

## How do you know where you're going if you don't know where you are?

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Managing a successful credit organization is a complex task. The management team has a number of crucial areas to supervise and monitor in order to ensure a successful and profitable operation that meets the demands of internal and external customers. Of greatest importance in the management of customer receivables is ensuring a high level of profitability while maximizing sales. So how do you know how you are doing?

Key Performance Indicators (or KPI's) are used to measure an organization's performance or its performance relationship to its own historical data or to other organizations. KPI's are used to determine the degree of change from where the relationship stands today to where it was in the past and to where the performance will need to be in the future. A KPI is often an established target, associated with a date and a path for improvement used in setting objectives or goals.

Without meaningful performance metrics, managers find it difficult to evaluate organizations, departments, processes and individuals. However, organizations that measure and manage performance, are much more likely to achieve operational and financial goals. Your ability to identify your organization's Key Performance Indicators is the first step in improving the overall performance of your credit and collections or revenue chain. Obviously, without the proper KPI's, it is nearly impossible to support continuous operational improvement.

Using Key Performance Indicators will allow you to manage by achieving of the following:

- Immediate Feedback up and down the operating staff;
- Information for preventive and corrective actions;
- Facilitation of ongoing process improvement;
- Identification of trends and alarms;
- Improved communication between different management levels.

### ***Why use Performance Measures?***

"Tell me how I'm being measured, and I'll tell you what my focus." An anonymous employee.

It is now clear that organizations that manage performance through measurement do better than those that don't -several recent studies confirm this. If people throughout an organization are well informed about their current and likely future levels of performance, and the factors that have contributed to those results, they can make more confident and more effective decisions.

Measurement-based management that is focused on objectives, issues and decision-making leads to success. Major benefits of performance management include:

- Better achievement of objectives. (Often objectives are exceeded.)
- Better and quicker decision-making. (Action is encouraged.)
- All staff are aligned to common goals and rewards. (Creating teamwork)
- Managers and staff have greater confidence and motivation. (How do you know where you're going if you don't know where you are?)

Business performance management ensures a management style that plans and acts to achieve strategic and operational objectives by measuring and monitoring outcomes and drivers. But, not all measurement

is good. Many organizations are in chaos because of a flood of mismanaged data that is irrelevant, too detailed, poorly integrated, difficult to access and of little value in making decisions. Too much data is just confusing! Some measures bear little relationship to what the organization is trying to achieve – they are not relevant to objectives. Other measures are misleading because their meanings are poorly understood, unclear or ambiguous. Irrelevant or misleading measures lead to poor, or even disastrous, decisions. As an example, DSO, for all its popularity, is one of the most improperly used metrics in business.

There are dozens of KPI's that are used to monitor sales, credit and collections, order activity and performance, and product distribution activities. Clearly illustrated in CRF's publication Management Reports, nearly 20 sample performance reports and their use are demonstrated. These are easily reproduced in spreadsheet format. This is 65 page publication is available from the NACM bookstore on line at [www.NACM.org](http://www.NACM.org) (click on Bookstore).

Focusing on the area of credit and collections however, there is what might be called Super Key Performance Indicators of interest to credit managers. The Credit Research Foundation has, for each quarter since 1958, focused on six simple performance measures in its survey called the National Summary of Domestic Trade Receivables. Each quarter the survey examines by industry, Collection Effectiveness Index (CEI), Days Sales Outstanding (DSO), Best Possible DSO (BPDSO), Average Days Delinquent, (ADD), Percent Current and Percent over 91 days past due. These KPI's allow businesses to benchmark their own performance against others within and outside their industry and more importantly, against themselves from period to period. Hundreds of companies compare their performance continuously each quarter in a quick and systematic way. This survey, free to participants, the NSDTR is a quick A/R health check. Moreover as companies introduce new management practices or enter into new markets the Super KPI's provide a means of monitoring these impacts. The following is a brief definition of each of the Super KPI's measured in the NSDTR survey along with some self-assessment questions you may want to ask yourself.

1. Collection Effectiveness Index - This figure expresses the effectiveness of collection efforts over time. The closer to 100 percent, the more effective the collection effort is. It is a measure of the quality of the collection of receivables.

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

*\*N = Number of Months*

CEI can be used as a departmental or individual performance measure.

2. Days Sales Outstanding - This figure expresses the average time (aggregate), in days it takes a firm to convert its accounts receivables to cash. DSO is one of the most often misused and misunderstood performance measures. Widely used (or misused) in corporate valuation on Wall Street makes this an important metric for the credit manager to understand. It's value lies in the ability help 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 composed of: terms (the future & current receivables), delinquent invoices and operational errors, service and quality problems, disputes and customer dissatisfaction (deductions). But like any measure, if it is used consistently and routinely, it has value.

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

By calculating your company's DSO and comparing it to others in your industry, you may be prompted to ask yourself these questions: Are credit terms in line with competitors? Are they enforced? Are collection procedures appropriate? Is the customer base risky? Are invoices issued promptly and correctly? Are invoices easily understood to avoid disputes and encourage prompt payment? Would early payment discounts be cost effective? Can product or service quality be easily disputed? Are customers dissatisfied?

3. Best Possible DSO - This figure expresses the best possible level of receivables under the most favorable condition – A/R with no delinquency. This measure should be used together with DSO. The closer the overall DSO is to the Best Possible DSO, the closer the receivables are to the optimal level, and therefore should relate closely to your terms of sale.

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

4. Average Days Delinquent: ADD reflects the average number of days invoices are past due. It provides a snapshot to evaluate individuals, subgroups or overall collection performance. However, it can be deceiving by masking the performance of delinquent accounts if other accounts are discounting their bills.

Formula: 
$$\text{DSO} - \text{Best Possible DSO}$$

Like the many measures, there are flaws and biases, however, used consistently and routinely, these DSO related measures can be indicators of performance and can be an early warning sign by pointing out problems.

5. Percent Current - Reflects the relationship of non-past due receivables (current and future) to total receivables outstanding. It can be used in forecasting receivables condition and workload at a staff or individual level. Percent current is a quick check-up on the relative condition of receivables. It is easy to understand and calculate.

Formula: 
$$\frac{\text{Ending Current A/R}}{\text{Total Receivables}}$$

6. Percent over 91 Days – There's nothing special about the period of over 91 days, except that it represents CRF's consistent methodology for over 45 years in the NSDTR which makes it a valuable benchmark. You can use whatever aging category suits your needs. This measures a specific overdue period of invoices and expresses it as a percentage of total receivables. It represents a good comparative measure of receivables condition and can focus and alert management to unusual increases in A/R requiring prompt attention. This metric can be used to evaluate individuals or groups and is simple to calculate and easy to understand.

Formula: 
$$\frac{\text{Total Amount in the Over 90-Days and beyond Category}}{\text{Total Receivables}}$$

Upon calculating the % over 91 days past due, some questions that you may need to answer are: Are the reasons for late payment analyzed and understood? Are late payers monitored more closely? Is some late payment tolerated? Would discounts have an impact on speeding up collections?

### ***You can't control what you don't measure***

Choosing the key performance metrics that bring the most measurable benefit to your organization can vary substantially from organization to organization due to the uniqueness of each business. However, measuring and understanding the results, then further communicating them to staff and senior management is a requirement for success.

The process of credit and collections (and order to cash for that matter), lends itself very conveniently to improvement initiatives. By measuring statistically, the components become easily accessible due to their tangible performance nature. By focusing on the relevant, meaningful statistics you choose to manage your business, you can achieve a sense of knowledge about activities that may not have been previously realized.

*By knowing where you are, you will know where you are going.*