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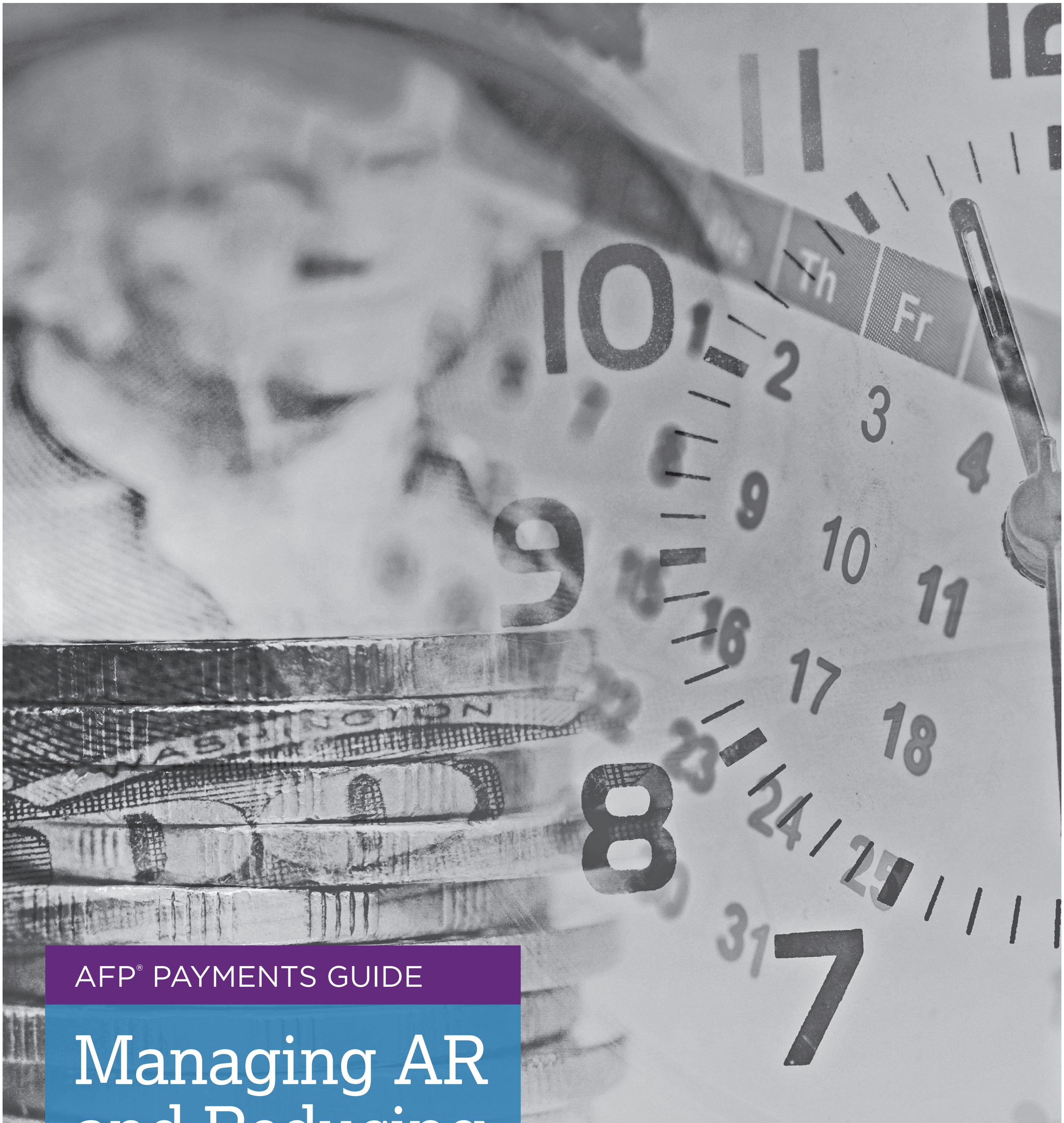

AFP® PAYMENTS GUIDE

Managing AR and Reducing DSO

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MANAGING AR AND REDUCING DSO

Technology and data analysis can play a key role in liquidity and working capital management for companies of all sizes and across all industries. As part of a business strategy, technology can enhance Account Receivable (AR) processes and reduce Days Sales Outstanding (DSO). For a deeper dive into this subject, MUFG Union Bank, N.A. is pleased to sponsor our eleventh AFP Payments Guide titled Managing AR and Reducing DSO. This guide provides insights into how companies are managing DSO throughout the payment process.

