



THE CREDIT DEPARTMENT, INC.
SMART BUSINESS. STRATEGIC VALUE.

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“Improving cash flow and earnings through strategic credit management.”

What Is Your Accounts Receivable Worth?

Sounds like an easy question to answer. An accountant would tell you to take the existing receivable balance and subtract your bad debt reserve. We would argue that this estimate may *not* tell you what your receivable is worth.

Why is the accuracy of the value important?

Besides the obvious issue of compliance for public companies, all professionals responsible for managing the asset in private or public companies need to understand the risks to the portfolio for accurate reporting of the value.

Why isn't the current valuation process enough?

The bad debt reserve formula used by most companies has little to do with probable bad debt of the *existing* portfolio and more to do with historical levels based on success and failures of managing the *past* portfolio.

The current evaluation process does make sense where there's little change: either in your customer base or in their credit-worthiness. The reality, however, is that most receivable portfolios are in constant flux; and risk needs to be carefully computed on a regular basis to fully understand the value.

Part of the existing valuation process is to account for receivables aged beyond collectability--generally over 90 days. This is hardly reflective of the total risk to the asset. Too often, companies overlook the probable losses that *will be incurred* from selling to higher risk customers. Unfortunately, those risks are rarely understood.

We also take issue with the practice of using historical bad debt expense in the calculation. Most bad debt

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losses aren't strategic risks taken knowingly. They're MISTAKES made in managing the asset that need to be fixed!

How do I know if the value in our balance sheet is accurate?

Unless you have a high-caliber risk assessment process including tested and accurate scorecards (which few companies possess), you need to work to improve the accuracy of your valuation. Here are some signs that your receivable value may not be what you think:

1. You have no visible credit exposure levels (balances) at customers' corporate level. You aren't sure how customers are related and aren't monitoring activity between subsidiaries, related, and parent companies.
2. You experience bad debts that are "**surprises**" (not planned).
3. Your company can't identify your top credit risks, nor can you name customers that are experiencing deteriorating credit risk quality.
4. Regular credit reviews aren't completed, especially on the high-risk customers.
5. Payments aren't monitored and charted regularly on high-risk customers.

What can be done to better value the asset?

It takes a high skill level and much due diligence to correctly identify and manage risk in the receivables portfolio. Once risk is properly identified, companies should:

1. Have a cohesive credit policy that spells out acceptable levels of risk, requirements for new customers to obtain credit, etc.
2. Assign risk categories (i.e., low, medium, high, very high) to all customers. Bad debt reserves then accurately reflect categories of risk (i.e., 100% of very high risk customers).
3. Forecast bankruptcy risk and payment default probabilities by customer or groups of customers.
4. Tie pricing, terms, and marketing offers to credit risk.
5. Establish bad debt reserves that directly correlate to the existing portfolio.

In our consulting work, we see numerous "ticking time bombs" where losses, and sometimes devastating losses, are inevitable based on current processes. You don't need to wait to suffer a disaster in your portfolio before you do something about it.

It's critical that you work now to accurately reflect the value of the asset. Historical bad debt may or may not reflect the baseline. Your job should be to work on determining the probability of the *existing portfolio's* bad debt and reflect this number in your reporting. Then, you can accurately answer the question: *What is your accounts receivable worth?*

For more information on managing your accounts receivable e-mail us at info@tcd.com or phone us at 800-451-0164.

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