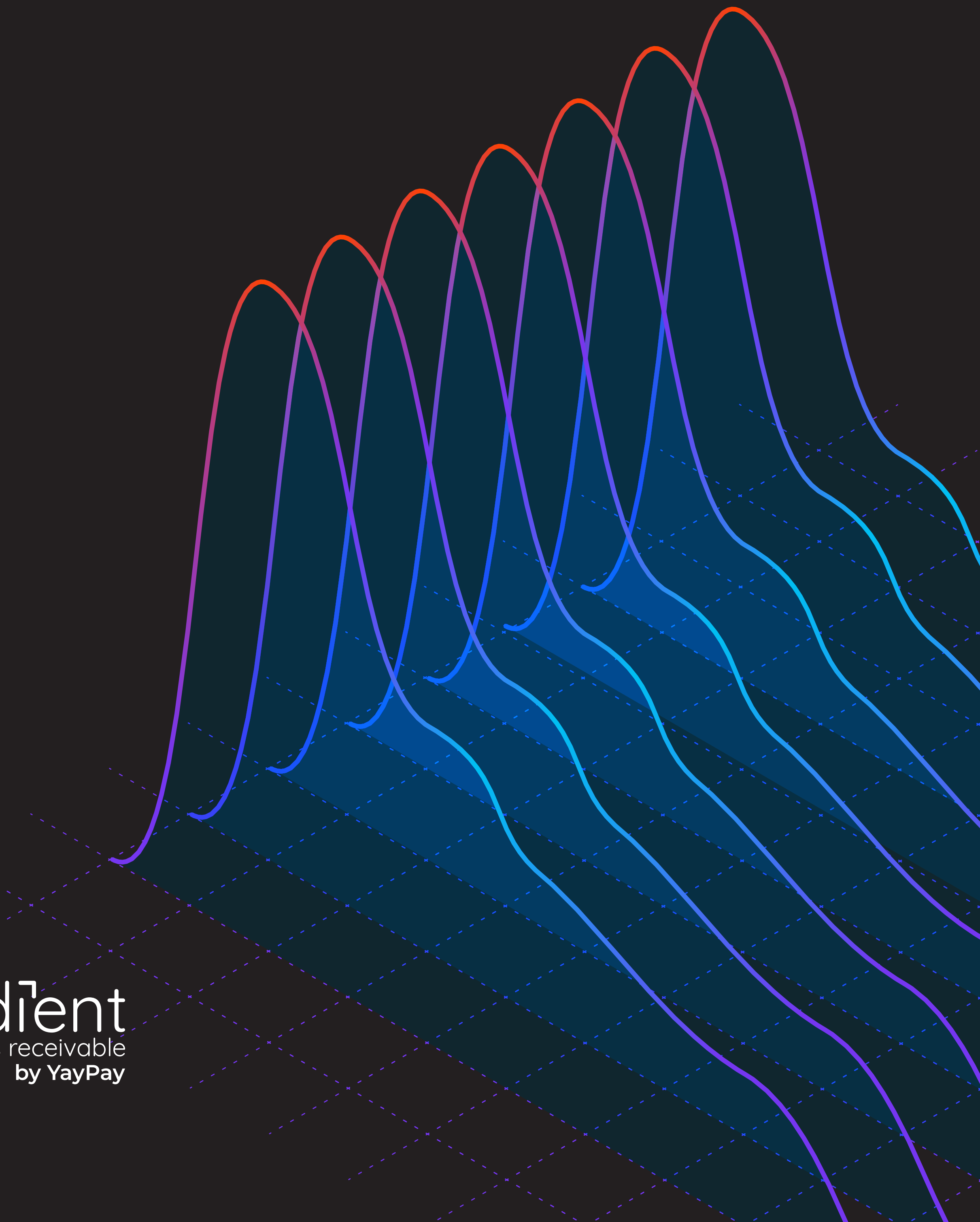
Metrics Matter: 7 KPIs to Elevate your AR Performance



