

# How to More Effectively Convert Your Accounts Receivable into Cash

By  
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**Converting accounts receivable into cash is a critical process in the development of a healthy cash flow.** While booking a receivable is accomplished by a simple accounting transaction, the process of maintaining and collecting payments from your customers requires a steadfast commitment to a systematic process of Accounts Receivable Management. To more effectively convert accounts receivable into cash it's essential that the credit and collection process be highly efficient in order for you to shorten the accounts receivable cycle time.

**The accounts receivable cycle starts with a sale (credit sales) which in turn creates a receivable (monies due your company), and then, ultimately converts into cash.** The length of time that it takes your company to complete this cycle, from sale to accounts receivable to cash, is the collection period. The shorter the collection period, the less time cash (capital) is tied up in the business process, and thus the better for your company's cash flow.

**Try to limit outstanding accounts receivable to no more than 10 to 15 days beyond your credit terms.** If your credit terms are net 30 days, then the collection period should not extend beyond 45 days. Keep in mind that average collection periods do vary because of industry standards, company policies, or financial conditions of the customer. Comparing your company's actual days of collection to the average days of collection within your industry is a wise business practice. Benchmarking your actual days of collection to that of your target days of collection (no more than 10-15 days over credit terms) is also advisable.

**Your company's average collection period is calculated by using an Average Collection Period Ratio.** The ratio is referred to as an Activity Ratio; it measures how quickly your company converts non-cash assets to cash assets.

**Average Collection Period (ACP):**  $ACP = \text{Accounts Receivable} / (\text{Credit Sales} / 365)$

A high Average Collection Period implies that your company may be too liberal in extending credit to your customers and too lax in the collection process. A low number of days in your collection period could imply that your credit and collection policies are too restrictive. This restrictive position may be repressing your sales.

Accounts Receivable Turnover Ratio (ART) is an accounting measure used to quantify your company's effectiveness in extending credit, as well as, collecting its debts. This ART Ratio is considered a Liquidity Ratio; it measures the availability of cash to pay debt.

**Accounts Receivable Turnover (ART):**  $ART = \text{Net Credit Sales} / \text{Average Accounts Receivable}$

A high Accounts Receivable Turnover Ratio implies that, either your company operates on a cash basis, or that its extension of credit and collection of accounts receivable is efficient. A low ART Ratio implies that your company should re-assess its credit policies in order to ensure the timely collection of monies due from the accounts receivable ledger.

**A key requirement for effective Sales and Accounts Receivables management is the ability to intelligently and efficiently manage your entire credit and collection process.** Greater insight into a

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customer's financial strength, credit history, and trends in payment patterns is paramount in reducing your exposure to bad debt. While a comprehensive collection process greatly improves your cash flow, your ability to penetrate new markets and to develop a broader customer base hinges on the ability to quickly and easily make well informed credit decisions and, to set appropriate lines of credit. Your ability to quickly convert your accounts receivable into cash is possible if you execute well- defined collection strategies.

## ***Credit Process:***

**The initial requirement of an effective credit management process is to have each company that you plan to do business with, complete and sign an Application for Credit form.** Your Application for Credit form should include, the "terms and conditions of sale," space for the prospective customer to provide information on company background, a list of principal owners with their percent of ownership, three to five trade credit references, and the name of their bank(s).

**It is important to personally review with the prospective customer their projected product purchases - in both dollars and in units.** This review helps to initially assess the amount of credit necessary to purchase the projected products. This review also helps to determine inventory requirements based on a projected sales forecast

## ***Collection Process:***

**An efficient and effective collection management process includes well defined policies and procedures that facilitate a more expedient, sale-to-cash cycle.** The collection procedures require "attention to detail" and should include:

- **Billing:** Preparation, recording, and delivery of invoices as soon as the product/service is delivered or installed.
- **Statements:** Preparation, recording, and delivery of follow-up statements that indicate aging of outstanding balances.
- **Accounts Receivable Aging Schedule:** Preparation and distribution of an Aging Schedule that lists all of the customer accounts that have outstanding balances. These outstanding balances are then categorized into 4 categories of time: 1 to 30 days, 30 to 60 days, 60 to 90 days, and over 90 days.
- **Telephone Calls:** Placement of courteous and professional telephone follow-up calls to customers with past due, outstanding balances for the purpose of establishing a date of payment.
- **Collection Letters:** Preparation, recording, and delivery of collection letters with an urgent message that demands payment and provides details of the action that will be taken if payment is not received by a certain date.

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- **Recording Payments:** Posting of the amount of payment to the appropriate customer account. If possible, it is advisable that the person performing the collection duties not be involved with the posting of payments.
- **Deposits of Collected Funds:** Preparation of the deposit ticket, along with accompanying funds, should be deposited in the bank on a timely basis.

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## ***Factoring as an Option***

**Very simply, factoring is short-term financing that is obtained by selling or transferring your Accounts Receivable to a third party - at a discount - in exchange for immediate cash.** In most cases, the third party, a factoring company, audits your accounts receivable to determine their collect-ability. If the factoring company feels that your receivables are *bona fide* then, they will offer to purchase the current ones at a discount. A factoring company may also, under the right circumstances, purchase your future receivables at discount off the face value of the receivables. The percentage discount depends upon the age of the receivables, how complex the collection process will be, and how collectible they are.

**Once the factoring company collects a particular receivable, they will pay you the remaining balance of that receivable's face value, less their fee.** Fees vary widely from one factoring company to another. So, it is recommended that you do your due diligence before engaging the services of any particular company. Factoring fees are not insignificant when compared to the amount of interest you might pay to a commercial lender. For this reason alone, you should view factoring only as a short-term solution rather than a regular outlet for collecting your receivables.

**Many businesses, that need an immediate infusion of cash in order to survive and/or to bridge their cash flow gap, could benefit from the process of factoring accounts receivable.** Since failing businesses regularly turn to factoring as a last resort, factoring may be viewed by many people as a negative. Although factoring may be a great way to generate cash quickly, you should consider the perception that factoring may convey to your customers and to others in your industry. Your good judgment here should dictate if your company could benefit from the quick cash flow that factoring provides, or whether or not it would be just adding to your company's financial burdens.

**Shortening the accounts receivable cycle time generates the healthy cash flow that is required to sustain your company's growth and prosperity.**

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