Measuring Performance for the Credit Function

EXECUTIVE SUMMARY

Within the world of credit reporting, comparison of data and competition, there is always someone else's metric, of one kind or another. The important thing is, to always keep in mind that a competitor's data does not consider your company's version of success. The same goes for a reporting agency rating, although there are certain standards.

With that said, there are sound reasons for comparing your results, with those of not just your competition, but with other vendors and, most importantly, with what your company management expects. Hopefully, your senior management people understand the metrics, and how their expectations fit into them.

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Indeed, how does one measure the performance of a Credit Department? On one hand, there are a series of calculations, which I will discuss shortly. On the other, there are the expectations of Management, owners and customers.

Customers? Why do their expectations matter? The answer is simple; they, through their continued purchases, are the ones who, ultimately, pay the bills for your company. Yes, there is the working capital line of credit, with the bank. Even then, your company has to repay them. How a Credit Department performs must take into account the need to maintain and grow a customer base.

Ownership? That can vary, from remote stockholders in a public environment, to a single owner, who also participates in the daily management of the company. The former are mostly interested in a constant flow of dividends, or in a growth pattern that fits their investment strategy, of whether to buy, sell or maintain shares. However, the other person or persons, the ones who work in the office everyday are closer to the customer, and the need to keep them coming back. Then, at the same time, they are equally, or even more, concerned about paying the bills, and creating a growth environment, at the same time.

Management? I mentioned above, that owners, who are active in the business, are, by design, the managers. In other circumstances, senior management personnel are paid employees, like you. These management people will have set goals and priorities for the company. Sometimes, these goals will fit right into a pattern consistent with traditional measures of performance. Other times, they will be inconsistent with them, prompting adjustments on your part. In a nightmarish scenario, they will expect both. Been there, done that, in all three circumstances. All of it can be accomplished, trust me.

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Keys to Successful Performance Measurement

Determining whether a Credit Department is meeting its performance expectations, or not, is dependent upon several factors:

- The first of these is whether the particular metric is meaningful, within the variables mentioned above.
- Once that is accomplished, one must set a goal or objective, for each useable metric.
- To be an effective measurement, it, or they, must be calculated regularly, and, then, reported to Management, as well as to your department.
- It should also be compared with other performance metrics, outside of credit management. In other words, is the so-called successful performance, with a certain credit and collections metric, having a positive or adverse effect elsewhere, perhaps with Sales or Payables? If the effect is negative, be prepared to explain same to both Management and the affected party. Should changes be made, with one or both sides?
    - Example: If one or more credit and collection metrics point to success, and Sales does not meet its goal, is it due to being too strict on the Credit side? Then, again, is there an issue on the Sales side?
    - Example: Is being required to be liberal in accepting customer payment plans having an adverse effect on cash flow, thus prompting the need to draw on the bank line, to meet vender terms? Is it also possible that, heaven forbid, the company is paying vendors too fast, when just a little slower is OK?
- Be prepared to view a metric, within the realm of your specific industry. For instance, it is important to consider trends. When comparing performance from month to month, also compare the same against the same month(s) in the previous year(s). Seasonality in specific industries will often negatively affect a single month's performance, while a review of the trends with previous timeframes will put it perspective.
- While it is important to measure performance, it is equally important to use those metrics, to take appropriate action. If the metric shows a negative effect, make changes to reverse that. If it is positive, make sure that your department is prepared to continue that trend.
- Always be prepared to explain the metric(s), to Management and your department. This can be done in two ways:
    - Formal monthly reports, designed in such a way as to provide meaningful data to Senior Management, Sales and Field Operations personnel and the Credit Department.
    - Hold regular meetings, with your personnel, to discuss accounts, specifically those with an impact on the metrics. Record the results, and, then, distribute that information, to relevant people, with an interest in this. For instance, it is doubtful that the senior IT person will care, while it is very important to Sales and the CFO.

