Best Practices for Managing Credit Risk on Trade Receivables

Acknowledgments - Four leading organizations (AiVidens, Atradius Collections, Graydon, Allianz Trade) volunteered to bring their expertise to bear on this whitepaper. Agoria would like to thank them and their individual associates who devoted many hours to this whitepaper.

Preliminary comment - In this whitepaper we strive to provide a broad and accurate view of and best practices for managing trade credit risk. However, it is impossible to be complete. If you believe we have overlooked or misstated certain areas, please contact financialservices@agoria.be.

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Allianz Trade AiVIDENS Atradius Collections GRAYDON next generation intelligence

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Contents

1 Introduction

The purpose of this whitepaper is to share best practices for managing credit risk on short term B2B trade receivables. It provides practical advice and tools for companies to assess and manage credit risk actively on its B2B trade receivables.

The principles which we discuss are valid for large and small companies, for short and medium/long term trade receivables, for goods and services and for commodities and high value-added products. The implementation and priorities of these principles might be very different however, depending on the profitability, customer mix and context.

Preliminary notes :

Short term trade receivables are payments which customers owe to their suppliers for goods or services. We will focus on undisputed invoices with a payment typically due within one to three months as of the date of invoice. Trade receivables are also known as Account Receivables (AR) in accounting terms. We will use the term 'trade receivables' throughout this document.

The likelihood that an invoice is not paid depends on the credit quality and the willingness of the debtor to pay. The financial impact of a non-payment depends on the size of the trade receivable, the amount which can be recovered, and whether the trade receivable was insured.

Payment terms on trade receivables as well as unrecoverable receivables have a direct impact on profit and liquidity. The default rate on trade receivables refers to the percentage of trade receivables which cannot be collected from customers.

Taking credit risk on customers is typically not part of the core business of a private company. Payment terms are in essence a form of credit from a supplier to his customer. Credit scoring is the analysis to assess the level of customer reliability with regard to the timely payment of a financial obligation. Credit scoring of a trade receivables portfolio will sort customers into groups with a similar risk profile.

2 Credit risk on trade receivables

2.1 Credit risk is cyclical

Default rates on trade receivables may receive little attention when the economy is strong, but they are on top of mind when a crisis hits.

The 2007-2009 financial crisis was caused by cheap credit and lax lending standards that fuelled a housing bubble. The period of economic recovery saw accommodative monetary policies and a drop in default rates on trade credit.

During the COVID-19 crisis, the Belgian government created a support scheme to enable trade credit insurance underwriters to maintain credit lines as much as possible on Belgian companies so that they could continue to pursue commercial transactions without non-payment risk.

Still, according to a study by Gartner, bad debt increased by 26% in 2020. Companies were affected on multiple fronts:

- a company's trade receivables became riskier overnight
- most own credit quality deteriorated, making it harder for companies to borrow
- suppliers and credit insurers reduced their credit limits on their customers putting their working capital requirements under strain.

In Baden-Powell's words, the Scout motto "Be prepared" is in order.

2.2 Getting ready

Map and review internal processes

Internal errors are a leading cause of late payment and non-payment and can stem from errors in connection information, a failure to update IT systems, incorrect data in addresses, VAT numbers, contracts or prices, and multiple other factors.

It may be that the greatest risk to your trade receivable is not a customer, but rather your business' internal collection processes. Improving internal collection processes may result in a lower Days Sales Outstanding (DSO – see 3.2.2) and reduced risk.

Conduct a risk assessment of your trade receivables

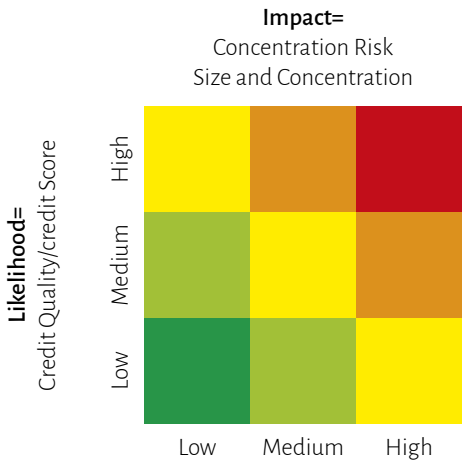
Assessing the quality of your receivables has become more important than ever during the COVID-19 pandemic, with increased levels of insolvency and other factors such as the interruption of supply chains having a negative impact on businesses throughout the world. You should assess your receivables regularly, before and during periods of economic uncertainty. Early detection of risk will help you avoid or minimize potential losses.

Determine your trade credit risk management strategy and process

It is nearly impossible to reduce your credit risk to zero, but you should work actively on minimizing your credit risk and on determining the instruments and procedures to shield you from unwanted trade credit risk.

3 How to conduct a risk assessment of your trade receivables

3.1 Risk matrix applied to credit risk



The traditional risk assessment matrix maps the likelihood of a risk event against the impact that this risk event may have on the company. For a portfolio of trade receivables the likelihood of a risk event depends on the credit quality and the willingness of the debtor to pay.

The impact of the risk event depends on the size of the (group of) trade receivable(s). A portfolio which consists of a few high quality customers might have the same level of risk as a well-diversified portfolio with more risky customers. It is important to have a good view on the risk categories because the type of risk mitigating measures may be different for each risk category.

3.1.1 Concentration risk

Customer concentration risk is a result of relying on a small pool of clients. If a few clients represent the majority of your trade receivables, you have an imbalanced receivable risk or a high trade receivable concentration. This is a standard way to measure the riskiness of your trade receivable.

The company faces a cash flow risk if those trade receivables become uncollectible due to their high concentration.

