Accounts Receivable Management Best Practices

John G. Salek

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This book is dedicated to the people and institutions who have helped me immeasurably through the years.

My parents, who persevered in their lives through the Great Depression and World War II to provide a wonderful childhood environment for my brothers and I to grow up and be happy in our chosen endeavors.

My brothers, who walked beside me during the early years and who have since prospered in their chosen professions.

Linda, the love of my life and my wife of 27 years, who has been at my side the majority of my adult life, providing support and stability.

Our two children, Michael and Stephanie, who have been an unending source of joy and pride.

The teachers, professors, and coaches at Ramapo High School in Franklin Lakes, New Jersey; The University of Connecticut; and The Amos Tuck School of Business Administration at Dartmouth College; who provided the educational foundation to succeed.

Bob Troisio, my mentor at International Paper Company, who introduced me into the field of receivables management over a quarter of a century ago.

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PREFACE

In today's global marketplace, competitive pressure and industry practice mandate that products and services be sold on a credit vs. cash-on-delivery basis. This practice often produces a receivables asset that is one of the largest tangible assets on a company's balance sheet. A review of the 2004 Fortune 500 certainly reveals this truth. Receivables ranked among the top three tangible assets for 75% of the top 100 companies. Surprisingly, management of this multi-million (or multi-billion) dollar asset rarely receives much senior management attention, except when a serious problem develops. The custodians of the receivables asset are similar to umpires of a baseball game; they are not noticed unless they do a bad job.

This book discusses the importance of managing accounts receivable, and provides proven principles for achieving benefits such as increased cash flow, higher margins, and a reduction in bad debt loss. The focus is primarily on commercial (business to business) receivables management. It excludes the specifics of managing retail (business to consumer), healthcare provider (third party reimbursement), and intercompany receivables. The principles described apply to all business-to-business commerce, but will often need to be tailored to industry-specific practices.

The Best Practices in this book are real-world, field-tested practices. They were developed, refined, and improved by the author over a 16 year period while working with over 100 companies in a wide range of industries to generate tangible, measurable improvements in the management of customer receivables. Examples drawn from those engagements will be used throughout the book to illustrate real-world problems and solutions that drive measurable results.

This book is designed for all managers who are responsible for managing the receivables asset, either directly, such as directors of customer financial services and credit managers or indirectly, such as controllers, treasurers, and CFOs. Reading this book will enable readers to better understand how to manage this important asset while learning numerous practical techniques that can be implemented immediately to drive improvement.

CHAPTER 1

Introduction

WHY IS RECEIVABLES MANAGEMENT IMPORTANT?

It can be argued that revenue generation is the most critical function of a company. Dot-com companies that created exciting new products but failed to generate significant revenue burned through their cash and ceased operating. Every company expends substantial resources to generate increasing levels of revenue.

However, that revenue must be converted into cash. Cash is the lifeblood of any company. Every dollar of a company's revenue becomes a receivable that must be managed and collected.

Therefore, the staff and processes that manage your receivables asset:

- Manage 100% of your company's revenue.
- Serve as a service touch point for virtually all your customers. (Only Sales and Customer Service speak more with your customers.)
- Can incur or save millions of dollars of bad debt and interest expense.
- Can injure or enhance customer service and satisfaction, leading to increases or decreases in revenue.

If increasing revenue, enhancing customer satisfaction, and reducing expenses are important to you, read on.

The benefits of effectively managing the receivables asset are:

- Increased cash flow
- Higher credit sales and margins
- Reduced bad debt loss
- Lower administrative cost in the entire revenue cycle
- Decreased deductions and concessions losses
- Enhanced customer service
- Decreased administrative burden on sales force

These benefits can easily total millions in profit and tens of millions of cash flow in a year.

IF IT WAS EASY, EVERYONE WOULD DO IT (WELL)

Management of the receivables asset is a demanding task. The vast majority of companies expect that over 99.9% of all billings will be collected. *Collecting ninety five percent of revenue is not good enough.* Companies will tolerate bad debt expense of several tenths of a percent of revenue, but not much more. Which other departments are expected to perform at 99 plus percent effectiveness?

