WAUSAU FINANCIAL SYSTEMS

WHITE PAPER

IMPROVE PROFITABILITY

BY REDUCING THE COST OF DEDUCTIONS

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EXECUTIVE SUMMARY

- Customer deductions plague thousands of companies in dozens of industries. Reaching levels as high as 10% of sales, deductions amount to billions of dollars annually.
- Deductions flow directly to a company's bottom line. If a company has a 5% profit margin, a $1 million reduction or recovery in deductions has the same financial impact as $20 million in sales
- Senior management is leaving millions of dollars on the table by not focusing on preventing controllable deductions or reducing costs by streamlining deduction processing
- Standard out-of-the-box ERP systems often do not have the necessary functionality for effective deduction processing
- Technology solutions are available which focus on automating and streamlining areas of deduction management that have traditionally been most labor intensive
- Millions of dollars can be saved by reducing preventable deductions and embracing technology to reduce processing costs

THE IMPACT OF DEDUCTIONS

Want to make a $1 million savings look like $20 million in sales—focus on reducing and controlling customer deductions. Customer deductions, also known as chargebacks in certain industries, are short payments taken by customers when paying invoices and are a major source of concern for many companies. In my experience working with hundreds of companies, it is not unusual for total deductions to reach levels as high as 10% of sales. Looking across all of the industries affected by deductions, this translates into billions of dollars in deductions annually. Since deductions flow directly to a company's bottom line, the financial impact of reducing or recovering deductions is impressive. Take the following example: **If a company has a 5% profit margin (i.e., for every $1 in sales, $.05 flows to the bottom line), a $1 million reduction or recovery in deductions has the same financial impact as $20 million in sales.** In other words, the company would have to sell $20 million in order to get the same $1 million benefit to the bottom line. By focusing on reducing deductions, companies can create their own financial recovery plan. The table below shows the potential financial impact of an improvement. If a company has annual revenue of $1 billion and deductions of 5%, if they are able reduce deductions by 25%, it will give them an annual savings of $12.5 million. Even a reduction of only 10% will bring an additional $5 million in profit.

FINANCIAL IMPACT – WHY FOCUS ON REDUCING DEDUCTIONS

Assumptions ($000):	Company A	Company B	Company C
Sales	$750,000	$1,000,000	$5,000,000
Deductions 5% of Sales	$37,500	$50,000	$250,000
Additional profits if reduce deductions by 25%	$9,375	$12,500	$62,500
Additional profits if reduce deductions by 10%	$3,750	$5,000	$25,000

Once thought to primarily affect companies selling to retailers, deductions are a big problem for those selling to distributors and manufacturers as well. Based on the 2009 CRF Customer Deduction Survey conducted in collaboration with Attain Consulting Group in which over 700 companies across 33 different industries responded, 53% of the responding companies reported that their primary customers were retailers, while 47% identified their primary customers as distributors and manufacturers.

There are two types of financial costs associated with deduction management. The first and most obvious is the cost of the deduction itself. If a deduction can be avoided or recovered, this savings will flow directly to the bottom line, as discussed above. The second financial cost is the cost associated with deduction processing. This includes the time and cost of internal resources used to identify, research, validate, dispute and resolve each deduction as well as the cost of any outside services used for deduction management (e.g., bank processing). The cost of processing a deduction is typically between $200 - $300.

To reduce the cost of deductions, improvement strategies must include looking for ways to decrease the overall level of deductions received as well as reducing the processing costs of those which cannot be avoided. Adding to the challenge is that all deductions are not created equal. Most can be classified into three major categories—intentional, preventable and unauthorized. Each deduction category has a different impact on profitability and requires a different strategy to achieve best practices and minimize costs.

TYPES OF DEDUCTIONS

Intentional, or sales-related deductions include items such as markdowns, discounts, advertising and promotions. These "deals" are typically negotiated, pre-authorized and budgeted and are truly the "cost of doing business". Since intentional deductions have been pre-approved, most are valid and are not recoverable. Therefore, the goal is to minimize the processing costs. As soon as a "deal" is made with the customer, it should be documented and communicated with the appropriate people within the organization so that when the deduction comes in, it can easily be identified, matched and validated. If time is spent figuring out the reason for the deduction, searching for the correct deal to which it should be applied (or waiting for a sales person to approve the claim), or manually retrieving documents needed to validate the claim, then there is an opportunity to save money by reducing deduction costs.

