

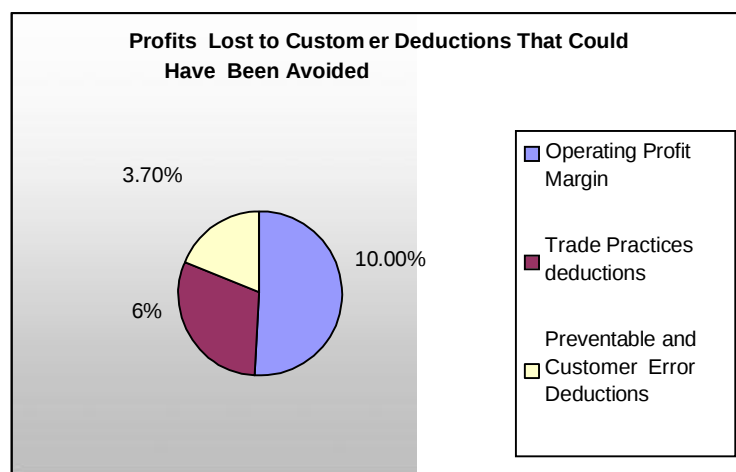
ACCOUNTS RECEIVABLE DEDUCTIONS - STILL A PLAGUE ON PROFITS

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Over the past two decades, corporate order-to-cash processes have received investment of billions spent on consultants and software, with the aim of streamlining transaction processing with customers.

The results, however, are that at the bottom line, deduction losses have not been reduced, and the process has gotten even more complex. Customer deductions remain an intractable problem causing significant revenue and profit dilution for manufacturers, costing even mid-market companies millions of dollars of expense every year: depending on the industry, up to 5-15% of *revenues*.

To understand the profit impact of customer deductions, consider at a \$1 billion retail-channel supplier with a net operating margin of 10% and experiencing a typical 9.7% (\$97 Million) *customer deduction* rate. Of the 9.7%, questionable deductions may total a third, which is also about a third of the net margin, which leaves a significant profit improvement opportunity.



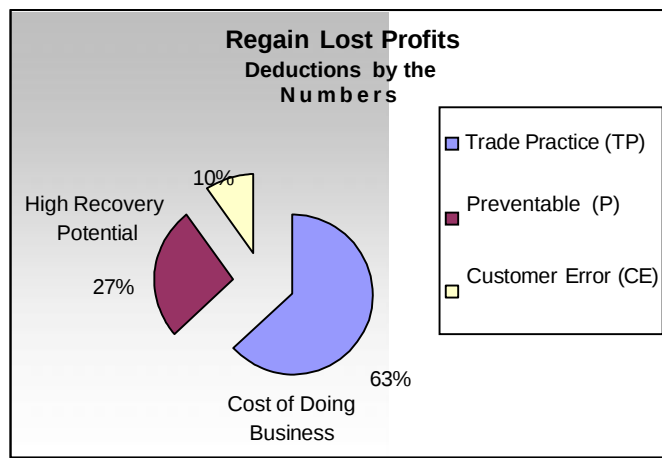
Chain retailers, especially, have invested in technology that has created an even larger problem for many smaller suppliers since few can comply perfectly with their major customers' technology and purchase order requirements.

Deduction processing is labor intensive and complex since deductions result from a panoply of business problems and misunderstandings. Deduction resolution depends on the participation of the broader organization beyond accounts receivable, including sales, distribution, finance, transportation, marketing, pricing, etc. Few companies are able to track the true cost of customer deductions since the expense is distributed among so many departmental budgets. Those who look at it closely will be surprised at its magnitude.

There is the potential for a significant payoff from managing deductions, but achieving it requires expertly configured accounts receivable deduction software automation plus staff with industry know-how. The payoffs include Identifying and correcting the root causes of systemic problems and customer disconnects and, more directly, the deduction profit leakage recaptured through the reconciliation of excessive deductions, which can more than outweigh the costs of the entire process.

DEDUCTION MANAGEMENT CATEGORIES

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



1. **Trade Practices**, where deductions are the chosen settlement and reimbursement vehicle, such as trade promotions, co-op advertising, markdowns, coupons, and the like. This is the “cost of doing business” deduction category.
2. **Preventable Deductions**, such as poorly communicated price data, slow credit memo issuance, misinterpreted trade deals, purchasing compliance violations, EDI mistakes, conflict in terms and conditions, or errors in order entry, shipping, billing, etc.
3. **Customer Errors include** unauthorized or excessive deductions, such as unearned discounts, misinterpretation of pricing, duplicate deductions, post-audit claims, customer process errors, and (occasionally) intentional abuse.

