

Credit Department Metrics

CREATING, MEASURING AND COMMUNICATING VALUE
FOR YOUR ORGANIZATION

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

Presented by:
Lyle Paul Wallis, CCE

PRESIDENT
FEDERATION OF CREDIT & FINANCIAL PROFESSIONALS

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

Considerations in Establishing Meaningful Metrics

1. Fill the need of a specific objective
2. The metric must have a standard
3. A metric must be compared to some standard or it has no meaning
4. Consistency is critical to meaningful measurement
5. Using the metric to take action
6. An effective metric provides a benefit &
7. Measures and standards must be communicated

Filling the need of a specific objective

- ▶ What gets measured gets done
 - ❖ What are we doing?
- ▶ If a metric doesn't accomplish a purpose, don't use it
 - ❖ Why are we doing it?
- ▶ Use the metric to support the organizations mission
 - ❖ How are we doing?

The metric must have a standard

- ▶ The standard can be a set value or range
 - ▶ e.g., the DSO target is 33 days
 - ▶ or, the DSO target is between 30 and 35 days

A measure must be compared to some standard or it has no meaning

- ▶ Standards may be set according to past organizational or industry values or trends
 - ▶ e.g., internal year to year or month to month comparative analysis or
 - ▶ comparative analysis to industry standards

Consistency is critical to meaningful metrics

Pick a method and stick with it...

- ▶ Formulas
 - ❖ DSO calculated for 30 days, 90 days, or 360 days will yield slightly different results
- ▶ Variables
 - ❖ Receivable balance with or without deductions

Using the metric to take action

- ▶ Specific
 - ❖ a target value
 - DSO must be 33 days
- ▶ General
 - ❖ a target range
 - DSO must be between 30 & 35 days

An effective metric provides a benefit

- ▶ If a metric provides no benefit, why bother using it &
- ▶ It provides the satisfaction of reaching a goal

Measures and Standards must be communicated

- ▶ Getting people to use any performance measurement solution depends on how well the solution links measurement to management and work practices.
 - ❖ *"Tell me how I am rewarded and I will tell you what my focus is."*
- ▶ Ensure regular, routine evaluation meetings to address issues in a timely manner.

Some Performance Metrics Employed for Credit & Collections

- ▶ CEI - Collection Effectiveness Index
- ▶ DSO - Days Sales Outstanding
- ▶ BPDSO - Best Possible DSO
- ▶ ADD - Average Days Delinquent
- ▶ % Current
- ▶ % over XX Days
- ▶ Gross Bad Debt to Sales
- ▶ Active Customers per Credit Employee

CEI Collection Effectiveness Index

- ▶ Expresses the effectiveness of collection efforts over time
- ▶ An index representing two performance "flows" - amount collected and amount available to collect
- ▶ The closer to 100, the more effective the collection results
- ▶ Can be used to measure individual or group performance
- ▶ It is simple to calculate



Collection Effectiveness Index

$$\frac{\text{BEGINNING A/R} + (\text{CREDIT SALES/N}) - \text{ENDING A/R}}{\text{BEGINNING A/R} + (\text{CREDIT SALES/N}) - \text{ENDING CURRENT A/R}}$$

Days Sales Outstanding... What it is, what it isn't

- ▶ It is:
 - ▶ the most widely used and common measure of performance for credit and collection
 - ▶ the most misunderstood (mis-used) metric
 - ▶ a reflection of the number of days worth of sales tied up in the A/R portfolio
- ▶ composed of:
 - ▶ terms (the future & current receivables)
 - ▶ delinquent invoices
 - ▶ operational errors, service and quality problems, disputes and customer dissatisfaction (deductions)
- ▶ your link to adding value to the corporation

Days Sales Outstanding - what it is , what it isn't

- ▶ It is not:
 - ▶ an accurate or appropriate measure of credit and collection performance
 - ▶ the best portrayal of the condition of total receivables

Days Sales Outstanding – Factors Influencing Movement in DSO

DSO is composed of two variables:

- ▶ Receivables and
- ▶ Sales

Days Sales Outstanding – Understanding the Components

If sales remain the same and:

1. Receivables increase, DSO will increase
2. Receivables decrease, DSO will decrease
3. Receivables remain the same, DSO will remain the same

Days Sales Outstanding – Understanding the Components

If receivables remain the same and:

1. Sales increase, DSO will decrease
2. Sales decrease, DSO will increase

Days Sales Outstanding - Understanding the Components

- ▶ If both sales and receivables change (as is usually the case), the relative movements between the two variables will determine the change in DSO.

