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It's a Better Mouse Trap

I recently attended a Lunch-And-Learn program sponsored by our credit reporting agency. Their guest speaker spoke about the importance of accurate bad debt forecasting. His presentation described a study he had conducted for the credit reporting agency in which customer ratings were used to establish appropriate bad debt reserves. I was intrigued.

He recommended that every creditor company rate its customers on a scale of 1 to 5, with 1 being the lowest risk and 5 being the highest risk customers. Without repeating the actual formula used to calculate the bad debt reserve, suffice it to say that accounts rated a 5 had significantly higher reserves as a percent of open A/R than low risk customers.

On the drive back to the office, it occurred to me that problem with this process was that the classification of customers into one of the five risk categories was largely arbitrary. Once that became clear to me, the idea of testing this methodology for establishing an appropriate bad debt reserve was abandoned. However, my manager liked the idea. He said our outside auditors would love reviewing the documentation used to calculate the bad debt reserve.

In my experience, bad debt reserves are difficult to calculate and usually incorrect… often grossly inaccurate. I think that the idea of building a better mouse trap is good, but that this was not a winning design.

Michael is a frequent Webinar presenter for WCA, and the author of the Encyclopedia of Credit, a fast, free, searchable online resource for credit professionals: http://www.encyclopediaofcredit.com/. *All Rights Reserved.*