Given the current economic environment, DSO may take a more prominent role in a company's liquidity and working capital strategy since it is often tied to factors within an economic cycle such as the availability of credit. In order to fully realize the benefits of technology such as Machine Learning and other Artificial Intelligence, it is important that treasury professionals examine organization design and processes before deploying new technology or tools for its DSO strategy.

This guide gives CFOs and Corporate Treasurers insights into key components of AR that can impact efficiency and implementation of technology such as the evolution of lockbox, understanding your customers' payment habits, and reconciliation practices. We plan to share this guide with our clients as they make business decisions and navigate the economic climate.

MUFG Union Bank supports the AFP in its mission to provide continuing education for its members so they can stay up-to-date on the latest research and information in working capital management.

We are also pleased to sponsor the AFP Pinnacle Awards that highlight innovation in treasury and finance.

Best regards,

Ranjana B. Clark
Head of Global Transaction Banking and Transaction Banking Americas, and Bay Area President MUFG Union Bank, N.A.

“When money is cheap to borrow, and I’m making my payroll, I can buy supplies, and everything is running well, then customers can pay me a little slow and I’ll be okay.”

INTRODUCTION

Days sales outstanding (DSO) is a metric for corporate performance that falls in and out of fashion, typically depending on companies’ available cash. Coming out of the Financial Crisis along with record low interest rates have put DSO on the backburner for most companies. Measuring a company’s outstanding accounts receivable (AR) is just less relevant when cash is readily available.

“When money is cheap to borrow, and I’m making my payroll, I can buy supplies, and everything is running well, then customers can pay me a little slow and I’ll be okay,” said Brian DeGraw, associate principal at The Hackett Group.

In a 2019 survey of the 1,000 largest nonfinancial companies, The Hackett Group noted that DSO fell to a low of 35.6 days in 2014, slowly increased through 2017 to 39.3, and then fell in 2018 to 38.5. That drop—from the most recent data available—may reflect concerns that year about rising interest rates, although the decrease was less than 1%, and excluding the oil and gas sector there was virtually no change.

The arrival of the coronavirus prompted the Federal Reserve to effectively cut its benchmark rate to zero on March 16, 2020. Providing companies with liquidity, the Fed intended the cut to counter a likely economic slowdown that may drain many companies’ cash coffers.

Consequently, the DSO metric may regain prominence. Companies are likely to face new challenges in terms of collecting payments from customers, stretching DSO. This guide seeks to provide AFP members with insight into how their peers are managing DSO across different parts of the payment process.

2 LOCKBOXES EVOLVE

Along that process, collecting payments from customers is a component that tends to have a big impact on DSO, and it is an area they have little control over in terms of timing. Lockboxes, which collect a company's payments in locations maintained by its bank, have for decades accelerated matching up payments with invoices and improved the flow of information between parties. While lockboxes can improve DSO, they have tended to be a costly option.

A plethora of vendors have stepped up over the years to provide companies with alternatives to lockboxes and other elements of the "order-to-cash" process, whether end-to-end solutions or those focusing on specific steps along the way. In turn, lockboxes have adapted. David Bochnovic, executive vice president of Phoenix-Hecht, which has measured the performance of individual banks' lockboxes for upwards of 50 years, said that technology has enabled lockboxes to "morph" essentially into remittance hubs, whether for NACHA's ACH with emailed invoices and other electronic payments or paper checks, or all of the above.

