Managing Trade Debtors

David Pickup, Sales Director – Trade Credit, asks why Trade Debtors are ignored, even when detrimental to a business.

Trade debtors represent amounts owed to a business by its customers for goods or services provided on credit terms. While trade debtors are an essential aspect of business operations, they can also pose significant risks if not managed properly. As a specialist credit insurance broker, it always surprising to learn that the majority of businesses will insure all the assets on their balance sheet (such as stock, plant and machinery etc.) with the exception of the trade debtors item.

It is common for the trade debtor to be the largest single asset on a company's balance sheet, and therefore by definition one of the largest risks to the business if it cannot be realised through customer payments.

Nature of trade debtors

When a business provides services or goods to another business customer, it is common practice for the supplier to have to offer open credit terms of payment to its customer – typically 30 or 60 days from the date of the invoice. This creates an automatic risk to the supplier since the service has already been provided and the goods have already been delivered, but no payment has been received. If the customer fails to pay the invoices as they fall due, this can create significant issues for the supplier.

1) Cash Flow – There will be an immediate impact on the suppliers' cash flow. The supplier may be relying on the payment from its customer to pay its own overheads such as wages and suppliers.

2) Loss of profit – If a business operates with a margin of 10%, the non-payment of a £10k invoice means the business has to generate an additional £100k of sales just to stand still.

3) Reduced margins – This may lead to additional pressure on the operations of the business.

4) Insolvency – In extreme cases the supplier could face its own Insolvency. We quite often see a "domino effect" where a large company fails leaving its suppliers unpaid and unfortunately a number of the suppliers will then fail as well.

Looking into the 'why'

So, why is it that businesses forget about protecting their largest asset? We explore some of the reasons below.

1) Lack of Awareness – many companies do not know about Credit Insurance and the benefits it can provide.

2) Complexity – the Trade Debtor balance will change daily with the raising of new invoices and the receipt of customer payments. For this reason, some businesses fail to monitor it effectively. Credit Insurance will provide up to date financial information on customers.

3) Misplaced Priorities – companies may chase sales and place this as more important than monitoring or insuring the Trade Debtor balance. High sales are only good if the customer payment is received.

4) Overconfidence – companies that have historically had minimal bad debts may become complacent. Equally we often hear that the customer base is too good to fail. This myth has been disproved many times with the likes of The Body Shop, Lloyds Pharmacy and Henry Construction going into Administration.

Cost and practicality of credit insurance

There is a preconception that credit insurance is extremely expensive, however it's important that businesses consider the number of factors that impact the cost of a credit insurance policy before making this assumption. These are:

1) Sector – Currently the construction sector is experiencing extremely high levels of corporate insolvencies. As the risk of non-payment is significantly higher, we are seeing higher premium rates when compared to other sectors.

2) Bad Debt History – If the policyholder can demonstrate good credit control processes with low levels of bad debts in the past 3 years, there is a greater chance we can negotiate a reduced premium rate with the insurer.

3) Export Levels – If a business exports heavily, the risk of non-payment is greater due to the lack of financial information on their customers. There are also political risks that insurers take into consideration here.

The premium for credit insurance is calculated as a percentage of the insurable turnover of the policyholder. This typically ranges from 0.1% to 1% and is normally much less than a business would have as its bad debt provision. The protection provided by the credit insurers is a multiple of the premium, so if the premium is

£20k, the policy could provide £800k of cover. In comparison, if the business put aside a £20k bad debt provision, this is all the protection the business would have.

Credit insurance for significant debtors

For some businesses they may have a significant exposure to one or two customers and may just want to insure these alone. This can be done and quite often the cost of this is economical in comparison to the amounts outstanding. If a business has multiple customers that all owe small amounts, a bad debt with one of those customers will have a minimal effect on cash flow, however the opposite is true if a single customer makes up a sizeable percentage of their trade debtors.

Credit insurance can be used as a tool to avoid the risk of a large exposure before it happens. The specialist insurers have access to a lot of up-to-date financials on companies and with the use of credit insurance, businesses can vet their potential customers before they trade with them on credit terms, thus reducing the risk of a bad debt.

Diversification of risks

A lot of businesses operate on the 80:20 rule in that 80% of turnover comes from 20% of its customers. It is common for the business to know its largest customers very well, but as it moves down its customer base it may know them less. With access to the specialist insurers' market intelligence, a business can get to know its customers more intimately.

Some customers will be well known companies, however there will be several smaller companies that are less well known and may only file abbreviated accounts at Companies House. This makes it harder to assess them from a credit risk point of view. In the same vein, when customers are based overseas, it is harder for a business to make a credit assessment due to lack of financial information. The credit insurers are global and have agents worldwide making it easier for them to access accounts for companies outside of the UK.

Monitoring and management

Quite often a business will assess its cutomer at the account opening stage, but this will be a one-off exercise. Credit insurance involves good disciplines such as efficient credit control, controlling late payments and monitoring a customer's credit rating as it changes when they file more up to date accounts.

With the use of effective credit management practices, bad debts can be avoided.

Key takeaways:
If a comprehensive assessment is conducted, credit insurance can provide a cost-effective way to insure the trade debtor amount on the balance sheet.

THE TRADE DEBTOR IS OFTEN THE LARGEST SINGLE ASSET ON A COMPANY'S BALANCE SHEET, AND ONE OF THE LARGEST RISKS TO THE BUSINESS.