CRF Bad Debt Recovery Survey Analysis

By: Al Carmenini

Abstract

Ultimate collection and the charging off of an account to bad debts are the two ways in which a customer may be liquidated from a company's receivables. The percentage of sales eventually charged off to bad debts has been a misunderstood and often misused measure of the effectiveness of credit and collection. A record of bad debt losses should be maintained by every business, but it is dangerous to let this become the sole criterion of how good a job has been done.

CRF Study on Bad Debts

The Credit Research Foundation conducted a survey recently to explore bad debt recovery rates and practices. For over 40 years CRF has reported annually on the condition of bad debts related to annual sales along with the allowance for uncollectible accounts as a percentage of trade receivables. However, this recent survey was the first time recoveries were studied. The survey provided valuable data to facilitate analysis and insight determination to augment CRF's annual bad debt report. For consistency purposes, bad debt recoveries were defined as the dollar amount subsequently recovered from the original write-off.

Recoveries may be paid out in a single payment or spread out over several years in a typical payment plan. In most cases, the actual receipt of recoveries significantly lags the original event that triggered the write-off (bankruptcy, etc.). This timing lag often results in recoveries being received in fiscal years subsequent to the original write-off, which complicates the tracking process. The most accurate method would be to match and track recoveries to the original customer account that was written-off and build overall recovery data from the account level up. However, many organizations typically net recoveries received in the current year (even if the payments are for previous year write-offs) against current write-offs. The assumption is that the timing issues will, over time, equalize within the portfolio.

The survey results indicated almost 80% of the respondents regularly measure and track bad debt recoveries. However, only 62% tracked recoveries back to the original write-off. This was most likely a combination of not having enough time/resources to track at the account level and, possibly, that recoveries were not material enough to warrant a more detailed analysis. In the CRF 2005 Annual Bad-Debt Report, the last available report as of this writing, the total median net bad-debt write-off as a percent of sales was 0.0417%, which tends to support a lack of materiality position for many industries. (However in certain industries the median was as high as 0.60%). As expected in the survey tracking recoveries, the data indicated typical recoveries showed a bias toward the lower rates. Almost one-third of respondents typically received recoveries of 7% or less, while over half recovered no more than 20%. This may add further credence to the materiality issue.

Compliance requirements are no doubt playing a role in defining a framework for all bad debt activity and reserve justifications. This is understandable, since receivables represent a major asset on the balance sheet for most companies, and public companies especially are required to state the true value of the receivable portfolio. So it is not surprising to find that almost 80% of the respondents regularly measure and track bad debt recoveries on some level.

In terms of future trends, CRF's recently published 2006 "Credit Scoring" study indicated that 88% of respondents were either using credit scoring or anticipate they will be using it in the next 5 years. The survey also indicated that 26% of the credit scoring platforms used a statistical model. These models use a variety of data, with many also using recovery rates to support their internal calculations. As the sophistication of these models evolves beyond credit scoring into recommending credit lines they will no doubt utilize more data points. Expected losses and recoveries are anticipated to become more important as these models embrace concepts pioneered and proven by bond market models which currently use these data points. This would support a requirement to better map and monitor recoveries in the future as credit scoring/model implementations accelerate.

The following business sector charts add perspective to the 305 participants in this survey. In total, 12 individual sectors were represented.

1. Business sectors of responding organizations:			
Consumer Goods		59	19%
Industrial		32	10%
Building Supply		29	10%
Technology		10	3%
Services		10	3%
Basic Materials		17	6%
Distribution & Wholesale		66	22%
Healthcare		10	3%
Energy		6	2%
Telecommunications		7	2%
Transportation		5	2%
Conglomerate		1	0%
Other		53	17%
Total		**305**	**100%**