DSO Days Sales Outstanding

- ▶ Days Sales Outstanding represents the number of days on average that it takes a firm to convert its accounts receivables to cash
- ▶ Helps determine if a change in A/R is due to a change in sales, or to another factor such as change in selling terms
- ▶ It is quick and simple (but not standardized)
- ▶ It can be used to evaluate individual portfolios, sub-groups or the enterprise

DSO...The Final Word

- ▶ Large increases in DSO can indicate a situation where a company is "forcing" sales by accepting poor receivable terms, or selling its product at a discount to create sales for the period.
- ▶ Companies that show improving DSO are indicative of management's that are focusing on making their operations more efficient.
- ▶ Firm's with significant changes in their DSO should be investigated in greater detail.



Days Sales Outstanding

$\frac{\text{ENDING TOTAL A/R X NUMBER OF DAYS IN PERIOD}}{\text{CREDIT SALES FOR PERIOD}}$



BPDSO Best Possible Days Sales Outstanding

- ▶ Used in conjunction with DSO
- ▶ The closer the overall DSO is to BPDSO, the closer receivables are to optimal level
- ▶ It is a quick and simple
- ▶ In a perfect world, BPDSO correlates closely to selling terms



BPDSO Best Possible Days Sales Outstanding

$\frac{\text{CURRENT A/R X NUMBER OF DAYS IN PERIOD}}{\text{CREDIT SALES FOR PERIOD}}$

ADD



Average Days Delinquent

- ▶ Reflects, on average, the number of days credit sales are past due
- ▶ It provides a snapshot to evaluate individuals, subgroups or overall collection performance
- ▶ Can be deceiving by masking the performance of delinquent accounts if other accounts are discounting their bills.

Average Days Delinquent



$$\frac{\text{DSO}}{\text{BPDSO}}$$

% Current



- ▶ Reflects the relationship of non-past due receivables (current and future) to total receivables outstanding
- ▶ Can be used in forecasting receivables condition and workload
- ▶ A quick "check-up" on the relative condition of receivables
- ▶ Easy to understand and calculate



% Current

$$\frac{\text{ENDING CURRENT A/R}}{\text{ENDING TOTAL A/R}}$$



% Over XX Days Past Due

- ▶ Expresses the percentage of total receivables that are over xx days past due
- ▶ Good comparative measure of receivables condition
- ▶ Can focus and alert management to unusual increases in A/R requiring prompt attention
- ▶ Can be used to evaluate individuals or groups
- ▶ Simple to calculate, easy to understand



Percent Over XX Days Past Due

$$\frac{\text{TOTAL IN THE OVER XX DAY AGING AND BEYOND CATEGORIES}}{\text{TOTAL RECEIVABLES}}$$

Gross Bad Debt to Sales



- ▶ Expresses the percentage of credit sales that were written off to bad debt
- ▶ A measure that works in conjunction with the credit policy (strict or liberal) and organizational goals sales versus profit
- ▶ Can be evaluated at the individual or group level
- ▶ Simple to calculate and easy to understand
- ▶ When calculated as net of recoveries, it becomes a contributing factor in measuring the cost of business

Gross Bad Debt to Sales



$$\frac{\text{TOTAL BAD DEBT}}{\text{CREDIT SALES}}$$

Active Customers per Credit Employee



- ▶ Generally, the higher the number of accounts per employee, the more efficient the operation is through the:
 - ❖ use of technology
 - ❖ use of qualified people
- ▶ Can be used as a gauge for personnel requirements when adding workload (merger, centralization, etc.)