Preventable, or controllable deductions are often the result of not complying with a customer requirement regarding the packaging or shipment of an order. Examples of preventable deductions include ticketing/labeling issues, freight & handling errors and early/late delivery. Contrary to intentional deductions, preventable deductions are characterized as the "cost of doing business poorly". Many preventable deductions result from poor internal practices within an organization. By failing to identify and correct these controllable issues, companies are leaving money on the table. While savings can be achieved through processing improvements, by fixing the underlying issues and reducing preventable deductions, companies can often add hundreds of thousands if not millions of dollars to their bottom.

The third category, ***Unauthorized*** deductions, include those which are not necessarily pre-planned yet may not always be preventable. Returns, shortages and pricing are typically found in this category. Some of these deductions (especially pricing) can often be prevented through sound business practices, and others need the proper processes and supporting documentation in place to either validate or dispute.

The table below provides a summary of major deductions by category

INTENTIONAL	PREVENTABLE	UNAUTHORIZED
• Agreed Upon Discounts	• Late Delivery	• Pricing
• Co-op Advertising	• Wrong/No UPC	• Returns
• Markdown Allowances	• EDI/ASN	• Full Carton Shortages
• Rebates	• Carton Markings	• Concealed Shortages
• Margin Guarantees	• Freight/Handling	• Unknown/Misc.

REASONS COMPANIES STRUGGLE TO CONTROL DEDUCTIONS

Companies struggle to control deductions due to a variety of issues, including senior management's perceptions, the lack of cross departmental coordination within a company and limited processing capabilities of existing ERP systems.

Senior Management Awareness

Senior management has often come up through the sales and marketing ranks within an organization. When they think about deductions, they often think of them as predominantly intentional, or the ''cost of doing business'' or as customer profit centers and are not aware of the controllable nature of some deductions or the hundreds of thousands of dollars in internal time and effort that go into managing deductions. **As a result, senior management may be leaving millions of dollars on the table by not focusing on preventing controllable deductions or reducing costs by streamlining deduction processing.**

Cross-Departmental Coordination

Deductions are a company-wide issue. They are not caused, resolved or prevented by a single department. Therefore, the coordination, communication and cooperation of multiple departments is required to achieve world class deduction management performance. Unfortunately, companies often struggle when required to work or coordinate across departments. Based on the 2009 CRF Customer Deduction Survey, cross-departmental cooperation is the number one internal challenge companies face when trying to control deductions.

ERP Systems Lacking

In managing deductions, there is a ''need for speed''. Deductions do not improve with age, rather they burden a company's AR and the older they get, the less likely the chances of recovery, even if they are invalid. If valid deductions are not credited on a timely basis, they often require internal resources to spend time performing non value-added activities to validate/approve the deductions. **One of the struggles companies face is that standard out-of-the-box ERP systems often do not have the necessary functionality for effective deduction processing.** ERP systems are often set up to handle one type of processing. While they may be flexible and can be customized to process transactions in multiple ways, businesses often make standard decisions as to the general process flow of sales transactions and that flow is followed for all sales. Unfortunately, when it comes to deductions, there are very few standards. As most companies know, many customers have unique requirements when it comes to how invoices should reflect trade promotions or how product should be packaged, labeled and shipped. When deductions are taken, the information provided and the way it is provided also varies by customer. Lacking a detailed understanding of the nature of deductions or deduction processing, most ERP systems are designed with only rudimentary deduction management capabilities. Much of the functionality which would enable a company to adopt best practices is not available in a single ERP solution. Certain more sophisticated ERP systems, such as SAP, are quite configurable and therefore theoretically can be customized to meet the unique deduction processing requirements of most customers. However, each customization requires programming, which is often either not available or at a premium within an organization. In addition, customers frequently make changes in their deduction requirements and documents, therefore keeping up with the changes is an ongoing activity. If the resources necessary to make the changes are scarce or not available in-house, the updates can become quite costly.

Three of the key deduction processing areas I see which are affected by ERP limitations are 1) cash application/remittance processing; 2) deduction workflow; and 3) retrieving supporting documentation to validate/dispute deductions.

Cash Application/Remittance Processing

Deduction processing begins with the receipt of payment from the customer. Being able to quickly and automatically identify short payments and understand the reason for the deduction is critical to effectively resolving the claim. Customers have different ways to identify and code deductions on their remittance information, therefore there is not a standard "template" to use when processing deductions included with payments. Even if your bank is keying in remittance information, customer reason codes are mapped to internal reason codes and the cash application group is trained to understand key deduction issues, because of the differences in the format and content of the data between various customer remittance documents, there is often a lot of manual effort involved in creating and posting deductions. For example, columns may need to be added, signs changed and subtotals created in order to properly upload deductions to the AR.

