Accounts Receivable Turnover Ratio: What Is It, How to Calculate It, and How To Improve It

Process improvement is an essential part of maintaining a successful business, and few areas offer more potential for increasing value than accounting. A healthy balance sheet begins with effective and efficient financial processes—particularly in accounts receivable (AR), where revenue is collected to provide the assets that support operations and organizational goals for competitive performance. Through the use of financial ratios and performance metrics, both large and small businesses can measure and improve accounts receivable performance over time.

One of the most commonly used metrics for determining the operatiodiginal efficiency and overall effectiveness of your company's accounts receivable performance is the *accounts receivable turnover ratio*. With a thorough understanding of its function, you can refine this ratio to ensure your company is being paid in a timely fashion, managing credit effectively, and has the working capital it needs to fund innovation, invest in growth, and cover unexpected expenses.

What is Accounts Receivable Turnover Ratio?

Whereas its financial sibling, accounts payable (AP), is concerned with securing goods and services with maximum efficiency and minimum needless expense, the accounts receivable department tracks, manages, and collects money owed to your business while also managing credit extended to your clients.

Both AP and AR use a variety of metrics and activity ratios (also called *efficiency ratios*) to measure performance and efficiency in order to lower costs and provide greater value to the organizations they serve.

In AR, the accounts receivable turnover ratio is used to establish and improve the efficiency of a company's revenue collection process over a given time period. It is a numeric expression of the average collection period for outstanding credit sales.

Its complement in AP is known as the accounts payable turnover ratio.

A well-optimized accounts receivable turnover ratio is an important part of bookkeeping. It's essential when preparing an accurate income statement and balance sheet forecast. Ensuring it falls within the standards determined by your company's credit policies can also help you maintain a healthy cash flow and preserve positive relationships with your clients.

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How to Calculate Accounts Receivable Turnover Ratio

Also known as the *debtor's turnover ratio*, the accounts receivable turnover ratio measures how many times in a given time period (usually a month, quarter, or year) a company collects its average accounts receivable.

It is expressed as a simple formula:

Net Credit Sales ÷ Average Accounts Receivable = Accounts Receivable Turnover Ratio

Where

(Sales on Credit) – (Sales on Returns) – (Sales Allowances) = Net Credit Sales

and

(Beginning Accounts Receivable) + (Ending Accounts Receivable) ÷ 2 = Average Accounts Receivable

Note:

- Net credit sales are any sales for which cash is collected at a later date.
- Average accounts receivable refers to the total sum of beginning and ending accounts receivable over a specific period of time (e.g., a month, quarter, or year).

Another metric—derived from the accounts receivable turnover ratio formula—which measures the total number of days required for the average customer to pay for sales made on credit, is appropriately called *accounts receivable turnover in days*.

It is expressed using the following formula:

Days in Accounting Period ÷ Accounts Receivable Turnover Ratio = Accounts Receivable Turnover in Days

Accounts Receivable Turnover Ratio Example

Let us consider the ways a hypothetical business might use the accounts receivable turnover formula in calculating their own collection process efficiency.

Company X sells computers and accessories. They offer credit sales for their customers, and in the fiscal year ending December 31st, 2019, recorded $2,000,000 in annual credit sales, with returns of $50,000.

The starting accounts receivable for 2019 were $200,000, and at the end of the year, ending accounts receivable were $300,000.

Plugging these values into the accounts receivable turnover formula, we get:

($2,000,000 – $50,000) ÷ (($200,000 + $300,000) ÷ 2) = 7.8

Company X collected its average accounts receivable 7.8 times over the course of the fiscal year ending December 31st, 2019.

We can determine the accounts receivable turnover in days by using these values in the appropriate formula:

365 ÷ 7.8 = 46.79

Rounding up, we see it takes approximately 47 days for Company X's average customer to pay their outstanding debts to the company.

What is a Good Accounts Receivable Turnover Ratio?

Determining the strength of a company's receivable turnover ratio isn't so much a question of "good or bad" as it is "low or high."

Let's take another look at Company X. With a turnover ratio of 7.8, its average time to collect on an invoice is around 47 days.

