THE ULTIMATE AR COLLECTIONS

BENCHMARKS REPORT

In theory, accounts receivable should be tidy. You sell, you invoice, you get paid, right? Accounting and AR have grown exponentially more complex over time with things like credit limits, collections, bad debt, supply-chain management, deductions, and cash applications all playing into the mix. Every day, you face pressure to be more efficient to survive and thrive in an increasingly competitive business environment. Use this benchmarking report to diagnose your receivables operations, reveal inefficiencies, and identify opportunities for improvement.

LAGGING METRICS MEASURE OUTCOMES

When managing AR department performance, metrics calculated off outputs and after-the fact information are known as "lagging" metrics. These tell you what happened and are easy to measure, but harder to improve because you're starting from the point where problems already exist.

01 DAYS SALES OUTSTANDING (DSO) AND BEST POSSIBLE DAYS SALES OUTSTANDING (BPDSO)

DSO and BPDSO tell you how your AR and collection departments are doing. Overall, an ideal DSO should closely align to your credit terms. Research from Euler Hermes reveals the closer you are to the consumer, the shorter your DSO.

Retail, food services, and direct-to-consumer services report an average DSO around 50 days. Consumer industries such as electronics, construction, and heavy machinery average 80-90 days. If your DSO is way out of line, your knee-jerk might be to blame collections or your customers.

Look past the usual suspects to find the real culprit. Your AR collection issues might be systemic or could be unique to each account.

Things to consider:

- Did sales-team enthusiasm push through a high credit risk client?
- Are your credit terms out of line with competitors' terms?
- Is your accounting team invoicing late?
- Are AR collectors spending too much time on manual reports?
- Is there a lack of alignment between client AP cycle and your invoicing?
- Are unhappy customers intentionally delaying payments?
- Are there patterns in past behavior that my team hasn't detected yet?

OVERALL, AN IDEAL DSO SHOULD CLOSELY ALIGN TO YOUR CREDIT TERMS. [THE] CLOSER YOU ARE TO THE CONSUMER, THE SHORTER YOUR DSO."

DSD BUSINESS SYSTEMS

quadient accounts receivable by YayPay

02 AVERAGE DAYS DELINQUENT (ADD)

Another lagging metric that lets you know how your collections department is doing is ADD. Since ADD is the difference between DSO and BPDSO, the lower, the better. A survey by the AR & O2C Network offers encouraging data. Across an array of industries (based on credit terms averaging net 30), they found a median DSO of 37, a median BPDSO of 28, and a median ADD of just three days. They also found that reducing DSO was the second greatest concern for AR professionals.

The raw numbers are informative, but also look at how ADD moves relative to DSO. CFO magazine offered insight that when DSO and ADD move in tandem, the collections process is responsible. If they rise or fall independently, though, there are other factors at work, including:

- Better or worse customer service (and satisfaction).
- Better management (or mismanagement) of credit expectations.
- Changes in credit terms (and customers not in compliance).

Give kudos to the collections department when ADD and DSO are low and track together—or give a pat on the shoulder to an account executive if DSO drops, but ADD rises. Figure out if (and why) the two metrics are in a graceful tango or doing bad disco at opposite ends of the dance floor.

Questions to ask:

- Are ADD and DSO movements synchronous? If not, why?
- Is the DSO/ADD shift across all customers or singular?
- Have policies or practices changed recently?
- Is one key account (or a few) weighting the metrics?
- How can you correct (or capitalize) on trends around Median ADD?

03 COLLECTION EFFECTIVENESS INDEX (CEI)

CEI represents your ability to get customers to pay. The benefit of CEI is that it's an effective measure at shorter intervals (weekly/monthly), while DSO is more accurate with a volume of data feeding it. DSO is more useful at quarterly, semi-annual, or annual intervals, with CEI used in the interim.

Since CEI is the percent of invoices paid in a given period, 100% is the perfect score. DSO measures efficiency (how fast you get cash), while CEI reveals the effectiveness of the collection process. CEI focuses on invoices presently due rather than all invoices. If your business has seasonal or cyclical sales, CEI is a better indicator of collections than DSO.

For teams that have more than one or two people managing collections, CEI can also be used to weigh team efficiency on a weekly basis. This can drive friendly competition and "gamify" your department's efforts.

Averaged across all industries, data from Credit Research Foundation show a CEI median near 85%, but much lower (55-65%) in transportation and fabricated metal. Food products, petroleum, coal, chemicals, and electrical products have demonstrably higher CEIs, tipping the scales at 97% or more.

