FCFP 2016 Bad Debt Survey Analysis

FEDERATION of CREDIT and FINANCIAL PROFESSIONALS

EXECUTIVE SUMMARY

A company's Bad Debt results are probably the most visible performance measurement for its Credit Department. A multitude of reasons exist, of course, for why an account is ultimately written off. Circumstances beyond a customer's control is one. Certain companies may also have requirements for generating revenue "at all costs". In between, it is the responsibility of the Credit Professional to determine how to handle these extremes, while recognizing that one cannot spend Accounts Receivable, only cash in the bank. The latter may also involve meeting an asset-based lender's parameters. In other words, managing Bad Debt is not an easy task. What follows are the results of a voluntary survey conducted by the Federation of Credit & Financial Professionals during the month of February.

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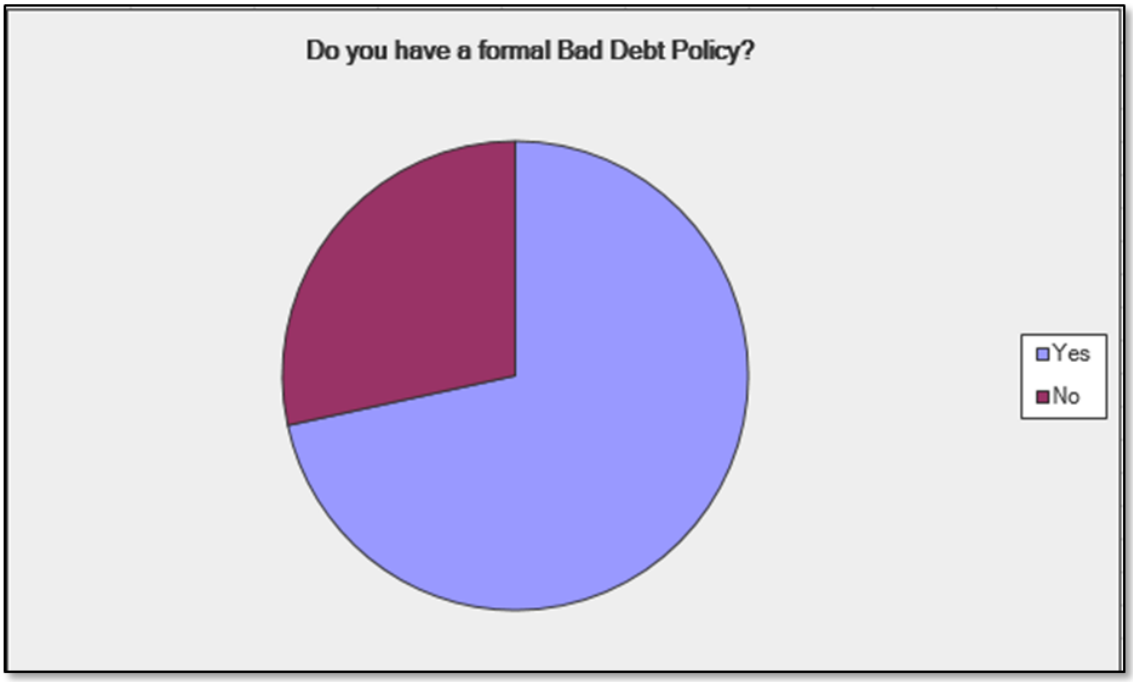
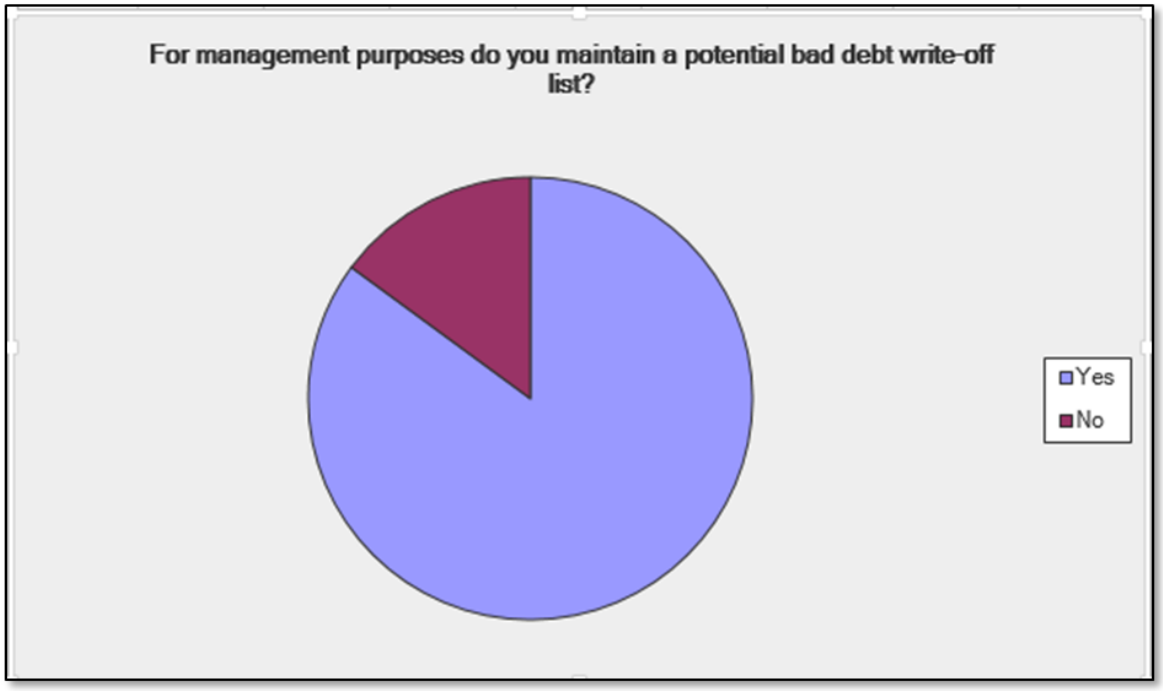
Question One: First of all, of 155 survey participants, 111, or nearly 72%, have a formal policy in place:

