Accounts Payable Turnover Ratio: What It Is, How To Calculate and Improve It



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Financial ratios are metrics that you can run to see how your business is performing financially. From simple to complex, these common accounting ratios are frequently used in businesses large and small to measure business efficiency, profitability, and liquidity.

One of the most important ratios that businesses can calculate is the accounts payable turnover ratio. Easy to calculate, the accounts payable turnover ratio provides important information for businesses large and small.

What Does the Accounts Payable Turnover Ratio Measure?

Considered a liquidity ratio, the accounts payable turnover ratio, also known as the payables turnover ratio, determines the company's ability to pay vendors and suppliers during a specific accounting period by calculating the number of times AP has been paid during that period.

While measuring this metric once won't tell you much about your business, measuring it consistently over a period of time can help to pinpoint a decline in payment promptness. It can be used effectively as an accounts payable KPI to benchmark your accounts payable performance.

Why Is your Accounts Payable Turnover Ratio Important?

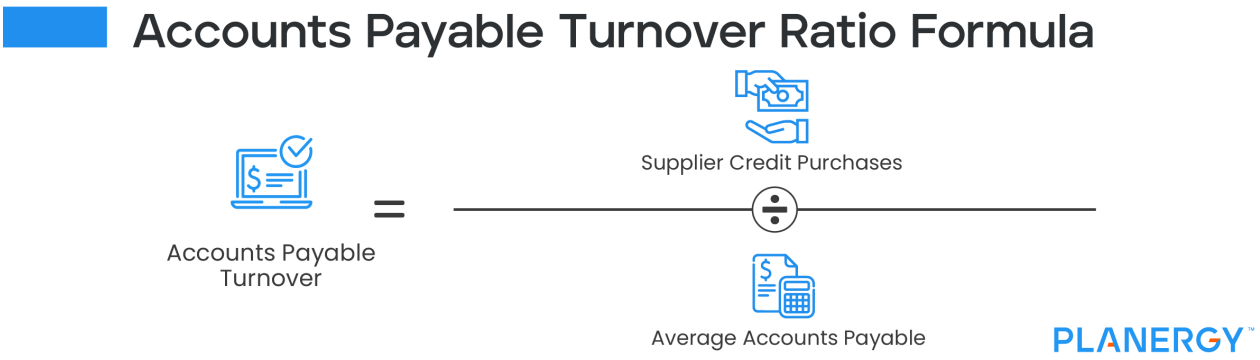
Used frequently by creditors and suppliers alike, the accounts payable turnover ratio helps a creditor determine the creditworthiness of your business and ultimately helps determine terms or interest rates when applying for credit or a loan.

As a business owner, understanding exactly how the accounts payable turnover ratio works provides you with a level of control over the cost of goods sold (COGS), and services while retaining adequate liquidity levels, which are necessary for long-term success.

How Do You Calculate the Accounts Payable Turnover Ratio?

The formula for calculating your accounts payable ratio is:

Accounts Payable Turnover Ratio = Supplier Credit Purchases / Average Accounts Payable



Unlike many other accounting ratios, there are several steps involved in calculating your accounts payable turnover ratio.

1. ## Calculate Average Accounts Payable For the Period

   First, you'll have to calculate your average accounts payable. This is done by obtaining your beginning and ending AP balance for the period you're measuring.

   Both numbers can be obtained from financial statements such as your balance sheet. Take a look at the following example.

   January 1, 2021, beginning AP balance – $77,000

   December 31, 2021, ending AP balance – $ 85,000

   Next, calculate the average AP balance:

   ($77,000 + $85,000) / 2 = $81,000

   Your average AP balance for 2021 is $81,000

   While smaller businesses may find it adequate to calculate this ratio annually, larger businesses will find it more helpful to calculate the accounts payable turnover ratio more frequently.

2. ## Calculate Net Credit Purchases

   Next, confirm your total supplier purchases for the year. If you're using

QuickBooks or any comparable accounting software application, you'll be able to obtain this total from a vendor expense report. If you're calculating this manually, you'll need to factor in any returns made against purchases.

For example, let's say your business made total purchases of $395,000 with returns of $20,000. Your net credit purchases for 2021 would be $375,000. This is the number you'll use in your accounts payable turnover ratio formula.