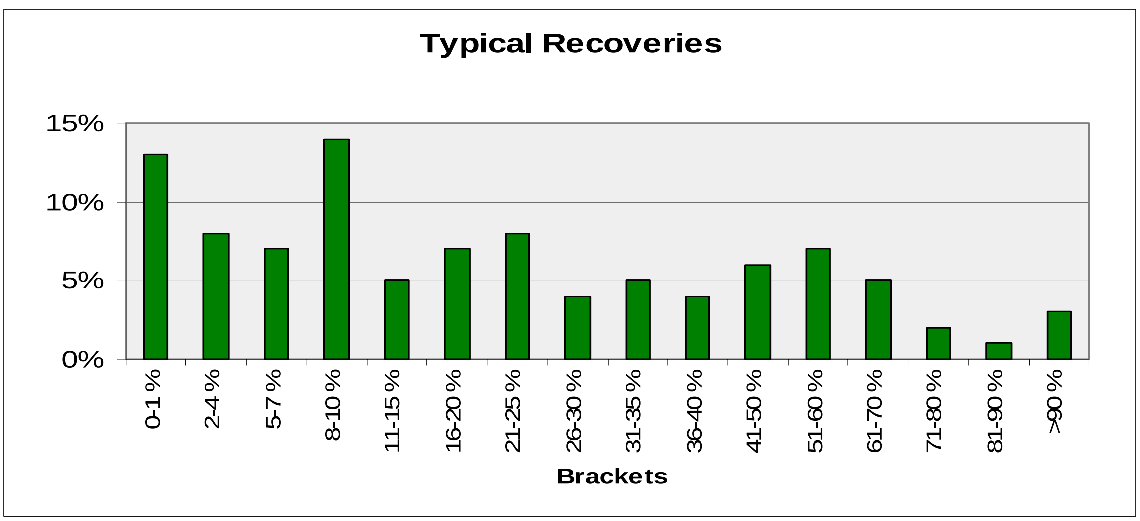
It was not surprising to find almost 80% of the respondents regularly measure and track bad debt recoveries. By tracking and tabulating recoveries, net write-offs can be measured over time at both the customer and portfolio levels. The resulting metrics can be applied to forecast future bad debt activity, provide rationalization of existing reserve levels, and support compliance requirements.

2. Do you regularly measure and track bad debt recoveries?			
Yes		237	78%
No		66	22%
Total		**303**	**100%**

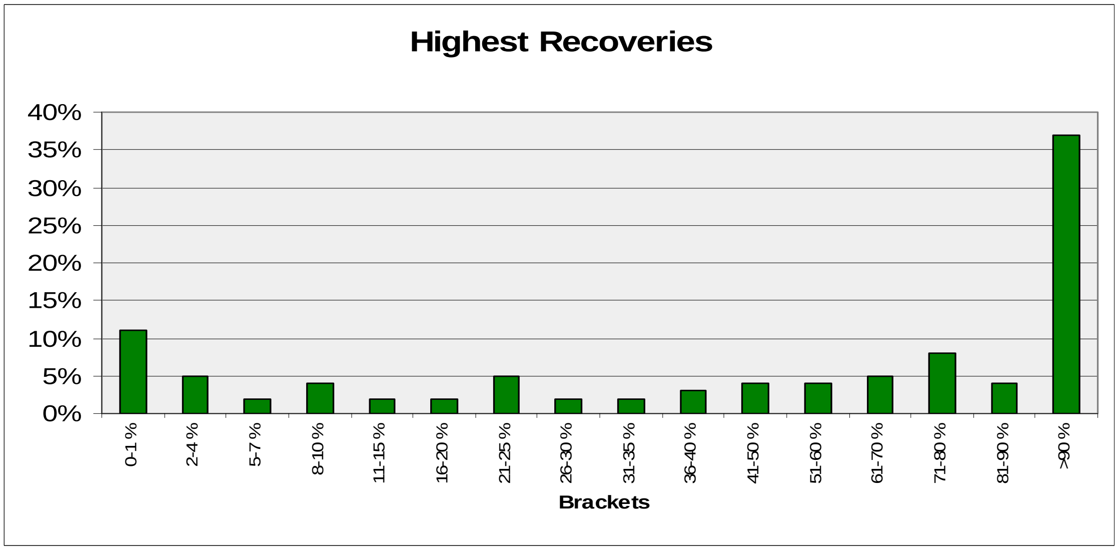
As expected, almost two-thirds of the respondents compare or track the recoveries to the original write-off. This is significantly lower than the reported 78% tracking overall recoveries in question 2, primarily due to the Consumer Goods and Distribution & Wholesale sectors. This was most likely due to a combination of not having enough time/resources to track at the account level and possibly that recoveries were not material enough to warrant matching and tracking them individually to the original write-offs.

