WHITE PAPER

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Managing DSO

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If you can't measure it, you can't improve it—a sentiment that many credit professionals know all too well. Knowing what to measure, how to measure and what the results mean are important tasks for credit managers. On their own, metrics are just numbers. Although companies often use different approaches to apply metrics, the analysis and steps taken based on the results are what give them meaning.

Metrics can help paint a picture of the effectiveness of certain processes. However, knowing which metrics to select and analyze can present challenges. Input from management, uncertainty about which metrics are important, and understanding what goes into a metric and how that affects outcomes add to the uncertainty.

While there are many metrics from which to choose, there is one metric—though not fans of— that many credit professionals are required by their management to track: days sales outstanding (DSO). DSO remains a long-standing benchmark for C-Suite members for measuring receivables performance because it measures the number of days it takes to turn sales into cash. There are a number of ways to compute the ratio—each has its pros and cons.

Depending on the formula used to measure DSO, shifts in terms may not be evident for a few months, which could result in unnoticed *terms creep*. For example, if a company begins extending terms, a DSO calculation will not pick up the change the first month or so. All of the new longer-term sales will still be in the current bucket, aligned with current month sales. Use of an average DSO or even sales weighted DSO will not immediately identify the shift in terms.

One DSO calculation that will pick up the shift sooner is to track the terms granted by each individual invoice. However, this may be an overly burdensome task for companies with portfolios consisting of thousands of open invoices with a wide multitude of payment terms. Which variation of the formula is used often depends on the business line of a company or the way it has historically calculated DSO.

$$\frac{\text{ACCOUNTS RECEIVABLE}}{\text{NET CREDIT SALES}} \times 365$$

Standard or Average DSO

Overall, a low DSO is favorable because it shows the company takes less time to turn accounts receivable into cash. However, payment terms granted to customers is the primary driver of DSO, and it is difficult to compare the DSO of one company to another because of variations in product mix and terms. The ability to collect on the due date can add to the collection period.

DSO has erroneously been translated into how well credit teams manage accounts receivables. Members of the C-Suite continue to use DSO because they are familiar with it. It is a metric often used to measure the efficiency in which a company turns sales into cash. And DSO does that, but it has been misunderstood to mean a measure of effectiveness of the credit and collections operations.

DSO is largely dependent on the sales department. It is a good number, but it should not be used in isolation because it is out of the credit manager's control. The credit team only impacts it if they are not collecting within payment terms.

Factors such as fluctuations in sales, disproportionate mix of terms and seasonal sales can influence DSO. The only time DSO correlates to receivables performance is if sales levels are steady and all sales are made with exactly the same payment terms. Creditors should use DSO to assess internal gaps and areas for improvement in managing accounts receivables, invoicing processes and sales fluctuations.

DSO only serves as an indicator of the average payment term and does not quantify whether invoices are current or past due. Five reasons DSO does not reflect credit department performance:

1. It does not account for the terms agreed upon in the sales contract.
2. It does not account for industry standards regarding terms.
3. It ignores seasonal shifts out of the credit department's control.
4. It ignores company marketing efforts such as special offers.
5. It is biased toward sales.

Senior management will often review DSO on a monthly or quarterly basis to see if the credit approval process is too strict or too lenient. However, DSO relates more to the customer's ability or willingness to pay on time. Other factors that can reduce or increase DSO include:

- The creditor's risk tolerance
- Percent collected on current targets
- Sales extending credit to riskier customers
- Effective billing practices from customer service

Credit departments often take different approaches to using DSO depending on the company's industry and objectives. For credit managers to get the most out of DSO, they must find ways to combine it with other metrics to create a clearer objective tailored to their team.

Industries that have flat sales patterns and payment terms can find use in Standard DSO. However, it can mislead when other factors must be considered. If you are in an industry that is project based or you have split terms, multiple terms, 30-day customers, cash in advance customers or 60-day customers, then Standard DSO calculations get convoluted.

Best Possible Days Sales Outstanding

According to an *eNews* poll, 21% of respondents use the best possible days sales outstanding (BPDSO) metric. Think of BPDSO as a snapshot of current invoices whereas standard DSO measures both current and overdue invoices. BPDSO looks at your receivables in the current month and tells you how quickly your customers are paying right now. It is a very focused look, so it makes sense to use BPDSO against other metrics rather than alone.

$$\left(\frac{\text{ENDING CURRENT RECEIVABLES}}{\text{CREDIT SALES FOR THE PERIOD}}\right) \times \text{NUMBER OF DAYS IN THE PERIOD}$$

The closer your standard DSO number is to your BPDSO, the better. If your standard DSO falls within roughly 20% of your BPDSO, it is safe to say your company has a healthy cash flow. The metric helps identify whether collection problems are with your current accounts or those in the past. It answers questions about how well your credit policies are doing right now. For example, are your credit terms too loose or is the sales team selling to the wrong people? Best possible DSO can help you decide if your process is working well for you on a real-time basis.

However, it is important to remember, as with all DSO calculations, the numbers can fluctuate quickly. So, remember that DSO calculations are a combination of both the sales and credit departments; company wise DSO is a good number to use, but it is not always a good number to hold the credit team accountable.

You can lower the risk of outliers and fluctuations by comparing DSO and BPDSO to previous years. Tracking the difference between your actual DSO and BPDSO consistently rather than sporadically also will help give you a more accurate picture.

