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The Hidden Risks to Accounts Receivable Exposed

Risk is not something that can be avoided by businesses. Therefore, it must be managed to allow the company to take advantage of opportunities, while protecting the assets. In most companies, the position of Risk Manager is a senior position charged with the responsibility of managing the risk to the corporate assets. Unfortunately, often the responsibility only attaches to managing the physical assets and the financial assets are excluded, notwithstanding that the financial assets on the Balance Sheet are, on many Balance Sheets, the largest and the most important assets. They are not fixed, but rather they are the lifeblood of the company. Any threat to these assets can prejudice not only the cash flow, but also the income and net worth of the company. The importance of the financial assets was dramatically demonstrated when the Asset Backed Securities Market froze and resulted in the collapse of Lehman Bros. and forced Governments, around the world, to bail out banks. The result is, the new International Financial Reporting Standards, IFRS and revisions to accounting standards in Canada, EIC 173, both address the importance of correctly representing the fair value of financial assets on the Balance Sheet.

Accounts Receivable is one of the most important financial assets. The Accounts

Receivable grows as the sales grow. Accounts Receivable must be collected on a timely basis to support the cash flow of the company. Accounts Receivable support a large part of the working capital financing and any slow down in collecting Accounts Receivable or the write-off of a major account, or a block of smaller accounts, can impair the company's cash flow and access to working capital financing. All too often investors and credit granting agencies, including trade creditors, don't know the fair value of one of the largest assets on the Balance Sheet. The new rules should ameliorate the problem.

The Chief Financial Officer, the Audit Committee Member, the Treasurer and the Credit Manager will now have to manage the Accounts Receivable asset better because if it is not managed properly, the fair value of the asset will be eroded and the erosion will have to be reported and the net worth of the company will be impacted. It is incumbent upon the financial management of the company to know all of the tools available to manage the risk to the Accounts Receivable and to be pro-active in their management. A well-structured insurance program can be an excellent tool that can transfer risk and help set the true fair market value of the asset.



All or Nothing? Not Anymore.

Ten years ago credit insurance was as flexible as a brick. Companies had to insure their whole portfolio of accounts receivable. The biggest change in the industry is the client's needs now drive how the coverage is structured. The challenge of this advancement is the client must be able to define its requirements and analyze the cost benefits of the option best suited to meeting those needs.

With the introduction of new accounting standards, the implications of correctly assessing the risk and developing the appropriate risk management strategies will become more important.

An actual example is on the Balance Sheets of a number of companies today. The buyer is a major Canadian retailer with an S&P rating of BBB. Over the years the exposure to this buyer has grown exponentially because of acquisitions by both the supplier and the buyer. Depending on the company and the time of year, the exposure can range from \$1.0 million to over \$20.0 million. If this buyer is downgraded or becomes overdue on its payments, what information will have to be provided to the suppliers' shareholders or what provisions would have to be established?

Obviously, this is one receivable that must be managed. Again it is not an "all or nothing" situation, the company needs only to look at transferring the exposure above its comfort level or by insuring the whole risk with a well rated credit insurer, enhance the credit rating of the asset. Coverage with some underwriters can now be locked in on a non-cancelable basis for the life of the policy. Therefore, if the account is downgraded or becomes overdue, it maintains the rating of the underwriter for a year.

In many cases that are presented to the underwriters for coverage, the shareholders would be amazed at the level of risk they are carrying on one of the major assets on the Balance Sheet and if one uses the probability of default associated with the credit rating, the high degree of probability of a default occurring.

The Millennium CreditRisk Management approach to Credit Insurance is not to sell a product, but to act as an expert in helping companies structure Risk Management programs to meet their needs and return tangible cost benefits.



Double Dip or No Double Dip? That is the Question

From the perspective of credit risk or political risk, the answer is irrelevant. Whether GDP growth is negative for the next quarters or just very weak, credit risk will be high as the fundamentals of many economies are poor.

