Accounts Receivable Deduction Management:
A Plague on Corporate Profits

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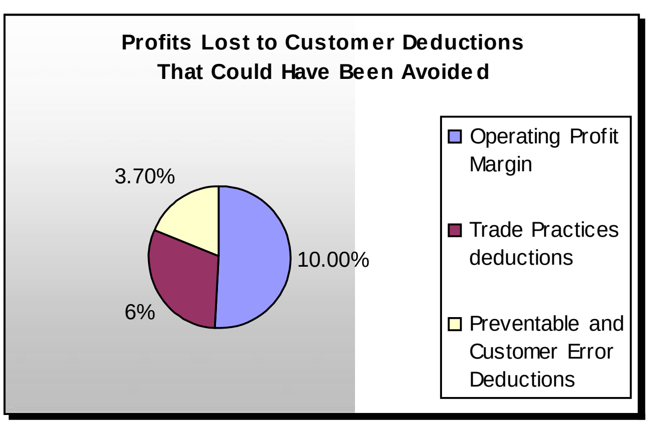
Over the past years, corporate order-to-cash processes have evolved significantly, enabled by billions spent on new technology that streamlines transaction processing with customers. All this money, however, has had little impact on the off-line manual paper-based processes used for the settlement of the payment exception, the “customer deduction.”

Customer deductions remain an intractable problem causing revenue and profit dilution costing even mid market companies man years of back office work and millions of dollars every year - depending on the industry up to 5-15% of *revenues.*



To understand the impact of the problem, let us look at a successful $2 billion retail channel supplier with a net operating margin of 10%, experiencing a (typical) 9.7% *customer deduction* rate. Of the 9.7%, preventable and erroneous deductions total 3.7% (of revenues).

The broad deduction classifications are *Trade Practices*, which are largely unavoidable, *Preventable* that cover reasons under the supplier's control, and *Customer Error*.

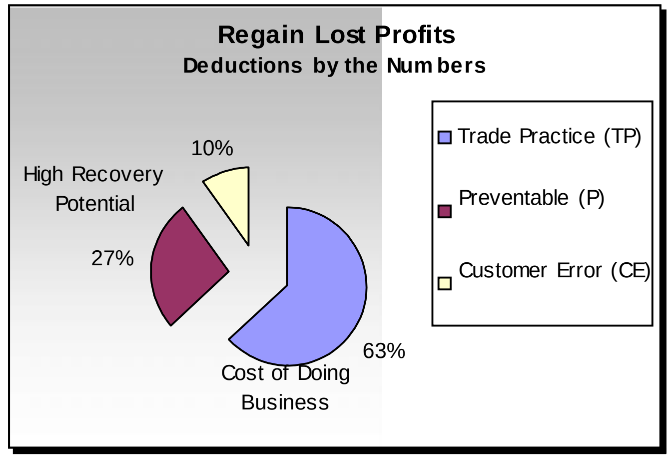
Technology has actually created a larger problem for many companies, since few are unable to comply perfectly with their major customers electronic data requirements.

Deduction processing is non-core, labor intensive but also very complex since deductions result from panoply of business problems and misunderstandings. Deduction resolution depends on the participation of the broader organization, including sales, distribution, finance, marketing, pricing, etc. Few companies track the true cost of this function, since it is dispersed among so many budgets, but those who do will be surprised at its magnitude.

Deduction Management Categories Explained

1. **Trade Practices**, where deductions are the chosen settlement and reimbursement vehicle such as promotional pricing allowances, co-op advertising, markdowns, coupons and the like. This is the "cost of doing business" deduction.

2. **Preventable Deductions**, such as poorly communicated price data, slow credit memo issuance, misinterpreted promotions, compliance violations, EDI problems, conflict in terms and conditions or processing errors in order entry, shipping, billing, etc.



3. **Customer Error,** unauthorized or excessive, such as unearned discounts, clerical error, misinterpretation of pricing, duplicate or excessive deductions, post-audit claims, or customer process errors and (occasionally) intentional abuse.

While many deductions are in fact “a cost of doing business”, there remains plenty of profit leakage that *can* be eliminated or reduced.

- **Discover** and fix root causes of systemic problems that cause deductions.
- **Understand** your customers’ operating needs and imbed them into your processes from trade planning to billing to fulfillment.
- **Manage** the deductions incurred so that no monetary recovery value is lost, using best practice systems and processes.
- **Benchmark** your results monthly against where you started.

Customer Deductions - A Plague on Profits

The impact of deductions varies considerably by industry, with the most basic industries having the lowest percentage of deductions, and those having the most promotions or complex supply chains the highest percentage. These high dilution businesses often “plan” to incur deductions in excess of 15% for heavy promotional and advertising bill-back expenses, or return of unsold seasonal or excess product. Deduction causes also vary by industry: for example, compliance violations run rampant in the apparel industry, slotting fees do in the grocery industry, and price protection and rebates elsewhere.   Here are a few of the industry issues.

- The shift to “go to market planning”. Push marketing, with discounts and incentives built into the invoice cost result in bill-back deductions.
- The trend towards electronic vs. paper transactions has streamlined but also complicated processes and created more error and non-compliance opportunities.
- Need for fast delivery sometimes conflicts with following through on order editing and shipping notifications.
- Complex promotional and increasingly complex pricing matrices.
- Third party sales partners such as brokers and the subsequent division of information and complex deals have benefited accounts payable recovery party auditors but not the suppliers.
- Most teams responsible for deduction resolution have little or no insight into upcoming or proposed promotional events. Absence of cross-

functional collaboration and timely access to information are frequently cited as problems.