- The lower the credit quality of your debtor and the greater the trade receivable, the greater the risk your revenue holds
- The lower your margins the bigger the impact on your company's profitability

3.1.2 Credit Scoring

Credit scoring is the analysis which determines the level of customer reliability with regard to the timely payment of a financial obligation. This is based on the analysis of information sources such as financial statements, credit history and other customer characteristics. This credit scoring is often provided by credit bureaus such as Graydon. Ideally a credit score should incorporate both the probability of default and the loss given default. Loss given default is the amount of money the seller loses when the buyer defaults on a payment after taking into consideration any recovery. It is good practice to prepare and frequently review client credit reports.

Credit insurers like Allianz Trade and credit information companies such as Graydon offer tools for individual credit reports per company and clear dashboards to gain insight in your existing trade credit portfolio by risk, concentration, sector or by country.

If you keep all your eggs in one basket, make sure that you control what happens to that basket

Freely adapted from Andrew Carnegie

Figure 1 shows an example of a credit report.

Client ABC				
in '000€				
Name	Client ABC Manufacturing NV			
VAT n°	123 456 789			
Internal Account N"	C1234			
Client Financials	2022	2021	2020	2019
Sales		45.665	50.885	51.443
EBIT		4.100	4.600	4.200
Equity		91.002	101.220	130.222
Financial debt		31.000	32.004	32.004
Balance sheet total		158.005	165.215	163.228
Credit score	BB-	BB-	BB+	BB+
Sales and Payment history by Client	1/3/2022	2021	2020	2019
Purchases by Client	7.652	7.500	3.500	3.000
Outstanding	765	750	350	300
Not due yet	638	625	292	250
1-30 days late	90	100	58	50
31-60 days late	-	25	-	-
61-90 doys lotc	37	-	-	-
>90 days late	-	-	-	-
Payment terms	30	30	30	30
Credit limit	850	850	750	500
ADD	5	4	-	-
DSO	33	32	29	28
Amount submitted for recovery	-	-	-	-
Sales manager	Marc D.	Marc D.	Marc D.	Linda M.

Figure 1 Client Credit Report Template

An example of a detailed credit report template from Graydon can be found HERE.

Figure 2 shows an example of a risk analysis on a trade credit portfolio "best practices for managing credit risk on trade receivables" ?

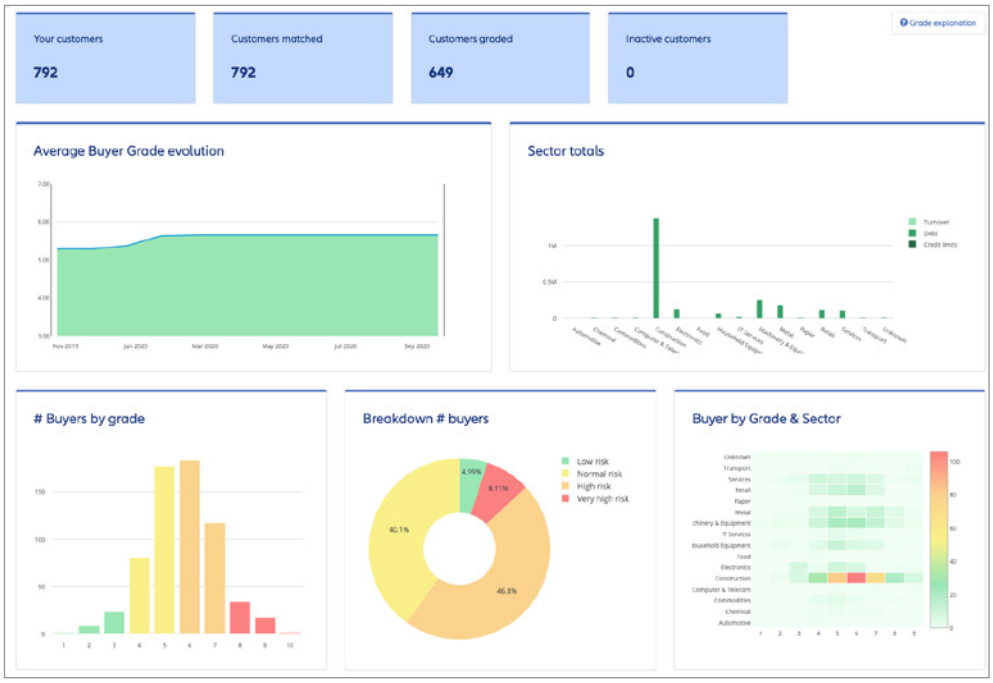


Figure 2 Credit Risk Analyser Template by Allianz Trade

Credit insurers such as Allianz Trade and credit information providers such as Graydon make it possible to connect to your ERP system via APIs. Figure 3 shows how the credit information from Allianz Trade can be linked to the company's ERP system.

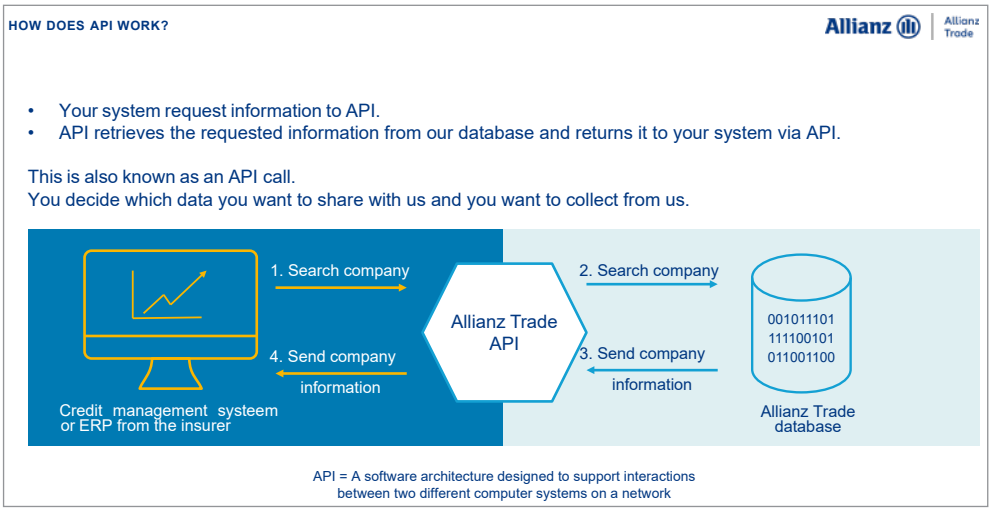


Figure 3 Example of how credit information from Allianz Trade is linked to the company's ERP