It is generally expected that a high percentage of invoices will be paid on time and over 90% within 30 days of the due date. Management expects that the asset will be managed to promote sales and that all customers will be served promptly, courteously, and professionally. Astoundingly, most firms also expect this all to be accomplished for a cost equal to about *two to three tenths of a percent of revenue. Quite a bargain!*

Management of the receivables asset is a complex task. It addresses the ramifications of practices and processes usually outside the span of control of the responsible manager. It requires balancing of opposing

CASE HISTORY

How Improved Receivables Management Can Revitalize an Organization

A high-technology firm whose products were well regarded by the marketplace was experiencing an especially serious receivables management problem. Bad debt exposure and the investment in receivables were high (days sales outstanding [DSO] was just over 100 days). Millions of dollars in disputed amounts were being conceded annually, not in response to valid customer disputes, but simply as a function of age. In addition, the company's stock price was depressed because of the high DSO. Wall Street analysts interpreted the elevated DSO as an indication that:

- Their new products did not work properly, or
- Products were delivered on a trial basis, were not valid sales, and therefore were not true receivables.

Clearly, this firm was feeling tremendous pain from failure to manage its receivables.

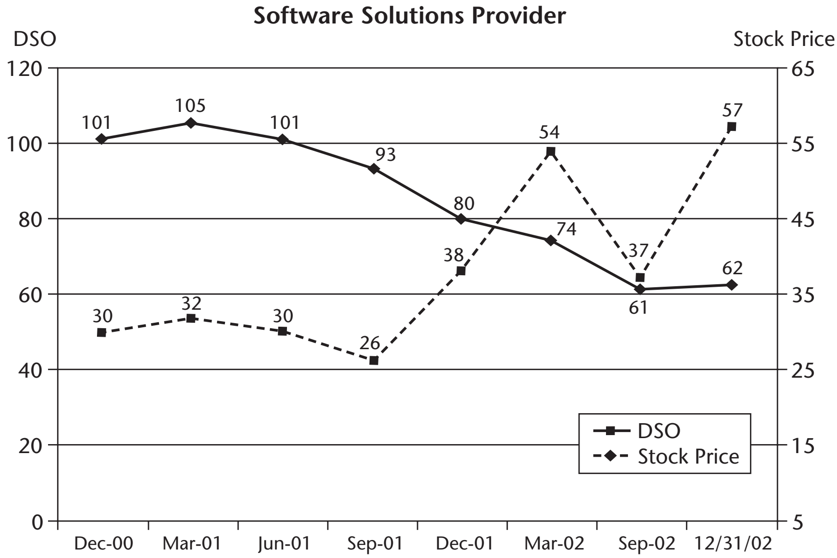
Over an 18-month period, this firm completely redesigned its receivables management process, tools, staff skills, and management culture, implementing most of the principles and techniques described later in this book. The benefits from the company's improvement in its receivables, illustrated in Exhibit 1.1, include:

- A huge increase in the stock price, and
- An increase in cash on hand equivalent to four months of sales.

In addition to the increase in stock price and cash on hand, bad debt and concession expenses decreased by several million dollars annually.

priorities. It is affected by the state of the domestic and global economy, interest rates, foreign exchange rates, banking regulations and practices, business law, and other factors. Excellence in receivables management is a combination of art as well as science; it involves business process, technology tools, staff skills, motivation, company culture, changing behavior of both customers and coworkers, the right organization structure and metrics, incentives, and flexibility to deal with changing external influences.

