

Fallacy in Logic: Payment Terms

By Robert Endres and Jarvis Cheung

A client received a notice from a buyer that “Beginning May 2010, standard payment terms for all non-production spend will be Net 60. Suppliers will be notified when the new terms will take effect. Where possible, Suppliers will also have the option to enroll in an Accelerated Payment Program, which will enable them to be paid in 20 days with a 1% discount off the total invoice.”

The Buyer claimed they “conducted extensive research, including benchmarking against peers, and selected the new payment terms to be net 60.” Today, Buyer’s payment terms to supplier “are significantly below what is considered standard when compared to our industry peers.”

First, let’s look at the transaction.

Our client is currently getting paid in 30 days. Under a move from 30 days to 60 days payment terms, the Buyer borrows from our client at 0% for 30 days. The Buyer then may allow our client to be paid in 20 days with a 1% discount. This is equivalent to our client lending at 9.2% pre-tax for 40 days. Pretty good for the Buyer. Where can you borrow at 0% and relend at 9.2%? Net-net, if our client enrolls in the early payment program, the effective move is from 30 days to 20 days with 1% discount. And the Buyer’s effective pre-tax lending rate to our client is 36.9%. Pretty high.

Next, let’s look at the fallacy.

The Buyer is assuming that all other terms, conditions and prices are equal to their peers and furthermore, that our client has not already dialed them into their prices to the Buyer – the benefit of 30 day payment terms (vs. the payment terms they could achieve with other Buyers- which we will assume is 60 days.)

We believe that the move attempted by the Buyer will equilibrate over time. Sellers are not stupid.

About Synaptic Decisions

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