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Accounts Receivable

A Guide To AR Strategy

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Want To Improve Cash Flow :
A Guide To Develop Accounts Receivable Strategy

Learn how you can analyse your Accounts Receivable portfolio and dene a strategy to manage and reduce Days Sales Outstanding (DSO).

From start-ups to well established companies, the core purpose of business is to keep growing, and the growth rate will vary basis multiple parameters - internal and external, the stage and size of the business.

Growth is great. However, it comes with its challenges especially when you are offering credit to customers.

When Accounts Receivable and Accounts Payable cycles do not match, the first and foremost challenge a growing company will experience is - " Growth Affects Cash Flow. "

Why does one need a Strategy to Manage Accounts Receivable?

What water is to a tree, cash is to a growing business; growth will consume cash.

From founders to CXOs, the best talent, systems, and processes are disproportionately allocated toward growing the business, and rightly so. It is a general observation that when access to cash starts getting tight and external sources of cash are expensive or difficult, the balance of attention shifts more towards - Trade Receivables or Accounts Receivable.

For B2B companies, Accounts Receivable continue to be among the top three tangible assets. Anywhere between 15% to 30% of revenue is sitting on the balance sheet as trade receivables - one of the most valuable assets. However, for many companies, this asset is highly undermanaged.

If this situation resonates with you, it is time to develop a strategy and proactively manage receivables as a portfolio.

Key Components of Accounts Receivable Strategy

Like any strategy, the Accounts Receivable strategy also requires a goal in terms of cash or DSO target measured with time.
Based on the company's cash position and debtors list, one can define a short-term or a mid-term AR strategy and accordingly press the button on the relevant components to gain maximum benefits.

In the hub of the Wheel of Accounts Receivable Strategy are the company's goals to ingest cash by reducing DSO. The spoke of the wheel is key operating components that can potentially decide the accounts receivables outcome. Like in a wheel, the hub and spokes are connected; each component described will significantly impact the cash flow goals.

1. Goals and Objectives

Whether monthly, quarterly or yearly, the top management of the company has visibility of the financial goals. To achieve these goals, it is important to understand your cash flow.

Cash flow refers to the money you collect, use to purchase inventory and pay suppliers other expenses. It represents the amount of money that actually comes into and moves out of the business within a specific period of time.

There are three elements of cash flow

1. **Accounts Receivable - Generally measured in terms on DSO**
2. **Accounts Payable - Measured in Days Payment Outstanding**
3. **Inventory - Measured in Days Inventory Outstanding**

On Accounts Receivable, if you are collecting receivables every 50 days, you may have an opportunity to bring it down to 30 days. If your supplier payments are within 30 days, by collecting receivables 20 days earlier, you will not be in as large of a cash crunch because that cash is in the bank 30 days after the service is rendered versus 50 days.

Companies use different ways to set their Accounts receivable goals, DSO being the most popular one, others are Trade Receivable Turn Over Ratio and actual invoice to cash time period.

To calculate DSO, you may use the following formula:

DSO = 365 * (Average Accounts Receivable / Total Credit Sales)

To make sure collection team is focussed, you may want to set DSO target for the company.

2. Customers

Customers will always critical component and one need to recognise that every customer you follow for payments is unique. Credit period offered, their accounts payable process, people you deal with, size of the business, industry they belong, contractual terms, the documents they will ask while processing payments and many more.

Classic mistake made with receivables is - one size fits all approach.

Draw an AR plan by segmenting customers in various groups. For example, segmentation can be basis invoice to cash stages, disputes or dunning. This approach will not only help engage with clients more effectively, AR managers or Collection teams can ask for support from right department ensuring high customer satisfaction.

When your customers receive invoices from you, irrespective of the size of the organisation, there will be an approval process which will include matching it against purchase orders or other documents. Larger the value of invoice or the ageing of the invoice, it is critical to map the customer's payable process flows.

Many companies issue payments periodically in batches or their payment cycles. Understanding of these cycles will enable collection team to update cash forecast.

3. Credit Risk

Credit Risk in an Order-To-Cash (O2C) process is the possibility of a loss resulting from a customer's failure to pay as per the contractual obligations. It refers to the risk that a supplier may not receive payments against invoice or contract, which results in an interruption of cash flows and increased costs for collection.

To minimise the default risk, Accounts Receivable Manager or Sales team responsible for collecting payments must work very closely with the Credit Risk Manager.

