Business Management Advisory

For Precision Custom Manufacturers

IN06 **File: INSURANCE**

SAFEGUARDING PROFITS THROUGH CREDIT (BAD DEBT) INSURANCE

SUMMARY

This BMA covers a method of guaranteeing that profits will not be wiped out by excessive bad debt losses. Specific details on the advantages of credit insurance vs. the costs of having this type of profit protection should be obtained from a qualified commercial finance company.

No matter what size your operation may be, large or small-the end result by which you judge yourselves is the amount of profit resulting from all your planning and performance. Profit is the yardstick by which good management is judged.

Insurance plays an important part in sound planning. The protection of the value of your assets is vital, if you are to reach your profit goal.

The insuring of buildings, machinery, parts and inventory is familiar to everyone. While you own your product, you can protect it through several types of insurance. But what happens when you ship the finished product to your customer? You no longer own it because you have passed to that customer the title to the product- you no longer have an insurable interest in the product itself. In its place, you now have an account receivable at a price which includes your profit.

You can still protect your investment through Credit Insurance, a type of protection that should be more generally understood.

A GUARANTEE OF ACCOUNTS RECEIVABLE

Credit Insurance is a guarantee of your working capital invested in accounts receivable.

Your invoices are guaranteed on a percentage basis, up to 100%, depending on the credit standing of your customer at the date you pass title through shipment.

Mercantile agency ratings are used to establish this credit standing, and Dun & Bradstreet, Inc. is the one most generally used. For the smaller company, there is a policy which gives a flat, open amount of coverage on each debtor regardless of standing (no ratings are used), but coverage under this form is usually a flat 75% of invoices.

INSURANCE COVERS MOST OF LOSS

Loss payments to you are on an excess basis; that is, you take an amount of loss yourself (a percentage of your annual sales, with stated minimum) and the insurance company pays the losses over this amount. For example: A sales volume of $1,000,000 for a tool and die manufacturer carries with it a deductible (known as Primary Loss) of $2,850. This is 28.5/100ths of 1% of that sales volume.

Let us assume three bad debts in one year:

	Amount Receivable	Insurance Coverage	Net Allowed
Account A	$3,000	90%	$2,700
Account B	5,000	90%	$4,500
Account C	700	80%	560
TOTAL	$8,700		$7,760
Less deductible		(Primary Loss)	2,850
You receive from the insurance company			$4,910

The insuring company takes as assignment the full amount of the claim (in our example the total amounts to $8,700)-but only as their interests appear. For example, Account "A" is covered for 90%. You have an interest equal to 10% of all amounts collected from "A", and if the unusual should happen and the entire $3,006 is finally collected, you get an additional $300, less any fees which might be involved because of collection procedure. The same apportioning applies to all other amounts collected from the other accounts, after adjustment is made.

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"BACK COVERAGE" OR "FORWARD COVERAGE"

There are two broad types of policies written. One is known as Back Coverage, the other as Forward Coverage.

Back Coverage picks up the current accounts on your books when the policy starts, and pays you for losses occurring in the twelve-month policy period. Past due accounts need not be filed for collection. Forward Coverage policies do not pick up any accounts already on your books, but start protection from the day the policy is put into effect. Sales are covered for a twelve-month period, then after the Sales Period, an added length of time is allowed for filing claims. The filing of past due accounts is compulsory under Forward Coverage policies.

LOSSES MAY BE OF TWO TYPES

What constitutes a loss under a Credit Insurance policy? There are two general situations:

1. Whenever an account is filed for collection before it is more than 3 months past due, under the original terms of sale, it is a claim against the policy; and the policy-holder will be reimbursed in accordance with the terms of his or her policy.

The sooner the insurance company's collection department can begin work, the better the chances of success. Therefore, to encourage early filing, any account filed before it is 3 months overdue is immediately classified as a claim.

ACCOUNTS OF INSOLVENT DEBTOR IN CLASS II

2. In case an account is not filed for collection until it is more than 3 months past due, it is not classed as a claim until one of the following types of insolvency occurs:

- A debtor shall have absconded.
- A sole debtor shall have died.
- A sole debtor shall have been adjudged insane.
- A receiver shall have been appointed for a debtor.
- The stock-in-trade of a debtor shall have been sold under the Bulk Sales Act.
- The business of a debtor shall have been sold under a writ of attachment or execution, or the writ of execution returned unsatisfied.
- A debtor shall have made a general offer of compromise to creditors for less than the amount of indebtedness.
- Possession shall have been taken under a chattel mortgage given by a debtor on stock-in-trade.
- A debtor's business shall have been assigned to or taken over by a Creditors' Committee for the sole purpose of liquidation.
- Possession shall have been taken of a debtor's assets under an assignment or deed of trust executed by the debtor for the benefit of creditors.
- A voluntary or involuntary proceeding shall have been instituted to adjudge a debtor bankrupt.
- A proceeding for an arrangement of the debts of a debtor shall have been instituted in a Court of Bankruptcy.

The metalworking manufacturer may continue his or her own efforts to collect as long as wished-up to the time of filing the account or the insolvency of the debtor. But once the account is turned over to the insurance company, it alone may try to collect.

SPECIAL TOOLING INVOLVES AN ADDED RISK

The tooling and machining industry has an added risk which is not found in most other lines. You have what the insurance companies call "specially purchased and/or processed merchandise." It is possible for your customer to become insolvent while you are still working on the order. If you are making, for example, a special die, fixture or mold, and your customer becomes insolvent, the special tooling is worthless, except for its scrap value.

Through an arrangement with the insurance company, this risk can be included in the policy. The amount to be included is the amount you can prove against the debtor's estate. You should always be careful to allocate costs against each contract, and in this way your proof against the debtor's estate becomes that much easier.

A GUARANTEE AGAINST LOSS OF PROFITS

What Credit insurance does for you is to provide a guarantee that profits, if they otherwise exist, will not be wiped out through excessive bad debt losses.

The insuring company offers nationwide facilities for handling claims and collecting past due accounts, and in addition, one company has an office in Canada.

Credit Insurance is being used by many companies as an integral part of sound business management. The old adage is true here, too:

It is better to have insurance and not need it, than to need it and not have it.

This BMA was reviewed by NTMA Staff.