Measuring Collections Performance

Understanding and using key Accounts Receivable metrics: DSO, ADD and CEI.
Knowing where you stand is a crucial prerequisite to understanding where you want to go. Particularly important when liquidity and cash flow are top of mind, monitoring your company’s Days Sales Outstanding, or “DSO”, can provide valuable information as to your company’s cash position and financial health.

This SSF InfoCast™ will discuss what DSO measures, how this metric is built, what factors impact this metric and what business and operational indicators are brought to light by following your company’s DSO over time.
**What is DSO?**

Days Sales Outstanding (DSO) is a measure of the average number of days a company takes to collect revenue after a sale has been made — in other words, the average collection period. A low DSO means that it takes a company fewer days to collect its accounts receivable (A/R). A high DSO shows that a company is selling its product/service to customers/clients on credit and taking longer to collect related revenues.

**DSO is calculated as:**

\[
\text{DSO} = \frac{\text{Accounts Receivable}}{\text{Total Credit Sales}} \times \frac{\text{Number of Days in Measurement Period}}{360}
\]

As cash drives so much of a business’ operations and opportunities, best practices dictate that a company collect outstanding receivables as rapidly as possible. By quickly converting sales into cash, the business can put the cash to use again—ideally, to reinvest and generate sales.

**How does knowing my DSO help my business?**

DSO provides a good basic overview of the effectiveness of the account receivable collection policies and staff in charge of executing on these policies. It is also a way for a company to benchmark its own A/R trends, and to compare itself against similar companies and industry-wide DSO results.
Typically, a low DSO indicates that a company collects its outstanding accounts receivables quickly — generally a good business practice. A rising DSO measured over a period of time may also indicate other business or operational issues, often including lack of attention on accounts receivables collection efforts or credit policies that may be too generous or lacking in proper analysis before credit is extended.

For some companies, a DSO that trends upward over time can also be an indicator of impending or existing cash flow issues. These issues may require mitigating actions including more aggressive collections activity, re-assessment of credit policies, or an increase in the company’s bad debt reserve.

Essentially, there needs to be a “Best Practice” goal, which we can call “Best Possible Days Sales Outstanding.” This calculation will look only at current accounts receivable (“current” as defined by your receivables policy). The formula for Best Possible DSO is virtually identical to the formula on page 2 – the only change is to swap out the fraction’s numerator from “A/R” to “Current A/R.”

**Best Possible DSO is calculated as:**

\[
\frac{\text{Current Accounts Receivable}}{\text{Total Credit Sales}} \times \frac{\text{Number of Days in Measurement Period}}{365}
\]
The Best Possible DSO yields insight into delinquencies as it uses only the current portion of receivables. Therefore, as a measurement, the closer your regular DSO is to your Best Possible DSO, the closer the receivables are to their optimal level.

Notwithstanding this discussion of utilizing DSO as a collections bellweather, we should note that DSO is not the most accurate way to indicate if your company is addressing accounts receivables effectively. DSO can be misleading as it has a key weakness – it fluctuates with revenue. Changes in sales inversely affect DSO. If your overdue receivables balance remains constant, an increase in sales for the month will lower your DSO. If you suddenly experience a dip in sales, your DSO will shoot up. Therefore, it is important to keep in mind that while valuable for benchmarking, DSO alone cannot give you a clear picture of the performance of your A/R. Other measures of collections performance include Average Days Delinquent (ADD) and Collection Effectiveness Index (CEI). These two metrics help complete your A/R picture and together will allow you to gauge the efficacy of your collections efforts.

Most companies measure and compare their DSO to prior periods either quarterly or annually – allowing some time between measurement dates helps provide a metric that is more reflective of the company’s position as the calculation is less susceptible to short-term fluctuations in sales or collections.
Measuring Collections Performance: Average Days Delinquent (ADD)

Average Days Delinquent (ADD), sometimes called Delinquent DSO, calculates the average time from a receivable’s due date to its paid date. In other words, it’s the average number of days that invoices are past due. It provides a snapshot to evaluate the overall company’s collection performance and also provides useful information regarding individual customers, customer types, collector segments, etc.

ADD is calculated as:

Average Days Delinquent (ADD) = Standard DSO - Best Possible DSO

Example:
Measuring Collections Performance: Collection Effectiveness Index

The Collection Effectiveness Index (CEI) is becoming increasingly popular in the credit and collections world. CEI was developed by Dr. Venkat Srinivasan and the Credit Research Foundation. With the Credit Research Foundation collecting statistics, it is also possible to conduct industry benchmarking and comparisons similar to DSO. CEI is a percentage that expresses the effectiveness of collection efforts over time – the closer you are to 100 percent, the more effective your collection effort. CEI is a ratio that measures the quality of collection efforts over time. It is essentially the percentage of receivables closed or paid in a given time period. While “Percent Current” has an implied limit of 100%, this is not the case for CEI.

CEI is calculated as:

\[
CEI = \frac{\text{Beginning Receivables} + \text{Month’s Invoice Revenue} - \text{End Total Receivables}}{\text{Beginning Receivables} + \text{Month’s Invoice Revenue} - \text{End Total Receivables}}
\]

CEI is a more appropriate measure of performance over time while DSO is for measuring performance at a single point in time. CEI does not change if a company nets their receivables by removing items they deem disputed and therefore uncollectible. Logically, CEI and DSO should move in opposite directions: if your collections...
efforts increase, your DSO should decrease. There are certain write-off and revenue conditions, however, under which you might experience DSO and CEI tracking in the same direction.

SSF Tips to Keep in Mind

• DSO data is used with accounts receivable aging reports, which detail outstanding customer debts over four periods (0–30, 30–60, 60–90, and over 90 days). They also show the proportion of total accounts receivable in each period, with figures (derived from the profit and loss account) for potential default and bad debt.

• Cash sales are not included in DSO calculations – only credit sales. Sales of items other than merchandise (like fixtures, equipment and real estate) are also not included.

• For DSO to be meaningful it needs a context, which is usually the company’s own trading terms. Typically, DSO is considered to be within reasonable limits if it exceeds terms by no more than one-third to one-half. So if terms are 30 days, an acceptable DSO might be between 40 and 45 days.

• Like all such calculations, a more accurate picture is obtained if DSO is reviewed regularly – a single analysis may not be representative.
• DSO varies widely between sectors. Some goods are time-limited (such as high-tech products that are quickly superseded by new models) – in which case excessive DSO could indicate problems – while others have a much longer shelf life.

The Last Word

In light of the fact that DSO alone does not accurately measure performance in credit and collection, we can now arm ourselves with two more indicators for accurately measuring performance; CEI and ADD. When CEI and DSO track the same way because of revenue fluctuations or changes in the company’s terms of sale, ADD comes to the rescue and takes both into account.

While DSO has its faults, it is a must-have indicator because it is so well understood and enjoys wide acceptance amongst financial professionals.

When combined with the ADD and CEI you can generate a truly complete picture of your accounts receivable performance.

For more information or to discuss your organization’s collections performance measurement or other accounting and tax issues, please contact Sensiba San Filippo’s Manufacturing Team at manufacturing@ssflip.com.
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