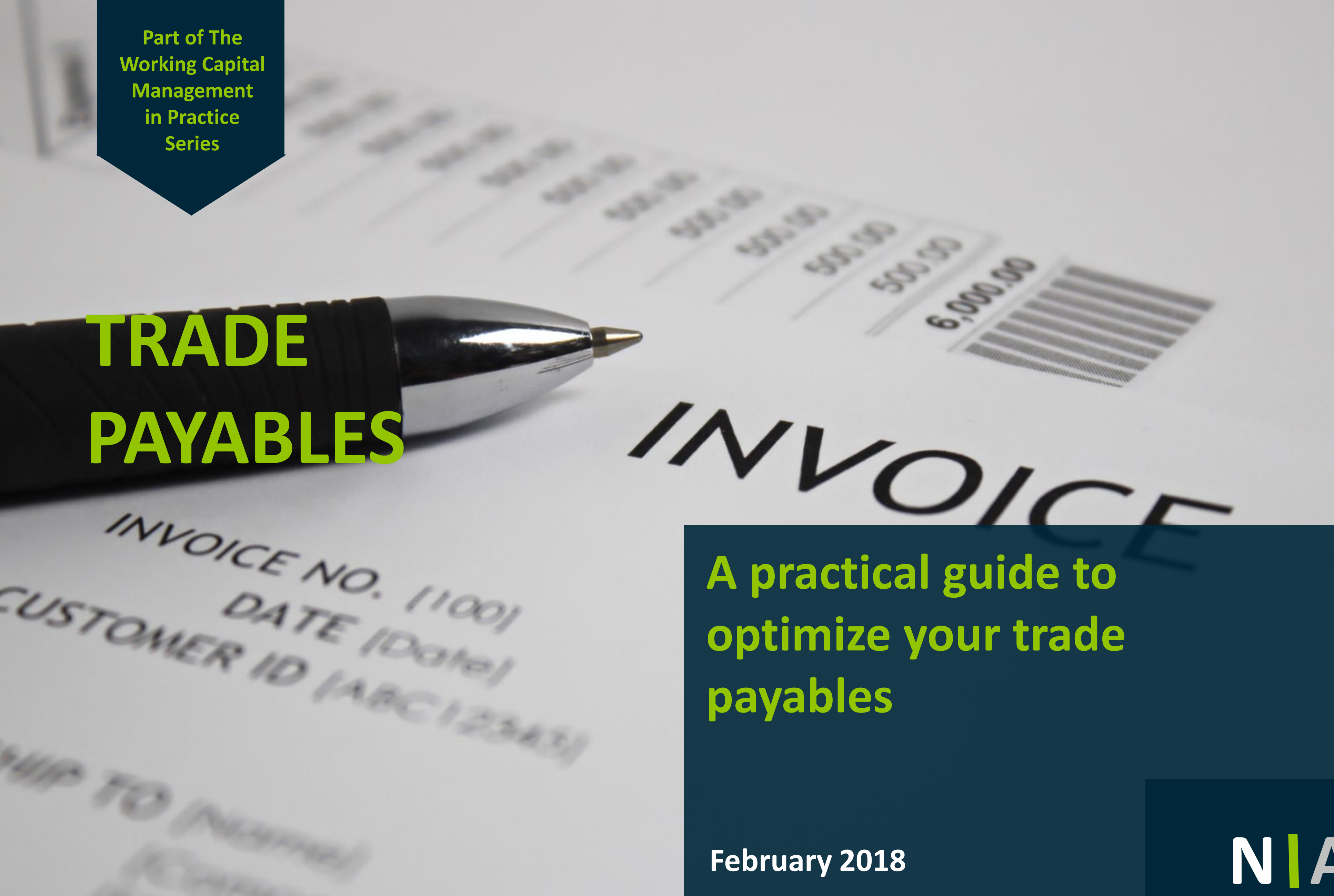
Part of The Working Capital Management in Practice Series



TRADE PAYABLES

A practical guide to optimize your trade payables

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NORSK ARBEIDSKAPITAL

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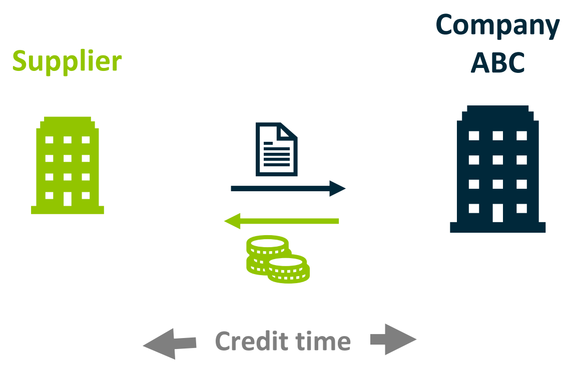
Introduction

Trade payables is counted among the three main components of working capital, the others being trade receivables and inventory. It is a proven strategy that any improvements in trade payables can lead to significant enhancement of working capital. The premise behind working your trade payables is to improve cash flow by decreasing the speed in which you pay your trade payable.

But it is a common mistake to think that this can be achieved by just paying your suppliers later! Although this might work for the (very) short term, it will not be sustainable in the long run. For companies looking to take on the challenge of generating additional cash, here are six important activities to optimize your trade payables level in a more sustainable way.