> “The lockbox has become the consolidator of information that the company needs to update its receivables.”

“The lockbox has become the consolidator of information that the company needs to update its receivables,” Bochnovic says.

According to Bochnovic, vendors have stepped up to provide technology that essentially allows companies to take part of the lockbox function in-house and integrate it with other steps in the payment process. For example, High Radius launched an on-premise multi-module solution aimed at Fortune 1000 companies in 2006, when it began operations. It automates steps along the AR process, starting with the initial customer credit check and including cash application when incoming payments are matched with receivables invoices, deductions related to short payments, and collections.

In 2010, ahead of many competitors, High Radius moved the modules to the cloud, providing corporate customers with a more accessible software-as-a-service (SaaS) solution. It also reached agreements with several large banks, including Bank of America, Citibank and PNC, to update their lockbox solutions by white labeling the firm’s software, incorporating machine learning and other state-of-the-art technology.

Companies weigh the cost of using a third-party solution compared to performing the function in-house, and midsize and smaller companies often decide that the advantages of banks’ lockbox services outweigh the costs. Even large companies with significant resources may opt for third-party solutions, to avoid the often complicated and tedious chore of matching payments to invoices.

“When companies use lockboxes today, it’s more for outsourcing, because they have a large volume of small payments coming from smaller customers,” said Susan Hillman, a founding partner of consultancy Treasury Alliance. “There can be a lot of paper to process, so outsourcing it to a bank means the company doesn’t have to do it internally.”

In addition, the cost differential between performing the function in-house and using a third party has fallen. Bochnovic says the cost to process an item through lockboxes has changed negligibly over the last decade, “so there’s been downward pressure on pricing.”

3 DSO CONSIDERATIONS

Advances in technology will likely make the payment process even more efficient, and that should enable companies to reduce DSO further, at least on the surface. Experts note that DSO is an imperfect metric that can be gamed by operational staff, and taking steps to lower DSO may have a negative impact elsewhere. Providing a discount to reduce DSO, for example, could end up costing the company more in absolute terms.

In addition, companies may calculate DSO in very different ways, complicating comparisons with peers. For example, some companies may say the payment is due in

30 days, while others start the countdown at the end of the month and still others from the date of the invoice. In addition, she added, if the payment term is 30 days, customers receiving an invoice between the first and 15th of the month often will pay it at the end of the month, and if the invoices arrives in the latter half, they'll wait and pay it at end of the next month. That results in an average DSO of 45 days due to customer policies the company has little control over. Furthermore, said Hillman, standard terms differ from country to country.

