

**ACCELERATING YOUR CASH FLOW**

*By Bob Carberry of Direct Insite*

In today's challenging economic environment, cash is king. To reduce working capital and improve their Days Payable Outstanding (DPO), buyers are increasingly extending their payment terms while looking for ways to take advantage of discounts offered by their suppliers in exchange for early payment.

This focus on early payment discounts creates an opportunity for cash-strapped suppliers to directly offset the effect of the buyers extending payment terms. As a result of being paid early, the supplier can improve cash flow and show an improvement in their Days Sales Outstanding (DSO) - an important overall business metric.

Nearly one-third of buyers responding to PayStream Advisors' 2010 Electronic Invoicing Benchmarking study listed the ability to capture discounts as a priority for their organization, while another 49 percent of respondents described the ability to capture discounts as "somewhat important."

Overall, we're not surprised that buyers are interested in increasing their discount capture or that more suppliers are interested in early access to cash.

Today, interest rates are extremely low, capturing even a traditional discount of 2/10 net 30 (which translates to a 36 percent annual percentage rate minus the cost of buyer's capital) makes good financial sense. Said differently: a 2 percent discount on a \$10,000 invoice (\$200) may not seem like much, but multiply it by the number of invoices you process and you'll see how much money you're leaving on the table.

Moreover, an eye-popping 84 percent of businesses surveyed by Aberdeen Group in 2010 say they have increased their focus on cash management with the top performers successfully reducing their cash conversion cycles, optimizing discounts, and eliminating late fees -- all to improve overall liquidity.

Few businesses can ignore an investment that delivers the type of returns available through early payment discounts. The case for capturing discounts is even more profound for businesses operating on razor-thin margins, as these types of returns can have a significant impact on their bottom line.

Meanwhile, early payment discounts and trade financing let suppliers use receivables to fund cash flow at below-market rates, without taking on debt, enhancing credit ratings and minimizing impact on their balance sheets. Additionally, trade financing helps suppliers mitigate risk and avoid failure.

**EARLY PAYMENT ALTERNATIVES**

Four early payment alternatives are currently generating the most interest:

- Early payment discounts
- Dynamic discounting
- Factoring of receivables (not guaranteed by the buyer)
- Factoring of receivables (guaranteed by the buyer)

In the case of early payment discounts and dynamic discounting, the buyer is the financing party. In the case of factoring of receivables, a third party (such as a bank) provides the financing.

**Early Payment Discount**

When a supplier's invoice has been "approved for payment" by the buyer's business rule criteria, the buyer can either: pay the invoice at the "net term date" (e.g. 45 days after receipt of the invoice) or pay the invoice early (such as within 10 days of the invoicing date) at a fixed discount (e.g. 1.5 percent of the value of the invoice), with the buyer providing the funds to pay the invoice.

Suppliers using certain automated solutions also have the ability to offer a 'Pay Me Now' discount, where the discount is provided for payment prior to the net due date or discount due date on the purchase order.

**Dynamic Discounting**

Dynamic discounting allows buyers and sellers of goods and services to dynamically change the payment terms - such as net 45 - to accelerate payments based on a sliding discount scale.

When a supplier's invoice has been "approved for payment" by the buyer's business rule criteria, the buyer can either: pay the invoice at the "net term date" (e.g. 45 days after receipt of the invoice), pay the invoice at an "early payment date" (e.g. 10 days from date of

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receipt at a 1.5 percent discount) or pay at a later date based upon a sliding rate (e.g. after 20 days at a 1 percent discount).

The most common early payment discount is 2/10 net 30. This means that although the payment is due on the 30th day, the buyer can take a 2 percent discount if they pay the invoice before the 10th day. This translates to a 36 percent APR; even 1/10 net 30 translates into an 18 percent APR.

Designed to provide suppliers greater control over payment timing, the discount amount is calculated dynamically based on the number of days remaining until the due date. Importantly, discounts do not need to be negotiated in advance; they can be taken dynamically as working capital needs dictate (buyers and sellers can make discount proposals, while retaining the right to accept or reject them).

What's more, in a dynamic discounting arrangement, trading parties can tap into an alternative source of working capital through the use of third-party creditors who pay early on behalf of the buyer.

#### **Factoring of Receivables (not guaranteed by buyer)**

Many third-parties are willing to purchase an approved invoice or receivable from a supplier at a discount, and then collect the full value at the net term date -- improving the cash flow of suppliers, at a cost. If the payment is not guaranteed by the buyer, there is a "hold back" of typically 20 percent until the net date. This effectively increases the discount rate charged to the supplier.

#### **Factoring of Receivables (guaranteed by buyer)**

In this case, a third-party is willing to purchase the approved invoice or receivable from a supplier at a discount and then collect the full value at the net term date. If the payment is guaranteed by the buyer, there is no "hold back" of the 20 percent until the net date; this effectively decreases the discount rate charged to the supplier. Again, this arrangement improves the supplier's cash flow.

#### **The Payoff**

Why are treasurers and suppliers alike so interested in early payment alternatives?

From a treasury perspective, early payment discounts help maximize returns on available cash over short periods -- and with minimal risk and no loss of control. For instance, if a company can invest short term cash at a 4 percent interest rate, and it is possible to "invest" such funds to support an early payment discount of 1.5 percent for 30 days (translating into an 18 percent APR), then the risk-free return for treasury for using funds for early payment is 18 percent versus just a 4 percent rate of return on cash.

Other benefits of early payment alternatives for treasurers include:

- Additional degree of freedom for cash management
- Full visibility and liquidity control
- No affect on purchase price negotiations
- Should not require new data processing infrastructure if the buyer is using an accounts payable automation system

From a supplier's perspective, early payment alternatives can solve the cash crunch that can occur waiting for the full value of an invoice to be paid (as much as 60 days in some cases).

As one example, if a supplier sells an "approved for payment" invoice or receivable to a third-party (such as a bank), it can receive immediate cash (from the time the invoice is sold) in exchange for a discount; if the discount rate is 2 percent per month, then the effective interest rate is 24 percent.

PayStream Advisors notes that dynamic discounting mitigates the uncertainty surrounding the timing and amount of payments, improving cash flow forecasting. But dynamic discounting also offers suppliers the flexibility of discounting some or all of their receivables, eliminating the need to utilize high-cost financing options like factoring or asset-based lending to obtain cash liquidity and stronger balance sheet positions: By participating in a dynamic discounting program where the supplier could propose early payment to the buyer of 1.5 percent (as an example) then the effective discount rate is 18 percent -- a 25 percent improvement over what the supplier would pay in the "factoring" example.

Regardless, early payment alternatives provide suppliers:

- Early access to cash and working capital
- Improved cash management
- Potential reduced working capital requirements
- Improvements in Days Payable Outstanding (DSO)

#### **THE BOTTOM LINE**

With today's focus on maximizing cash, it's not surprising that suppliers and buyers would be increasingly interested in early payment alternatives. The good news is that there is a variety of arrangements -- encompassing early payment discounts, dynamic discounting and factoring programs -- to meet the needs of trading partners. The challenge that remains for many buyers is to make their procure-to-pay business processes efficient enough to take full advantage of the discounts offered by their suppliers

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