'Know Thy Numbers' Installment #5: Understanding Accounts Receivable

May 14, 2021 / Business Owners & Executives / By Ralph Nach and Michael Pakter

Tags: Accounting-Auditing-Taxation, Business Management, Financial Literacy, Financial Management, Small Business,

3

Accounts Receivable Management and Analysis

We often hear a respected businessperson say that "cash flow is the lifeblood of a company's financial health." While this is true, there is a corollary: *accounts receivable are the lifeblood of a company's cash flow*. And, in turn, sales of products and/or services create those accounts receivable.

Many, if not most, commercial enterprises do not predominantly transact their business with customers in cash. Thus, they cannot generate cash flow until they first generate accounts receivable in exchange for transferring products and/or services to their customers. And, in turn, those cannot be generated until products and/or services have been sold. Proper accounts receivable management allows businesses to stay on top of their cash flow.

What Is an Account Receivable?

An account receivable is a monetary amount that a buyer legally owes to a seller, representing the seller's unconditional right to receive that amount within an agreed-upon time. There is not necessarily a legal document evidencing an account receivable. The account receivable ("A/R") may have arisen from a sales transaction orally agreed upon by the parties, or the transaction may have been executed in accordance with customary trade terms for the particular industry(s) in which the parties operate.

[Editors' Note: As Rihanna and Tony Soprano so elegantly explain, an account receivable is the "Where's my money?" statement of accounting. It's the money your customer/client rightfully owes you for the products or services you provide, whether the transaction was a written agreement or an implied obligation.]

Accounts receivable are presented on a company's balance sheet—one of several key financial statements.

[Editors' Note: The balance sheet is a snapshot of the assets, liabilities, and owners' equity at a specific point in time. Just as the title states, the balance sheet must balance. Generally speaking, a company's assets are classified as either "current" or "long-term." Read more in Installment #3.]

A current asset is expected to become cash within one year from the date of the balance sheet, and a current liability is expected to be paid within one year from this date. Accounts receivable are customarily presented as current assets unless the repayment due date exceeds one year. Should that be the case, only the portion of the accounts receivable that is due one year from the balance sheet date is classified as a current asset, with the remainder classified as long-term.

How Receivables Originate

Generally, there is a sales agreement between seller and buyer as to their respective rights and responsibilities. The agreement can be evidenced by:

- A purchase order originated by the buyer and accepted by the seller;
- A formal sales contract negotiated between the buyer and seller; or
- Under implied customary trade terms that are standard for a particular type of business.

Once an agreement between the parties has been reached, the seller has the responsibility to transfer control of the contracted products to the buyer or to perform the contracted services on behalf of the buyer. Once the seller has performed all or a portion of its obligations, the seller is entitled to issue a sales invoice to the buyer requesting payment of the agreed-upon price.

[Editors' Note: Note the use of the words "transfer control?" Why didn't the authors just use the word "deliver" instead? The reason is that the contract between buyer and seller may provide that the seller will deliver the product being sold but, on the other hand, it may not.]

Some contracts permit partial billings, referred to as "progress billings" based upon the achievement by the seller of mutually agreed-upon milestones. Thus, as a sales transaction is being fulfilled by the seller over a period of time, the seller may be contractually entitled to receive partial payments to help defray the costs of fulfilling its obligations to the buyer. Some contracts may even require that the buyer submit, in cash, a deposit in advance of any performance by the seller.

A receivable may be due upon presentation of the invoice (immediately), or it may provide for various other payment terms such as:

- **Net 30**–Net amount of invoice due 30 days from invoice date
- **2/10/30**–A 2% discount if paid within 10 days from invoice date—otherwise, the seller is owed the full amount of the invoice if paid after 10 days and within 30 days from the invoice date

Assessment of late fees—Late fees and/or interest for invoices not paid within the agreed-upon time period

[Editors' Note: One trick to ensuring faster payment is the timing of your invoices. How quickly are you sending out an invoice after the products are sold or the services are provided? A billing lag not only affects your accounts receivable, it also affects how fast you get paid. So, be on top of your "books," as Mr. Soprano would say.]

Collectibility Considerations

A business that carries accounts receivable balances must take precautions to ensure that these balances are collectible when due. Failure to accomplish this can result in the business suffering credit losses when receivables that were expected to be collected end up becoming worthless.

The most important way to mitigate credit losses is to perform thorough credit checks before accepting the first order from a new customer. If a prospective customer has less-than-stellar credit, the company may take measures to protect itself from credit losses by:

- Requiring payment in full by the buyer prior to transferring control of products or performance of services.
- Setting payment terms of cash-on-delivery (C.O.D.), whereby the seller is paid at the time it receives the products or performance of services.
- Requiring collateral for the receivable in the form of a security interest in the products sold.
- Filing mechanics liens, as is common in construction, for unpaid amounts that would prevent the buyer from obtaining or transferring legal title to the real estate until the unpaid amounts are paid in full.