Do you have a formal Bad Debt Policy?		
Answer Options	**Response Percent**	**Response Count**
Yes	71.6%	111
No	28.4%	44
	answered question	**155**
	skipped question	**0**



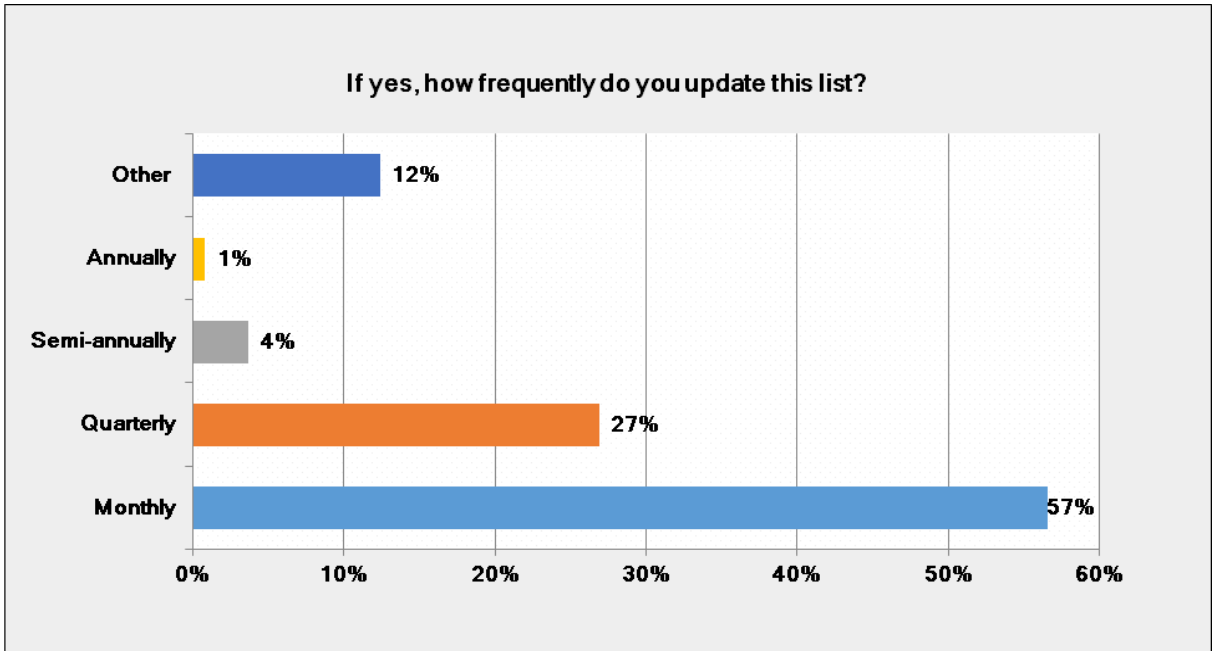
Question Two: As for reporting potential write-offs to management, of 154 respondents, 85% keep a list. That statistic tells us that some Credit Departments report the potential for a specific Bad Debt, without necessarily having an overall written policy for managing that potential.

