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HOW TO KEEP DEDUCTIONS FROM KILLING YOUR BUSINESS

A primer for CPG Brands on how to unlock the hidden power of deductions and chargebacks to increase your effectiveness in retail.

MEET HARRY.

He's the hairy monster behind out-of-control, overwhelming and unexpected deductions from your distributors and retailers. Harry causes mischief for CPG brands by taking a big bite out of anticipated checks and remittances. But with the right skill set and tools, you can tame Harry. We'll show you how!

Introduction

Managing deductions is tedious, time consuming, and expensive for any brand – but especially so for those who have not developed an in-house capability in this area, and emerging brands who may have less resources at their disposal.

If you're a CPG company experiencing challenges with distributor or retailer deductions – and looking for solutions to manage them – this guide is for you.

Typically, CPG brands struggle to manage deductions effectively for the following reasons...

1. Too much data to deal with
2. Complex and opaque market dynamics
3. Lack of the required skill set on the team
4. Lack of time and resources to throw at it
5. Competing priorities and opportunity costs

But there is one significant **reason to pay more attention** to deductions...

A huge amount of useful information is buried in your deduction data that can reveal details about your actual trade spend, identify problem areas with customers or operations, and help to improve planning processes.

This guide covers a complete understanding of deduction management from the ground up, so that you can make more informed decisions on where to focus and how to proceed.

So...let's begin! We'll start with the basics.

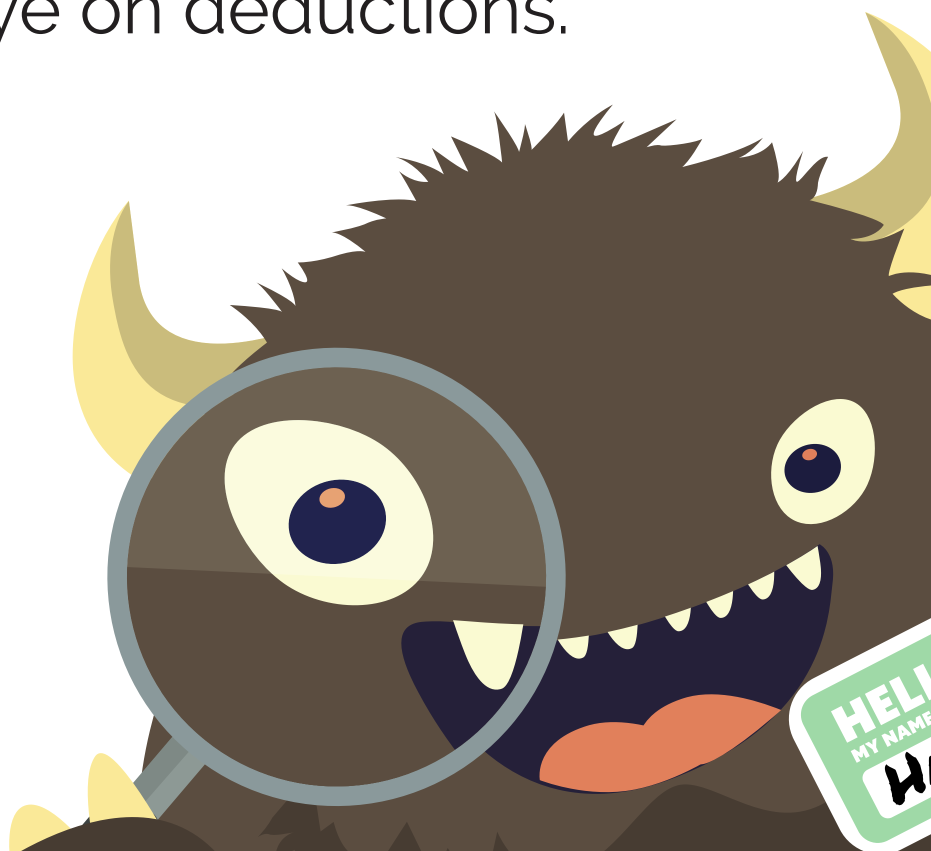
What ARE Deductions?

