Best Practice Handbook for **Accounts Receivable**

ENKEL

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A Note from our CEO

My parents owned paint stores growing up – my first job was at their store. Over the years, one thing that has stuck with me is how often customers wouldn't pay their invoices. I saw the difficulty my parents experienced with write-offs and it always seemed so unfair. *Why should they have to pay for a product that someone else used?*

As a small business owner, there is no shortage of administrative tasks that eat up your time and accounts receivables (AR) tends to be an area that is often neglected.

Not because collecting money isn't important, but because it can take a lot of time, be uncomfortable, and is easy to put off or forget. But if there's no follow up and payment isn't received, that revenue will end up getting written off and have a negative impact on cash flow and profits.

When I think about the support growing businesses need, AR is at the top of the list. If you can collect your payment faster and reduce your bad debt, why wouldn't you?

So whether you're doing it yourself, or outsourcing it to a partner, read on as we share our tried-and-true best practices to improve your AR workflow and metrics to measure AR effectiveness.

Enjoy the handbook.

Omar Visram
CEO

Introducing the AR Journey

Accounts receivable (AR) is the balance of money due to a company for products or services that have been delivered but not been paid for by the customer. It is essentially purchases made on credit that are owed back to the business.

Before diving into best practices, we want to start with defining the key stages of the AR journey once the transaction has occurred.

Stage 1.
Credit issued via invoice and sent out

Stage 2.
Payment is made by customer

Stage 3.
AR is marked as collected

Now, let's break it down further to the key inputs within these three stages.

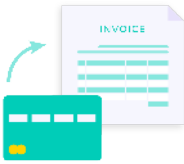
3 Stages of the AR Journey

Stage 1

Credit issued via invoice and sent out

It all begins by the issuance of the invoice. Is it manually or automatically generated? When it is generated? How is it delivered to the customer and who is receiving it?

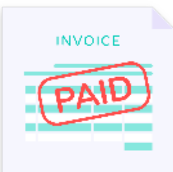
Stage 2



Payment is made by customer

Noted on the invoice are payment terms and how payment can be made. Payment terms define how much time the customer has to pay the bill (i.e. “net 30 days”). Acceptable payment methods might include cash, cheque or credit cards.

Stage 3



AR is marked as collected

In a perfect world, the customer will pay the invoice prior to the due date. However, from what we’ve seen, the world isn’t perfect. Collecting money often requires follow up.

In the following sections, we’re going to dive deep into each of the stages and share best practices to improve the efficiency and success of your AR process.

Stage 1.

Invoicing

When it comes to invoicing, it is imperative to bill the **right amount**, to the **right person**, at the **right time**.

Accurate Invoicing

Billing the right amount

Generating an accurate invoice is simply a matter of process. It involves taking data from one system and populating a number of fields in the invoice. You can easily automate this process to reduce errors on invoices, ensure all necessary fields (i.e. amount, tax, billing contact, terms) are populated, and get invoices sent out as soon as possible.

Invoicing contact

To the right person

Having the right invoicing contact is also key to getting the invoice paid. This responsibility might fall on sales team, the account manager or the accounting team, depending on your sales process. If the invoicing contact has changed, make sure you have a clear process for getting the contact updated in your invoicing system so future invoices are sent to the right person.

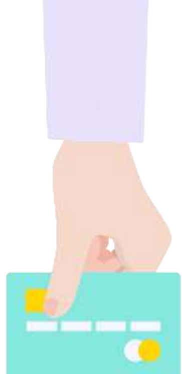
Timeliness

At the right time

If you want to get paid fast, you should send out your invoices as soon as the service or product has been delivered.

When an invoice is sent out late, nobody wins. Your customers may have budgeted for the expense accordingly and if a late invoice is sent, they may have reallocated that budget/cash, making it more difficult to pay. Also, your customers will need your invoices to close their month-end books quickly.





Stage 2

Payments

Collecting payment is an integral step in the collection process and there are 3 main components to payment collection: **Payment terms, Payment types and Payment processing.**

Payment Terms

Having payment terms on your invoice will inform your customers when they're expected to pay for the invoice. These terms can allow you to better predict payments and give you more control over your business' cash flow.

