

Skipping Cash Discounts: The Loan Shark of Distribution

**By Jason Bader, Partner
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Don't you just love running across some information that supports a practice you have always just assumed to be true? I found myself in this position recently. One of the best pieces of advice I ever received was, "if you ever want to get your point across, prove it mathematically." Numbers don't lie. Now some folks apply numbers in a way that is far from the truth; but, that isn't the numbers fault. Up until recently, I have always just accepted the general theory that it is a good idea to take cash discounts, when possible, when you pay your suppliers. In my experience, most distributors take cash discounts in times of strong revenues and solid cash flow; but when the business starts slowing down we tend to opt for extended dating. What recently hit me like a 2 x 4 across the backside of the noggin was this: If we don't take advantage of the cash discounts presented by our suppliers, we are essentially borrowing money at the highest interest rate most of us will ever experience.

Let's look at a common set of terms for a supplier. The supplier will offer us a 2% discount off of a particular invoice if we pay it within the first 10 days of the due date. The due date of the invoice is actually 30 days. You will see these terms printed somewhere on the invoice in this fashion: 2% 10th, net 30. The supplier is giving us a reward of 2% of the total invoice value for paying 20 days early. If we choose not to take the discount and pay within the 30 days, we are actually paying 2% more for the product than we have to. Stated another way, we are paying a 2% interest charge for the privilege of holding our money an additional 20 days. Roll that interest charge out on an annual basis and we are talking about an interest rate around 36%. Holy loanshark, Batman. We are talking about real money here. I don't know about you; but I think that I can find a little better interest rate out there – especially in our current economy.

Let's take a look at one more set of terms. Many of our suppliers like to be paid in 25 days, not 30. Some folks will offer 1% for paying in 10 days on an invoice due in 25 days. The terms will be stated: 1% 10th, net 25. Again, this is a very common set of terms in wholesale distribution. Let's analyze this scenario. If we choose to hold on to our cash and pay in 25 days, we have essentially borrowed money for 15 days at an interest rate of 1%. If we push this out to an annual percentage rate, we just signed up for a 25% interest rate loan. Ouch.

Annual Interest Rates When We Don't Take Discounts

Early Pay Discount	Borrowing 20 Days (Net 30)	Borrowing 15 Days (Net 25)
1%	18.43%	24.58%
2%	37.24%	49.66%
3%	56.44%	75.26%
4%	76.04%	100.39%

5%

96.05%

128.07%

Looking at this table is enough to make me grab the extra strength Malox. I can't tell you how many times I chose to forego the cash discount just to hang on to my cash for a few extra days. When I realized the penalty here, I was literally blown away. Could you imagine admitting to the owner of your business that you just signed up for 50% interest rate loan? If you are the business owner, could you admit it to your spouse? This is what you just did if you avoided the cash discount option of 2% 10, net 25.

We can all pretty much agree that the interest rates stated in the table are pretty substantial and should be avoided if possible. I do understand that cash can get very tight at times. Sometimes it just isn't possible to pay in 10 days. This is where a solid line of credit comes into play. Using a lower interest business line of credit in order to take advantage of early payment discounts is a sound business practice.

I have only stated a few examples of possible terms from our supplier partners. Special extended dating terms are very common in our business. Many of us have negotiated Net 60 and Net 90 terms. While it may sound great to hold on to our money for an additional couple of months, we need to be able to prove our position beyond the old gut feeling analysis. Remember, if you ever want to justify your actions, prove it mathematically. Fortunately, we have a secret formula. If you want to determine what the annual interest rate would be if you chose to skip the cash discount, use this calculation:

Discount % / (1 – Discount %) x (365 / Number of Borrowing Days)

Just because I really like this formula, let's run through an example. The supplier gives a 2% discount for payment in 10 days. The invoice is due in 30 days. Let's say that you are a pretty savvy negotiator and you have convinced the supplier to extend the due date out to 90 days. The question is: Should I pay in 10 and grab the 2% or should I hold my cash for an additional 80 days. Run the math.

2% / (1 – 2%) x (365 / 80)

.02 / (1 - .02) x (365 / 80)

.02 / (.98) x (4.56)

.0204 x 4.56 = .0931 or 9.31%

Should I take the discount and borrow on my line of credit? Let me give you a true consulting answer: it depends. It really depends on the interest rate for your line of credit and your borrowing capacity. In some cases, 9.31% might not be such a bad rate. The most important thing here is that we can justify our actions. Being able to prove our business decisions mathematically goes a long way toward improving the bottom line.

Before I close this article, I want to throw one more log on the fire. Many of us offer cash discounts to our customers. The same formula can be applied to determine the interest rate on the loan we just picked up from our customer. By offering 2% 10th Net 25 terms, we just borrowed money from any customer who chose to take the cash discount – at the same outrageous rate stated in the table above. Some industries require cash discounts as a matter of tradition. Giving cash terms should be avoided if at all possible because once you start it can be really difficult to get rid of them. Early in my distribution career, I remember hearing some very sound advice on cash discounts from Dr. Don Rice, former head of the School of Industrial Distribution at Texas A&M, “Always take ‘em, never give ‘em.”



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