Competitive Edge
How early payment discounts can help your business

By Padraic Moran

Early Payment Discount programmes and Supply Chain Finance support key suppliers in a supply chain. The financial benefits to both buyers and suppliers are significant, and these programmes can be straight-forward to implement as Padraic Moran explains.

Scenario

You're the Finance Director of a manufacturing, distribution and trading business, and you have a big problem.

The competition is eating your lunch. Their cost of materials is up to 5% less than yours; they have lower administration costs, strong supplier relationships, cheaper sales prices and a better bottom-line.

How come they can do it if you can't?

As if that weren't bad enough – you have another big problem.
Your shareholders are watching. The €10m loan you took out to buy that new machine two years ago may not have been such a great idea after all. Your liquidity is still ok, but you need to watch your working capital ratios.

Cash is valuable and you can't afford to take on any additional long-term liabilities. Your customers are extending payment terms on your invoices; you'd like to do the same with your own suppliers, but already they're saying that they can't handle it any more.

You feel like the meat in the supply chain sandwich and the Chairman's about to take a big bite.

How can an Early Payment Discount programme help?

With an Early Payment Discount (EPD) programme, suppliers give a discount in return for having their invoices paid early. This isn't a new concept, but what has changed recently is that processes, standards and platforms now exist that allow trading partners to collaborate in real time to provide fully-secure programmes at a very low cost.

Suppliers are happy to offer reasonable discounts in return for early payment. For them, it improves cash flows and locks in receivables. Bad-debt risk is removed at a very early stage, and their Days Sales Outstanding (DSO) is reduced significantly which improves their working capital position. A recent report showed that 35% of suppliers would take early payment all of the time, while 65% of the rest would take early payment some of the time.

A functioning EPD programme with good supplier engagement can give the buyer a number of percentage points' savings on the cost of materials – a saving that goes straight to the bottom line. This allows you to outperform the competition on price and margin – and helps with your first big problem.

Providing an early payment option for your suppliers allows you to maintain, or even extend, your Days Payables Outstanding (DPO), even if you self-finance the early payment. DPO is one of the major components of working capital, and extending DPO helps with your Other Big Problem. It frees up cash, allowing you to pay down debt, maintain a healthy balance sheet, or expand your business.

How does an EPD programme work?

Supplier invoices are approved by Accounts Payable as soon as they are received. Where everything is in order, invoices are approved within days of receipt, and made available for early payment. Suppliers are informed through a supplier portal; they can view the details of the invoice, see the approval status, and request a quote for early payment. Dynamic Discounting procedures calculate a financing quote there and then – usually based on a daily rate set by the buyer, and the difference in days between the early payment date and the normal payment terms that that supplier normally enjoys. The supplier decides if they are happy with the quote, and if so, they accept the early payment. The money is transferred by EFT immediately.

What if you don't have cash?

A common variant on an EPD programme is called Supply Chain Finance. In this case, the buyer either does not have, or is not in a position to use, free cash to fund early payment themselves. However, they would still like to offer early payment to suppliers. In this case, they may be able to reach agreement with one or more banks or financing institutions, who are prepared to fund the early payment in return for some or all of the supplier discount, and on the back of a commitment from the buyer that the invoice has been approved for payment, and will be paid by them in due course. This has a significantly different risk profile to invoice discounting - fraud risk is removed, default and liquidation risks are minimised and, because of this, the costs of financing are lower.

