How Automating the Management of Customer Deductions Reduces Time, Complexity and Cost in Accounts Receivable

An AR & O2C white paper

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After years of focusing on defensive cash management strategies, corporate growth and profitability have moved to the top of the CFO's agenda. Seventy-one percent of CFOs surveyed by Accenture say that supporting corporate growth is their finance organization's top priority. It is no wonder that more CFOs are taking a hard look at their accounts receivable (AR) processes. As one of the largest assets on the balance sheet, AR can have a big impact on the financial performance of a business. One way that CFOs are improving their organization's AR processes is by rethinking the way it researches and resolves customer deductions — when a payment is made on an amount less than the net invoice amount. Poor deductions management results in lost profits, high operational costs, wasted employee time, and frustrated customers and departmental stakeholders. Thirty-five percent of AR professionals surveyed by Shared Services Link say that the length of time to resolve customer deductions is one of their greatest barriers to improving Days Sales Outstanding (DSO). This white paper details the three types of deductions, shows how manual approaches to deductions management increase the time, complexity and cost of AR, describes an automated approach to deductions management, and details the benefits of automation.

18% of AR leaders say that too many customer deductions are among their top challenges, Shared Services Link reports.

The Situation

Deductions can be taken as a short pay on an invoice where the amount remitted against the invoice is less than the balance due, or when the items listed are debited on cash remittance details (which can be related to multiple invoices or related to a different agreement not tied to invoicing).

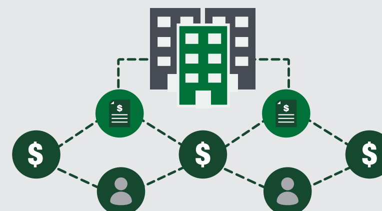
Deductions fall into three broad categories:

1. **Trade practices:** Trade practices are legitimate deductions that are a "cost of doing business." These deductions typically include: promotional pricing, damaged or defective merchandise, shortages in a shipment, disputed amounts, slotting fees, marketing and advertising bill-back allowances, rebates,

Deductions are the preferred method for paying promotional dollars in the consumer goods industry.

mark-downs, the return of unsold seasonal or excess product, freight charges, bank fees, and price protection programs. In some industries, taking a deduction is an acceptable form of making a payment to a customer for pre-agreed upon terms such as a promotion or a rebate. In these industries, most deductions are valid. For instance, one major retailer instituted a program several years ago that allows it to deduct 3 percent from the cost of goods sold for suppliers who fail to deliver goods to its retail locations within a four-day window more than 90 percent of the time during a month.

Most mass market retailers short pay most of their invoices. Yet these deductions are valid, with corresponding credits sitting in an account or waiting for internal approvals.



2. **Preventable deductions:** Preventable deductions include: poorly communicated pricing data, slow credit memo issuance, misinterpreted promotional programs, conflicting terms and conditions, processing errors in order entry, missed edits to orders, rush orders sent without shipping notifications, billing errors, incorrect taxes, compliance problems, and electronic data interchange issues. One common cause of preventable deductions is an incorrect invoice to a customer caused by mis-keyed line-item level information from a sales order. Complex promotional programs and pricing matrixes also can result in preventable deductions.

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CFOs are demanding greater accountability and transparency over financial processes such as deductions management.

3. **Erroneous customer deductions:** These are unauthorized or excessive errors such as unearned or duplicate discounts, clerical errors, processing errors and misinterpreted pricing. Errors during accounts payable processing are a common cause of erroneous deductions.

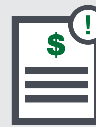
Two-thirds of credit leaders report an **increase in the volume of deductions**, per the Credit Research Foundation (CRF).

The Problem

While some deductions are an unavoidable part of business, preventable and erroneous customer deductions take a heavy toll on billers. Preventable and erroneous customer deductions are:

1. **Time-consuming:** Inefficient and ineffective processes for resolving customer deductions waste a lot of staff time — time that could be better spend on core or value-added activities. What's more, the longer it takes to resolve a preventable or erroneous customer deduction, the greater the chance that the biller will not collect the full amount of the invoice.
2. **Complex:** The array of departmental stakeholders (e.g., sales, marketing, finance, distribution and pricing), and information sources involved in preventable and erroneous customer deductions makes them complex to resolve. The vast number of departmental stakeholders involved in resolving deductions also makes it hard to track their cost to the business.

