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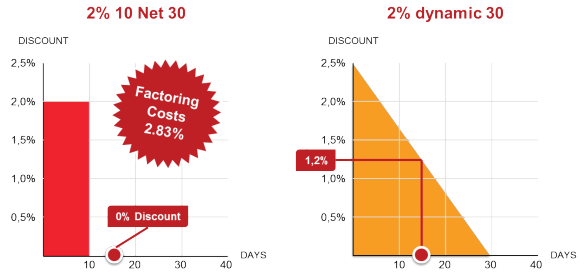
Dynamic discounting opportunities

Improved cash management strategies to capture dynamic discount opportunities

Early payment vs. dynamic discounts



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EXECUTIVE SUMMARY

Enabling dynamic discounting can be a key initiative to improve cash flow management, minimize financial risk in the supply chain as well as enhance and even repair supplier relationships.

The global credit crunch has directly impacted many supply chains and many organizations have taken extraordinary measures to ensure positive cash balance such as delaying payment, enforcing collection terms, curtailing inventory and even selling invoices (factoring) to keep operations going. Unfortunately, all four tactics are short sighted and unsustainable.

Dynamic discounting is sustainable in the long run, yet yields returns from day one. It provides working cash management benefits for both buyers and sellers and allows both parties to tap into the €2 trillion global factoring market. For buyers savings can amount to nearly 25% of annual spend, and suppliers can drastically lower DSO while improving their working capital.

A first step towards implementing a dynamic discount strategy is to automate the AP process. Automating the AP process will tangibly increase AP process efficiency; increasing control, transparency and touch-less invoice processing rates. This increase in efficiency and transparency will not only lead to advantages through process best-practice but also enable organizations to capitalize on the discount opportunities that often lie hidden in lagging manual AP processes.

AUTOMATING AP TO IMPROVE WORKING CASH MANAGEMENT

Over the past few years, the global credit crisis has made credit harder to come by. The credit crunch has forced many organizations to cut their spending, and with less money being spent, many suppliers have found themselves in a perfect storm leading to lower liquidity.

In order to maintain healthy cash balance and ensure positive cash flow, many organizations have had to resort to extraordinary measures.

Unfortunately, many buying organizations opt for short sighted and unsustainable measures such as delaying supplier payments, aggressively enforcing collection terms and squeezing replenishment of inventories in order to ensure the liquidity that keep operations running smoothly. Many suppliers on the other hand have resorted to selling their invoices – relying on factoring to keep operations up and running.

All of these working cash management tactics are short term and often push the cash flow problem around the supply chain rather than address the root of the problem, resulting in higher supply chain risks, poorer supplier relationships and missed rebate opportunities for all parties.

By automating the AP-process and taking a more holistic approach to the procure-to-pay processes, organizations can move towards more sustainable cash management tactics such as dynamic discounting. Tactics that enable organizations to extract greater value from the AP process.

Dynamic discounting is a discount *(or rebate)* management strategy where buyers and suppliers agree on a sliding scale of discount for early payment. The discounts often start in the range of 2 to 3 percent and slides to no rebate at the end of the negotiated payment terms.

To exemplify: if a buyer has negotiated a dynamic discount range where a 2 percent discount is awarded on the payment of an invoice after 10 days – basically paying a 30-day-net invoice after 10 days – instead of earning interest on the cash held in an account for those differing 20 days, the amount can be seen as "invested" for 20 days at a 2 percent return.

From an investment perspective, this represents the equivalent of an over 36% annual return on capital.

While that figure of course would lead to a reduction on the interest on the cash, the benefits of early payment far outweighs that loss. Supplier relationships improve, supplier financial risks are minimized and both parties can reap benefits of their working capital strategies. And best of all, dynamic discounting makes every day of improvement count.

