

AVERAGE DAYS PAYABLE

Average Days Payable indicate how long, on average, a company takes to pay its suppliers.

This metric is useful both for business owners who want to manage their company's liquidity effectively over time, and for investors or lenders who aim to assess the company's financial reliability compared to its competitors.

A consistently high value may suggest potential issues with cash flow management or delays in payments, while a very low value might indicate that the business is not fully utilizing the available credit terms offered by suppliers.

In general, companies aim to keep their average days payable at relatively low levels as a sign of consistency in meeting their financial obligations. However, if the ratio is extremely low, it could imply that the company is not taking full advantage of the payment terms provided by its suppliers.

On the other hand, an excessively high number may indicate that payments to suppliers are being made past the agreed terms, which could lead to interest charges or penalties. It may also point to internal liquidity issues and a negative impact on the company's creditworthiness.

1. How do you calculate average days payable?

To calculate the average days payable, divide accounts payable by total purchases during a specific period, then multiply by the number of days in that period.

Formula Application

$$\text{Average Days Payable} = \left(\frac{\text{Days in the Period} \times \text{Average Accounts Payable}}{\text{Purchases on Credit}} \right) \times 365$$

EXAMPLE

Suppose a company has an average account payable of €40.000 over the course of a year, and its total credit purchases during the same period amount to €300.000.

Using the formula:

$$\text{Average Days Payable} = \left(\frac{\text{Days in the Period} \times \text{Average Accounts Payable}}{\text{Purchases on Credit}} \right) \times 365 = \left(\frac{365 \times €40.000}{€300.000} \right) \times 365 = 48.7 \text{ days}$$

This means the company takes about 49 days, on average, to pay its suppliers.

2. What happens when the average days payable goes up?

An increase in Average Days Payable means the company is taking longer to settle its obligations with suppliers. This may be a sign of liquidity issues or a strategic choice to retain more short-term available capital.

Some businesses intentionally delay payments to use the funds for other needs, such as repaying debt or investing. However, if this becomes regular practice, lenders may interpret it as a sign of financial risk.

That said, in the context of mutual trust between both parties, suppliers may be more understanding and willing to accept extended payment periods.

3. What does a lower average day payable mean?

A drop in the average day payable means the company is settling its supplier invoices more quickly than before.

In many cases, suppliers are open to offering discounts for faster payments. For instance, they might give a 2% discount if payment is made within 15 days instead of the standard 60.

Paying suppliers faster can improve operating margins and build stronger, more trusting relationships. By showing that your company is financially responsible and dependable, you create goodwill and, in the future, if you need more flexible terms, your supplier may be more willing to accommodate you.

4. Which business should focus on optimizing average days payable?

While average days payable is a helpful indicator for any business, it's especially valuable for companies that depend on supply chains.

Take, for example, a bakery located in a tourist town. Like most bakeries, it sources ingredients like flour and sugar from multiple suppliers. However, its revenue fluctuates seasonally peaking during the warmer months when tourists are in town and dipping during the off-season.

To manage cash flow efficiently, the bakery can adjust its payment terms throughout the year. During slower months, when it purchases fewer supplies and has more available cash, it could shorten its average payable from 60 to 15 days. This quicker payment might help the bakery negotiate a supplier discount, reducing costs.

In contrast, during the busy season, when expenses are higher and cash is tighter, the bakery might extend its payment window to 60 or even 90 days. This would allow the business to preserve cash for immediate needs while effectively using supplier credit.

While adjusting payment terms can be a smart strategy, clear communication is key. If a supplier starts receiving late payments without notice, they may tighten terms or

require payment upfront. For that reason, any changes in payment practices should always be discussed in advance.

5. What is the typical level of Average Days Payable observed in the sector?

To assess whether your business is effectively managing its obligations to suppliers, it's important to compare its Average Days Payable with those of other companies in the same industry. This comparison can reveal whether adjustments are needed in your payment management practices.

Typical payment terms vary across industries. For example, construction companies often have longer payment periods due to the complexity of their supply chains, while technology companies may operate with shorter terms since they rely less on physical goods.

If your business's indicator is significantly higher or lower than the industry average, it may signal a weakness. The company might be paying suppliers more slowly than competitors, or faster than necessary, which could negatively affect its cash flow.

Staying close to or below the industry average can offer a competitive advantage. In highly competitive markets, paying suppliers faster than competitors could lead to discounts or more favorable cooperation terms.

6. How to Improve Your Average Days Payable?

Average Days Payable is just one part of a broader set of financial metrics that guide both short- and long-term business decisions. Although it doesn't function in isolation, this indicator plays a key role in understanding how effectively a company manages its cash outflows.

To improve the effectiveness of the indicator, the following best practices must be followed:

- Monitor the indicator monthly to identify trends early and adjust your strategy accordingly.
- Set payment terms that typically range from 15 to 90 days. If the terms are too long, it may reflect poor liquidity management; if they are too short, you may lose flexibility without real benefit.
- Extend payment terms when your business requires additional liquidity.
- Shorten terms when cash flow is strong, allowing you to take advantage of supplier discounts and improve profit margins.
- Build relationships of trust with suppliers, so you can negotiate better terms when needed, giving you a flexible tool for maintaining financial stability.

Ongoing monitoring and management of Average Days Payable is essential for any business owner aiming for long-term financial health. This is especially important in competitive industries, where strong liquidity management is crucial for survival.

By consistently tracking this ratio and adjusting your strategy as needed, you can maintain strong supplier relationships while safeguarding your company's overall financial position.