💡 4 Ways to Optimize Your Payment Terms

1. Scope out the competition

You can determine your payment terms based on your industry's practices. For example, if the norm is net 90 but you're offering net 45, you may lose out on business if your customers are cash flow sensitive or the purchase value is high.

2. Shorten payment terms

If you typically receive money on time and are looking to collect payment faster, consider decreasing the time window. You may change net 60 to net 45, or net 30 to net 21.

3. Discounts for early payment

Offering early payment discounts come at a cost. However, the cash inflow and time saved on collections might outweigh the cost of the discount. If your payment terms are 2% 10 Net 30, your customer will be entitled to a 2% discount on the bill if payment is made by day 10.

4. Late fees

Consider adding a fee – and enforcing it – for late payments. You can add a term on your invoice that states that invoices not paid on time will be subject to a 2% interest per month penalty on the invoice total.

Payment Types

Common payment methods include: cash/direct deposit, cheque, & credit cards. However, the type of payments your business accepts will depend on:

- **The types of customers you have** – Are you a B2B or B2C company?
- **The processing fees** – The convenience of a payment type may not outweigh the cost of the fees if your bill sizes are high.
- **The billing intervals –** Is the invoice for a one-time payment or an ongoing/subscription service that is billed at a regular interval?

By offering a wide range of payment options to your customers, you're making it as easy as possible for them to pay which should result in faster payment.

Payment Processing

Along with payment types, how a payment can be made is an important factor for getting paid faster. Online and mobile payments are convenient and often require little effort for customers.

For direct Interac deposits, your customers can simply log into their online banking to make the payment. If you have any recurring payments, you can consider auto-debit solutions like Rotessa or Plooto, or allowing for automatic credit card payments.

In these cases, you may, for example, debit your customer's bank account or charge their credit card 7 days after the invoice is issued. Thus allowing you to receive the payment promptly, while eliminating the need for collections.

💭 Should we accept credit card payments?

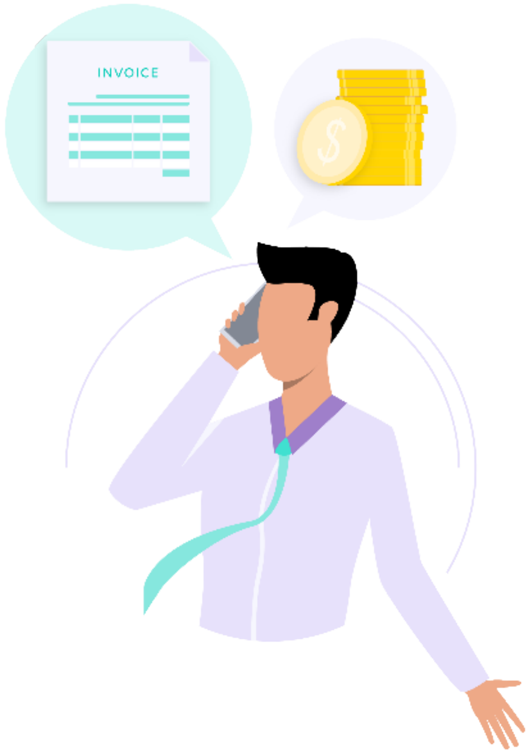
The short answer is YES – if you have enough margin to cover the fees and the bill size fits within typical credit card transaction limits.

Though processing fees will hurt your bottom line, the convenience could reduce the barriers to payment, potentially eliminate collections efforts with automatic charges, and prevent write-offs.

Internal approvals for credit card expenses may also be different than invoices, which could result in faster payment.

Stage 3

Collections



Following up on receivables takes time and is often an undesirable task. That's why it is important to be strategic when defining your follow up process, so you can maximize return on your efforts.

Why aren't my customers paying?!

Common reasons for invoices not being paid on time by customers include:

1. The invoice hasn't been submitted for payment
2. The billing contact no longer works there
3. They're taking their time or have forgotten
4. They don't have the money and are delaying payment

The first two points can easily be addressed by having the correct billing contact. If kept current, the invoice should always go to the right person and be approved accordingly. Ideally the invoice should also be routed to a central email address, such as ap@companyname.com. That way, if the contact is on vacation or no longer works there, the invoice won't be missed by the payee.

The last two points are where an AR collections process comes in.

