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White Paper

World Class Receivables Management

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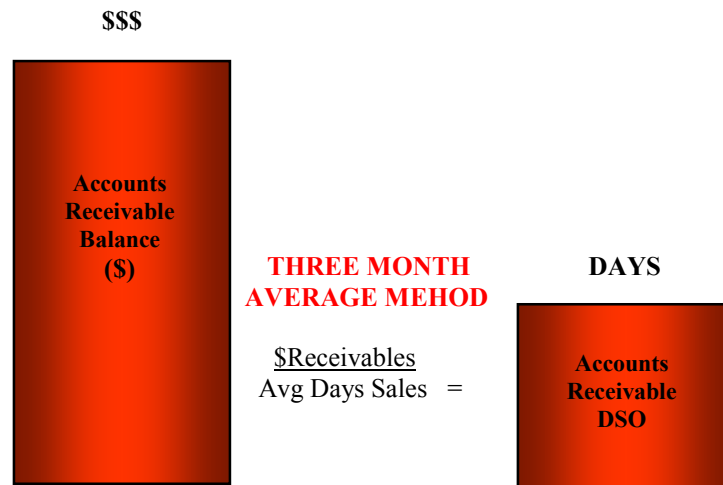
What Does “World Class Receivables Management” mean?

In the simplest terms, world class receivables management means getting the cash owed to you in receivables collected as fast as possible! The standard measure used for collections efficacy is Days Sales Outstanding or DSO. This can be calculated in many different ways, but one standard method is the three months average method. With this method, DSO is calculated in the following way:

$$\text{Average Day's Sales} = (\text{Sales for last 3 months}) / (\# \text{ of days in last 3 months})$$

$$\text{DSO} = (\text{Current A/R}) / (\text{Average Day's Sales})$$

DSO represents your A/R in terms of the number of days of sales needed to achieve it. So, reducing DSO is equivalent to reducing your receivables.



To demonstrate the value of reducing DSO, let's look at a simple example.

Company X:

Revenue = \$1 Billion Annually
DSO = 62 days
Average Day's Sales = 2.7 million (1 billion/365)
Cost of Capital = 10%

If DSO can be reduced by 6 days or approximately 10%,

Company X Savings = \$1.7 Annually!

By using tools available to credit managers,

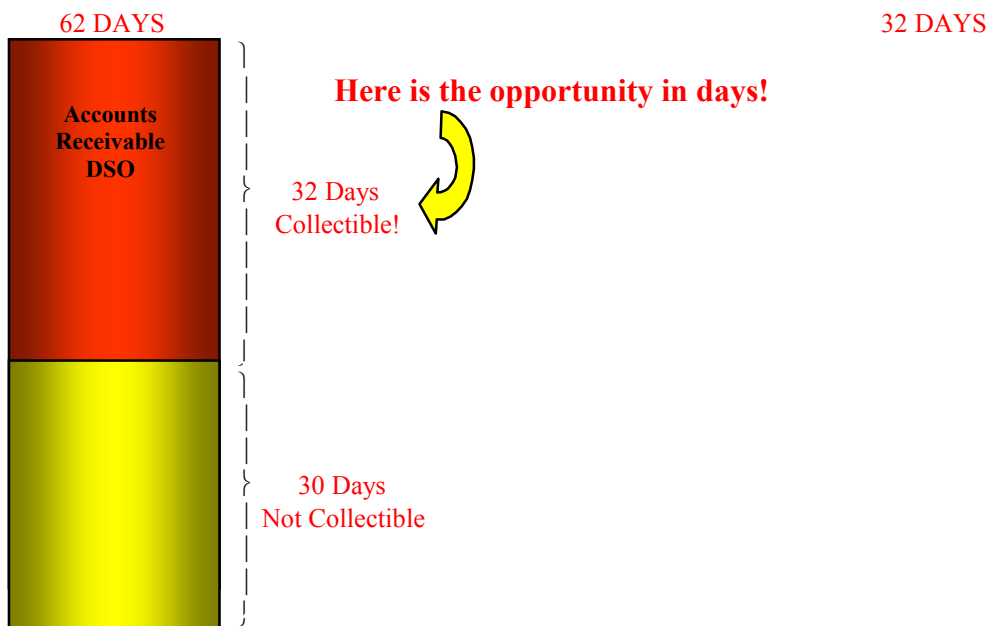
- Credit Limits
- Customer Segmentation

- Customer Contact Management
- Dispute Management
- Receivables Targeting

you can achieve the lowest possible receivables balance or the best possible DSO for your company.

What is your company’s “Best Possible DSO”?

It depends on your payment terms. Let’s look at another example. If your terms are net 30 across the board, then the best possible DSO for your company would be 30 days. Any receivables less than 30 days old are uncollectable because of your terms. Your goal is to push your DSO as close to 30 days as you can.



If we are talking about our one billion dollar company, the opportunity for DSO reduction is 32 days. In dollar terms, that is about 8.5 million per year $[(32/6) * \$1.7]$. Reducing your DSO pays off!

How do you achieve your DSO goals?

Achieving your best possible DSO usually involves modifying both processes and supporting systems. The first thing to do is to identify your most important customers. Occham’s rule tends to hold true. The top twenty percent of your customer base represents about eighty percent of your company’s revenue and therefore about eighty percent of your receivables. These are the customers that you want to have pay on time. In fact if you can get them to pay on time, four fifths of your collectible DSO will be taken care of!

