

How Much Does A Cash Discount Cost?

Typically, assets are allotted in the consideration that they will give a particular return. If this return is at a minimum, the same as the cost of the capital of that particular asset, then it will result in a damaging outcome on the total earnings.

Vendors should be mindful of what they are losing versus what they are gaining when a cash discount is extended. On one side, it loses the dollar total of the discount, and on the other it gains the extra days gained from early receipt of payment. If the terms of the sale are 2 percent, 10 days, net 30 days, then the vendor would gain 20 days' availability of cash by extending this cash discount.

Only when the capital exceeds the cost of extending a cash discount should discount terms be considered. The formula for computing the equivalent rate of cost of capital to that of a cash discount term offered for terms of 3 percent 10 days, net 30 days is:

$$\frac{\text{Discount Rate} \times 365 \text{ days}}{\text{Number of days gain in early receipt of cash}}$$

Number of days gain in early receipt of cash

The offset of gaining 20 extra days of cash availability requires that the cost of capital be equal to or in excess of 54.75 percent to make the terms offered worthwhile to the vendor.

Cash discounts are a way of life in some industries. A typical credit term in the pharmaceutical industry is 2 percent 30 days, net 31 days. The other downside to cash discounts is collecting the infamous disallowed cash discount.

Many firms will take the cash discount, yet pay the vendor later than the designated discount due date, or, worse than that, take the discount and pay later than the net due date. Many firms have a serious problem controlling disallowed discounts from their major customers who are usually the worst offenders. Some vendors have drawn a line and dared the buyer to cross it, while others have simply written off the deductions as a cost of doing business with some larger customers.