Deductions are the standard method that retailers and distributors use to get compensated for the marketing, promotional and logistical services they provide to CPG manufacturer brands. But why wouldn't they just invoice the brands separately for those services and have them pay with a check?

Quick CPG history lesson: Prior to the 1980s, the payment cycle between brands and their customers was the reverse of what it is today. CPG manufacturers would "reimburse" retailers for promotional and support costs after they had been paid for the product. Retailers would submit claims including proof of performance in order to receive payment. Unfortunately, turnaround times for settlement of these claims grew lengthier over time. Retailers were increasingly left "holding the bag" waiting for payments – and, due to financial pressures and shrinking margins, began resorting to deducting amounts owed by the CPG brand from their invoices. Hence, the birth of the deduction.

Deductions are not the cleanest way to account for all the services and exchanges that happen in the course of a transaction between a CPG brand and their customer, but the fact is it's been this way for decades and will not change any time soon. As a brand, keep in mind that just as the previous system was heavily tilted toward the CPG manufacturer, today it now firmly tilts in the opposite direction.

If mistakes are made on either side, chances are high it will favor your customer. And mistakes happen often…so it's very important to keep a close, vigilant eye on deductions.



Administrative and Financial Impact on Brands

It’s important to understand that the administrative and potentially financial burden of deductions on CPG brands will multiply exponentially as it gains doors and wider distribution. Huge volumes of information about your retail sales are flowing in every month through these deductions, with what amounts to **an adjustment for almost every single shopper purchase** – plus a host of other expenses for logistics, marketing, and commercial non-idealities.

CPG brands should brace for the additional administrative burden deductions will bring and prepare for it as they grow.

To add to the overwhelm, each distributor or retailer provides deduction information in their own unique, non-standardized format. Often, it's in a pdf file that's neither easy to read, nor scan, nor analyze. Layer on to that the different contracts from each retailer or distributor that govern what deductions can or cannot be taken. It makes it impossible to easily combine the data from all customers into one dataset for comparison and analysis.

The inability to compare and analyze deduction data is a real problem, because statistically chances are high there will be mistakes – and the brand ends up paying. Consider industry-accepted averages for invalid deductions. Different industry experts have weighed in and estimated that anywhere from 10-25% of deductions are either invalid, erroneous or preventable.

In our own experience processing over $100M worth of deductions for our clients, we have found that on average 17% are invalid and disputable.

Let that sink in: 10%-25% of your trade spend – which itself equals as much as a quarter of your retail sales – could be disputable. That represents **2.5%-6.25% of your top line** that could have contributed to your margin or been reinvested into growing your company. In a business where every margin point counts, that's a pretty significant impact.

To get the funds from these invalid deductions back, you first have to be able to find them. And that's where a deduction management process and method come into play.

The Deduction Management Process

Deduction management is the process of taking all of the deduction data you get back from your customers and getting it into a format where you can a) properly account for all those expenses in your company's financial analyses, and b) assess which expenses were excessive or erroneous and seek to have them reversed (i.e., dispute and recover).

This is arguably one of the most tedious and difficult processes a CPG brand getting into retail will go through. Depending on your volume, and the volume of deductions flowing in, attempting to take it on without expert help could be a futile effort that costs you way more in the end. Part of the challenge of managing deductions is that they are not standardized; distributors and retailers each have their own internal management system with thousands of brands to communicate with. Without such standardization, the best we can do is unpack what the typical deduction workflow looks like unmanaged – and recommend best practices along the way that better capture and organize deductions for a more managed process. Let's focus on that now.

Deductions:
Unmanaged vs Managed

To understand where deductions come from and how they can proliferate, it is helpful to start with a typical flow of goods from CPG manufacturer (Brand) to store shelves:

1. A Brand creates a product at a price and offers it to retailers or distributors (i.e., Customer) for sale on store shelves.

2. The Customer orders some quantity of that product via **a purchase order**, according to a set of standard commercial and negotiated **contract** terms (including price, discounts and various allowances and performance requirements).

3. The Brand ships the product to the Customer who then puts it in their inventory.

4. The Brand sends the customer a sales invoice for the amount of the purchase, less any "**off-invoice**" terms they may have previously agreed to.