- When exchanging or providing information to people outside of the corporate environment, stress the fact that all such information is strictly confidential. They should not even hint at issues, involving paying habits or the financial position of a customer, to that customer's employees, in particular, or to anyone else.

Please remember, always, that a particular metric is a mathematical calculation. It serves a purpose, to the extent that it provides data. The more important aspect of this subject is what you, the Credit Professional, does with it.

Metrics, in Detail

1: Workload: One metric that is sometimes overlooked is the workload imposed on, I mean allocated to, the Credit Department (humor?). The ability to perform is significantly altered, if the number of accounts assigned to a person is too high, to the extent that, said person cannot deal with them in a given month. Of course, that ability is also impacted, by the tools available, such as an automated follow-up system, which, in turn, can communicate with some accounts digitally. The more complex accounts can, then, be left to a person to handle.

The assigned workload is also affected by, whether a Credit Department is centralized or de-centralized. Having worked in both environments, for large nationwide organizations, along with smaller localized operations, with more limited customer lists, I can attest to the fact that a centralized environment offers efficiencies with certain tasks, along with the ability to personally interact with co-workers. Its problems include the inability to easily visit customers and to interact with field personnel, face to face. A de-centralized organization is, by nature, closer to its customer base and its field operation, thus, it is easier to visit both.

Either way, the number of accounts assigned to a person will definitely impact the rate of success or failure, more appropriately expressed as "inability", of that person to do the job, as required. All else being equal, a Regional Credit Manager with an assigned account load of 800-1,200 customers will be better able to do so, as opposed to a colleague with an account load of 5,000. It is a simple matter of there being only so many hours, in a day.

If you are in the position of managing a Credit Department forced to operate in the latter environment, it is the perfect time to look into workflow automation and various other digital efficiencies. The first step in this process, or to simply justify increasing your staff accordingly, is to calculate various metrics, then analyze the results, to build a case for improving efficiencies. Of course, these metrics may also relate to quality of your staff, which still calls for the same process.

Besides the account load per Credit person, those who actually monitor the account, approve credit availability and collect the money, other statistics may help with determining workload allocations. These include:

- Checks processed and transactions posted per Cash Applier
- If your industry is impacted significantly by deductions, do the same, per Cash applier and/ or Deduction Specialist, someone who is responsible for resolving these issues.
- Both of these are areas in which significant improvement can be achieved by Workflow Automation (See previous papers on this subject). To further help with justifying the expense, calculate the cost per transaction, vs. the cost of implementing automation. Ideally, break down the transaction costs by type of transaction:
    - For a system that will partially automate some processes within the department, as whole, use the total operating costs, divided by the number of employees.
    - To automate only certain processes, such as cash application, use only costs associated with that group, divided by the employees assigned to the task.

<u>2: % of Total A/R beyond a given # of days:</u> This is a very common metric, used for everything from credit reporting agencies calculating a rating, to a simple comparison with past performance in your company and with the same category in other companies. It is very simple to calculate:

<u>The dollar amount in a chosen aging bucket</u>
(divided by) Total Open Account Balance

Consider the following:

- You do need to convert the answer to a percentage.
- The Total A/R should include even money due in the future.
- It is best to do this for all aging categories, not just the oldest overdue amount. This will enable you to consider immediate trending, in addition to yearly trends in the older buckets.
- The data is easy to compare, with established goals.
- It is also particularly useful for comparing performance between staff members, and also between various geographic regions within the company.

<u>3: % Current:</u> This is similar to above, in that the calculation is the same, but its use is different. It also includes any receivables due in the future. Comparison to other periods will provide insight into sales patterns, and it can potentially help to forecast cash flow and delinquency. It can also be used to analyze the overall condition of your customer base, when comparing it to the percentages in the older aging categories. For instance, a high percent Current and a high >90-Day percentage, with lower numbers in between, could point to a few particularly problematic accounts, or to the need for some procedural changes, to target the older category.