3.2 Risk assessment process

3.2.1 Sort your customers into groups

Sorting your customers into groups with a similar risk profile will help you identify patterns and establish a risk profile. These groups may consist of customers with similar risk scores or similarities in terms of geography, industry or other relevant characteristics.

You can use this exercise to help assess both the credit risk and concentration risk. Examples of possible groupings include:

- Domestic customers
- Foreign customers (you could further differentiate this by country or region)
- Trade sectors
- Product categories
- Size of customer
- Percentage of your overall receivables the customer represents
- Debtors with and without payment guarantees

3.2.2 Listen to your data

Assess your history of unpaid invoices

The history of losses incurred enables you to draw conclusions about general default risks and to discern patterns. For example, are the bad debts clustered in a particular sector or geography? Can you identify a group that has a greater need for security arrangements and guarantees than other customer groups? Analysing past bad debts can also help you assess the quality of your company's trade receivables management and identify areas for improvement within your own company's policies and processes.

Solutions like AiVidens (see Figure 4) provide an overview of historic payment behaviour of your customers so you can create segments according to payment profiles and how they develop over time. The outcome results into a segmentation per payment profile that you see developing over the time.

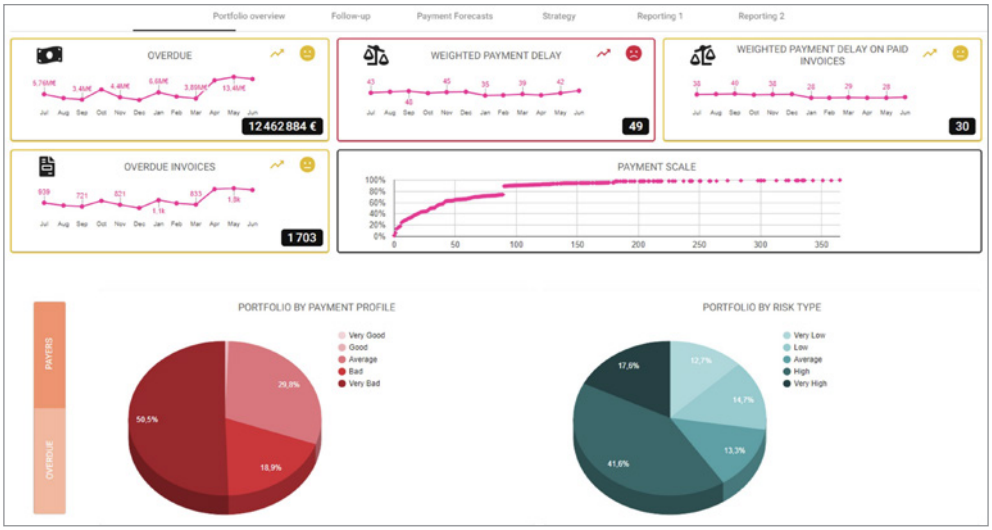


Figure 4 Screenshot from AiVidens

Include Days Sales Outstanding (DSO) and Average Days Delinquent (ADD) in your KPI dashboard

The average time in terms of days between invoicing and payment is your Days Sales Outstanding (DSO). This is a good indicator of the efficiency of your receivables management.

To calculate your DSO, first divide your total trade receivables by the total value of your credit sales. Then multiply this figure by the number of days in the period you are assessing. Credit sales are net sales after deducting discounts, returned goods and goods sold against cash payments. The DSO formula can be used with the average trade receivables in the period or with the trade receivables at the end of the period. Most companies use a monthly DSO with end of period trade receivables. It is appropriate to use average DSO when working with annual sales figures, however when a using weekly or monthly sales, the trade receivable total at the end of the period can be used.

$$\text{Days Sales Outstanding (DSO)} = \frac{\text{Trade receivables}}{\text{Credit sales in the period}} \times \text{number of days in the period}$$

$$\text{Best Possible DSO} = \frac{\text{Current trade receivable (*)}}{\text{Credit Sales for the Period}} \times \text{number of days in the period}$$

(*)Current trade receivables= Trade receivables not due yet

Average Days Delinquent (ADD) refers to the average number of days the invoices are delinquent (past -due)

Average Days Delinquent (ADD)= Average DSO-Best Possible DSO

ADD helps assess the health of your trade receivables. ADD should be put in relation to your DSO. There are a few pitfalls when using ADD. First, it's a snapshot in time, so you want to look at the development of your ADD over time and in relation to your DSO. Second, ADD is impacted by sudden spikes or drops in sales or disputes and settlements. In general, an ADD of between 5 to 8 days is not uncommon.