CUSTOMER DEDUCTIONS CAUSES AND IMPACTS

The financial impact of deductions varies by industry, with businesses having the most trade promotions or complex supply chains having the highest incidence of deductions. There are “high-dilution” industries that plan to incur deductions more than 15% of revenues because of heavy trade promotion bill-backs or the return of unsold seasonal or excess products. Deduction causes vary by industry. For example, compliance violations run rampant in the apparel industry, slotting fees in the grocery industry, and price protection and rebates elsewhere. Here are a few of the industry issues.

- a. Trade promotion spending, with discounts and incentives built into the invoice cost, results in heavy bill-back deductions.
- b. Electronic vs. paper has streamlined but complicated processes and created more repetitive systemic errors and non-compliance opportunities.
- c. The need for fast delivery often conflicts with careful order editing and timely shipping notifications (ASNs).
- d. Complex promotional and pricing matrices, poorly communicated to customers.
- e. Communication of price or policy changes needs to be improved. A pharmaceutical company recently discovered that price change notices were not reaching the right person at its largest customer. As a result, they were hit with more than \$500,000 in hard-to-solve pricing deductions within the next 60 days.

In the consumer goods industry, bill-back deductions are the institutionalized process for paying trade promotion dollars. This practice allows the customer to settle (deduct) claims immediately. But, unfortunately, being on the receiving end puts the burden of proof squarely on the supplier to document, research, validate, and resolve the deduction.

The supplier must carefully investigate all deductions to sort the valid from the invalid so they can keep their marketing budgets and customer profits on target. Invalid or excessive claims need to be carefully handled and collected. Otherwise, the supplier will relinquish significant profits.

Regardless of industry, deduction resolution takes concerted effort and intensive labor by several departments, including customer service, sales, finance, accounting, logistics, and IT. As a result, it represents a significant part of a company's SG&A expense.

BLAME THE CUSTOMER?

It's easy to blame the customer for using deductions as a profit item, but the root of most deductions goes back to supplier inattention to purchasing rules or internal failures of one sort or another, as well as long-standing industry practices. Customer errors are also significant and tend to increase if not consistently counteracted.

Large customers have a valid argument. Non-compliant supplier shipments cost them hundreds of millions of dollars in unnecessary processing and rework. BAs a result, they charge you back for mistakes and track your performance using "Supplier Scorecards," which measure order fulfillment percentages, EDI compliance, on-time delivery, packaging, labeling, etc. More deductions mean a lower supplier score, ultimately affecting the relationship.

OFFSHORING

While there may be individual success stories, offshoring customer deductions has been a failed attempt to "eat your cake and have it too."

Large corporates that see accounts receivable and customer deduction management only as a low-value transaction process were sold that offshoring was the solution to high personnel costs. A more holistic view may show a different picture.

- Offshore customer service (we all have personal experience with this) and lack of subject matter and industry know-how is a recipe for poor results and customer dissatisfaction.
- Combining the above with the need to negotiate dispute outcomes is a recipe for poor results.
- Many offshore outsourcers, even today, use rudimentary systems, even spreadsheets, instead of specialized automation for routine tasks.
- Offshore services that continue to use the client's existing software are worse off than the client was before, applying lower knowledge to the same process.

KPIS, METRICS

Before you start, figure out what the right tracking metrics are for you so that you can benchmark progress. Industry peer benchmark data is not particularly useful as company processes and policies differ. Hence, the best way to track your progress is to set internal baselines (where you are today) and work to improve from there.

Deduction Days Outstanding (DDO) By Dollars. Track deductions using Deduction Days Outstanding (DDO), not combined with Days Sales Outstanding (DSO), which is the invoice collection benchmark. To calculate DDO, add the value of deductions taken in 90 days, then divide by 90 to get the average per day. Then, divide the total still open on the books by the

average per day to calculate DDO. For example, if deductions at the end of a month total \$1,000,000 and you receive an average of \$25,000 per day, the DDO = 40 days.

DDO by the Number of Deductions (DDO-N). Another way to think about DDO is to use the *number* of unresolved deduction items since the usual DDO by dollar metric often looks better than it is because of the natural focus on resolving large dollar items. Using this method, if unresolved deductions at month-end total 6,000 items and you receive an average of 100 deductions per day, the DDO-N = 60 days.

