



Time to Pay Extending Payment Terms to Free Up Capital

Introduction

The question of how quickly you should pay your suppliers is a hot topic. Many companies, especially those financed by private equity, are looking for new ways to improve their working capital position. Lengthening the time you take to pay suppliers – extending payment terms - is one way of doing it.

However, in these tough economic times suppliers are under increasing pressure. How quickly customers pay their bills can make a big difference to their chances of surviving and prospering. In the recent Efficio Grassroots Procurement Survey of procurement professionals, some respondents reported fears among their colleagues that tightening payment terms could push vulnerable suppliers into insolvency.

In this edition of Viewpoint we look at some of the implications of extending payment terms as a way of freeing up working capital. We also outline ways of doing it that can bring benefits for both the buyer and the supplier.

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Background

Extending payment terms has been viewed historically very much as a top down initiative, typically imposed across the board on all suppliers. It is a controversial approach, however. In the latest case to hit the headlines, computer giant Dell has come under fire from its global suppliers after announcing an extension in standard payment terms from the current 50 days to 65 days.

There are several schools of thought on how best to achieve an increase in working capital through extending payment terms. It depends on several factors: to what extent working capital savings are needed, for example, and the number of suppliers concerned.

Extending payment terms in this way has its limits. Incumbent suppliers, naturally, will not welcome adverse changes in their terms and conditions.

The volume of reciprocal trade should also be taken into account. For many companies, some of their suppliers are also customers and will therefore need to understand the balance of trade between the two organisations. If company A is a bigger supplier to company B than it is a customer, then self-evidently reducing accounts receivable (the money A owes B) is more important to company A than reducing accounts payable (the money B owes A).

Commonly accepted industry norms for payment terms vary hugely from one geography to another. In the UK it is generally 60 days, while elsewhere in northern Europe 90 days is usual. In southern Europe 120 days is general practice. Clearly, from the buyer's point of view, the longer the accepted term, the better. Conversely, from the supplier's perspective, shorter payment terms are beneficial.

How to do it

Procurement professionals wanting to extend payment terms may come up against resistance from other functions in the business that fear that it will go down badly with suppliers. They may also suspect that it will simply lead to suppliers building the extra cost into their pricing structures, thus passing the burden back to the buyer. Such fears among non-procurement colleagues were raised in the recent Efficio survey.

Experience, however, suggests such fears are largely unfounded. If handled correctly, and only for categories that are not finance-based, it is possible to extend payment terms without incurring additional costs.

The first stage in examining payment terms is to segment your supplier base to ensure that those suppliers for whom it may be appropriate are isolated. It is during this process that payment terms should be added to the list of conditions in the RFP document. Including the terms in the sourcing process has a far greater chance of success than negotiating after.

There are several categories in which it will not work, however – generally those for which terms are generally not negotiable such as rent, rates, taxes, fuel and utilities.

However, for existing suppliers who will not be approached through the RFP sourcing process, these suppliers should be prioritised and split into three main groups:

'Letter' Suppliers

'Letter' suppliers are large suppliers with the highest working capital improvement potential. They are the best source of savings but are also likely to be strategically crucial to the buying organisation and will therefore need to be dealt with carefully. A letter from the CFO outlining why payment terms need to change would be required. They also need to be provided with a way to challenge the process so that those suppliers who wish to discuss and/or negotiate can do so without any risk of "being cut off".

'Autoswitch' Suppliers

Medium suppliers in terms of purchasing significance also offer potential working capital reductions. These, however, are less likely to be key to the business and would automatically be switched to the new payment terms.

'Tail' Suppliers

Tail, or smaller, suppliers are usually out of scope for extending payment terms for a variety of reasons and the potential savings are much smaller. These are probably not worth pursuing.

Implementation

Implementation of extended payment terms raises two important issues. First, you will need to amend the payment terms in the financial systems which are driven by the controllers or accounts payable team. The procurement professional's involvement is limited to submitting the supplier list with new payment terms.

Second, you need to establish a helpdesk function. This will take the fear away from the controllers and accounts payable teams that they will have to deal with unhappy suppliers.

Once the changes have been implemented it is critical that the agreed payment terms are adhered to. If 90 days has been agreed then payment should be made at 90 days not 95 or 105. This is a sure way of upsetting suppliers and given that they will incur additional financing costs as a result of this exercise, it is important to stick to the agreed terms to maintain goodwill. These terms must also be final - you cannot go to them proposing to change payment terms and then go back again three months later asking to reduce rates.

It is critical that on making the change that it is made very difficult to change the term in the finance system and all payment term change requests are dealt with at a very senior level.

It is also vital to manage relations with the suppliers affected and keep them on side. In some cases there may be a risk of damaging relationships with valued suppliers and, handled badly, it could lead to losing important suppliers for the sake of relatively small cash benefits.

If the supplier challenges the move it is important to be prepared to negotiate to achieve a mutually agreed outcome. This could include the extension being staggered over an introductory period or an alternative way of raising working capital that has mutual benefits.

The Alternative

Whilst extending payment terms is effective in freeing up working capital, there is now an alternative with benefits for both the buyer and supplier.

The buyer can offer the supplier early payment, which is likely to be highly welcome, if they are prepared to offer a small discount, say 3%, on the price they are charging. Thus, the supplier receives prompt payment and the buyer a discount, so both parties have gained.

To fund the programme, a rolling facility can be sourced by the buying company's treasury either from its own resources or from a third party funding provider. The facility required is equivalent to the total value of payables that would be typically made over a given period and is placed against an account nominated by the buying organisation.

Once the invoice is authorised by the buying organisation, payment is made from the nominated account, at 97 per cent of its value in our scenario, and a commission is paid to the funding provider and transaction processor. What remains of the 3 per cent fee is retained by the buying organisation as income.

Below are the key steps when implementing payment term changes:

Action checklist

1. Identify which suppliers are out of scope for extension of payment terms
2. Segment those for whom it is appropriate into large, key suppliers, medium-sized and small suppliers
3. Inform those suppliers of your intention to extend payment terms
4. Be prepared to negotiate the changes
5. Ensure that any agreed changes are built into your systems