

The beneficial world of virtual accounts

MA-AN DAVID AND WENDEL KWAN LOOK AT HOW CORPORATES CAN IMPROVE THE ACCOUNTS RECEIVABLE PROCESS AND DISCOVER THE VIRTUAL ACCOUNT.

One of the many consequences of the credit squeeze has been the reduced availability of liquidity from external sources. As a result, companies have sought to replace this by sourcing additional internal liquidity. A relatively popular strategy is to centralise cash previously held in local business units through some form of liquidity structure. However, another method for companies of all sizes is simply to improve the accounts receivable (AR) process.

This can be done partly by improving processes – for example, ensuring that communications with customers are timely, so that there are no outstanding queries and that payments are made according to agreed terms. But such improvements are dependent on the quality of the data relating to customer remittances. It is essential that the AR team have the most accurate and up-to-date information possible.

FACED WITH REALITY In an ideal world, all incoming payments to the company bank accounts would contain information that could automatically knock off open invoices in the financial system. Companies would not need to go into a guessing game to match who has paid for what. There would be no need to call customers for clarification and no more long outstanding unreconciled items that muddle up the receivables age analysis. Companies could then devote the entire day to productive activities instead of having to spend hours reconciling payments. It would be the perfect situation for accounts department staff. However, the reality is that most of them struggle to reconcile their accounts receivables due to insufficient information.

Many cash managers struggle to reconcile thousands of payment transactions credited to their collection bank accounts daily. For most of these transactions information on who paid what invoice is not available. This means the payment cannot be reconciled, which in turn results in an inaccurate cash position and increased day sales outstanding (DSO).

In an effort to close their AR records, the managers will send reminders to all customers who have not paid – reminders that are

based on inaccurate records. They will then receive phone calls from customers claiming they have already paid. This situation has several undesirable implications:

- Increased DSO translates into an increased working capital requirement and greater funding costs.
- The company's reputation with customers suffers because they are wrongly chased for invoices they have already paid.
- If it is a quoted company, investors will be unimpressed if its DSO and other working capital figures lag behind those of its competitors. If it is a private company, sources of external liquidity – banks, for example – will be similarly unimpressed.

Improving the quality of customer remittance information is the foundation on which wider AR improvements can be built, which in turn delivers business benefits across the organisation in terms of improved availability of liquidity.

A TREASURY MANAGER'S PRIORITIES The payment instruments that customers use to send remittances have a significant effect on a company's ability to improve its AR data. Put simply, paper is a bad idea. Cheques are inherently inefficient and processing them, even via an efficient lockbox operation, inevitably raises costs and introduces delay. Therefore, the cash manager has a strong incentive to encourage customers to switch from cheque payments to electronic methods such as wires or an automatic clearing house.

To some extent, the market in Asia is gradually moving in this direction anyway, although there are some specific local exceptions. But some companies are taking a more direct approach in encouraging this behaviour. One method is to make electronic payment a business condition for new customer accounts. In the case of existing accounts, some companies will offer a small initial discount or other incentive for customers switching from paper to electronic payment methods.

Any reduction in the volume of paper remittances from customers eases the transition from manual to electronic matching methods.

Remittance information gathered electronically can be fed into an automatic matching system, which reconciles remittances with the right outstanding invoices. This is not only far less expensive than manual reconciliation but is also faster and more reliable, which can be critical at the beginning or end of a month when remittances are at their highest levels. An AR department under this sort of volume pressure and still using manual matching can easily develop a backlog or make errors, resulting in customers being incorrectly placed on stop.

Maximising electronic remittances also helps to justify new investment in technology to support treasury processes. Where such systems are already in place, more extensive and cost-effective use can be made of them to automate reconciliation. This, in turn, pays dividends in terms of transparency when it comes to control and audit, which are both areas where companies are keen to improve their performance. To some extent, this is due to an internal desire to manage risk more tightly, but there are also external pressures in the form of regulation such as Sarbanes-Oxley, which imposes stringent requirements in respect of control and accountability.

The combination of these factors creates a compelling need for AR managers to focus on improving AR reconciliation through better-quality remittance information. It also dovetails neatly with a broader business trend – the migration of AR activity in Asia to a shared service centre (SSC). Historically, only payments have been processed in Asian SSCs, as Asian collections were deemed too difficult and diverse to centralise. As the payment infrastructure in Asia continues to evolve, this is beginning to change, but the success of such change is, of course, heavily dependent on the quality of remittance data.

INFORMATION IS THE KEY So what determines whether remittance data is of sufficient quality to achieve straight-through reconciliation? Completeness is an obvious requirement – if a payment covers multiple invoices, how will all those invoices be identified in the data provided by the remitter? A long-standing issue here is the truncation of such data. Many electronic clearing systems have limitations on the number of characters permitted in the reference field of the payment message. As a result, only the first few of a batch of invoice numbers might survive transmission through clearing. Similar limitations can also apply to the electronic banking platforms that remitters may be using.

A further consideration is that any incoming data must be in a format that can be handled by the recipient's enterprise resource planning (ERP) or accounting application. Given the progress made on standardisation in recent years, this is generally less of a problem than in the past, but on occasions some intervention or assistance by the recipient's bank may be necessary to deal with issues such as interpretation of local language characters.

If the remittance data is both complete and in a comprehensible format, then (assuming the ERP or accounting system includes suitable functionality) the basic requirements for automated delivery and reconciliation matching are in place. Depending on the bank's technology, the remittance data may be streamed in real time or the

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company's application may poll the bank application for data on a scheduled basis.

