Forecasting Accounts Receivable And Bad Debt

By Ards.co.com

Accounts Receivable has a great impact on a company’s cash flow. Therefore, it is very important for Credit Managers to forecast receivables. Becoming involved with cash management and forecasting cash flow adds value for the organization.

Why Cash Flow Is So Important

Cash flow is the life line of any business making the need to forecast future cash flows essential. Following are just a few of the reasons that cash flow is so important:

- A company’s ability to transact business, make regular purchases, meet payroll, plus pay taxes and other expenses is all dependent upon cash flow.
- Adequate cash flow can provide a company with the ability to take advantage of cash discounts.
- Cash flow is necessary to prepare for emergencies.
- It positions the company to take advantage of new business opportunities as they arise.

Analyzing A/R Aging And Estimating Bad Debt Expense

It is beneficial for a Credit Manager to become very familiar with their customers and their practices. Understanding payment habits and customer cash flow issues will help to apply the appropriate assumptions to create a meaningful forecast of accounts receivable.

Many folks in Credit and Accounts Receivable merely monitor Days Sales Outstanding (DSO). DSO is calculated as A/R divided by daily sales, or:

\[ \text{DSO} = \frac{\text{Accounts Receivable}}{\text{(Annual Sales / 360)}} \]

While this tells you how long your receivables have remained uncollected, it does not offer any insight into the future, the status of your outstanding debt collections and when you can expect cash to come in.

Analyzing the accounts receivable aging can help to forecast the cash you expect will be collected and the timing of same. This analysis will also help you to estimate your bad debt expense.

For example, the percentage of receivables basis can be used to estimate which bad debts will remain uncollected. For this method, once an aging schedule is prepared, percentages are assigned to the totals for each category. These percentages are based on prior collection history and represent the likelihood of non-collection. The longer the debt is past due, the less likely it is going to be collected so a higher
percentage is applied. For instance, accounts over 120 days past due may be assigned a percentage of 40, whereas current accounts are given a 10% rate of non-collection.

The Credit Manager can then apply what they know about their customer’s payment habits, etc. to the collectible portion and create a forecast of the receivables.

**Forecasting Future A/R**

In addition to the current accounts receivable, don’t forget that your A/R balance will be fluctuating each period due to new credit sales. For this part of the forecast, you will need to have a current sales forecast. Using the sales forecast, you can estimate the accounts receivables of future periods. Apply the average days needed to collect your A/R to the sales forecast to determine the amount and timing of cash inflows.

The ability to provide management with an estimate of the cash flows expected from accounts receivable will facilitate planning at all levels of the organization.

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