How CFOs are managing the largest asset on their balance sheet

The word “insurance” makes most people think of protection from financial loss. But while accounts receivable (A/R) insurance does that, creative CFOs see it even more as a cost-effective tool to help maintain a strong balance sheet, increase their borrowing capacity to expand sales and increase profits.

Many CFOs are not yet fully aware of A/R insurance’s multiple uses, however, and accounting professionals are ideally suited to bring it to their attention.

Considering that accounts receivable often is a company’s largest asset, the power of A/R insurance can be substantial. In addition to simply bringing it to the attention of CFOs not familiar with it, accounting professionals also can help clients that already use A/R insurance to ensure they are getting the most bang for their buck.

The opportunity is particularly strong today at a time when mergers and consolidation in many industries are resulting in companies having fewer distinct corporate customers to spread their credit risk over.

Benefits of A/R Insurance
The list of potential benefits of A/R insurance is long. Here are the most important. Purchasers of A/R insurance can:

- Increase sales to existing customers, and sell to new ones,
- Expand their global reach into new markets,
- Improve cash flow and liquidity,
- Eliminate the prospect of violating loan covenants for A/R-based credit,
- Strengthen the balance sheet, and, ultimately,
- Increase profitability
- Maintain or reduce the allowance for bad debt expense
- Getting a better bank deal with a higher advance rate

As its name indicates, A/R insurance indemnifies policyholders from loss due to nonpayment for products sold and services rendered. The coverage is available to large companies and small. (AIG, for example, issues policies covering sales anywhere from $5 million to $100 billion.) A/R insurance, in fact, is a tool that can help small enterprises to become large.

One AIG A/R insurance policyholder of long standing began using credit insurance when its revenues were $8 million. After 25 years, its revenues had grown tenfold, to $80 million.

“Hedging our credit risk has been an important part of our ability to grow,” the company’s CFO told Glenn Robins, a Los Angeles-based AIG executive who focuses on A/R coverage.

“Our bank loves the fact that our receivables are insured. Because of this we have been able to negotiate a larger advance rate on our receivables and a lower interest rate on our loan,” the CFO added.

Additionally, since part of a CPA’s job is to consult with the CFO on business solutions A/R insurance provides a CPA with an opportunity to help his client grow safely.

Increasing Working Capital
Having receivables secured by A/R insurance typically will increase the proportion of receivables a bank is willing to finance from 80% to 90%. That means, for example, that a company with $5 million in receivables would be able to borrow nearly $500,000 more than it could without A/R insurance.
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While there is no “free lunch,” annual premiums for A/R coverage are affordable, typically hovering around $1 per $1,000 on domestic sales, and $1.50 for exports sales. In the example above, for domestic sales, for the $45,000 cost of a premium of insuring $5 million in receivables, the insured was able to secure an additional $500,000 in funds that can be put to productive use immediately, instead of a month or two later when payments came in.

One productive use of those additional funds is simply enabling more sales. “The companies who we have covered with A/R insurance have averaged an 18% annual increase in credit exposure,” says Robins.

Burden of risk management

Purchasing trade credit insurance not only out-sources insuring the risk, but a good part of the risk management function. The following burdens go with the territory of self-insuring:

- Companies must allocate resources to a bad debt reserve fund,
- Maintaining a credit management team and the data and analytical resources it needs, and
- The cost of specialized accounting systems.

With A/R insurance, the insured expands their credit terms to include underwriting and economics to assess the credit worthiness of a customer. The coverage extends to non-financial events such as fire or natural disaster, which could impair a customer’s ability to pay its bills.

Teamwork

In performing that function, however, a good A/R carrier will work hand-in-hand with its clients. The financial hazard involved in extending credit to some potential customers, and the attendant insurance cost, can lead to a decision to use an alternative payment arrangement, such as a letter or credit. “My job is to be a financial collaborator and help our clients find the value where it pays for itself,” says Robins.

If the ever-present risk of nonpayment turns into a reality, the back-stop of A/R insurance shields policyholders from the impact. However, as with any other kind of coverage, not all A/R contracts are created equally. One of the biggest distinctions is between cancellable and non-cancellable contracts.

Some policies can be cancelled based on particular events that affect a buyer’s creditworthiness. “Be sure you understand exactly when you are covered, and when you are not,” Robins cautions.