The Deductions Paradox…

Few subjects captivate the imagination, or play with the psyche of executives from the credit manager to the CFO, as do customer deductions.

Perhaps it's the perceived reneging of the deal or the realization that something's gone awry. It could be feeling a loss of control in the transaction when the customer determines how much to pay and when or the feeling that someone is not honoring a commitment.

Whatever the reason, for all the attention and for the best intentions, most companies still haven't gotten a handle on their short payments and unauthorized deductions.

Managers have been hired and fired, departments restructured, and project teams assembled all in the hope of limiting, challenging or resolving unauthorized deductions. Cottage industries have grown offering third party resolution and counseling on how to offset deductions. Software solutions have sprung up focused solely on dispute resolution at the unfortunate and ill-conceived exclusion of the broader issues of credit and collections, not to mention customer relations.

Experts estimate unauthorized deductions to be a $10 billion a year problem that's growing at 20 percent annually. They say deductions are a major commercial-debt collection issue. Unfortunately, some things are missing beyond the full payment of customers:

- Perspective about the size of the problem in relation to broader and more significant collections issues…
- Determining the reason deductions occur and the realization that most unauthorized short payments are substantiated and settled in favor of the customer…
- Well-conceived and planned tactics that keep deductions from occurring from the start or to resolve them expediently in a quality driven process…
- Identifying the proper amount to invest or how to invest in deduction resolution before you reach the point of diminishing returns…
- Balancing the balance sheet with customer relations…

This White Paper will shed light on the nature of unauthorized deductions as they relate to credit and collections in its entirety and explore why unauthorized deductions have become a problem. In broad strokes it will outline some of the underlying and repetitive causes for short payments and illuminate why understanding these root causes is valuable and can improve your processes and performance as well as customer relations. Finally, this paper will examine how to engineer a deductions management program that offers an optimum return for your investment and is an investment in good customer relations as well.

Dammed it you do… dammed it you don't

Deductions can be likened to debris that has cluttered a stream. There may not seem to be much of a problem until the debris begins to accumulate. Before you know it, the dead branches have formed a natural dam that soon becomes solidified with silt. The effects are flooding upstream and limited flow down river. With deductions, an inflated, difficult-to-manage, accounts receivable develops (the flood) while collections end up substantially below normal (reduced flow).

Breaking up the dam has the benefit of restoring the stream to its normal flow, but that is not necessarily a permanent solution. The logjam might re-form to yet again dam up cash flow. Trying to remove the debris as quickly as possible from the river does not guarantee long-term success. That approach will be labor intensive, time consuming, and therefore expensive. The only permanent solution is to keep the debris from ever entering the collection stream in the first place. While that is a worthy first priority, it is a virtually impossible goal. The second important priority should be to develop a process to separate deductions automatically so that they do not infect the remainder of the accounts receivable portfolio. Then, the system will not get backed up and dilute the value of precious collection resources.

It is not uncommon for companies that sell to retailers to suffer from a deduction rate of 15 percent. In such a circumstance, a $10 million accounts receivable will contain $1.5 million in deductions. Of this amount, typically only 10 percent is collectable. The remaining 90 percent will eventually be written off, though it is more likely that some sort of credit is due the customer. That means $150,000 worth of small collectable balances are sitting on this receivable. Most companies, because of limited resources, will collect only 10 percent of that value, a yield of only $15,000. That is not a particularly significant sum of money, and it can be very difficult and time consuming to retrieve it.

Balance that payoff with the total net collectable from an overdue receivable. An undisputed receivable is collectable for its total value. To add a little perspective, compare the diminished value of chasing a deduction with the value-laden payoff of receiving payment quickly on an overdue receivable. Staff time and related costs are minimized. You enjoy the benefit of increasing working capital and improved cash standing. Further, studies show that the longer an overdue receivable is allowed to sit before collection activity is initiated, the less likely it will be paid. By chasing down deductions, collectors perpetuate a cycle of non-payment. The disputes that are worked will only yield a 10 percent return on average. As collectors spend time working disputes, they lose time on overdue receivables, which in turn devalue as time passes. Quite simply, solutions aimed solely at resolving deductions are valuable but have significantly less return on investment compared to solutions that espouse a holistic solution for a broad spectrum of collections and deductions issues.

