Jindal Healthcare

Which key metrics should you measure and monitor to improve accounts receivable?

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Introduction

Any business's driving force is its cash flow. Although revenue may appear impressive on paper, it means nothing if sales aren't translating into real money. This can seriously impact your capacity to develop and function normally. The Accounts Receivable (AR) function is essential in preventing this. A proficient accounts receivable department guarantees precise customer payment collection, maintaining a healthy cash flow and smooth business operations. However, having an AR department alone is insufficient. You must track and measure the appropriate metrics to properly optimize AR performance.

This eBook will give you the information and resources you need to accomplish that. We'll examine the key performance indicators (KPIs) offering insightful information about how well your AR procedures work. You'll be able to apply data-driven strategies, spot areas for improvement, and eventually improve your bottom line by comprehending these metrics. This guide will offer important metrics, how to compute the metrics, and doable tactics for enhancing your AR performance. Now let's get started and see how powerful data-driven AR management can be!

Core AR KPIs

The goal of debt collection management is to have invoices paid. It requires keeping an eye on collections and sending out the appropriate reminders to recover your client receivables. The business may choose to handle these tasks in-house or assign them to a collection agency. Therefore, if the collection is handled internally, it is worthwhile to examine the action's performance. Examining operational performance helps you manage your team and may indicate some processes that need to be reviewed., it is a good idea to keep an eye on the actions being taken and to have indicators available to better manage your cash flow when a collection agency is involved.

Several KPIs (Key Performance Indicators) are available for businesses to assess how well their cash flow procedures are working. At both organizational levels, managing and operational, use DSOs. Managers may benefit more from others, such as credit managers, financial directors, and administrative staff. The PWC guide on key performance indicators advises that, typically, companies find that between four and ten measures are most effective as core metrics, rather than prescribing a specific number of KPIs to adopt.

Days Sales Outstanding (DSO)

The average number of days needed to collect payment after a credit sale is represented by DSO. It is therefore also known as "Average Debtor Days." By dividing the average daily sales by the average debtor days, one can find the average debtor collection period formula. The term "Average Debtor Days" describes the middle number of days that pass between sending out invoices and getting paid by a client. A low Days Sales Outstanding (DSO) or a short average debtor collection period enhances the cash convert cycle by indicating efficient client receivable collection. High DSO may be a sign of cash flow issues and ineffective collection techniques.

The DSO formula is simple to calculate, it is the difference between your gross sales for the same period and your account receivable at the end of the period. This figure can be multiplied by the total number of days in the period. To ensure that you can evaluate and adjust your strategy as needed, you must have a strong understanding of the debtor collection period.

Days Payable Outstanding (DTO)

DTO is the inverse of DSO as it helps to measure the average time it takes the company to pay its suppliers. The formula is as follows: opening inventory + purchases – closing inventory.

If you have a high DPO you can hold cash longer and invest in the short term for higher returns. However, a very high OPD may also indicate that your credit conditions may be at risk in the future. A low Days Payable Outstanding (DPO) may indicate that your company is not fully utilizing available credit terms or effectively negotiating favorable terms. Like DSO, DPO can differ across industries. Generally, a creditor period of around 30 days is regarded as an optimal DPO.

Accounts Receivable Turnover (ART)

The accounts receivable turnover rate provides insight into how well a company collects debts. It can be calculated by dividing the average number of accounts receivable during a specified period by net credit sales. This rate reflects how often receivables are transformed into cash within that time frame. It is also known as the turnover rate for accounts receivable. Businesses that have a high ART are more successful in collecting their receivables. Businesses with a low ART either struggle to collect their receivables or give their clients unnecessarily long terms for payments. To accurately assess your collection period, you must also understand the formula used for the collection period. The accounts receivable turnover ratio and average collection period ratio are closely related as well in providing insight.

You can determine the average time it takes to collect payments using this calculation, which starts when the invoice is issued and ends at the payment receipt. A shorter average collection period is better as it indicates that accounts are being settled quickly. A long-term averagereceivables collection period suggests that you are having problems getting your accounts paid. An elevated average collection period ratio may suggest that there is a problem with your cash flow.

