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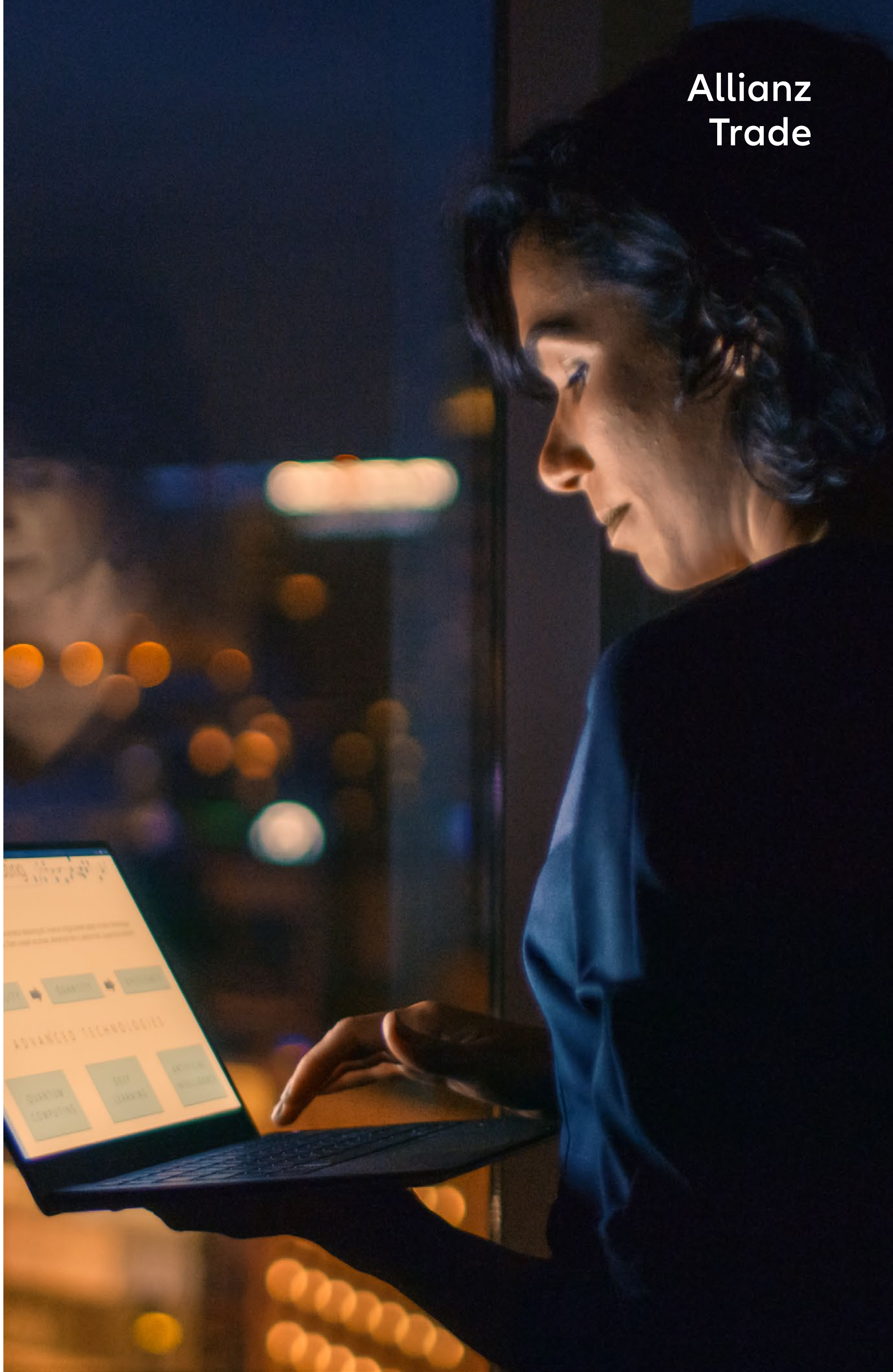
ARTICLE:

