Accounts Receivable…the end of the funnel

by John Stasz

Accounts receivable is typically viewed as something the accountants control somewhere in the back office. If the day's sales outstanding (accounts receivable cycle time) is high, the focus is directed toward the collection process and billing. The reality of the situation is that the receipt of cash on a timely basis from a customer is the ultimate test of virtually all the processes of the company from the design of the product; the manner in which the product is positioned by the salesman, the taking and entering of the order, the manufacturing and shipment of the product, the installation of the product and the billing and collection process. Accounts receivable is the *end of the funnel* for all the processes in the company. If all the processes were performed in a timely seamless manner with good customer communication, the bill gets paid. On the other hand if the process or communication is not *crisp*, the payment will be delayed. To significantly impact accounts receivable cycle time or Days Sales Outstanding (DSO) most of the effort must be focused outside the accounting department to fix the root cause problems of late collections. Operational management must be an integral part of the collection process and have measurements and incentives that are focused on cash collection. As long as management views accounts receivable cycle time as an accounting issue, excellence will not be achieved.

Accounts Receivable Assessment

An overall assessment of the general characteristics of a company's accounts receivable can be achieved at a macro level by analyzing certain data and briefly reviewing the key sub processes in the revenue cycle. The key questions or data sets required are as follows:

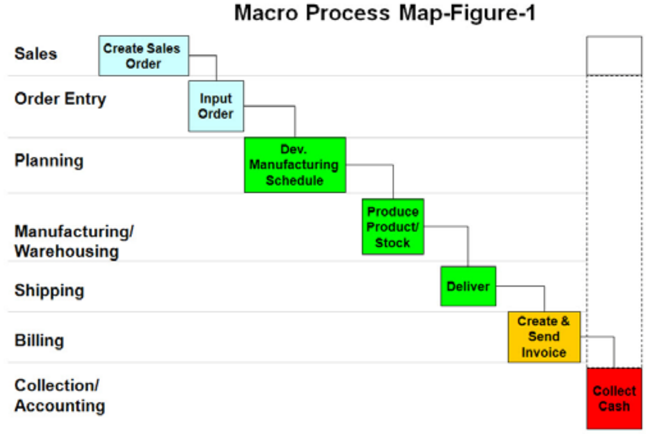
- Historical trend analysis of the accounts receivable aging and day's sales outstanding by month for the last two fiscal years and the current year
- Types of billings the company makes (equipment sales, parts and service contracts) and percentage of each type to total revenue
- Number of invoices, average size of invoice and sales by each type of billing
- Invoice terms including discount policy
- Credit approval process
- Collection process
- Order entry process including first pass yield measurements and major barriers
- Write-off history for the past two years and the current year
- The number and dollars of sales credits processed each month
- Commission payment policy on new and overdue invoices

With the above information, an initial understanding of a company's accounts receivable performance and an estimate of the improvement opportunity can be formulated,

Order to Cash Process

Achievement of improved days sales outstanding represents a significant cash opportunity to most companies. An additional payoff is improved customer relations. The accounts receivable team must focus on the *revenue cycle process* which is depicted in Figure 1. This is the process from the point the salesman takes the order until the payment for the goods service is received by the accounting department.

Macro Process Map-Figure-1



Order to Cash Process

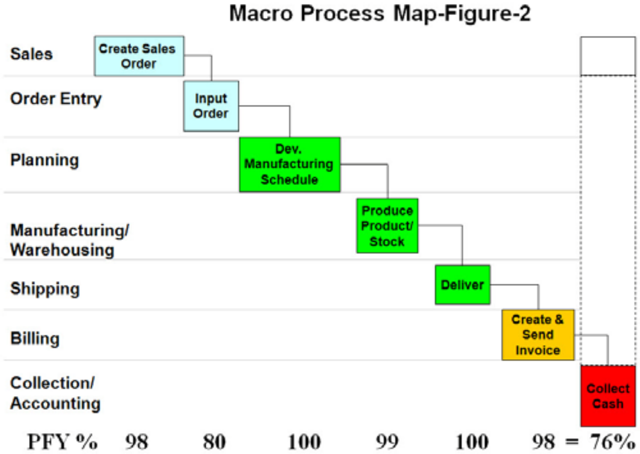
The revenue cycle consists of six sub processes which need to be individually mapped in the barrier identification phase of the program. These sub processes are as follows:

Process	Description
Order entry process	Sales taking order to entry into system
Customer credit limits	Decision to grant credit on order
Billing process	Shipment of product to bill mailed to customer
Collection process	Process to ensure collection of outstanding accounts receivable
Credit and return process	Decision to issue a credit/return to a customer
Cash process	Process for receiving and applying customer remittances

Each of these processes should be mapped and the key policies and process metrics understood. The key processes to improving accounts receivable typically are the order entry process and the collection process.

