WHITE PAPER

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Beyond the Numbers: The Art of Measuring Modern Credit Department Performance

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Key Findings

- 65% of credit departments surveyed by NACM use DSO to measure performance despite its limitations.
- Metrics help define the grey areas within which credit professionals often work.
- Metrics other than DSO exist to measure AR health more accurately. However, if you must track DSO, use it to your advantage by creating attainable goals.
- Measuring the wrong results can have a negative impact on accounts receivable performance.
- The formulas used to measure efficiency have not changed, but the strategy to drive improvement using metric findings is different today and will continue to evolve.
- Every metric should drive an action in the credit department, otherwise it is meaningless.
- Tracking meaningful metrics can unlock success by helping the credit team reach goals, gain recognition and run at the highest efficiency.
- It can be easy to become numbers-driven and lose sight of the strategy those numbers are meant to represent.

Overview

In the credit industry, there is rarely a clear right or wrong approach to any given situation. Credit professionals are tasked with using their best judgment to find solutions to complex problems. This makes measuring credit department performance both challenging and necessary.

A wide range of formulas exist to measure the ever-expanding list of tasks that fall under the responsibility of credit managers. While the formulas themselves have not changed, the strategy to drive improvement using metrics is different today and will continue to evolve. Days Sales Outstanding (DSO), for example, is a metric commonly requested by senior management. However, credit professionals should know that better metrics exist to accurately measure AR health. If you must track DSO, use it to your advantage by creating attainable goals.

Metrics help tell a clear story about different parts of the order-to-cash process, and tracking meaningful metrics can unlock success by helping the credit team reach goals, gain recognition and run at the highest efficiency. But measuring the wrong results can have a negative impact on accounts receivable performance.

Driving Credit Decisions with Meaningful Metrics

Every metric should drive an action in the credit department, otherwise it is meaningless. Use the results to steer the credit team in the right direction and prioritize tasks, just as you use the dashboard of a vehicle. For example, when the gas gauge gets low, you stop to fuel up. When the odometer reaches a new high, you change the oil. When the check engine light comes on, you take your vehicle to a mechanic. What resources do you rely on in credit to chart a new strategic route?

Metrics help define what tasks need to be improved first and what is already working efficiently. If your low gas light came on at the same time as your check engine light, which one would you fix first? Apply that logic to the credit profession and it works the same. If Bad Debt as a Percent to Sales and % of Invoice Accuracy were both declining, what is your plan for improvement?

Don't drive your credit department while looking in the review mirror. It is crucial to track some forward-looking metrics so your department is always working toward a future goal. This will allow you to maintain as much control as possible over the performance of accounts receivable and help trade credit professionals make informed decisions. When possible, choose metrics that lead rather than lag so you can reach future objectives. NACM's Credit Managers' Index, for example, can help credit professionals anticipate changes in the economy.

When a metric is no longer meaningful or relevant, retire it. Many companies often fall into a trap of complacency. But it is crucial that performance assessment systems change with the times. For example, the pandemic sparked some credit departments to start tracking the amount of customers who requested longer terms because the team wanted to stay ahead of cash flow issues. Others started focusing on the DSO of individual customers. Some metrics might be more helpful to track during recessionary times opposed to normal economic times.

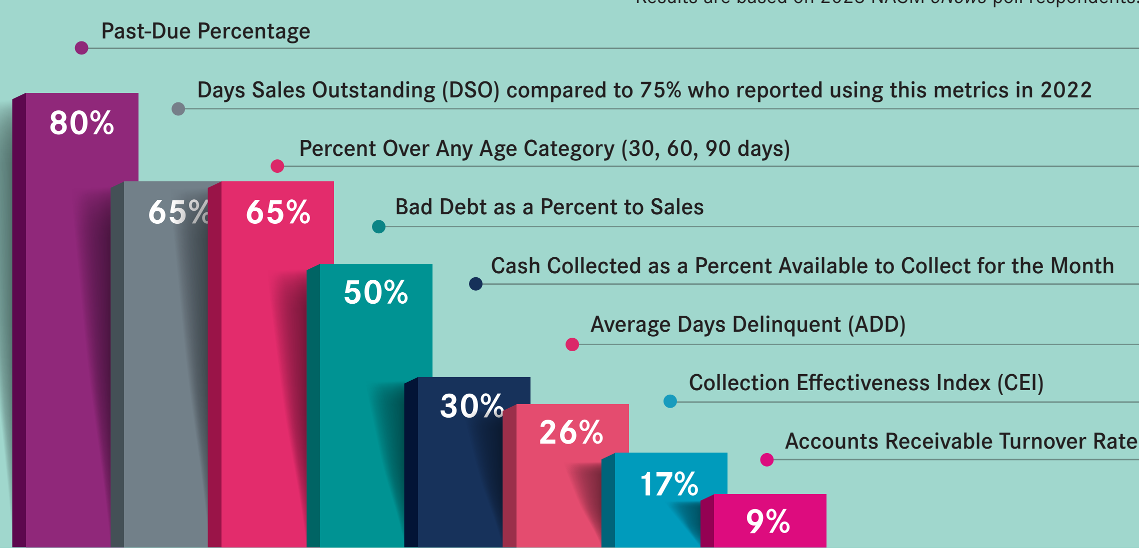
The metrics you track should change at different stages of business life. In the early stages, performance is all about survival and cash availability. But as a company matures, the focus should include profit and future growth in addition to cash. So, do not be afraid to retire a metric if it no longer serves a purpose or to start measuring new tasks that actually matter.

