Receivables

Introduction

Businesses keep track of all the money their customers owe them using an account in their books called accounts receivable.

Receivables, also referred to as accounts receivable, are debts owed to a company by its customers for goods or services that have been delivered or used but not yet paid for. For example, when customers purchase products on credit, the amount owed gets added to the accounts receivable. Accounts receivable is the lifeblood of a business's cash flow and it is treated as current assets on the balance sheet. The amount of account receivable depends on the line of credit which the customer enjoys from the company. Usually, this is offered to customers who are frequent buyers.

On the balance sheet, accounts receivable appears under assets. Often, some portion of accounts receivable go uncollected because customers are unable to pay or for other reasons. To allow for this, the number on the balance is reduced by an estimate for bad debts.

Some companies sell unpaid debts at a discount to collection agencies that then collect on the amounts owing.

Definition

Sometimes referred to as A/R, "accounts receivable" is the accounting term for the money a business should receive from its customers from the sales of goods or services.

When to use it

To improve cash flow, and to measure how effectively a business extends credit and collects debt on that credit

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Details

Receivables are created by extending a line of credit to customers and are reported as current assets on a company's balance sheet. They are considered a liquid asset, because they can be used as collateral to secure a loan to help meet short-term obligations. Receivables are part of a company's working capital. Effectively managing receivables involves immediately following up with any customers who have not paid and potentially discussing a payment plan arrangement, if needed. This is important because it provides extra capital to support operations and lowers the company's net debt.

To improve cash flow, a company can reduce credit terms for its accounts receivable or take longer to pay its accounts payable. This shortens the company's cash conversion cycle, or how long it takes to turn cash investments such as inventory into cash for operations. It can also sell receivables at a discount to a factoring company, which then takes over responsibility for collecting money owed and takes on the risk of default.

The accounts receivable process starts when a business sends a client an invoice. The business will then add the value of the invoice to their accounts receivable. Once their client pays the invoice, they will debit the A/R account and credit the cash account for the corresponding amount. Between these two instances, a business may need to follow up with the client to receive payment. To explain with a situation, here's an example:

Suppose you are a manufacturer M/S XYZ Pvt Ltd and you manufacture tires.

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A customer gives you an order of $10,000 for 100 tires. Now, when the invoice is generated for that amount, sale is recorded, but to make the payment the company extends the credit period of 30-days to the customer.

Till that time the amount of $10,000 becomes your account receivable because the customer will pay that amount before the period expires. If not, the company can charge a late fee or hand over the account to a collections department.

Once the payment is made, the cash segment in the balance sheet will increase by Rs 1,00,000, and the account receivable will be decreased by the same amount, because the customer has made the payment.

Accounts receivable is best managed on a consistent and routine basis. In retail, each transaction is paid for immediately. With other industries, customers apply for a credit line, and they place orders against the credit line. The customer is provided an invoice and payment terms with the shipped product, payable at a later date.

Regardless of the business system, ensuring payment is crucial.

EXAMPLES:

Most business to business or B2B billing hinges on accounts receivable, so standard invoicing practices make for great accounts receivable examples. If you bill your clients hourly, invoicing that client every hour, day or even week would quickly become tedious for both parties. Instead, you're likely issuing monthly invoices and expecting payment within 60 days. The value of your invoice, which represents a month's worth of work, is part of your accounts receivable.

Other examples:

- An electric company that bills its clients after the clients received the electricity
- A farm supply business sells a tractor to a farmer for $75,000. The sale is on credit.
- A furniture manufacturer that has delivered furniture to a retail store. Once the manufacturer bills the store for the furniture, the payment owed is recorded under accounts receivable. The furniture manufacturer awaits payment from the store.

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