Exhibit 1.1 Benefits of Improved Receivables Management



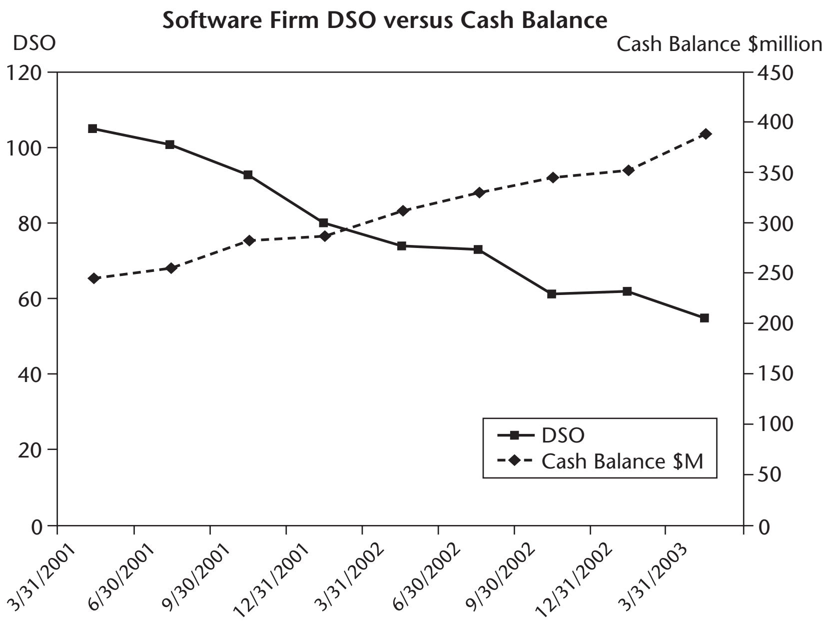
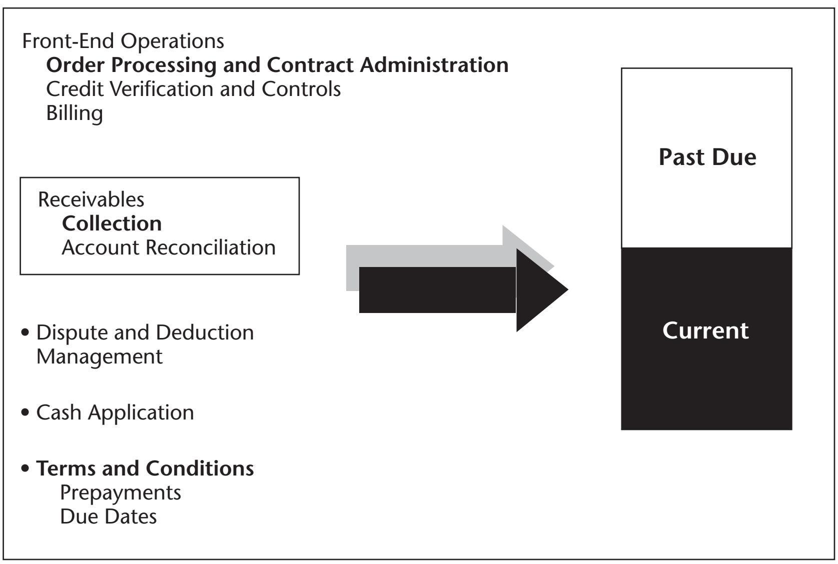


Exhibit 1.2 illustrates the determinants or drivers of receivables management. Most of them are outside the direct control of the manager with responsibility for receivables.

INFLUENCES OUTSIDE THE CONTROL OF THE RESPONSIBLE MANAGER

The receivables asset is sometimes called the garbage can of the company. This is because the receivables asset reflects the quality of the entire revenue cycle operation. If an error is made in taking an order, fulfilling it, invoicing it, applying the customer payment, or if the customer is dissatisfied with the product or service, it will manifest itself as a past due or short payment in the receivables ledger. The quality of the receivables asset is an excellent barometer of customer service. It is feedback the customer willingly and quickly gives. It is tempting to call it a free quality control measurement system, except it is not free. The firm does not have to pay customers for the feedback, but it does incur costs in remediating the problems.

Exhibit 1.2 Drivers of Improved Receivables Management



In most companies the sales strategy and/or the front-end operations (i.e., order processing and fulfillment, etc.) are outside the direct management control of the person responsible for receivables management results. In such cases, the manager is measured on the results of a process that he or she does not fully control. In response to this, enlightened companies will place the entire revenue cycle (order to cash cycle) under the control of a single executive, as a "process owner." This arrangement has numerous advantages, the primary one being the matching of authority with responsibility. Even then the executive does not have total control over all the determinants, specifically the sales strategy and the "need to make the numbers" at the end of a month or quarter.