More is not always better. Credit is a complicated function of business that cannot be measured by a single metric. But tracking too many metrics can water down results and muddy the important picture. For example, the dashboard of your car only displays the metrics most important to driving, and your credit department dashboard should do the same. Focusing on the metrics that align with your department goals can help reduce errors, improve customer service, reduce costs, reduce bad debt, improve cash flow and increase productivity. But tracking the wrong metrics can waste time, add confusion and limit the credit department from reaching its full potential.

Whether it is Excel or PowerBI, it does not matter the platform used to track performance. It only matters that you can clearly find and interpret the data, and are measuring appropriate results. By tracking multiple metrics over a period, you can compare and watch as the credit department changes. Focusing solely on the number is a misuse of metrics. Instead, focus on improving processes within the credit department for a better outcome. It also is important to understand the connectivity and correlation between the various metrics.

How Others Measure Credit Department Performance

Results are based on 2023 NACM *eNews* poll respondents.



Quick Formulas

Past-Due Percentage $= \dfrac{\text{Overdue Invoices}}{\text{Total Receivables}} \times 100$

Days Sales Outstanding (DSO) $= \dfrac{\text{Ending Total Receivables} \times \text{Number of Days}}{\text{Sales}}$

Best Possible DSO $= \dfrac{\text{Current Receivables} \times \text{Number of Days}}{\text{Sales}}$

Sales Weighted DSO $= \dfrac{\text{Aged Receivables for Each Month}}{\text{Comparable Sales Figure for Each of the Aging Brackets}} \times 30$

True DSO $= \dfrac{\text{Invoice Amount}}{\text{Net Sales for the Month in Which the Sale Occurred}} \times$ Number of Days from Invoice Date to Reporting Date

DSO AR Composition $\dfrac{\text{Year-to-Date Revenue}}{\text{Year-to-Date DSO Sales}} \times 1 \text{ Month} = 1 \text{ Day of DSO \$}$

Divide the 1 Day of DSO $ value into the total AR dollars for the aging categories you want to track for trends or improvement to derive the number of "days" in each category.

Your company may also want to modify the formula to reflect YTD or 90-day value of 1 Day of DSO $.

Percent by Age Category (30, 60, 90, future, current, past-due buckets) $= \dfrac{\text{Total Amount in Chosen Age Category and Above}}{\text{Total Receivables}} \times 100$

Bad Debt as a Percent to Sales $= \dfrac{\text{Bad Debt Net of Recoveries}}{\text{Sales}} \times 100$

Cash Collected as a Percent Available to Collect for the Month

$$\frac{\text{Amount Collected Within the Month}}{\text{Amount Available to Collect (e.g. Current Receivables + Past Dues − Deductions)}} \times 100$$

Average Days Delinquent (ADD) = Days Sales Outstanding – Best Possible Days Sales Outstanding

Collection Effectiveness Index (CEI)

$$\frac{\text{Beginning Receivables + Monthly Sales − Ending Total Receivables}}{\text{Beginning Receivables + Monthly Sales − Ending Current Receivables}} \times 100$$

Accounts Receivable Turnover Rate $= \dfrac{\text{Net Sales}}{\text{Average Accounts Receivable}}$

Percent of Invoice Accuracy $= \dfrac{\text{Number of Accurate Invoices}}{\text{Total Number of Invoices}} \times 100$

Dive Deeper

Days Sales Outstanding (DSO) is still widely recognized and used in the trade finance industry despite its limitations. Still, the data suggests that credit professionals are increasingly relying on alternative metrics to measure performance. Senior management often request DSO measurements because they are familiar with it.

Pros:

- It is a relatively quick and understood metric.
- Measures liquidity of receivables and terms extensions.

Cons:

- Heavily influenced by actions outside of the AR department, such as sales.
- Does not accurately represent AR performance when used alone and is misleading.

Best Possible DSO should be as close to your Standard DSO as possible in order to represent healthy cash flow. Best Possible DSO helps identify whether collection problems are with your current accounts or with those in the past and defines how well your credit policies are doing in the present.