Figure 5 shows a concrete example for calculating ADD and DSO.

in €	Jan	Feb	Mar
Gross Sales	120	118	150
Sales against cash payment	-20	-5	0
Returned goods	-10	0	0
Credit notes	0	0	-4
Credit sales	90	113	146
Trade receivables	109	145	150
of which delinquent (past due)	16	26	40
Current AR	93	119	110
Trade receivables	109	145	150
/ Credit Sales	90	113	146
x number of days in the period	31	28	31
D50 =AR/ Credit Sales x number of days in the period =	37,5	35,9	31,8
Trade receivables	93	119	110
/ Credit Sales	90	113	146
x number of days in the period	31	28	31
Best possible DSO	32,0	29,5	23,4
DSO	37,5	35,9	31,8
Best possible DSO	32,0	29,5	23,4
Average Days Delinquent {ADD)	5,5	6,4	8,5

Figure 5 DSO and ADD calculation template

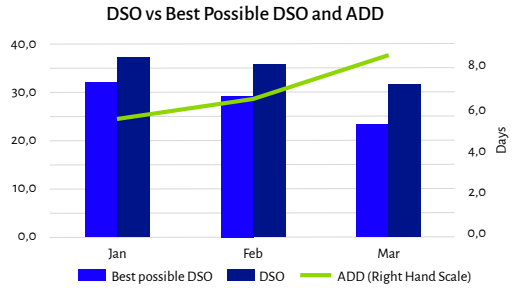


Figure 6 Development of DSO, Best Possible DSO and ADD

$$\text{DSO} = \frac{€145}{€113} \times 28 \text{ days} = 35{,}9 \text{ days}$$

$$\text{Best Possible DSO} = \frac{€119}{€113} \times 28 \text{ days} = 29{,}5 \text{ days}$$

ADD=35,9 days-29,5 days= 6,4 days

Figure 6 shows graphically how the ADD increases despite a drop in DSO. Note that in this example the company has generated substantially more sales in March. The increase in ADD might be linked to the increase in sales or new customers.

Prepare an aging report

Depending on your tracking software, you can run customized trade receivable aging reports that offer greater insight into the timing of payments. These can include parsing by region, salesperson, collector, and amount. Customized reports enable you to identify internal versus external issues in the trade receivable process.

An aging report is important because it is potentially an indication of a deteriorating credit quality before the situation becomes problematic. By tracking trade receivable aging, you can identify concerns before they spin out of control and avoid a negative cash flow surprise. Trade receivable reports are critical to improving receivables performance.

Aging report 30/9/21

Name of customer	Sales			Overdue, €			
	Last 12 months	Total outstanding	Not due, €	1-30 days	31-60 days	61-90 days	> 90 days
Customer A	37.650	1.222	3.138	1.222			
Customer B	146.832		12.236		4.566		
Customer C	8.316		693				4.000
Customer D							
Customer E							
Customer F							
Total	**192.798**	**1.222**	**16.067**	**1.222**	**4.566**		**4.000**
Provision as per group policy	0,2%		0%	0,35%	0,5%	1%	2%
Amount of provision	**386**		**0**	**4**	**23**	**0**	**80**

Figure 7 Aging report template

3.2.3 Identify future risks to your cash flow

When assessing your debtors' creditworthiness, the following aspects should be taken into account:

- New products/target groups: Moving into a different customer base, or launching new products or services can give rise to new payment risks.
- New regions: Entering a new geographical market can be fraught with risk including unfamiliar trade laws or practices, (statutory) payment terms, varying rules on imports and customs duties and potential political instability.
- Expanded sales: If your business has experienced growth in sales, it is wise to investigate whether your debtor structure base has remained unchanged or whether market changes or new products have affected the rise in sales.
- New customers: New customers without a proven payment history can represent a higher credit risk.
- Future developments and plans.

3.2.4 Recommendations:

- Review payment terms of customers in order forms, terms and conditions, and contracts.
- Frequent monitoring – Check your DSO, ADD, payment profiles (see 3.2) and aging reports regularly
  - Plot the history of DSO and ADD over the past three years.
  - Compare your ratio to your industry's average.
  - Differentiate individual insolvencies and insolvencies per sector, region, and type of client.
- Assess future potential risks inherent to individual segments and put in place processes to minimize the risks.
- Monitor internal processes: are invoices sent on time? Number of disputed invoices.

4 Trade credit risk management

4.1 Trade credit - Risk management strategy

It is nearly impossible to reduce your credit risk to zero, but you should work actively on minimizing your credit risk and on determining the instruments and procedures to shield you from unwanted trade credit risk. This risk management strategy is documented in the trade credit policy.

In short, the best risk management strategy will

- first use preventative measures: avoid, minimize and limit credit risk on trade receivables
- then consider to assume or insure the residual risk and to determine the preferred type of insurance
- lastly: have a recovery strategy ready and evaluate your collections process regularly.

1. **Avoid unnecessary risks:**
   a. Create guidelines for Marketing and Sales Departments to avoid risks which you deem unacceptable. Guidelines may include discounts for early payments.
   b. Review payment terms of customer in Order forms, Terms and Conditions, contracts in line with the credit risk of your customer.
   c. Optimize internal processes for onboarding new clients, invoicing, monitoring receivables and recovery of overdue invoices.
2. **Minimize and Limit credit risk:**
   a. Create credit limits per customer.
   b. Create credit limits per customer group (see categories in Chapters 3.1 and 3.2).
3. **Determine the level of residual and acceptable risk:**
   a. Companies with high gross margins (e.g. software sales or SAAS services) have a much higher risk tolerance than companies with low gross margins.
   b. The acceptable level of risk is a strategic decision to be set or approved by the board of directors/shareholders.
4. **Determine the mix of instruments and processes:** which the company will use to manage the risk. Both preventive (credit limits, payment terms) and curative credit management solutions (insurance, recovery, factoring) should be considered.
5. **Insure risks that you can't or don't want to take:**
   a. A known premium is better than an uncertain and undesired loss.
   b. Credit insurance is designed to offer you protection from bad debt. This coverage comes at a cost and may be unnecessary — so it's important to weigh your options carefully.