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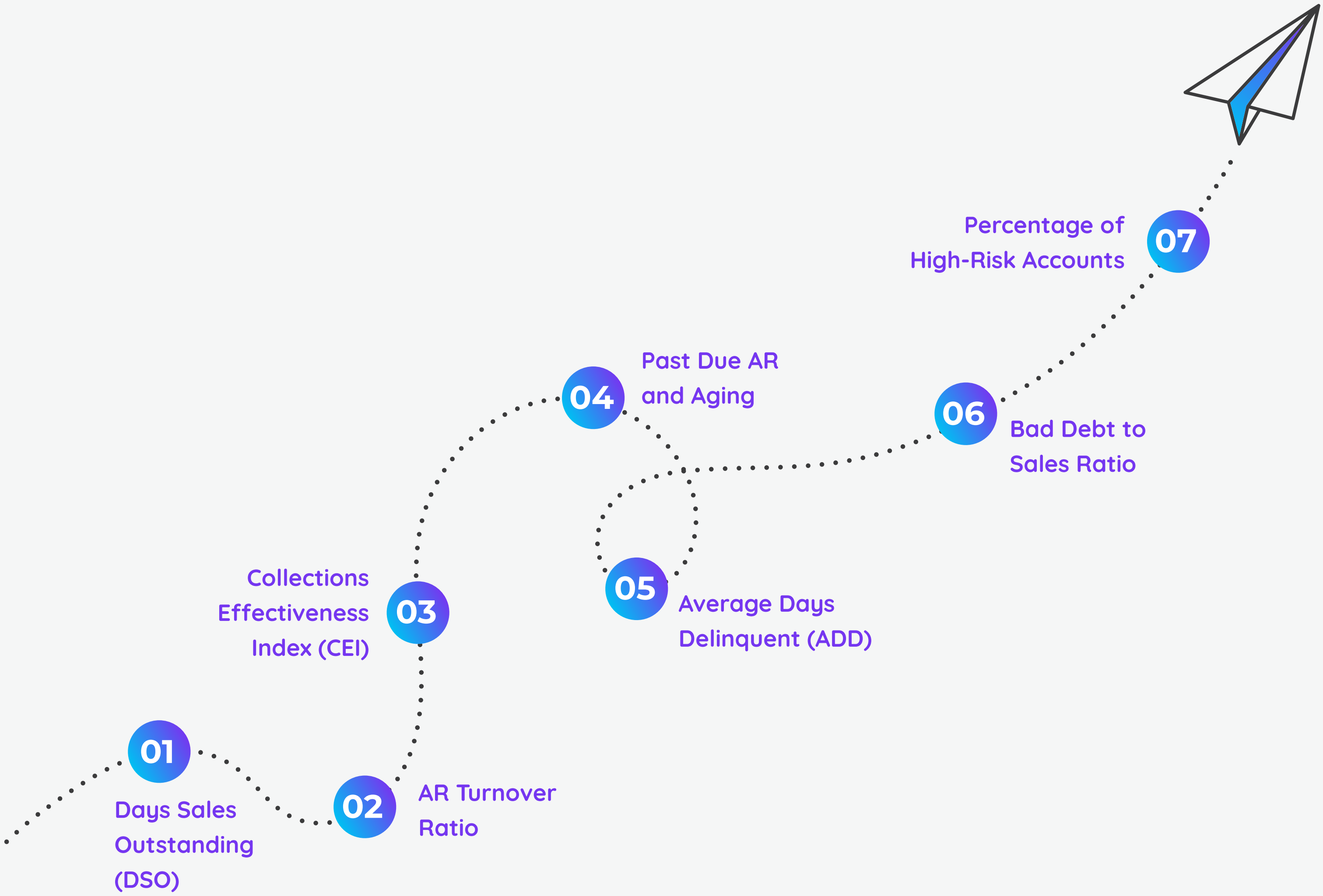
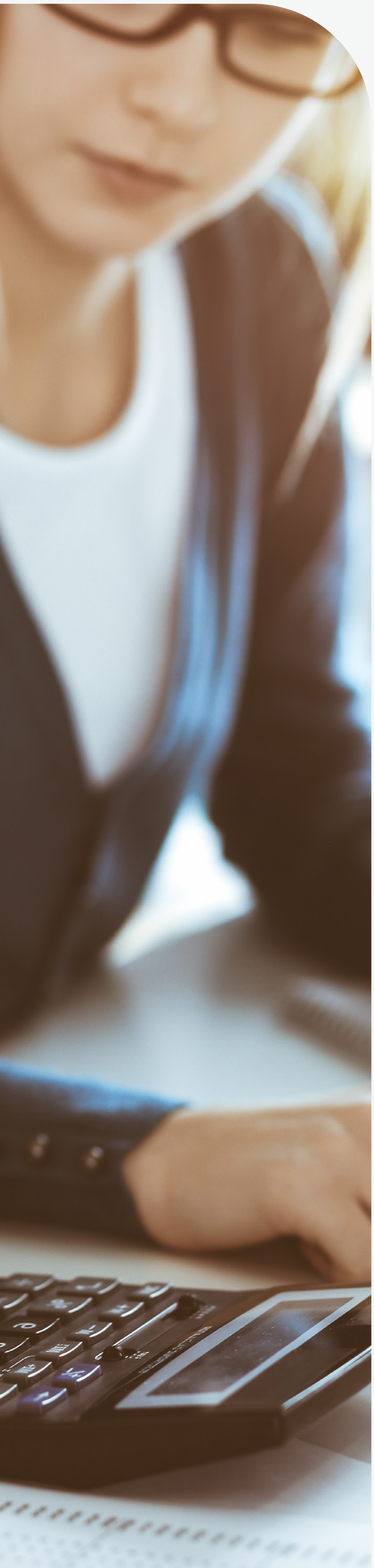
It's an oft-cited business maxim that you can't manage what you don't measure. The problem? Knowing that you should be monitoring key performance indicators (KPIs) and knowing which you should prioritise are two completely different matters.