Higher the risk, will only increase the efforts to collect.

Invoices greater than 3 months, there is 26% probability it will end up in an uncollectable bucket. Invoices greater than 9 months, there is a 90% probability you may not be able to collect the payment.

It is advisable to have a robust credit risk policy and it equally important that Invoicing and Accounts Receivable team should work very closely with the Credit Risk team.
A strong credit approval process goes a long way toward being able to keep DSO under control and minimise defaults leading to write-offs.

4. Invoicing

When business is done on credit, the starting point of Accounts Receivable is invoicing. Businesses need to create invoices to ensure they get paid by their clients. It serve as legally enforceable agreements between a business and its clients, as they provide documentation of services rendered and payment owed.

The Accounts receivable team cannot contribute to your cash flow until company has invoiced against product or services and paid. Therefore, any delay in invoicing a customer can have negative effects on your cash flow. The longer it takes to submit invoices to customers, the more likely there will be delays in getting payments processed. Because of delayed submission, one may miss customer's payment cycle, affecting your cash flow forecast.

To encourage customers paying you on time, have a clear understanding on due date of the invoice. Because an invoice is an official request for payment, adding the due date makes it clear for the customer. It helps avoid any ambiguity about when the payment is expected.

Knowing due date will also facilitate calculating interest wherever applicable and charge to the customers.

5. Receivable Ownership

Depending on the nature of the business, companies assign AR ownership to either collection department or sales and few cases each product or service department is responsible for collecting payments. Few have a model where after certain aging of the invoice, ownership transfers from collection department to sales.

Irrespective of the AR ownership model, following for receivables will involve engaging with customers. If done right, customers may not express satisfaction, however, if done in a wrong way, it will adversely affect the customer satisfaction and may cost you business.

Having a competent person or a team backed by right tools can boost your cash flow.

6. Invoice Payment Reminders

Accounts receivable reminders improves collection efficiency, one just need to ensure that reminders are consistent, persistent and polite. 60% of customer pay on time because they were reminded on time.

One of the main challenges in receivable management is manual reminders.
This significantly impacts collection teams productivity. Managing reminders for 1000s of invoices over 100s of customer is really hard and can slow down collections.

One can prepare ready templates or use an automation platform to streamline reminder process. When it comes to customer delight, personalisation is the name of the game.
The same philosophy is applicable with the accounts receivable reminder templates.
One should ensure that multiple templates are available based on customer segment you are dealing with.

7. Documents

The department who consumes the product or services very likely will be different from the procurement or finance department, sometimes they're not even in the same building, same city or same country.

To minimise duplication of payments or avoid fraud, every company's payable department will have some basic internal controls on validation of invoice against their purchase order of other related supporting invoice documents.

The required supporting documentation is different at every company and industry and its is important for collection team to have a visibility. Some of the example of documents list could be -

- **Purchase Order (PO) based on which invoice was.**
- **Contracts, its not uncommon for invoices to be accompanied by a contract.**
- **Goods Receiving Document or Good Received Note, a document included with the goods when they are received. Sometimes referred to as a packing slip.**
- **Advance Shipping Notice (ASN), a notification letter for a delivery of pending goods. Can be crucial document if goods shipped is not going to match what's on the PO.**
- **Timesheets, for projects billed hourly along with user sign-off.**

8. Payments

Unlike consumer payments, B2B buying process typically will have multiples stake holders from procuring to payments.

A B2B transaction process involves the customer creating a purchase order, the supplier fulfilling the order, the supplier's Accounts Receivable (AR) department creating an invoice, the customer's Accounts Payable (AP) department processing and paying the invoice and finally AR team reconciling marking the invoice as fully paid in their books of account. This process usually takes 30-90 days and in certain situations it may take more time.

When it comes to the payment, given there are multiple options - paper cheques, ACH, Wire transfers or cards, what suppliers accept vs how buyers want to pay, can vary significantly.

Offering convenience to pay to the customer can a positive impact on cash flow. Replacing paper invoices with their electronic equivalents and automating Accounts Receivable function with integrated payments can dramatically help businesses remove inefficiencies created by the complexities in traditional B2B transactions.

9. Reconciliation

Irrespective of the payment modes used by your customers or there are Credit Notes or other entries passed in the books to close the invoice, reconciliation is core to Accounts Receivables.

