Decreasing debtor days

Strategies for accounting practices

Moula

Contents

Introduction

The Australian accounting industry plays a vital role in the ongoing successful operation and growth of all types of businesses. Australian accountants generate over $20 billion in annual revenue. From one-person operations to the Big 4, there are nearly 34,000 accounting firms in Australia.

While industry revenue is projected to grow at around two per cent annually between 2020 and 2025, accounting firms face a number of challenges, including client fee sensitivity, enhancing efficiency and managing cash flow.

Research conducted by Moula revealed that cash flow is a major challenge for many SMEs, especially for businesses selling to other businesses and offering invoice payment terms. Despite their expertise in financial management, accounting firms experience large gaps between commencing services and getting paid for them. Based on survey responses, one study estimated that the average lock up – work in progress plus debtor days – for accounting firms is 77 days.

Moula was founded with the goal of backing good business, including accounting practices. In this white paper, we take a deeper look into the problem of late payments and cash flow for SMEs in general and accounting firms in particular. We then examine potential solutions with the goal of helping accounting business owners and managers overcome some of their biggest challenges.

Background

The problem of late payments and cash flow for SMEs

Accounting professionals recognise the challenges that SMEs face when it comes to the cash flow positions of their clients. This is especially challenging for businesses that sell to other businesses and offer invoice payment terms.

Research commissioned by Moula revealed that business-to-business suppliers are negatively impacted by late payments and the resulting impact on cash flow. Among the 500 SME owners surveyed:

65% said their customers don't pay on time

36% of their customers pay later than 30 days, regardless of the payment terms in place

63% said their cash flow is negatively impacted by late payments

In addition to the effects of late payments, there is also the time and cost of managing accounts receivable. The research showed that 31 per cent of SMEs use an external credit agency and 65 per cent have a credit officer who manages accounts receivable.

Despite the cost of managing payment terms, the majority of SMEs continue this practice for a number of reasons. When asked why they offered invoice payment terms:

- 47 per cent said because their customers expect it
- 34 per cent said it's an important selling point for their business
- 30 per cent said it was because their competitors do
- 21 per cent said it enables them to sell more.

Given the expectations and benefits that drive business owners to offer invoice payment terms, most are willing to continue to let their customers receive products and services without paying in advance or immediately after they are delivered.

Accounts receivable challenges for accounting firms

In Australia, most accounting firms are categorised as SMEs. While the Big 4 accounting firms receive approximately 22 per cent of the $20.4 billion industry revenue, there are nearly 34,000 small-to-medium accounting practices in Australia, earning the 78 per cent of industry revenue.

Professional services businesses, including accounting firms, are not immune to slow-paying customers and cash flow challenges. Payments for accounting services can be seen as a 'grudge payment' – something that's a necessary expense but doesn't directly contribute to business growth. An invoice for accounting services might fall to the bottom of a business' priority list when compared to other expenses, such as paying staff and keeping the lights on.

Research has shown that the average work in progress for accounting firms is 24 days and the average debtor days is 53.[1] This makes the total 'lock up' (work in progress plus debtor days) 77 days on average. The high average debtor days figure points to ineffective accounts receivable management by accounting firms. If payment terms are 30

1. *Business Fitness, Good, Bad and Ugly of the Australian Accounting Profession, 2018, p. 12.*

days, firms are receiving payments 23 days late on average. Even worse, if payment terms are 15 days, payments are 38 days late on average.

Compared to average 9.9 late payment days for all industries, accounting firms experience average debtor days that are much worse (23 days late on average).[2] Despite their expertise in this area and helping their clients with this issue, many accounting firms are like the proverbial cobbler with bad shoes when it comes to getting paid on time.

Furthermore, as a result of COVID-19, 55 per cent of accounting firms surveyed have introduced more favourable payment terms.[3] This means that debtor days and lock-up are likely to increase for many accounting businesses. Research conducted in 2020 revealed that cash flow is rated at number three in the top five challenges for accounting practices. In 2016, 2017 and 2018, cash flow did not rank in the top five challenges.[4]

For accounting practices, as with other businesses, the gap between delivering services and getting paid can result in cash flow shortages.

Research has shown that the average work in progress for accounting firms is 24 days and the average debtor days is 53.