Companies with high gross margins (e.g. software sales) have a much higher risk tolerance than companies with low gross margins

4.2 Trade Credit - management

4.2.1 Close cooperation with marketing and sales departments

Customer satisfaction – The cash collection and recovery process is closely linked to the company's customers and therefore requires an awareness of the impact it may have on customer buying decisions. However, keeping the customer happy must be weighed against cost, control and liquidity management.

Use a customized approach as much as possible. A customized approach helps create continuity between finance, marketing and sales and augments customer satisfaction. In many cases, artificial intelligence applied to payment patterns makes it possible to adapt the recovery processes to the customer's context. Figure 8 shows graphically the level of difficulty to recover payments and actions to be taken for a given debt portfolio.

Figure 8 AiVidens – Difficulty to collect

One Size Fits None – A standardized approach does not mean One Size Fits All. Sending a standardized reminder to a customer who's invoices are two weeks overdue might not be the right approach for a customer with a long standing relationship and with a strong credit quality. In managing your debtors a One Size Fits All approach will probably turn out to a One Size Fits None approach. A creditor can make use of a set of scripts specific to each situation.

Integrated approach – In order to be efficient, credit management starts with marketing and sales. It is counterproductive to spend time and money on prospective customers who do not meet the company's guidelines on minimal credit quality.

Set appropriate guidelines in sales contracts – If a salesperson has consistently late-paying clients, then the organization needs to assess whether he or she does not respect the company's credit guidelines or whether credit guidelines are still appropriate.

Early payment discounts – Early payment discounts can be useful to motivate customers in a positive way to pay on time. A 2% discount for early payment is not uncommon.

Regional and sectoral issues – If one region or customers in a specific industry are continually problematic for trade receivable aging, perhaps trade credit policies need to be overhauled or a stricter review process for issuing credit is required for that segment.

Across the board issues – If your trade receivables see above-average days delinquent, a systemic problem may be in the offing. Are you out of step with industry invoice terms? Are your clients dissatisfied?

Understand your customer's payment behaviour – Some companies operate with payment runs whereby they only pay invoices once every week or once every month.

In debtor's management a "One Size Fits All approach" might turn out to a "One Size Fits None approach"

Make sure that you can view the whole customer relationships in one place, from communications and conversations to payments and collections. In other words, link your payment history to your CRM system. That means you can think strategically, coordinate internally, and act immediately upon real time information. It is important to "know your customers" and to have your systems act accordingly.

4.2.2 Integrate credit management into your ERP

Credit Management is much more than trade receivable management. Trade receivable management is a financial and administrative process of getting paid on time by customers. Credit Management integrates with marketing and sales, invoicing, shipping and trade credit insurance. Marketers, salespeople, accountants and credit managers are partners with a common goal: to sell in a sustainable and profitable way to customers who pay on time. Optimizing cash flows is not the sole responsibility of the finance department, but is a shared responsibility throughout the organization.

Credit Management is an integral part in the order to cash (O2C) process. In order to be efficient it is a must to automate and streamline the process of monitoring trade receivables. Typically ERP platforms:

- have built in tools to create and monitor DSO, ADD and aging reports
- can assist in payment reconciliation and
- can prepare automated payment reminders.

Marketers, salespeople, accountants and credit managers are partners with a common goal: "Sell in a sustainable and profitable way"

The trade credit policy can formalize the relationship between Credit Management and Marketing, Sales, Invoicing/Accounting and can assist Sales by addressing the decision moments:

- Lead generation: Focus on acceptable clients. Depending on the credit quality, the prospective customer may have different prices, credit limits and payment terms.
- Acceptance: Create a formal acceptance process or checklist before accepting a new customer. Determine the payment terms, credit limits insurance coverage before onboarding a new customer. Include the new customer in the credit monitoring process.

Prospects with a poor credit, may have different prices, credit limits and payement terms

4.3 Risk management process

A risk monitoring process implements the trade credit policy and consists of the procedures and practices for assessing, managing and reporting risk. As such, the company's payment terms and general terms of business need to be within the legal limits and in line with the company's strategy and policies. The steps in the credit risk management process are:

1. Monitor credit risk and concentration risk. The credit monitoring process tracks the outstanding positions frequently (weekly or monthly)
2. Check compliance against the objectives and thresholds set by the trade credit policy
   a. Risk Monitoring per debtor
   b. Risk Monitoring for the entire portfolio
3. Determine actions
   a. per debtor
   b. for the portfolio
4. Feedback loop: build in feedback loops to evaluate the effectiveness of the credit policy. Does the policy achieve the company's objectives? Are the bad debt write-offs within the acceptable margins?

4.3.1 Credit monitoring, recovery and collection: a lockstep process

Credit monitoring is not the same as recovery, however they are closely linked. Credit monitoring refers to the process of reviewing overdue receivables on an individual and portfolio basis whereas recovery refers to the process of handling failed payments whether this process is automated or manual. Note that both the recovery and the collection can be run internally or externally using specific software platforms or collection agencies for example. The monitoring process will check compliance with the rules set by the policy. The breach of a rule (the customer didn't pay its invoices within a certain pre-defined timeframe) will trigger an action in the recovery process, therefor credit management, recovery and collection are a lockstep process.

It is important to understand where the risk comes from. Risk may indeed be linked to geographies, industries, dependencies on industries (waterfall effect) or product lines (due to product maturity for example). Understanding the risk will help to define actions better.

Low value tasks and operational tasks should be automated, but human interaction remains indispensable

Turn your ERP into an AR management tool to save time, effort and aggravation

4.3.2 Streamline and digitize processes

A trade credit policy is only as strong as the weakest link. Create efficient policies and procedures and ensure that internal processes run flawlessly. Internal processes should be designed with efficiency and the company's objectives in mind.