More disheartening is the time and effort spent clearing up the other 90 percent of the deductions. Studies have shown that collectors can spend up to 75 percent of their time working on deductions. That time is at the expense of more critical collection activities. The problem collectors face is that if they do not effectively manage the deduction issues under their control, these problems will multiply, with the potential for creating serious credit and collection situations.

Collectors are not the only employees affected by deductions. Salespeople who are brought into the deduction resolution process can typically find themselves devoting 10 to 40 percent of their time to solving these problems.[1] Here, the opportunity costs can get substantial as time is taken away from selling, and lost sales do not contribute anything to the bottom line. Other functional areas that are touched by deductions can be similarly affected: customer services, shipping and receiving, or quality assurance, for example. In every instance, deduction resolution will detract from the function's core responsibilities, and negatively effect on departmental and corporate performance.

The fault, dear Brutus, is not in our stars, but in ourselves

How have deductions become a $10 billion a year business issue? Deductions can be driven by payment or promotional discounts, resulting from billing or shipping disputes or involving damaged goods or questionable service.

Before companies begin pointing fingers at bold, brazen, unscrupulous or out-of-control customers, they must face facts – up to 90 percent of unauthorized deductions will be written off or settled in favor of the customer. Deductions are based upon credit practices and norms established by the very manufacturers or service providers who now try to recoup payment.

Typically, credit operations offer discounts for early or prompt payment. The foundation for this practice is based on (the hope of) improved cash flow, streamlined activities for credit and collections with less account maintenance and better customer relations. Companies also offer promotional discounts or advertising allowances to jump start marketing and sales.

A subtle, but powerful change, has occurred over the past few decades. Customers, who grew accustomed to receiving rebate checks or future invoice credits, began taking discounts on their own behalf in the form of short payments or non-payments. One result is that customers remit short payments or hold up payment of non-disputed items while disputes are under consideration. (So much for improved cash flow.) A second result has been additional work for collectors attempting to align payments with invoices that never seem to match. (Forget streamlined collection activities.) A third result has been questionable deductions that regularly come under dispute. (Goodbye good customer relations.) A fourth result is that the costs of resolving deductions offset the gains driven by promotional or advertising allowances. (And, in extreme cases, credit holds may be issued for non-payment bringing sales to a screeching halt.) Ultimately the handling (or mishandling) and management (or mismanagement) of deductions will determine whether customer-oriented credit policies meet their objectives or do more harm than good.

Between 75 and 80 percent of deductions a company experiences are based on internal causes. (Including the discounts and allowances previously discussed.) However, for many companies, most deductions are the result of unintended but preventable consequences. These deductions represent a breakdown or weakness in the order processing/ billing system.

By identifying, correcting or eliminating these breakdowns and weaknesses, a company can measurably reduce the volume of deductions clogging their collection process. By embracing automated systems and quality-driven processes, a company can increase its capacity to resolve deductions and speed the time in which deductions are resolved.

Information is power

Identifying the primary causes of deductions is just the first step toward reducing the number of deduction issues that may clog accounts receivable. A baseline analysis will uncover the extent to which the deductions are present in the receivable portfolio and reveal the relative effect of each type of deduction. Cataloging the occurrences of the deductions is essential to compiling the data. Finally, analyzing the data will provide the information to unclog the receivable logjam and to perpetuate process, system and performance improvement.

Overly complex pricing structures, poor shipping controls or too many handoffs involving paper-based order processing documents have the potential for creating persistent, system-clogging deductions. The obvious solution is to eliminate deductions at their source. That requires first identifying the different types of deductions affecting account receivables and the collection effort. A baseline analysis will uncover many reasons for deductions. These reasons should be catalogued so that similar types of deductions can be dealt with in similar fashion and expeditiously. Some categories include:

- Pricing
- Returned Goods
- Short Shipments
- Quality Problem
- Unearned Discount
- Unpaid Freight
- Advertising Allowance
- Promotional Allowance

These categories form the basis for putting a cost on deductions. By analyzing the processes behind only the six to eight most common types of deductions, it is possible to calculate reasonable estimates as to the cost, and correspondingly the opportunities for improvement, for upwards of 90 percent of a company's deduction exposure.