2. *Ilion, Late Payments Australia, December Quarter Analysis, 2019, p. 4.*
3. *CommBank, Accounting Market Pulse, June 2020.*
4. *Business Fitness, Good Bad Ugly, Insight Poll, 2021 rates, pricing & outlook, 2020, p. 11.*

The importance of debtor days

As a standalone metric, the debtor days ratio can speak volumes. It underscores the cash flow gap between delivering value and rendering a fee for service. By dedicating more time and resources towards managing ageing debtors, the debtor days ratio also reveals an opportunity cost.

The longer it takes for debtors to pay, the more strain this can have on a business. Over time, rising debtor periods will threaten a business' working capital ratio and, as a result, adversely impact potential profits and ability to scale. Ultimately, this decreases the ability to survive business setbacks caused by uncontrollable factors, such as higher interest rates and the broader economy.

Debtor days disproportionately affect SMEs. However, the situation is arguably much worse for professions such as accounting, already impacted by seasonality. When trying to manage cash flow in a seasonal business with naturally slower sales periods, controllable causes of cash flow shortages should be avoided.

Quick refresher: debtor days ratio

The debtor days ratio is determined by dividing the average balance of accounts receivable by total net credit sales for a particular period. The result is the average amount of time it takes for a business to receive payments, which are already owed in arrears.

$$\text{Debtor Days} = \left(\frac{\text{Average Accounts Receivable}}{\text{Annual Credit Sales}} \right) \times 365$$

For example, if a company's annual credit sales are $250,000 and its average accounts receivable are $25,000, its debtor days are 36.50. In this case, if the company's payment terms are 30 days, it gets paid 6.5 days late on average. But if its payment terms are 15 days, it gets paid 21.5 days late on average.

Consider average debtor periods in context. For example, 25 days might seem reasonable if a business offers 30-day payment terms, but it would be a stretch for a business offering 14-day payment terms. Equally, it pays to remember that the average debtor period is variable, so it is important to calculate debtor days at regular intervals, on a monthly or quarterly basis.

Again, focusing on the bigger picture, the weight of the economy on debtor days should be considered, even if the impact can't be measured accurately from a numerical standpoint. While this exists outside of the immediate control of business owners and managers, it reinforces the need to focus on what can be controlled. This framework of thinking can be a guide to adopt payment tools and processes that will build a business on more favourable terms.

How to reduce work in progress and debtor days

Given the gravity of the problem of high lock-up for accounting firms, here are a few steps that can assist in reducing work in progress and debtor days.

Document credit policies and procedures

Clear credit policies and procedures will set the stage for lowering average debtor days and bad debts. These should outline payment terms and the steps to approve new clients, including completing credit checks, checking credit references and screening out risky clients. In addition, policies and procedures should include timeframes and action steps when accounts are overdue, such as when to stop additional work when invoices are overdue and when to refer debts to collection agencies. Documents can include email templates and phone scripts to use to follow up when payments are overdue. Documenting credit criteria and actions removes emotions from decision making.

Clearly communicate payment terms for new customers

Once a client has been approved for payment terms, it's important to make sure that these are clearly communicated up front. This should be clearly stated in the credit application completed by the client to avoid misunderstandings about when work is invoiced and when payments are due. Having a documented credit policy from the beginning will prevent confusion that can delay payment.

Confirm fees upfront

Accountants have rated client fee resistance and sensitivity as their top challenge in 2020.[5] One of the causes of

[5] *Business Fitness, Good Bad Ugly, Insight Poll, 2021 rates, pricing & outlook, 2020, p. 11.*

late payments is misunderstanding about fees. If there is an issue with fees, the client can raise it before the work is completed. Research has shown that 52 per cent of business owners would prefer fixed fee billing for accounting services, while only 16 per cent prefer hourly billing. Despite this, around 52 per cent of accounting firms use hourly billing.[6] Although a fixed fee model might not be practical, providing an estimate before starting work will prevent surprises that can delay payments.

52 per cent of business owners would prefer fixed fee billing for services

Invoice regularly

With projects that take more time to complete, it might seem easier to wait and invoice at the end. This, however, will increase work in progress days. Progress billing will improve cash flow and avoid surprising the client with one large invoice at the end. Accounting firms that use progress billing should make this clear up front when payment terms are agreed upon before taking on a client. Work in progress days will increase if clients delay in providing information needed to complete projects or reach milestones. For this reason, outline how work in progress will be billed in situations where delays result from a lack of information or action from the client.

