Credit Risk Management - Key Issues

Important standards to measure credit management performance:

- DSO – Days Sales Outstanding
- CEI – Collection Effective Index
- BDS – Bad Debt to Sales (Open Account)

Credit Risk Management - Key Issue: DSO

A measure of how many days worth of sales are outstanding and not paid for at any given time. A company with a lower amount of DSO is getting its cash back quicker and hopefully putting it to use.

$$DSO = \frac{365\ \text{Days}}{\text{Account Receivables Turnover}}$$

$$A/R\ \text{Turnover} = \frac{\text{Last 4 Quarters Sales}}{\text{Current Account Receivables}}$$

Credit Risk Management - Key Issue: CEI

A Measurement on how effective the payment collection is with a company. It shows in a form of percentage. The closer the result is to 100%, the more effective the payment collection system

$$CEI = \frac{\text{A/R at year beginning} + \text{Current open account} - \text{A/R at year end}}{\text{A/R at year beginning} + \text{Current open account} - \text{A/R left for current year}} \times 100\%$$

Key factor: A/R left for current year

Credit Risk Management - Key Issue: BDS

A measurement on how successful the open account sales are for the company and how effective the company manages payment collection on such sales.

$$\text{BDS} = \frac{\text{Bad Debts}}{\text{Open Account Sales}}$$

- Companies need to check reasons leading to a high BDS.
- Failure to conduct a thorough credit assessment before granting credit
- Failure to monitor closely the financial conditions of the buyer or take prompt and effective actions on past due payment
- Action plans for improvement. Don’t just stop open account sales.