True DSO

$$\left(\frac{\text{INVOICE AMOUNT}}{\text{NET CREDIT SALES FOR THE MONTH IN WHICH THE SALE OCCURRED}}\right) \times \text{NUMBER OF DAYS FROM INVOICE DATE TO REPORTING DATE}$$

True DSO is a lesser known or used calculation and is built on the Sales Weighted DSO method. It attempts to remove the sales bias associated with Standard DSO and produces an accurate view for all accounts receivable. The formula calculates the actual number of days credit sales are unpaid by tracking individual invoices to the month of sale. According to an eNews poll, only 14% of respondents acknowledge using it, compared with 75% who use Standard DSO.

True DSO is calculated for each invoice. It measures the number of days each invoice is open—from the invoice date to the date of measurement divided by the number of open invoices. One of its biggest drawbacks is that it is extremely cumbersome to calculate, and it only works for invoices that have been paid—attempts to apply it to open invoices will give results that make no sense, according a LinkedIn article, *TRUE DSO: The New Life of the Fine Old Friend*. As a result, it is more commonly used for tracking payment performance for individual customers.

> "It grows as a result of high levels of arrears, takes into account long-standing overdue rates and nearly disregards small or insignificant values. At the same time, it balances past-due payments and those paid earlier, thus giving an objective view on payment practice for each particular customer. Furthermore, if calculated for a long enough period, like one year, it could provide a sound background for a realistic estimation of future payment dates."

STANDARD DSO – BEST POSSIBLE DSO

Average Days Delinquent

Metrics such as average days delinquent (ADD) or other past-due measures would indicate better how well your credit team turns receivables into cash. These types of metrics provide an indicator of how well the credit team enforces payment terms and on-time collections.

ADD, also known as delinquent days sales outstanding, tells the credit department the average amount of time it takes for late payments to get collected and converted into cash If your department's ADD is high, it means customers are taking longer to pay and may require more proactive collections efforts. A low ADD means you are collecting cash from your customers quickly.

As with any metric, ADD has strengths and weaknesses. ADD is great for helping the credit team predict default rates, project cash flow and improve communication with customers. It is a good barometer of where you are at because credit and collection teams generally work on past due invoices. As quickly as sales are made, companies want the cash back in their pockets so they can do something else with it, and ADD can help measure how well that is happening.

However, it is important to note that the metric has some blind spots. ADD only measures late payments for *right now*, not over a long period of time. Because the metric's formula hinges heavily on DSO, it is subject to drastic swings.

A company's revenue figure can make DSO fluctuate constantly, so that portion of the calculation makes it difficult to measure collection efforts. When you are dealing with DSO and BPDSO to get to ADD, every time you bring another part into it, it levels out that metric and helps normalize the wild swings. But it is still a problem because revenue will either help or hurt DSO even though collections has not changed a bit.

ADD is typically measured against standard DSO, and both should almost always trend in the same direction. If you see a high DSO and low ADD or vice versa, it likely means there has been a change in credit terms or AR cycle rather than an efficient or inefficient credit department. That's because changes to AR can affect DSO without affecting your ADD number. For example, a really good sales month or a really bad sales month can cause both metrics to go in opposite directions.

Sales Weighted DSO

The sales weighted DSO metric provides a more accurate way to measure a credit department's collection effectiveness because it removes the impact payment terms and sales have on some days sales outstanding formulas.

$$\frac{\text{AGED RECEIVABLES FOR EACH MONTH}}{\text{COMPARABLE SALES FIGURES FOR EACH OF THE AGING BRACKETS}} \times 30$$

Sales weighted DSO uses sales like other DSO calculations, but it also uses specific aging buckets within the calculation, which makes it unique. For example, instead of calculating DSO based on averages derived from the total sum of outstanding accounts, it is calculated using averages derived from specific outstanding accounts in 30-, 60- or 90-day aging buckets. It is otherwise similar to standard DSO.

Many credit teams use DSO calculations as a KPI to measure against the gap between payment terms and the amount of days the AR is outstanding to show trends of improvement or decline over a period of time. Removing bias from metric calculations is important because a credit department's portfolio may contain a variety of accounts with differing face values and payment terms. Sales weighted DSO smooths out sales and payment terms of the sales, when there is an account with higher terms or a wide variety of terms, or both, within the portfolio.

However, these calculations may potentially cause more work for credit professionals looking to gain an accurate measurement. For example, creditors may have to compute a weighted terms of sale to establish a benchmark to determine if their sales weighted DSO number is good or not. Furthermore, if few companies use sales weighted DSO, it may be hard to establish a baseline.

Final Thoughts

Different industries have different DSO calculations, so it is difficult to compare between companies or have a set benchmark if your clients are from different industries. Some companies use DSO to see if there are collection issues from one year to the next on the same client.

Another credit manager uses a variety of terms so he uses a three-month blended DSO number derived from his company's ending AR. It includes deductions, advertising, shortages and any other factors that contribute to the ending AR number. Then the department uses the sales number, including any type of service charges, interest surcharges, fuel surcharges and whatever else the customer may owe and applies that to a three-month average.

Ultimately, how you calculate DSO depends on who the DSO is for. Is it for credit managers, shareholders or senior management? What are you trying to do? Are you trying to shed some light on the credit department's progress or its trends?

Other companies may calculate DSO by excluding deductions or some sort of advertising allowance. So, what *true sales* might be for you and your company may be totally for another. Looking at DSO in a couple of different formats provides a snapshot in time. DSO is changing every single day. It is more important to establish what you're looking for in that DSO number.

Every organization should decide what DSO calculation it will use from day one. That way, they can establish a benchmark for analyzing trends from month to month or year to year using the same calculation. Don't focus on one metric. Track several metrics over a period of time.

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