5. The Brand and Customer agree at some point to do something "extra" (beyond the standard commercial terms) to promote demand and move the product out of their inventory faster. This is known as **trade promotion.**

6. The Customer executes (fulfills on the terms of) the promotion.

7. The Customer totals up what the Brand owes them for the Customer's expenses in the promotion and submits those expenses in **deduction invoices**, which they then subtract from what they owe to the Brand for the product sold, and leaving a difference:

   a) If the Customer still owes money to the Brand, they will send a **remittance** (a check for the difference).

   b) If the Brand now owes the Customer money, the Customer will send **a check request or credit request** for the difference.

This is where the process ends for most brands – because they may not realize that the amounts in that last step could be disputable, or the amount of information coming in is too overwhelming to be able to decipher issues within a reasonable amount of time.

Given the difficulty and time involved with actively managing deductions, most Brands just pay the bill and move on. And that's unfortunate because the Customer will get to keep an extra 2%-6% of the brand's hard-earned profit.

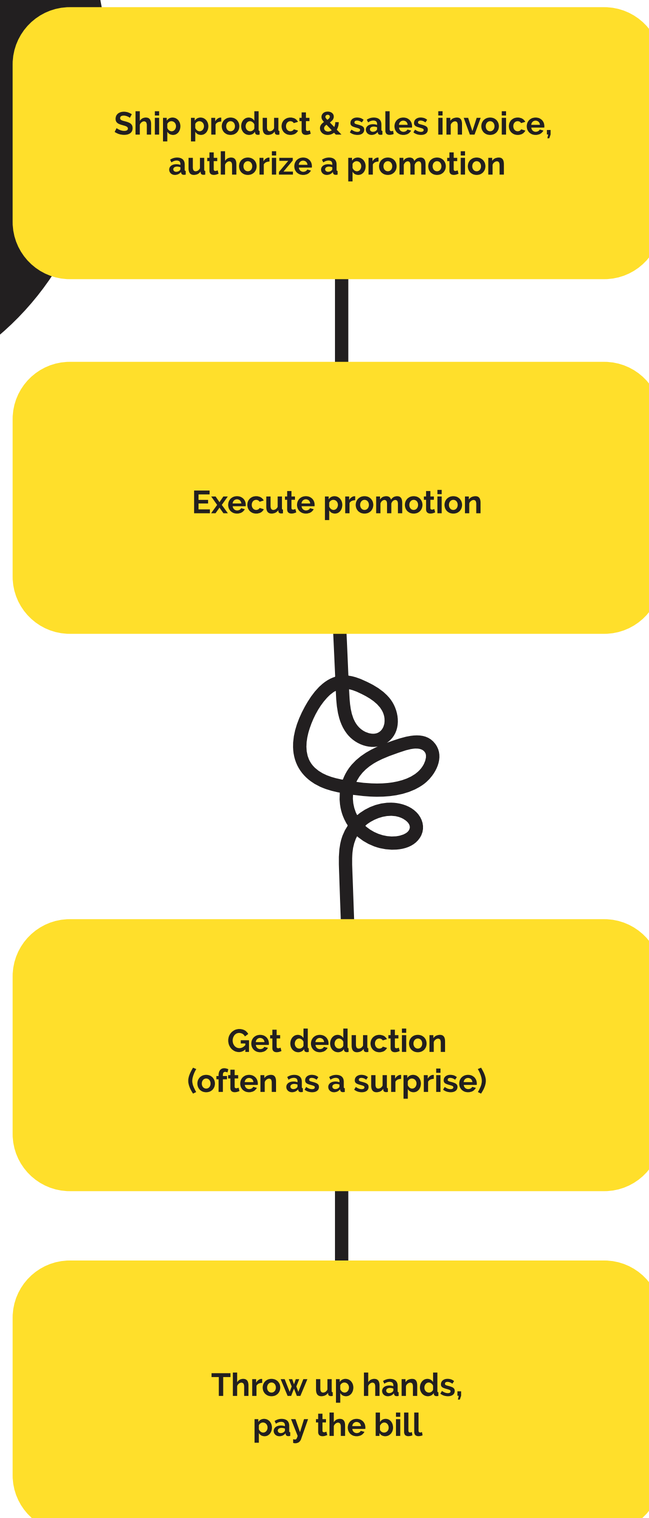


Figure 1: How Brands typically deal with deductions

Instead of ending the process with a diminished remittance (or worse, a payment to the Customer) this can be the beginning of an efficient management process for capturing, categorizing, validating, and disputing your deductions. An added bonus is the end of that nagging feeling of not knowing what's happening in stores once you begin to understand the invaluable intel buried in deduction data.

Here's how we recommend continuing the process to minimize profit leakage and invalid deductions – and maximize details behind your trade spend.

8. Translate the deduction invoice data from the multiple formats into a single universal data format.

9. Combine the data into a database and "clean" the data such that it is complete and correct enough to allow meaningful analysis later.

10. Account for the expenses (close your books) at a greater level of detail that allows the clean and proper classification of the expenses into general ledger (GL) categories.

11. Scrutinize expenses for validity and dispute any that are not legitimate.

12. Analyze your finalized expenses in each category:

    a) Compare them with expectations and industry standards.

    b) Compare regions, banners, promotions, and even salespeople to see which are performing better than others.

13. Take management action based on those analyses to improve subsequent promotions and your working relationships with your customers and salespeople.

