Executive Exchange: Performance Metrics

Moderator: Wanda Borges, Esq.
Panelists:
Larry Lipschutz, CCE, CICP
Kathryn Marsh, CCE, CICP
Dennis Walsh, CCE, CEW
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WHAT ARE PERFORMANCE METRICS ANYWAY?

- What should we be measuring?
- What can using the appropriate measures of performance accomplish?
- Key Measures?
  1. DSO
  2. Best Possible DSO
  3. Bad Debt
  4. Current A/R vs. Past Due A/R
  5. Collection Effectiveness Index
  6. Cash Collected
  7. Deductions
  8. Risk Exposure
DAYS SALES OUTSTANDING

- Should this be primary performance metric?
- Flawed yet management still wants it?
- Often Misunderstood
- Better for finance than credit?
Days Sales Outstanding DSO

• **Pros**
  – Measures Actual Age of the Asset
  – Management wants it
  – Creates a Trend analysis
  – In itself not a bad metric

• **Cons**
  – Credit departments hate it but everyone uses it!
  – Misunderstood by management as a collector’s performance metric
Best Possible Days Sales Outstanding

- **Definition:** This figure expresses the best possible level of receivables. TIP this measure should be used together with DSO. The closer the overall DSO is to the Best Possible DSO (Average Terms Based on Customer Payment Patterns), the closer the receivables are to the optimal level.

- **Formula:**

  \[
  \text{Current Receivables} \times \text{Number Days in Period Analyzed} \div \text{Credit Sales for Period Analyzed}
  \]
PERCENTAGE OF BAD DEBT AS A PERFORMANCE METRIC

- Is there a good percentage of bad debt for a company to have?
  - Industry Driven
    - Local Credit Groups
    - Industry Benchmarking
  - Factors to consider
    - Bankruptcy
    - Cyclical review
    - Profit Margins
    - Management Tolerance for Bad Debt
MEASUREMENTS FOR BAD DEBT

- Match Bad Debt to Revenue
- Justify sufficiently
- Do not overstate
- Frequency
- Reserve Analysis system for each customer
  - Adjust as necessary
  - Special circumstances
  - Potential bankruptcy
PERCENTAGE OF PAST DUE AS A PERFORMANCE METRIC

Question Raised: “We are being asked to be below 11% as a percentage of sales”

Panelists’ Viewpoints:
- Should be viewed as a percentage of receivables
- Need to take periodic snapshots
  - 15 days
  - 30 days
  - 90 days
- Factors to consider
  - Trend analysis
TOP COLLECTION PERFORMANCE METRICS

- Collection Effectiveness Index
- Collection range
  - Collection performance versus collection forecast
    - Over credit or under collected
- Collection performance by collector
  - Past due percentage
Collection Effectiveness Index [CEI]

- **Definition:** 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.

- **Formula:**

  \[
  \text{Beg Rec} + \frac{\text{Credit Sales}}{N} - \text{End Total Rec} \\
  \times 100
  \]

  \[
  \text{Beg Rec} + \frac{\text{Credit Sales}}{N} - \text{End Current Rec} \\
  \times 100
  \]

  \(* N = \text{Number of Months or Days}*\)
Other Collection Metrics

- Total Cash Collected
  - Compare to previous period
  - Compare to same period previous year
- Cash Collected as a percent of beginning AR
- Cash Collected as a percent of available AR
  - Subtract from beginning AR all invoice due beyond the end of the accounting period
Prior Month’s Past Due Collected

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

- **Formula:**
  
  \[
  \left[ \text{Current Months Past Due Age Categories} \right] 
  
  1 - \text{Beginning Receivables of Prior Month less any invoices not due by end of current period}
  \]
MOST VALUABLE METRICS FOR CREDIT ANALYSTS

- Different from Collection Metrics
  - Is the credit analyst processing enough?
  - Turnaround time?
  - Each Department has to decide what is important
CAN INCENTIVE PROGRAMS BE USED AS PERFORMANCE METRICS?

- **OPINIONS:**
  - No – incentives should be based on collections
  - Collection Effective Index – a good place to start

- **Collector Efficiency Index**
  - Accurately measures collection effectiveness
  - Not swayed by sales

- **BPDSO**
  
  \[
  \text{Current AR} \times \frac{\text{Number of days in period}}{\text{Tot AR}}
  \]

- **ADD**
  - Measures the difference between the DSO and BPDSO
BAD DEBT RESERVES

- Calculating Bad Debt Reserves
  - Fluctuation in Sales
  - Fluctuation of accounts’ receivable
- Expense Bad Debts
- Adjust reserve each month
  - Remove or add specific accounts
    - Calculate reserve based on aging buckets
SHARED SERVICE CENTERS

- Shared Service Center Metrics
- In-House Metrics
- Centralized Credit & Collections Department
- Credit Controlled at Headquarters
- Is Credit or Sales Controlling?
SUPPLIER RISK MANAGEMENT

- Similar to Customer Risk Management?
- Identical to Customer Risk Management?
- How are credit metrics used in relation to Supplier Risk Management?
SCORECARDS

- Are these necessary to establish a credit matrix?
- Using a credit scoring model

Effective Scorecards
  - Customer scorecard
  - Employee scorecard

Direction for self-development scoring matrix

Assigning credit scorings to credit analysts
IN–HOUSE SCORING MATRIX
[ART V. SCIENCE]

Advantage:
Totally Objective

Disadvantage:
Inhibits use of personal judgments
Industry comparisons

Comment Posed:
- Nice to see some of the Industries compared/trended/regionalized (Collection Effectiveness, Bad Debt, DDO)

Panelists’ Responses and/or Recommendations
- Specific Industry Organizations
- CRF
- Others