The formula for calculating the accounts receivable collection period is as follows: Days x Average Accounts Receivable / Net Credit Sales = Average Collection Period Ratio.

Additional AR Performance Measures

Beyond the core KPIs such as DSO and ART, a comprehensive understanding of your AR health requires looking at some additional performance measures. These metrics provide deeper insights into specific aspects of your collection process and customer behavior.

Collection Effectiveness Index (CEI):

This metric goes beyond just speed and measures the actual percentage of collectible revenue your AR team recovers. It considers both the number of outstanding invoices and the amount collected within a specific period.

Calculation: CEI = (Total Cash Collected During Period / Total Accounts Receivable at Beginning of Period) x 100%

Interpretation: A high CEI indicates your team is effectively collecting what's due. A low CEI might suggest inefficiencies in the collection process, potential bad debt, or issues with customer creditworthiness.

Bad Debt Ratio:

This metric tracks the percentage of AR that you have to write off as uncollectible. It reflects the effectiveness of your credit risk assessment and collection efforts.

Calculation: Bad Debt Ratio = Total Bad Debt Written Off During Period / Total Credit Sales During Period

Interpretation: A low bad debt ratio is desirable, indicating strong credit controls and successful collections. A high ratio suggests potential problems with creditworthiness assessment, collection procedures, or a need for stricter customer payment terms.

Customer Satisfaction with AR Processes:

Although not a conventional KPI, customer satisfaction with your AR practices is an important area to consider. Practices such as timely and accurate invoicing, clear communication regarding outstanding balances, and providing user-friendly online payment options significantly enhance the customer experience.

Methods to Measure:

1. Conduct customer satisfaction surveys to gauge their experience with invoices, communication, and payment options.

2. Monitor social media sentiment and address any customer concerns related to AR processes.

3. Track the number of customer inquiries related to invoices or payments

By monitoring these additional measures alongside core AR KPIs, you gain a more comprehensive view of your AR performance. You can identify areas where customer experience can be improved, potentially leading to faster payments and a stronger relationship with your customers.

Core AR KPIs: The Foundation for Improvement

For any business, a smooth flow of cash is essential for survival and growth. A common challenge lies in bridging the gap between revenue generation and actual cash in hand. This gap represents AR, the money owed by customers for goods or services purchased on credit. An efficient AR function ensures timely collection of these payments, maintaining a healthy cash flow and fueling business operations. Several essential KPIs serve as the core for AR analysis. Let's explore these core metrics and how they can be leveraged for improvement:

Days Sales Outstanding (DSO):

This widely used metric reflects the average number of days it takes a company to collect payment after a sale is made.

Calculation: DSO = (Average Accounts Receivable / Total Credit Sales During Period) x Number of Days in the Period

Interpretation: A lower DSO indicates a faster collection of payments, leading to improved cash flow. Industry benchmarks and your company's historical data can help establish an optimal DSO target.

Strategies for Improvement:

1. Offer Early Payment Discounts: Incentivize prompt payments by offering discounts for early settlements.
2. Streamline Invoicing: Ensure invoices are accurate, detailed, and sent electronically for faster delivery and processing.
3. Implement Clear Payment Terms: Communicate payment terms and due dates on all invoices.

Accounts Receivable Turnover Ratio (ART):

This metric reflects how efficiently a company collects its outstanding receivables.

Calculation: ART = Cost of Goods Sold / Average Accounts Receivable

Interpretation: A higher ART indicates better collection efficiency, meaning the company is effectively converting credit sales into cash. ART can be compared with DSO to gain a more comprehensive picture. A high DSO with a high ART could indicate a company is selling a high volume of credit but might not be collecting efficiently.

Strategies for Improvement:

1. Tighten Credit Policies: Implement stricter creditworthiness assessments for new customers and review existing credit limits regularly.
2. Prioritise Collection Efforts: Focus collection efforts on overdue accounts, particularly those with high balances.
3. Automate Collection Tasks: Leverage technology to automate tasks like sending payment reminders and late-payment notices, freeing up staff for personalized communication with high-risk accounts.

