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Collecting Money in a Bad Economy

Yes, it's harder now, particularly for small companies with limited resources. We offer a practical guide to collections

by John Tozzi

How do you get customers to pay on time? What do you do if they don't? And how do you determine if you'll spend more time and money tracking down a debtor than the payment is actually worth?

Third-party debt collectors recovered $40.4 billion in 2007, according to a PricewaterhouseCoopers study commissioned by ACA International, a trade group for the collection industry. The study estimated that businesses wrote off $152.5 billion in bad debt that year, based on IRS statistics. (The IRS would not confirm the estimate and said the actual data for 2007 would not be available until next year.) And delinquent debts are expected to increase in 2008 as the struggling economy leaves more people and companies strapped for cash.

"There probably will be more debt that will go out to collection, but it's going to be even more difficult to collect because people don't have the money," says John Nemo, ACA spokesman. Recent surveys of small business owners show that delinquent accounts and bad debts remain concerns, although their relative importance has dropped over the last two decades, according to data from the National Federation of Independent Business. The group attributes the decline to the increased use of credit cards, which shift the problem of late payments from small business owners to credit card companies.

With the help of industry veterans, we review tried-and-true practices and take a look at newer services, to offer a practical guide to collections.

1. Insist on credit applications.

"Right now, a lot of customers who have always paid on time are suddenly unable to pay," says Michelle Dunn, a Plymouth (N.H.) author of several books on debt collection who ran a collection agency for eight years. Her first piece of advice for preventing late payments? Require customers to apply for credit. Credit applications (BusinessWeek.com, 1/8/04), which can be bought at office supply stores, record contact information for the customer, personal references and business references, like banks or employers.

Calling references can help you evaluate a customer's risk, but even if you don't check them, just using the form can deter customers who might default. "When you have someone fill out that credit application, it lets them know that you're serious about your business and you're not just handing out credit," Dunn says. If you wind up in court over an unpaid debt, the signed credit application will bolster your case.

2. Offer incentives to encourage clients to pay early.

You can also reduce late payments by giving customers incentives to pay early (*BusinessWeek SmallBiz*, Spring 2005). At a time when many companies are looking to save, offering a 1% or 2% discount on payments received within 10 or 15 days can improve your cash flow, and the discount you give up might pale next to the cost to collect a late payment. "If you wait and then you have to make calls and send letters, now you're spending money to get money," Dunn says.

3. Create transparent payment policies and stick to them.

To avoid disputes that can lead to late payments, make sure that prices are clear and in writing before work begins, says Eric Rigby, principal at eight-person New Orleans accounting firm Rigby Financial Group. Depending on your industry, you may be able to get a deposit or partial payment up front. For certain service providers such as home-improvement contractors, Rigby suggests they secure deposits of 50%, with full payment due when the work is finished. "You totally lose your leverage once your job is completed," he says. He also suggests that businesses make it easy for customers to pay, by accepting credit and debit cards.

4. Act quickly when a customer misses a payment.

If customers do miss payments, don't wait to contact them. "If someone is just 10 days past due and you just give them a friendly call or a letter, it sets a precedent," Dunn says. Listen to a client's reason for not paying and work out a repayment plan. By making contact right away and showing that you're willing to work with the client, Dunn says, you have a better chance of getting paid before other creditors who are less diligent or less understanding.

The references on the client's credit application can help if the debtor does not respond to calls or letters. While creditors can't ask those references about the debt, you can say the customer listed the reference on a credit application and ask how to get in touch with the applicant. Often, just hearing that a creditor called a reference spurs a client into paying, according to Dunn. "They don't want you calling their work and their friends and the people they listed," she says.

5. Hire a collections agency.

If your initial efforts fail, you can turn to a collections agency, depending on the size of the debt. Many collections agencies won't take on small debts or will charge higher commissions on them. "By volume and sheer commoditization of debt, they're set up for the traditional credit-card debt of a couple thousands dollars and up," says Patrick Lunsford, senior editor of InsideARM, a Web site covering the receivables management industry. However, Lunsford says some companies are jumping in to offer automated online services for small businesses trying to collect low-balance debts.

In May, Kennesaw (Ga.) risk management firm MicroBilt launched a service to collect debts for flat fees ranging from $7 to $13. The service, called SmartTarget, uses MicroBilt's address verification databases to track down debtors and send customized letters with increasingly firm language. "A lot of small companies don't want to lose a customer, so it can be tailored to have that right tone to say: 'You owe us $200. Please pay in the next 30 days,'" says Brian Bradley, MicroBilt's executive vice-president for strategy.

The catch is that companies must subscribe to MicroBilt's existing services, which include credit reporting, records searches, and ID verification, to use the debt collection service. Subscriptions start at $30 per month. The company also offers small business owners a stick few had before: the ability to report delinquent debtors to credit bureaus. That threat, Bradley says, can compel customers to pay debts to small firms they might otherwise ignore.

6. Build a cash cushion.

While precautions can help reduce delinquent debt, businesses need to prepare for some payments simply to not materialize. Rigby says companies should accumulate cash reserves equal to three to six months of operating expenses in case they run into cash-flow problems. That's especially important for small companies that use cash-basis accounting rather than accrual-basis. Cash-basis accounting records revenue and expenses at the time money changes hands, rather than at the time the sale takes place. Under the cash method, businesses can't write off uncollectible debts on their taxes, in the way companies using the accrual method can, Rigby says. Such write-offs can soften the blow of an unpaid invoice, but small businesses often have to bear the full brunt of bad debt.

Tozzi covers small business for BusinessWeek Online.