

The Relative Importance Of Cash Discounts

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Vendors have offered cash discounts for many years to encourage prompt payment of invoices or accounts. Under such an arrangement, the seller receives payment without delay while the buyer minimizes both cash outflow and operating costs or expenses. Because these discounts can substantially reduce routine operating expenses in areas like patient care and ancillary supplies, hospitals should seriously consider purchasing from vendors that offer them.

COMPARE COSTS

In deciding whether to claim a cash discount, providers should compare the cost of forgoing the concession with the cost of taking it. The following formula offers a close approximation of the cost of forgoing a cash discount:

$$\text{Approximate cost of forgoing discount} = \text{CD}\% \times \frac{360}{N}$$

where

CD% is the stated cash discount percentage or reduction from the invoice total being offered for prompt payment.

360 is the assumed number of days in the year

N is the number of days a payment can be delayed by forgoing the discount (i.e., number of days until the full amount of the invoice must be paid less the number of days during which the cash discount may be claimed)

The cost of forgoing a cash discount is the implied interest rate associated with postponing the payment from the end of the discount period to the end of the credit period (Lawrence J. Gitman, *Principles of Managerial Finance*, 6th ed., Harper & Row, New York City, 1991, pp. 682-683).



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The cost of taking a cash discount may be calculated in at least two ways. If the payer must borrow the money required to claim the discount, the annual interest rate on the loan may be viewed as the cost of taking the discount. Another approach is to calculate the cost as the return forgone because paying within the discount period leaves funds unavailable for a certain investment. In either case, the cost will usually be at least equal to the market interest rate.

These calculations provide hospitals with a clear basis for deciding whether to claim a cash discount. The discount should be taken as long as the cost of short-term borrowing (the interest rate) is less than the cost of forgoing the concession as computed with the aforementioned formula. In most cases, it is to hospitals' advantage to routinely claim cash discounts—even if they must borrow to do so (John L. Bohannon and Donald E. Edwards, "Cash Discounts Can Minimize Operating Costs," *Healthcare Financial Management*, December 1990, pp. 72-74).

HOSPITALS' USE OF DISCOUNTS

Because little has been published on how providers view and use cash discounts, we sent a questionnaire to a sample of U.S. hospitals to gather data on the discount's significance in choosing vendors and making routine purchases. Our purpose was to determine the relative importance of cash discounts in hospitals' day-to-day operations.

From the American Hospital Association's 1989 *Guide to the Health Care Field*, we chose 863 hospitals at random to participate in the study. Federal facilities were excluded, as were large teaching hospitals, because we believed that the financial environment in these facilities would often make cash discounts less important than in other types of hospitals. We received 281 replies, for an overall response rate of 33 percent.

We analyzed the survey replies according to hospital size (fewer than 100 beds, 100 to 250 beds, and more than 250 beds) and by profit ori-

entation (for-profit and not-for-profit, the latter category including state and local government hospitals). However, only in a few instances, which are noted in the following discussion, was information based on these factors meaningful.

As the **Table** shows, vendor cash discounts are readily available to most hospitals. It is interesting to note, however, that the discounts were not available to 32 of reporting facilities. Twenty-two of these were small hospitals, suggesting that vendors might not offer discounts to smaller facilities as frequently as they do to larger ones.

One hundred and eight of hospitals reported receiving a discount of 2 percent, making this the most common rate. And 153 of hospitals reported 10 days as the discount period (see **Table**). Various other terms, such as discount rates of less than 1 percent and discount periods as short as "on receipt of invoice," were reported and appear in aggregate in the **Table**.

Although 244 of the responding hospitals are offered cash discounts, only 106 facilities consider these concessions for prompt payment to be important in vendor selection (see **Table**). Apparently, the majority of hospitals consider factors other than cash discounts to be more important when establishing relationships with vendors. The data also indicate that more not-for-profit hospitals and fewer for-profit hospitals than might be expected consider cash discounts to be important when selecting a vendor.