<u>4: % of Bad Debt to Sales:</u> This is a very useful metric, for several reasons:

- Bad Debt is an expense item, directly affecting a company's financial position, especially since every dollar in Bad Debt is a dollar reduction in Net Profit.
- This percentage can be used to evaluate the company's pricing strategy, especially for certain geographic regions, if each area shows a different percentage.
- The same can be said for evaluating staff performance, if one person's percentage stands out. If it is particularly low, is that person being too conservative or is the region economically sound, with a good selection of customers. If it higher than the average, then the opposite may be true. Either way, it should prompt an account review, starting with the write-offs, followed by the most delinquent.

Calculation is also simple:

$$\frac{\text{Total Bad Debt}}{\text{Credit Sales}}$$

Note: Some companies may use Total Sales, rather than simply those on Open Account.

<u>5: DSO</u> (***<u>D</u>***ays ***<u>S</u>***ales ***<u>O</u>***utstanding): This is the most widely used, as well as the most widely misunderstood, method for evaluating the effectiveness of the Credit Department, as well as the company, as a whole. Admittedly, it is widely used, so we include it here, in order for you, the Credit Professional, to use it, with an asterisk, regarding its problems.

Its most useful aspect is that it is so widely used, it is fine for comparisons, as long as it is "apples-to-apples". By that, I mean some companies include Gross Sales, including CODs (***<u>C</u>***ash ***<u>o</u>***n ***<u>D</u>***elivery) and credit card sales, while others use only Credit Sales. By nature, the former will result in a lower DSO than the latter. As a result, it is not an accurate measure of Credit Department performance. For the best and most useful result, a Credit Professional wishing or told to use DSO for that performance evaluation, make the adjustment yourself. With cash sales included, the DSO will automatically be lower, so, when using a competitor's data, it is imperative to know which method they use.

Another acceptable usage for DSO, regardless of the method, is the fact that it is within the confines of your organization, and, therefore, trends can be useful, for both Credit and Sales. The fact that it simply tells everyone just how many days-worth of sales remain open in A/R, it is fairly easily understood.

Then again, many people do not realize that the simple fact that a sale remains unpaid, especially when DSO is rising, it is not necessarily a reflection on Credit's performance.

Instead, A/R will include customer disputes with Sales or Operations, uncredited returns and other deductions. The metric is also influenced by the presence of dating terms, with payment due in the future, so a seasonal rise in DSO will reflect that. If such terms are regularly offered, it will likely not show independently, unless specifically evaluated, as a cause for reduced cash flow.

One particular instance, where DSO can be useful for the evaluation of a Credit Department's performance, is when it is compared to a set goal. Let's say:

- Your CFO determines that Accounts Payable will pay all vendor invoices at 55 days, unless there is a cash discount.
- You are told to not exceed a DSO of 50 days, on general terms of Net 10th Prox., wherein payment is due by the 10th of the month following the invoice date.
- You calculate your DSO on credit terms only.
- If you consistently maintain a DSO between 45-48 days, you have provided 7-10 days-worth of cash flow flexibility to your boss. Nice job!
- At year-end, the financial statements include all COD purchases, so, with up to 20% of your business being paid that way, your actual total DSO, as viewed by the owner and the bank, averages 35 days, thus providing up to 20 days of cash, which is now available for other uses. (If you are also responsible for the credit card agreements, chargebacks, check approval process and NSF checks, you have contributed to that additional cash, as well. Nicer job!)

Other uses for DSO trends include:

- Increasing figures can indicate what everyone jumps to, a failure of the Credit Department to collect, but…
- …it can also mean that there is an increasing trend to sell, using dating terms or meeting a competitor's terms. Seasonal changes are one thing, but a general increase could mean that the Sales Department is meeting its goals by going beyond the standard terms of sale.
- Either way, such increases should be investigated. This goes for internal evaluations, as well as including such an evaluation, when your customer's DSO is going up.
- On the other hand, decreasing DSO can be a good sign, in that Credit is doing a good job. Then again, is Credit being too tight in extending credit, or is Sales not doing its job? Again, if such trends are significant, investigate and evaluate.