Deduction Effectiveness Index (DEI) New: The A/R department spends much labor and expense (often 75% of the A/R resources) to discover the root causes of errors, find the improper deductions, and ultimately get your money back. We employ what we named the DEI as a critical KPI metric to track the bottom-line results of how we are doing. To determine the DEI every month, compare the total deductions vs. the deductions found to be incorrect vs. the collected deductions. Do this by category (returns, shortages, discounts, trade promotions, etc.) and track your company's progress.

YOU CAN'T JUST WRITE THE STUFF OFF.

Sarbanes Oxley (SOX) requires documentation to support trade allowances and deductions. Transparency and accountability are the watchwords for corporate management, and CFOs are demanding compliance. This also applies to your primary customers; they are now much more receptive because of SOX.

A SIMPLE DEDUCTION ACTION PLAN

While certain deductions are, in fact, “a cost of doing business,” there remains plenty of profit leakage that can be eliminated if you have a plan and measure your efforts.

Use best practice systems and processes to manage deductions so that no monetary recovery value is lost. Examine the revenue cycle from order entry to cash collection to find the delays, error-prone areas, extra hand-offs, and paper shuffling you can eliminate. This will free up both cash flow and resources.

1. Measure. You start with auditing and benchmarking your company’s operations. Issues will often be found not just where you expect but also where you *inspect*.
2. Analyze deductions by type, customer, amount, etc., to identify trends and problems. Report and fix the root causes of systemic issues that cause deductions.
3. Understand your customers’ operating needs and embed them into your processes, from trade planning to billing to fulfillment. For example, understand the format in which each customer wishes to see your collection reconciliations, statements, or documents.
4. Review purchasing agreements and resolve conflicts with your policies and terms. Send product, pricing, and promotion information to the right people, not just generic email addresses.
5. Design easy-to-understand invoices, as Accounts Payable only have a minute to check invoices, and use easy-to-interpret trade promotion deal sheets.
6. Do an in-depth audit of the top 10 customers, including (a) policy and process disconnects and (b) deduction experience, abuse, and profits lost.
7. Prepare a detailed customer P&L for your top 10 customers, starting with gross profit and deducting deduction losses. You are losing money on some of your biggest accounts because of deductions and may not know it.

A/R MANAGEMENT SOFTWARE CAN TRANSFORM DEDUCTION MANAGEMENT

When transaction levels are high, great technology is the key to performance. You set the strategies, and the system can drive the entire process from cash application through deduction and collection management, eliminating redundant overhead. For example, consider a Software as a Service (“SaaS”) system with flexible rule-based workflow down to deduction type (i.e., return deductions follow a different process than do discounts) and customized by the customer (since a Wal-Mart requires a different process than mom-and-pops). The best systems will include robotic process automation to eliminate the repetitive work of interacting with customer portals and transportation carriers. Assigning departmental accountabilities and responsibilities

- Automatic escalation rules are based on type, amount, or age.
- Automation to reconcile large numbers of credits and debits using custom algorithms to match partial and varied reference numbers.
- Automated validation of trade deal deductions.
- Fully automated contact control so that follow-ups are not overlooked.
- The ability to reclassify deductions and problems after research.
- Ability to forecast cash collection results and then manage against that.
- Drill-down reporting at both the enterprise level for the CFO and customer and department performance management at the functional level.
- Look at the state-of-the-art [trade promotion and deduction management software](#), which includes automatic matching *and* validation of deductions against trade promotion deals.. This will give your staff time to handle the most complicated customer issues.

SUMMARY: HAVE WE MADE ANY PROGRESS?

For all the talk about eliminating deductions, not much progress has been made over the past two decades. A recent survey by the Credit Research Foundation indicates that deductions continue at up to 10% of sales revenue, about the same as twenty years ago. In addition, the median deduction cycle from receipt to the resolution of excessive deductions is 105 days (45 days to investigate and 60 days to pursue collection if charged back), about the same as in 1995. A \$1 Billion consumer goods company may incur \$100-150 Millions of deductions annually and have \$20-50 Million tied up in deductions at any one time.

In today's competitive environment, no one can afford to let profits leak away, yet some companies still lose almost as much in deductions as they make in profits. Deduction Management is as close to "rocket science" as you can get in the accounts receivable field. It takes a management commitment, corporate focus, expert staff, and advanced accounts receivable deduction software to be a top performer.

Call if we can help.



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About Smyyth/Carixa

Smyyth provides advanced Carixa™ accounts receivable automation and expert project and outsourcing services for accounts receivable, including post-audits and deduction management, to help clients achieve extraordinary productivity, cash flow, and customer service.
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