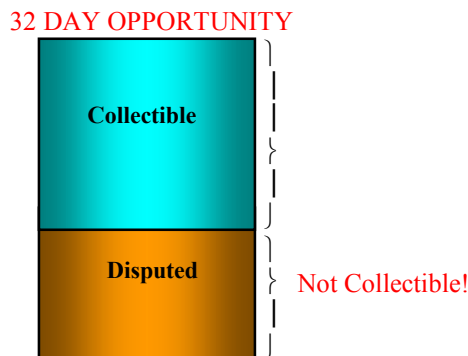
It is a natural business instinct to try to give the best service possible to every customer. So what collectors tend to do is try to give equal service to all of their assigned customers. This means that collectors may give the same effort to collecting a five thousand dollar receivable as they would a five hundred thousand dollar receivable. Obviously when this happens, effort is not being placed where the largest return is.

Segmenting your customer base into three, maybe four buckets allows you to develop programs for your most important customers. Your top tier customers receive the best care so that they are happy and pay you on time. This means lots of communication with them and tailored service plans from your collectors. Your second tier customers would receive good steady care with some direct communication, but not the same kind of time commitment as your first tier customers. Set up a dunning program to deal with your bottom tier customers. If they do not pay, send their receivables to a collection agency. In the end, the dollars they represent are not worth your collectors' time considering that their time is better spent with your premier customers.

The key to keeping your customers happy and paying on time is communication. Therefore you should have a standardized way of handling the outcomes of your calls. Predefine the outcomes that may result from a call (follow up call, payment expected, dispute, etc...) and the required actions from a collector based on those outcomes. This on the one hand standardizes call procedure making it easier to track communications and do appropriate follow up, and on the other hand simplifies call management for your collectors by forcing them to collect and track all the information that they need to manage their customers efficiently.

What about Disputes?

Disputed invoices are a wrench that can be thrown into your plans for DSO reduction. Any disputed invoices older than your best possible DSO are not collectible until resolved! Resolving disputes in a timely manner and preventing them from reoccurring is an important task for any company looking to achieve world class revenue management.



The key to timely resolution of disputes is to make sure that someone is specifically responsible for taking care of them and that they remain visible. When there is no clear cut owner of the resolution of a dispute, disputed invoices can and do get lost in the shuffle. Calling out who should tackle a disputed invoice to a big audience (i.e. all of AR, management, etc...) creates a clear incentive to chase down and resolve disputes.

One effective way to push the time to dispute resolution down to its minimum is to create escalation schedules. These schedules set time limits for resolution of particular types of disputes that if not met cause escalation of the dispute in importance. Each time a dispute gets escalated, higher ups get notified and start to become involved in resolution. So this type of escalation has the dual purpose of setting specific goals in days for resolution and of bringing those who have more influence (management) into the process of resolution if necessary.

Obviously, the most effective way to avoid uncollectible disputed receivables is to prevent them in the first place. But how can a dispute management system help you do this? The answer is categorization. By categorizing types of disputes and associating the internal sources of the problem (or at least those who

have the most control over the issue) you can, over time, identify where your company is having problems that lead to disputes.

By tracking disputes as separate entities from the invoices against which they are lodged, you can keep records of the types of disputes you have most often and what their causes are. Trend analysis of this data points out specific areas that can be addressed to improve your dispute performance.

What is the value of Receivables Targeting?

Just like any sort of planning, receivables targeting establishes goals for your collections group. As a tool, it can be used to establish specific expectations for the achievement of the group and individuals within the group based on real numbers provided at an organizational level. Setting DSO targets for the company's performance can tell a collector exactly what they need to do to reach the organizational goals.

Sales and Marketing forecast revenue numbers. Why not use those numbers to come up with expected collections during a quarter? By looking at current A/R and then adding expected collectible A/R based on the revenue numbers, your organization can determine the cash that should be collectible going forward. By then applying your DSO goal to that number and filtering the numbers down through your collections managers to individual collectors based on their account distribution, you can give everyone very specific collections targets.

The process of getting to those specific individual targets will take some analysis and probably some give and take to reach the overall target. Not all collectors can be expected to carry the same load given that their assigned accounts are not likely to carry equivalent revenue loads. With some accounting for previous performance to go with the a DSO goal that is reasonable, it should be possible for just about everyone to be excited about going after the specific collection targets that have been established for them on a quarterly, monthly and weekly basis.

How do you achieve world class results?

As stated above, there is a lot of analysis and often much procedural adjustment that goes into implementing the kinds of processes discussed in this white paper. Defining where your customers rank in terms of importance to your organization, setting up the right kinds of customer programs, establishing call outcome rules, setting your dunning process, discovering what kinds of disputes your organization deals with, and learning the process of receivables targeting all take significant analysis and time to get right. But this effort wins only half the battle.

The other half of achieving your goals involves system support. You need a software solution that offers you the ability to segment your customer base, enter detailed dispute information and track performance against managerial goals. A system needs to be flexible enough to allow for the uniqueness of every organization to be reflected properly. This means user defined dispute categorization and escalation rules, user defined A/R hierarchy, user defined dollar amount cutoffs and other user defined rules. You also want those who need access to parts of system to have that access available from wherever they are, whether it is the collections department, the shipping dock or the field. Additionally, the system should have reporting, alerts and worksheets available to support the day to day activity of collectors as well as management's analysis of progress against current goals and trends over the long term.

This sounds like a lot to tackle and it does take some time to get to your company's best possible DSO. But start on the road to "best practices" in this area and you will see immediate rewards. In our one billion dollar company example, a six day DSO improvement was worth \$1.7 million in savings annually. Even for a company one quarter that size, this modest percentage improvement would mean that the cost to implement the kinds of changes we discussed should easily be repaid in the first year after implementation. And the opportunity for much greater savings is there and within your reach!