When considering Company X's overall financial performance, we have to also consider a few other factors, including:

- **The company's credit policies and payment terms.** If Company X has a firm Net 30 policy in place, averaging 47 days to collect payment means something is seriously askew. The company needs to improve this ratio quickly to avoid potential issues (such as a cash crunch). If, on the other hand, Company X has a Net 60 policy, it's actually exceeding its goals.
- **Average turnover ratios for the company's industry.** An AR turnover ratio of 7.8 has more analytical value if you can compare it to the average for your industry. An industry average of 10 means Company X is lagging behind its peers, while an average ratio of 5.7 would indicate they're ahead of the pack.

All that said, a high turnover ratio is generally considered to be better than a low turnover ratio.

A **high accounts receivable turnover** ratio is strongly associated with:

- Efficient collection processes.

- A high-quality customer base.
- Conservative credit policies.

Conversely, a **low accounts receivable turnover ratio** is often seen as a strong negative, as it can indicate:

- Inefficient collection processes.
- Extending credit to the customers unwilling or unable to pay.
- Ill-defined, poorly monitored, or overly generous credit policies.

It's dangerous to adhere too stringently to absolutes, however. A company with a high turnover ratio (for example, 10) thanks to strict credit policies and aggressive collection methods may find themselves starving for business if the economy takes a downward turn and potential customers take their money to competitors who offer more lenient terms or discounts for those paying in cash.

Revisiting Company X, let's assume their peers have an average AR turnover rate of 6, and Company X itself offers credit terms of 45 days. They're ahead of the game at a 7.8, but with a 47-day average for payment on credit sales, they're still missing the mark with regard to collecting revenue needed to ensure adequate cash flow.

Clearly, Company X needs to identify the problem areas and make the necessary adjustments. Whether that means modifying their payment terms, redefining their qualifications for credit, or improving their process efficiency with regard to consistent and accurate invoicing.

Ultimately, a "good" accounts receivable turnover ratio is one that allows you to track and collect sales in an efficient manner so you can plan your cash flow effectively, whether you're investing in growth or holding cash against unexpected expenses.

Improving Your Accounts Receivable Turnover Ratio

Even if your business already has an enviable AR turnover ratio, there's always (or at least, usually) room for improvement. You can give a low ratio a boost by following a few simple best practices.

1. **Prioritize consistency.** Ensure you're sending invoices on time, and that every invoice is complete and accurate.
2. **Be clear and communicative.** Getting paid on time requires being able to enforce the credit policies you've set. Your payment terms should be clearly and completely enumerated in all contracts, invoices, and customer communications. Your customers won't have any nasty surprises in their budget, and you can collect your payments with confidence.
3. **Get flexible with payment options and discounts.** Offering a reasonable range of payment options not only allows you to offer your goods and services to more customers, but it simplifies payment—increasing the likelihood that you'll get paid on time and in full.
   Everybody loves a bargain, too, so don't be afraid to offer your customers discounts for paying ahead or cash sales. You'll get something of a bargain yourself, too, by lowering your accounts receivable costs while boosting your accounts receivable turnover rate.
4. **Practice proactivity.** Collecting outstanding invoices can be challenging in the best of circumstances. Waiting until customers have high receivable balances that are weeks or even months behind before you get serious makes a tough job even tougher.
   Establish policies for generating automatic payment reminders at regular intervals. Set flags to activate escalations, and carefully set and track metrics for customer payment and compliance to identify potential late payments or no-pay customers who may need extra intervention or, in extreme cases, removal from your customer base so you don't accumulate bad debt.
5. **Invest in automation.** Digital transformation is no longer a matter of "someday;" in a complex and competitive global market, it's an essential

part of successful business strategy. Accounting software is a good place to start, but in order to transform data into actionable insights that drive better decision making and improved performance, you need next-gen tools like artificial intelligence, process automation, and advanced analytics.

By adding these tools to your workflows, you can ensure you're sending accurate and timely invoices, monitor and streamline business-critical metrics, automatically generate invoices and payment reminders and ensure you always provide complete and accurate information to your customers.

Better still, by integrating it with a comprehensive procure-to-pay software solution like Planergy, you can leverage these benefits for all your financial processes to generate even greater value, performance, and savings.

Fine-Tune Your Accounts Receivable Turnover Ratio for Financial Performance

Getting paid promptly and regularly gives your business the cash flow it needs to grow, innovate, and compete effectively in today's marketplace. Make sure your accounts receivable turnover ratio is where you want it to be—based on the goals you've set for your organization and the standards of your industry—and you'll have the working capital you need as well as accurate and complete financial statements.

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