To do this, the most common types of deductions need to be diagrammed; a computer spreadsheet is the easiest way to handle the data. As the key factors associated with each type of problem are entered into the spreadsheet, the resources being consumed by each deduction category become apparent and a summary of the overall collection environment is produced. From this information, resources can then be focused at the most opportune solutions.

The key factors can be identified by applying the questions below to each type of deduction. The idea is to identify problems that relate to the company's internal delivery and resolution systems. Neither cash flow nor delays caused by customers that collectors or deduction analysts cannot affect should be considered – only those issues that can be impacted. In this way, the diagram being created serves as a tool to identify the weakness in internal corporate systems.

Twelve Step Program for Identifying Customer Deduction Problems

1. Who at your company, outside of your collections/deductions group, resolves this problem?
2. What information do they need to resolve this problem?
3. What do they do to resolve this problem? (I.e. What decisions do they make, what information and documentation do they provide?)
4. On average, how many minutes in working time should it take to resolve one deduction?
5. On average, how many days in elapsed time does it take to resolve one deduction?
6. How much of your collection time is being spent to resolve this specific type of customer problem?
7. What is the volume of transactions?
8. What is the dollar amount of accounts receivable involved in the specific problem being diagramed?
9. Who in the collection/deduction group is primarily responsible for monitoring these types of problems?
10. How do your collectors check a deduction's status with the external department(s) involvement?
11. What percentages of these deductions are eventually collected?
12. What can your company do to resolve the source of this problem so that it never happens again?

The primary weapon an individual or team will use to break down departmental barriers and address core issues behind deductions is good intelligence. That can only be derived in sufficient detail from a computerized database. Collection software provides such a database and tracks deduction-related data automatically. The collector does not need to depart from the routine when a deduction is encountered, because beneath the surface, the software is creating the intelligence that will guide management in formulating long-term solutions to these issues.

Automated collection software is an essential tool in the identification and quantification of the different types of deductions. This information serves to help root out the internal causes underlying most deductions. Deductions can be analyzed by type, number, dollar amount, and age. Generating reports that include this information is by itself a power tool for eliminating the root causes of deductions. Without this information, it is difficult for credit and collections to convince other corporate functions of the seriousness of deductions. Being able to quantify the pervasiveness of a particular type of deduction goes a long way toward getting the key decision-makers within an organization to take action. Decisions can be made to eradicate the root causes and also enact system changes that lead to process or performance improvement. Listed below are some systemic solutions for deductions.

System Solutions to Deduction Problems

Cause	**Solutions**
Pricing disputes	Customers need to understand your price schedule. Keep pricing as simple as possible and then make sure your pricing schedules are explained to your customer's decision-makers.
Misinterpreted promotions	As with pricing, simplicity is key. Get input from trusted customers before distributing promotional material. Make sure they can understand your program from your literature.
Advertising allowances	Once you are sure your customers understand your program, you must be prepared to reconcile and process customer claims quickly and accurately. You do not want to give credit more than once.
Short shipments	Sloppy handling, poor controls or pilferage can cause these. Corrective steps are easier once the source is identified. Incentives for accuracy, better systems and additional security should fix the problem.
Undocumented deductions	Insist that all deductions claims be documented. Responding immediately and following up aggressively should change the customer's behavior.
Unearned Payment discounts	Documenting each instance provides a strong argument to present to the customer. Chronic offenders who won't change their ways should lose their discount terms.
Conflicts with terms or conditions	Make sure all accounts sign a credit agreement, which stipulates terms and conditions. Once all parties know what the rules are there should be no room for excuses.
Handling and penalty charges	These should be stipulated in the credit agreement. Again, it is important that everybody knows the rules.
Order entry, shipping, or billing process errors'	Simplify the order fulfillment process by routing out excessive hand-offs, repetitive paperwork, the re-keying of data, and duplicated procedures. Pre-edit your customer's purchase orders before shipping.
Slowness issuing credit memos	Make timely issuance a performance criterion for the departments responsible for approving credits.
Returned merchandise	Streamline the process so that goods are quickly re-disposed and a credit issued. The requirement that customers get authorization before returning goods can facilitate this process.
Duplicate deductions	Respond immediately with full documentation. Problem tracking helps identify each individual deduction.
Coupon redemption	This should be a part of your cash application process so that credits are issued immediately.