Calculation of DSO varies, potentially yielding slightly different results. Two such calculation methods are shown here:

$$\frac{\text{Ending Total A/R x Number of Says in a given period}}{\text{Credit Sales for that period}}$$

$$\frac{\text{Total A/R @ Month-end}}{\text{(Sales for past 90 days/ 90) = Average single days-worth of sales}}$$

6: BPDSO (**B**est **P**ossible **D**ays **S**ales **O**utstanding): This is more, or less, self-explanatory. By using only the current A/R, you are, essentially, seeing how close you can get to the actual terms of sale. By comparing this result to the "normal" DSO, especially over time, you have a good idea just how you are doing compared to those terms, regardless of the actual terms. A gap that is closing is good, while the opposite is not that good, unless you are still within your goal. Still, it pays to know the relationship, between the two.

7: ADD (**A**verage **D**ays **D**elinquent): At best, this number represents the average number of days past due. On the other hand, it can be confusing, in that people who take advantage of discount terms could skew the result, giving a false perception on the past due. To calculate the number, subtract BPDSO from DSO.

8: DTP (**D**ays **t**o **P**ay): Defined as the number of days, between the invoice date and the payment date, this number is very useful, especially under certain circumstances:

- Prox. (Proximo) Terms: The Latin word "Proximo" is used to define when payment is due on a specific date, beyond a calendar month. For instance, Net 10th Prox., means that payment of an invoice, billed on any day during a calendar month, is due on the 10th of the following calendar month. The issue is that the time allowed, on a typical 30-day month, can be anywhere from 10 to 40 days.
- Some A/R systems will re-age invoices, such as those with Net-30 terms, as of the end of that timeframe, causing the Aging to change daily. Others, with the same terms structure, may do so at month-end only.

Basically, the aging buckets are less than accurate, regarding how past due an account may be. When evaluating the creditworthiness or collection potential of such an account, the logical way is to calculate the number of days it takes that customer to actually pay. Example, with Net 10th Prox. terms:

- You're A/R system has the following buckets:
  - *Future*: This serves two purposes, in that it includes dated invoices that are not yet due, as well as including invoices billed in the present month, which are also not due yet.
  - *Current*: The month in which an invoice becomes due.
  - *30, 60, 90 and 120+*: Obviously, the past due buckets.
- Re-aging is done at month-end only. Thus, newly billed invoices will sit in "Future", until they re-age to "Current", at the end of the month. Any unpaid invoices will re-age to "30" and be billed a late-payment or service charge. Therefore, an invoice billed on the June 1 will be 60 days old, before it shows "past

due", on August 1. An invoice dated June 30 will only be 30 days old, on August 1. At the same time, both are actually, per the terms, 20 days delinquent, on August 1, and each will have a late-payment charge.

- When viewing each of these invoices on separate accounts, if both are paid on July 30, while the invoices are sitting in the "Current" columns on their respective accounts, are they demonstrating the same payment pattern? With DTPs of 50 days and 20 days, they do not. When considering payments made on August 30, the circumstances are that much different, with DTPs of 81 and 51.
- It gets more complicated if one account pays on August 1 and the other on August 31. They both appear to have paid "slow 30". Which one is a better risk? It is much easier to determine that, based on the actual Days-to-Pay, rather than the bucket.

Summary

Metrics are good, to the extent, that they make sense, within your organization, and when you and your company actually use them, to improve the performance, of both the Credit Department and the total organization. It is, therefore, very important that everyone understand what they say and mean. You, the Credit Professional, may need to take the initiative, to train others in the company. In some cases, that may only mean making sure that Senior Management understands relevant metrics. In other circumstances, you may need to train field personnel, if Management agrees. If they prefer to assign that task to Sales and Field Operations, ensure that you have a "Train the Trainer" program available.

Note: To access a free downloadable Excel based model designed to calculate key performance indicators, as discussed in this paper, click on…
http://www.federationofcredit.com/page/KPIForm

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