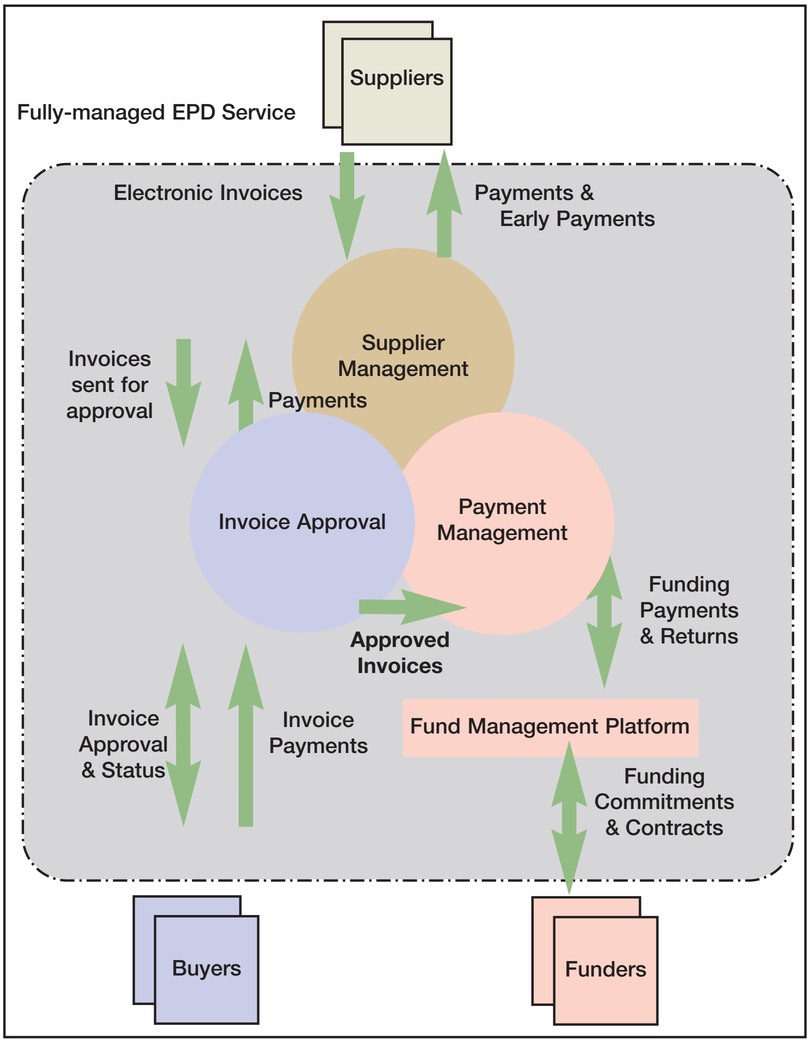

Figure 1: Diagram of a fully-managed Early Payment Discount Service

There are three main reasons why a buyer would choose such an arrangement

1 To support vulnerable or key suppliers in the supply chain

Buyers may have strategic relationships with - or dependencies on - some or all of their suppliers. In these cases, it makes sense to support those suppliers by brokering early payment, even if there is little direct financial benefit to the buyer.

2 To access a portion of the supplier discount

While the bulk of the supplier discount will be taken by the funder as a return on their investment, it is standard for the buyer to take a share of the discount as a reward for facilitating the transaction.

3 To improve their working capital position

Some buyers will introduce early payment programmes in tandem with an extension of their standard payment terms. This allows them to improve their own working capital position (through increasing Days Payable Outstanding or DPO) without impacting the financial stability of their suppliers.

Your industry and your own specific business conditions will determine the relevance and importance of each of these three factors.

Operational requirements

It is fundamental that early payment on an invoice can only be made after the invoice has been fully and correctly approved. This implies that purchase invoices must be approved early enough in the payment cycle to provide substantial value to suppliers through paying early.

Many companies don’t currently approve invoices immediately on receipt from a supplier – rather, they follow a ‘just in time’ approval process, where invoices are approved just in time for payment. To take advantage of early payment discounts, this needs to change, but that doesn’t have to be a big deal. There are accepted, industry-standard processes and tools available to assist with up-front approval, with the added benefits of complete visibility of upcoming and committed payments; solid AP control over invoice approval and payment reducing the risk of fraud and errors, and advance notice of cash requirements, payment spikes and foreign currency needs.

