

Experts in the News

Best Practice in Accounts Receivable Reconciliation

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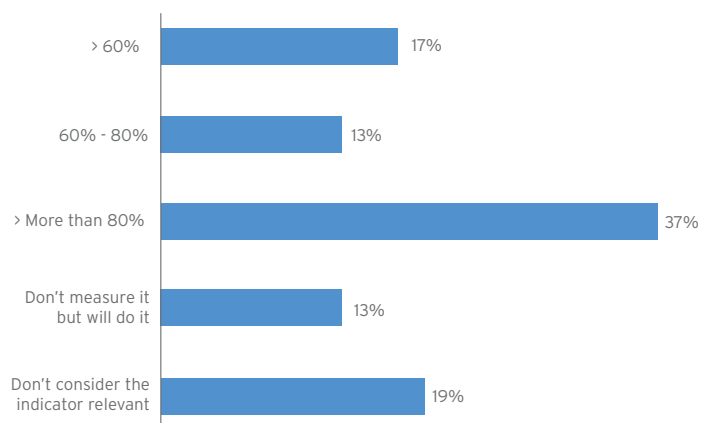
Elena Cengher
Receivables Product Manager,
Europe Middle East & Africa
Treasury & Trade Solutions
(TTS) Global Transaction
Services, Citi

Efficient accounts receivable (A/R) and cash application functions are key to the financial health of companies, and have the potential to considerably influence a company's overall financial performance.

Consolidation, standardisation and automation across multiple geographies have been key objectives for treasury over the past 25 years. In the post-crisis environment, there has been a renewed focus on efficient working capital management (WCM), order-to-cash (O2C) cycle process optimisation and on the need to balance credit terms with days sales outstanding (DSO).

While some of the challenges in the collections process are related to the instruments, for example the use of paper instruments resulting in delayed receipt of funds, the most significant challenges are related to internal accounts receivable (A/R) processes. Citi's recent survey (see Figure 1) found that only 37% of corporates have an A/R reconciliation rate of more than 80%. This highlights the magnitude of the problem facing corporates.

Interestingly, the same survey shows that 19% of respondents do not consider the indicator relevant, which is surprising considering its importance. A high A/R reconciliation rate has a positive impact on DSO, frees up credit lines for further sales and releases cash into the organisation's ecosystem.



Source: Citi

A/R is clearly an area for improvement, with a number of challenges to be addressed to make the process more efficient and to achieve a higher reconciliation rate. The goal, therefore, is to fully automate the A/R reconciliation process, including rejects and returns handling, and thereby increasing the straight-through reconciliation (STR) rates to more than 90%, to the point where minimal manual intervention is required.

Significant improvements can be achieved by corporates through a combination of banking capabilities, technology solutions, internal process standardisation, as well as changes in market practices and payer behaviour.

A/R Reconciliation: Challenges

Corporates require increased visibility of incoming payments within the O2C cycle in order to maximise the use of cash. In the post-sales, or order-to-invoice (O2I), stage, the invoice-to-cash (I2C) cycle begins with a corporate's enterprise resource planning (ERP) system issuing an invoice; any invoice issued will eventually be settled by the buyer who can use various payment methods to cover the outstanding invoice(s).

When the A/R department receives the payment, the A/R system is updated by allocating the payment to the respective buyer/customer. The corporate is then able to identify who has paid and, in turn, able to update the credit lines of its customers. Knowing who has paid is not enough - further reconciliation, at the invoice level, is the next step.

Hence the success of the reconciliation process is dependent on availability of complete information and a clear description of what has been paid for. This reconciliation process may sound easy in theory but is extremely difficult to implement in reality, as demonstrated by Citi's survey results above. Various factors contribute to the challenges faced by multinationals trying to reconcile their incoming collections, for example:

Type of commercial flows

- Business-to-business (B2B) payments: business payers usually combine invoices when making payments. Moreover discounts can be part of the payment. This makes the cash application segment significantly more complicated.

Payers' behaviour

- The lack of invoice numbers or otherwise partial details.
- Different information is provided in different countries.
- One payment to settle several invoices, partial payments or overpayments.
- Payers accustomed to certain payment instruments (such as cheques or cash).

Internal challenges

- Decentralised processes across departments.
- The fragmentation of information management infrastructure across the entire WCM cycle.
- A strong attachment to legacy processes, systems and market customs.
- The existing ERP system and the degree of automation when importing bank information.

Market specifics

- Market practice dictates how collection items are shown on a standard statement (i.e. MT 940, BAI2, ISO XML, etc).
- The amount of information accompanying the payment varies by country and instrument.
- Every instrument has a different flavour in every market (in terms of rules, settlement, etc).

Geographic variations can be very challenging for those operating in many markets. For example, Dutch payments are predominantly electronic, whereas in the UK cheques are still popular in spite of the fact that they will be phased out by 2018. In Germany, direct debits are prevalent but there is also still a lot of cash, which is the payment method of choice in the central and eastern European (CEE) countries. A corporate needs to understand what happens in each of these markets and how to make best use of the many different payment instruments.

Let's take a closer look at two challenges - type of commercial flows and internal challenges.

Type of Commercial Flows: The Reconciliation Issues in the I2C Segment

Within the O2C cycle, breakdowns late in the I2C segment - payment receipt, cash application and update A/R - can have a negative impact on reconciliation rate. There are a number of challenges at each level and a number of questions that a corporate needs to consider including:

Payment receipt

- Who makes the payment and what instrument do they use?
- How is the remittance information being received?
- Is the information consolidated across geographies?
- How is the information uploaded into the corporate's environment (manual or auto upload)?
- What pain points are associated with this step in the process (formats, timing, accuracy of information, etc)?