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04 BAD DEBT TO SALES RATIO

Simply, the bad debt ratio is the percent of invoices not paid. Selling to customers on credit terms means rolling the dice, even when you thoroughly vet them for risk. Bad debt is inevitable, and some bad debt can be an indicator of health, although it seems counterintuitive.

Don't assume the lowest bad debt ratio is ideal. Just 1% of your invoices going bad seems great, but it's not. If you're not taking some losses, then you're not selling (and profiting) optimally.

A 1% bad debt ratio indicates overly cautious credit terms and missed sales. If you sell $500k with 1% bad debt, you write off $5k. Loosen your credit terms and broaden credit limits and risk tolerance, and you've almost doubled your net even with a quintupled bad debt loss. You don't want this ratio too low.

05 ACCOUNTS RECEIVABLE TURNOVER RATIO (ART)

AR turnover ratio is a key health indicator. A nice high ART ratio says you're running a tight accounting ship, collecting invoices effectively, and generating needed cash flow. A low ART means you're losing opportunity cost and edging toward bad debt issues.

Best-selling author and serial entrepreneur David Finkel wrote, in a business thought piece on AR for Inc., that the only thing worse than not making a sale is "making the sale (and delivering the product or service) and not getting paid!"

You want a strong ART, but what's ideal? If your annual ART is 10, average AR was collected 10 times (365 days ÷ 10 ART), and your average days to collect was 36.5. Assessing whether this is a red flag versus a cause for celebration requires context.

If your terms are net 30, 36 days to collect is good. If your terms are net 15, it's not great.

If your terms are net 15 but one large client tends to pay a bit late, it may be okay.

Is your ART in line with your industry? Food ART averages 10, while steel hovers at 9-13.

If your historical ART is 9, but it ramped to 10 last year, break out the champagne!

Also, remember that a single large account can unduly influence KPIs across the board. You might have a troublesome ART, but it may not be a systemic issue or sign of impending doom. If one of your largest customers pays late but always in full, ask yourself what matters more: a happy mega client or better ratios?

06 AR LESS THAN 90 DAYS

Without context or if viewed independently, individual metrics can be misleading. Acting without all the info can make things worse. When observing that ART, DSO, ADD, and CEI are at or above industry standards, you might think things are going well, but you might be missing subtle issues that are brewing.

AR metrics largely rely on total and averaged dollars. If your customer mix is such that you have a handful of very large clients that pay on time, their good credit behavior can skew metrics. Your numbers might look good overall, but delinquent accounts may be lurking in the shadows.

If you focus solely on weighted metrics, you can miss underlying problems. AR >90 offers supplemental insight. Serve it as a side dish to your big-picture metrics.

If you're borrowing, have a line of credit, or are publicly held, you're subject to audits or lender collateral field exams. If your AR >90 is 25% or greater, you may face heightened scrutiny. Optimally, you want to see 15% (or less) of AR at >90 days.

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LEADING METRICS IDENTIFY OPPORTUNITIES

Leading indicators are more conceptual and fueled by inputs. They are harder to measure but easier to influence. Lagging metrics tell you about the past and reveal problems to solve. Leading metrics give you a heads-up and allow you to test opportunities to identify issues before they bloom into full-fledged problems.

"IF A CUSTOMER UTILIZES 100% OF THEIR CREDIT LIMIT BUT PAYS LIKE CLOCKWORK, MORE GENEROUS TERMS MIGHT BE IN ORDER. HOWEVER, IF CLIENTS PUSH THEIR LIMITS AND RUN CONSISTENTLY BEHIND ON PAYMENTS, IT'S A RED FLAG. "

07 PERCENTAGE OF CREDIT AVAILABLE

Do you limit or cap outstanding invoices? If so, evaluate how many clients are maxing their lines. Also, look at which clients routinely hit the ceiling and their patterns of behavior. If a customer utilizes 100% of their credit limit but pays like clockwork, more generous terms might be in order.

However, if clients push their limits and run consistently behind on payments, it's a red flag. You may want to further parse this data and segment into client profiles to ID those that respect versus those that abuse credit lines to inform future decisions. Overlay this information with the next metric for greater insight.

08 PERCENTAGE OF HIGH-RISK ACCOUNTS

Knowing how much of your AR is owed by high-risk clients helps prevent loss. High-risk clients represent potential bad debt and more effort for AR collections, increasing the cost of doing business with them. Remind sales reps that signing a client closes the deal but starts a relationship.

To calculate what percentage of your accounts are high risk:

- Decide what is high-risk to you (such as young businesses or a low D&B score).
- Categorize your clients into risk buckets.
- Weigh your AR against risk buckets.
- Target clients to focus on for AR compliance.

Urban Stat, an insurance risk assessor, has some universal advice on choosing clients. Identify your ideal client and risk level. From there, they recommend you take a granular approach and recognize that "every client is different so are their risks." They recommend you categorize, but personalize.