Who should follow up?
In-House or Outsourced

Before determining your follow up workflow, it's first important to decide who will be conducting the follow ups. Accounts receivable follow ups can be taken care of in-house or by working with an outsourced online partner.

> **"Have no shame, pride doesn't pay the rent."**
>
> – Thom Gimbel

In-house AR
When done in-house, follow ups often fall on the list of responsibilities of a staff accountant or controller. The biggest challenge we see in this scenario is when AR follow up is deprioritized for more urgent tasks. Consistency with follow up is key for success.

Outsourced AR partner
Getting external support with your AR is a great way to ensure that follow ups are done consistently, in a timely fashion.

Key Considerations for Outsourcing AR

1. **Can your AR be defined in a process?**
   If you're not sure, engage with someone who has expertise in this. Oftentimes, a process can emerge even when you don't have one clearly documented.
2. **Do your communications adequately reflect your brand voice?**
   You'll want to make sure that your email follow ups and talking scripts are on brand with your company. After you've defined the process, create templates for every follow up, including talking/voicemail scripts and email copy. Your messaging may change depending on how far past due the invoice is, so the templates should be based on a timeline.
3. **Is there a defined process for escalations?**
   Your provider won't be able to resolve escalations, so they will need to know who to bring into the conversation when an issue arises.

When should you follow up?

Timing

Your follow up timing will depend on your business and your customers' typical payment behaviours. Don't forget that consistency is key! **If your accounting or invoicing system allows for it, set up auto-reminders for follow up if payment hasn't been submitted.**

For instance, businesses with multiple large project invoices may have a policy where each and every invoice is followed up on before the due date to ensure that payment will be made on time.

In other cases, where delinquencies are low, a policy of follow up after the due date is all that might be required. For example, if an invoice is net 30, you might want to set a reminder to follow up on the 45 day mark.

Very commonly, however, we see a hybrid of reaching out before OR after the due – depending on your customers. **Put your customers in two buckets:**

1. **Good paying customers who are rarely delinquent**

For customers in bucket 1, you may only need to follow up after the due date and not before.

2. **High-risk customers or new customers**

For customers in bucket 2, you may want to consider following up *in advance* of the due date so payment is made *by* the due date. This can be a courtesy reminder which may prompt the internal approval process if it hasn't already happened.

This may also trigger early warning for a potential dispute or identify if the invoice was not received in the first place.

How should you follow up?

Messaging & Tone

As mentioned earlier with outsourced partners, messaging and tone are important for follow up communications. Even if you're managing AR in-house, the same principles apply for aligning communication with your brand.

Once you've crafted your process, identify the key touchpoints where you will be following up. At each of these touchpoints, you will want to create templates with messaging that reflects the urgency and message.

For example, if you are sending a pre-due date courtesy email, this will be a gentle message. But if the invoice is more than 30 days past due, the tone may be sharper and more direct.

It's recommended to engage with your marketing or communications team to review and edit your scripts and emails.

KPIs To Measure Your AR Process

By assigning metrics to your AR process, you can hold your team or outsourced partner accountable for efficiency in collections. Here are 3 metrics we recommend.

KPI #1: AR Turnover Ratio

Accounts receivable turnover is a measure of how effective your business is at converting AR into cash in the bank. You can gauge how efficiently you extend credit to customers and collect money owed by using the AR Turnover Ratio.

In this formula, Net Credit Sales is equal to your total credit sales for the accounting period being measured (monthly, quarterly, annually), less any customer returns and refunds.

$$\text{AR Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

Generally speaking, the higher your accounts receivable turnover ratio is, the more cash your business will have available to pay expenses and service debts.

A low turnover, on the other hand, could be a warning that your business has:

- Poor credit control policies,
- A haphazard approach to customer collections, or
- A financially unreliable client base.

KPI #2: Days Sales Outstanding (DSO)

Your days sales outstanding (DSO) measures the average number of days it takes for your business to receive payment. Your accounting software should be able to provide you with your DSO.

$$\text{DSO} = \left(\frac{\text{Average Accounts Receivable}}{\text{Billed Revenue}}\right) \times \text{\# of Days}$$

High DSO = 👎

A high DSO, or an upward trending DSO, means that your business is taking a long time to collect its receivables. This could cause cash flow issues in the long run, making it difficult for the business to make payments for operational expenses due to lack of working capital.