For management purposes do you maintain a potential bad debt write-off list?		
Answer Options	**Response Percent**	**Response Count**
Yes	85.1%	131
No	14.9%	23
	answered question	**154**
	skipped question	**1**



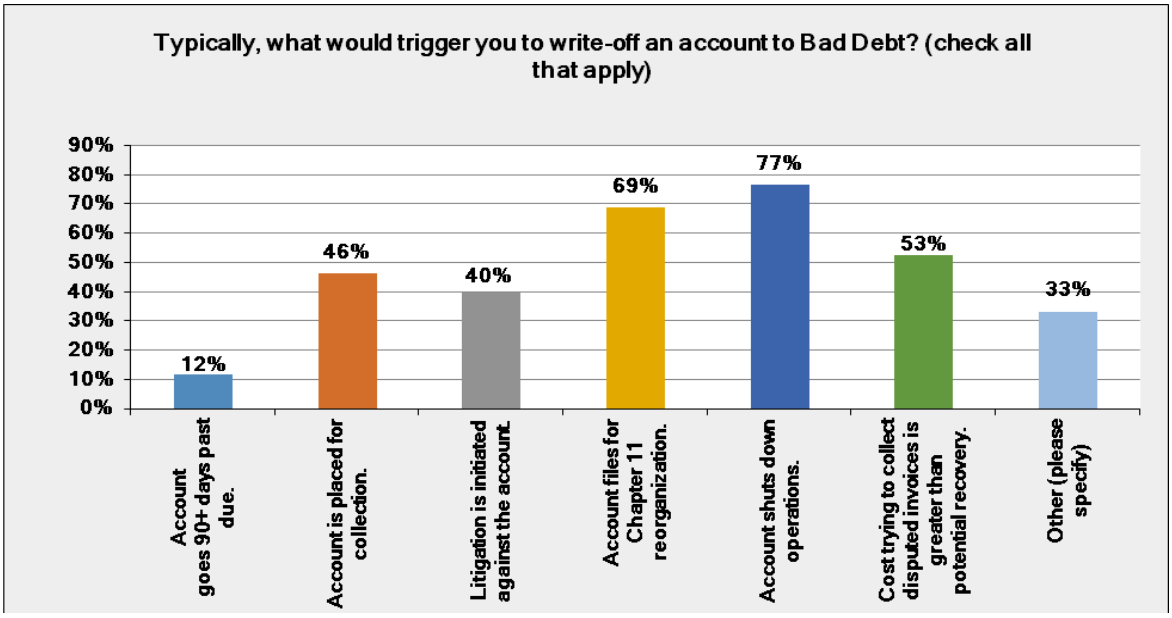
Question Three: Of the original 155 respondents, only 138 answered this. The majority of them keep the list updated on a monthly or quarterly basis. An assumption here may be that the actual write-offs are done on a similar schedule, and it is important to keep management informed about what is coming. Some companies do not actually do Bad Debt adjustments that often. Many of those that do frequent adjustments may also make some sort of adjustment to a sales commissions and so forth. Publicly-held firms will also have stricter reporting requirements than some, but not all, privately-owned ones.

If yes, how frequently do you update this list?		
Answer Options	**Response Percent**	**Response Count**
Monthly	56.5%	78
Quarterly	26.8%	37
Semi-annually	3.6%	5
Annually	0.7%	1
Other (please specify)	12.3%	17
	answered question	**138**
	skipped question	**17**



Question Four: At some point, regardless of overall Credit Policies or forecasts, the actual adjustment to AR must be done. The more obvious cases of Bankruptcy and business closings trigger the majority of people to do so. Almost 12% and nearly half do so when specific milestones are reached, such as rolling 90 days or being placed for collection. Almost 40% wait until an actual lawsuit is filed. The significance in these cases is that there is still the possibility that the ultimate collection of some money is there, whether through Personal Guaranties or a reorganization plan through the bankruptcy court.