Getting everything on track

Problem tracking is an essential component of any deduction management solution. In addition to providing a mechanism for identifying problems that enables you to get to the root causes, problem-tracking software can isolate the problem receivables from those that have not been affected. This allows collectors to exclude problem items from their routine collections so that their workflow is focused on productive calls and contacts with the highest potential for bringing in the most money as soon as possible. It also enables collectors (or deduction analysts) to work on the deductions in their accounts receivable portfolio separately and also grouped by common problem codes for more productive handling along predetermined strategies.

Problem tracking also makes recurring problems more obvious and apparent. Quantitative data identifies shear numbers of deductions and reasons are the first step. Qualitative information is generated and learning occurs as collectors deal with similar types problems and gain familiarity and experience in dealing with their causes. There are six critical functions:

The six critical functions performed by Problem Tracking	
1.	Separately identifies problems from other past due items
2.	Identifies recurring deductions
3.	Allows quantification of problem types
4.	Enables prescribed strategies to be used to resolve problems
5.	Tracks contacts with other internal functions
6.	Speeds resolution

The “real life” benefits of problem tracking extend beyond reducing the number of deductions and saving time. Utilizing problem tracking, companies are able to link the key departments involved in dispute resolution and improve customer service.

Automated Problem Tracking Provides Multiple Benefits

One of the prime reasons Liener Health Products sought out an automated collection solution was to gain control of the payment deduction and chargeback process. They wanted to both identify the customers who were primarily responsible for issuing deductions and the types of deductions that recurred most often. Knowing that, Liener believed they could then institute the front-end controls to prevent deductions from recurring. To do that they needed some sort of mechanism to track deductions and chargebacks.

With the automated collection system in place, Liener has found that not only do they have the information desired to make informed decisions in regard to deduction management, but they are also saving a great deal of time over their manual processes of compiling and sharing information about deductions. Previously, schedules for tracking advertising and pricing deductions had to be prepared manually before any information could be shared with other departments such as general accounting, sales, customer service, and order entry. With an automated system, as soon as problems appear, they are routed to the appropriate departments for handling, while the collectors retain the ability to keep track of these issues both individually and collectively. What previously took a significant amount of collector time now takes only seconds.

In addition, the collective deduction information is indeed helping Liener identify and correct the root causes of their more serious deduction and chargeback issues. One check they have instituted is purchase order audits. It turns out that customer service was entering orders, often over the phone, but was never checking the confirming purchase orders. As a result, they are discovering and resolving bottom line pricing discrepancies before orders are shipped. Besides saving processing time and reducing the number of deductions, automated problem tracking is also helping Liener maintain their sales margins.

Problem Resolution

In most companies, collectors serve as a sort of gatekeeper for the administration and resolution of deductions and other problems. Some companies delegate this responsibility to specialists, otherwise known as deduction analysts or administrators, whose function is essentially the same as a collector handling the problem. In either case, the people who will approve or deny the deductions, or otherwise resolve any problems, are staff members or managers of corporate functions outside of the finance area where credit and collections typically resides.

The key role of a collector or deduction specialist in regards to problems is to be a communicator. Having all the facts makes this task much easier, and that is exactly what problem tracking software provides. Because problems need to be corrected at the source, which is usually internal, the collector or deduction specialist must be prepared to relay information back and forth between the customer and the decision-maker. Documentation is usually the critical factor, so the collector or deduction specialist must be equipped to disseminate this information to both the internal and external parties to the matter at hand, and then be able to follow-up with the decision makers until the problem is resolved. The automatic fax and e-mail capabilities of the problem tracking software facilitate this task without creating additional paperwork.

Problem tracking software also offers the ability to produce documentation sufficient to convince other departments of the seriousness of recurring problems. In conjunction with any baseline analysis that may have been conducted, collectors and deductions specialists can use this powerful tool for enlisting the support of other departments in rooting out the system weakness, policies or procedures that cause most deductions. Documentation that shows costs and trends is hard to refute, even more so when people in other departments can see the impact deductions are having on their own performance. Change seldom occurs easily, and enlisting corporate wide support is a critical element of the change process. That is more easily done when people admit there is a need for change and can then be shown the advantages of any new process or procedure. If other departments do not see a particular type of deduction problem as a serious matter, it is unlikely they will agree to changes.