09 DEDUCTIONS/ SHORT-PAYS/ CHARGEBACKS

Assessing the "why" behind deductions, shortpays, and how often you issue chargebacks reveals underlying problems in sales, shipping, accounting, customer satisfaction, and internal communications. Your chargeback issuance policy is a good starting point.

Funding company FSW aptly captioned that "deductions are the bane of Accounts Receivables professionals across the country."

Deductions can be authorized or unauthorized. Authorized deductions for early payment of invoices (2/10 n30, for example) or promotions are a legit cost of doing business.

For instance, if sales promised a discount or offered a promo but failed to communicate with accounting, the invoice would be inaccurate, and the customer would be totally justified in deducting what they were overcharged.

Unauthorized and preventable deductions that trigger intentional short-pays demand analysis to identify the underlying issue, such as:

- Incorrect delivery method or timeline.
- Unwarranted or unrequested services rendered.
- Chargebacks issued with no investigation or pushback.
- Incorrect tax amount on the invoice.
- Wrong items delivered/items damaged in transit/too many items.
- An upset client that short-pays out of frustration or dissatisfaction.

10 EXTENDED-TERMS REQUESTS

If extended-terms requests are rolling in regularly, you should be tracking the trend to revisit (or establish) your policy. On a case-by-case basis, the ask might not seem significant, but if half your customer base wants to slow payments, your cash flow will be hard hit.

The most recent Working Capital Survey by The Hackett Group shows DSO is at its highest point in a decade, with a rise of 5%+ over the past year alone. Payables are outstanding almost four days longer year over year, representing an almost 8% rise to over 53 days outstanding, on average.

Hackett's Craig Bailey said, "Net-60 is becoming almost standard in the United States, and some companies are pushing that out to 90 or 120 days."

Lengthier payment terms stress your cash flow, compound collections issues, and complicate dealing with delinquencies. On the flip, declining to extend terms, if this trend continues, could cost you customers and sales opportunities. If your closest competitors seize the opportunity and extend terms, what will you do?

11 COST OF COLLECTIONS

Budgeting is a look-ahead activity, and a critical line item is the cost of collections, both internal and external. As invoices age and tip from one bucket to another, they consume a greater share of AR resources.

Older AR is worth less every day, yet the prevailing practice is to burn time trying to collect it.

Internal cost to collect is harder to parse since it's a portion of overall collections activity. External costs of collection are easier to reckon. Cost Owl's 2018 estimates reveal that collection agency fees range from 15-50%, with lower dollar invoices triggering the highest percentage cost.

If the 50% cost triggers sticker shock, bear in mind these exorbitant fees are in addition to the internal costs you paid before you gave up and outsourced that debt.

As you estimate the future cost of collections, consider a solution to streamline the process and lessen or eliminate this cost. Automating AR collections is almost always more cost-effective than continuing to combat delinquencies internally or pay collection agencies steep fees to collect on your behalf.

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WHERE TO GO FROM HERE

Small businesses and startups handle everything in-house. At first, you must. But as you grow, you'll quickly find that miring yourself in minutiae crushes your ability to scale. Accounts receivable automation should top your list of affordable efficiencies that free you to focus on growth.

When transitioning from small- to mid-sized, a business must grasp every opportunity to compete more effectively and at a lower cost. Automation was once highly costly and the domain of big business, but disruptive tech has made it affordable to businesses of all size.

AUTOMATE WHERE IT MAKES SENSE

You don't need to (and reasonably cannot and should not) try to automate every business function. Most companies start with outsourcing payroll and tax filings because of the expertise required for compliance and the obvious inefficiencies of trying to tackle these activities in-house.

Chasing down overdue accounts receivable is not the best use of your time or that of your accounting department. Automating this critical function frees you up so you and your team can focus on building your business, developing customer relationships, and achieving your goals.

Download our buyer's guide to learn more and see how Quadient AR can help your business grow in the right direction.

"ACCOUNTS RECEIVABLE AUTOMATION SHOULD TOP YOUR LIST OF AFFORDABLE EFFICIENCIES THAT FREE YOU TO FOCUS ON GROWTH."

Quadient Accounts Receivable Automation by Yaypay is a leading accounts receivable automation solution providing intelligent credit-to-cash software, payment processing and industry best practice. Our end-to-end platform ensures process efficiency, team productivity and customer delight while accelerating cash flow. Quadient supports hundreds of thousands of customers worldwide in their quest to create relevant, personalized connections and achieve customer experience excellence.

For more information, visit [www.quadient.com/ar-automation.](www.quadient.com/ar-automation)