Workflow

Once deductions have been set up in the system, the next step is researching the deduction to determine whether it is valid and should be credited, or invalid and should be disputed with the customer. Different reason codes require different research processes, supporting documentation and input or approval from various departments to validate or dispute. The lack of automated workflow capabilities in many ERP packages to systematically guide this process makes the research and routing between departments a fairly manual process. This not only results in more time spent to manually manage the process, but it also limits the controls in place to ensure that a consistent process is being followed. Even if workflow capabilities are available in an ERP solution, often the time, resources and knowledge needed to develop and program the step-by-step workflow associated with deduction management is lacking.

Supporting Documentation

One of the most time consuming activities in researching deductions is the gathering of supporting documentation. Whether retrieving sales agreements or point of sale (POS) data to validate a trade promotion claim or pulling a proof of delivery (POD) to dispute a late delivery deduction, having the proper documentation to support your conclusion is critical. Supporting documentation is found within internal systems, such as sales and warehouse management systems, as well as external data sources, such as carrier web sites and customer vendor portals. ERP systems are not designed to automatically pull, retain or index this information therefore much of this document retrieval is performed manually, requiring a large resource investment.

OPPORTUNITIES TO IMPROVE DEDUCTION PROCESSING THROUGH TECHNOLOGY

To substantially reduce the costs of deduction processing, look for ways to automate manual activities to increase agility, processing speed and efficiencies. **Several technology solutions are available which focus on automating and streamlining areas of deduction management that have traditionally been most labor intensive.**

Many of these newer tools are offered as Software-as-a-Service (SaaS) solutions. Saas, sometimes referred to as "software on demand" is software that is designed to run over the internet from a local area network or personal computer without having to install any software. Rather than purchasing the software, a 3rd party service provider licenses the application to customers who may pay on a per use or subscription basis. SaaS solutions can be rapidly deployed, require much less support from internal IT departments, are often considerably less expensive than purchasing software. System maintenance, including updates, is often included in the service and performed by the 3rd party.

Cash Application & Remittance Pre-processing

Much of the manual pre-processing of customer payment and remittance information done during cash application can be automated. By using rules-based engines customized for the unique requirements of individual customers, manual tasks, such as deleting prefixes or suffixes from deduction invoice numbers, properly identifying customer deduction reason codes and mapping them to internal codes, creating subtotals and adjusting signs to match internal system protocol currently performed by companies to modify and "clean-up" customer remittance data to prepare it to be uploaded to ERP systems can be eliminated, resulting in a significant reduction in the resources required and costs associated with cash application.

Implementation of pre-processing technology can often save thousands of hours in manual processing annually. Companies who are using this technology have typically reduced their overall cash application costs by 50% while dramatically increasing their auto-match hit rates. In addition, as customer remittance documents and reason code information changes, the software providers will take responsibility for making the necessary updates, thereby eliminating any burden on internal IT resources. For banks and other financial institutions who offer traditional lock box services, pre-processing software and SaaS solutions offer tremendous value added services you can provide to your customers.

Workflow Engines

Standalone workflow technologies as well as ERP workflow enhancements are available to automate the flow of deductions through the system. Often pre-configured with best practice research strategies by reason code, these tools can be customized for specific business processes and pre-defined roles and responsibilities. Standardizing the process used to research deductions can streamline the process, reduce manual activities, increase efficiencies and facilitate consistent deduction management practices.

Document Retrieval

For many companies, searching for and retrieving documents to validate or dispute claims and deductions is the single most manually intensive and time consuming activity in the deduction management process. Innovative technology has been developed to facilitate the document retrieval process of supporting documents found on external sources as well as within internal systems.

For externally-based documents, such as proofs of delivery (PODs) from carrier web sites and customer claims, debit memos and deal sheets from customer vendor portals, web aggregation technology exists to automatically retrieve the information. These tools effectively automate the keystrokes and logic currently used to pull documents, such as logging in to a carrier website or customer vendor portal and entering a tracking number or claim number, thereby eliminating often hundreds of hours of manual effort.

Companies are also using technology to facilitate the retrieval of documents stored within their own internal systems. There are tools (and system logic) that work with a company's

ERP system to automatically retrieve certain documents depending on a standard set of conditions. For example, these tools can be programmed so that if a pricing deduction is received, the invoice and purchase order from predetermined locations within a system are pulled and added as attachments to the specific deduction record or otherwise made available to review. This can dramatically reduce the time required to research deductions. Additional technologies, such as scanning and OCR (optical character recognition) are also being used to speed the processing of paper-based documents.

Automated document retrieval technology typically saves between 50% - 75% of the time it takes to manually perform the same task. In addition to significantly reducing the resources and processing costs to retrieve, validate and track claims, often, tens of thousands of dollars or more can be recovered by having the supporting documentation previously unavailable to dispute invalid claims.