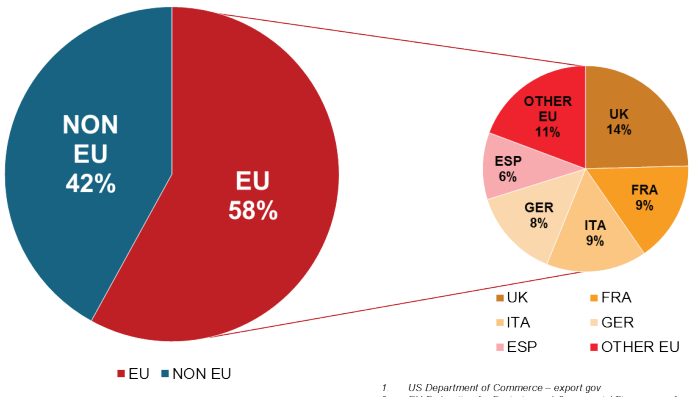
TAPPING INTO THE GLOBAL FACTORING MARKET

For many selling organizations, factoring has become a de-facto way life. In order to keep operations up and running, invoice financing has been the only way forward.

In short, factoring allows sellers to be short paid by a third party, who steps into the buyer-supplier relationship and fronts the cash. Invoices are sold at a discount to ensure a positive cash balance.

For the buyer, this may seem like the suppliers problem, but more often than not, when a supplier is forced to forfeit a chunk of their expected profits to a third party – they will inevitably attempt to recapture those losses and the buying organization will be the one that's eventually going to pay the price.

Global factoring market is valued to €2 trillion[1,2]



1 US Department of Commerce – export.gov
2 EU Federation for Factoring and Commercial Finance – euf.eu.com

The global factoring market is huge – the US department of commerce puts it at €2 trillion[1], of which more than half is accounted from the EU. This is money that suppliers are paying to ensure that they stay in business, and downstream in the supply chain, this negatively affects buyers.

In the EU, the top five economies – the United Kingdom, France, Germany, Italy and Spain – account for nearly 80% of the European factoring revenues[2].

The factoring market has grown by more than 20 percent annually, mostly due to the fact that many buying organizations purposely delay or lack the capabilities to pay their invoices in time.

Significantly, being able to process invoices quickly is a defining factor for many successful businesses. At the same time, process efficiency and transparency also enables organizations to better capture offered supplier discounts, discounts that could enable suppliers to maintain a healthy cash balance without having to forfeit a large chunk of their profits to third party factoring firms.

In essence, by improving AP efficiency, both buyers and suppliers can tap into the global €2 trillion factoring market, bringing money back into the supply chain improving relationships and minimizing the exposure to financial risks.

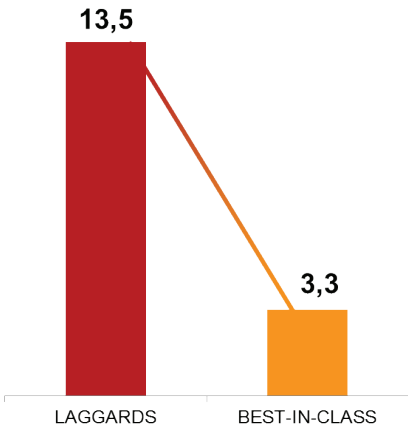
INVOICE PROCESS BEST PRACTICE

Accounts Payables best practice is deeply rooted in excellence in three areas: the level of **AP automation**; the establishment and leverage of **common processes** and the degree of **electronic invoicing**.

Recent research, as well as industry experience, indicates that there is an almost threefold factor that separates the best-in-class organizations from their lagging peers.

Looking at the invoice process, best-in-class organizations process their invoices nearly 10 days quicker than their lagging peers according to Ardent Partners[3]. Best-in-class organizations process invoices in 3,3 days on average. If these organizations can pair this process efficiency with transparent contract management, capturing even the most basic of contracted discounts *(such as "2% 10, net 30")* could be a reality.

PROCESS CYCLE TIME[1]
(DAYS)



1. ARDENT PARTNERS – ePayables 2013: AP's New Dawn

The threefold factor also applies to the number of invoices per FTE that best-in-class organizations process per month. But more important, best-in-class organizations also boast highly impressive figures when looking at straight through processing and invoice exception rates.