Six Steps to Reduce DSO



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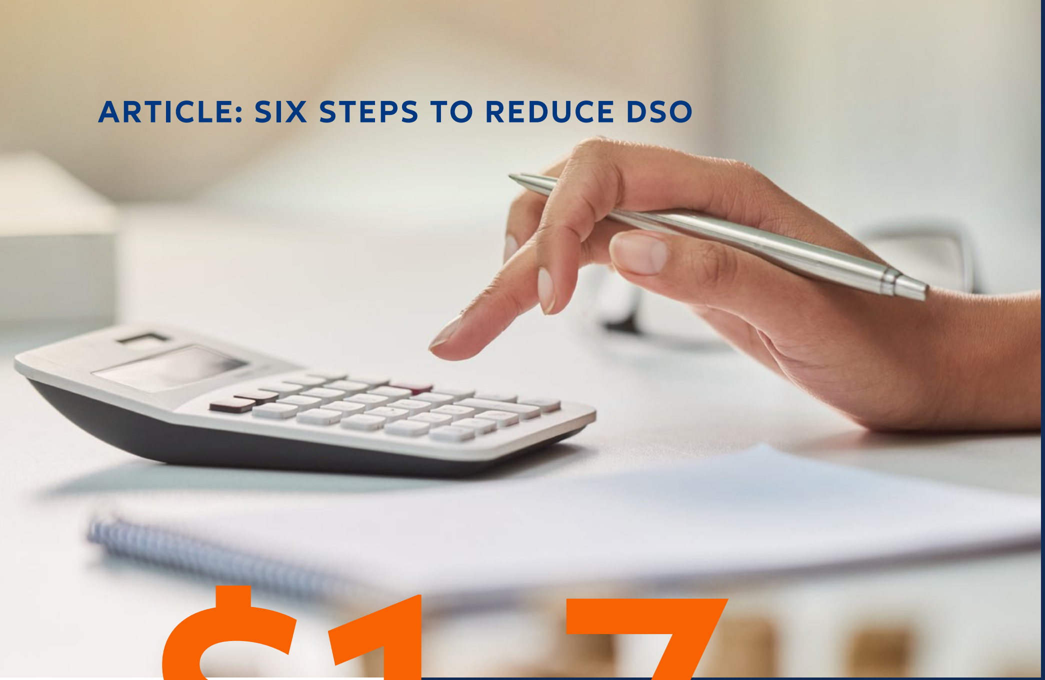


$1.7 trillion tied up in working capital*

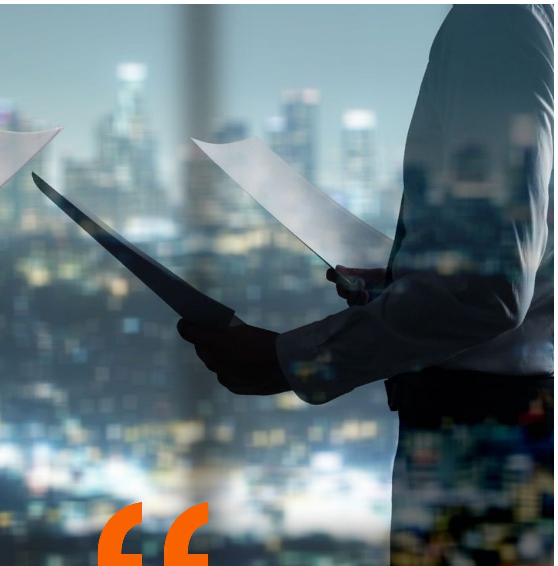
* from a 2022 survey of the 1,000 largest listed nonfinancial companies in the United States

Cash flow is the lifeblood of any business and a key measure to track for a healthy cash flow is Days Sales Outstanding (DSO). DSO represents the number of days it takes for a company to convert its accounts receivables into cash. The sooner the company gets that cash, the stronger its cash flow and financial position is likely to be.

However, years of low interest rates and easy credit have allowed companies to take their eye off the ball when it comes to managing DSO. If the company can easily borrow money at low interest rates, there is less need to worry about DSO increasing by a few (or more) extra days.

After the enormous operational and financial disruptions of 2020, DSO trended positively for the year. According to The Hackett Group's annual analysis, this has not been seen since the Great Recession of 2008. The 2022 Hackett Group Working Capital Survey (registration required) of 1,000 non-financial companies in the US found that despite continued supply chain issues and an inflationary economy, many industries accelerated post-pandemic recovery during 2021. However, the working capital gap between best-in-class and median companies continues to widen as top companies' fast-track their working capital conversion. Businesses' need to continue to focus on optimizing DSO and other working capital elements to ensure healthy cash flow and prepare for unpredictable economic times.

Strategies for Reducing DSO



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Reducing DSO is not completely within the control of the finance and accounting. Other parts of the company also have an impact on this metric. Therefore, reducing DSO requires not only a focused effort on the part of finance executives but the cooperation of various departments in the company. Here are some steps to begin reducing DSO.