STEPS TO TAKE TO SAVE

Millions of dollars can be saved by reducing preventable deductions and embracing technology to reduce processing costs. The steps below provide you with a roadmap to identify your biggest opportunities and help you get started:

How Much Can You Prevent?

1. Look at the deductions you have received in the past 12 months.
2. Classify the deductions by reason & high level deduction category (e.g., Intentional, Preventable, Unauthorized)
3. **Look at the Deduction Dollars Classified as Preventable – This represents the money you are "leaving on the table". With the proper focus, internal communication and corrective action you should be able to eliminate up to 75% of these deductions.**
   - Select one of the largest preventable deduction reasons
   - Create a cross functional team to identify the underlying factors causing or contributing to the deductions
   - Include representatives from all departments that "touch" the issue
   - Communicate potential financial impact of improvement with senior management *(Without senior management support, this type of effort is rarely successful)*
   - If your company does not have a good track record of managing cross functional teams or implementing process improvements, consider enlisting outside help. *(Make the project self-funding by retaining someone who is willing to work on a contingent basis, where payment is based on savings or recoveries actually achieved)*
4. **Intentional Deductions –** These are the cost of doing business and typically will run at least 60 – 70% of total deductions. Other than recovering the rare duplicate deduction or claim in excess of agreed upon allowance, the savings companies can achieve with intentional deductions are through reducing the costs of deduction processing (see below).
5. **Unauthorized Deductions –** Shortages and pricing deductions can often be prevented, so follow the steps under preventable deductions above. For returns and defective deductions, cost savings opportunities are usually found in improving and streamlining the processing.

   (For more information on how to prevent deductions, please visit www.attainconsultinggroup.com)

How to Reduce the Costs of Deduction Management

1. Understand your current costs of deduction processing by looking at internal resource costs as well as applicable service costs and outside processing costs
2. Review the following questions regarding key deduction processing areas to identify where you have opportunities to use technology to take costs out of the process.

   Cash Application

   - What are the costs associated with your cash application processing (both internal resources and traditional lock box fees/bank costs)?
   - Based on your top 10 customers, how many hours are spent manually "pre-processing" remittance information before deductions can be uploaded to your AR system?
   - Are your customer's deduction reason codes mapped to yours so that they are automatically assigned to deduction reasons in your system?

   Workflow

   - Do you have standard process flows that guide research and other deduction management activities?
   - If so, is the process automated so that new work items will be automatically routed to the inbox of the appropriate person?
   - Are you concerned that invalid deductions may not be recovered because of inconsistent research processes or claims falling through the cracks?

   Document Retrieval/OCR & Scanning

   - How many hours does it take to pull supporting documentation to validate trade promotion claims?
   - How many people do you have pulling PODs and customer claims from vendor portals?
   - Have you had to write off deductions because supporting documentation was no longer available on web sites or vendor portals?
   - How much research time is spent searching through paper documents and are any keyed into your system?
3. Use your responses to the questions above to evaluate which area(s) may benefit from the implementation of technology to automate manual processes.
4. Further investigate and explore available technology alternatives to estimate potential cost savings.

Deductions continue to undermine the profitability of thousands of companies across dozens of industries. Rather than dismissing them all as the cost of doing business, companies can be look at those deductions which are preventable, and often the result of poor business practices, and proactively work to eliminate the underlying causes. In addition, the processing costs associated with deduction management can be dramatically reduced by embracing new technologies aimed at streamlining and automating traditionally manual processes.

ABOUT JESSICA BUTLER

Jessica Butler is the founder of Attain Consulting Group, a deduction and chargeback management advisory firm. Known throughout the industry as an expert and thought leader in the area of deduction management as well as negotiation, Jessica works with companies to help them Take Control of Deductions, is frequently published and is a highly sought after speaker at conferences and seminars. Jessica can be reached at jbutler@attainconsultinggroup.com.

ABOUT WAUSAU FINANCIAL SYSTEMS

WAUSAU Financial Systems is a premier provider of payment and remittance processing solutions, serving businesses of all types to develop strategies that move money faster. With its products, services and consulting, WAUSAU works with customers to speed check processing, electronic presentment, ACH payments, transaction processing, distributed capture and enterprise content management. WAUSAU's innovative solutions provide results for a wide range of organizations, including financial institutions, insurance companies, utilities, retail businesses and governmental agencies. Find more information about WAUSAU Financial Systems at www.wausaufs.com or call (800) 937-0017 ext. 4639 and talk to John Gustafson.

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