or Toll Manufacturing. Even in situations of high demand and capacity constraints, an advance payment can secure the placement of an order. Prerequisites are a completed credit and risk assessment and clear contractual protection.

How can prepayment be avoided or reduced?

With a strong negotiating position, proof of the buyer's own creditworthiness and building a supplier relationship across multiple orders, the supplier's willingness to demand prepayment declines. Alternatives include early payment discount agreements, payment terms, documentary letters of credit or guarantees. A good Supplier Rating from previous business strengthens the argument.