The survey asked the facilities that view cash discounts as unimportant in vendor selection to indicate which factors they consider important. Ten percent of these hospitals responded that the opportunity to be part of a group purchasing arrangement was an important consideration, suggesting that the discount available from volume purchasing was greater than the discount for prompt payment. About 15 percent of the hospitals indicated that price itself is the primary factor in selecting vendors. The composition of this group (11 for-profit and 11 not-for-profit entities) implies that price is, overall, a more important consideration for for-profit facilities than it is for not-for-profit hospitals.

Respondents mentioned a number of other factors as being important when choosing vendors. These included how long they had known

the vendor and the vendor's availability or accessibility. However, no miscellaneous factor was mentioned more than 10 times.

Some firms find it expedient to have a routine policy dictating that cash discounts be taken whenever possible. Since the cost of forgoing the discount usually exceeds the cost of taking it, such a policy eliminates the need for invoice-by-invoice evaluation and ensures minimization of operating costs and expenses.

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CASH DISCOUNTS AND VENDOR SELECTION

Performance Measure	Number of Respondents	Percentage*
Availability		
Cash discounts offered by vendors	244	87%
Cash discounts not offered by vendors	32	11
No response	5	2
Discount Terms (Percent/Days)		
1/10	45	18%
2/10	108	44
2/15	8	3
Miscellaneous	52	21
No response	31	13
Perceived Importance in Vendor Selection		
Availability important	106	38%
Availability unimportant	146	52
No response	29	10
Vendor Selection Criteria Where Discounts Are Unimportant		
Group purchasing arrangement	15	10%
Quality and service	18	12
Price	22	15
Miscellaneous	91	62

*Percentages may not add up to 100 because of rounding.

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REGIONAL NETWORKS

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rates an attitude more compatible with the goal of providing the best possible care using available funds and resources. This mandates a cooperative network of providers with a focus on prevention and alternatives to costly intervention.

The movement toward cooperative ventures will have a significant impact on all involved in healthcare. In the long run, it should be beneficial to those who use and provide health services, as well as to those who pay for them. But in the near term, the changes will often create difficulties—particularly for organizations that are unprepared.

To make the transition from a competitive to a cooperative healthcare delivery system, providers will have to reexamine their mission and values and, in many cases, refocus their vision of the future. They must also be prepared to address possible legal and policy barriers (e.g., anti-trust) to collaborative venture. Executives must become aware of the organizational and corporate structures best suited to the new realities within healthcare and learn the negotiation, mediation, and consultation skills that will enable them to work effectively with others. At the same time, healthcare employees must be given the kind of training and education necessary to adapt to the new corporate cultures and organizational structures. Forced integration will not succeed.

The question is no longer whether to develop regional systems but which model to use and how quickly it should be implemented. Missions of service will once again be the priority in the new era of delivery. Many have finally realized that competition, profitability, and market share are results of a mission-driven vision and commitment, not the goal. An organization's mission, vision, and faith in its delivery design will be its bridge to success. □

FINANCIAL MANAGEMENT

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Overall, 198 respondents reported they did have an operating policy requiring that cash discounts be taken, and 77 reported they did not. (Six participants did not answer the question.) Thus, although most hospitals consider the availability of cash discounts to be relatively unimportant in the vendor selection process, many still view it as significant enough to merit routinization once a vendor has been chosen.

Of the 77 hospitals with no routine policy for taking vendor cash discounts, only 11 reported that they use a formula, such as the one presented earlier in this article, to determine whether a particular discount is worth taking.

A SIGNIFICANT OPPORTUNITY

The fact that most hospitals do not consider the availability of cash discounts to be an important factor in vendor selection suggests that many of them are overlooking a significant opportunity to minimize routine operating costs and expenses. The tendency to give more weight to certain other considerations indicates that hospitals may overvalue nonfinancial, subjective factors in dealing with vendors. Perhaps it would be more productive for hospitals to emphasize cost containment, an essential ingredient of which would be to use cash discounts.

The efficient use of resources requires that hospitals, regardless of size or profit orientation, take advantage of financial concessions that facilitate operations and ultimately improve the ability to serve the public. Unless conditions make it impossible to do so, hospitals should strive to take advantage of this concession. □