In analyzing collection problems, the root cause of approximately 50% of the problems will occur in the order entry system. The first pass yield data (FPY) for the revenue process will look something like Figure 2.

Macro Process Map-Figure-2



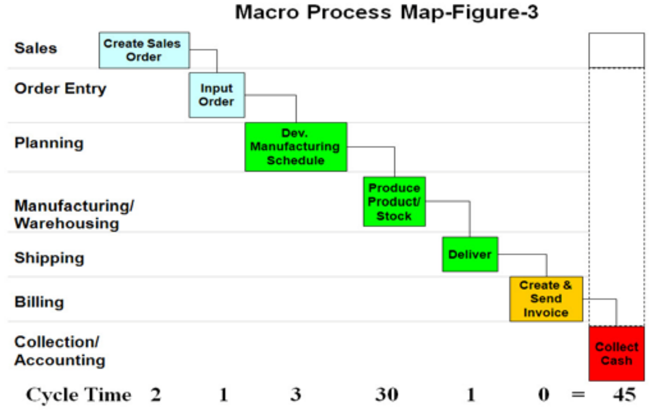
The first pass yield in the front of system (order entry) will be low, driving a number of collection problems. The purchase order number was not entered correctly, the wrong freight carrier was used, the wrong part was ordered or the pricing was not what the salesman quoted. Thus the order entry process from the salesman preparing the order to entry into the system must be mapped in detail and appropriate measurements established. The more subtle aspects of the order entry process or what can be termed *customer communication system* should also be understood during this mapping. What is the customer communication system to handle conflicts with customer requested ship dates, requested change orders and late shipments. Managing customer expectations often times will impact collections as much as actual performance.

The collection process is the second key process. The key to world class collection processes is consistency. The process has to react to the same set of circumstances in the same manner and in the same timeframe every month. The system must be consistent from month to month to month. Collection systems vary from company to company, however, some of the attributes of a good collection system are as follows:

- The process is consistent from month to month
- The cycle time to resolve a non-payment (commitment to payment or turn over to legal) is 90 days or less
- The follow up with a customer account is consistent and in short intervals such as every 10 days
- The sales (either internal or external) performance goals and measurement system are aligned with collection goals by paying commissions upon cash receipt, charging back overdue accounts or providing added incentives for good receivable performance
- A formal system to resolve collection problems is in place and actively involves the appropriate operational management (sales, service and manufacturing)
- The credit/collection department is accountable for monthly collection goals
- Customer credit limits are utilized and credit holds are a collection too

The computerized order entry/billing systems have resulted in the billing process itself being an automatic process triggered by the product shipment with a very short cycle time in most companies. A typical cycle time of the accounts receivable process is generally hours for high volume manufacturing company to a matter of weeks in a contract-driven company like an accounting firm. The industry can drive the billing cycle time and therefore accounts receivable cycle time. A sharp reduction in the cycle time of the billing process typically will not have an impact on the days sales outstanding performance measurement. The billing process needs to be mapped, as there are situations in which the billing process is extremely complex such as government project work or the process is broken to such an extent that a major opportunity exists in the billing process.

Macro Process Map-Figure-3



Measurements

The measurements that are most important to driving results in accounts receivable are:

- **Order entry first pass yield** – This is a key measurement that a company typically will not have in place. The root cause of a large portion of the collection problems can be traced back to low first pass yield in order entry.
- **Order entry cycle time** – The reduction of cycle time from order receipt by the salesperson to entry into the system drives higher quality orders and customer satisfaction.
- **Sales credits as a percent of revenue (second level first pass yield measurement of revenue system)** – Attacking the percentage of credits to revenue with an aggressive reduction goal will focus the team on "doing it right the first time." This approach will get to the root cause barrier identification and avoid the company's sales credit process which traditionally is a slow, approval intensive and low priority process resulting in customers withholding payment.
- **Sales credit cycle time** – In some companies the lack of a *crisp* process coupled with a long cycle time will provide the customer a valid reason not to make any payments: "I am not going to pay anything on my account until I see a credit for the equipment I returned four months ago."
- **Shipment linearity** – Measure shipment linearity and coordinate with the fulfillment team to drive this issue in manufacturing.
- **Percentage of accounts over 60 days** – Ensure the high dollar accounts in this category are actively being worked in the collection process. This data will provide a causal analysis of collection problems.
- **Billing cycle time** – The cycle time is not long; however, this measure may surface resources devoted to non value added custom billing work.

The performance measures to determine the progress being made are:

- **Accounts receivable as a percentage of revenue** – Typically measured as accounts receivable at month end divided by the last three months annualized sales.
- **Days sales outstanding** –This measurement is calculated in a number of ways. The key is not the precise method of calculation; it is that the calculation is consistent over the measurement period because it is a trend measurement.

Barrier Identification

The mapping and analysis of the revenue sub processes will identify barriers. The team should prioritize the barriers identified and begin working the high impact barriers. However, data collection activity should be started in parallel to confirm the barriers identified to date, discover additional barriers and define more clearly the root cause of barriers identified. Some of the best theories are blown out of the water by a little data.

