

# Tightening Credit Terms for Almost Free

## Working Capital Series

By Perry Tong

### Customer to Cash – Credit Term Analysis & Optimisation (Receivables)

How do we know if receivables are well managed to terms? Are we performing at our best? What if we are the best in industry according to external benchmarks? How may we then do better or is it possible at all? Credit managers often face these questions in the never-ending quest to collect to terms and to drive down terms where possible. An analysis of the customer master is requisite to answering these questions as well as to enable one aspect of credit term optimisation.

#### Customer Master Analysis

As firms grow a variety of factors lead to an accumulation of ‘multiple’ customer line items. These items are found or logged in the *customer master* (or equivalent in an ERP or accounting system) are the details for each customer including entity name, billing details, terms and other notes that relate to the customer. We have found common errors in both paper and IT based systems of firms we have worked with and these include:

- 1 customer listed multiple times due to spelling differences or billing/contact address differences
- Multiple differing terms due to numerous customer listings from the point above though this results more often as a result of legacy resulting from personnel turnover
- Both points above are found as a result of M&A activity where names, addresses and terms are inherited or grandfathered

Understanding this level of detail permits one to commence investigation into terms granted to a customer from the working capital management perspective. Conducted either together or apart from an aged trial balance for third party receivables this analysis allows the firm to ‘clean’ up administrative details such as multiple names for a single entity (see ‘client’ in table below). Sales is often involved in this project to enable an organisational understanding of where the client stands and should stand. A cross functional and cross-business unit project - customer analysis enables a common understanding among different business units that may be selling to the same client.

The optimisation that occurs upon analysis of the customer master is that of simplifying billing (to a single entity as opposed to multiple entities) and reducing the opportunity for disputes (spelling error, legal name error, billing address errors etc) that delay payment.

## Terms Analysis (BPDSO)

Client	Terms	Real Terms	Total AR	% of AR	% AR * Real Terms
ABC Co. Ltd.	30	30	7,854	18%	5.3
abc Co. Ltd.	30	30	5,643	13%	3.8
Abc Co. Ltd.	15	15	8,982	20%	3.0
AbC Co. Ltd.	45	45	5,956	13%	6.0
ABC co ltd	45	45	9,091	20%	9.1
ABC Company Limited	90	90	2,453	5%	4.9
ABC Company Ltd.	30 EOM	45	4,879	11%	4.9
Total AR for Single Entity			44,858	100%	
Average Terms for Single Entity	42.86				
<b>Weighted Terms for BPDSO</b>					<b>36.94</b>

Table 1: Sample of Terms Analysis for a single customer

A derivative of fields from both the customer master as well as current receivable data we are able to calculate what an appropriate *Best Possible Days Sales Outstanding* (BPDSO) would be.

This is performed by aggregating the receivables found listed across the differing 'entities' that repre-

sent one client or one segment.

Table 1 demonstrates the receivable data put together with the customer master and 'open' or 'uncollected' receivables data. Adding all weighted terms (% AR \* Real Terms) for this particular customer, represented by 7 recorded entities, yields a summed number of 36.94. BPDSO therefore represents in real terms that at this point in time there should be not more than 36.94 days worth of sales in terms of uncollected receivable for this customer – with the assumption that all receivables are paid on time and in full. This is despite that there are a variety of terms ranging from 15 days through 90 days.

BPDSO is far more accurate since there is a weightage assigned to the outstanding receivables, unlike a simple average terms analysis – 42.86 days outstanding in Table 1 – which many credit managers are prone to use as a measure of best possible performance when faced with a multi-credit term customer.

## Term Optimisation

Combining the customer master file analysis reveals terms that a customer already finds acceptable. For sales conducted across multiple business units (supplier and customer) this information represents an optimal credit term which the customer finds acceptable. A Terms Analysis yielding a BPDSO tightens overall credit terms and assists credit managers as well as sales persons to keep customers on a well defined credit scheme.

BPDSO is also a useful indicator for best possible internal performance (internal benchmark) especially when one may already be performing at relative industry 'best.'

For several clients with whom we have performed Account Receivable projects for this portion of the project yields:

- An overall tightening of terms by 10% to 35% resulting in and from simplified credit schemes for customers – resulting in quicker cash in and also lower operating costs as a result of less conflicts and confusion between sales and finance
- An ability to forecast cash requirements resulting from open AR (a portion of cashflow forecasting)
- Management's ability for clearer insight into customer behavior and opportunity to formulate strategic sales deals utilizing credit as a facility responsibly
- An ability to gauge AR and credit term performance particularly when external benchmarks are no longer applicable

## About the Author

**Perry Tong** is the Singapore-based Managing Consultant for Centre for Organisational Effectiveness Pte Ltd, a management consulting company focusing on the Asian Market. He helps companies in Asia, Europe and North America understand the importance of process improvement with impacts on working capital as a primary objective and increased customer service levels as a secondary objective. He has extensive experience in implementing process and organisational improvements for various industries. Perry can be reached at [Perry.Tong@COE-Partners.com](mailto:Perry.Tong@COE-Partners.com)