Bad debts can be hidden in your organisation for years and only come to light when it is too late. But maybe a risk management bomb squad could get you out of trouble. Deborah Johnston explains

DEFUSING YOUR FINANCIAL RISKS

The rise in corporate collapses and reporting requirements has made financial risk a burning issue for most organisations. Risk managers are extremely concerned that a financial time bomb could be hidden somewhere in their organisation.

Ansett, Enron, Harris Scarfe, Worldcom, HIH, One.Tel, Pan Pharmaceuticals are daily reminders to us all of how volatile business is these days. The need for professional risk identification, analysis and minimisation has never been greater.

By addressing one of your most complex and vital areas of risk within your business, ie. your trade credit exposure, you can identify your company's financial risks and work towards significantly minimising, or even defusing them altogether. A well-structured credit insurance program, along with a rigorous credit risk management system, is a sure way of securing your debtor ledger, probably one of the largest assets on your balance sheet. The vast majority of businesses do not have any reservations about insuring their assets such as their property, inventory or plant and equipment, yet many do not insure their debtors' ledger – a surprising thought when, at the end of the day, the most important aspect of any business is to protect its bottom line and to prevent its profits going up in smoke.

Often a bad debt can occur without any warning signals whatsoever and the unexpected and unpredictable demise of a customer can be a huge strain to a company. If your largest customer were to become insolvent, how would this affect your business and balance sheet? For example, a company operating on a 10% profit margin, a debt of $50,000 would require extra sales to the value of $500,000.

A bad debt is similar to a financial time bomb and can easily be hidden out of sight. If it isn't handled with care and without sound risk management, its impact can be devastating to your business. So why else should you consider

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using credit insurance? How will it assist you in avoiding or minimising potential disasters to your business? The following points will give you some indication of why credit insurance and credit risk management are vital financial risk tools for your business and how they can help you defuse potential financial risk disasters before they occur:

- Preserve your profit – as mentioned previously, credit insurance and credit risk management protects and reinforces your balance sheet from the risk of bad debts. On average about 40% of a company's assets are from the debtors' ledger – a significant part of your business that should be protected.
- Protects your liquidity and cashflow – apart from the long term loss of a customer and future revenue streams, there is the short term effect on cashflow and the immediate loss of profit, which in the very worst case scenario can lead to your own business failing.

If you had the choice of receiving a cheque for the value of up to 90% of your bad debt(s) from your credit insurer on confirmation of debt or you had to wait until the administrator of your insolvent customer had completed their investigations and recoveries for you to receive possibly a few cents in the dollar, which would you rather have? Wouldn't you rather have the option of immediate cashflow into your business?

- Confidence to expand – if you feel safe in the knowledge that any costs of potential failures of your customers are already covered, it stands to reason that you can grow your business in confidence. You can also be more aggressive in your sales and marketing by extending higher and longer credit terms with your customers.
- Strengthens your credit management – whether you trade with customers locally or internationally, your customers' status can be affected by many internal or external factors that in many cases are unknown to you. Even if you have effective, stringent, credit control procedures in place, you could further enhance the quality of decisions made on credit limits through working closely with an insurer and gaining access to their huge knowledge database. Wouldn't it be great to be able to focus on other areas of your business? You can spend less time worrying about venturing into new markets or territories and be 'in- the-know' about the customers you are dealing with.

Whichever way your company's credit management is structured, a credit insurance policy can tailor arrangements that are centralised or decentralised across a group. For example, for a captive and its group subsidiaries, this means the credit risk management and reporting requirements can be satisfied.

Credit management administration and reporting lines can be co-ordinated and centralised throughout a company's group structure from head office so that a consistent external discipline is supporting all the credit management functions.

Alternatively, it can be decentralised and localised to suit the needs of each subsidiary, which is a huge benefit if your business operates worldwide and requires more flexibility.

- Adds security – by protecting your debtors' ledger you can access more efficient financing via bankers. The majority of Australian and New Zealand banks recognise credit insurance as collateral security when providing financing for local or overseas sales. Not only will your bank recognise the additional security in a credit insurance policy, but your shareholders can appreciate that their assets are being well-protected and their financial corporate obligations are being met or, at least, contributed towards.

There are several types of credit insurance covers for your debtors' ledger. The kind of cover required often depends on the size of your business, your sales turnover and diversity and spread of your customers. The following are the main types of insurance policies currently available.

- whole of turnover policy covers all your debtors and may have varying levels of cover by way of deductibles and indemnity
- specific account policy covers specific accounts or debtors
- principal accounts (major debtor) policy covers the bulk of your accounts or debtors that represent a large proportion of the value of your business, and
- catastrophe policy covers unforeseen substantial losses, ie. if you prefer to absorb moderate levels of bad debts but not unexpected larger debts.

The premiums involved vary and depend on factors such as the type of policy chosen, the level of turnover insured, the level of deductibles, the quality of debtors and also claims history. It is a common misconception that credit insurance is seen as too expensive – costs are typically between 0.2% and 0.5% of a company's annual sales turnover.

The ultimate aim of a proactive risk management team and their insurer could be likened to a bomb squad – identify where the threat is located, assess the situation and defuse it. ■

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