The data collection should generally result in a Pareto analysis of root cause collection problems. Sources for this data are:

- **Collection reports** – The collectors often will maintain a report of collection problems based upon customer calls. If this report is not in existence, request that the collectors maintain a report for a two-week period.
- **Major account reports** – Most collection departments will prepare a report of the large dollar account collection problems with customer comments. Again, if this report is not in existence, define a report and collect the data for a month.
- **Collectors' meeting** – If there is reluctance to collect additional data or an immediate sense of urgency, have a collectors' meeting to brainstorm the barriers and rank in priority sequence. The collectors work every day with customers and understand the collection problems.
- **Sales credit reports** – All companies account for sales credits in some fashion to properly account for net sales. Typically, a report exists in a causal format identifying the reason for the sales credit, the number of credits and the dollar value. This report, by definition, is a report of every revenue transaction that has to be reworked which obviously delays the payment of the transaction. Secondly, a long cycle time in processing customer credits may be a cause for customers withholding payment on their total account.
- **Salespersons' meeting** – Not a true data collection method in the sense of those described above; however, a perspective that is important to identifying barriers from a different perspective. Meet with a small group, or individually, of salespersons and ask them to identify barriers to entering an order properly, ensuring the order is shipped to customer expectations and collecting the cash. The salesperson is the interface with the customer. The customer communication system will not work well unless the salesperson understands the company's revenue cycle and it is a streamlined seamless process from their perspective.

Team Structure

The optimal team structure to reach entitlement in accounts receivable is to view the underlying process as the revenue cycle which starts at order acceptance by the salesperson and is complete upon collection of the cash (Figure 1). The team focus should be the entire revenue process and include representatives from order entry, credit/collection and accounting. In addition the team must reflect the true cross functional nature of receivables and include representation from sales, fulfillment and service. Additional barrier removal teams would be added as root cause barrier identification progresses.

If a revenue cycle team approach is not feasible a very close working relationship must be established with the order entry team as a substantial portion of the accounts receivable barriers will be solved in the order entry department.

Why customers do not pay?

The majority of collection problems are not collection problems. The customers that do not pay their bills due to cash flow problems range from 20-30% of the overdue accounts. The vast majority of accounts that are past due are not yet satisfied with the execution of their order. The credit department is simply a facilitator in solving customer's problems so that they achieve their collection goals. The road to accounts receivable entitlement is taking those same customer problems and instead of fixing the problem, fixing the root cause process that is creating the problem. Examples are:

Problem	Fix	Process Fix
My equipment hasn't been installed	Call service-install	Installation process with a feedback loop
You shipped the wrong thing	Reship correct thing	Product training
Salesman said I didn't have to pay for 90 days	Chew out salesman	Terms approval process
No purchase order number on your invoice	Get P.O. number and re-bill	Establish order definition for order entry and sales

Generic accounts receivable cycle time problems

The following are a number of generic problems that result in increased accounts receivable cycle time. This list is not intended to be all inclusive, but can be used as a mind jogger. The barriers encountered at a specific client are always somewhat unique and can only be identified by doing your homework. Here are some generic barriers:

- Revenue recognition allows premature recognition of revenue
- Poor disciplines at order entry result in not obtaining proper customer information (purchase order number, pricing and configuration)
- Product shipments spike in the last week of the month/quarter
- Complex pricing matrix that results in numerous credits
- Partial shipment of products
- Products not performing to customer expectations
- Terms and conditions policy not followed
- Low first pass yield (below 90%) at order entry
- Cycle time to process a credit is too long
- Sales force committing to numerous custom billing features
- Equipment not shipped or installed on a timely basis
- Sales force does not have any incentive to communicate or enforce collection policies
- Collection department not proactive in working with other departments in resolving process problems impacting collections
- Change order process is *fuzzy*
- Collection policies and procedures are not consistently followed
- Customer communication system does not work effectively
- Collection process is too long
- Operational management is not involved in the collection process
- The credit department is not accountable to monthly collection goals
- The goals of the company are not consistently aligned to collect receivables.

Summary

Accounts receivable performance is a window to the effectiveness of the total revenue process of a company. Mediocre days sales outstanding indicate that the company's revenue process; from the point the salesman takes the order to cash collection does not function as an effective seamless process.

As a number of the root cause issues that create collection problems are outside the credit department, a cross functional team including sales, order entry, manufacturing, and accounting is required to identify and solve the problems to drive improvements. Because of all the different functional areas involved an experienced process consultant is useful to drive a company's accounts receivable improvement program. Initially there will be some finger pointing by the functional team members, but as the data collection removes the emotion from the discussion and actions begin to drive results the team's momentum will build and days sales outstanding will begin to come down. The power of an aligned team will become apparent.

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