NEXUM Analysis™

NEXUM

Credit Management Briefing Series

The

key areas of Measuring performance

Overview, why, what and how.

At Risk2Resolve we strongly believe that the implementation of the NEXUM® Credit Management software around your existing accounting/ accounts receivables systems will provide substantial rewards. Establishing best business practices around the order to cash cycle requires benchmarking. Reviewing the current position together with existing working practices is a major part of our review. Working with you to develop new working practices aimed at improving the entire order to cash cycle is a key objective. The final translation of best practices into the NEXUM® system once completed then requires a process of monitoring performance. The challenge is to define how we measure your existing operation together with how we measure your performance once the NEXUM® system has been implemented.

Evaluating performance around the Credit function either at individual, departmental or company level has always proved challenging. Agreeing which measurement to use even more so. At the end of the day each business will have it's preference; this is often determined by which formula 'presents' the information in the most appropriate manner.

The purpose of this document is to serve as a guide providing a background and understanding of the various measurements available. Our approach is often to work with you to establish the best method of reporting as it is important that performance figures are presented in a manner which can be easily interpreted and benchmarked.

The right measurement is the one that meets your organizational needs. To determine if a measure meets your organizational needs, logic dictates that you must first understand those needs. Once your needs are understood, you must then identify the most appropriate measure to meet them. This requires a thorough understanding of what the measure expresses. The right measure will express a value that complements and supports the objectives of the company, division, department, or subgroup.

The following questions will help you determine if the right measure is being used:

- What does the measure express?
- What do the results of the measure indicate?
- Does the measure support the objectives?
- Is the measure valid?
- Is there a more valid measure that should be used?
- Does the use of the measure's results comply with organizational goals and values?
- Should the measure be used independently or in conjunction with other measures?

Why measure performance?

Identify areas of expertise	Identify areas of potential growth
Improve policies and procedures	Reduce the level of customer disputes
Shorten lead time	Increase customer satisfaction
Reduce customer complaints	Increase customer retention
Improve financial performance	Improve employee morale
Focus employee training and support	Increase productivity
Increase cash flow	Reduce costs
Reduce bad debt	Perform fair individual and group evaluations

Regardless of the measurements chosen to evaluate an organization, they must be able to stand the test of time. The measures that make an organization look good today may not in the future. The goal is to identify and consistently use valid measures that work over time, not just measures that work for the moment.

If a measure is not understood it should not be used. It is difficult to explain or defend something that is not understood. Always use measures that accurately reflect reality, and then manage for improvement.

What makes a measurement beneficial?

A beneficial measurement fills a need and meets a specific objective. If a measurement does not accomplish a purpose, don't use it. If a measure is being used and the objective is not understood, figure it out. All productive activity has a purpose. Meaningful measurements will support the organization's mission and help reach organizational goals.

The measurement used must have a standard. The standard can be a set value or a range. For example, if the controller of a company is using Days Sales Outstanding (DSO) as an overall measure of accounts receivable in relationship to credit sales, what is acceptable? Is the standard a set value such as 45 days, where any value below 45 days is acceptable? Perhaps the standard is a range such as 42 days to 51 days, where any value within the range is acceptable. Using a range as a standard has some benefits. In this example, the low-end of the range may reflect a credit policy that is too strict, while the high end may indicate a policy that is too liberal. If a company does not sell to marginal customers, the company's DSO will be lower than if they accept the increased risk and potential profit associated with marginal customers.

A measurement must be compared to some standard or it has no meaning. Standards may be set according to past organizational or industry values or trends. Again, using the DSO example, the acceptable range may be the industry high and low from a standard determined externally.

Consistency is the next element of a meaningful measurement. If the standard DSO calculation is used one month, Sales Weighted DSO cannot be used the following month. Likewise, the acceptable standard and the comparable standard cannot change monthly. It's true that measurements need to be evaluated and updated from time to time, but the update should be completed on more of an annual basis than monthly.