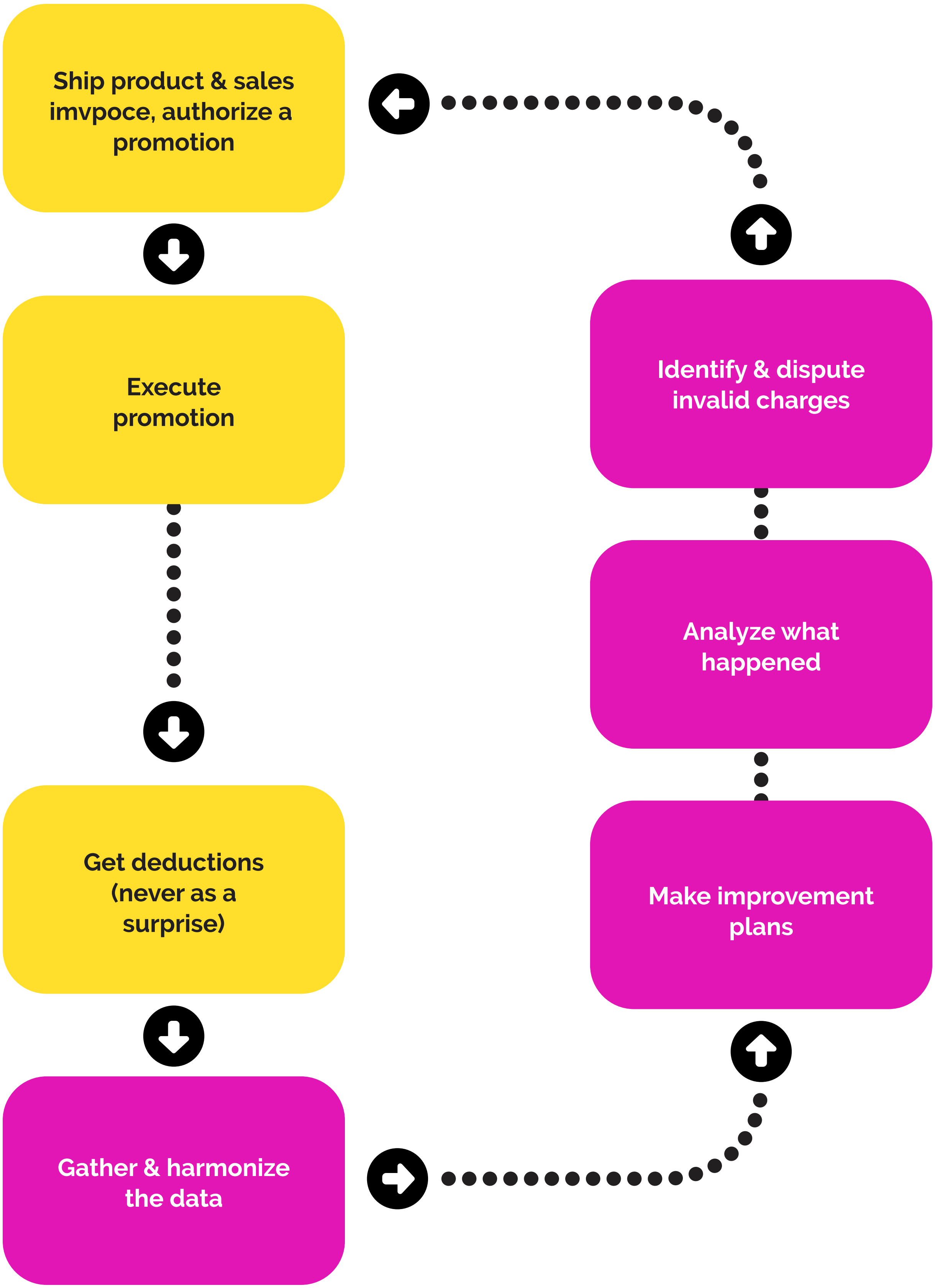


Figure 2: How Promomash recommends Brands deal with deductions

Is Deduction Management Worth the Effort and Cost?

The short answer: Deduction Management is more than worth it – it is a matter of survival.

CPG is a competitive industry, to put it mildly. Net profit margins are often measured in single digits – so again, every point counts. Earlier in this eBook, we stated that industry benchmarks estimated anywhere from 10-25% of deductions as being disputable – erroneous or invalid (and our own experience processing deductions puts that average squarely in the middle at 17%).

A CPG brand cannot afford to relinquish 10-25% of their trade spend. Assuming trade spend is 20-25% of top line, that's between 2-6% of lost margin.

So, suffice to say that whatever you can do to mitigate or reduce that loss (without spending more than the loss itself) is a good thing. Let's now take a look in a bit more detail at the additional process steps we recommend Brands take, outlined above, which we'll term best practices for full deduction management.

Best Practices for End-to-End Deduction Management

An excellent deduction management (DM) program first has to start with the end in mind. This means two things: 1) knowing the information that you are going to need and 2) deciding how you are going to organize all of the documents necessary to refer to during the analysis, validation, and (potentially) audit phases later. In order to do this, you need to understand how deduction accounting and validation teams work, and what information they need to do their jobs efficiently.

DATA ORGANIZATION & STANDARDIZATION

You will first need to assemble all received deduction documents in the various formats and organize them by accounting period. You'll need a place to organize and store them – think Dropbox, OneDrive, a dedicated space on your company intranet, or you can hire a third party to do this for you (more on these requirements later).