According to Ardent Partners research, best-in-class organizations have a straight through processing rate of nearly 45%. This means that there's no touch in the invoice process: invoices are automatically validated, matched to POs, GRN and/or contracts, approved, booked for payment and archived without manual intervention. Interestingly enough, the highly automated process has a direct effect on the invoice exception rate. Best-in-class organizations have an invoice exception rate that is more than half of the rate recorded by their laggard peers.

Not only can the best-in-class organizations focus of higher value tasks as the manual tasks are

AP PROCESSING METRICS[1]

METRIC	LAGGARDS	BEST-IN CLASS
NUMBER OF INVOICES PROCESSED/FTE/MONTH	1 335	3 559
PERCENT OF STRAIGHT THROUGH PROCESSING	18,4%	44,2%
INVOICE EXCEPTION RATE	16,1%	7,7%

1. ARDENT PARTNERS – ePayables 2013: AP's New Dawn

automated, the number of exceptions that need attentions are significantly lower leading to further enhancement opportunities.

By being able to process invoice more quickly, with higher accuracy – these best in class organizations are able to capture all types of early payment discounts that their suppliers are offering, providing the foundation for better supplier relationships while maintaining a sustainable working capital management strategy.

AP automation is key to achieve invoice process excellency as it leads to improved transparency and control as well as enables organizations to capitalize on discount opportunities that otherwise would have been missed. Opportunities that benefit both buying and selling organizations far more than just the tangible process savings that most often account for most of the ROI calculations that justify the process improvement costs.

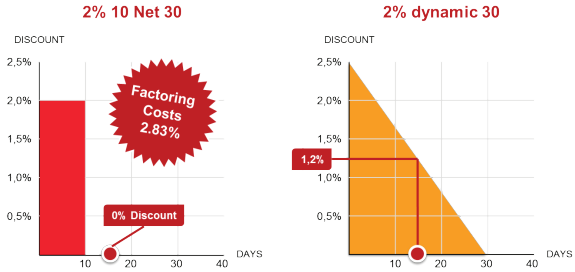
DYNAMIC DISCOUNTING OPPORTUNITIES

One of the key reasons that hinder the capture of discounts is that most AP organizations still are too encumbered to manage payments within the required timeline. Yet even organizations that have their processes up to speed need to have transparency into their contractual terms to ensure that the invoices from suppliers offering discounts are processed on time.

Obviously, a supplier wants to get paid early to reduce their DSO *(Days Sales Outstanding)* to ensure that they get paid sooner rather than later, hence the discount-offer. But since the discount is offered by the supplier, it does not take into account that the AP process may lack in capacity to process the invoice in time. More often than not, this result in the supplier getting paid within the regulated terms *(though not as early as wanted),* but the buyer loses out since the organization is unable to capture any discount. Even worse; it may result in the buyer paying the invoice with a 2% discount yet performing the payment too late, leading to an endless credit and exceptions process that deteriorates the promising supplier-buyer relationships.

So how can organizations improve on this sub-optimal situation?

Early payment vs. dynamic discounts



By taking control of the discount-offer, buyers and suppliers can suggest a model for discounts that can generate value for both parties regardless of how much earlier a payment can be processed.

Dynamic discounting simply means that a discount is offered on a sliding scale, with full discount if payment is made on day one *(the invoice date)* and no discount is offered if the payment is made on the due date with a sliding scale between the two end-points.

Let's demonstrate the difference: Imagine that Acme corporation has a processing lead time of 14 days in accounts payable.

Using a traditional 2% 10 net 30 early payment discount, they will not capture a single cent of discounts even though they clearly are processing invoices fast enough to keep the relationship in check. They are unable to process the invoice and payment within the 10 days that act as limitations to the discount on offer.

Looking at the same situation but with dynamic discounting, the buying organization can pay on 14 days after invoice date yet capture a discount somewhere in the 1,2% range.

1,2% on money spent is impressive in itself, but consider that this is a 14% non-compounded yearly equivalent. For organizations that capture the full 2,5% in the example shown, this would yield a 25% saving on a yearly basis.

Naturally, most organizations will have a hard task attempting to realize these savings levels on their full spend, but one of the alluring upsides of dynamic discounting is that an organizations full spend is addressable and even if only the discount is on offer for 10% of the spend, organizations will

have a very hard time finding any other initiative or tactic that will yield the same kind of payoffs.

