Better profits without increased sales or lower costs

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Achieving higher profits is often associated with an increase in sales or a decrease in expenses. While in many cases this is the route to a better bottom line, focusing on these two items can produce the opposite outcome if pursued without regard for the quality of sales and the ability of your buyers to pay for their purchases.

You can address these issues – quality and security – by selling on cash terms, clearly the most risk free way to trade, but this could also be a deterrent to winning orders, especially if competitors are prepared to offer more attractive terms. This means selling on credit which provides more sales opportunities, but creates payment risk. This risk can be significantly reduced by using credit insurance.

Many companies write off the idea of using credit insurance as too expensive. For some companies this may indeed be the case, but the perception of cost really needs to be addressed in the right perspective. Comparing the cost effectiveness of credit insurance with other methods of managing your credit exposure is an exercise that all businesses should undertake.

For example, a company with annual revenues of €100 million which had absolutely no bad debts over the course of a year and did nothing to protect its receivables would have no bad debt expense. The same company paying, for our example, €150K on credit insurance would have had a €150K expense. But very few companies experience no bad debts. An Atradius survey of more than 6,000 companies in 30 countries found that almost 5% of the value of their invoices was uncollectable.

But, for our example, let's assume that the company is very good at collecting its receivables and only 0.2% of the value of receivables is uncollectable. This produces a loss of €200K if uninsured. A credit insured loss would be around €130K (credit insurance premium of €150K – claims payments of €180K (€200K claims - own risk which is usually about 10% of the unpaid debt). The investment in credit insurance has netted you a €70K savings which directly improves your bottom line.

But what if this same company only has €100K in bad debt losses? It now looks like credit insurance would cost you €50K more. But that's not necessarily the case. €100K is not your real cost. If the company has a profit margin of 10%, your €100K loss results in an actual out of pocket loss of €90K. But recovering that €90K is going to cost €900K in additional sales (10% profit margin on €900K revenue = €90K).

If credit insured you would have paid €150K in premiums and received around €90K in payments on your claims resulting in an out of pocket expense of about €60K but only the need to sell €600K to recoup your annual insurance cost. The uninsured company will have to sell an additional €300K more than the insured company just to get back to breakeven.

As your profit margins shrink, the cost of a bad debt climbs. From a simple, but pure numbers argument, for many companies, credit insurance makes sense when premiums are less than 1.8 times the value of your bad debts.

But credit management is never that cut and dry. Businesses reserve against bad debts to ensure they have enough cash to keep the business running. They buy credit reports and other information to check the creditworthiness of their buyers. When things do go wrong, they hire a collection agency to pursue the debts - or even sell their debts. With

Annual cost of bad debts (in thousands except percentages)

Sales	100,000	100,000	100,000	100,000	100,000	100,000
Profit margin	20%	20%	10%	10%	5%	5%
Cost of insurance	0	150	0	150	0	150
Bad debts	100	100	100	100	100	100
Out of pocket loss	80	60	90	60	95	60
Sales required to recoup loss	400	300	900	600	1,900	1,200

all these options at hand, it seems a company should be able to reduce its bad debt expenses on its own by simply paying a little more attention to its internal credit management procedures.

A strict and proactive approach to credit management can reduce your bad debts. It will help you get paid earlier and, if a customer does go bankrupt, you can put your company in a better position to collect at least some of the debt. However, all of these credit management activities cost time and money and they don't guarantee a default free receivables portfolio.

For instance, smaller debts are sometimes not pursued while larger ones are. Individually it seems the larger debts have the potential to do the most damage and can be the most difficult to recover, but it's the smaller ones that often present the more significant risk of loss because the cost of pursuing them is often greater than the value of the receivable. At Atradius Credit Insurance, many customers keep very close tabs on the large buyers and rely on Atradius to keep a close eye on their smaller buyers.

Back to the time and money issue; Bad debt reserves represent money that is unavailable for use in growing the business. While credit insurance is not going to fully compensate for reserving, it can reduce the amount you need to reserve, freeing up cash that can be used to grow the business.

Checking a customer's creditworthiness is itself a bit of a risk. While a credit report may tell you about the customer's finances, you still have to make a judgement call on whether or not to extend credit. Most companies want to complete the sale and are therefore more inclined to take the risk than not take it. More often than not they come out OK but, as pointed out earlier, if just one out of 20 of those invoices ends up uncollectable you could lose half the profit on the other 19.

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It's like having a team of risk analysts to advise on how to best work with a customer – cash, credit or a combination. There will always be some unavoidable payment defaults, and when these occur, credit insurance pays you.

Finally, collecting debts; whether done in-house or through a collections agency, the aim is the same. And your chances of recovering the debt are improved by good credit management practices: reminders of approaching due dates, understanding and adhering to legal procedures, trade laws and trade practices in the debtor's country, and taking timely action when a debt is late, to name just a few.

In the end, a good collections agency can increase success. It can help address the legal aspects of the collection, with timing of actions and applying the appropriate pressure to secure payment while preserving relationships with the debtor, if desired. Some debtors simply wait to pay until the debt is turned over to an agency - as if the seller is not serious about the invoice until they call in the professionals. Particularly when it comes to foreign debtors, as an agency that specialises in international collections will have more resources on hand to obtain payment. Good international collection agencies can be hard to find but, if you're credit insured by an international credit insurer, the collections support is usually part of the credit insurance package – protection plus collection.

While credit insurance may not be right for every company, every company should at least have a serious discussion with a credit insurer to compare the real cost of insured and uninsured trade debts on their business. ■