In general, automated processes are faster, cheaper and more reliable than manual processes. There is a wide variety of tools to centralize and monitor customer information, automate risk assessment processes and recovery strategies. Automated tools enable credit professionals to shift their focus from operational work to value-adding activities, strengthening relationships both internally and externally, and working on the continuous improvement of the O2C. Low-value tasks and operational tasks should be automated, but human interaction remains indispensable both internally between departments and externally vis à vis debtors. Robotics enters the credit department and often takes a bionic approach, where robotic processes imitate or emulate human behaviour.

4.3.3 Synchronize policies and processes with the legislation

Since May 2018, new insolvency legislation has been in force. Belgium's corporate law has been reformed and a Central Solvency Register has been created. The Central Solvency Register enhances transparency, supplying stakeholders with fast and up-to-date information on a company's situation, resulting in a better chance of collecting (bad) debt.

The law provides for an abridged procedure whereby the creditor can skip the step of going to court and collect directly through a bailiff. If the debtor does not respond within one month, or responds by making partial payment of the debt or by requesting payment facilities, the bailiff will draw up a non-dispute report which can be used as enforcement (e.g. by seizure).

4.4 Credit monitoring

External credit monitoring services: Credit monitoring services and credit insurers have a significant information advantage because they have access to payment histories of thousands of companies. This information is typically not available to a corporate credit department.

Credit monitoring services such as Graydon and Dun & Bradstreet systematically check public and private information sources such as the National Bank, Central Solvency Register and payment records from utilities or banks. External credit monitoring services are useful because companies often lack the data, tools, skill and/or time to monitor the creditworthiness of clients themselves.

Internal payment history: More and more companies start to use the payment history on their outgoing invoices, although today this trend is still relatively timid. Various solutions exist on the market today that analyse the payment behaviour of the company's customers.

Analysing customer behaviour can be challenging because of the sheer volume of customers and payments and a limited ability to collect and consolidate this information. Software solutions such as AiVidens will work with the company's ERP package to automate this process. Some ERP packages (for example: SAP) have this capability built into the system. Artificial intelligence can play an important role. Indeed, solutions using these technologies enable companies to anticipate their customers' payment problems by predicting, among other things, if and when customers will pay their bills, as well as by segmenting customers according to various payment behaviour and risk typologies. These predictions make it possible to chart predictive cash flow tables and to determine work streams and priorities for collection teams.

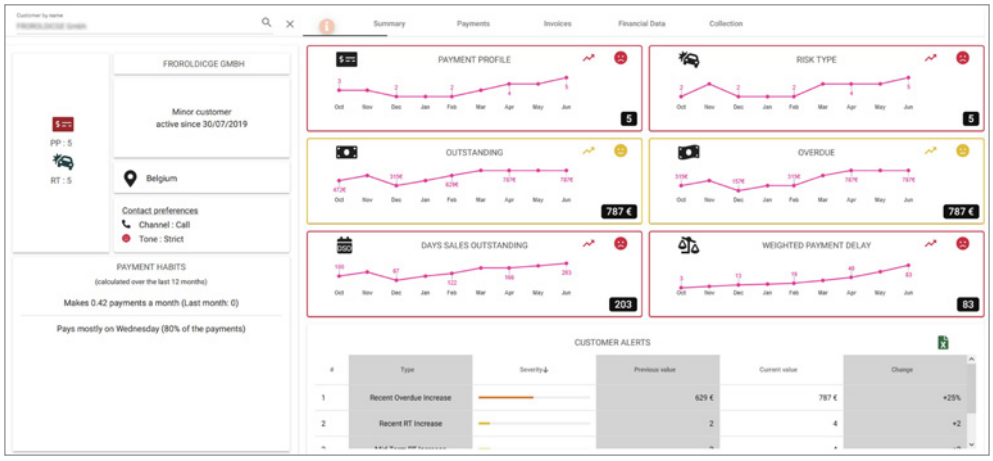


Figure 9 Customer behaviour (source: AiVidens)

Figure 9 shows a template dashboard with payment KPIs and a snapshot of customer behaviour. This information allows ERP systems to send payment reminders in line with the customer's payment context and thus making the process less black and white. A customer who regularly requires more collection effort will not be treated in the same way as a customer who is late with one payment. This seems obvious, but the reality of recovery today is surprising.

Setting limits: The input from external credit monitoring services (Graydon, Dun & Bradstreet, ...) and internal systems (AiVidens, SAP, ...) is used to set credit limits. Credit limits can be proposed by credit monitoring services or can be set by the company based on pre-defined formulas. The rules for calculating a credit limit can be simple or very complex. It can be very cumbersome to update these rules frequently. It is important to communicate new credit limits to customer to avoid untimely blocking of orders.

5 Trade credit policy

5.1 Trade credit policy is part of the overall treasury policy

The trade credit policy should be an integral part of the overall treasury policy and these policies should not operate on an island, but be closely linked to other departments such as Marketing, Sales, Legal and Strategy.

The trade credit policy should serve as a "road map" to guide the O2C activities throughout the company, and to establish performance evaluation guidelines and process measurements.

5.2 Components of the trade credit policy

A vital step in developing a trade credit policy is to appoint a champion to lead the effort. Typically, the treasurer will develop the credit policy. The Board of Directors should approve the policy, and the internal audit department should be involved to ensure compliance with the policy.

The trade credit policy will

- state the objectives for trade credit management
- determine the strategy to manage the trade credit risk
- set the tactical approach:
  - set the levels of acceptable and unacceptable risks
  - set the payment terms
  - determine which risks should be insured
- Create procedures, guidelines and checklists
  - provide guidelines on whether to involve trade credit insurance
  - set the ratios and KPIs to monitor
  - create checklists and procedures for recovery
  - include performance indicators where appropriate to measure the efficiency and effectiveness of the policy
  - include external benchmarks when available
  - impose payment terms, interest rates for late payments and lump-sum fee in contracts or terms and conditions

6 Trade credit insurance

6.1 What is trade credit insurance

Trade credit insurance is not an alternative for credit management. It is a component of trade credit management. Insurance doesn't mean we don't have to be diligent with respect to trade receivables.