Reconciliation enables companies to minimise potential payment errors flowing in and out of the business and allows companies to determine where discrepancies lie. The more frequent the reconciliation, the faster the company can recognize and correct the underlying problem. It is advisable to reconcile payments and customer's ledger at least once a month or, ideally, each time a statement is generated. In the event of a discrepancy, the closer the reconciliation is performed to when the initial transaction took place, the easier it may be to recall details about the transaction.

It happens in every B2B business; a customer pays an invoice but remits less than what was due. Some industries term it as short pay and some as deductions. No matter how the terms are defined, deductions are the bane of Accounts Receivable and Finance professionals across industries. Lack of insights into root causes of the deductions compounded with lack of process, governance, disparate sources of information and high cost of manual efforts add to the operational overhaul.

The deduction your customer take could very likely indicate internal problems within your organization and will stress your operations because for the following reasons -

- **High volume of deductions**
- **Time and efforts needed for manual reconciliation and deduction research**
- **Cross-departmental collaboration**
- **Sending customer communication and denial of their deduction with supporting documents.**

Reconciliation and deduction management cloud platform enable businesses to automate the entire invoice, goods received note, payment advice reconciliation process. and enhances the dispute resolution component of an existing ERP or the receivables management solution. Automation of reconciliation management in accounts receivables could help reduce:

- **DSO**
- **Risk of bad debt write-offs**
- **Cost and time for dispute resolution**

10. Disputes

When two organisations come together to do business with multiple people getting involved, invoice disputes, rejection or delays in payments are going to be part and parcel of business.

One cannot eliminate disputes, but need to define the process to handle it more efficiently and elegantly ensuring they do not become a bottle neck to timely release of payments, Remember, receivables portfolio or aging is a great indicator of an organisation efficiency.

Leveraging the credit period offered to customers to get early visibility on invoice disputes as against the end of credit period can have a significant impact on receivables and the cash flow. Common mistake made by collection team or sales, is when they follow for payments almost at the end of the credit period and that's when customers indicate disputes.

Being on same page with customer on invoices dispute early in the credit period is core to minimising the damage it can do to cash flow or customer satisfaction. Identifying which invoices are disputed, knowing the reasons for dispute, what it takes to resolve and most important having an owner to execute the dispute resolution plan is critical to addressing disputes and getting paid on time.

11. Dunning

A dunning letter is a notification sent to a customer, stating that it is overdue in paying an account receivable to the sender. Dunning could mean many different strategies - verbal reminders, warnings, letters, sending collection agents, and even threats and intimidation. In absence of clarity on dunning, many times it is interpreted as more negative approach.

Irrespective of the interpretation, every organisation is encouraged to have a dunning process. If used in a right way, dunning management can create a positive customer experience while getting paid for overdue payments. It is all about assisting your clients to make timely payments.

Using AR automation the dunning process can be simplified, with rule defined by customer. One can build standard dunning templates to get the desired outcome of getting paid faster.

12. AR Review System

60% of managerial times spent on AR reviews either goes in sorting or accessing right data points of making teams talk to each other to resolve invoice disputes.

Accounts Receivable Review is a formal, structured meeting which involves top management and takes place at regular intervals throughout the year and frequency could be daily, weekly, monthly or quarterly.

Like any other meeting, AR review meetings can be successful when the objective is defined, team come prepared with updated data points and inputs from the customers. It is critical to have a visibility on which are the invoices that are going to get paid on time and once should refrain from investing review time on such invoices.

Anywhere between 30% to 40% invoices are generally have the possibility of delayed payments. This invoice bucket should be reviewed very differently as against invoices that are going to get paid irrespective of review or no review. Many occasions, companies spend disproportionate amount of time on those invoices which are any way going to get paid.

Implementing a robust AR review system that allows you to determine and evaluate the collection performance, the need for change and improvements, is core to execution and ultimately will determine contribution to cash flow.

Conclusion

For collection to work in an auto pilot mode, ensuring sustainable ingestion on cash into business by reducing DSO, the flywheel need to be set in motion. The goal and the key components work like hub and spoke. For the wheel to gain momentum, AR components must be tightly aligned with the goal.

The flywheel effect happens when collection wins from difficult customers, for your business build on each other over time and eventually gain so much momentum that growth almost seems to happen by itself - similar to the momentum created by a flywheel on a rowing machine.

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Streamline Receivables, Maximize Cash Flow & Boost Revenue with Kapittx. Don't Miss Out

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