The strength of the recovery depends on the consumer's habits:

1. consumer spending drives the world economy, with the US consumer leading the way;
2. consumer spending depends on consumer confidence; and
3. consumer confidence depends on the consumer's perception: of the individuals' wealth as represented by real estate and investments; the dependability of the family's income source, from employment salary, social insurance and pensions; and the availability of easy credit.

When credit managers are assessing the credit risk to determine if losses will be more frequent or the consequences of losses will be more serious, the daily press should keep them awake at night.

- ◆ The USA economy is still suffering from the collapse of the housing market and 8 million jobs lost since 2007. 625,000 people left the labour force in June. This year, 908,000 individuals filed for bankruptcy in the USA.
- ◆ In Canada, the Bank of Canada dropped its growth forecasts for the remainder of 2010 and 2011.
- ◆ Sovereign debt is a major concern of economists. It not only affects the European PIIGS, but also a large number of States in the USA. Growth will not eliminate the deficits. Programs will need to be cut and taxes will need to be raised.
- ◆ Seven of 91 banks in Europe failed the Stress Test. If Government Bond prices dropped, they would not have sufficient capital. These banks will have to raise capital and the other problem is inter-bank lending is becoming more restricted.
- ◆ S&P has indicated that over \$1.8 trillion in debt will have to be refinanced in the coming years by publicly traded companies. Recent reviews of some Canadian companies with lower rated debt, which has been recently refinanced, shows material increases in the interest rates.

The financial executives of both privately held and publically traded companies will have to assess the fair value of the accounts receivable and how to protect against the downside risk.

IFRS & The Private Company

David Milstead in his column in the *Report on Business* was clear in that most private companies will not be adopting the new International Financial Reporting Standards because of the requirements for additional reporting and monitoring. The only companies that really need to be concerned are subsidiaries of publicly traded companies or companies planning an Initial Public Offering.

However, he referred to "GAAP Light", which with the introduction of greater emphasis on the Financial Assets on the Balance Sheet under EIC 173, will require more disclosure of the fair value of assets, such as Accounts Receivable.

Notwithstanding that private companies won't have to adopt IFRS, they will be responsible for advising stakeholders of the fair value of the assets and any threats to them

The Insurance Market

Jason Myers, President of the Canadian Manufacturers and Exporters, was recently quoted in the *Report on Business* as saying the conditions today are very similar to those that existed in 2007 just prior to the recession. Payments are being extended and orders are being cancelled.

Unfortunately, the market for credit insurance also appears to be similar to 2007. The insurers are again seeking to put new business on the books at premium rates well below the normal guidelines.

In 2007, Millennium raised its concern about the aggressive underwriting and what would happen if the economy slowed. The embarrassing part is the prediction was correct. As losses rose, the underwriters had to reduce their higher risk exposure by canceling or reducing many credit limits.

Again it must be asked, is this the proper environment to be aggressively seeking new business by offering low rates? Will they be able to maintain the coverage if losses again begin to mount?



Ask Ron

If you were buying credit insurance to protect against write-offs of Accounts Receivable, what would you consider?

I ask myself that question and even more directly, would I buy credit insurance? The answer is "yes", but a qualified "yes".

I would analyze my A/R and identify my comfort level on an individual account basis and an aggregate exposure basis.

Once I had determined how much risk I wished to retain and how much risk I would like to transfer. I would consult with my professional broker at Millennium to see the best program structure to meet the goal set out in item 1.

Once we had agreed, I would have Millennium approach the insurance markets for terms.

When the terms were received, I would sit down with Millennium to evaluate the various options.

The points of analysis would be cost, coverage and the dependability of the coverage.

The benefit to also consider would be potential incremental sales, reduced administrative costs, better margining and improved financial planning & reporting.

One cannot guard against every risk, but one can have a plan to manage the risks and to put a "stop loss" on any write-offs.

ICBA Briefs – Sovereign Risk, is it Contagious?

Millennium is the Canadian member for the International Credit Brokers Alliance ([ICBA](#)).

Millennium's Ron Doyle and Mark Attley regularly contribute to the ICBA blog.

Ron has recently posted the first of a series of 3 blogs addressing the specific area of Political Risk. The blog can be found [here](#).