3. Calculate Accounts Payable Turnover Ratio

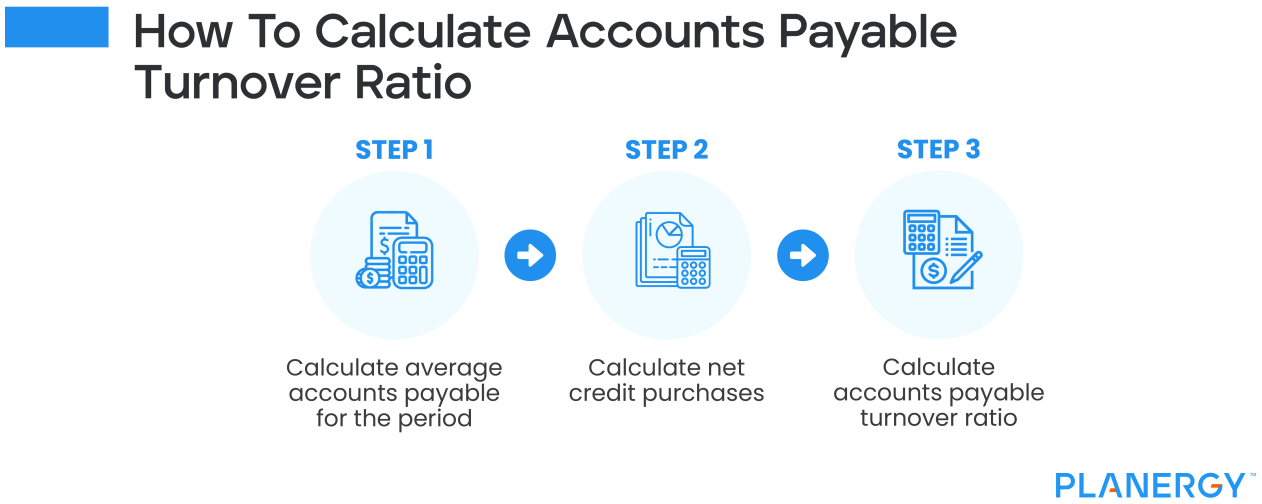
Now that you've calculated both your average AP totals for the period and your net purchases, you're ready to calculate your ratio. The formula for calculating the ratio is:

AP Turnover Ratio = Supplier Credit Purchases / Average Accounts Payable

$375,000 / $81,000 = 4.63

You can also take the calculation one step further by calculating days payable outstanding or DPO, by dividing the number of days in the period by your AP turnover ratio results. Since the calculation above reflects the entire year, your calculation would be:

365 / 4.63 = 78.8, which is the average number of days it takes you to pay your suppliers.



How to Interpret Your Accounts Payable Turnover Ratio

Proper ratio analysis is important. Learning how to calculate your accounts payable turnover ratio is also important, but the metric is useless if you don't know how to interpret the results.

The above example shows a company with an accounts payable turnover ratio of 4.63, which means that during 2021, the company paid its average accounts payable balance 4.63 times. But what does that mean? Is it good, or is there some room for improvement?

Since the accounts payable turnover ratio is used to measure short-term liquidity, in most cases, the higher the ratio, the better the financial condition the company is in.

A ratio that is trending upward indicates that a business is paying its bills more rapidly than in the past, while a ratio that is trending downwards indicates that bills are being paid slowly.

While providing important information, the accounts payable turnover ratio is not the only metric that a creditor or supplier should use when determining creditworthiness.

For example, a higher ratio in most cases indicates that you pay your bills in a timely fashion, but it can also mean that you are forced to pay your bills quickly

because of your credit terms.

Conversely, while a low ratio can indicate potential cash flow problems, it can also mean that your turnover ratio is lower because your creditors or suppliers have extended your business a more generous line of credit.

It’s important that the accounts payable turnover ratio be calculated regularly to determine whether it has increased or decreased over several accounting periods.

What Is the Ideal Accounts Payable Turnover Ratio?

An ideal accounts payable turnover ratio is open to interpretation. For example, an ideal ratio for the retail industry would be very different from that of a service business.

A high accounts payable turnover ratio indicates that a business has adequate cash flow and also allows businesses with the opportunity to negotiate better credit terms and obtain early payment discounts, which can further improve cash flow.

But as indicated earlier, a high turnover ratio isn’t always what it appears to be, so it shouldn’t be used as the sole marker for short-term liquidity.

A lower accounts payable turnover ratio can indicate that a company is struggling to pay its short-term liabilities because of a lack of cash flow. This can indicate that a business may be in financial distress, making it more difficult to obtain favorable credit terms.

But again, there are exceptions. A low ratio can also indicate that a business is paying its bills less frequently because they’ve been extended generous credit terms.

The best way to determine if your accounts payable turnover ratio is where it should be is to compare it to similar businesses in your industry. Doing so provides a better measurement of how well your company is performing when it’s analyzed along with other companies.

What Are the Limitations of the Accounts Payable Turnover Ratio?

While the accounts payable turnover ratio provides good information for business owners, it does have limitations. For example, when used once, the ratio results provide little insight into your business.

However, if calculated regularly, an increasing or decreasing accounts payable turnover ratio can let suppliers know if you're paying your bills faster or slower than during previous periods.

Let's say you own a small manufacturing company that first opened in 2020. The first year you owned the business, you were late making payments because of limited cash flow and an antiquated AP system.