Payment policy

Every company should have a payment policy. A payment policy does not only guide your employees but also lets your suppliers know what you expect from them and what they can expect from you. It includes, for example, your invoice requirements, your standard payment terms, how you handle invoices that fall due during a weekend or official holiday and how often your company makes payments. By paying for instance twice a week in stead of every day, you will already increase your trade payables level without the need for negotiating longer terms.

Having a standard payment term of, for example net 60 days, does not imply that all your suppliers will have this payment term in practice. Some suppliers, like your utility providers, are likely to have a shorter payment term, while you might be able to negotiate longer terms with a specific number of suppliers. A standard payment term acts therefore often as an internal (minimum) guideline. Any payment term below the standard needs to be upfront agreed upon by management.

After having defined a payment policy, it is crucial that you make your payments according to your policy. In that way you will become a trustworthy business partner for your suppliers which ensures a good starting point for future negotiations.

Payment terms

Negotiating longer payment terms is at the core of improving your cash flow from trade payables. To successfully negotiate better payment terms, knowledge of your own position is however essential.

Many companies may not have full visibility into one or more of the following: how much is spent, with whom, by whom, for what and at what terms. In these cases, the first step is a data analysis exercise. Investing the time to fully-understand and strategically segment vendor payments is critical to successfully negotiating longer payment terms.

A good rule of thumb is to use your current best available payment term in a supplier segment as the floor for term targets. Terms can often be extended without giving up anything if the data show that the current term is too short compared to competing suppliers.

But don't negotiate with every supplier. This may seem a counterintuitive step but negotiating with every supplier is inefficient or impractical. The overwhelming majority of suppliers can be moved to improved payment terms without any negotiations. How?

Once identified, send all your small-spend and less strategic suppliers a letter or email announcing that company policy is changing, and future transactions will be at the new standard terms. Some suppliers will reject the terms, but clients tend to get a remarkably low response rate. There are often more worries from internal parties about supplier pushback than actual pushback.

Finally, make sure that your weighted average supplier payment term is at least equal or longer than your weighted average customer payment term. You want to avoid a situation where you need to pay your suppliers faster than you receive money from your customers!

Payment discounts

Suppliers often offer discounts for early payments and many finance departments collect them. But should you always collect these early payment discounts? For example, a supplier might offer 2%

30 net 60 days. Should you pay within 30 days and take the discount or use the 60 days payment term? To be able to answer this question you need to know your company's cost of capital. When you have access to this percentage, it is easy to determine whether you should take the early payment discount or not. How?

Well, the equivalent payment term for a discount of 2% when paying within 30 days, assuming a cost of capital of 15% is 78 days. This follows from the following formula: 30 days + (360*2%) / 15%. So, in this case, taking the discount (equaling a term of 78 days) is more worth than using the payment term of 60 days.

But remember, review and accept only those early payment discounts that you can afford. It makes no sense to go for early payments discounts if you do not have sufficient cash in hand!

Accurate master data

Inaccurate data of supplier payment terms can lead to erroneous payments and loss of discounts. So, make sure that your ERP-system reflects the accurate supplier terms. Often, we find out that companies have negotiated better payment terms with their suppliers but forgot to update the master data in their ERP-system. As a result, payments are still being done using the old payment terms.

To prevent this from happening, we recommend performing an annual check on the accuracy of your supplier data in your ERP system.

Alternative solutions

Your company might also benefit from the use of supply chain financing or the use of letters of credits. Both solutions can help increase your supplier payment terms.

A letter of credit is a document from a bank that guarantees payment. Overseas suppliers often require prepayments before they ship their goods as they find it risky to do business with you. With issuing a letter of credit the overseas supplier has a guarantee that he will be paid, making it easier for him to accept your standard payment term.

Supply chain finance allows a supplier to sell its invoices to a bank at a discount as soon as they are approved by the buyer. That allows the buyer to pay later and the supplier to secure its money earlier. Both sides improve their working capital while the banks get a fee. Ask your bank whether this kind of solutions could be beneficial for you.

Automation

Small companies with a limited number of suppliers and invoices can handle their payment process quite easily with the right amount of focus. But when the number of suppliers and invoices are becoming larger, you might consider automating your system.

Automation can reduce the risk of losing an invoice, forgetting to make a payment and human error or memory failure. In other words, automation ensures better compliance with your payment policy, making you a more trustworthy business partner.

Automation can be expensive, but the return on investment is considerable as there are fewer errors and, in many cases, employee productivity gets a boost too. An example of a provider of automation solutions is our partner Medius (www.mediusflow.com). They are a global provider of accounts payable invoice automation solutions in the cloud. Their solutions automate and simplify the entire purchase-to-pay process, enabling touchless invoice processing, shortened lead times and greater control.

Keeping your cash

Whether you need to restructure your entire trade payables process or simply want to improve your payment terms, the process begins by understanding your current situation through conducting an analysis of your transactional data. From there, you can identify the steps you need to take to structurally improve your trade payables level.

Beyond simply helping you identify areas for improvement, the working capital professionals of Norsk Arbeidskapital work with your teams to implement new processes, monitor and track your performance and share specific action items your employees can take to optimize your accounts payable processes. You work hard to earn your cash. Isn't it time to keep your cash working hard for you?

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