In parallel with that, you'll need to create a standard data template that will serve the analytical and accounting needs of the various managers who will be interested in seeing insights from the data. Typically, they will include:

The controller and the AP team

The VP of Finance or CFO, who will be looking at profitability analysis

The business management team, who will be looking to see how these expenses affect the overall picture of product line, customer, and promotional profitability/effectiveness

The VP of Sales, who will likely be tasked with implementing the actions identified from the insights.

Since promotional effectiveness is influenced by several factors, your analysis will want to tease out how much each of those factors affects the overall picture. Thus, for each expense line item you will need to capture the following information:

- Retailer, i.e. Customer (or Indirect Customer, if sold via distributor)
- Product
- Volume
- Price
- Promotion (and the parameters of that promotion)
- Date sold (shipped) to the Customer
- Date sold (scanned) to the Shopper/End Consumer
- Any other details required by the platform used by the accounting team

As you can see, a lot of information is required for an effective analysis. This immediately brings up a decision point: How much detail are you going to maintain? Even a small emerging brand can have hundreds of deduction invoices, and tens or hundreds of thousands of individual charges within those invoices.

If you are going to keep track of every $0.23 discount claimed per scan, it’sgoing to get very expensive to database that information unless you have automated the process somehow. This is almost certainly too expensive an option to make economic sense.