Aging of Accounts Receivable:

This analysis categorizes outstanding invoices by their age, providing a detailed picture of your AR portfolio. Common categories include current (not yet due), 1-30 days past due, 31-60 days past due, and so on.

Interpretation: A significant portion of receivables falling into older delinquency categories could indicate potential bad debt or collection inefficiencies.

Strategies for Improvement:

1. Implement Early Intervention: Segment overdue accounts and implement early intervention strategies, such as personalized phone calls or emails, for accounts falling into delinquency buckets.
2. Develop a Collection Strategy: Create a structured collection process with defined escalation steps for increasingly overdue accounts.
3. Reserve Analysis: Regularly analyze reserved accounts for potential write-offs to maintain accurate financial statements and make informed decisions about future collections efforts.

Beyond the Core: Additional Measures for Holistic Insights

While core KPIs provide a strong foundation, a more comprehensive understanding of AR health requires additional performance measures. These offer deeper insights into specific aspects of your collection process and customer behavior:

1. Collection Effectiveness Index (CEI): This metric goes beyond speed and measures the percentage of collectible revenue recovered within a period. A low CEI suggests potential inefficiencies in the collection process, bad debt, or issues with customer creditworthiness.

2. Bad Debt Ratio: This metric tracks the percentage of AR ultimately written off as uncollectible, reflecting the effectiveness of your credit controls and collection efforts. A high ratio signifies weaknesses in these areas.

3. Customer Satisfaction with AR Processes: Customer satisfaction is enhanced by prompt and accurate billing, transparent information regarding unpaid amounts, and convenient online payment choices. Track client happiness and resolve issues to promote quicker payments and more solidified bonds.

From Data to Action: Implementing Strategies for Improvemen

Once you have a clear picture of your AR performance through KPIs, it's time to translate data into actionable strategies. Here's how:

1. Benchmarking: Compare your AR KPIs with industry standards and competitor data to identify areas where you might be lagging. This can provide valuable insights for improvement strategies.

2. Identify Areas for Improvement: Analyze your KPI data to pinpoint weaknesses in your AR processes. For example, a high DSO paired with a low CEI could indicate slow collection efforts or issues with customer creditworthiness.

3. Develop Action Plans: Create specific action plans to address identified weaknesses. This might involve implementing stricter credit policies, automating reminder emails, or training your AR team on better communication techniques for late payments.

4. Continuous Monitoring and Reporting: Track your progress toward established goals and continuously monitor AR KPIs. Regularly report key metrics to stakeholders to ensure transparency and keep everyone aligned with the improvement initiatives.

Following these steps, you can transform AR data into actionable strategies that optimize your collection processes and improve cash flow.

Technology as an Enabler: Leveraging Automation and Analytics

Technology plays a crucial role in driving AR efficiency. Here's how:

1. Automation: Automate repetitive tasks like sending invoices, payment reminders, and late-payment notices, freeing up your AR team to focus on more complex collections and customer communication.

2. Analytics Tools: Utilize data analytics tools to gain deeper insights into your AR data. Analyze trends in payment behavior, identify high-risk customers, and predict potential delinquencies. This allows for proactive collection efforts and improved forecasting.

3. Cloud-Based AR Solutions: Cloud-based AR software offers centralized data management, real-time access to reports, and improved collaboration between finance and sales teams.

Conclusion

Optimizing accounts receivable has moved beyond relying on intuition. By leveraging crucial AR key performance indicators (KPIs) and adopting a data-driven approach, companies can identify areas for improvement and gain valuable insights into the effectiveness of their collection processes. Businesses can achieve quicker collection times, lower bad debt, and ultimately improve cash flow by putting targeted strategies into place. By doing so, you will provide a solid basis for long-term, sustainable growth in a business. Remember, a robust accounts receivable (AR) function does more than ensure timely payments; it also facilitates informed decisionmaking, bolsters client relationships, and contributes to the overall financial stability of your company.

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