How to Handle Bad Debts

There often comes a time when businesses must account for nonpaying customers. This typically means deleting them from the company's books and from regular accounts receivable records by writing off the outstanding receivable as a bad debt.

Because bad debt write offs impact a firm's cash flow and profit margins, credit professionals must use a combination of allowances and write-off guidelines, which must conform with Internal Revenue Service regulations, to handle this process. A firm's general credit policy should include this information.

Some companies establish allowance for bad debt accounts, contra asset accounts, to recognize that write offs are inevitable and to provide management with estimates of potential write offs. In 1986, the IRS repealed the use of the allowance method for tax purposes, taking the position that specific accounts are to be charged off only after they have been identified as uncollectible. Accountants, however, continue to prefer the allowance method, also known as the income statement method, since this method allows for matching bad debt expenses more closely with the time periods in which they were created. General accepted accounting principles rules require the allowance method to be used for external reporting.

Allowances for Bad Debts

Allowances for bad debts or uncollectible accounts accrue for bad-debt write offs in the accounting period that revenues are recorded, thereby matching revenues and expenses. They are contra-assets, reducing current assets (accounts receivable) accordingly on the company's balance sheet. There, offsets give a more accurate picture of the outstanding receivables and provide a clearer picture of the firm's performance.

Establish allowances quarterly or annually, based on past experience as well as on management's willingness to accept a certain level of bad debts, or on recognition that an estimated level of bad debts is inevitable. In some cases, businesses view allowances as a type of budget item, with periodic comparisons providing another form of performance measurement.

You can base allowances on qualitative evaluation of specific accounts and include a percent of total receivables by relating past levels of bad debts to current market and economic conditions. Another method uses third-party credit scores or scores defined and determined internally. Each score is then analyzed to determine how likely a customer is to fail to pay. The technique also helps develop more effective and finely-tuned collection actions and can provide useful estimates of potential bad debt amounts.

Put an account into the allowance category when there is substantial doubt that it will be collected in full and the uncollectible balance can be reasonably estimated. Reasons include legal action, bankruptcy protection, assignment, credit extension agreement (beyond a reasonable period), compromised settlement, or the death or disappearance of the debtor. Often, accounts in the allowance category carry an allowance of 100%. However, if regular payments are being received or if an agreement or

compromise settlement has been reached on an account, the allowance should be less than the total amount due.

Write Offs and Recoveries

A business writes off accounts when there is no probability that it will collect on them and when they comply with IRS regulations regarding bad-debt write off. Some companies don't use allowance accounts; they keep the doubtful accounts in the receivable until such time as they qualify for partial or full write off. Other firms that use an allowance account will write off bad debts from the allowance account when they qualify for full or partial write off according to IRS regulations. The fact that an account is in insolvency proceedings may not be sufficient to make an account completely worthless because partial recovery could occur. But it may not be worthwhile to purse a claim where the recovery expense is greater than the amount to be recovered. Company policy should outline the customer file information for bad debt accounts that needs to be maintained for possible future audits.

The credit function also has an important role in continuing to monitor receivable accounts that have been written off as bad debts. Any income that can be recovered by further follow up of these accounts or from dividend recovery from bankruptcies, for example, can be reinstated as a receivable and as income.

Source: NACM's *Principles of Business Credit*