What is covered – Trade credit insurance insures your trade receivables and protects your business from unpaid invoices caused by customer bankruptcy, default, political risks (not standard), or other reasons agreed with your insurer. Pre-shipment costs can also be covered, although this is not standard. Trade credit insurance effectively mitigates both credit risk and concentration risk.

B2B only – trade credit insurance only covers business-to-business accounts receivable. Accounts receivable on government entities and private individuals are typically excluded. Companies selling to government entities can seek coverage from export credit agencies.

Term – Trade credit insurance typically covers short term risk (12 months or less), but multi-year coverage is available as well.

Level of coverage – Typically the insurance company will cover between 75% and 90% of the receivables. For information: the standard coverage levels of Allianz Trade are 85% or 90% depending on the circumstances.

Your obligations – Adequate debtor management is often a condition for insurance companies to sell you trade credit insurance. You must do everything in your power to receive payment for your deliveries. These are some of the obligations insurance companies often impose:

- You must agree upon good terms and conditions for delivery and payment with your customers.
- You must put an ownership reserve clause in your sales contract.
- If your customer fails to pay on time, you must send reminders.
- You have to inform your insurance company directly when a customer fails to pay on time.

Claims payments – The insurer pays the policyholder the claim benefit, typically within 60 days from the date of loss on domestic claims. Next to claim payments collection services are also included in a credit insurance policy. Large credit insurers have their own international networks who know local habits and legislation in order to organize an efficient collection process.

6.2 Benefits of trade credit insurance

- Protection from bad debt
- Supports growth
- Embeds credit management discipline
- Improves the quality and predictability of receivables
  - enhances working capital
  - strengthens the balance sheet and this in turn is a strong argument in credit applications. Insurance coverage can be used as pledge vis à vis lenders.
- Alternative for expensive Letter of Credit where you depend on the willingness of the buyer
- Peace of mind

Online business intelligence tools – Some insurance companies provide online business intelligence tools which can help monitor, prepare, and protect your business from bad debt. They deliver data intelligence that helps the trading decisions and can save management time. The credit insurer will continuously analyse your insurable customers' creditworthiness and financial stability and assign a credit limit to each of your customer accounts. Credit insurers analyse key factors including debt, liquidity, country and sector risks. As economic parameters change, credit limits may be adjusted as part of the credit-monitoring process.

6.3 Types of trade credit insurance

A company can choose to insure:

- The whole turnover
- A specific group of customers such as a region, key accounts
- A single buyer
- A specific transaction
- A single invoice

Excess of loss insurance – Excess of loss insurance protects against losses above a specific and fixed limit. The losses up to the limit are for the insured whereas the insurance company covers the losses above the limit. Excess of loss insurance can be a cost-effective way to provide effective cover with a single policy over a set limit. A well-developed credit management with a proven track record is a requirement before contracting excess of loss insurance. The interference of the credit insurer in the credit management process is minimal.

6.4 Trade credit insurance premium

Your insurance premium depends on the type of insurance you choose. Insurance companies determine the premium based on:

- turnover volume (price per product times number of products sold)
- the number of debtors (risk-spreading)
- the credit quality of your buyers
- your debtors' country of residence
- the cover percentage for claims (often between 85% and 90%)
- the amount of deductible excess (how much of the damage you have to pay for yourself)

6.5 Factoring

Credit insurance and factoring are often mentioned together with debtor management. Both credit insurance and factoring are part of the management process of trade credit, however they are very different. Factoring is a form of financing whereas credit insurance is insurance against non-payment. Factoring in itself does not shield a company from non-payment. However, factoring and trade credit insurance can be combined. The advantage of factoring is that it adds liquidity and instils discipline on the collections process.

The financial institution which offers factoring is called the factor. There are two types of factoring: recourse factoring and non-recourse factoring.

Recourse factoring is the most common form of factoring and means that the company must pay back any invoices that the factor is unable to collect payment on. The company is ultimately responsible for any non-payment.

In **non-recourse factoring** the factor (the buyer of the invoices) takes on the bad debt risk. It accepts risks related to the debtor's failure to pay, but it does not protect debts that are unpaid because of disputed invoices. Non-recourse factoring is more expensive than recourse factoring because the factor's only security is the unpaid invoice; the factor has no recourse against the seller who issued the invoice.

6.6 Alternatives to credit insurance

Non-recourse factoring – Sale of receivables against a discount. The discount includes both the time value of money (interest rate) and the remuneration for the credit risk.

Self-insurance – Self-insurance means that a business puts a reserve on its balance sheet that covers any potential bad debt for the fiscal year. When a company decides to self-insure, it is not covered by an external insurance company, but it uses an in-house reserve to cover future losses. When a company reserves funds for self-insurance, these reserves are not available for growth opportunities. In addition, general provisions for future bad debts are not tax deductible.

Letters of credit – A letter of credit is an effective alternative to credit insurance because the company receives a payment guarantee from a bank. However, a letter of credit is expensive and it provides debt protection for one customer and only covers international trade. The seller depends on the willingness of the buyer to provide a letter of credit.

7 Recovery/sale of bad debt

It is nearly impossible to reduce trade credit risk to zero, so it is important to have an appropriate recovery process. The recovery process can be managed internally or outsourced to a collection agency such as Atradius Collections.

The approach and tone in your communication to customers can differ greatly depending on the circumstances. The tone reflects the attitude or the feelings that are associated with your message. Typically, the tone will become more stern as the recovery process escalates.

Often a late payment is due to a human or technical error, in which case it is appropriate to use a flexible and friendly tone in your communications with the customer. Gradually the tone becomes uncompromising when an amicable settlement cannot be reached within a reasonable timeframe.