The median deduction cycle — from receipt to resolution — stands at an eye-popping 105 days, CRF reports.



Deductions account for up to **10 percent of sales revenues**, CRF reports.

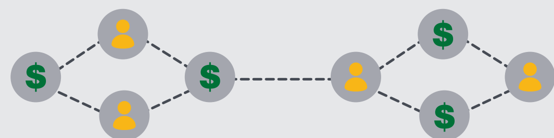
3. **Costly:** Customer deductions also chip away at net operating margins. The cost to research and resolve an unauthorized customer deduction is between $200 and $300 per deduction, studies show. Worse, of the average 10 percent net operating margin of a successful retail channel supplier, 3.7 percent is lost to preventable and erroneous customer deductions. Businesses with complex supply chains or a heavy stream of promotions suffer the biggest losses due to preventable and erroneous customer deductions, industry studies show.

Suppliers must investigate all deductions to separate the valid and invalid ones.

The time, complexity and cost associated with preventable and erroneous customer deductions is a direct result of manual processes that most AR departments use to manage them.

The first step in resolving a deduction usually is to assign it to someone for research and resolution (usually, an AR

50% of businesses rely on manual processes to manage their receivables, per the Association for Intelligent Information Management.



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representative, analyst or collector). The person responsible for managing the deduction starts by capturing the reason given by the customer for taking the deduction or contacting the customer to learn the reason. In the case of a short payment, a biller may apply the paid amount and leave the invoice open with the remaining balance. For necessary or valid deductions taken on the receipt, billers may create a debit memo to record the deduction and a credit memo to pay the short pay and apply the payment receipts in full.

Deductions can be settled as a **credit memo** when they're valid.

The person then must research the deduction for validity. The invoice is then reviewed for incorrect pricing, wrong terms and conditions, and other reasons for a valid deduction. Staff also might request clarifying information on the invoice from the customer, and/or stakeholders such as sales, marketing, or distribution. Notes on each activity performed to resolve a customer deduction also must be recorded. Based on the information uncovered by their research, staff then can determine how to proceed on the deduction, such as creating a chargeback invoice for the customer for the deduction amount, writing off the deduction amount, applying a credit memo to the deduction, treating the deduction as an unearned discount, or reversing the customer deduction.

All deductions must be accounted for in a biller's enterprise resource planning (ERP) platform or financial solution.

Despite the strides that businesses have made in automating their AR processes, the management of customer deductions remains a largely manual, paper-based affair.

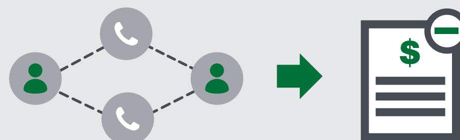
Manual processes add to the time, complexity and cost of managing customer deductions. For starters, capturing the deduction information from EDI or other sources and

Creating deductions workflows in most ERP platforms.

then determining the valid verses the invalid ones is a challenge.

In a manual deductions environment, there also is no real way for AR staff to prioritize actions. Staff waste a lot of time determining who to call or email and coordinating back-and-forth emails and/or phone calls between suppliers and departmental stakeholders such as marketing, sales or shipping. Communication breakdowns lead to bottlenecks that impact day-to-day efficiency. There also is increased likelihood of frustrated customers whose expectations aren't being met. The number of people involved in researching and resolving deductions also makes it hard to track costs. And since the information necessary to resolve deductions may reside as paper or electronic documents in multiple systems, processes are typically fragmented and non-standard, and information may be incomplete, inaccurate or not readily available to departmental stakeholders. For instance, researchers may not have access supporting documentation or line-item level detail and stakeholders don't have easy access to information on promotions and other trade practices.

The use of third-party sales partners such as brokers makes it more difficult to access the information necessary to resolve deductions, particularly in cases of complex deals.



The Solution

Automating many of the tasks within deductions management provides a digital platform for routing content and collaborating with stakeholders and customers.

Deductions can be assigned to an AR representative or analyst.

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Reason codes can be captured and assigned to customer deductions during the cash application process.

In cases where trade discounts are referenced in the note field of an EDI transaction or in the remittance of a check, automation can identify that the credit was taken as a trade discount and assign the necessary deduction reason code.

49% of businesses have little or no visibility into the deduction resolution process and little or no ability to measure the performance of the process, per Shared Services Link.