Active Customers per Credit Employee



$$\frac{\text{NUMBER OF ACTIVE CUSTOMER ACCOUNTS}}{\text{NUMBER OF TOTAL DEPARTMENT EMPLOYEES}}$$

Some Operational Metrics for Accounts Receivable to Consider



- ▶ Transaction Turnover per Cash Applicator
- ▶ Deduction Turnover per Cash Applicator and Deduction Specialist
- ▶ Operating Cost per Transaction

Transaction Turnover per Cash Applicator



- ▶ Indicates the number of transactions processed per person responsible for cash application, *(invoices, credits, adjustments, deductions, overpayments, cash, etc.)
- ▶ Can be used to evaluate the efficiency of the organization's cash processing system and personnel

Transaction Turnover per Cash Applicator



$$\frac{\text{NUMBER OF TRANSACTIONS PROCESSED}}{\text{NUMBER OF CASH APPLIERS}}$$

Deduction Turnover* per Cash Applicator and Deduction Specialist



- ▶ * Deduction turnover is the combined transaction activity of creating and removing deductions over a year.
- ▶ The figure indicates the total number of deductions processed by cash applicators and deduction specialists.
- ▶ It measures productivity of the group and can be used to compare the productivity of the employees versus an auto-cash process

Deduction Turnover per Cash Applicator and Deduction Specialist



$$\frac{\text{ANNUAL DEDUCTIONS CREATED + ANNUAL DEDUCTIONS REMOVED}}{\text{TOTAL CASH APPLIERS \& DEDUCTION SPECIALISTS}}$$

Operating Cost per Transaction



- ▶ Illustrates the cost of an individual transaction
- ▶ An important internal benchmark or cost measure of an individual transaction
- ▶ Lower costs can be due to technology (efficient auto-cash) or relatively low cost labor

Operating Cost per Transaction



$$\frac{\text{DEPARTMENTAL OPERATING COSTS}}{\text{NUMBER OF TRANSACTIONS PROCESSED}}$$

What Can You Do To Add Value To Your Organization?



- ▶ Understand the cost of your standard selling terms
- ▶ More importantly, understand the impact of extended terms:
 - ❖ define the acceptable condition for accepting them
 - ❖ develop and adhere to a policy dealing with terms

More You Can Do

- ▶ Evaluate your billing process
 - ❖ timeliness
 - ❖ accuracy
 - ❖ clarity
 - ❖ standardization
- ▶ Evaluate your credit policy-is it meeting the enterprise goals
- ▶ Evaluate your collection and dispute resolution practices

More You Can Do

- ▶ Focus on what you do best
 - ❖ Identify those functions which you are most proficient at, and outsource the rest. Don't squander resources on fringe activities that lend minimum value to the firm.
 - ❖ If 85% of your receivable portfolio is focused in your top 125 accounts, consider surrendering the other accounts to a third party.

More You Can Do

- ▶ Carefully scrutinize each step in the process
 - ❖ document and map the flow for processes such as:
 - new account and order approval
 - routine credit investigation
 - collections
 - deduction management
 - ❖ If a procedure can be eliminated with minimum impact on proficiency, eliminate it.
 - ❖ Have your customers do it. Shifting the burden of processes to your customer can lend tremendous value to the organization if it is done without jeopardy to customer relations.

Measuring Process Performance...

What Gets Measured Gets Done

- ▶ Why we report:
 - ❖ to measure actual performance
 - ❖ comparing it against a standard
 - ❖ and taking managerial actions to correct deviations or inadequate standards
- ▶ Reporting promotes:
 - ❖ communication
 - ❖ benchmarking
 - ❖ monitoring
 - ❖ planning
 - ❖ a means of recognition

Types of Reports for Credit & Receivables Management

- ▶ Performance Reports
- ▶ Management Reports &
- ▶ Workload Reports

Report Development

- ▶ Before assembling a report ask several questions:
 - ❖ Why? What is the purpose of the report
 - ❖ Who? What is the distribution
 - ❖ When? What is the frequency of the distribution
 - ❖ How? What will be the format of the report

Your Existing Report Review

Periodic reevaluation of any report is essential and should be examined for intent, content & form

► Intent

- ❖ why was the report first issued
- ❖ does the need for this report still exist
- ❖ is the need still being met by the current format
- ❖ are the current recipients really using it

► Content

- ❖ is superfluous data included
- ❖ is important data missing
- ❖ is the chosen form the most readable
- ❖ is the time spent compiling the report proportionate to the value of the report

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