- Communication of price or policy changes needs to be improved. A pharmaceutical company recently discovered that price change notices were not reaching the right people at its largest customer, and in turn was hit with more than $500,000 in pricing deductions within 60 days.

In the consumer goods industry, deductions are the preferred method for paying promotional dollars, and this is an institutionalized business process. This practice allows the customer to settle claims immediately. Unfortunately, being on the receiving end puts the burden of proof squarely on the supplier to document, research and resolve the deduction.

What this means is the supplier must investigate all deductions to sort the valid from the invalid so they can keep their marketing budgets and customer profitability analyses straight. The invalid or excessive claims still need to be handled also to identify and collected. If not done, the supplier will relinquish significant profits.

Regardless of industry, deduction resolution takes concerted effort and a lot of labor by a number of departments, including customer service, sales, finance, accounting, logistics, and IT. It represents a significant part of a company’s SG&A expense.

Accounts Receivable Forensics: Figuring out where the profit went.

Consider a *Forensic Deduction Audit* to determine financial performance gaps, to find out.

1. Prepare a detailed customer P&L. You are losing money on some of your biggest accounts because of deductions.
2. Do an in-depth audit of the top 20 customers including (a) policy and process disconnects and (b) deduction experience, abuse and profits lost.
3. Audit the unresolved, the write-offs, as well as a large sample of the credits issued to make sure the reasons are documented
4. Flow chart the process and figure out the bottlenecks
5. Implement tracking systems so you can figure out the root causes
6. Does not let your staff get buried in old work. Consider outsourcing it to experts.

Sarbanes-Oxley and Accounts receivable

If increasing profits is not enough, you now have another reason to focus on deductions, Sarbanes-Oxley provides it. Trade allowances and deductions can no longer be used as an undocumented sinkhole to lose sales deals, trade promotions and pricing disputes. Transparency and accountability are the new watchwords for corporate management, and CFOs are demanding compliance. This applies to your major customers as well; they are now much more receptive because of SOX.

Customer Relations

"To err is human, to blame the next guy even more so". It's easy to blame the customer on using deductions as a profit line item, but the root of most deductions goes back to internal failures of one sort or another, and long standing industry practices. Customer abuse and error is still significant, however, and tends to increase if not consistently counteracted.

The customer has a valid argument, also. Non-compliant supplier shipments cost customers hundreds of millions of dollars in unnecessary processing and rework. It is common today for buyers to measure errors using "Supplier Scorecards" which measure order fulfillment percentages, EDI compliance, on time delivery, packaging, labeling, etc. More deductions mean a lower supplier score, which will ultimately have an effect on the relationship.

A Simple Order-to-Cash Action Plan

The entire revenue cycle needs be examined from order entry to cash collection to find the delays, error prone areas, extra hand-offs and paper shuffling. This will free up both cash flow and resources.

Internally, you start with auditing and benchmarking your company's operation. Issues will often be found not where you expect, but also where you *inspect*. You can start by analyzing deduction experiences by type, customer, amount, etc., to pinpoint trends and identify problems.

1. Establish a continuous claims tracking to identify breakdowns and root causes.
2. Review customer agreements, and resolve the conflicts.
3. Pre-edit orders and reject for price and terms errors.
4. Have understandable invoices, as Accounts Payable only has a minute or two to check each.
5. Establish a system to manage customer compliance requirements.
6. Visit your customers, meet their people and learn their practices and policies.
7. Send product, pricing and promotion information to the right people.
8. Record special sales deals, something always talked about, often not done.
9. Make sure that your procedures and processes match your customer needs.
10. Understand the format in which each customer wishes to see your collection reconciliation, statement or documents.
11. Start collecting sooner and you are more likely get paid in full.

Use of Accounts Receivable Management Technology to Bridge the Performance Gap

When transaction levels are high, great technology is the key to performance. There are several enterprise systems available as well as a couple of bolt-on applications. While Smyyth's proprietary Cfari™ software is not available for sale, it can be used to benchmark the competence of available systems, as it incorporates the best practices and features developed in twenty-five years of accounts receivable management outsource experience.

- Internet based so that outside staff can take part in the resolution of receivables problems.
- Flexible rule-based workflow down to deduction type (i.e.; returns follow a different process than do discounts), and to customer name level as well (since a Wal-Mart, GM or Government requires a different process than a mom and pop customer).
- Assigning departmental accountabilities and responsibilities
- Automatic escalation rules based on type, size or age
- Automation to reconcile large numbers of credits and debits using custom algorithms to match partial and varied reference numbers.
- Fully automated contact control so that follow-ups are not overlooked
- The ability to reclassify deductions and problems after research
- Ability to forecast results and then manage against that
- Drill-down reporting at both the enterprise level for the CFO, as well as for customer and department performance management at the functional level.

Have We Made Progress?

For all the talk about prevention, in fact not much progress has been made over the past decade. A recent survey by the Credit Research Foundation indicates that deductions continue at up to 10% of sales revenue, a figure comparable to ten years ago. In addition, the median deduction cycle from receipt to resolution is 105 days (45 days to determine validity and additional 60 days to pursue collection if charged back), which, in the writer's experience, is about the same as in 1995. Extrapolating, a $1 billion company may incur $100 million of deductions per year and have $30 million tied up in deductions at any one time.

In today's competitive environment, no one can afford to let profits leak away, yet many continue to lose as much in deductions as they make in profits. While it is not "rocket science" solving this issue takes a good bit of expertise, a lot of hard work and a management commitment to implement good practices.