AR metrics such as Days Sales Outstanding (DSO), AR aging, and Average Days Delinquent (ADD) — among others — are key to gauging the efficiency of your process and identifying areas in need of improvement.

If you want to elevate AR performance and maximise cash flow, it starts with effective management of these seven key performance indicators (KPIs). This eBook explains what they tell you, how to calculate them, and the steps you should take to improve them.





Days Sales Outstanding (DSO)

Days Sales Outstanding (DSO) is a big hitter in the world of AR metrics. It shows the speed of your cash flow, while providing an indicator of your organisation's efficiency and profitability.

DSO - the average number of days that receivables remain outstanding before cash is collected.

WHY IT'S HELPFUL

- It allows members of the C-Suite to discover how quickly the company can reinvest cash for sales and growth.
- Regular monitoring reveals if your AR team is becoming more or less efficient, if collections policies need to be adjusted, and even how economic conditions are impacting your business.
- You can use the metric to examine individual customer trends. By studying the DSO of accounts, your team can determine if any cash flow issues necessitate changes in credit management or payment terms.

There's a direct correlation between AR activity and DSO!

The longer it takes you to collect on invoices, the higher your DSO. While other factors play a role — such as industry standards, external economic conditions, and seasonal trends — optimising collections is the first step to take if you're looking to lower DSO.