3. Do you currently compare or track the recoveries to the original write-off?			
Yes		186	62%
No		115	38%
Total		**301**	**100%**

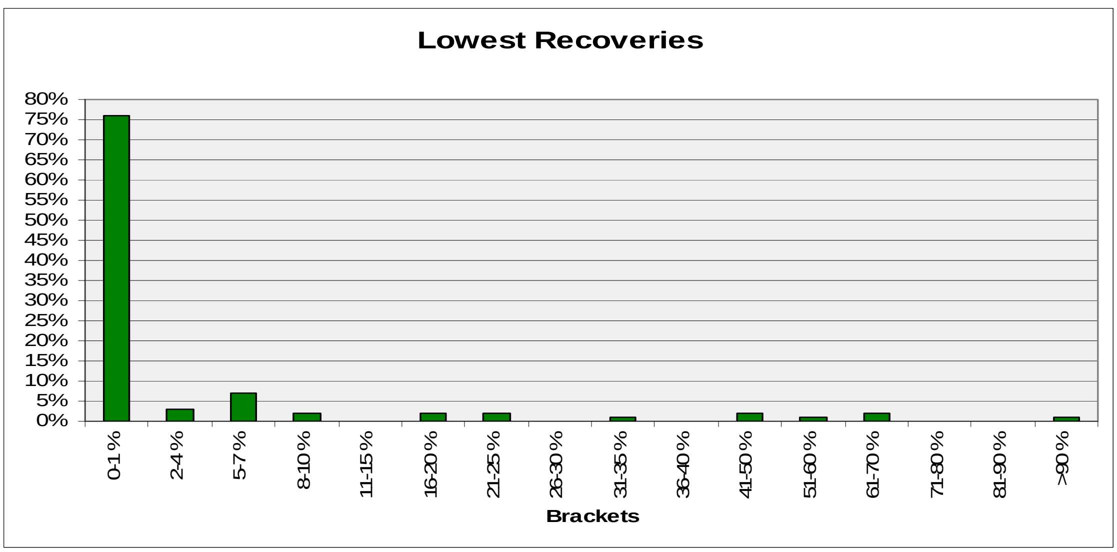
Typical recoveries as a percentage of the original bad debt were spread out over the entire spectrum and, as expected, a bias toward the lower rates was noted. Almost one-third of respondents usually received recoveries of 7% or less. Over half recovered no more than 20%. As a contrast, only 6% typically recovered more than 70%.



When asked to indicate the highest recovery rate experienced in the last year, it was surprising to note that 37% of the respondents indicated a rate of >90%. This may suggest that collateral security interests were successfully exercised to support these recoveries. Meanwhile, the second highest response of 11% for the 0-1% bracket was at the other end of the spectrum. All the other responses were spread among the remaining brackets, with responses ranging from 2-8%.



The responses for lowest recovery rate told a very different story versus the highest recovery. More than three-quarters of the respondents indicated that the lowest recovery was in the 0-1% bracket. This would seem to support the premise that when things do not go well the creditors are left holding the proverbial "bag". In fact, almost 90% reported that in the worst case scenario the recoveries were 10% or less.



Al Carmenini is the Senior VP, Product Development at CreditRiskMonitor. He is responsible for consulting with customers and enhancing the service. Al was a contributing author to the CRF book "Re-engineering the Credit Function" and the newly released "Future Trends in Business Receivable Management" which includes a "future vision" section that Al spearheaded.

CreditRiskMonitor (http://www.crmz.com) is an Internet-based financial information service that provides comprehensive commercial credit reports covering public companies world-wide and includes detailed financial analysis, financial statements and trend reports, credit scores, company background information.