An online portal provides AR staff with real-time insights such as:

- The status of deductions
- The latest conversations with customers
- AR aging
- Tasks to perform and research

The Benefits

Automation reduces the time, complexity and cost of researching and resolving deductions:

- **Time:** Automation significantly reduces the time required to research and resolve preventable and erroneous customer deductions. For instance, customizable workflows enable users to digitally route deductions for research, approval and resolution. And information regarding a deduction is instantly accessible for research and online collaboration. Some solutions can even settle deductions automatically by validating deductions against promotional programs or other pre-agreed upon terms and conditions. One benefit of faster deductions resolution cycles is reduced Days Deductions Outstanding (DDO). DDO is calculated by dividing the amount of a business' open deductions by the average value of deductions incurred over the last three months. If business' open deductions average $1 million each month and deductions total $2.5 million, the business would have 2.5 months or 75 days of deductions open. The lower a business's DDO, the better. Industry studies show that automating deductions research and resolution reduces DDO by 30 percent.
- **Complexity:** Automation eliminates the complexity of manually creating tasks for staff to research deductions, can validate invoice amounts against pre-agreed upon terms, and provides a clear audit trail of deduction settlements, including any subsequent payments.

Automation empowers businesses to identify and address the root cause of preventable and erroneous customer deductions.

- **Cost:** Managing deductions involves a tremendous amount of effort on the part of customer service, marketing, finance and accounting, distribution, and IT. The time spent resolving deductions takes staff away from core tasks and value-added activities. Businesses can calculate the cost of manually researching and resolving deductions by multiplying the average number of stakeholders involved in resolving a deduction by the average time each person spends and their average hourly compensation (including benefits) and adding any expenses associated with deductions management. Automation also enables businesses to reduce the cost of write-offs and recover revenue normally lost to invalid deductions. For instance, automated solutions can force customers to provide a reason for short-paid invoices when paying through customer payment portal. This provides billers with greater control over the process of managing short-paid invoices to help prevent profit leakage.

According to Aberdeen Group's report, *The Order-to-Cash Cycle: Integrating Business Processes to Improve Operational Performance,* best-in-class organizations are 13 times more likely than other businesses to automate major AR processes. Top-performing organizations are characterized by: a 31 percent reduction in order-to-cash cycles, a 44 percent greater likelihood to be able to trigger an alert for deductions, and a 59 percent greater prevalence for using automation.

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Conclusion

Customer deductions involve a complex research and resolution process to assess the validity of a deduction against supporting back-up documentation which can come from multiple stakeholders and/or systems. Managing deductions requires collaboration across many departments, including sales, marketing, finance, distribution and more. Automating the research and resolution of customer deductions reduces the time, complexity and cost of AR. It also frees employees to focus on core and value-added activities. For CFOs looking for ways to help drive corporate growth and profitability, streamlining deductions management with automation is an ideal solution.

About the Sponsor

This white paper was sponsored by Esker.

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About the AR & O2C Network

The AR & O2C Network is the leading provider of training, education and certification programs specifically for Accounts Receivable, Order-to-Cash, Global and Shared Services professionals.

Membership to the AR & O2C Network (**www.aro2c.com**) provides comprehensive tools and resources to financial operations professionals who manage or are deeply involved in the Accounts Receivable and Order-to-Cash process.

Topics include Accounts Receivable and Order-to-Cash Policies, Managing Customer Information, Process Automation Technologies, AR Compliance (Sales & Use Tax, Canadian Tax, Sarbanes-Oxley, Escheatment, Government Restriction Lists and Uniform Commercial Code), and Accounts Receivable and Order-to-Cash management issues.

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Nearly 10,000 professionals have been certified as an Accredited Receivables Specialist or Manager (available in English, Simple Chinese and Spanish) through the AR & O2C Network and its parent company, the Institute of Finance & Management.

AR & O2C Network also hosts the annual Accounts Receivable & Order-to-Cash conference, designed to facilitate education and peer networking.

AR & O2C Network is produced by the Institute of Finance and Management (IOFM), which is the leading organization providing training, education and certification programs specifically for professionals in Accounts Payable, Procure-to-Pay, Accounts Receivable, and Order-to-Cash, as well as key tax and compliance resources for Global and Shared Services professionals, Controllers and their F&A teams. With a universe of over 100,000 financial operations professionals, IOFM is the trusted source of information in the rapidly evolving field of financial operations.

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