Apart from invoice matching, a large part of the effort in invoice processing is spent purely in capturing the invoice data from paper. Electronic Invoicing systems which capture the data at source – in the suppliers’ systems – provide a step-change improvement in efficiency and accuracy over traditional data capture solutions, including scanning and optical character recognition (OCR).

Best-in-class buyers use Purchase Order-based invoice matching for materials and supplies, and contract-based matching for exceptional or recurring items such as utility bills, rent, maintenance and one-off large projects. This removes much of the approval effort from invoice approval; when an invoice is received it is a simple task to match against the original agreement. This can be automated partially or fully, and current best practice shows that over 90% of purchase invoices can be automatically approved without manual intervention. Benchmark figures show that this can save 50% or more of purchase invoice processing costs.

The benefits of streamlining the invoice capture and approval processes are:

- Making the majority of purchase invoices available for early payment immediately
- Drastic savings in the cost of processing invoices
- Greatly increased visibility, control and predictability of invoices and payments

Getting started

Implementing an Early Payment Discount programme with your supplier base is quite straight-forward. With an opt-in early payment model, where the supplier offers a discount for early payment on an invoice-by-invoice basis, early payment can be made even with existing purchase agreements.

Online tools will manage all of the dynamic discount calculations, present all of the necessary information to the supplier, and manage any additional Terms and Conditions that cover the early payment and the discount elements of the transaction. They will also manage your reconciliation of payments, discounts, bank and accounting information.

Supplier engagement may be seen as an inhibitor by some buyers. There is a left-over impression from traditional on-boarding interactions with suppliers, and particularly in EDI and electronic invoicing, where too much 'stick' and not enough 'carrot' was used to force suppliers to comply with unilateral, proprietary initiatives. However, the offer of early payment is seen as a very attractive carrot by suppliers, and is a very good reason for them to engage in a buyer-led, standards-based campaign which provides significant services and benefits to all parties. A specialist service provider will have methodologies to deal with supplier engagement.

Supplier self-service portals are essential if your programme is not going to consume whatever savings you have made in AP. A portal will allow suppliers to check the status of invoices online; view and resolve any issues and disputes with their invoices; get quotes for early payment, and manage the discount and payment request process themselves.

What type of company will find this useful?

Savings from Early Payment Discount programmes are typically expressed as a percentage of total procurement spend. The best-in-class company with 60-day payment terms will see a reduction of up to 5% of total spend – that being the total discounts received from all suppliers. As such, any company can benefit from an EPD programme, and the more you spend, the more you save. The saving is related to the total spend amount, rather than the number of invoices or suppliers. Obviously, having all of your suppliers involved in the programme, or at a minimum your highest-value suppliers, is important.

The potential saving is also related to your standard payment terms. The longer they are, the greater discount you can receive for early payment. Some buyers will choose to introduce longer standard payment terms once an early payment option is available to their suppliers.

Businesses that process large numbers of invoices, and from a large supplier base, will benefit greatly from the improved processing efficiencies. For them, removing the overhead of capturing and approving large volumes of invoices will return significant value.

The buyer will need to set aside enough cash to finance a portion of their payables. As a rule of thumb, the buyer will require a cash float to cover the standard payment terms for all participating suppliers. Where all suppliers - or all high-value suppliers - participate, this float could be sizeable, so there are additional mechanisms that can be put in place to prevent the float impacting on important working capital ratios.

The buyer may choose not to self-finance, or to partially self-finance. If they want to incorporate external financing, they will need access to funding partners, who could be banks, corporate treasury operations, private equity etc, who are prepared to finance early payment on invoices once they have been approved by the buyer.

Conclusion

Early Payment Discount programmes and Supply Chain Finance provide opportunities to improve supplier stability, working capital and bottom-line returns. Processes and tools are available to coordinate the supplier base, to share information between buyers and suppliers, and to coordinate and audit the payment of invoices using a variety of funding sources. An integrated approach gives significant financial returns to both buyers and suppliers alike.

Padraic Moran is Managing Director of Lighthouse BCS. www.lighthousebcs.com.