Effective Measuring Tools

by: Josef Busuttil
MBA (Henley); DipM MCIM; FICM
Director General
Malta Association of Credit Management
e-mail: jbusuttil@macm.org.mt

DSO is the tool widely used by businesses in all the four continents to measure the performance of the credit management function. However, in my humble opinion, if a credit department uses DSO as the only measuring tool, it will be neither effective nor profitable to the business organisation as a whole.

When using DSO, the tool has to factor in the Revenue *(Turnover)* figure somewhere in the equation, because DSO on its own has little or limited value. My suggestion to the credit practitioners however, has always been to use other Financial Ratios, both to measure their own finances, as well as to analyse and measure the finances of their customers; and to make use of KPI's to help the credit practitioners gain and sustain competitive advantage in the market whilst continuously improve the internal systems and performance.

I will try to explain both the Financial Ratios and why each particular Ratio is important, as well as how to use KPI's in an effective and meaningful manner:

Profitability Ratios

To evaluate the level of profit of an organisation, profit must be compared to another aspect of the business, which include the amount of capital invested in the business, and to the sales revenue:

1.

$$\text{Net Profit Margin} = \frac{\text{Net profit before interest and taxes}}{\text{Sales Revenue}} \times 100$$

This ratio measures ***the trading profit relative to the sales revenue*** of the business. Thus a profit margin of 7% means that every €1.00 of sales revenue generates €0.07 in profit before interest and taxes. *This should obviously be compared with the industry norm to evaluate the efficiency of the company within its industry.*

2.

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{Net Profit before interest \& Taxes}}{\text{Total Capital Employed}} \times 100$$

This popular ratio measures the general management performance in relation to the capital invested in the business. Capital Employed is defined as the investment required to enable a business to function efficiently. i.e. Current Assets less Current Liabilities.

Solvency Ratios

Solvency ratios, or short-term liquidity ratios as they are referred to, evaluate the ability of a company to meet its short term financial commitments (Current Liabilities) such as Creditors, Bank overdrafts, PAYE, VAT and any other liabilities which falls due within the next 12 months.

3.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

This ratio evaluates the ability of a company to meet all its current liabilities by converting its current assets to cash. Therefore, *the Current Ratio should be always greater than **1**.*

4.

$$\text{Acid Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

The Acid Ratio provides a more realistic measure than the Current Ratio because Stock and Work-in-progress are deducted from the Current Assets. Therefore, it recognises that Stock is not always possible to convert it into cash at its full value.

5.

$$\text{Debtors Collection Period} = \frac{\text{Debtors}}{\text{Average daily Sales}}$$

No business wishes to extend the credit period given. The Debtors Ratio can be used as a monitoring tool *to measure how long your customers are taking to pay their debts.*

6.

$$\text{Credit Payment Period} = \frac{\text{Creditors}}{\text{Average daily Purchases}}$$

It is equally important to monitor how long is your company taking to pay its creditors. Late payment may easily harm your business relationship and cutting off credit facilities by your suppliers.

Gearing Ratios

Gearing Ratios or the Long-term Liquidity Ratios are concerned with the financial structure of the company. These ratios measure the extent to which ***the Capital Employed*** in the business has been financed either by the shareholders or through borrowing and other long-term finance.

7.

$$\text{Gearing Ratio} = \frac{\text{Long term Debt}}{\text{Equity + Long term Debt}} \times 100$$

The Gearing Ratio measures the percentage of Capital Employed that is financed by debt and long-term finance. It indicates the level of dependence on borrowing and long-term financing of a company. So, high level of gearing means high level of risk.

8.

$$\text{Interest Cover} = \frac{\text{Net Profit before Interest \& Taxes}}{\text{Interest Paid}}$$

The Interest Cover Ratio measures the Cost of Long-term debt relative to earnings. This ratio provides whether or not the company can afford the level of gearing it has committed to.

