Top 5 Reasons DSO is a Bad Way to Measure Credit Department Performance

When most credit professionals think of metrics, they probably think of Days Sales Outstanding (DSO). This metric is calculated by taking the number of outstanding receivables in a period, dividing that by the total credit sales in the same period and then multiplying the result by the number of days in the stated period. It's used by companies all over the world to measure the speed at which their credit department is converting receivables into cash and, by extension, as a judgment on the credit department's efficiency.

Part of the reason why so many companies rely on DSO to grade their credit staff is because it's such a simple calculation, and easy to understand. But the metric's simplicity is also its undoing. DSO may be nearly ubiquitous in the world of credit management, but it fails to account for some very important factors that have an effect on receivables and cash flow. Here are the top five reasons why DSO is, at-best, an incomplete and, at-worst, a misleading measure of a credit department:

1. **Ignores terms.** A company that sells on 180-day terms and is getting paid according to those terms is technically performing quite well. They could even be collecting ahead of schedule, getting customers to pay earlier than the terms dictate, but they'll inevitably have a really high DSO figure due to the 180-day period. The metric itself can't account for what's been agreed to in the sales contract.

2. **Ignores industry standards.** Certain industries demand sellers to sell at longer terms, like the ones mentioned above. A company in such an industry that tries to make sales on tighter terms wouldn't be able to compete. So, while the credit department's speed of converting the company's receivables into cash maybe on par with industry standards, DSO wouldn't account for that fact.

3. **Ignores seasonal shifts that have nothing to do with the credit department.** Sales can shift with time, edging higher in certain periods and edging lower in others. This could lead to wildly inconsistent monthly DSO measurements, when really this is just the way things go in certain industries, and the DSO numbers are being affected more by these predictable seasonal shifts than by a lapse in credit management performance.

4. **Ignores marketing efforts.** Companies may inaugurate a focused marketing campaign that may generate increased short-term sales, but the same promotion could offer longer-than-standard terms to acquire those extra dollars. Therefore, this successful marketing campaign could end up increasing the company's DSO, even though it has more to do with the company's own advertised offers than credit's capability to perform its job.

5. **Biased to sales.** This is the mother of all complaints against DSO as a measurement of credit department and collection performance. Sales go up, and when they outnumber remaining receivables in, say, a 90-day period, the result of dividing them is less than one, and that figure is multiplied by 90, and DSO is less than 90. When receivables outnumber sales for the same period, the result will be greater than one, and DSO will then be higher than 90. Positive and negative sales fluctuations can occur unpredictably throughout the year, and through no fault of the credit department's performance.