Chartered Institute of Internal Auditors

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Accounts receivable

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Accounts receivable are an essential part of any organisation's balance sheet. Often referred to as debtors, these are monies which are owed to an organisation by a customer. Our guide explains:

How does an account receivable work?
What are doubtful debts?
What should management do to ensure that accounts receivable balances are accurate and fully recoverable?
Why are accounts receivable important?
What are the important points to look for?
Potential risks and responses

You may also find our guidance on Auditing Collections relevant - although FS focused it is useful for all sectors.

How does an account receivable work?

The most common form of an account receivable is a sale made on credit, via an invoice, to a customer. The customer subsequently pays the debt within agreed credit terms, which may differ from customer to customer. Some companies offer discounts to incentivise early payment or privileges to customers permitting a direct debit to be set up.

Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organisation's balance sheet as accounts receivable as illustrated below. Where payment is overdue, it is followed up by the credit control officer or team until the amount is recovered, or written off if no longer recoverable.

Company X balance sheet

ASSETS	LIABILITIES
Current assets:	**Current liabilities:**
Cash	Accounts payable
Cash equivalents	Accruals
Short-term investments	Bank overdraft
Accounts receivable:	Short-term loans
Inventory	

Sub total	**Sub total**

What are doubtful debts?

Where the recoverability of an accounts receivable balance is doubtful, although not definitely irrecoverable, it is referred to as a doubtful debt. An example may be where a customer is heavily questioning the validity of the invoice/debt or has gone into liquidation.

Accounting concepts require prudence in this area. Therefore, there is a requirement for an allowance (also referred to as a 'provision') to be created to recognise the potential loss arising from the possibility of incurring bad debts.

The provision for doubtful debts is created by forming a credit balance which is deducted from the total accounts receivable balance in the balance sheet (a debit balance). The provision is treated as a deduction from the receivable balance as illustrated below.

Gross accounts receivable	£10,000
Allowance for doubtful debts	(£3,000)
Net accounts receivable	**£7,000**

The net £7,000 balance is recorded in the balance sheet as 'accounts receivable'.

A 'provision' for doubtful debts usually takes two forms, being a specific provision based on individual debts; and a general provision, which is usually in the form of a percentage of total debts.

The practice of creating general provisions however is on the decline after changes to International Financial Reporting Standards (IFRS).

What should management do to ensure that accounts receivable balances are accurate and fully recoverable?

Many organisations have a dedicated credit control manager or team. Their primary objective is to ensure that cash is received from the customer within the organisation's credit terms, which are in the form a pre-determined number of days (for example 30 days from the invoice date).

Credit terms are set using a formal assessment of the customer’s ability to pay based upon bank references and other checks, usually with one of the main credit bureaus, e.g. Experian, Dun and Bradstreet.

Other activities/responsibilities that are likely to fall within the scope of the credit control team include:

1. Recording cash receipts and payments
2. Establishing follow-up procedures which usually include phone calls, emails and letters, with

different levels of escalation

3. Reconciling the sales ledger/debtors ledger to ensure that all payments are accounted for and are properly posted. This involves matching the detailed amounts of unpaid customer debt to the accounts receivable total stated in the general ledger. This matching process is important, as it proves that the general ledger figure for receivables is justified

4. Preparation of monthly, quarterly or annual management information/reports detailing outstanding balances and other accounts receivable activity.

It is good practice for a member of the finance team to issue statements to customers where they asked to confirm the outstanding debt balance. This enables any errors or anomalies to be identified and corrected at the earliest opportunity.

The automatic recording of debtor balances from sales invoices raised and reconciliations of the general ledger balances to sub ledgers are further methods of determining whether the balance is incomplete or inaccurate.

The credit control manager should periodically review outstanding debts (aged accounts receivable listings) to determine whether balances which are nearing or have surpassed their collection date are fully recoverable.

If balances are not recoverable then these amounts will need to be written off as an expense to the profit and loss account. If balances are not chased on a timely basis, this may reduce the probability of recovery resulting in an inflated profit figure and potential cash flow issues.

The credit control manager should also engage in dialogue with the customer as amounts approach their overdue date to establish why monies owed are not being paid. This is particularly important at period end where the accuracy and recoverability of the receivable balances will be scrutinised by the organisation's external auditors.

The identification of inaccurate or unrecoverable balances by the external auditors may lead to provision of bad debts being or debts written off, both of which will reduce the organisation's profits.

Comparison of the total balance or list of balances against the previous month or quarter is also a useful check on how debt is increasing or declining although this needs to take into account known anomalies such as busy periods or customer trends. Failure to perform analytical procedures such as these may result in a gradual increase in debt that goes unnoticed or inaccurate balances going undetected.

Why are accounts receivable important?

The prompt and full collection of monies owed is vital to ensure the organisation has the necessary cash flow to operate effectively and to remain a going concern.

Pro-active management of accounts receivable is of critical importance, this includes:

- Ensuring that customers are in a position to pay by setting appropriate credit limits, including the regular review of limits
- Ensuring that limits are not exceeded

- Collecting debts on a timely basis to avoid balances becoming too old and therefore more difficult to recover
- Use of effective management information to identify potential issues or challenges with certain accounts
- Regular communication with third parties to identify potential issues and unrecoverable balances.