Low DSO = 👍

A low DSO, or a downward trending DSO, means that your business is taking fewer days to collect its receivables. A low DSO is beneficial because it reduces cash flow problems and allows the business to quickly reinvest any surplus back to boost future earnings.

A word of caution for calculating your DSO...

Since billed revenue is a key driver for this calculation, the longer the time period that you're evaluating, the more representative this ratio will be (i.e. your fiscal year vs a single quarter). If you experience wide fluctuations in revenue one quarter to the next, you'll notice volatility in your ratio even if your average AR balance is steady.

Along with DSO, you'll also want to look at your Best Possible DSO. In this case, average AR is replaced by the current receivables balance.

$$\text{Best Possible DSO} = \left(\frac{\text{Current Accounts Receivable}}{\text{Billed Revenue}}\right) \times \text{\# of Days}$$

If the difference between your DSO and Best Possible DSO is low, you're operating at an optimal level.

Both of these calculations are inputs for the final metric we'll discuss: **Average days delinquent.**

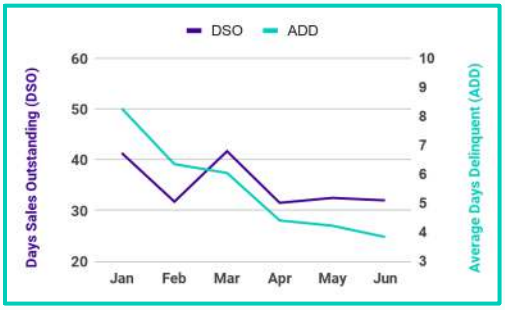
KPI #3: Average Days Delinquent (ADD)

The Average Days Delinquent (ADD) is a measure of the average time between the bill's due date to its paid date.

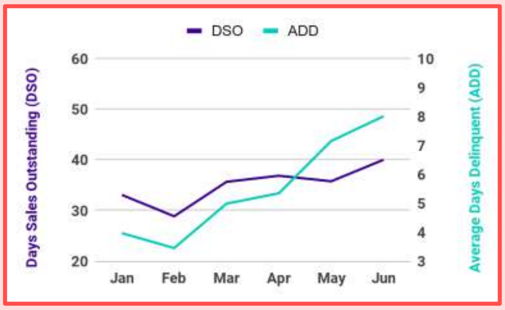
ADD = DSO – Best Possible DSO

By comparing your ADD with your DSO, you'll get a more complete picture of the impact AR has on your cash flow and collections process. Consider plotting these on a line a graph to get a visual representation of the trends.

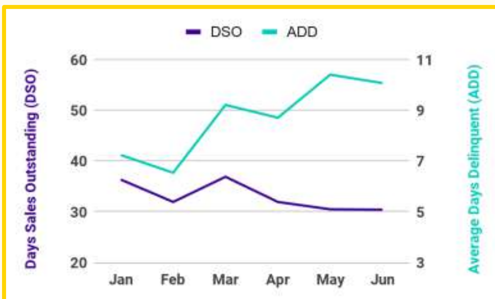
If both ADD and DSO are trending down, you can assume that your credit and collections processes are working well together and improving. Credit is extended and being paid back in a timely manner.



If both ADD and DSO are trending up, you can assume that there's an issue with your receivables process that need to be addressed and further delays could lead to cash flow issues in the long run!



If ADD and DSO are moving in different directions, the improvements to your DSO are not a result of collection efficiencies. The changes could be a result of change in your payment terms or other external factors that you should look into.



Keep the cash flowing

For an effective AR process, it's important to look at the key inputs that impact invoicing and payment, and ensure you're setting both you and your customer, up for success.

With diligent execution and tracking, you will be sure to see improvements in your cash collection and reduction in your bad debt. If you need an external partner to support your receivables function and improve collections, we can help!

At Enkel, we provides accounts receivables support to businesses across Canada. If you're interested in learning more, visit enkel.ca and reach out.

About Enkel

Enkel Backoffice Solutions is one of Canada's leading accounting as a service providers. We offer bookkeeping, payroll, accounts payable and accounts receivable services to over 300 businesses and not-for-profit organizations across Canada. Our team of accountants and bookkeepers can help you manage your back office on an ongoing basis. Get the monthly reporting and financial visibility that your business needs.

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