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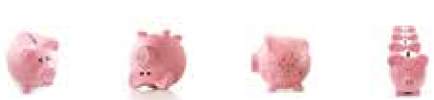
Make your working capital work for you

Strategies for optimizing your accounts receivable



Part of the Deloitte working capital series

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Strategies for optimizing your accounts receivable

Strategies for optimizing your accounts payable

Cash management

Strategies for optimizing your inventory

Given the cost of new capital, no business can afford to let their existing capital go to waste. However, some businesses don’t realize how much cash is trapped on their own balance sheets. Freeing up that cash – by optimizing their working capital – delivers more than improved operational efficiency. It also gives companies the added liquidity they need to fund growth, reduce debt levels, lower costs, maximize shareholder returns and even outperform their competitors.

While there are numerous ways to free up working capital, this series focuses on four core strategies: accounts receivable, accounts payable, cash management and inventory. This first installment looks at accounts receivable.

It is better to receive than to lend

Most businesses have formal accounts receivable policies that dictate when to bill, how much to bill and when to collect. Unfortunately, not all businesses enforce those policies effectively – or even adopt the right processes at all. In many cases, it comes down to culture. Businesses that prioritize sales often fall into the trap of extending credit to customers, offering discounts or ignoring payment terms if it means winning new sales. However, if management does not have a focus on working capital, no one will. The upshot? You end up unintentionally providing customers with free financing.

Some may argue this is no big deal, but the truth isn't so simple. If a company needs to borrow money to meet its obligations because customers are paying late, it could incur losses on the financing charges alone. Even if that's not the case, carrying overdue accounts receivable still has a cost. It puts you on a cash flow tightrope. Rather than having free capital to invest in growth opportunities, increase shareholder payouts, buy new equipment or introduce new products, your money is tied up on your balance sheet.

Common risks

While no company intends to adopt weak accounts receivable policies, lack of planning, poor enforcement or a failure to focus on the function can result in unintended consequences. These often arise when companies:

- Fail to follow up with customers in a timely manner when payments are past due
- Allow sales reps to override credit limits – and end up suffering losses from bad credit risks
- Neglect to provide staff with appropriate training on how to deal with late paying customers
- Don't pay sufficient attention to the accuracy of their bills, invoices or credit terms
- Allocate cash payments incorrectly, making it harder to figure out which payments are outstanding

Adopting best practices

Gaining access to this cash takes more than introducing new processes. It also requires the finance and sales departments to work together to develop payment terms that make sense for both the business and its customers. While there are no hard-and-fast rules for achieving this end-state, certain best practices do exist. For example, businesses can realize cost efficiencies by centralizing accounts receivable processing, perhaps through a centre of excellence which develops and enforces common practices and standards. Similarly, by automating processes, you can eliminate manual data entry errors and reduce transaction times.

Adopting key performance indicators (KPI) and defined metrics is also important. For instance, by adding working capital metrics to your standard revenue and profit tracking reports, you'll get a clear picture on items like days sales outstanding (DSO), the percentage of customers who pay late, the number of invoices or customers passed through your system, unreconciled items or accounts, the monthly percentage of write-offs, collection rates on bad receivables and even collection efforts made. This will position you to track performance on an ongoing basis.

A note on choosing KPIs

Rather than relying simply on a high-level metric like DSO, try to identify the metrics that impact DSO. After all, even if you know daily sales are 45 days outstanding, do you know if that's appropriate for your industry? To delve deeper, consider some more granular metrics, such as:

- How many invoices are past due?
- How many have unapproved discounts?
- How often does the sales team override standard terms?
- If overrides are frequent, should you change your terms?

There are five activities within the accounts receivable function that, if optimized, can help you free up cash and strengthen your working capital:

1. Customer credit approval

First off, you need a process – clear and concise policies for issuing credit and recovering debt in a timely fashion. To do this, you need to:

- Set responsibilities. Solicit input from the sales team when setting policies to ensure market realities are reflected. For instance, you need to understand when to grant credit, circumstances that may merit overriding credit limits and situations that would justify placing accounts on hold. Once those policies are established, however, the finance team must enforce them and sales should not be authorized to issue credit or change terms without pre-approval. The aim is not to have finance interrupt the sales process, but to acknowledge as an organization that not all customers are good customers.

- Determine when to assess credit limits. If a new customer is buying low volume items on short terms, a simple internal scorecard may be sufficient to assess their creditworthiness. Conversely, if a new customer is interested in purchasing large volumes on a regular basis, you may need a more stringent process, such as full background and credit history checks.

- Commit to approving or rejecting credit applications within a certain time period. Often, companies lack policies around how long it should take to turn around credit applications. If the time frame lags, it could result in lost sales and put a strain on the relationship between sales and finance – a relationship that demands cooperation if companies hope to realize long-term success.

- Regularly review the credit approval process. As customers and industries change, risk profiles change as well. If customers are in a high-growth industry, or one struggling against economic conditions, you may want to alter their credit terms. That means you'll need to review your credit approval process on a regular basis, and set policies around this too. For instance, will you ask for financial statements from customers? Will you grant terms for only limited time periods?

2. Customer master data

Once you assign credit limits, payment terms, discounts, tax rates and return policies, and any other relevant terms (i.e. delivery address,e-mail address etc.) to specific customers, those terms must be accurately reflected in your billing and collection systems. Customer master data should indicate what the customer is allowed to purchase, any dollar limits that apply, payment terms, whether they get volume discounts or advertising credits, and any other relevant terms.