CONFLICTING PRIORITIES

Excellence in receivables management requires trade-offs between conflicting goals. The trade-offs are best balanced in accordance with the company's overriding strategic objectives. To optimize the trade-off, the relative ranking of these strategic objectives must be understood:

- Sales growth
- Profitability
- Cash generation
- Market share
- Risk tolerance

The conflicting objectives are to:

- Loosen credit acceptance criteria and controls to boost sales versus tightening credit controls to minimize the investment in receivables and the exposure to bad debt loss
- Achieve strong receivables management results and provide excellent financial service to your customers versus minimizing the cost of the function

The Best Practices described in this book, when tailored to a company's strategic objectives, culture, and industry, will enable excellence in receivables management in all of its dimensions. This excellence will deliver the profit and cash benefits available to your company.[1]

Note

1. *Fortune*, Special Issue, vol. 149, no. 7 (April 5, 2004), pp. F1–F20.

CHAPTER 2

Receivables Antecedents

Receivables antecedents are defined as all the up-front operations required to create a receivable. They include:

- Quotation
- Contract and pricing administration
- Order processing
- Credit control
- Invoicing

This chapter addresses these receivables antecedent functions only as they affect receivables management. Naturally, there is a great deal more information and detail about these functions, but we will limit the discussion as noted.

The antecedents are absolutely critical to the management of the receivables asset. They directly impact the quality and collectability of the asset and are the key driver of the cost to manage a company's revenue stream. A simple formula to illustrate this point is:

High customer satisfaction + Accurate invoice =
Excellent receivables results

This formula holds true even if the core receivables management functions (i.e., credit control and collections) are lacking. Excellent order fulfillment drives high customer satisfaction. In combination with accurate invoicing, the cost of delinquency, concessions, and management of the receivables asset can be dramatically reduced. When competent credit control and collections are added, the total receivables management benefits are maximized.

QUOTATION

Overview

Quotation is the process of extending a formal offer for a product or service to a prospective or existing customer. A clear, complete quotation lays the foundation for excellent fulfillment of a customer order and accurate invoicing.

The two key attributes of a quotation that promote excellent receivables results are:

1. **Feasibility/deliverability of offering.** Do not quote something you cannot deliver. The product or service quoted must be able to be delivered by your firm and perform as sold. If not, the customer will be dissatisfied with the product/service and withhold payment of your invoice
2. **Clear commercial terms and conditions agreed by both parties.** The six elements of a quotation that affect receivables results are:
    1. The unit and total price (clearly stated including all discounts)
    2. Applicable sales or use tax
    3. Freight/delivery (actual versus allowance, who pays it)
    4. Payment terms (when is payment due?)
    5. The timing of issuing the invoice (upon shipment, at the start or completion of a project, on reaching a milestone)
    6. Description of product or service offered (product number, layman's description, proper or trademarked product name).

CASE HISTORY

Make Sure Receivables Management Is the Problem

A European supplier of turnkey computer systems that included hardware, software, and training was experiencing poor cash flow and seriously delinquent receivables. After speaking with collections, customer service staff, and customers, it was apparent that many of the systems were not working as promised. This company did not have poor receivables management processes or practices; it had a product that did not work. Improvement in receivables results could not be achieved without first improving product performance.

CASE HISTORY

Improved Product Performance Leads to Improved DSO

A New England manufacturer of big-ticket production equipment rushed a new product into the marketplace before it was completely debugged. Performance problems developed, customers withheld payments, and DSO approached the 200 level. The manufacturer devised a solution and methodically retrofitted the installed base of the new product. Customers were pleased but insisted on running the "fixed" equipment for 30 days before accepting and paying for it. The retrofit program required six months to complete, but it was successful. The firm's DSO dropped as much as 10 to 20 days per month once the retrofit program progressed, returning to normal levels after approximately eight months. No improvement in receivables management practices was made; the improvement resulted entirely from improvement in product performance.

Best Practices

- Limit quotations to offerings in the approved sales catalog or other official product listing.
- Utilize an automatic "product configurator" tool. Doing this prevents offering a combination of products, options, and/or accessories that are not compatible. An example of incompatibility