Bill immediately when work is completed

After completing a project or reaching a milestone, billing immediately creates a sense of urgency and enables the client to connect the invoice to the work completed. Invoicing monthly or fortnightly will increase work in progress days and impact debtor days as well. If a firm completes a project on the fifth of the month and waits until the 15th of the month to invoice, for example, this will automatically add to the average work in progress days. The increase in work in progress days will be even greater if invoicing is delayed until the end of each month. Despite this fact, 13 per cent of accounting practices send invoices at the end of each month, regardless of when the work is completed.[7]

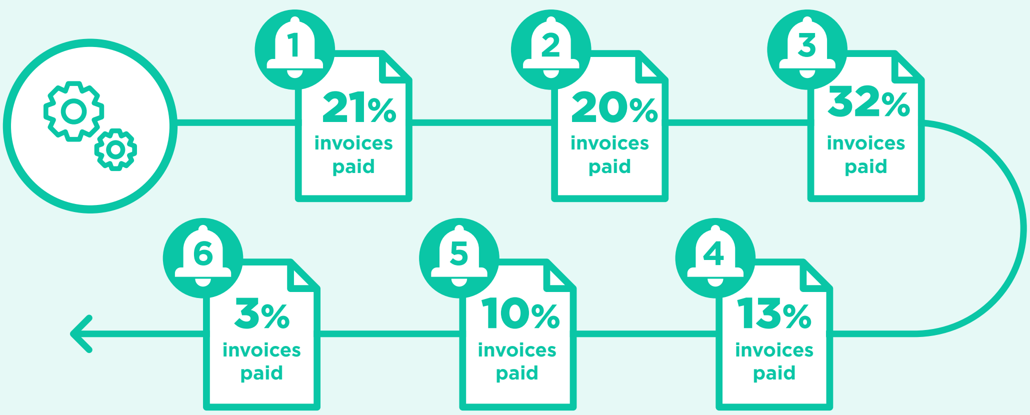
6. *NAB, Key Insights into the Accounting Industry, 2018, p. 10.*
7. *Business Fitness, Good Bad Ugly, Insight Poll, 2021 rates, pricing & outlook, 2020, p. 5.*

Make it easy for clients to pay

Making it easy to pay invoices will help to reduce debtor days. This includes offering several payment options, including bank transfers and credit cards. Make sure the amount, payment terms and payment options are clearly displayed on the invoice. Include contact details for clients to get in touch if they have any questions.

Automate accounts receivable

Automating reminders for overdue invoices is a proactive step that will reduce debtor days. Research revealed that reminders are effective for getting invoices paid. One study by ezyCollect, an accounts receivable software developer, found that 59 per cent of overdue invoices require three or more follow-ups before they're settled. The research based on 213,000 invoices found that:



- 21 per cent of invoices are paid after the first follow up
- 20 per cent are paid after a second reminder
- 32 per cent are paid after the third reminder
- 13 per cent are paid on the fourth reminder
- 10 per cent are paid on the fifth reminder
- 3 per cent are paid on the sixth reminder.

So once the invoice goes beyond the due date without being paid, it's essential to follow up. Automating this step will prevent unpaid invoices from falling through the cracks and boosting average debtor days.

Getting paid faster and improving cash flow: what are the options?

Accounting firms have several options when it comes to meeting the needs of their clients paying for services.

In-house accounts receivable

Accounting firms can continue with 'business-as-usual' and offer invoice payment terms to their customers. The tips outlined above, including implementing automated systems and improving collection techniques, can help in reducing debtor days and improving cash flow.

Even if new technology and improved processes are implemented, debtor days can be reduced but not eliminated. For example, if an accounting firm could improve accounts receivable and decrease average debtor days by around 50 per cent – from 53 to 26 days – the gap between beginning a project and getting paid would still be 50 days (based on the average of 24 days for work in progress).

Although keeping things in-house may seem to avert the cost of outsourcing, the expense of employing staff to manage accounts receivable also needs to be considered. According to the Indeed employment website, the average full-time salary for an accounts receivable officer is $61,813. Additionally, benefits and overheads need to be added to the salaries of accounts receivable staff when weighing the options.