1 Get ready

Any effort to reduce DSO must begin with data on company's current DSO status and a benchmarking analysis that shows how that level of DSO compares to peers and competitors. This insight not only provides a starting point for the effort but also provides a sense of what DSO result is possible for the business. The Hackett survey offers some basic data by industry but other industry surveys or private benchmarking studies may provide greater detail.

Accounting and finance executives can also use this data to make the case for reducing DSO to senior management and the various departments whose cooperation is necessary. By making DSO reductions a strategic priority, executives can more readily justify the resources they devote to the project and incorporate DSO improvement metrics into the individual performance objectives and incentives of those driving the effort.

Overall, companies should focus on DSO reductions that are both attainable and sustainable based on the realities of the business. For example, companies may be able to reduce DSO by, say, 20 days by significantly tightening customer credit approvals but that will not be worth much if customer acquisition and retention suffers as a result.

2 Focus on customer credit

DSO is often driven by customer ability to pay their invoices on time. Therefore, any effort to reduce DSO must address customer credit risk with the development of appropriate parameters for acceptable customer credit risks as a good first step. A company can then use that criteria to ensure that all new customers do not represent an unacceptable risk of slow payment or non-payment. Companies can also extend this criteria to existing customers, starting with those that have been slow to pay.

The sales function must be on board with this renewed focus on customer credit risk. Salespeople do not want to lose a sale because a customer has credit problems. Therefore, companies may need to implement specific incentives and penalties to make sure salespeople and sales managers adhere to the company's customer credit requirements. In some cases, companies can strategically deploy tools like credit insurance to help mitigate these risks without losing an otherwise attractive customer.

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Reducing DSO often requires changes to habits as much as administrative processes and procedures. Therefore, companies will need to make sure those changes stick and people do not return to the old ways of doing things.

3 Define customer payment terms

DSO metrics are heavily influenced by the payment terms a company extends to its customers. Those payment terms must carefully balance the company’s own DSO goals against common industry practice and customer needs and expectations. This means identifying under what circumstances the company will offer customer incentives for faster payment or require deposits or upfront payments, supported by a clear approval process when making these decisions.

Invoices must clearly and visibly state payment terms to reduce the chances of confusion over when payment is expected. The company should also be regularly communicating with customers about outstanding invoices and how the company can make it easier for customers to pay them. For example, some customers may be moving to electronic payments or prefer their employees use payment cards for certain purchasing.

4 Look at invoicing processes

Slow or inefficient accounting processes can also extend DSO. Therefore, reducing DSO often requires a focus on making sure that invoices are going out on time, contain all necessary information and are free of errors. A thorough review of the billing process, including spot checking invoices, can uncover errors, large or small, that could delay payment. Incorrect charges, invoices that do not reflect agreed-upon discounts and even the wrong mailing address are just a few examples of common errors that can delay payments.

Companies should also regularly review and update policies on when to send invoices (When the contract is signed? At delivery? Using some other milestone?) and make sure that those policies are being followed. They should also be auditing invoice processes to identify delays or errors.

5 Manage accounts receivable carefully

Once invoices have been sent, a company must have a plan for following up on outstanding balances and reminding customers of unpaid invoices. This communication should focus on identifying any problems that are preventing the customer from paying the invoice. In some cases, an otherwise strong customer may be having cash flow problems that make it appropriate to offer a special arrangement or payment plan.

If non-payment continues, the company should have a clear policy and process for handling these situations and any disputes that arise, including guidelines on when and how to escalate the situation as needed. For example, this guidance might include when to turn over unpaid invoices to a collection agency.

6 Keep up the momentum

Companies must commit to reducing DSO and sustaining this effort over the long term. Reducing DSO often requires changes to habits as much as administrative processes and procedures. Therefore, companies will need to make sure those changes stick and people do not return to the old ways of doing things. By conducting regular reviews of and discussions about DSO metrics, companies can keep the focus on these efforts and reinforce their importance to the company.

ARTICLE: SIX STEPS TO REDUCE DSO

Easy Money

Reducing DSO is a relatively straightforward way to strengthen your company's cash flow. It just takes a focused and sustained effort. When they realize the impact lower DSO can have, those leaders are likely to lend needed support and provide a strategic focus for the initiative. There is no reason not to get started lowering DSO today.

For more information on how to help your business reduce DSO, contact us:
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