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Can you really afford to take advantage of Early-Pay Cash Discounts?

By Jim Morphey
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In the industry, Early-Pay Cash Discounts (EPD) have been around since the beginning of financing. Sometimes it can be a terrific way to boost your gross margin. However, are they right for you? That depends.

If you have excess cash, EPD may provide a better return than just about any other type of investment. For example, terms of 1.5 percent 10/Net 30 would provide you with the opportunity to earn a 27 percent return in exchange for accelerating your payment by 20 days.

The formula used by accounting professionals to calculate the return rate on discounts is:

$$\text{Return rate on discounts} = \left[\frac{\text{Amount of discount}}{\text{Discounted price}}\right] \times \left[\frac{\text{Number of days in the year}^{1}}{\text{Number of days paid early}}\right]$$

Many publically traded companies stretch out their payables as long as possible to maximize cashflow – even though they have plenty of EPD opportunities with suppliers. In most cases, they determined it was better to operate on supplier's full terms, particularly in instances where they wanted to conserve cash. What do these large and well financed enterprises know that you don't?

Let's do the math on matching payment terms. If you don't have a lot of excess cash, the old adage "turns should always match terms" becomes more important. In order to match 10 day payment terms, your inventory turns will need to equal 36x's in order for it to make sense to accelerate your payment by 20 days. Inventory turns equivalent to 12x's (30 days) or more are considered best-in-class and rare.

You need to carefully evaluate several factors before taking advantage of EPD. These components include inventory and accounts receivable turns, cost of capital, and cost of debt.

Understanding and regularly monitoring inventory and accounts receivable turns is essential to understanding cashflow health. Your cost of capital includes borrowing costs, the amount of equity invested in the business, leverage, and the potential lost opportunity to invest elsewhere because the cash was used to accelerate payments.

You should also consider your available credit lines. You most likely need to finance the accelerated payment. Ultimately, taking advantage of EPD might initially look attractive but could result in a future liquidity crisis because excess cash is sitting on the floor as inventory rather than earning interest. Remember inventory typically loses value over time.

Jim Morphey is the vice president of corporate development for Wells Fargo Commercial Distribution Finance (CDF). Morphey has more than 40 years of management experience in consumer finance, trade credit, and most recently with domestic and international inventory financing, as well as factoring. Morphey's career has been devoted almost entirely to the domestic consumer electronic, appliance, and outdoor power industries. His background includes executive assignments in operations, credit, and relationship management at the national level with Whirlpool, Whirlpool Financial Corporation, Transamerica Distribution Finance, and senior relationship assignments at GE Capital.

Morphey received a Bachelor of Science in Management from Northern Illinois University. He was a member of the Association for Finance Professionals (AFP). He earned professional certifications from The National Association of Credit Management/Credit Research Foundation (NACM/CRF) Graduate School of Credit & Financial Management held at Dartmouth College, and also from The Finance, Credit, and International Business Association (FCIB). Morphey has published many articles on the topics of inventory management as well as cashflow. He also helped produce a six part video series on a variety of cashflow topics which may be found at www.cdf.wf.com/learningcenter. Morphey and his family reside in southwestern Michigan.

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[1]Accountants use a 360 day year. For example, you are offered 1.5 percent 10/Net 30. The equation would be (1.5/98.5) x (360*/20) = 0.27 or 27%.