Pros:

- Can help you decide if your process is working well on a real-time basis.
- When tracked consistently with Standard DSO, can paint a more accurate picture of AR performance.

Cons:

- Number can fluctuate quickly, like Standard DSO, based on external factors.
- Holds little value when tracked sporadically on its own.

DSO AR Composition takes open AR dollars in designated aging categories and converts it into days. This metric can be used for past, current and future buckets to calculate DSO days by bucket.

Pros:

- Can be used to set more specific and realistic goals for the credit department, such as days improvement associated to "past dues" vs. total AR.

Cons:

- Is still a function of DSO that can be influenced by external factors.

Sales Weighted DSO provides a more accurate way to measure a credit department's collection effectiveness because it removes the impact payment terms and sales have on Days Sales Outstanding formulas.

Pros:

- Mutes the impact of sales bias by weighing age categories.
- Identifies trends in customer payment behavior.

Cons:

- Is one of the more complicated calculations and can be difficult to understand.
- Can be skewed by large sales orders.

True DSO focuses on measuring the period between an invoice issue and the actual payment date. It gives an objective view on customer payment habits on an individual level.

Pros:

- Can paint a picture of future payment dates if tracked over a long period of time.
- Unbiased to sales because it tracks each invoice to the month of the sale.

Cons:

- Could be calculated based on paid invoices.
- Time-consuming for companies with a high volume of invoices.

Percent by Age Category (30, 60, 90, future, current, past-due buckets) defines the percentage of total receivables that are X days or more overdue.

Pros:

- Alerts department to abnormal increases in delinquent accounts.
- Straightforward measurement of receivables health.

Cons:

- If the quantity of aging buckets is too limited, this measurement is not as helpful. You need older buckets to know what needs attention. Define the buckets that make the most sense for your business and the behavior change you are driving.

Bad Debt as a Percent to Sales defines the percentage of credit sales that were written off to bad debt and can signify the effectiveness of credit procedures.

Pros:

- Straightforward measurement of receivables health.

Cons:

- Is an estimate and may not reflect actual losses, as it does not include potential future collections of past-due accounts.

Average Days Delinquent (ADD), also known as delinquent days sales outstanding, tells the credit department the average amount of time it takes for late payments to get collected and converted into cash. ADD is typically measured against standard DSO, and both should almost always trend in the same direction. If you see a high DSO and low ADD or vice versa, it likely means there has been a change in credit terms or AR cycle rather than an efficient or inefficient credit department. That's because changes to AR can affect DSO without affecting your ADD number.

Pros:

- Mutes some impact of sales.
- Helps the credit department predict default rates, project cash flow and improve communication with customers.

Cons:

- Consists of DSO and Best Possible DSO, two measurements still highly impacted by sales numbers.
- Does not take differing terms of sale or dating into account.

Collection Effectiveness Index (CEI) measures the quality and effectiveness of collection efforts over time. The closer the index is to 100%, the better the collections effort.

Pros:

- Neutralizes sales bias by using sales in both the numerator and denominator.
- Measures effectiveness of collection efforts, including invoices available to collect and already collected.

Cons:

- Relatively new measurement and is not expressed in days.
- Does not take differing terms of sale or dating into account.

Accounts Receivable Turnover Rate measures how quickly collects its outstanding debts. The higher the number, the more frequent a credit department is collecting receivables. It also could indicate a conservative credit policy, such as net-20 days.

Pros:

- Can help identify if an AR team is understaffed or too reliant on manual processes.

Cons:

- Not useful to compare this metrics with departments in other industries because payment terms will be different. For example, construction and manufacturing typically have longer terms than retail.
- Customers who pay unusually early or late can skew results.

Reporting Data to Senior Management

Whether reporting metric findings to senior management on a daily, weekly or monthly basis, it is crucial to present the data in a clear and concise manner that accurately represents the health of accounts receivable.

1. Be sure to highlight key trends, accomplishments and any issues. This is your opportunity to influence senior management and make an impression.

2. Don’t just report the numbers—tell a narrative. Start with a high-level overview of the data before drilling down into each metric and what it means, but be cognizant of your audience.

3. Include as many visuals as possible (graphs, charts, tables, videos, images) to help illustrate the data points in a memorable and easy-to-understand approach.

4. Provide context to help emphasize the significance of the data, including how it measures against competitors, external factors and the entire industry.

5. Make recommendations and create an action plan for next steps that can address any issues or opportunities the data revealed.

Insight gathered from NACM’s Thought Leadership Groups and weekly *eNews* poll questions made this white paper possible. Member participation is critical for our ability to gather accurate data and write quality articles. We thank the members who are generous with their time and invite our Editorial Team to engage in further discussion. To learn more about our Thought Leadership Groups, please contact Tracey Lerminiaux at traceyL@nacm.org or 410-423-1830.