If you are willing to accept less detailed reporting and analysis, it may make sense to have a member of your own team keep track of the claims at the deduction invoice level. **But if you want deeper understanding or a greater level of confidence in where the data came from, you’ll have to maintain all that information at the level of the individual charges.** At that point, it will be almost impossible for a brand to do this themselves.

If you require deduction detail at the individual charge level, it’s best to consider an outsourced deduction management service with economies of scale like Promomash to handle the process for you.

Either way, the next step is to transcribe the information from the Customers' various formats into your standardized data template and create the database for the current accounting period.

DATA ENTRY, QC & BACKUPS

Once the data is in the current period's database, you'll need to check it for completeness and accuracy. **This QC (quality control) step requires the experienced eye of someone who has been working with deductions for some time (months at least, preferably years).** Such a specialist will typically need to verify the right charge codes (which are different for each customer), and to ideally associate that charge back to the promotion(s) which caused the expense to be accrued in the first place, or at least to the accrual that was planned for such expenses.

When the period's data has been entered into the deduction database and checked for accuracy, it will be ready to submit to accounting so they can close the books for that period. Since the accounting team works on a particular platform (whether a dedicated platform like QuickBooks, or a bespoke system such as NetSuite or Oracle), the database will probably need to be translated into a format that can be uploaded to the brand's accounting system.

Typically, you'll be taking the data in Excel and programming a macro to rearrange the data to the desired ERP format. The process of entering the data into the database means getting that information from various "backup" documents. In parallel with entering the data, those documents will need to be organized and stored for future reference. Examples of "future reference" include validating charges, for team reference as they drill down and examine the data, and for use as supporting documentation in the event of an audit.

DEDUCTION VALIDATION & DISPUTE

As soon as the data has been sent to the accounting team to enter into the larger company financial database, a separate team can begin the work of validating (or invalidating) the individual charges. This step demands a highly specialized skillset and mindset. Validators are typically very experienced accounting professionals who also display a high level of curiosity and desire to find things that don't make sense (like mistakes and illegitimate charges). **This is where your prior preparation and organization of the detailed backup documents will determine the efficiency (and ultimate success) of the activity.**

If validators can quickly zero in on suspicious items AND quickly reference materials needed to confirm or deny their suspicions, then validating deductions should be a worthwhile and profitable activity.

We're almost finished. We've uncovered invalid charges. Now what? You hand them to the dispute team. **This is another specialty: here you need someone who likes a good fight, and who won't take "no" for an answer.** They will need to submit any invalid deductions for refund; the catch is, every customer has a different form, procedure, and timeframe for their submissions. So, this individual or team needs to be organized and patient as well.

As invalid charges get credited, your dispute team will need to submit adjustments to the accounting team. This effectively finalizes the promotion-deduction settlement process. Hooray!

POST-EXECUTION ANALYSIS

Now that you and your team are armed with an entire database of deduction charges organized, scrutinized, and finalized, you can perform a multi-dimensional post-execution analysis by any or all of the factors listed out earlier (retailer, product, promotion, etc.).

Depending on how deeply it goes, this type of analysis can provide insights on more than promotion effectiveness, but pain points and opportunities with specific customers, products, or other factors across the business.

The surge in clarity that is sure to come with this data and the insights they provide will no doubt make for a happy management team. They now have real information to make decisions that positively impact the business – and greater confidence and control than they've ever had.

The company performs better and the entire team has greater job security. In short, you win.

Reality Check:
Should We Do This?

A couple of important questions still remain. Even though the above best practices are an abridged version of what needs to take place, it was still a lot. Should every CPG brand in retail do everything described? Theoretically, ideally, yes. But of course, that's not a realistic expectation.

In reality, the best course is chosen through what we refer to as "situational management." In other words, what's the best course for your particular company and situation? While it's impossible to make a blanket statement that will reliably choose the right path for your company, we can share a few helpful guidelines that we've concluded from our experience. In summary, your size and level of distribution will likely dictate the path that makes the most sense.