HOW TO CALCULATE

TIPS TO IMPROVE IT

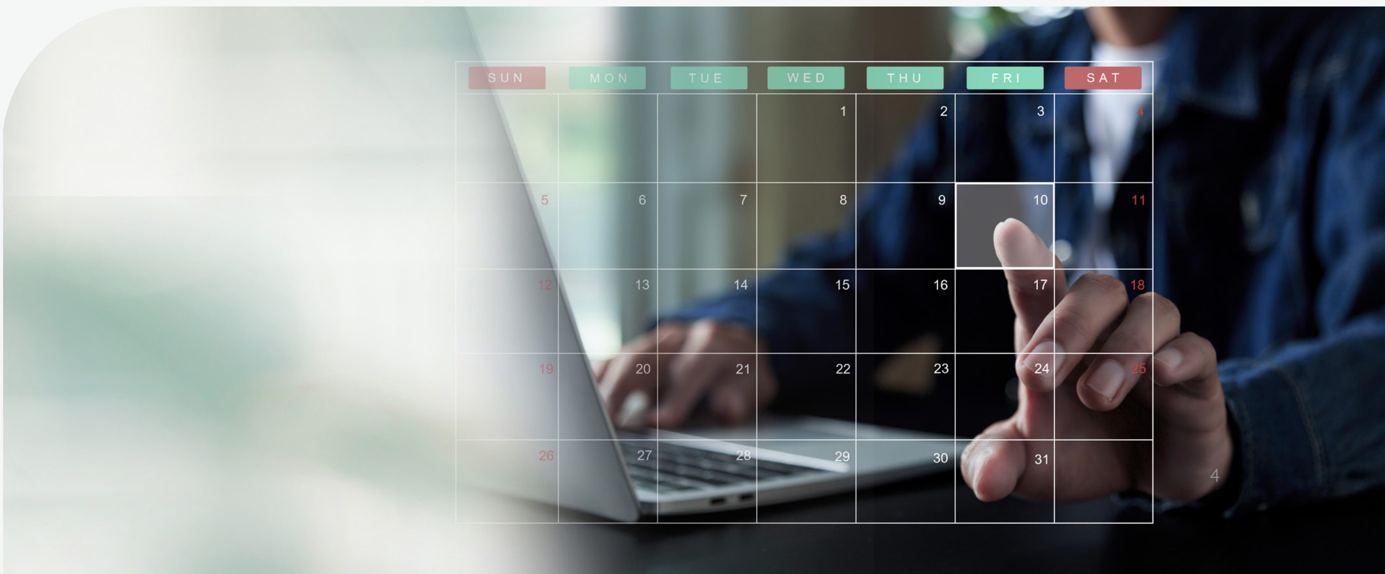
These steps will help you to reduce DSO and improve your organisation's cash flow.

Tighten credit policies – Creating stricter credit policies helps reduce late payments. This may involve a more detailed screening process before offering credit, or even requiring partial payment upfront.

Deliver invoices promptly and accurately – Faster payments start with more efficient invoicing. Delivering accurate invoices in a timely manner to customers ensures faster payment.

Encourage early payment – Offering incentives or discounts encourages customers to pay promptly.

Follow up on late payments – Establishing a thorough dunning process minimises the impact of late payments, thereby reducing DSO.



AR Turnover Ratio

AR turnover ratio - the number of times a company collects its AR over a given period.

WHY IT'S HELPFUL

- The number reflects how efficiently your company collects its receivables.
- It demonstrates how quickly credit is turned into cash and illustrates the amount of risk you are exposed to.

HOW TO CALCULATE

To determine your AR turnover ratio, you'll use the following formula:

In this equation:

- **Net credit sales** – all sales where cash is collected at a later date. To determine this amount: **Net Credit Sales = Sales on credit – Sales returns – Sales allowances.**
- **Average accounts receivable** – The sum of the starting and ending accounts receivable for a given period — i.e. year, quarter, month — divided by two.

You can also calculate your AR turnover ratio in days, demonstrating the average number of days it takes a customer to pay a credit sale. To calculate this figure, use this equation:

Receivable Turnover in Days = 365 / AR Turnover Ratio

What is a good AR turnover ratio?

In general, the higher your AR ratio, the better it is for your company as it indicates that your customers are likely to pay promptly. However, it can also indicate conservative credit policies.

While this may be an advantage when it comes to combatting late payments, credit policies that are too conservative may deter potential customers.

What is a low AR turnover ratio?

A low turnover ratio suggests your organisation may be too lenient with its credit policies, has poor collections processes, or has many customers who are not creditworthy.

TIPS TO IMPROVE IT

Provide prompt & accurate invoices – As with DSO, ensuring that your customers receive accurate invoices in a timely manner will minimise potential disputes and speed up payment time.

Always state payment terms – Your payment terms should be clearly outlined in any contract agreements you have with customers, as well as on invoices and in relevant customer communications.

Offer multi-payment options – Different customers have different payment preferences — be it credit, ACH, or wire transfer. The more payment options you provide, the more likely a customer is to pay faster.

Set regular follow-ups – Set a cadence of communications and follow-up reminders prior to an invoice's due date to keep the matter top of mind for your customer.

Offer incentives and discounts – Offering a percentage discount or some other incentive to customers who pay early can help encourage speedy payments.

Collections Effectiveness Index (CEI)

Collections Effectiveness Index (CEI) is a crucial data point for teams looking to understand their credit and collections team's performance.

