THE TRUE COST OF BAD DEBT

Bad debt is never a subject that businesses want to discuss. Unfortunately, when you finally decide to write off an uncollectible receivable, do you know what the true cost is to your business? If you answered, "the amount of the invoice," you are not correct. The true total cost includes other critical items often overlooked by many businesses.

Bad Debt Expense = Less Bank Credit = Lower Sales

Accounts receivables are the key component in the borrowing base that determines how much credit a bank will make available to finance working capital. Typically, a bank will lend 80% of your current accounts receivable. However, if you often write off delinquent receivables, a bank is likely to lower the borrowing percentage, 75%, 70% or lower, to account for the fact that many of your receivables never get collected.

Also, the bank only lends against **current** receivables. Once a receivable is delinquent, it is excluded from your borrowing base. When that happens, you must either replace the delinquent receivable with another current receivable or pay down the line of credit, if you are able to do so.

In either case, you have less bank credit to finance your business, which prevents you from accepting larger orders and inhibits your ability to grow and innovate.

Loss on Obsolete or Customized Products

If you decide to stop doing business with a customer because they never pay, you will incur a loss on the sale unless you can find another buyer for your product. If you serve a limited market, or the product is a customized item, it will be even harder to find someone who will buy the product at full value, so your loss is likely to be even higher.

Marketing Expense for Finding New Customers

When you stop sales to the delinquent account, you must offset your lost revenue. Ideally, you can do this by increasing sales to existing customers. If not, you must now make a concerted marketing effort to find a new customer, which will mean new unplanned sales expenses.

Do not let a collectible debt become a write-off, the cost is just too high. Most receivables can be collected if you are diligent, persistent and produce correct invoices.

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Emergent Partners is a management consulting firm specializing in helping companies define and execute operational and financial excellence, devise effective strategies, and align those strategies with actions enabling them to take advantages of opportunities in their markets.

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However, sometimes you simply cannot avoid writing off a bad debt. Whenever that happens, take time to review your credit policy and consider whether it needs to be revised. For example:

- Should you be more aggressive in your collection efforts? If yes, how can you do this without alienating your customers?
- Sadly, some customers will always pay late. What level of slow-paying accounts is acceptable? How many slow payers can you afford to carry?
- Should you tighten your credit standards? Many business owners are afraid to this because they fear losing sales to customers that will object to the new credit terms. Do not make this mistake. Do you really want customers who cannot meet reasonable credit terms?

Think carefully about any planned revisions to your credit policy. Focus on distinguishing non-payers from slow payers, determining when to cancel credit privileges and making sure you are protecting your lien position. Most importantly, review all critical items that make up the whole cost of the bad debt before you declare it a bad debt.

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