Cash Flow Is King. Whether at Home or on the Job. It’s Important to Know When Your Money Comes In

By Abe WalkingBear Sanchez

In many businesses, Accounts Receivable are one of-if not the-largest asset. Next to cash on hand, the A/R is probably the closest thing to money in the bank. The time it takes for the A/R to turn around and be collected is important for accurate cash flow projections and as a gauge-a way of measuring what kind of job is being done in managing A/R.
DSO, the Old Way

DSO (Days Sales Outstanding) has been used to measure A/R turn time for a long time, but it has some failings.

When credit is extended, (a sale made on the basis of payment at a later date) we create an A/R (account receivable). A/Rs sit on the right side of the balance sheet along with the other assets; the liabilities sit on the wrong side.

Using DSO to compute the A/R turn time is like putting all A/Rs into a box.

In a month when sales increase, we put more new A/Rs into the box. It’s like a population boom, and the average age and DSO go down. A drop in sales means fewer new, young A/Rs being placed in the box, and the average age and DSO go up.

The failing of DSO is that it is an after-the-fact measurement, and we can’t change history—not yet.

CDI. The New Kid

There is a simpler formula than DSO for computing the turn
Not All Bad Debt Is Bad

A key factor to be weighed in Credit Approval, along with the customer’s profile (type of business, time in business, business status) and past performance, is the Product Value to the seller at the time of sale. A product/service with a big markup has a low product value. A product/service with a small mark-up has a high product value.

Junk sitting in a warehouse for two years has a low product value whereas product that sells as soon as it's available has a high product value.

Unused capacity, for example, the ability to take on more business without incurring additional fixed expenses or having to hire new people, represents low product value.

A prospective credit customer may have less than a perfect profile or past performance, but if we have low product value, we may say yes to this customer knowing he will pay slow or not at all.

Not all bad debt is bad; it depends on your product value at the time of sale.
time on AR, and it’s more accurate and provides ongoing and real-time feedback on collections. CDI (Collection Days Index) is equal to the Terms of Sale divided by the end of month Collection Percentage, here’s how it works:

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CDI = \frac{\text{Terms of Sale (for each term of sale)}}{\text{Collection Percentage (end of month)}}
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**Step One**

Start with the beginning total A/R balance as of the first of the month. This means all A/Rs, regardless of age. Any new credit sales made during the month will be picked up in the next month’s beginning total A/R balance.

For example, our total A/R balance as of the first of the month is $1,000.

**Step Two**

Track collections (payments and credits) on those invoices that make up the beginning total A/R balance.

During key times of the month (the 10th and the 20th), we want to compute the Collection Percentage as of that date by dividing the amount collected by that date by the beginning total A/R balance.

For example: If, by the 10th we have collected $200 of the beginning $1,000 total balance, our collection percentage as of the 10th is 20 percent. We can compare this month’s 10th-day collection percentage against last month’s 10th-day collection percentage. If last months 10th-day collection percentage was 40 percent and this month it’s 20 percent, it doesn’t mean that we are doing a poorer job this month than last. If there’s a great variation between this month’s collection percentage and last month’s collection percentage, it’s not a matter of good or bad, but of why?

A lower collection percentage may be due to the A/R person going on vacation and no one following up on past due A/R. It may be a matter of a product/service with a lower Product Value being sold to someone with less than perfect past performance (see sidebar on page 75).

If by the 20th we’ve collected $400 of our beginning balance of $1,000, our collection percentage as of the 20th is 40 percent. By tracking the collection percentage during the month, we can deter-
mine if we need to exert greater efforts. It’s like a sales guy who by the third week of the month is way behind his sales quota, knows he’s got a week in which to turn the month around. If we are not happy with the collection percentage as of the 20th, we have 10 days to turn it around.

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If you have varying terms of sale, you must compute the CDI for each and then average them out, just as you would do with DSO.

The advantages of CDI over DSO are (1) A more accurate and real-time measurement of A/R turn time, and (2) A way to track cash flow (collections) during the month, and the ability to know if corrective action has to be taken to turn the month around.

At home or on the job, it’s important to know when your money comes in.

About the Author
Abe WalkingBear Sanchez is an International Speaker/Trainer on the subject of cash flow/sales enhancement and business knowledge organization and use. Founder and president of www.armgusa.com, Sanchez also sits on the board of www.BestBizways.com Inc. He has conducted programs for many groups, including the “Inc.” Magazine Annual Business Conference, IBM, STAFDA, Pet Industry Distributors Association, Winroc and Johnstone Supply.

Step Three

At the end of the month, compute the CDI by dividing the collection percentage into the terms of sale.

For example: At the end of the month, we have collection $500 of our beginning A/R total of $1,000, our collection percentage is 50 percent or 0.5. If we are selling on 30-day terms, our CDI would be 60 days.

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