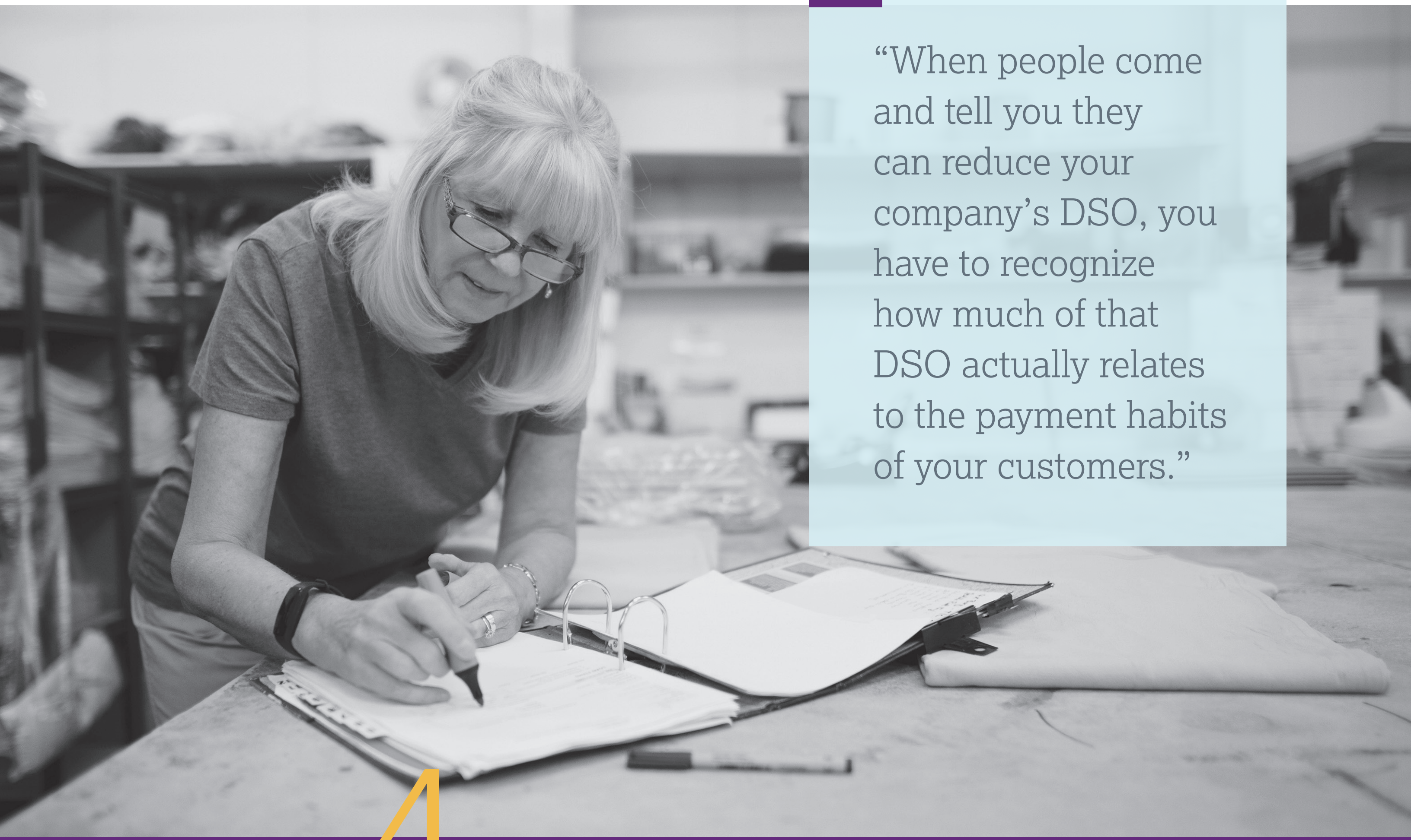
BILLING AND DELIVERY ACCURACY IS KEY

Taking DSO's imperfections as a measure of corporate performance into consideration, it is nevertheless widely accepted as a valuable measure for companies to track, especially when cash is tight. One area where companies have significant control and can shave DSO is accurate order entry, billing and delivery.

Goods or services customers receive must be what they originally ordered or they are likely to raise questions that can result in significant payment delays. Closely integrating order-entry and billing with the delivery systems—facilitated by new technology such as the Internet of Things—enables companies to bill more accurately for what was actually delivered, reducing the likelihood of such snafus.

Timely billing can also reduce DSO. Some companies may still bill monthly and some more frequently, but whatever the sales cutoff cycle is, it is important to minimize the delay between the cutoff and when bills are sent. Such delays often result from companies having to make sure the bills are accurate, emphasizing the importance of integrating billing and delivery systems to reduce the likelihood of inaccuracies.

Such accuracy typically requires automating those processes, and such automation can facilitate employing multiple billing cycles per month, another way to squeeze days out of DSO. Billing weekly rather than monthly encourages customers to pay more promptly, especially for customers seeking products or services on demand, and it tends to spread out the payments a company receives more evenly.



> “When people come and tell you they can reduce your company’s DSO, you have to recognize how much of that DSO actually relates to the payment habits of your customers.”

4 KNOW YOUR CUSTOMERS

In the age of automation, sometimes fundamentals such as knowing one’s customer can be overlooked.