Even with extremely clean remittance information, the percentage of auto-matching achieved can vary considerably. One factor that can reduce this percentage is the deduction of bank charges by the remitting bank, or any correspondent banks along the

payment chain. Some ERP and accounting applications can allow for this by hard-coding bank fees associated with remittances from regular remitters or by automatically assuming that any minor discrepancies are attributable to bank charges levied in transit.

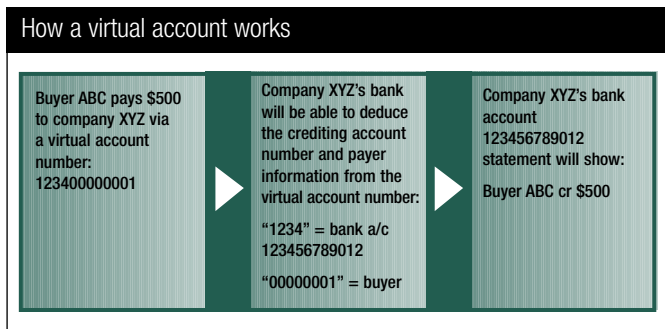
THE NEW FRONTIER IN COLLECTIONS The growth of electronic clearing systems in Asia represents a considerable opportunity to improve AR management. As the convenience and cost savings inherent in e-payments become more widely appreciated, the number of customers remitting electronically will increase.

However, because the reference data field in many electronic clearing systems is often too short to accommodate a full list of all the invoices covered by a single payment. In addition, the field may be needed for other purposes, such as the customer account number to which the payment relates. As a result, while electronic clearing systems are an opportunity to improve AR management, fully capitalising on that opportunity requires something more.



cash and liquidity management

VIRTUAL ACCOUNTS



One such something is the virtual account, which is rapidly growing in popularity as a means of streamlining automated AR reconciliation. Under a virtual account arrangement, the bank provides its corporate client with a range of virtual account numbers. The client can then assign these numbers to its individual customers. When customers make a payment through paper or electronic channels, they need only to quote the virtual account number as the crediting account number. In reality, this virtual account number does not physically exist. The bank's virtual account engine will deduce the crediting account number from this virtual account number, and the respective virtual account number will be captured on the statement so that the customer can use it to immediately identify the remitter (see Box 1).

BUSINESS BENEFITS Virtual accounts offer a number of important practical advantages:

- administration costs fall because virtual accounts can be used to identify remitters automatically and are not dependent on the quality of remitter details provided in the payment reference field, eliminating the costs of hiring personnel to reconcile receivables manually;
- reporting quality improves because virtual accounts speed up operations turnover with transactions captured and displayed on statements in real time; and
- credit control is stronger because virtual accounts enable timely and accurate reconciliation of collection information, thereby delivering a clearer individual and overall credit picture of customer accounts.

These advantages translate into material business benefits. Faster, more accurate reconciliations deliver reduced DSO, working capital requirements and funding costs. They also minimise damage to the business and its reputation caused when delayed reconciliations trigger the wrongful suspension of shipments to customers that have actually paid. By the same token, they reduce credit risk through the early and accurate identification of accounts that are delinquent. Finally, treasury control of both process and available liquidity is also improved, which gives an opportunity to improve investment returns as well as making regulatory compliance easier.

BANK DEPENDENCY While virtual accounts have much to offer when it comes to enhancing AR performance, the exact level of benefit achieved is heavily dependent on the provider bank's capabilities. An example here is collection channels. As a virtual

account is not a collection channel in itself, its effectiveness will depend on whether a bank's collection channels can recognise the virtual account number as the depositing account number. These channels include the bank's branch counters, ATM network, cash and cheque deposit machines, internet banking and high- and low-value collection systems. It is therefore important to have an understanding of customers' payment behaviour and, based on this knowledge, equip the appropriate collection channels to accept virtual account transactions.

Another consideration is the method used by the bank to generate virtual account numbers. By default, banks tend to use system-generated numbers for virtual accounts. However, corporate clients are ideally looking for a more intuitive approach, such as customised account numbers that use reference numbers already familiar to the company's customers. For example, an insurance company might want to use its policy numbers as virtual account numbers, as this information would already be available to its customers. If the bank is able to offer this facility, this obviously streamlines the implementation – and uptake – of virtual accounts.

Although virtual accounts have considerable potential, for various reasons they may not be universally applicable to all customers. Nevertheless, the company still needs a complete picture of all its collection activity. Therefore, if the bank is able to plug virtual account transactions into its centralised reporting engine, then the company's clients will benefit from a consolidated picture of both virtual and non-virtual account activity.

FUTURE DEVELOPMENTS Partly in connection with the need to make virtual account numbers intuitive to the corporate client's customers, there is a growing demand for flexibility. For example, rather than just numeric virtual account numbers, there is an increasing need for alphanumeric alternatives. Also, some companies are now looking for dynamic virtual account numbers where only part of the number will be pre-registered and the remainder can vary.

This last innovation is particularly important when it comes to identifying not just the remitter but also the invoice numbers the remitter is paying. For example, the first few digits of the virtual account number might be specific to the remitter but the last few might be used to indicate the invoice number being paid.

RECONCILIATION TOOL Information is key to an efficient accounts receivable management process and the virtual account's ability to deliver 100% accurate identification of the remitter makes it a necessary reconciliation tool. However, as it continues to evolve, the virtual account also has the potential to deliver accurate, quick and cost-efficient end-to-end reconciliation down to the individual invoice level, with all the attendant business benefits that that implies.

Ma-an David and Wendel Kwan are assistant vice presidents, product management, global payments and cash management, Asia Pacific, HSBC Hong Kong.
cashmanagement-uae@hsbc.com

