AR vs Inflation

Bringing Back Control

In the current inflationary environment, the financial reverberations reach far and wide into the business world. With cash flow concerns having risen rapidly up the agenda, a sharp but balanced approach to AR is essential. In the first of this two-part exploration of the wider reach of AR, Ben Sepehri, Director, AR Finance, Taulia, scrutinizes current causes, consequences, and options.

While it is clear to most businesses that inflation is now having a material effect on their finances, it may not be so apparent to all observers just how systemic an issue it is becoming as the consequences permeate all aspects of the business cash flow cycle. Nonetheless, the message that must be understood now is simple, notes Sepehri "given the squeeze on margins, business models are going to have to become more agile to cope with these material changes to the cost base".

Few businesses are left unimpeded by current circumstances, but product-based industries are being particularly challenged, with inflation impacting every key aspect from cost of goods and commodities prices to shipping and inventory costs, says Sepehri. While for these players, there are some early green shoots offering hope, with shipping costs having fallen slightly to marginally ease supply chain issues, the upside is offset in other areas, most notably in rising energy costs.

"Companies heavily reliant on energy use – manufacturers in particular – are facing unavoidable cost rises just to maintain the same level of production," he notes. "But in terms of inflationary impact, these costs are beginning to have consequences for businesses right across the board." Indeed, there is a second-order impact of inflation on business finance, and that is the rapid raising by central banks around the world of their benchmark interest rates. Inevitably, as these rises are imposed to try to confront inflation, businesses relying on working capital financing vehicles and loans, for example, are going to be paying more for their debt finance.

> **"This comes at a time when some firms will be looking to increase, or have already increased, their borrowing to bridge the cash flow gaps which had arisen during the pandemic," notes Sepehri. "With money more expensive now than it has been in a long time, margins are further diluted. It's why increasing cost efficiency in business finance to combat the effects of inflation is a priority for treasurers right now." While the great temptation is to simply pass on rising costs to customers, many businesses have tried to absorb the shortfall. Indeed, "there are no guarantees that price rises will be accepted by the customer base, which is after all facing its own difficulties," comments Sepehri. "The wrong decision now could materially affect the ability of the supplier to secure new orders and even damage existing customer relationships."**

AR pressures

But it will be increasingly tough for businesses not to pass on rising costs to their customers. In an inflationary environment, companies are effectively spending more to stand still, and this has multiple consequences for AR, especially around sales and collections processes. "The AR book is a snapshot in time. It serves as a metric that easily demonstrates the effects of inflation on the business," says Sepehri. "And the most immediate measurable consequence seen is that customers will take longer to pay as they too are squeezed on cash and look to shore up their own balance sheet." Once this takes hold, it will in some cases, lead to increased delinquencies on the receivables book. As well as the obvious impact of bad debt on company finances, a secondary outcome is an increased cost and cadence for collections activities by credit control. The unfortunate notion of spending more to stand still is a live example of this, with more investment in collections processes and procedures required to achieve the same return.

> **"This will be hard to contain for many companies. It will be bringing debt financing more into the equation as they try to leverage their receivables book to affect DSO and improve cash flow positively and significantly."**

> **"It's evident that the impact of an inflationary environment will almost unavoidably be felt in DSO, as customers look to hold on to cash for longer," says Sepehri. "As cost increases are pushed on to customers, some will be looking to negotiate harder on pricing or payment terms, and the AR book may quickly start to look rather unsettled."**

One perhaps unexpected outcome of this unsettled environment is that some buyers have been increasing their orders, notes Sepehri. However, while increasing inventory has created a sales spike in some areas, it is a short-term measure to mitigate the risk of future price rises, he explains. As a result, he anticipates that going into Q2 or H1 2023 there will be a lull in these markets, with the longer-term effect being almost inescapable increases to average DSO.

Developing AR efficiencies

"The overriding goal now is control," states Sepehri. "This is about having a deeper understanding of the receivables book and the cash collection function." Success here starts with visibility over and understanding of the orders book. "It means having a precise and effective relationship with the sales function, to see what, if anything, is materially changing in terms of customer relationships," he clarifes.

The longer-term gains of enhanced control also require the business to pivot towards more proactive management of the AP side of their customer relationships. By engaging in active and ongoing dialogue with buyers, Sepehri suggests that any changes on the horizon can be detected, and mitigating plans put in place, before they become an AR issue. Indeed, he continues, early identifcation of negatively impacting trends is a vital component of assessing and responding to risks in the short to medium term.

When it comes to appropriate action, one of the key defences against the impacts of inflationary pressure is to systematize and digitize invoicing and payments functionality. "We are seeing a number of companies exploring their own invoicing channels and procedures, particularly with key customers, and they are taking steps to ensure these are optimized," reflects Sepehri.

Targeting invoicing efficacy is a quick win when seeking to improve DSO. One of the most popular approaches to optimization is the adoption and rollout of e-invoicing platforms. These can no longer be seen as new or innovative, comments Sepehri. Instead, they should be considered by businesses as the de facto norm. "And the deployment of an e-invoicing platform can be seen as a precursor to leveraging solutions such as customer early payment discounts supplier financing programs."

Of course, as volatility remains entrenched within markets, so customer credit ratings will begin to slip, reflecting the difficulties in which some firms find themselves. "As a supplier, being able to pivot quickly on emerging threats is now a prerequisite for resilience and stability," declares Sepehri.

The capacity to understand where the threats to key relationships exist, where financial risks are mounting, and to what extent credit terms need to be reviewed is enabled by the interpretation of accurate and timely data. This data flows from the systematization and subsequent digitization of invoicing and payments functionality. For Sepehri, using technology to harness that data will become increasingly prevalent over the next 12 to 24 months.

Optimizing strategy

> **"While switching from a reactive to a proactive stance is an operational necessity in current climes, adopted tactics should always be underpinned by a clear collections strategy and dunning process," advises Sepehri. "Managing customer relationships remains important, but converting receivables into cash is the number one aim in a stressed market. This means the current guiding strategic thought around AR will or should be optimization."**

Indeed, in today's trading environment, understanding where quick wins can be achieved is essential. "Opening up payments channels and optionality ensures customers have fewer reasons not to pay in good time," notes Sepehri. "And because methodically communicating with customers on AR matters can be difficult when collections are decentralized, run on local rules, or based on circulating paper documents, a thorough review of connected legacy processes should reveal the extent to which these can be centralized and made more homogenous."

Of course, the receivables and collections function is one where decision-critical data that is relevant to a broad section of the business is readily available, says Sepehri. "By using that data to expose AR process weaknesses and to drive process optimization, it hands the finance team an opportunity to gain control over receivables, with an immediate lowering of DSO." And anything that can mitigate cash flow challenges brings the element of control back on side.