As a result of the late payments, your suppliers were hesitant to offer credit terms beyond Net 15. As your cash flow improved, you began to pay your bills on time, causing your AP turnover ratio to increase.

Your suppliers take note of your timely payments and extend your terms to Net 30 and Net 45. This action will likely cause your ratio to drop because you'll be paying creditors less frequently than before.

That's why it's important that creditors and suppliers look beyond this single number and examine all aspects of your business before extending credit.

How Can You Improve Your Accounts Payable Turnover Ratio?

After analyzing your results and comparing those results to those of similar companies, you may be interested in how you can improve your accounts payable turnover ratio. There are several things you can do to help increase a lower ratio, but keep in mind that the number won't change overnight.

- ## Increase Your Cash Flow

  Increasing your cash flow will allow you to pay your bills earlier. In many

cases, businesses have to make the decision to pay their bills early or retain cash for business purposes. The solution could be to revisit your company's accounts, calculating your accounts receivable turnover ratio to see how quickly your customers are paying, and make any adjustments in collections activity as needed.

By increasing your cash flow, this either/or situation goes away, leaving your business enough cash flow for reinvestment while also allowing you to pay your bills earlier.

Pay Your Bills Early

The decision to pay or not pay your vendors and suppliers early may have nothing to do with your cash flow, and everything to do with the internal processes used to process accounts payable. If cash flow is not an issue, making a concerted effort to pay your bills before their due date also allows you to take advantage of early payment discounts your suppliers may offer.

Renegotiate Payment Terms

In some cases, a high accounts payable turnover ratio is the result of stringent credit terms. If your creditors have not extended generous payment terms, but you have continued to pay your bills on time, you may want to revisit your terms with your suppliers. Asking for extended credit terms can help bolster your cash flow while maintaining a higher AP turnover ratio.

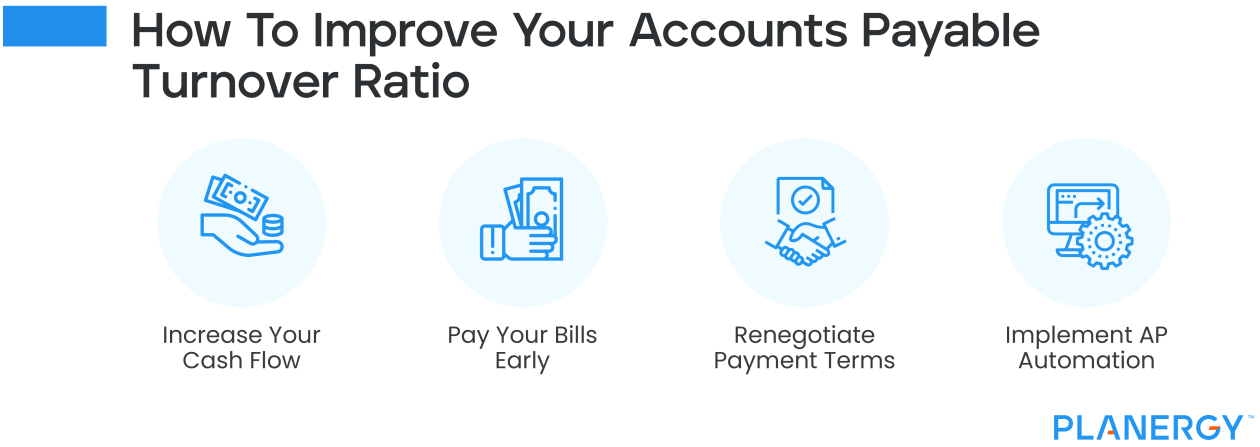
While this process may lower your ratio, it will be more accurate and will no longer be artificially inflated, but will better reflect your current financial situation.

Switch To an Automated AP Solution

If your biggest problem is late or delayed payments due to a manual AP system, consider making the move to accounts payable automation software. Using this software automates the entire accounts payable

process, from the initial purchase order to routing an invoice for approval. Switching to AP automation can also strengthen your relationship with your suppliers, while ensuring that invoices are paid on time.

An automated AP system also provides immediate access to real-time reports so that you always know exactly where your business stands on cash flow, expenses, and outstanding invoices.



Accounts Payable Turnover Ratio Can Be Useful

Like other accounting ratios, the accounts payable turnover ratio provides useful data for financial analysis, provided that it’s used properly and in conjunction with other important metrics. An important ratio for business owners, CFOs, and suppliers alike, this ratio can help you see how your business handles its short-term debt as well as gain a better understanding of how others view your business.

Most useful when calculated regularly to help identify trends, and when viewed with comparable businesses in your industry, the accounts payable turnover ratio can help you better manage cash flow while ensuring that valuable vendors and suppliers are paid on time.

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