“When people come and tell you they can reduce your company’s DSO, you have to recognize how much of that DSO actually relates to the payment habits of your customers,” said Matthew Johnson, treasurer at Nashville-based Genesco Inc., a retailer and wholesaler of branded and licensed footwear. “If I’m not getting paid for invoices because there’s a pricing discrepancy, then I need to know that.”

For example, a customer may issue a purchase order for shipments to multiple distribution centers, and their payment-terms clock starts clicking the day the goods are entered into the last distribution center’s system. The invoices may all be sent out on the first of the month, but some shipments may not be received for a week or 10 days or longer.

Third-party solutions to reduce DSO often apply technology to what essentially is a people issue. “My challenge to them is to show me how they’re going to make that customer start the term-clock ticking closer to the invoice date,” Johnson said.

The issue is especially acute for companies who have relatively few customers making up a large percentage of their AR base. “If I can’t get that customer to receive the product faster, you can’t change my DSO for love or money,” Johnson added.

Inaccurate billing can be especially problematic in certain industries. A provider of behavioral health services that operates a network of hundreds of facilities, receives payments from a variety of sources. Most come from Medicare, Medicaid and commercial insurers, explained the company’s director of treasury.

The executive noted that the government agencies “are never quick to do anything” and present a constant challenge for the company’s business office. On the commercial side, inaccurate billing, perhaps stemming from incorrect coding for services, results in bills getting “kicked back by the insurance company, and that’s at least a six-week period to get paid—quite a struggle.”

CREDIT CHECKS NOW SAVE DSO LATER

Another key element of knowing one’s customer is their creditworthiness. Credit checks when onboarding new customers enable companies to start the process of segmenting customers according to behavior patterns. In turn, noted Todd Glassmaker, director at The Hackett Group, companies can more accurately grant terms and credit limits.

“That’s going to cascade downstream into how well those receivables will be maintained, based on how risky that customer is and how well the business understands the risk of that customer,” he said.

Third parties have stepped up to largely automate that process, starting with facilitating credit approval for new customers, as well as enabling companies to monitor their customers’ credit status, typically using third-party data and sophisticated proprietary software. The long list of vendors providing those services includes Cforia, Billtrust and Esker.

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“If I can’t get that customer to receive the product faster, you can’t change my DSO for love or money.”

5 SOME HAVE IT EASY

Some institutions have it easier in terms of billing, and for that matter the rest of the payment process. Most property insurers bill clients at the start of the coverage period, so there's no DSO at all. "Customers can choose to make premium payments in installments, so that's where DSO comes into play," said a treasury director at one such insurance company.

But either way, the executive added, there's a grace period—30 days in the case of her company. If the payment isn't received, the policy is canceled—an effective inducement to pay on time.