Typically, what would trigger you to write-off an account to Bad Debt? (check all that apply)		
Answer Options	**Response Percent**	**Response Count**
Account goes 90+ days past due.	11.7%	18
Account is placed for collection.	46.1%	71
Litigation is initiated against the account.	39.6%	61
Account files for Chapter 11 reorganization.	68.8%	106
Account shuts down operations.	76.6%	118
Cost associated with trying to collect skipped or	52.6%	81
Other (please specify)	33.1%	51
	answered question	**154**
	skipped question	**1**



Note that 1/3 of the respondents specified “Other” triggers. Without listing all of them word for word, a majority said that they do the adjustment when the account balance is considered to be uncollectible, particularly if a third party said that all efforts were exhausted. A few mentioned the extreme age of a balance vs. the amount of effort expended to date, without results.

In the end, the reason is a judgment call, unless a specific court decision or other absolute legal principle is involved. The factors involved in the call are very complex, and that requires continuing education. For instance, is Chapter 11, even 7, always the end? What about Chapter 13? What kind of security option is fitting for your industry? Consider this often-overlooked issue; what is required to recover from a write-off? The answer is an exponential increase in sales revenue, beyond what may be budgeted for by the company and its sales force. On the one hand, every dollar written off reduces the Net Profit for that year by exactly one dollar. For further analysis, Bad Debt, actually any expense, is usually considered as a percentage of sales generated for the same fiscal period. Many people believe that once a year is in the past, it is what it is. To a certain extent, that may be true. However, during that year, everyone worked for a

certain percentage increase in business and profits. Once a profit dollar is lost, to continue with the same relative percentage of growth, additional revenue is needed to offset the profits lost the prior year. It is much more complicated than simply recovering the actual BD dollar. To see the effect, it takes simple algebra and an abstract view of the issue. Let us say that a profit projection of 6.25% actually comes in at 4.0%. To come up with a revenue number to replace a $5,000 reduction in NP, one must use the reciprocal, as in divide the reduction by the NP percentage. The answer to $5,000/.04= $125,000. To do so if the profit percentage was at the budgeted amount, the answer is only $80,000.

What constitutes a good Credit Department BD performance?

Taking into account the multitude of causes for a write-off, it all comes down to what is acceptable to Management. It also relates to overall company performance in revenue, gross profit margins, other expense management issues and so on. There are national statistics, across all industries, which can provide a basis for rating oneself:

1. LOW- .065% of Sales: This may look good to Management as a pure raw number, but it speaks to a very tight Credit Policy; one that reduces potential revenue by declining orders or assigning low credit limits with tight collections.
2. IDEAL- .2% of Sales: This evaluation is based upon a number of abstract analyses that are hard to fit into a paper this size. However, it is likely a consensus of opinions related to rates of return on investments, loan approvals, bank parameters, and so on.
3. GOOD- .3% of Sales: This is also abstract, in that it is reflective of a gentle balance between the demand for a liberal credit extension policy, to increase revenue, and a sound credit management procedures. Yours truly is tempted to say that this is an ideal circumstance intended to please everyone, including Sales and the CFO.
4. HIGH- .5% of Sales: This means it is time to consider looking for another job. It may not kill the company, but it will definitely displease banks and investors, who will then pressure Management for changes.
5. DANGER- 1% of Sales or higher: There is no need to comment further.

Note that these are national averages, across all industries. Specific industries and specific company issues, such as a start-up business vs. a well-established leader is traditionally high profit margin industry, will alter the actual numbers. Also, there may be slight over/ under values that are equally relevant to a given category. Finally, it is important to remember that Credit Management is an art form supported by science.

What can you look for in advance of extending open account credit that may save you later? FCFP is prepared to provide the education, so stay tuned for more. Watch for announcements regarding Webinars, physical presentations and training sessions, plus articles and so forth on federationofcredit.com.

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