Cash application/operational reconciliation

- What percentage of transactions is automatically reconciled?
- What cash application functions are supported manually and why?
- What are the key drivers of the exceptions (certain payment types, certain geographies, insufficient data, etc)?

Update A/R

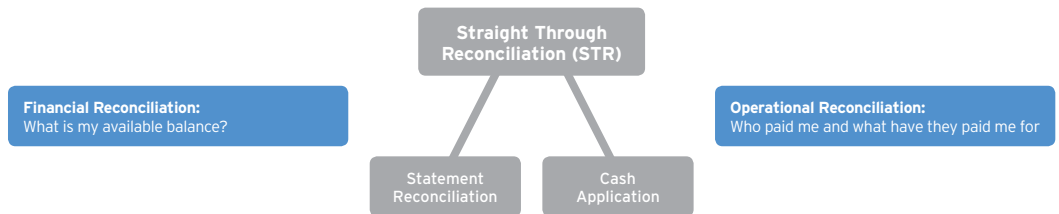
- What data elements are used to post to the general ledger (GL) system?
- What are the problems in posting to the GL?

Internal Challenges: Financial Reconciliation Versus Cash Application

The corporate/internal specific issues revolve around the fragmentation of the information management infrastructure across the entire WCM cycle. For practical purposes, stakeholders within the cycle have different interests/goals.

To understand how to align the interests of each stakeholder, it is important to understand the distinction between financial reconciliation and operational reconciliation, or cash application. The former is the treasurer's purview because they are interested in cashflow forecasting, account balances and investing available money; the latter is the focus of the A/R department whose main mission is to ensure that all 'cash receipts' are applied on time against open items. In today's environment, operational reconciliation is as important as financial reconciliation.

In addition, there is the credit manager who is responsible for freeing up credit lines so that the salespeople can sell more. The credit manager doesn't need to know what invoices have been paid, just the amount matched against a specific buyer/customer.



Stakeholder	Information Needs	Desired Outcome
Treasurer	What is my balance When can I release funds?	Reduce DSO Cost savings Cash flow forecasting
SSC Clerk	File received? Transactions good or bad?	Efficiency Standardization Automation
AR Manager	Who has paid me? What have they paid me for?	Easy reconciliation of the cash account The respective GLs Apply receipts to open AR item(s) Increase automation and reduce exceptions
Credit Manager	How much money have I received for one particular customer	Payment receipts and dishonours Minimized credit utilization/update credit lines
Clerk in charge with the Statement Reconciliation	What is entry on my account for? Can I match it to my records?	Post on internal entry for every statement item (bulk or itemized)

Source: Citi

How to Improve the Reconciliation Rate

The philosophy of STR revolves around reconciling outstanding receivables without the need for manual intervention. The STR concept is linked to the content and quality of information received by a corporate from its markets and banks. Once the information has been made available, the corporate then needs to identify, capture and apply various parts of the information to its open A/R. The capability to automatically retrieve and apply the relevant information fields to open A/R is still a long-term vision for many companies. However, a combination of banking and technology solutions, market practices, and changes in the payer behaviour can help improve the reconciliation rate.

Migrating from paper to electronic instruments, such as electronic collections, will help, but there is much more to it than that. STR will be a result of the identification and application of relevant data fields and also needs to be facilitated by complete, high-quality data and electronic instruments capable of capturing, storing and feeding that information from the market and banks to the corporate.

The technology solutions employed by the company influence directly the reconciliation rate. Integration between the ERP and the bank is essential. Generally, companies' approach in this space falls in two major categories.

First is to program and customise their ERP so that they can read and understand the information from the bank. This approach is typically client-specific and it often involves internal IT resources to a great extent. At the same time, while the automation gets a boost in the first phase, at a later stage there is a risk to achieving a lower automation rate as external changes are implemented (the company may decide to change banks, or an existing bank may change the structure of the information provided, etc).

The second approach is to use an external tool specifically to address the reconciliation challenges. This approach gives the company more flexibility, as the business users can easily customise the system rules for cash allocation.

Changes in payers' behaviour will also have a big role to play. For example, a corporate is dependent on information provided by the payer - if the payer doesn't provide an invoice number, discounts claims or other relevant payment details, then reconciliation is extremely difficult. The quality and completeness of information available from a payer limits the ability of a bank to help, but banks can provide various services to enrich the data received from the payer. Banks can help their customers enrich the information based on additional data that is received from the customer in the form of remittance data file.

In addition, banks can help enrich the remittance information based on customer's master data file, for example defined nine-digit invoice reference numbers, beginning with a certain digit. Based on the customer master data and reference points, a bank can enrich the information received in the clearing file and give the customer a consolidated report with enriched information.

Banks need to start from a corporate's pain points and then recommend a solution. One immediate solution is to move from paper to electronic collection. This should be followed by improving integration between the corporate's ERP system and the bank's system. Consolidating the number of banking relationships will help the corporate along its journey.

Conclusion

Winning the A/R reconciliation game can pose several challenges. However, investing the time and resources to achieve efficiencies in this space is worthwhile for any corporate treasury. It starts with the corporate evaluating its processes, systems and interfaces with its banks and markets. This is the stage when opportunities for improving the STR rate are normally identified.

Once that done it is a matter of investing the time and resources to get the efficiencies that will drive benefits not only in terms of allocating full-time equivalents (FTEs) to other business processes, but also in terms of unlocking value in the I2C cycle, reducing DSO and optimising working capital.

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