

# Outlook

Issue 10-03

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## The Global Economy and Credit Risk

Countries around the world, with the possible exceptions of China, India and Brazil, are facing serious fiscal problems. The major elephant in the room is the USA which is Canada's largest export market. Recent articles in the press report the more than trillion dollar deficit facing the USA Federal Government is understated because of the large deficits in many major states. The Federal Reserve is almost out of options and is now looking at the second round of Quantitative Easing which is really just another way of increasing the money supply. This action will put further pressure on the US dollar which may mean a higher Canadian dollar.

Detailed analysis of the global economy is not necessary because unless the USA can solve its problems, any recovery in the global economy will be very slow. Canada is perhaps the most vulnerable as it is so dependent on exports to the USA. The risk is measures taken to reduce the US Current Account Deficit may have very protectionist overtones.

In an article in the Report on Business on October 27, 2010, by Tavia Grant and Bertrand Marotte, Peter Hall, Chief Economist of Export

Development Canada, forecasts that the Canadian dollar will remain high and that export growth will likely slow to 6% next year compared to 11% this year. This theory is consistent with the outlook for overall world trade slowing.

How does the slowing of trade directly affect credit risk? It is simple. Credit managers will have to identify those companies in their buyer portfolio that are heavily dependent upon exports and factor in the impact of lower export sales. Countries are using all methods available to attempt to increase exports. For example, the serious discussion taking place to attempt to head off an international exchange crisis as countries lower their currency to become more competitive in world markets. The downside of such measures is world trade may be impeded, further increasing the impact on export dependent companies.

For assessing creditworthiness, the current economy is a nightmare. Will the economy struggle forward towards recovery or will there be a complete meltdown? In either case, both of which are bad, how will the buyers be affected?



## How Does the Value of a Currency Relate to Credit Risk?

If the value of the Canadian dollar increases against the US dollar, it makes the cost of Canadian goods to US buyers higher, thus putting the Canadian exporter at a disadvantage. Conversely, the lower US dollar makes US exports cheaper and more competitive. From a credit perspective, the Canadian exporter is likely a higher risk and the US exporter is a lower risk.

In looking at importers, if the value of the local currency declines, the price of the imported goods increases in terms of the local currency and unless the importer can pass the increases along to its buyers, its financial condition will deteriorate.

The major risk in this area is a devaluation of the local currency between the time the order is placed and the time the payment is due. As we have seen in Mexico in the last 2 years, a similar situation caused a spike in the payment defaults. If the devaluation occurs before delivery of the goods, the risks of repudiation or non-acceptance of the goods increase substantially.

## The Market for Credit Insurance

Ironically, the international credit insurers are starting to revert to their previous practice of offering exceptionally low rates. Whereas the average premium rate has traditionally been in the area of 50 basis points, today we are routinely seeing premium rates in the range of 10 to 30 basis points. These rates are appropriate for larger companies with exceptional credit and collection procedures, but in today's credit environment these rates are too low for the risks covered and the underwriters will again learn the lesson they seem to have missed in 2007.

The other major factor in today's credit insurance market is capacity. Out of the 6 private sector insurance companies, 3 appear to have capacity available and are operating normally, however the other 3 either do not have capacity on individual buyers or they are very careful as to the sectors in which they will provide offers.

As companies move forward on the planning for the implementation of International Financial Reporting Standards, capacity to cover the exposures on larger buyers will become more problematic.

# Ignorance or Negligence are Not Covered By Credit Insurance

If you leave a cigarette on the couch and the house burns down, you are covered by fire insurance, unless you have a non-smokers policy. If you are driving too fast on an icy road and you write off your car, you are covered by auto insurance. However credit insurance is not the same. If the insured causes the loss or fails to mitigate the loss, the claim would be excluded. Therefore, the holder of a credit insurance policy has the responsibility to act in a manner consistent with the norms of good credit management.