The average full-time salary for an accounts receivable officer is $61,813

Outsourcing accounts receivable

Some accounting firms choose to outsource all or part of their accounts receivable functions. Companies offering full accounts receivable outsourcing services sometimes use offshore staff. Offshoring by accounting firms has grown in popularity in recent years, and includes services provided to clients as well as internal administration tasks such as accounts receivable.

Research conducted by Bond Business School revealed that 25 per cent of accounting firms are offshoring some of their work.[8] Of these, around 35 per cent are offshoring their accounts receivable. So around nine per cent of all accounting firms are now offshoring their accounts receivable to staff in countries such as India and the Philippines.

Although offshoring results in lower costs, it raises data security risks. Of accounting firms currently offshoring work, 80 per cent said they believed there was some risk of client data breaches resulting from offshoring. In addition, the accounting firms that use offshore services need to provide training to their remote team members. Among the firms that offshore, 44 per cent send onshore staff to their offshore location to train offshore team members and 29 per cent send their offshore staff to their Australian office to receive training. These training activities add to the cost of offshoring.

Accounting firms that offshore might reduce expenses, but this does not guarantee that debtor days will be reduced.

Using collections agencies

Accounting firms with in-house accounts receivable can choose to outsource part of the accounts receivable process. A reactive approach can include hiring collection agencies or law firms to collect overdue invoices when clients do not respond to payment requests from the firm. Most collection agencies charge a commission for recovering debts, which is usually on a scale with a larger percentage charged for lower invoice amounts. For example, one prominent collection agency charges 25 per cent of the invoice amount to collect an invoice of between $1,001 and $10,000 and 10 per cent for collecting

8. *Bond Business School, Offshoring of Accounting Services in Australia: State of Play and Critical Success Factors, 2020.*

an overdue invoice larger than $50,001.[9] These fees will increase accounts receivable costs if invoices reach the collections stage.

Professional fee funding

Professional fee funding is another option for accounting firms that want to get paid faster and improve cash flow, which has become increasingly popular. With this form of finance, the professional fee funding lender pays invoice amounts in full within a few business days, if the client has been approved for finance. The lender then manages the repayment from the client, usually in the form of direct debit payments. The client usually pays a fee for the option of spreading payments over several months, so there is sometimes no upfront cost to the accounting firm. In addition, the accounting business can reduce the time and cost of managing accounts receivable.

Professional fee funding is not entirely without risk, though. If a client does not pay the amount owed to the fee funder under the payment plan, the accounting firm still wears the risk of bad debt, and is required to return the outstanding amount not paid by the client.

In addition, while professional fee funders can often help accounting firms get paid faster, they aren't a good option for accountants who want to offer their clients more generous payment terms. Payment terms offered to clients through professional fee funding are usually rigid, making this option less favourable to those who want to offer their clients flexibility, or extended payment terms, and help them with cash flow.

If a client does not pay the amount owed to the professional fee funder, the accounting firm still wears the risk of bad debt

Moula Pay

Another solution which can help accountants get paid faster is Moula Pay. It enables accounting firms to completely outsource accounts receivable, while also offering their clients extended payment terms. After registering as a

9. *http://www.prushka.com.au/products_and_solutions/in-house_debt_recovery.cfm*

Merchant, firms can offer Moula Pay as a payment option on invoices, and get paid upfront.

Unlike other fee funding solutions, Moula takes on all the risk of bad debts, so there's no clawback if a customer defaults. After an invoice is raised for services, SME clients can benefit from 12 months to repay, with the first 3 months interest and repayment-free. Clients can repay early at any time, giving them flexibility in managing their cash flow.

When their clients pay invoices with Moula Pay, Merchants receive funds immediately, meaning they don't have the cash flow issues resulting from slow-paying customers. In addition, there is no need to check credit references and credit history, or to chase overdue invoices.

Comparing the options

In-house accounts receivable	Outsourcing accounts receivable	Professional fee funding	Moula Pay
✖ Ongoing salaries and administration overheads ✖ No immediate payment for invoices ✖ No guarantee for decreasing debtor days ✖ Collection costs and risks of bad debts	✔ Lower cost if offshoring ✖ Cost of training an offshore team ✖ Increased data security risks ✖ No guarantee of reducing debtor days ✖ High costs of outsourcing if the debt reaches the collection stage	✔ Quick payment of invoices (for some funders, after client makes first payment) ✔ Fast approval of clients ✔ Reduced resources required for accounts receivable ✖ Clawback of outstanding debt balance if customer defaults ✖ Immediate cost to customers and rigid repayment schedule	✔ Immediate payment for invoices, eliminating debtor days ✔ Fast approval of clients ✔ Reduced resources required for accounts receivable ✔ No clawback if customer does not pay the debt balance ✔ Clients benefit from 12 months to repay, with the first 3 months interest and repayment-free

Expert insights

Accounts receivable questions and answers with Melanie Power

What's your advice for accountants who have challenges getting paid on time?