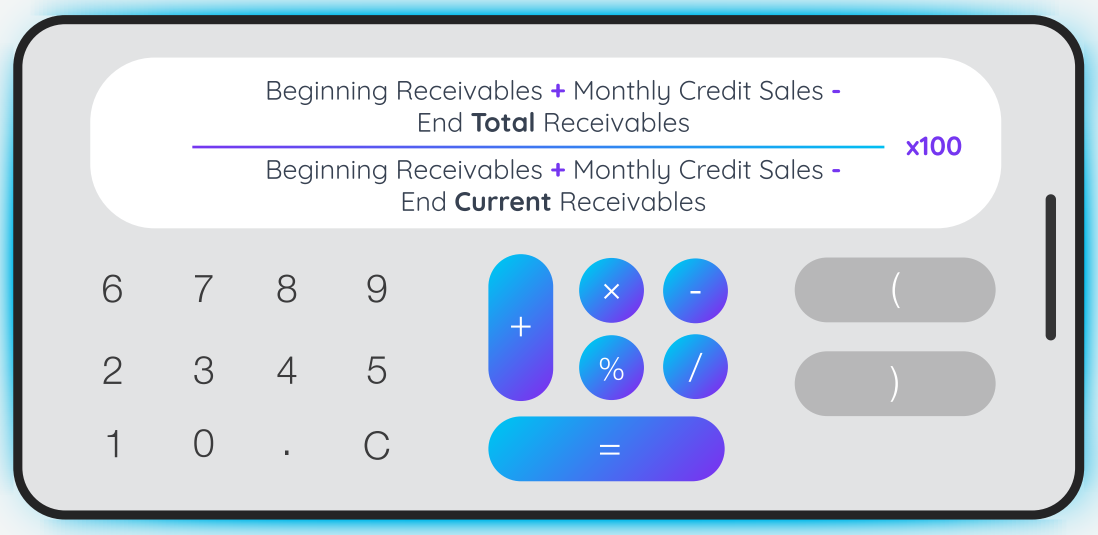
Collections Effectiveness Index (CEI) - the percentage of accounts receivable that are collected over a given period.

WHY IT'S HELPFUL

- While CEI and DSO both measure your organisation's collections performance, they serve different purposes.
- DSO shows how quickly you turn credit into cash but can be impacted by elements like sales cycles and doesn't focus specifically on the collections process. CEI provides insight into your collection team's success in securing revenue owed, with adjustments based on the sales volume.
- CEI is most valuable when you are attempting to improve your internal collections processes and want to track progress over time.

HOW TO CALCULATE

Calculating CEI is a slightly more involved process. Let's look at the formula and the elements that go into calculating it.



$$\frac{\text{Beginning Receivables} + \text{Monthly Credit Sales} - \text{End Total Receivables}}{\text{Beginning Receivables} + \text{Monthly Credit Sales} - \text{End Current Receivables}} \times 100$$

Here's a closer look at each of the terms:

- **Beginning AR** – the amount of AR at the beginning of the period
- **Credit sales** – The amount of credit sales per month
- **Ending total AR** – All open receivables, including current and overdue
- **Ending current AR** - the total of payments you received for credit sales made during the period.

WHAT IS A GOOD CEI?

In a perfect world, your team's CEI would be 100%. While this number is theoretically possible, it's highly unlikely. So, don't worry if you aren't there. That said, the closer you are to hitting 100%, the better your CEI. In general, anything above 80% is considered good.

TIPS TO IMPROVE IT

Elevating your CEI will require consistently monitoring the number and carefully studying areas that may be negatively impacting it. However, general practices can be employed to ensure that it's as high as possible.

Streamline invoicing processes – Ensure invoices are accurate and sent promptly and leverage electronic systems to reduce delays and errors.

Implement effective collections strategies – Develop a structure process, including escalation procedures for delinquent accounts. Train your team in effective communication and negotiation.

Manage delinquent accounts effectively – Creating a thorough dunning process with regular payment reminders will keep payment top of mind for customers. Including a link to an online payment portal in these communications will help spur faster payment.

Offer multiple payment formats – Offer customers the ability to make payments using their preferred method and currency — the latter is particularly important for businesses with an international customer base.