All of these control and monitoring arrangements have the potential to form the scope of an internal audit review.

What are the important points to look for?

1. Do formally documented policies and procedures exist for all accounts receivable and collection activities?

2. Have credit limits been automatically increased?

3. If/where a credit limit is breached has a review of the customer been undertaken?

4. How many times have services been withheld because of a poor credit risk or limits being breached?

5. Are reconciliations performed between the detailed accounts receivable ledger and the accounts receivable control account in the general ledger?

6. Are payments terms clearly included on invoices?

7. Are accounts receivable balance statements issued and include customer account activity, outstanding unpaid invoices and recent payments?

8. Are write-offs or other reductions in the receivable balances approved by a relevant member of senior management, for example the financial controller or finance director?

9. Is a report of all non-cash adjustments/non-standard journal entries to accounts receivable produced and reviewed monthly by a member of senior management?

10. Are accounts receivable recorded in a manner to permit an analysis of aged debtors (for example <30 days, 30-60 days etc.)?

11. Are all credit balances reviewed periodically?

12. Is the allowance for doubtful debts reviewed monthly, including the accuracy of the calculation?

13. Are there automated controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice?

14. Is there clear segregation of duties relating to the identification of debt, receipt of income, reconciliations and write off of debts?

15. Are credit controllers/ those with the customer relationship provided with debtor information so

that they can take informed decisions on continuing to provide services to a customer with significant aged debts?

16. The availability of system generated reports available that provide such statistics as average time to pay per customer, trends, etc.

Potential risks and responses

Risk 1

Allowing customers high credit levels beyond their capacity or willingness to pay will ultimately damage our business performance.

Potential impact

- The debtor is slow to their debts.
- The amounts owed are disputed.
- Inability to recoup all debts.
- Financial loss to the organisation.
- Reduction in profits.
- Cash flow issues.

Potential response

- Credit checks are undertaken prior to allowing credit being agreed.
- Credit limits set are based on the information from the credit check.
- Credit limits are regularly reviewed based on set indicators and not automatically increased.
- Indicators are set on the debtors file to flag up when they are reaching their credit limit.

Risk 2

Inefficient and/or ineffective procedures will hinder our ability to collect debts in a timely and correct fashion.

Potential impact

- Insufficient supporting documentary evidence for all transactions and balances.
- All transactions are not processed or not processed correctly.
- Difficulty in proving the debt and therefore inability to recoup all debts resulting in write off and loss to the organisation.
- Transactions are not recorded on a timely basis, or in the correct period, resulting in poor working capital management through the slow recovery of cash receipts.
- Inaccurate balances leading to disputes by debtors, delays in payments and/or unnecessary recovery action taken.
- Poor customer service, leading to queries and complaints and loss of customers and/or reputation
- Potential for fraudulent activity.
- Overstatement of sales and receivable balances.

Potential response

- Formalised policies and procedures are in place that includes minimum information requirements to support invoices raised.
- Invoices raised for manual sales are physically filed and retained.
- All sales and supporting invoices are automatically archived in the organisation's accounting system.
- A formal, approved document retention policy is in place which includes sales and receivables documentation.
- An order acknowledgment is sent to the customer as confirmation of the sales order and corresponding receivable balance.
- Where calculations are manual, calculations are checked by a second individual and signed off as being accurate.
- Checks are performed on a sample of calculations periodically to identify any systemic issues.
- The accounting system will not allow a transaction to be posted more than once.
- Invoices must be matched to supporting documentation (e.g. Goods Despatch Notes or Sales Orders) before they are processed.
- Where a manual process exists, sales invoices are posted in the accounting system daily.
- Sales and corresponding entries to accounts receivable are recorded in the general ledger automatically from the data held on the original sales order.
- The accounting system automatically processes the transaction in the appropriate period according to the date of the invoice.
- Statements are issued to selected or all customers on a regular basis.
- The accounts receivable team will agree and tick off all credit amounts from bank statements to the relevant customer account.
- The accounts receivable ageing report is reviewed by the accounts receivable team on a weekly basis and is formally reviewed and signed off by senior management.
- Analytical procedures are performed (weekly, monthly, or yearly etc.) using comparative data, reconciliation or other analysis, and are reviewed and signed off by management.
- Non-standard journal entries are reviewed and approved by a member of senior management prior to posting.
- Debtor Ledger Reconciliations are performed.
- Adequate separation of duties has been established.
- Cheques received are logged and passed to a member of the accounts receivable team for review and posting.
- Bank reconciliations are performed on at least a monthly basis.
- Periodic review of a sample of invoices raised where the company is both a customer and a supplier to determine whether netting off occurs.
- Clear communication that netting off is not permitted.

Risk 3

Debts that are uncollectable (bad debts) will give a false impression of our performance.

Potential impact

- Reduction in profits.
- Cash flow issues.

Potential response

- Formally approved policies and procedures covering the debt recovery and chasing process.
- Statements are issued to selected or all customers on a regular basis.
- The accounts receivable ageing report is reviewed by the accounts receivable team on a weekly basis and is formally reviewed and signed off by senior management.
- The allowance for doubtful debts is reviewed and formally signed off by management periodically.