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# Is your current bad debt allowance reasonable?

In today's volatile market conditions, it's important to review your accounts receivable ledger and consider writing off stale, uncollectible accounts. The methods that you've used in the past to evaluate bad debts may no longer make sense. Here's how to keep your allowance up to date.

## Know the rules

Under the accrual method of accounting, your company will report accounts receivable on its balance sheet if it extends credit to customers. This asset represents invoices that have been sent to customers but are yet unpaid. Receivables are classified under current assets if a company expects to collect them within a year or the operating cycle, whichever is longer.


Realistically, however, some customers won't pay their invoices. Companies report bad debts using one of these two methods:

1. **Direct write-off method.** Companies that don't follow U.S. Generally Accepted Accounting Principles (GAAP) record write-offs only when a specific account has been deemed uncollectible. This method is prescribed by the federal tax code, plus it's relatively easy and convenient. However, it fails to match bad debt expense to the period's sales. It may also overstate the value of accounts receivable on the balance sheet.

2. **Allowance method.** Companies turn to the allowance method to properly report revenues and the related expenses in the periods that they were earned and incurred. This method conforms to the matching principle under GAAP. The allowance shows up as a contra-asset to offset receivables on the balance sheet and as bad debt expense to offset sales on the income statement.

## Review your estimate

Under the allowance method, a company usually estimates uncollectible accounts as a percentage of sales or total outstanding receivables. Some companies also include allowances for returns, unearned discounts and finance charges.

Companies typically base the allowance on such factors as the age of receivables and bad debt write-offs in prior periods. But it's also critical to consider general economic conditions. Given the current economic stress you may be experiencing, your business might have to update its historical strategies for assessing the collectability of its receivables.

Monitoring changes in your customers' credit risk can help prevent your business from being blindsided by economic distress in your supply chain. If a customer's credit rating falls to an unacceptable level, you might decide to stop extending credit and accept only cash payments. This can help minimize write-offs from a particular customer before they spiral out of control.

## Think like an auditor

Bad debt allowances are subjective and can be difficult to audit, especially during economic downturns. Auditors use several techniques to assess whether the allowance for doubtful accounts appears reasonable. Management can use similar techniques to self-audit the company's allowance.

An obvious place to begin is the company's aging schedule. The older a receivable is, the harder it is to collect. In general, once a receivable is four months overdue, collectability is doubtful. However, that benchmark varies based on the industry, the economy, the company's credit policy and other risk factors.

If your customers have requested extended payment terms, it could cause an increase in older receivables on your company's aging schedule. In this situation, if your company's allowance is based on aging, you may need to consider adjusting your assumptions based on current conditions.

## Consider outside assistance

Businesses are facing unprecedented uncertainty as the end of the calendar year approaches. In fact, a recent survey of audit partners published by the Center for Audit Quality, an affiliate of the AICPA, found that 40% were uncertain about the outlook for their primary industries.

Contact us if you're unsure whether your bad debts allowance is sufficient in today's uncertain marketplace. We can help evaluate your estimate and, if necessary, adjust it based on your company's current circumstances. We'll also explain the tax implications.