Even after conducting due diligence on the creditworthiness of new customers, inevitably some customers will default on their obligations and refuse to pay them in full. To acknowledge this reality, receivables are presented on the balance sheet at their "net realizable value," which is defined as the amount that the company's management expects to collect. This is accomplished by reducing the amount of accounts receivable stated on the balance sheet by an allowance for credit losses (sometimes referred to as an "allowance for bad debts" or an "allowance for doubtful accounts").

The computation of the allowance for credit losses requires management to exercise judgment based on:

- Its assessment of the status of the current accounts receivable.
- Reference to experience with historical losses incurred.
- Consideration of the existing economic conditions at the balance sheet date and forecasts of how those conditions could change in the near term.

[Editors' Note: You should be using an accounts receivable aging report to help you manage your accounts receivable. Many software platforms will automatically produce these aging reports. The aging report will help you evaluate your receivables. The report will usually display unpaid invoices in aging buckets, such as "current," "30 days past due," "60 days past due" and "over 90 days past due."

By performing a detailed review of this report, you can determine which invoices are past due and send out statements and/or make phone calls to your customers in order to help in your collection efforts. You can also determine which

customers are slower in paying and consider changing their credit terms or making more frequent contact with these customers. You also will want to identify potential bad debts and create an allowance for bad debts.]

One way to protect further against the risk of non-payment would be to obtain credit insurance. This coverage protects the seller for up to 95 percent of the debt owed.

Analytical Ratios Derived from Accounts Receivable

There are a number of ways to analyze a company's accounts receivable to evaluate how effectively a company is managing this vital asset. For illustrative purposes, assume that a company's financial statements present the following numbers:

	End of Year	Beginning of Year
Accounts Receivable	$800,000	$700,000
Less allowance for credit losses	$30,000	$20,000
Accounts receivable, net	$770,000	$680,000
Annual sales on credit	**$5,000,000**	**$4,500,000**

So, in this example, we have a company that sold $4.5 million on credit last year and that sold $5million on credit this year. That may be good or bad in and of itself. We don't have enough information because we don't know if overall sales are up, or if only sales on credit are up. Let's leave this question aside and assume that all sales are on credit. We can then use some formulas to figure some things out.

So, with this assumption and based on the hypothetical metrics above, here are some examples of things we can figure out:

Example #1- Number of Days' Sales in Ending Accounts Receivable

For the current year, we can figure out how much money in credit sales there were each day by simple division:

Annual Credit Sales / 365 Days in the Year = Sales per Day

$5,000,000/365 = $13,699 of sales per day.

We can then figure out the average number of days a dollar of sales is stuck in accounts receivable by using this formula:

Accounts Receivable / Sales per Day = Number of Days' Sales in Accounts Receivable

$770,000 / $13,699 = 56.2 Days.

So, at the end of the year, accounts receivable consists of 56.2 days of credit sales.

If the customary terms for the company's receivables are net 30 days from invoice date, then this is bad. Why? Because it would mean that, on average, accounts receivable 26.2 days delinquent. This, in turn, would cause an analyst to question whether the $30,000 allowance for credit losses (which represents 3.75% of the gross receivables balance) is sufficient.

*[**Editors' Note**: "…would cause an analyst…" What analyst? Our authors may be referring to someone at the company's bank or another creditor of the company who monitors the financial health of the company to make sure that it remains a good credit risk. For more on this, read Business Borrowing Basics – Negotiating A Loan Agreement.]*

Trends Matter

It is always helpful to monitor trends, so a comparison of current year results should be compared to the prior year's results, as follows:

Annual Credit Sales / 365 Days in the Year = Sales per Day

$4,500,000/365 = $12,329

Accounts Receivable / Sales per Day = Number of Days' Sales in Accounts Receivable

$680,000 / $12,329 = 55.2 Days Sales in Receivables

Note that the days sales in receivables has deteriorated by one day between the prior year and the current year, increasing from 55.2 days to 56.2 days.

If the company being analyzed is financed by a line of credit that is collateralized all or in part by the receivables, this may also mean that the company's borrowing capacity will be diminished, because most lenders do not include delinquent receivables as eligible collateral.

Example #2- Accounts Receivable Turnover Ratio

This ratio allows us to measure how often accounts receivable are converted to cash in a certain time period, which tells you how fast our company is collecting receivables.

Annual Credit Sales / Average Accounts Receivable Balance

The math has to be done in two steps. First, we need to calculate the average accounts receivable balance:

Average Accounts Receivable Balance = ($770,000 + $680,000)/2 = $725,000

Then we need to divide the annual credit sales by that number:

Accounts Receivable Turnover Ratio = $5,000,000 / $725,000 = 6.9 Times

The larger this number, the faster the company is at collecting its receivables. This means that, over the course of a year, receivables are collected 6.9 times. Just as is the case with the prior ratio, this should be monitored over time.