The effective implementation of measurements requires action. This is similar to a guidance system on a missile. It has an acceptable standard (hitting the target). It also has a comparative standard (the course to the target). The missile is constantly comparing its current position (course) to its destination (target) and making the necessary corrections to stay on course. As mentioned earlier, the acceptable standard can be specific or general.

An effective measurement provides a benefit. One benefit could be the satisfaction of reaching a goal and realizing the implications of that success.

Organizations should communicate all measurements and standards to those individuals who are responsible for executing the action plan that will help the organization reach its goals. Measures of performance should be graphed or charted as part of the reporting process. The old adage that states, "when performance is measured, performance improves, but when performance is measured and reported, the rate of performance accelerates" is true.

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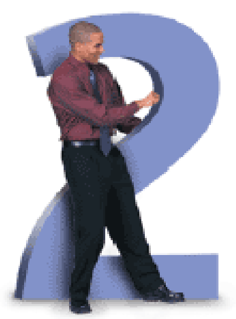
How

To use Credit and Collection Measurements

Collection Effectiveness



Days Sales Outstanding

Collection Rate Measurements

Operational Performance Measurements

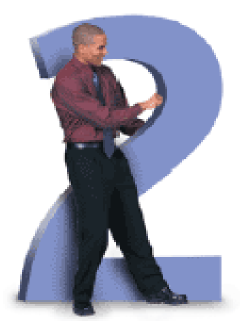
Collection Effectiveness Index (CEI)

Description: *This percentage expresses the effectiveness of collection efforts over time. The closer to 100 percent, the more effective the collection effort. It is a measure of the quality of collection of receivables, not of time.*

CALCULATION

$$\frac{\text{Beginning Receivables} + (\text{Credit Sales}/N^{*}) - \text{Ending Total Receivables}}{\text{Beginning Receivables} + (\text{Credit Sales}/N^{*}) - \text{Ending Current Receivables}} \times 100$$

***N** = Number of Months or Days



Days Sales Outstanding (DSO)

The Days Sales Outstanding financial indicator shows both the age, in terms of days, of a company's accounts receivable and the average time it takes to turn the receivables into cash. The DSO can be compared to industry and company averages, as well as company selling terms enabling you to determine how your receivable function is performing and the acceptability of such performance. There are several methods of calculating DSO, including a regular calculation and a best possible calculation.

Description: *This figure expresses the (aggregate) average time, in days, that receivables are outstanding. It helps determine if a change in receivables is due to a change in sales, or to another factor such as a change in selling terms. An analyst might compare the days' sales outstanding with the company's credit terms as an indication of how efficiently the company manages its receivables.*

CALCULATION

$$\frac{\text{Ending Total Receivables x Number of Days in Period Analyzed}}{\text{Credit Sales for Period Analyzed}}$$

2.1 Best Possible Days Sales Outstanding or Average Terms Based on Customer Payment Patterns

Description: Using only the current portion of receivables, the Best Possible DSO yields insight into delinquencies. As a measurement, the closer your regular DSO is to the Best Possible DSO, the closer your receivables are to the optimal level.

To calculate your Best Possible DSO three pieces of information are required:

- Current Receivables
- Total credit sales for the period analysed
- The Number of days in the period analysed

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CALCULATION

$$\frac{\text{Current Receivables x Number of Days in Period Analyzed}}{\text{Credit Sales for Period Analyzed}}$$

2.2 Sales Weighted DSO

Description: as with the regular DSO calculation, measures the average time that receivables are outstanding. This is an improved method of calculating DSO because it attempts to smooth out the bias of credit sales and terms of sale.

CALCULATION

((Current Age Category / Credit Sales of Current Period) + (1 to 30 Day Age Category / Credit Sales of Prior Period)+(31 to 60 Day Age Category / Credit Sales of 2nd Prior Period) + (61 to 90 Day Age Category / Credit Sales of 3rd Prior Period) + (91 to 120 Day Age Category / Credit Sales of 4th Prior Period) + (etc.)) **x** 30

Note: There are several formulas to calculate Sales Weighted DSO. This is a simple expression of those formulas. Other formulas or expressions yield the same results.