Revise credit policies – Study your customers' payment behavior and payment patterns to fine-tune your organisation's credit policies and management, adjusting credit limits as necessary based on the data.

Past Due AR and Aging

DSO helps your organisation understand how late your collections are on average, while past due AR and aging buckets give you a more granular view of how much AR has gone overdue.

Past Due AR - the number of receivables a company has that are collected past their due date.

AR aging bucket – a method to categorise past due invoices based on how far past due they have become.

Aging buckets are typically based on 30-day time periods, i.e. 0-30 days past due, 31-60 days past due, 61-90 days past due, and 90+. Invoices in a lower number aging bucket are considered lower risk.

WHY IT'S HELPFUL

- Past due AR indicates your outstanding invoices, helping you prioritise your collections by displaying accounts in need of urgent attention.
- The more past due an invoice is, the less likely it is that your organisation will collect the full amount; by focusing on aging invoices, you increase the likelihood of collecting the full value.

What is a good AR aging percentage?

It's intuitive to say that the fewer invoices you have in your AR aging buckets the better, but that doesn't leave you with a lot of actionable insight. When assessing your AR aging, a good measurement of your financial health is the percentage of AR that falls into your 90+ days bucket.

What is a good AR aging percentage?

In general, businesses shoot for a percentage between 10-15%, though this may vary by industry. As an example, the standard percentage of invoices over 90+ days in the construction industry is around 31%. On the other end of the spectrum, travel agencies typically have around 1% of their AR over 90 days past due.

TIPS TO IMPROVE IT

Collections prioritisation – Create a policy of prioritising high-risk and severely past-due accounts.

Predictive analytics – Employ tools like AI and machine learning to analyse customer payment behavior to aid collections prioritisation. By studying past payment behaviors, the technology makes predictions about when invoices are likely to be paid. If they are likely to be past due, the tech can also project how significantly past due they are likely to be.

Replace manual processes – Increasing the efficiency of your AR process will also decrease the amount of severely past-due invoices you have. Eliminating manual processes and replacing them with automation of tasks like invoice delivery and follow-up communications will help you collect faster.

Average Days Delinquent (ADD)

Average days delinquent (ADD) - tells you how late customers' payments are on average.

This metric only analyses past due invoices, excluding outstanding invoices (those that are unpaid but still within their payment terms).

WHY IT'S HELPFUL

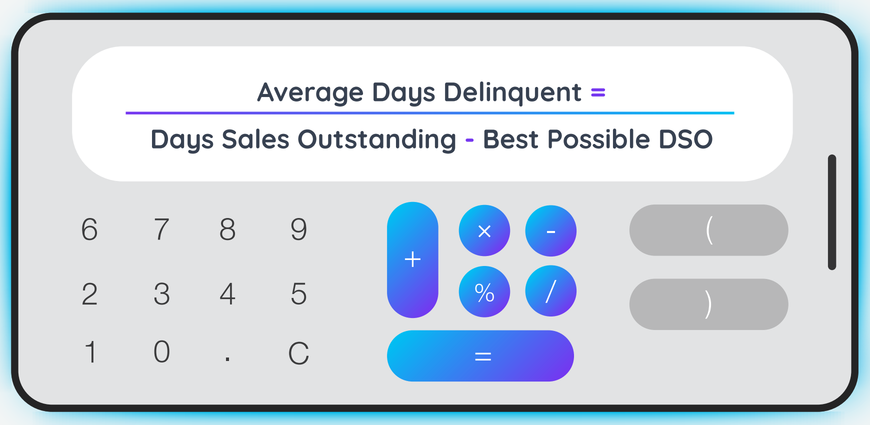
- A higher ADD indicates slow-paying customers, while a lower number suggests that your customers tend to pay promptly.
- When analysing the metric, it's important to be aware of standards that may impact your number. For instance, organisations within the construction industry tend to have longer pay cycles, meaning that this number will naturally be higher.
- ADD is also most valuable if viewed as a trend over time and in comparison to metrics such as DSO.
- While DSO is similar in some respects to ADD, the crucial difference between the two is that DSO measures the average of how long it takes ALL invoices to be paid, including early, on-time, and late. ADD only analyses past-due invoices. Because of this, ADD gives you a better idea of the severity of your late payments.

If your
DSO & ADD
are high or low, it means that the metrics are aligned.

HOW TO CALCULATE

You'll use several equations to calculate your ADD. The first equation you'll need to use determines your best possible Days Sales Outstanding.

Once you've determined this, you can plug that number into the formula for calculating ADD.



If your DSO and ADD are high or low, it means that the metrics are aligned. It indicates either an improvement or deterioration of your dunning process. However, a high DSO and low ADD, or vice versa, does not necessarily indicate effective collections, as seasonality may be at play. Other factors, such as modified credit terms, could also lead to the discrepancy.

TIPS TO IMPROVE IT

Let's look at a few immediate and easy-to-implement actions that can help optimise your ADD.

Clearly communicate payment deadlines - Frequently, late payments are caused by a company's failure to clearly state when payment is expected. The due date may not be placed in an easily visible location on the invoice or could be missing. It's also important to use common and easy-to-understand terms when outlining payment expectations. Standard examples include "Net 30" or "end-of-month."

Let customers know exactly what they owe - Your invoice should clearly state the total amount owed. Ideally, you should offer customers a self-service payment portal that allows them to see open invoices, credits, and payment history, as well as make payments.

Adopt an AR automation solution - This software will immediately send out invoices, payment reminders, and dunning notices until payment is received, keeping the bill top of mind and ensuring fast resolution.

Monitor customer creditworthiness - Keep a real-time view of things like payment history and monitoring customer credit. If certain customers show a tendency to pay late, it may be time to change their terms or discuss payment plans that help them meet their obligations.

Let AI support dispute resolution - Adopting a solution that leverages AI and machine learning to assess disputes can help with faster resolution. The software analyses disputes and prioritises them based on severity.

As bad debts impacts your company's profitability by being expensive to collect upon, while also

eating

into your cash flow.

Bad Debt to Sales Ratio

Any time your company makes a sale on credit, it assumes the risk of bad debt. This is the amount that a company must write off as uncollectible. It's listed as an expense on your organisation's balance sheet.

Bad debt-to-sales ratio – a metric that measures the amount of money your company must write off compared to your net sales.

WHY IT'S HELPFUL

Calculating the ratio helps you understand the efficiency of your collections, provides insights into your cash flow, and helps you understand your overall financial health, allowing you to:

- Improve your collections process and your cash flow.
- Avoid unpaid invoices from customers by identifying the profile of customers consistently in the "bad debt" bucket and adjusting your credit terms accordingly.
- Improve profitability, as bad debts impacts your company's profitability by being expensive to collect upon, while also eating into your cash flow.
- Improve your business' own credit rating by having a healthy business and growing cash flow, so your bad debt isn't impacted by your own creditworthiness.

Want to discover more ways to combat bad debt?

Check out our Accounts Receivable Collections Playbook

DOWNLOAD NOW!

HOW TO CALCULATE

There are two methods that you can use to calculate your bad debt. The first method is known as the **direct write-off method**. It uses your actual uncollectible amount of debt divided by the accounts receivable for the defined period.

This is how the formula works for a 12-month period:

(Uncollectible sales divided by annual sales) multiplied by 100 equals Bad Debt Ratio (%).

Sales = £10 million

Uncollectible = £300k

(300,000 / 10,000,000) x 100 = 3%

You can adjust this formula for whatever period is appropriate for your business and the needs of your analysis.

TIPS TO IMPROVE IT

To help reduce the amount of uncollectible debt impacting your business, you can follow these steps:

Conduct thorough credit assessments – Before extending credit to a customer, ensure that they are financially stable and creditworthy.

Create a thorough credit policy – Establish a detailed credit policy that outlines credit limits, payment terms, and the consequences of late payments.

Collect proactively – Don’t wait for payments to become delinquent before following up with a customer. Prioritise high-risk accounts and follow up with them first. Using AR automation software with AI capabilities can help this process by employing predictive analytics to anticipate payment behaviors.

Automate credit checks – Adopt a software that not only automates the credit check policy but provides real-time updates so that you are always presented with an accurate view of your customers’ credit health, including any significant changes in payment behavior.

Percentage of High-Risk Accounts

Percentage of High-Risk Accounts - a metric that estimates the proportion of accounts that may contribute to your bad debt.

WHY IT'S HELPFUL

- Having a working knowledge of which accounts are high risk allows your AR team to focus its collections efforts strategically.
- It gives you the chance to strengthen customer relationships and improve customer experience by working with customers to develop a plan that gets you paid while being conscious of their challenges.
- It reduces the risk of bad debt.

HOW TO CALCULATE

There is not a set method for estimating your percentage of high-risk accounts, but there are established steps you can follow when evaluating.

- **Determine the average collection period** – Find your average collection period, as well as the average for your industry and competitors.
- **Credit assessments** – conduct regular customer credit assessments. Ideally, use AR automation software that updates real-time so that you always have a current view of your customers' credit health.
- **Evaluate AR aging** – By continuous monitoring of your AR aging, you can identify accounts with deteriorating payment trends.

Using this framework, you can identify accounts that may be deemed high-risk. To calculate your percentage, simply divide the number of accounts you've labelled high-risk by your total accounts. You will then multiply the result by 100 to determine your percentage.

TIPS TO IMPROVE IT

By monitoring the KPIs discussed in this toolkit, you can go a significant way toward decreasing the number of high-risk accounts in your portfolio. Here are a few other steps you can take:

Cloud-based data storage – A key driver of credit risk is a culture where sales teams override standard credit terms, offer unapproved discounts, and waive payment requirements to get new sales on the books. This can particularly be the case when there is limited coordination or communication between departments. Adopting cloud-based storage for your data, particularly through an AR automation software, allows data to easily be shared between departments, providing the sales team with a picture of high-risk accounts to make more informed decisions during the sales cycle.

Eliminate manual processes through automation – Manual processes are slow and inefficient. They limit data visibility and force your AR team to focus on time-consuming manual tasks that keep them from taking a more strategic and proactive approach toward high-risk accounts.

Automation centralises your data from all your systems — such as

ERP & CRM

and stores it on the cloud so that it is readily accessible and reduces the risk of manual data entry errors.

Improving your KPIs with AR automation

While we've mentioned several practical steps that an organisation can take to improve their KPIs and increase AR efficiency, the single most effective step that can be taken is adopting an AR automation solution.

AR automation software allows you to:

- **Optimise customer communications** – From invoice delivery to follow-up and dunning notices, automation software helps you craft custom communication workflows based on your customers' preferences. Automation software aided by AI can also help you quickly create a library of communication templates specifically designed to spur payment, helping reduce late payments and increase cash flow.
- **Streamline the payment process** – The easier it is for customers to make a payment, the more likely they are to pay on time. AR automation solutions provide you with a customer payment portal where customers can make a payment using the method and currency of their choice. As it's an online portal, customers can access it at any time, meaning they can work at their convenience.
- **Enhance reporting** – Improving your KPIs relies on the ability to access accurate and timely data. Manual AR means that your data is stored across different storage systems — either physical or digital. Automation centralises your data from all your systems — such as ERP and CRM — and stores it on the cloud so that it is readily accessible and reduces the risk of manual data entry errors.
- **Predict payments and cash flow** - An AI-enhanced automation system levels up your reporting through predictive analytics that anticipate payment behaviors and identify high-risk accounts.

- **Simplify dispute resolution** – Disputes are a frequent cause of late or delayed payments. AR automation allows you to simplify dispute resolution through AI. Customer disputes are analysed using machine learning. Disputes that require a simple action — such as sending out a copy of an invoice — are automatically handled, while those requiring human intervention are prioritised and sent to your team for resolution.
- **Reduce credit risk** – With real-time credit scoring underpinned by predictive analytics that study past payment behavior, you can more accurately asset creditworthiness, adjust terms, and take proactive steps to prevent delinquency, decreasing bad debt and late payments.

To discover how Quadient AR can help you improve your AR metrics and optimise cash flow, contact us today .

Contact us today!

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Elevate credit-to-cash with Quadient AR by YayPay

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, personalised connections and achieve customer experience excellence.

For more information, visit quadient.com/ar-automation