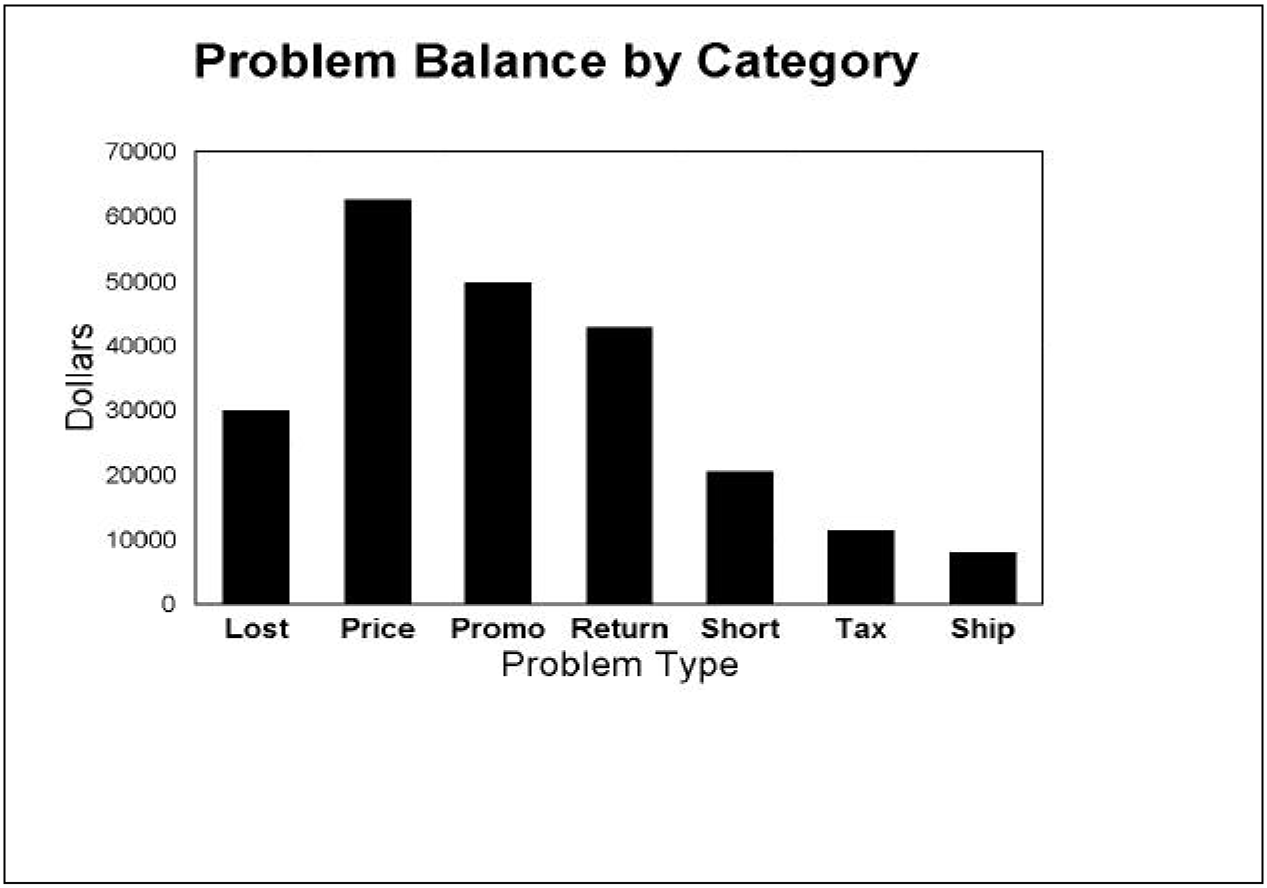
To be a problem solver, the collector or deduction specialist must be a communicator. Problem tracking software therefore needs to enhance this task by serving as a communication tool. It does so by integrating the various information components – documentation, messaging, reporting and follow-up – so the collector or deduction specialist can easily monitor and manage the entire process. That requires keeping all interested parties actively involved in the resolution of open deductions and other problems, essentially ensuring the deduction issues keep moving along toward resolution. It also requires motivating the internal decision-makers to take steps to reduce the number of unintended recurring type deductions. In so doing, the overhead deductions created can be significantly reduced.

