

The Welch Report

Money Has a Cost

When I speak about the "cost of money" I am talking about just that. Allow me to explain it here to avoid boring you by repeating the same definition whenever I talk about it. All money has a cost. Money is either used to make you money or you have lost the opportunity for your money to make you money. Or at least to make you as much as it could.

If you are borrowing money to operate your business this money has a price. The price, of course, is the interest you are paying on the money while you are borrowing it. If you have money that you are holding in the form of cash in a low interest bearing account or short term investment, this money may also be costing you money.

How? Simple. Let's say you are in a good cash flow situation and you have a cash balance of \$50,000. You know this money will be needed for operational expenses in the near future so you let it sit in your business checking account or a short term liquid investment account. Let's say you are earning 1/2% interest during this time.

It might seem that this money is working for you making you money, and indeed it is. But the question is whether or not this is the most effective use of that money. If your money is in one place it cannot be in another at the same time. Obvious right? Well, if your money is tied up in the bank you must ask yourself - is this the best place for it? Is there another use you could put this money to in order to earn more money?

For example, can you pay some bills off early and take a trade discount of 2%. I will cover this in future articles but for now think and understand money has a cost. If your \$50,000 sits in the bank earning 1/2% interest you will earn \$250 per year. Now I know I have not factored in compound interest but I want to give a simple example of how you should think.

If you have the cash sitting for 30 days you will have earned 1/12th of this \$250 or \$21. But what if you had used that \$50,000 to pay off bills early and get a 2% discount? A 2% discount on \$50,000 is \$1,000. A simplistic example to be sure, but even using this you have increased the return on your money significantly.

Leaving your money in the bank had a cost to you. A lost opportunity cost. An opportunity to use this money to make you more money. But you must consider your cash flow, no matter how effectively you might otherwise use your money, you only have so much of it to use and therefore the availability of cash must be considered.

Money does have a cost. If I have used \$10,000 to pay an invoice early that offered me a 1% discount I have saved \$100. If I used that same money to pay a bill early that offered me a 2% discount I have doubled my return on the use of that money as I have saved \$200.

Do you see my point? Now put aside any cash flow questions for a minute while I make another point.

Now what if I did not pay any bill off early, but instead put that \$10,000 in an investment for 12 months paying me 1%? Have I not done well by earning \$100 on my money? It would seem so, but this is not the case.

By paying off an invoice early to take advantage of an early payment discount, you will save much more than the discount. When you earn a 2% discount by paying an invoice early, you are earning a return far greater than 2%. Unless you understand this there will be no way you can properly determine whether the best use of your money is to pay the invoice off and take the discount or not.

The formula is simple so don't despair. Here is the formula:

$$\text{Effective annual interest} = \frac{365 \times \text{discount rate}}{\text{Number of days payment must be made ahead of the due date to earn this discount.}}$$

So if a supplier offers you terms of "2/10 net 30" what is the effective rate of interest? Well, first of all, he is offering you a 2% discount if you pay in 10 days. The normal terms are 30 days. This means that to get the 2% discount you must pay 20 days early.

For this example we are assuming that you would normally comply with the 30 days terms.

For the sake of this example let us say the amount of the bill in question is the same \$10,000 we have been talking about. This is what your formula looks like:

$$\text{Effective annual interest} = \frac{365 \times .02}{20} = .365$$

Your effective annual interest rate is 36.5%. Obviously, even if you had to borrow the money to pay off this invoice your rate of return will be well worth it.

Do not think I am suggesting paying off discounted invoices as the only option you want to look at. I have simply chosen this often overlooked strategy as an example.

You must always consider all your options for using your money. The goal is to seek out the most profitable option available to you at any given time.

Never forget that money has a cost. How you use it can make a great deal of difference to your bottom line.

This edition of The Welch Report has been provided by Derrick Welch the author of **'In Pursuit of Profits: How to at Least Double your Profits Without Increasing Your Sales'. Including 1,000 Cost Control, Expense Reduction, and Income Producing Strategies You Can Start Using Today To Dramatically Increase Your Bottom Line.**

And **'Defy Mediocrity. Choose to be Uncommon. Think of the Alternative'**.

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