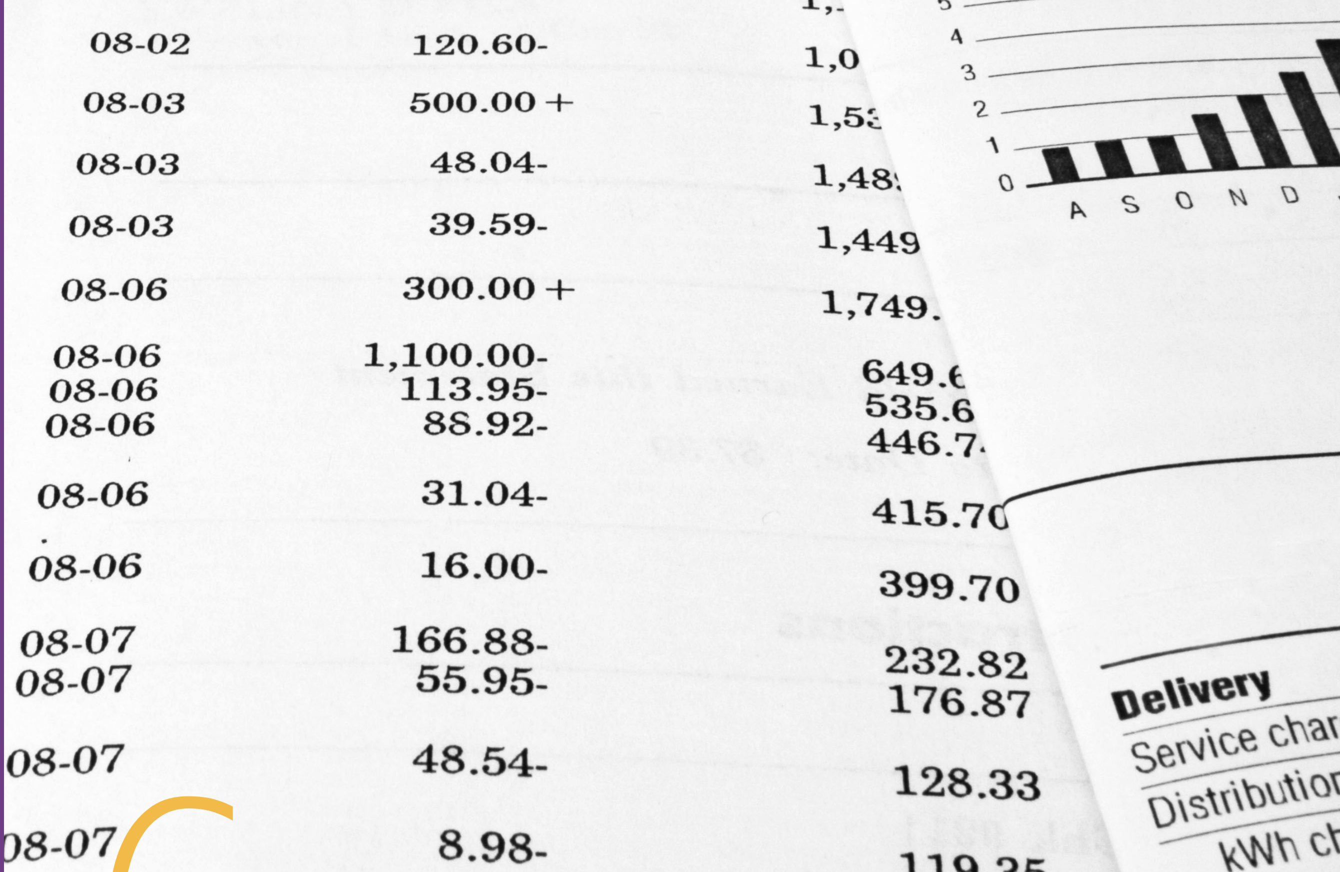
Universities have it at least as easy. Unlike manufacturers whose products are already in customers' possession when bills go out, or banks whose loans must be paid back, educational institutions typically require tuition and room and board to be paid in full before students begin school. Similar to other organizations receiving payments, it can be a challenge to apply certain incoming payments to the correct student accounts, given those payments may be arriving from scholarship providers, government grants and other sources.

But if those funds don't arrive on time, "I can hold up a student's graduation if payments aren't received," noted Denise Laussade, senior director of treasury operations at Purdue University.

MAKE PAYING EASY

For companies who receive payments after the goods or services are delivered, knowing one's customer is essential, but so is optimizing the subsequent steps along the payment process. ACH payments are a fraction of the cost of checks, and cards are less expensive, too, when rebates are included. However, the **2019 AFP Electronic Payments Survey** noted that while check use in B2B transactions has fallen significantly over the last 15 years, it still makes up 42% of those payments. And that's especially true among small and midsize businesses.

Depending on their current systems and technology, customers will have different payment preferences, so it's up to the payee company to provide whatever payment channels customers want to use, to avoid complications should a customer decide to use an unavailable channel. Modern lockboxes typically offer that ability, as well as many of the vendors in the AR space.



