What to Do With Bad Debts On Your Books

The longer you are owed, the less likely you are to be paid.

SUMMARIZE THE MAIN POINTS OF THE ARTICLE IN 10 BULLET POINTS. TYPE YOUR SUMMARY IN EITHER WORD OR POWERPOINT.

In a perfect world, you would be paid for the goods or services that you have provided to a customer or client - each and every time you provide them. Unfortunately, we don't live in such a world and there are times when a receivable is not collected - even after you've attempted to collect the debt. What do you do when you realize that the debt will never be paid? Besides being frustrating, bad debt has serious detrimental consequences for both your cash flow and accounting records. "It is necessary to write off a bad debt when the related customer invoice is considered to be uncollectible," writes Steven Bragg for Accounting Tools. "Otherwise, a business will carry inordinately high accounts receivable balance that overstates a number of outstanding customer invoices that will eventually be converted into cash."

Writing off a bad debt

According to the Accounting Coach, Harold Averkamp, there are two methods for computing the amount of bad debts expense; direct debt write-off and allowance method. The direct write-off method would require a customer's, "uncollectible account be first identified and then removed from the account Accounts Receivable. This method is required for U.S. income taxes and results in a debit to Bad Debts Expense and a credit to Accounts Receivable for the amount that is written off." The allowance method, however, "anticipates that some of the accounts receivable will not be collected. In other words, prior to knowing exactly which customers or clients will not be paying, the company will debit Bad Debts Expense and will credit Allowance for Doubtful Accounts for an estimated, anticipated amount." Averkamp adds that the allowance method is the preferred option since, "1) the balance sheet will be reporting a more realistic amount that will be collected from the company's accounts receivable, and 2) the bad debts expense will be reported on the income statement closer to the time of the related credit sales." However, if you plan on deducting the bad debt, then you must use the direct write-off method. Keep in mind that once you decide that you're going to write-off the debt you need to stop contacting the customer. Once it's in the books, it's gone.

Bad debt tax deduction

Due's Miranda Marquit says that "if you are owed money from a business transaction, and have been unable to collect, you might be able to write it off as a bad debt. The IRS allows you to deduct bad business debts connected with operating your business or trade. This can include such items as credit sales to customers or loans you make to your clients and suppliers." "If the situation reaches the point at which you can no longer expect payment within a reasonable amount of time, you might be able to write it off," says Miranda. "Make sure that the debt truly is related to your business, and you might be able to use it to reduce your business income."

When do you quit trying to collect?

This depends on your client's payment cycle and the payment terms that you've established. However, since only 18 percent of invoices are paid after 90 days, the longer you wait, the less likely you are to ever receive a payment. Ultimately, the best rule of thumb is to trust your gut and know how you worked with the client in the past. For example, if the client has always paid you within 30 days, then it could be a one-time fluke. Reaching out to the client could resolve the bad debt.

Bad debt hurts your bottom line.

Bad debt is expensive. In fact, bad debt costs you more than just the amount of money that you were owed. There are also pricey compensation costs. For instance, if you had $10,000 in write-offs and a profit margin of 5 percent, then you would need an additional $200,000 in sales to compensate for those write-offs.

Preventing bad debt.

Since bad debt hurts your bottom line, you should never give up on collecting a debt and always take the following steps from preventing bad debt in the first place:

- Have the client sign a contract so that they're held liable for paying you for the goods or services that you provided.
- Require a down payment.
- Make invoicing a priority and always send out bills immediately.
- Remind clients of the upcoming due date before the invoice becomes past due.
- Immediately follow-up on late payments. Tools like Due will do this for you automatically.
- Keep the lines of communication open between you and the client.
- Offer incentives for early payment, such as a discount if the bill is paid prior to the due date.
- Don't hesitate to take legal action or hire a collection agency. However, sometimes collection agencies are merely padding their own pockets for their own business -- so be aware and watch the timeframes and amount you are paying collections. It could be a write off becomes the less expensive option.