In a departmentalized setting, deductions are viewed by each internal business group as a problem in a box. No department sees the entire picture, and usually not even the same type of deductions. This situation does not facilitate system-wide fixes to prevent recurring deductions, whose origins, effects, and resolutions are usually spread throughout the organization. An automated deduction management system thus becomes an extremely valuable communication tool that can facilitate real change in how deductions are managed.

Solid reporting yields better deduction management

Reporting is a key component of the problem solving process. This is usually a weak point with manual collections systems even if receivables have been automated. The inability to analyze the big picture makes it difficult to get a handle on your deduction situation when operating manually. The difficulty in creating deduction reports from a manual system is two-fold. First, without reason codes linked to the accounts receivable database, there is not much you can learn beyond the total number and amount of deductions. Even if reason codes are available, that data is not tied into the collection process making it difficult to measure the efforts and time frames encountered in resolving the deductions. In addition to the lack of information, manual reporting is extremely time-consuming. Remember that deductions are a low dollar, high volume type of headache, so there are a lot of little, often very different items to count.

An automated collection system with a problem tracking capacity is not encumbered by these restraints. Reports are easily generated, and it is a simple matter to view specific answers to specific problems. This is because the data can be sorted by any combination of problem type, product type, sales representative, or shipping point. This can help identify if there is a correlation between any of the different types of deduction problems and these other identifiers.



If a company's pricing problems tend to originate from one or two salespeople, then corrective action can be taken. This scenario is indicative, not of a system problem, but of a staff issue such as training. By the same token, repeated problems at one shipping point over all others may also be a staff issue, but might also be a freight carrier problem or poor systems at that location. The reporting features of problem tracking software should help define deduction issues in detail sufficient to suggest possible causes. Otherwise, anybody trying to analyze deductions will feel like they are searching for needles in a haystack. A good reporting system helps illuminate the target.

Trends are also more observable from reports generated by an automated problem tracking system. Being able to identify negative trends as early as possible allows for changes in tactics and the reallocation of resources to control the situation. Since the law of unintended consequences does not directly stipulate that deductions will necessarily increase when corporate changes affect the order fulfillment cycle, it is difficult to anticipate new trends. Deduction reports make it easier to anticipate new trends when corporate changes affect the order fulfillment.

You cannot observe trends without an initial and secondary reference point. The data accumulated in between also makes it possible to project trends into the future. Being able to identify a trend early on, and then to be able to predict future deduction rates and cash flows allows management to stay on top of the situation.

A good reporting system also allows the adaptation of auditing principles to deduction management. If over a period of time, if a particular customer's deductions are found to be legitimate, then it is reasonable to assume future deductions will also be legitimate and to therefore accept them without further investigation. By the same token, if all pricing discrepancies within a particular sales rep's territory are ultimately approved, there is really no need to continue investigating such deductions, and instead a process should be established to automatically process the credit memos that will resolve these issues. Problem tracking software makes these types of analysis possible. Then only periodic audits need to be conducted to ensure there is no slippage.

The same type of analysis can be done for small deductions. If most small deductions are legitimate, it is very likely the expense of investigating all small deductions is greater than the potential collections, companies are justified to automatically approve all deductions under a specified threshold. Incidentally, these items should be automatically processed at the time cash is being applied.

Reports are also a means of communicating how well other corporate departments are able to process transactions. Deduction systems track how long each transaction is held by a given problem owner prior to issuance of a credit or advice to the collectors that the matter should be collected. One example of a report that helps expedite the processing of deductions by other departments is listing of transactions that require action, aged by the date they were distributed to the external departments and grouped by the department responsible for resolving any problems.