In my experience, a great way to manage these challenges is setting expectations up front. Package your service and then offer payment terms – this can make a huge difference. For example, you can structure terms where you incentivise pricing (something that showcases the value you offer). For example, if you pay upfront you pay 12 months, and get 14, plus access to our VIP package. If your client has a backlog of work to be done, a funding option like Moula Pay can help you get paid upfront and then the client pays the funder. Everybody wins.

What strategies do you recommend to your SME clients to help them get paid faster?

Communication and transparency are crucial when negotiating your terms and helping them get paid faster. For a service-based business, I'd recommend finding out about your clients cash flow situation upfront – this enables you to offer appropriate solutions that meet their needs. This is also important when considering your sales process. By having a robust sales process you can present a proposal and ensure you are getting your client the right solution. Clients want certainty, so being transparent and upfront and also discussing money and terms is important. Many people shy away from this conversation, and it's usually because we are uncomfortable. Learn to be comfortable with being uncomfortable and have the conversation – this will reduce pain points for both parties.

Melanie Power is an industry thought leader, with 30 years' experience empowering accountants and bookkeepers to scale their businesses. She is a self-proclaimed small business addict, helping grow a wide range of businesses across the accounting profession, in finance brokerage, and tech consultancy, into six and seven figures.

melaniepower.com

> **Moula Pay has empowered me to get paid upfront, and saved me chasing invoices. Since seeing how much my own business and debtor days have improved, I've referred several of my clients to become Merchants, too. It's been a real game-changer for cash flow.** - Melanie Power

What role will automation play in the future of accounts receivable, and how can accounting firms use it to strengthen client relationships?

Automation is here and it already plays a significant role. Right now we have full automation for firms and small businesses to onboard clients to processing, and automation is easy when using platforms like Moula Pay. The future is really exciting as the use of augmented reality increases and facilitates the process of POS, powered by AI and machine learning. The experience will become more personalised and although it won't be human, it will grow based on learned human responses. It will provide opportunities to bury your focus in strengthening client relationships. The technology provides more interactions and opportunities to upsell, and even identify key potential issues for the client.

Conclusion

Debtor days are an ongoing challenge for all types of small-to-medium businesses. The research shows that late payments have a negative impact on nearly two-thirds of SMEs. Despite this shortcoming, businesses continue to offer the option of invoice payment terms because customers expect it, competitors offer it and it helps increase sales.

Although they have the business finance expertise, accounting practices also struggle with debtor days. As service providers, they have significant work-in-progress days that increase the gap between beginning work for a client and getting paid.

There are a number of steps that accountants can take to reduce work-in-progress and debtor days. It’s also important to consider the options and costs for managing accounts receivable, such as managing them in house or outsourcing the entire function, or using collections agencies at the final stage when payments become delinquent. In addition, several finance solutions can help accounting practices decrease debtors and improve cash flow.

About Moula Pay

Moula Pay is a smarter way to offer payment terms. When clients pay with Moula Pay, your accounting practice gets paid upfront. Clients enjoy up to 12 months to pay, with the first 3 months interest and repayment-free. Become a Merchant today to free your practice from chasing invoices:

- **Improve client engagement:** Automate processes and see your relationships profit. No more late payments or hard conversations.
- **Increase practice productivity:** Free your team to focus on what matters. Moula Pay automates busywork, so you can focus on business.
- **Outsource all the risk:** Unlike other solutions, Moula Pay takes on the risk of bad debts. Once a transaction is approved, you are guaranteed payment.

To find out more, visit www.moula.com.au/pay/merchants-accountants.

Moula | Pay

Moula

Backing Good Business

info@moula.com.au
moula.com.au
moula.com.au/pay

Moula® and Moula Pay® are registered trademarks.
All rights reserved. Copyright © 2020 Moula.
ABN: 95 164 875 325