Example #3- Accounts Receivable as a Percentage of Credit Sales

What does the following ratio tell us?:

Accounts Receivable / Annual Credit Sales

It tells us the percentage of sales on credit that remain uncollected at the end of the year. Using the numbers of our hypothetical company:

$770,000 / $5,000,000 = 15.4%

This means that at the fiscal year end, 15.4% of annual credit sales remain uncollected.

Comparative Analysis

Ratio analysis is a commonly used tool in financial analysis. Therefore, computing the above ratios for accounts receivable is sometimes step one of two steps—step two is to compare those ratios to other comparable companies, divisions within the subject company and/or to the same company's prior year(s) ratios.

Ratio analysis allows the analyst to compare and contrast the subject company (and/or divisions within the subject company) to companies in the same industry. It is useful to compare a subject company's ratios to other reasonably comparable years, companies or industry benchmarks.

Care needs to be taken when drawing inferences from the year-to-year, division-to-division and industry benchmark analysis. This comparative analysis is a useful device for determining and examining trends and planning for the future.

Comparative analyses may be performed by comparing the above-discussed ratios to industry ratios that may be available from public databases. Examples of those include:

- Almanac of Business and Industrial Financial Ratios
- BizMiner
- IRS Corporate Financial Ratios and IRS-CALC
- The Risk Management Association (RMA) Annual Statement Studies®.

These publications obtain their data from financial statements provided to member banks by loan customers and/or gathered data industry-by-industry using NAICS codes and/or SIC codes. The North American Industry Classification System (NAICS) is a classification of businesses by type of industry and economic activity. NAICS codes are used by government and business in North America, and they have largely replaced the older Standard Industrial Classification (SIC) system, except in some government agencies, such as the U.S. Securities and Exchange Commission (SEC).

Better Accounts Receivable Management = Convert to Cash Faster

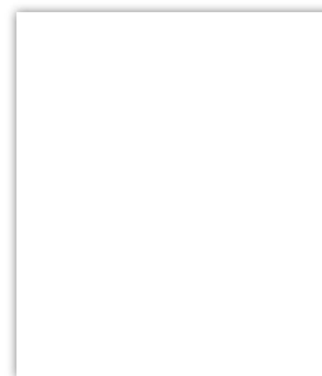
Accounts receivable are important assets that company management will be anxious to convert to cash as soon as possible so that the company is not “over invested” in its accounts receivable. Accounts receivable ratios are essential analytical and planning tools. There are various analytical tools that can be used by management to compare performance to prior periods and to peer statistics to continuously monitor collections and ensure that customers are adhering to the mutually agreed-upon contractual terms.

[**Editors’ Note**: Browse all installments of Know Thy Numbers/Know Thy Business, starting at the beginning with ‘Know Thy Numbers’ Installment #1 – Welcome to the Jungle, an Introduction to the Series.

To learn more about this and related topics, you may want to attend the following webinars: EBITDA and Other Scary Words and Where Did All My Profits Go? Mastering the Concept of Working Capital.]

©All Rights Reserved. May, 2021. DailyDAC™, LLC d/b/a/ Financial Poise™

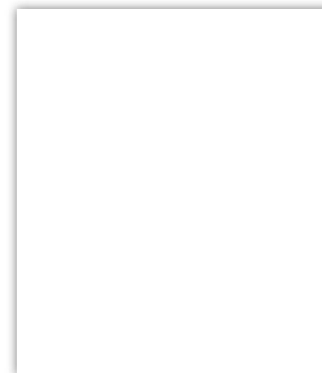
About Ralph Nach



Ralph Nach has more than 40 years of experience in the accounting profession in a variety of capacities including audit partner, quality control director, and external peer reviewer. He has also served as a partner in the National Office of Accounting and Auditing of the fifth largest international accounting firm, the U.S. Chief Learning Officer…

Read Full Bio » • View all articles by Ralph »

About Michael Pakter



Michael D. Pakter has more than 40 years of experience in forensic accounting, investigations and litigation services in numerous industries and diverse engagements, including more than 20 years of experience in economic damages and business valuations. State, Federal and Bankruptcy Courts, as well as arbitrators, have recognized him as an expert in forensic accounting, economic…

Read Full Bio » • View all articles by Michael »

Advertisements

Like what you just read?

Sign up to receive our free newsletter, Financial Poise weekly. It's our take on the most relevant and topical business, financial and legal issues affecting investors and small business owners.

First Name

Last Name

Email Address

RECEIVE OUR NEWSLETTER →

We respect your email inbox and will never spam!

Article Comments

Article printed from www.financialpoise.com.