Process improvement… No problem Mon

The primary goal of deduction management is not processing more deductions faster, but rather correcting the causes of deductions in the first place (with the obvious exception being intentional promotional type deductions). Without process improvement as its basis, problem-tracking software merely helps the collector or deduction specialist do more work with only minimal productivity improvements. However, when problem-tracking software is used as a change management tool a much higher operating efficiency is attained.

By using the reporting features of problem tracking software to identify error causing tasks and thereby involve the decision makers that effectively own the individual deduction issues, collectors and deduction specialists assume the role of change agents. To be an effective change agent they need to have an intimate understanding of the business processes that cause deductions and be able to work with all parties associated with these processes. In the end, deduction management is all about simplifying processes and quality improvement. This is where the collector's specialized knowledge can be transferred from process management to process improvement.

Reducing the handoff of documents from one person to another and eliminating redundant data entry tasks are good places to start. Handoffs and data entry are prone to error besides the fact they consume time unnecessarily. Process improvement teams charged with redesigning systems that will present fewer opportunities for deductions to be taken need to keep this in mind. Simplicity is an asset.

Resolving disputes mean satisfying customers, not proving them wrong

Are you a manufacturer or a service provider? In either case, you need to sell your product or service to someone – the customer. In fact, your business depends on them.

Unfortunately, too often deduction management has come to mean proving your customer wrong. And deduction software is more than just another arrow in the quiver in disproving or disputing their deduction. There are two key problems with this line of thinking. First, as has been pointed out, nearly 90 percent of deductions are approved or written off. Shooting at the customer is akin to shooting yourself in the foot. Second, are you the only manufacturer or service provider in your industry? If not, disputes will catch up with you. Dissatisfied customers will eventually look elsewhere.

Smart companies leverage deduction resolution as a way to improve customer service and customer relations. It comes down to knowing your customers and understanding their needs. If customers were getting everything they needed and they knew it, there would not be any deductions, so in a sense deductions reflect breakdowns in customer support or the perception there has been a breakdown in the delivery thereof. Customer input is essential for the process improvement team to consider.

A redesigned process that can minimize deductions will improve performance and productivity on both sides of the transaction. Customers are able to process payments more quickly. Their accounts payable personnel are no longer issuing as many debit memos or spending time trying to reconcile their account.

Automating deduction management will streamline processes, improve accuracy, and increase timeliness. Customers will come to rely upon the accuracy of your tracking mechanism and track record for an accurate record of deductions earned.

Managing deductions with an eye on ROI

As has been described, the comparative value of what can be collected from unauthorized deductions is significantly less than the cash value of overdue receivables. Therefore, software or solutions that solely aim at resolving deductions at the exclusion of broader and more significant collections issues are shortsighted at best and will have a limited impact on cash flow. They will have a less timely return on investment than comprehensive solutions to manage deductions as part of a systemic approach to improving productivity and performance in all areas of collections management.

The aggressive ROIs promised and delivered by broad-based collection management software is just one measure of their effectiveness. Collectors could formerly spend 75 percent of their time mired in deductions. The right tools enable them to focus on the greater payoffs associated with calling in receivables, as they become overdue. The gains in productivity are significant.

Collectors get to spend more time focused on their core responsibility, accelerating collections, rather than resolving problems, which for the most part are individually insignificant. The same is true for other departments whose responsibilities are impacted by the order fulfillment and collection process. Fewer deductions translate into greater productivity for all concerned. Improved deduction management translates into gains in working capital for your bottom line.

Improving your deduction resolution will help customer satisfaction indicators soar. As has been stated, the preponderance of deductions and disputes are resolved in favor of the customer. Given that, deductions didn't have a large impact on their bottom line. Unfortunately, disputes did endanger good customer relations and engender resentment on the part of customers. At best, disputes caused productivity loss on their behalf because their staff needed to research and answer for deductions. At worst, they would be turned away because of over-restrictive credit hold policies. In any event, the handling (or mishandling) of deductions can determine whether you capitalize on enduring, long-term positive customer relations or battle to maintain your customer base and market share.

In conclusion, effectively managing deductions demands you strike a balance to recapture your investment. The costs – tangible and intangible – of a poorly executed dispute resolution process can be enormous. But the costs for solutions need not be if they are well planned and continue to focus on the larger issues that dominate credit and collections.