Getting this wrong is more than a data entry glitch. For instance, if you enter an incorrect address, invoices go to the wrong place and receivables slow down. Likewise, if your master data indicates payment terms of 60 days when it should be 30, you won't be paid on time. Recognize, too, that the master data must be updated if a customer's credit profile changes. For instance, if you grant additional credit to a customer, this should be reflected in the system. Companies have a habit of assuming the master system trumps all, but that's only true if data accuracy is being maintained.

To get the most out of your data, you need to:

- Centralize the master data process and identify who should ultimately manage customer data*

- Conduct regular audits of master data to identify customers with abnormal credit limits, payment terms, and/or discount rates

- Document and communicate all changes to customer data. Changes should be approved by Finance and operations as they can have a significant impact on cash-flow forecasting

- Implement controls to ensure data accuracy and permit read-only access to staff to ensure they can't override customer data without proper sign-off

3. Invoicing/billing

You'd imagine that billing is fairly straightforward, but companies often struggle in this area. Some make consistent invoice errors regarding units of measure, price, customer accounts or other inaccurately reflected master data. Some fail to generate invoices in a timely fashion – or at all. Sometimes, team members make an end-run and bill outside the system. In other cases, companies bounce back and forth between mailed and electronic invoices, resulting in confusion. The key here is to establish a billing process that ensures accurate invoices are sent on a timely basis. To do this, organizations should consider the following strategies:

- **Automation**: can reduce time and human error

- **Timely/effective invoice generation and reporting**: can ensure billing is completed in a timely basis and reports are relevant to the end-user

- **Electronic billing systems**: EDI/electronic invoices can reduce delivery time and allow customers to download their invoices directly into their own accounting system

- **Exception reports**: can help to flag account anomalies (e.g.sales exceeding credit limits, discount rates above company policy, etc.)

- **Customer portal**: can reduce manual hours dealing with cash applications, disputes, collections, etc.

Manufacturer rebates often referred as Trade Spend is another area which provides management with an opportunity to optimize working capital. Rebate amounts can be significant and should be included in a company's working capital management and cash-flow forecasts. Standardized processes and controls should be put in place and monitored to ensure that the invoicing, accruing and collection/deduction (manufacturer / retailer vendor agreements may stipulate rebates are invoiced vs. being deducted from outstanding supplier invoices) of rebates is performed on a timely basis to maximize cash flow and minimize risk. Failure to implement strong processes can result in lost revenue and increased write-offs. The calculation and timing of manufacturer rebates can be complex, management should clearly define and communicate the company's terms and conditions throughout the business to ensure consistent implementation. A regular vendor agreement compliance audit is also recommended as these audits provide key data and metrics regarding the company's adherence to agreements and an opportunity to identify rebates not invoiced or deducted.

* If maintaining a centralized master data group is not feasible, assign a dedicated resource with privileges to make updates to the data. All other staff should have read access only.

4. Cash application process

Another area that causes trouble arises when customers pay their bills. As payments come in, it's essential they be applied both to the right customers and to the specific customer invoices they relate to. And this needs to be done on a timely basis so you always know which accounts are up-to-date and which are outstanding. Otherwise, it's impossible to track which customers paid on which invoices – making follow-up on late payments a virtual nightmare.

Companies that get this wrong often waste considerable time and resources reissuing invoices and even amending reconciliation reports where their systems can't "reverse" incorrect cash applications. To avoid this, you need to:

- Allocate payments to specific invoices rather than simply crediting the customer account
- Apply payments to the appropriate invoices, not just the oldest invoices
- Apply payments to each account on the day they're received, to maintain system accuracy. This can be complicated if the company accepts many different forms of payment, such as pre-authorized debit, cheques, wire transactions, electronic funds transfer or even payment over the phone. In these cases, it may make sense to limit the payment methods customers can use
- Post journal entries well before system cut-off dates
- Reconcile accounts on a timely basis by quickly and consistently following up on unidentified cash receipts rather than dumping them into suspense accounts and letting them languish

5. Collection process

While every business enjoys collecting revenues, not all organizations take a proactive approach to ensure receivables are collected on a timely basis. This is often due to weak processes. For instance, a lack of reporting can make it difficult – or impossible – to determine which amounts are collectible and which may be in danger of default. Similarly, failure to adhere to the company's credit or collection policies makes it harder to determine which payments are late and which will never arrive.

Of course, before they can follow up on late payments, your staff members also need assurance that the accounts receivable reports are accurate as of today and that there aren't days, or even weeks, worth of cash receipts that have not yet been applied to customer accounts. This requires a robust accounting process. Other ways to maximize collection of receivables include:

- Engaging in frequent and consistent collection efforts. This includes bolstering staff skills if they lack knowledge on how to collect amounts owing from recalcitrant customers
- Negotiating payment plans that align to corporate collection policies
- Ensuring any discounts offered benefit the company and are implemented accurately
- Strengthening processes to permit accurate reporting
- Automating processes to avoid manual entry errors

Getting cash fit

Whether you need to reconceive your entire accounts receivable function or simply want to improve on existing policies, the process begins by understanding your current state and conducting a gap analysis to determine how your performance compares to industry peers, competitors and best practices. From there, you can identify the steps you need to take to close those gaps.

Beyond simply helping you identify areas for remediation, Deloitte's working capital professionals work with your teams to tactically implement new processes, monitor and track your performance and share specific action items your staff can take to optimize your accounts receivable processes. You work hard to earn your cash. Isn't it time to get your cash working hard for you?

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