

Ask Profit Planning Group...

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One of our major suppliers has started encouraging us to use datings rather than take the cash discounts. Their terms of sale are 2% 15, net 60. What should we do?

Profit Planning Group says “Take the discount and run.”

The following formula calculates the Return on Cash Discount (ROCD). If the ROCD is greater than your cost of borrowing money, you should take the cash discount. If it is less, you should go with the dating. Using your numbers of 2% 15, net 60, the ROCD is:

$$\begin{aligned} & \frac{\text{Cash Discount \%} \times 365 \text{ Days per Year}}{\text{Days Paying Faster}} \\ & = \\ & \frac{2.0\% \times 365}{60 - 15} \\ & = \\ & \frac{730.0\%}{45} \\ & = \\ & 16.2\% \end{aligned}$$

Since every legitimate firm is borrowing money at less than 16.2%, every firm should take the cash discount. Even if the firm has to borrow money to pay earlier, it should take the cash discount.