



Finance Circular No. 2004/14

To all agencies subject to the *Financial Management and Accountability Act 1997*

Discounts for prepayment and early payment

Purpose

This circular provides guidance to *Financial Management and Accountability Act 1997* (FMA Act) agencies to assist in assessing when it is appropriate to agree to either:

- prepay a contract to receive a discount before the goods or services have been performed or delivered; or
- make an early payment to receive a discount on the invoiced amount after the goods or services have been performed or delivered.

It also provides guidance to agencies on when to consider applying this discount policy.

Target Audience

This circular is relevant to Chief Finance Officers, officials who are responsible for the procurement of goods or services, and officials who make payments for goods or services.

Key Points

1. FMA Act agencies should manage Australian Government resources in an efficient, effective and ethical manner. Additionally, the Commonwealth Procurement Guidelines (CPGs)¹ require agencies to ensure that all procurement processes achieve value for money.
2. Efficient, effective and ethical management of Government resources includes making payments no earlier than necessary having regard to programme and service delivery objectives. As such, prepayments and early payments should only be made where there is a benefit to the Australian Government after taking all costs and risks into account.
3. If agencies pay suppliers or contractors earlier than required, the interest on the Australian Government's money held centrally with the Reserve Bank of Australia is reduced. Agencies should take this whole of government impact into consideration when assessing prepayments and early payments.

¹ FMA Regulation 8 states that officials "performing duties in relation to the procurement of property and services" must follow the Commonwealth Procurement Guidelines (CPGs). The CPGs can be accessed at: http://www.finance.gov.au/ctc/publications/purchasing/cpg/commonwealth_procurement_guide.html

Prepayments

4. Suppliers or contractors often offer a discount to an agency for paying for a good or service up-front before the goods or services are provided. As the goods or services have not been delivered, these arrangements may create additional costs and risks for the government. Consideration should be given as to whether a prepayment is efficient, effective, ethical, and value for money.
5. