

AVERAGE COLLECTION PERIOD

1. What is the Average Collection Period?

The average collection period (also known as average days receivable) measures the average number of days it takes for your business to collect payments from customers after a sale.

This metric helps assess how effectively your company is managing its receivables. A longer collection period may signal issues with your credit terms, customer payments habits or cash flow and may indicate it's time to review your policies.

2. How to Calculate it?

Calculate average accounts receivables

Add your receivables at the beginning and end of the period, then divide by 2.

Formula application

$$\left(\frac{\text{Average accounts receivable}}{\text{Net credit sales}} \right) * \text{Number of days in the period}$$

*Net Credit Sales: It refers to net credit sales, that is, credit sales, less returns and discounts. The standard reporting period is one year (365 days).

Average Collection Period formula

Step 1: Calculate Average Accounts Receivable

$$\text{Average Accounts Receivable} = \left(\frac{\text{Beginning Accounts Receivable} + \text{Ending Accounts Receivable}}{2} \right)$$

- The Beginning Accounts Receivable represents the amount of money owed by customers at the beginning of the period.
- The Ending Accounts Receivable represent the corresponding amount at the end of the period.

Step 2: Calculate the Average Collection Period

$$\text{Average Accounts Receivable} = \left(\frac{\text{Beginning Account Receivable} + \text{Ending Accounts Receivable}}{\text{Net Credit Sales}} \right) * \text{Number of Days}$$

EXAMPLE

Let's say your business has an average accounts receivable of €150.000 for the year, and your net credit sales for the same period are €1.500.000.

To calculate the average collection period:

$$\text{Average Accounts Receivable} = \left(\frac{\text{Beginning Accounts Receivable} + \text{Ending Accounts Receivable}}{\text{Net Credit Sales}} \right) * \text{Number of Days in the Period} = \frac{€150.000}{€1.500.000} * 365 = \mathbf{36.5 \text{ days}}$$

This means it takes your customers, on average, 365 days to pay you.

If your standard payment terms are 30 days, this might be a sign that your clients are paying a bit late, and you may need to review your collection process or follow up more consistently.

3. Why Calculate Your Average Collection Period?

Your Average Collection Period shows how long it takes customers to pay you after a sale.

This number helps you understand how well your business is managing its receivables and cash flow.

If it takes too long to collect payments, you may need to adjust your payment terms, improve your invoicing process, or follow up with customers more effectively.

You can also compare your results with similar businesses to see if you're performing well or need improvement.

Slow collections can lead to cash shortages, making it harder to cover expenses or invest in growth.

4. What is a good average collection period?

A shorter collection period is usually a sign of effective financial resource management. This means you get paid faster and have more cash available to support your business.

5. The Business Costs of a Longer Collection Period

Delays in collecting payments from customers can have financial consequences that are not immediately visible. These typically include:

- Lost interest in your money
Cash that hasn't been collected can't earn interest. In fact, you're giving your customers an interest-free loan.
- Higher borrowing costs

If your cash is tied up with unpaid invoices, you might need to borrow more to cover expenses — and that means paying interest unnecessarily.

- A lower business growth rate
Without cash coming in, it can be harder to invest in new staff, inventory, or marketing.
- Harder to get approved for credit
Banks may view your business as risky if your clients are often late with payments.

EXAMPLE

The company's receivables amount to €12.000, and customers are significantly delayed in their payments. The business wants to hire staff, promote a new product, or purchase materials, but the available cash is tied up in unpaid invoices. This makes it impossible to move forward with any new actions, despite the immediate need for liquidity. To proceed, the company uses a credit line of €50.000, which means it pays interest on money that it should have already collected from customers.

6. Liquidity Cycle Analysis

The Average Collection Period is only one part of the broader cash conversion cycle, which shows how long it takes a business to turn its initial investment into cash from sales.

This cycle begins when the business spends money to create a product or deliver a service and ends when the customer finally pays. Whether the organization sells physical goods or provides services, there is often a significant time gap between the start of the work and the receipt of payment.

For example, a manufacturing company may spend money on raw materials, equipment, salaries, and other overhead costs to produce goods. After all of that, it only gets paid once the product is delivered, the invoice is issued, and the payment is completed with a process that can take several months.

The time between invoicing and receiving payment is the collection period.

7. Are Collection Periods Longer in Certain Industries?

The answer is Yes, and the differences can be quite significant.

Certain industries, such as hotels and restaurants, are used to getting paid immediately. Their customers typically settle the bill without delay, allowing them to maintain a short collection period and reliable cash flow.

In contrast, if your business serves large organizations such as government agencies or major corporations you may have to wait much longer to receive payment. These entities often have fixed payment terms, which can reach or even exceed 90 days. And since they usually don't negotiate, smaller businesses must adapt.

That's not necessarily a bad thing these clients are generally low-risk but it means you need to adjust your financial planning, especially if delayed payments affect your ability to invest, hire staff, or expand.

For manufacturers, this can be even more demanding. Their cash flow cycle starts with high expenses: purchasing raw materials, paying employees, and operating machinery. If customer payments are delayed, they may need external financing just to keep production running.

8. How to Improve Your Average Collection Period

If your average collection period is longer than it should be, there are practical steps you can take to reduce it and improve your cash flow:

- **Incentivize early payment**
Offer discounts to customers who pay quickly. For example, a 2% discount for payment within 10 days. Just be sure the financial benefit of early cash flow outweighs the cost of the discount, especially in high-interest environments.
- **Introducing late payment penalties**
Charging interest or fees on overdue invoices can motivate some customers to pay on time. While not always effective, this approach can be useful when delays become habitual.
- **Strengthen your credit and collections policy**
Make sure you're extending credit only to trustworthy clients. Set clear terms and follow up promptly when invoices are overdue.
- **Adjust your pricing to reflect overdue payments**
If certain clients consistently take 60 or 90 days to pay, consider incorporating that delay into your pricing structure to protect your margins.