Furthermore, dynamic discounting provides equal opportunities for best-in-class organizations as well as for their peers. In a linear dynamic discount scheme, improving payment efficiency by one day yield the same discount going from 30 days to 29 days as it does for high performers who improve from eight to seven days. This is essential learning as it allows organizations to capture savings from day one as well as keeps savings coming across all efficiency improvement initiatives.

For organizations looking for additional savings opportunities that can be drawn from a leaner AP process, dynamic discounting is an opportunity to increase the value generated beyond improving the processing capacity or saving minutes or hours.

In short, dynamic discounting provides an outstanding lever for AP process value generation:

- **Buyers will be able to capture discounts that return highly on invested capital**
- **Each day that the organization can shorten the AP process lead time can generate tangible savings**
- **Suppliers will shorten their DSO and the buyer/supplier relationship will improve**
- **Financial risk in the supply chain is minimized as suppliers have better access to cash and a healthier cash balance**

ROADMAP FOR DYNAMIC DISCOUNTING

To implement a dynamic discounting strategy several levers need to be considered, but key to the process is that the AP process is highly automated to ensure that discount opportunities are identified and if possible resolved without intervention. In addition, AP process automation is also key to resolving all top three AP-concerns identified by Aberdeen Group[4].

Top pressures driving companies to focus on AP:

1. Lack of visibility into invoices and A/P document
2. Corporate directive to lower invoice processing costs
3. Need for better cash management

Implementing a dynamic discounting program should track the following roadmap to ensure high adoption, continuous success whilst ensuring flexibility to capture all opportunities.

1. **Automate the AP process to shorten invoice-to-payment lead-times**
2. **Decide on levels of discount to be offered**
3. **Define a first wave of suppliers to engage and negotiate contract amendments for dynamic discounting**
4. **Build and communicate success and expand usage continuously**
5. **Offer on-the-fly discounting to non-contracted opportunistic suppliers**

AP automation is of course the crucial first step; it lays the foundation for the necessary process efficiency that enables the AP organization to act quick enough to ensure that rebates are attainable. Automation also improves control and visibility, enabling organizations to identify discount opportunities on both invoice and contract levels.

The second and third steps involve AP strategy and need be aligned to overall financial and treasury strategies as well as involve procurement to ensure that all necessary contract amendments are negotiated, contracted and implemented in the operational procurement process.

As adoption is reliant on suppliers understanding their upside, communication is vital, both internally as well as externally. By adding information about dynamic discount opportunities to all outbound purchase orders, suppliers are continuously informed and opportunistic suppliers can easily be on-boarded onto the program.

SOURCES

1. *US Department of Commerce – export.gov*
2. *EU Federation for Factoring and Commercial Finance – euf.eu.com*
3. *Ardent Partners – ePayables 2013: AP's New Dawn*
4. *Aberdeen Group – Best-in-class Strategies for Reducing Invoice Processing Costs and Time*

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About Medius

Medius serves more than 800 customers across the globe, with high density in the Retail, Manufacturing and Services sectors.

Medius offers a dynamic financial workflow solution called **Mediusflow** - the first ever financial workflow solution with out-of-the-box best practice applications for **Invoice Management**, **Procurement**, and **Contract Management**.

Key customers include Nordic retail powerhouses: Ica, Intersport, The New Wave Group and Mekonomen; manufacturing leaders such as: Stiga, Smurfit Kappa, Trelleborg, Brio and Lammhults; as well as services organizations such as: IDG, Hydroscand, Van Lanschot Chabot and Visit Sweden.

Founded in 2001 in Linköping, Sweden, Medius has grown steadily since the start and generated strong figures year over year. Twelve years down the line, Medius continues to grow, both in its home market as well as internationally. Today, Medius has more than 200 employees working out of offices in Sweden, Norway, Denmark, UK, France, Netherlands, Poland, USA and Australia. Medius also prides itself in a strong global partner network that delivers and optimizes Mediusflow solutions on local markets.

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