7.1 Recovery process

Recovery is the process of communicating, negotiating and taking legal action with customers in an effort to collect undisputed receivables owed for goods or services provided. The recovery process typically involves escalating degrees of intensity, typically involving the following steps:

- Friendly reminder (email or phone)
- Formal notice: communication requesting payment within a short term (e.g. 5 days) + late payment interest and lump sump
- Attempt to reach a negotiated solution such as accepting a payment schedule
- Invocation of retention of title (if it concerns goods and if provided for in the terms and conditions or contract)
- Escalation to either
  - Hiring third-party collections agencies
  - legal action
    - formal notice by lawyer as 'last warning'
    - procedure for undisputed invoices via the bailiff
    - court procedure

Find the best way to minimize losses. In case of default, segmenting customers and finding the most appropriate exit strategy for each of them is critical, with a bias toward fair outcomes and best customer experience. When unavoidable, a company can suspend or limit delivery of goods and services. It is good practice to send a formal notice to a customer before suspending service or delivery of goods.

The three basic principles of a good recovery process: consistency, credibility and escalation.

Consistency – Ideally your customers and prospects trust their supplier and understand that it will meticulously follow up on its outstanding accounts receivable in all cases. So: "do what you promise, and only promise what you can deliver."

Credibility – Each phase of your recovery process must be accompanied by a clear message. Debtors must know where they stand at all times. When your first reminder invariably contain the words "First reminder", then your debtor inevitably expects a second reminder if payment does not follow.

Escalation – As the reminders go by, you will increasingly use a stern tone and put more pressure on your overdue customers.

7.2 Debt collection agency

A **debt collection agency** is a company that is engaged in debt collection. Debt collection agencies apply thorough, consistent actions in order to increase the success rate.

When selecting a debt collection agency, it is critical to use proper due-diligence review including the quality of procedures, risk policies, policies for customer interactions, data security, cyber-policies and the GDPR.

Debt collection agencies can also help to negotiate an amicable settlement. At a certain point, the creditor has to decide to start litigation, use a debt collection agency, or sell the debt.

7.3 Sale of debt (overdue invoices)

Selling undisputed overdue invoices is a financing option which effectively removes the credit risk, but this can come at a significant cost. The undisputed invoice is paid by a third-party at a discount against immediate payment. This is a good solution if the company needs immediate cash or does not want to spend time and money on the collection. You can sell the invoice on the invoice date, the due date or after going through the collection procedure.

7.4 Disputed invoices

If your claim is not paid because of a dispute that you cannot resolve yourself and you are convinced that you are right, than you should start mediation or legal proceedings immediately. Make a good cost-benefit analysis beforehand.

8 Conclusion

A company which extends payment terms to its customers should assess its trade credit risk, concentration risk and the potential impact on its business by grouping customers with similar risk profiles.

The company should minimize its credit risk by having appropriate risk mitigating policies and procedures. Avoid unnecessary risks by giving guidelines to sales and marketing staff. Minimize risk by applying appropriate payment terms and credit limits. Credit monitoring services can help with the credit risk assessment of customers and with monitoring payment behaviour of customers.

Close monitoring of DSO and ADD and aging tables and links with your ERP will maximize the probability of recovery.

Assess whether the residual risk is acceptable or whether it should be insured and if so, determine the appropriate insurance policy depending on the circumstances.

The last phase in trade credit management is the recovery of unpaid invoices. This can be done internally or externally. It is good to have a recovery strategy and roadbook ready because the older the claim is, the harder it becomes to recover invoices.

9 Glossary

Trade receivables are the total amounts that a company has invoiced to a customer for goods and services that have been delivered but not been paid for yet. Trade receivables are also known as accounts receivable. The terms are used interchangeably.

Accounts receivable (AR) is the balance of money due to a company for goods or services delivered but not yet paid for by the customers. Accounts receivables are listed on the balance sheet as a current asset.

A **debt collection agency** is a company that is engaged in debt collection. Thorough, consistent action by experts from a high-performance system ensures a high success rate.

Factor(ing): The financial institution which offers factoring services is called the factor. The factor buys a company's unpaid invoices at a discount. The company receives a percentage of the invoice of +/- 85%, within a few days, and the factor will take care of the payment process.

Order-to-cash (O2C) is the entirety of a company's order processing system. It begins the moment a customer places an order and ends when the payment.

Agoria, the federation of the technology industry, brings together 2079 technology companies and all those who are inspired by technology. With more than 321,000 employees, the technology sector is the largest sector in Belgium and Agoria is the largest federation within FEB. Some 70 percent of Agoria's members are SMEs.

Agoria has more than 200 employees. They work at members' homes or offices in Brussels, Antwerp, Liege, Ghent and Charleroi. In the first three cities, Agoria has its own BluePoint business center and a Tech.Lounge.

Agoria's services and positions focus on digitalization, the manufacturing industry of tomorrow, talent management policy and training, market developments, regulation, infrastructure, climate, environment and energy. Agoria aims to connect all those inspired by technology and innovation, increase business success and shape a sustainable future. Through its Agoria Techlancers initiative, Agoria also offers a range of services to freelancers.

Through "Be The Change", Agoria focuses on the future of the labor market, via "Factory of the Future" on the strengths of our manufacturing industry and with "DigiCoach" on the further digitalization of individuals and organizations. Agoria has both a research center and an innovation center and is active at all policy levels. Bart Steukers is the CEO of Agoria. Agoria has existed since 1946.

CONTACTS

William Schoofs
Expert Financial Services
+32 2 706 79 54
william.schoofs@agoria.be

Patrick Van Hoye
Expert Financial Services
+32 2 706 78 08
patrick.vanhoye@agoria.be

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