KPI's

KPI's is another effective tool as it measures not only the financial part but also the competitiveness and profitability of the business.

If KPI's is wisely used, it would help the credit practitioner to enhance the internal systems and procedures when granting and managing credit. It is also customer-friendly, as it considers the expectations and needs of the customers. Thus, helps in gaining competitive advantage and sustain customer loyalty. My personal fear in this tool remains that not all credit practitioners are aware of how to use KPI's. I will therefore try to shed some light on this valuable measuring tool:

KPI cannot be established without a clear understanding of what are the key components of the KPI:

- ***KEY,*** *as they are fundamentally important to gain competitive advantage.*

- *Related to* ***PERFORMANCE,*** *as they are clearly measured, quantified and easily influenced by the organisation.*

- *An* ***INDICATOR*** *, as they provide leading information on future performance.*

To plan and develop meaningful KPI's, it is critical to understand and establish benchmarks, which need to be specific to the organisation. Benchmarks can be established from statistical data extracted from:

- The Industry;
- Competition – similar organisations;
- Past Performance - internal statistics and figures, using Financial Ratios explained above.

Benchmarks are essential to set up KPI's as they put the level of current performance in context.

Therefore, since there is no two business organisations alike in terms of internal culture, values and corporate objectives, each and every business should establish its own objectives and strategies as to:

- How Competitive Advantage can be gained;
- How can Performance be quantified, measured and influenced;
- How can information on future performance be provided.

KPI's as a tool helps an organisation to define and measure performance in order to achieve its goals and objectives and gain competitive advantage in a more cost-effective and efficient manner. They are important to quantify the critical success factors related to the *Credit Management function*.

Nonetheless, KPI's should be clearly communicated to the sales and the credit teams and continuously referred to. If understood and accepted by both teams at all levels, KPI's will strengthen the shared values and create common goals for the sales and the credit departments. Thus, will help to create and maintain synergy between the two functions.

The Balance Score Card

This brings us to the Balanced Score Card, developed by Kaplan & Norton (1992).

The Balance Score Card combines the two tools as it takes into consideration both the financial and the non-financial aspects in order to satisfy the expectations of all the stakeholders.

	Credit Function Objectives	Measures
Financial	Cash Flow Reliability of Performance *'Debtors'* Management Profitability Capital available Competitors' credit financing	Cash Flow statement Sales backlog / Credit Authorisation Profit forecast Working capital Market credit trends (Financial Ratios)
Customer	Customers' requests & expectations Understanding customers Customer loyalty Customers' payment behaviour Customers' strength in the market Competitive credit terms Customers segmentation Motivated staff *(internal customers)*	Customer satisfaction index Hours spent with customers Repeat purchases Payment receipts history Market reports & customers' requests Credit terms index Market reports Staff appraisal - satisfaction
Internal	Generation & sharing of Information Communication systems Credit policy flexibility Credit worthiness analysis process Support activities Sales ledger process Sales-Credit Meetings Debtors' monitoring systems Collection systems	Employee survey Employee satisfaction Number of declined credit requests Employee survey Efficiency & effectiveness (Backlog) Number of meetings held Understanding each other's role Debtors' Reports Overdue accounts Report
Innovation & Learning	Empowered workforce Access to information Continuous improvement Efficiency in granting credit Authority levels Team work	Staff attitude survey Credit / Sales information availability Number of employee suggestions Cycle time *vs.* industry norms. Job description Internal relationship attitude survey

Conclusion

The current credit crunch gave us an important lesson that credit management is a critical business function, as Cash flow is the lifeblood of any business irrespective of the country and type of industry.

Yet, credit management, as a critical business function, has not been the subject of published research as much as it deserves. In my opinion, credit management in general suffers from a lacuna in practical research studies, and I go along with Adams *et al*, (1992) arguing that:

"…little attention has been paid by the academic profession, as compared with other financial decision, to the valuation of trade credit, i.e., the decision to grant credit…."