

Introduction to Accounts Receivable and Payable

Introduction to Accounts Receivable (AR) & Accounts Payable (AP)

Key concepts, processes, and best practice tips for managing a company's cash flow cycle.

1. What They Are

Aspect	Accounts Receivable (AR)	Accounts Payable (AP)
Definition	Money owed to the business by its customers for goods/services already delivered.	Money the business owes to its suppliers/vendors for purchases already received.
Balance Sheet Position	Current Asset (usually listed under "Trade Receivables").	Current Liability (usually listed under "Trade Payables").
Primary Goal	Collect cash quickly to fund operations and reduce days sales outstanding (DSO).	Pay obligations on time to preserve credit terms and avoid penalties.
Typical Users	Sales, billing, credit control, collections teams.	Procurement, finance, accounting, treasury teams.

2. Core Workflow

2.1 Accounts Receivable Cycle

- Order Entry** – Customer places an order; credit check may be performed.
- Delivery / Service Completion** – Goods shipped or service rendered.
- Invoicing** – Invoice generated (paper or electronic) with payment terms (e.g., Net30).
- Recording** – Invoice posted to AR ledger; creates a receivable entry.
- Collection** – Payment received (check, EFT, credit card, etc.).
- Cash Application** – Payment matched to the correct invoice; balance updated.
- Reconciliation & Reporting** – AR aging report, DSO, write-offs, and bad debt provisions.

2.2 Accounts Payable Cycle

- Purchase Order (PO) Issuance** – Formal request to supplier for goods/services.

Introduction to Accounts Receivable and

Payable

2. **Receipt of Goods/Services** – Receiving department confirms quantity/quality; generates a receipt.
 3. **Invoice Receipt** – Supplier sends invoice (paper, PDF, EDI).
 4. **Three-Way Match** – PO ?? Receiving Report ?? Supplier Invoice must agree on amount, quantity, and price.
 5. **Approval** – Authorized personnel approve the invoice for payment.
 6. **Payment Processing** – Issue check, ACH, wire, or other payment method per agreed terms (e.g., Net45).
 7. **Recording & Reconciliation** – Post to AP ledger; update cash-flow forecast and vendor statements.
-

3. Key Metrics & Ratios

Metric	Formula	What It Shows
Days Sales Outstanding (DSO)	$(AR \div Total\ Credit\ Sales) \times 365$	Average days to collect cash from customers.
Days Payable Outstanding (DPO)	$(AP \div Cost\ of\ Goods\ Sold) \times 365$	Average days the company takes to pay its suppliers.
Cash Conversion Cycle (CCC)	$DSO + Days\ Inventory\ Outstanding - DPO$	Total time cash is tied up in the operating cycle.
AR Turnover	$Net\ Credit\ Sales \div Average\ AR$	Frequency of collecting receivables during a period.
AP Turnover	$Cost\ of\ Goods\ Sold \div Average\ AP$	Frequency of paying suppliers during a period.

Benchmark targets vary by industry; regularly compare against peers.

4. Credit Management (AR)

1. **Credit Policy** – Define credit limits, payment terms, and risk-assessment criteria.
2. **Customer Evaluation** – Use credit bureaus, trade references, and financial statements.
3. **Monitoring** – Run aging reports weekly