6 CASH APPLICATION COMPLICATIONS

Once bills are sent out and payments made, applying those payments to the correct customer accounts can result in errors and confusion that puts pressure on DSO. Different forms of payment provide different levels of information to indicate which customer accounts they are destined for, and multiple payments in the same channel can also cause confusion. For example, a company billing a customer multiple times throughout the month may receive a single ACH payment at the end of the month, making it difficult to match up invoices.

Further complicating matters, ACH payments carry minimal addendum information to aid the cash-app process. When companies don't know which accounts payments go to, those payments will sit in an "unapplied" bucket and instead of offsetting receivables, so they appear to still be outstanding even if they aren't.

"You can't actually do the full posting and application of that payment to an invoice, so you have invoices in AR that are aging, even though the customer has already paid you," noted Degraw with The Hackett Group.

Customers have adapted by following up with emails containing the necessary information. As a result, Bochnovic said, within the last several years companies have found themselves inundated with emails, causing major reconciliation issues that can adversely impact DSO. That has prompted many organizations to hand over the function to bank lockboxes or turn to vendors whose software seeks to automate the process.

> “Even if they can turn around and pay in one day, it doesn’t make fiscal sense for us to accept those payments.”

In fact, vendors have offered sophisticated mapping tools to match payments with customer accounts for decades. More recently, fintech firms have upped the ante by applying artificial intelligence and other state-of-the-art technology to make it more efficient.

NOT JUST TECHNOLOGY

Following established business rules can also help companies manage DSO. Johnson noted that deductions such as a 1% discount in lieu of returns essentially result in short payments. However, recognizing the discount at the cash-application stage allows the company to make an adjustment for it and remove it from the books right away; the 1% can go to the correct general-ledger account number, and the cash is applied.

“There are scenarios like that where if I have business rules in place, I can in effect handle the deduction right at the time of cash application,” Johnson said, avoiding delays that might otherwise lengthen DSO.

AND SPEED MAY NOT BE WORTH IT

Although new technology can shorten DSO, the healthcare treasury executive noted that some smaller insurance companies have partnered with fintechs to automate their payment methods, especially to remit via ACH rather than check. However, the fintech typically takes a small percentage of the payment, so a $1,000 payment may end up being $990.

“They always say, ‘You get your money faster,’ but we’re stilling missing a chunk of it, “ he said, adding that regardless of the positive impact on DSO, his team must weigh whether the fee its actually greater than an earnings credit or interest it could otherwise have earned in that period.

He added that a lot of customers are also turning to virtual cards but, similarly, payees must pay merchant fees. “Even if they can turn around and pay in one day, it doesn’t make fiscal sense for us to accept those payments,” he said. “It’s a similar situation to the ACH payments, but more extreme.”

An important part of that equation is the company’s AR base. Johnson maintains contact with vendors to keep on top of what “the cool kids are doing.” However, since his company’s customer base is highly concentrated and therefore its payments, and the cost of third-party solutions, tend to exceed that of the system currently in place. Today, there’s one person doing cash application, but that person is not a C-level officer, so the savings from replacing that person with a third-party solution have been insufficient to warrant the change.

Another consideration has been whether borrowing IT personnel to deal with day-to-day remittance issues that would otherwise be handled by a third-party solution pulls them away from important projects. So far, said Johnson, “The answer from IT has been ‘no.’

7 COLLECTIONS' DRAG ON DSO

Some customers simply won't pay in less than 45 days, even if contract terms stipulate within 30. The company can cut off the product or service to the customer, but management is unlikely to permit AR to make those decisions on its own, and if it's a large, highly valued customer, there's little to be done.

Technology provides little help in such situations, and the issue typically has to be handled at the customer-relationship level, with AR and the company's credit manager and sales department working together to fashion a way to persuade the customer to change its habits. Those departments are often not in sync, so a mandate from senior executives may be required to make them work together.

Nevertheless, there are a plethora of tools to encourage customers to make payments. Purdue students, for example, can sign up to receive email or text reminders starting seven days before payments are due, the day before, and then every three days afterward until the payment arrives. The University, however, holds the ultimate reminder, since the bill must be paid to attend class.