1. It is critical to establish an obligation of the buyer to pay through a legal and enforceable contract of sale. In most cases, the contract is evidenced by a Purchase Order and Invoice. In today's environment and specifically in some industries, the order is often received over the telephone. In such cases, it is critical for the insured to either receive a copy of the Purchase Order or to send an Order Acknowledgement setting out the terms of the contract for signature. If the insured cannot demonstrate that the buyer has a legal obligation to pay, the insurer will deny the claim.
2. The insured must establish the buyer is creditworthy prior to shipment, either by obtaining a written credit approval under the terms of the policy or by using their discretionary credit authority delegated in their policy.
3. Even if the buyer credit has been approved and it is in place, the insured must take all necessary action to prevent or minimize the loss. For example, an insured cannot continue to ship to a buyer that is seriously overdue, even if there is an approval from the underwriter in place. Several underwriters in the market now offer policies with non-cancelable credit limits. It is particularly important on these policies that the insured act as if it is taking the risk and follow its established and approved Credit and Collection Procedures rigorously.
4. The insured cannot give any concessions to the buyer or agree any changes in the contract payment terms which would prejudice the insurer's right to collect or take action against the buyer. The most common situation is the insured will agree to a Payment Plan with the buyer to pay an overdue balance without obtaining the prior approval of the insurer.
5. The insured must always advise the insurer of any event likely to result in a loss.

## The List of 5 Credit Analysis Limitations

1. Credit information by its very nature is at least 3 to 6 months out of date.
2. Credit information is often incorrect. Some is absolute garbage.
3. Payment history in Credit Reports only shows the suppliers reporting. For larger companies, only second or third level suppliers are reporting. The major suppliers are not shown, so the experience doesn't reflect the payment experience for orders of the magnitude being supplied.
4. Transparency in Financial Statements has been a problem as the true value of assets or any impairment of the assets may not be shown. Think of Enron, Merrill Lynch or Northern Telecom or a number of companies that had to go back and revise the Financial Statements of prior years to reflect the true picture. This exercise is usually done just before filing for bankruptcy. The new financial reporting standards may bring some surprises in 2011 as companies have to adjust for impaired assets.
5. Very few Financial Statements make reference to the political risks impacting the realizable value of the assets. While companies often refer to the risk of foreign exchange fluctuations, they don't address the consequences of a potential moratorium on payments or the need to write-off an asset held in a foreign country.

## IFRS, Credit Insurance and Reporting

2011 will bring the first requirement for publicly traded companies to issue Financial Statements under the International Financial Reporting Standards, IFRS. Canadian companies have been preparing for this eventuality for over a year and many of the Financial Statements published in 2010 reflected the changes that would be necessary.

Some Companies have included a Matrix in the Quarterly Reports showing the effects on the information due to the changes. These changes affect several areas of the Report, but for our purposes, the focus will be on the changes necessary to report the Fair Value of the Accounts Receivable.

From a review of the Financial Statements published towards the end of 2010, the major enhancements introduced to better reflect the Fair Value of the Accounts Receivable are:

1. Any impaired receivables are identified and are included in the Provision for Doubtful Accounts;
2. The Aging of the Accounts Receivable is shown;
3. Any concentration of receivables is indicated; and
4. The calculation to arrive at the Provision for Doubtful Accounts is shown.

An observed weakness in the calculation of many of the Provisions for Doubtful Accounts is the companies have only provisioned for the accounts that are actually impaired and will have to be written-off. The Provision often doesn't make any allowances for accounts that may be seriously overdue. In some cases, the receivables were more than 90 days past the due date which would bring their collectability into question. If the Provision for Doubtful Accounts is inadequate and cannot absorb the amounts required to be written-off, the write off would likely have to be against Equity unless the receivables were generated in the current period, in which case the write-off would be against *income for the period*.

Companies always have a Note in the Financial Statements addressing Credit Risk in which the risk is explained and any mitigating factors, such as, spread of risk or credit insurance, are noted. When companies have impaired accounts or seriously overdue accounts, a note that the impaired or overdue accounts are credit insured by a well rated insurer may give the Financial Management of the company comfort in reporting that the possible write-off is confirmed as covered or is likely covered by credit insurance.

## ICBA Newsletter

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

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