2.3 True DSO

Description: calculates the actual number of days credit sales are unpaid by tracking individual invoices to the month of sale

CALCULATION

Number of days from invoice date to reporting date **x** (invoice amount/net credit sales for the month in which the sale occurred) **=** True DSO per invoice

The sum of True DSO for all open invoices = True DSO per total accounts receivable.

2.4 Delinquent DSO or Average Days Delinquent

Description: *This figure expresses, in days, the average time from the invoice due date to the paid date.*

CALCULATION

DSO minus Average Terms Based on Customer Payment Patterns (Best Possible DSO)

Collection rate measurements

The measure should express a value that complements and supports the objectives of your company and department. It must be communicated to all individuals responsible for the process being measured .It must be compared to some standard, for instance, past company performance, or an industry benchmark. It must be used consistently, from month to month, year to year. The results should elicit some action - correcting course, managing change for improvement. It should provide a benefit. This could be as basic as the satisfaction of reaching a goal that contributes to the organization's success

3.1 Days Average Collection Rate

Description: *This figure expresses, in days, the average time from the invoice date to the date paid.*

CALCULATION

$$\frac{\text{Total Flow of Funds}}{\text{Total Funds Applied}}$$

3.2 Prior Month's Past Due Collected

Description: *This percentage expresses the amount that has been collected in the current month of the prior month's past due amount.*

CALCULATION

$$1 - \frac{\text{Current Months Past Due Age Categories}}{\text{Beginning Receivables of Prior Month}}$$

3.3 Percent Over 61 Days -- or Percent of Any Age Category

Description: *This figure expresses the percentage of Total Receivables that is 61 Days or more past due.*

CALCULATION

$$\frac{\text{Sum of the 61 Days and Older Categories}}{\text{Total Receivables}}$$

3.4 Bad Debt to Sales

Description: *This expresses the percentage of credit sales that were written off to bad debt. A lower percentage signifies that effective credit policies and procedures are employed.*

CALCULATION

$$\frac{\text{Bad Debt Net of Recoveries}}{\text{Credit Sales}}$$

Operational Performance Measurements

Operational performance measurements indicate how well the company, division, team and individual are performing. These are key measurements in ensuring that your Credit Operation is performing to an optimum level. In addition to monitoring these measurements will help identify areas requiring improvement.

4.1 Active Customer Accounts per Credit and Collection Employee

Description: *The higher the number of accounts per employee, the more efficient the use of technology and people.*

CALCULATION

$$\frac{\text{Number of Active Customer Accounts}}{\text{Number of Total Department Employees}}$$

4.2 Active Customer Accounts per Credit Representative or Collector

Description: *The higher the number of accounts per employee, the more efficient the use of technology and people. (This is an individual measure.)*

CALCULATION

$$\frac{\text{Number of Active Customer Accounts}}{\text{Number of Total Credit Representatives or Collectors}}$$

4.3 Operating Cost per Employee

Description: *The lower the cost, the more effective use of technology and people.*

CALCULATION

$$\frac{\text{Departmental Operating Costs}}{\text{Number of Department Employees}}$$

Cost per Sales £

Description: *This calculation relates £'s spent in the credit and collection effort to credit sales generated, or how much it cost the company to process each £ in credit sales. A higher percentage signifies that a more effective operation is employed:*

CALCULATION

$$\frac{\text{Departmental Operating Costs}}{\text{Credit Sales}}$$

Final thought.

Is your cost per credit sales £ good? This question is relative. It could be answered by benchmarking with other organizations or measuring itself against its own past performance.

Benchmarking and measuring performance is an important aspect of business improvement. Knowing where you are and where you want to go is key, agreeing on which measurement to use equally important.

Most organisations will benefit from our approach to reviewing existing processes. Understanding where you are and where you want to go is the critical path to success.

NEXUM Contact us

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