TRACKING CUSTOMERS

The healthcare treasury executive said his company's DSO is about 40 days, which the company considers reasonable. Nevertheless, it aims as much as possible to prompt customers to pay their full bill upfront if they have yet to reach their deductible, since they will have to pay it anyway eventually. At the same time, AR is working to collect payments from government and commercial insurance programs.

The healthcare provider uses the MEDHOST patient account system to track patients and all their touch and contact points from start to finish. A patient receiving treatment at a facility is entered into the account system along with his or her insurance policy. The system then tracks the services received, what was billed to insurance, and what insurers owe the company.

"Each collector is responsible for following up on those unpaid accounts, and the system documents when they contacted patients, who was contacted, and it will automatically flag to contact them again in x number of days if the bill has not yet been paid," the executive said.

He added that his company has used MEDHOST since it was founded in 2011, and its operations team has a strong relationship with accounting-system provider. He regularly talks with other vendors about their solutions, but the existing relationship with MEDHOST creates a "very solid barrier to entry." Even so, his company has been pleased with the system, and the arrival of new executive leadership, which can usher in changes, has left it in place.

INTEGRATION AND SEGMENTATION

DeGraw at The Hackett Group noted the importance of integrating collections with other parts of the payment process. For example, if payments are not posted and visible to collectors in a timely fashion, they may call on customers who have already made payments to say they are past due.

"What tools aim to do better today and in the future really comes around to predictability. How do these tools make us smarter, to be more predictable," DeGraw said. "There's no value in me calling a customer today about making a payment if they already did."

Some customers may fall into the segment of needing an extra call, perhaps because the company is going though a merger or another major change. An early call—not a collections call—may be in order to ensure everything went well and the customer received the product or service, whether the invoice was correct, and its payment will be on schedule.

"Sometimes during those calls you find out something went wrong and it can be fixed before the payment becomes past due," DeGraw says. "You can't do that with everybody, so tools help you segment customers and get smart."

NEW TECHNOLOGY CONFRONTS A LONGTIME ISSUE

For decades, vendors and banks have applied technology to develop solutions to help reduce companies' DSO. Increasingly sophisticated machine learning (ML) and other types of AI would seem to be particularly appropriate.

"One of the things we've observed is a lot of companies prioritizing accounts only after the invoices hit past-due status," said Sean Das, manager solutions engineering at Houston-headquartered High Radius, and early adopter of AI to address AR-related issues. "Then they follow up with the customer."

He added that AI enables companies to analyze data residing in their enterprise resource planning (ERP) systems to find payment patterns. For example, a customer may only pay invoices on the first Monday or perhaps last Friday of each month, or have a risk of historically bad payment behavior. The AI technology will digest that and other information from when the invoice was first created, generating inferences such as whether the customer's payment is likely to be delinquent or not. Combining that information with other components such as credit limits and past days due, companies can develop a collections work list that is proactive rather than reactive.

"We're giving collectors an edge by providing them with insight into what has happened in the past," Das said. "Our core philosophy for using AI [in collections] is to get those insights and help collectors be more proactive."

8 PREPPING FOR THE CHALLENGES AHEAD

The Hackett Group's working capital survey identified $1.27 trillion tied up in working capital in the top 1000 companies that could be released in cash when moving to the upper quartile levels of working capital performance. Inventory and payables offer the most opportunity, but accounts receivable isn't far behind, at $368 billion of the total.

Technology and other tools can play a significant role in improving the AR process and reducing DSO, potentially a major benefit to companies should cash become less readily available, whether sooner as a result of a coronavirus-prompted economic slowdown, or later as part of the economic cycle. However, to take full advantage of those tools, warned Glassmaker of The Hackett Group, companies must review their existing order-to-cash process for faults that may have been missed or ignored during the long economic expansion.

"Are there process gaps and does the company have the correction organizational structure?" Glassmaker said. He added that, while new technology can be helpful, "we strongly recommend that companies address their processes, effectiveness and organization design prior to bringing in that technology."

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