If you are just starting out and are under $2M in annual sales, deduction management should not be a priority…yet. You need to focus on basics like product-market fit, initial traction, door growth, establishing distribution, and the whole enchilada of operational issues and logistics. You'll have deductions, and many of them will be illegitimate – but there's no option (in house, or outsourced) that justifies the time and cost. With trade spend likely in the range of $300-$500k, invalid deductions will probably cost around $30k-$50k for the year. You'll spend twice that much trying to recover those invalid deductions. As unfortunate as it is to say, it may be better to just pay it and move on. You have more important things to focus on.

As you move into the $2M-$10M annual sales range, deductions will start to bite into your gross margins. That will affect a lot of things, including your ability to attract financing. Being on top of your expenses is very impressive to prospective investors; still, your lean and mean team can't dedicate full attention to this full-time activity. In this phase, outsourcing deduction management makes very good sense. It may or may not be super accretive, but it will definitely give you clarity on what's going on in the field, and it will position you very well to avoid problems as you scale. In other words, do it right from the beginning – because when you start to scale, it will be much harder to put a system in place to get deductions under control.

If you are in the range of $10M-$100M in annual revenues, outsourced deduction management will let you maximize your resources. Unless you have an unusually simple profile (few customers and only a few deductions that are well understood), at this revenue range bothering with deductions in-house is not the best use of resources. This allows your accounting team to be smaller so you can maximally leverage their time. You need to keep your eye on the most important ball and rely on the economies of scale and expertise that outsourcing can provide to ensure minimum fuss and maximum recovered funds.

From $100M-$1B in annual revenues, outsourced deduction management is still likely to make the most sense. At this scale, your teams will be more tightly interwoven with your deduction management service provider's teams, and the "machine" can be continually optimized for efficiency and return on investment.

Beyond $1B in revenues, building a deduction management capability in-house may be the best long-term option. This will require substantial planning and investment of both time and resources, but within a year or two the cost savings may be justified.

Business Metrics from Deductions

We've already established that deductions can provide a wealth of insights into your business. But how should you be measuring your business with this data? What are the KPIs? From our experience, here's a brief list of the most important metrics that deduction data can help you calculate:

Trade Rate.

What is your trade spend as a percentage of gross revenue?

Plan vs Actual.

What was your planned spend vs. actuals?

Invalid Rate.

What percentage of deductions were invalid?

Recovery Rate.

What percentage of invalid deductions were actually recovered?

Charge Categories.

How do charge rates by reason code compare to industry averages?

Trends.

How are all of the above trending over time?

Ideally, each of the above should be sliced and diced so that you can isolate the performance of your promotions, your salespeople, your products, and yes – your customers.

A Final Important Note

One of the greatest potential benefits of a top-notch deduction management program is the feedback that it can provide to the business management team. This is the team that is planning sales, promotions, and ultimately profit margin. They NEED to know the results of their planning and activities throughout the year. One of the common downfalls of CPG brands is that the planning, sales, and accounting organizations operate independently in organizational “silos”, failing to communicate what they know with each other. As you plan and implement your deduction management program, you should consider how to integrate deduction management activities and data across your business team so you can close the loop and create an opportunity for continuous improvement going forward.

Summary

As you can see, deduction management is a specialized activity, and one that highly impacts the company's bottom line. While it is a big, hairy beast, it can be managed. The important question is whether to do invest in an internal process and team or outsource it to a third party. The answer to that question is both a situational one, and a temperamental one: you need to consider the tangible, known dollars and cents, but you also need to consider strategic focus and where your core team will add the most value.

When a brand is a large, established, smoothly running machine with an accounting team that is operationally oriented, it may make sense to dedicate the effort to doing deduction management efficiently in-house with a focus on optimization and "shaving pennies." But while brands are in the emerging years and through the growth phase, it makes much more sense to preserve their team's time for core growth activities and leverage the economies of scale, specialized expertise, and rapid access to insights an outsourced service can bring. This gives management control and visibility to make informed decisions that can greatly impact success.

We hope this guide was helpful to you.

If after reading it you'd like further help in deciding which deduction management approach would be best for your company, please scan the code below or visit **promomash.com/deduction** to learn more and set a meeting. We'd be happy to discuss your particular situation.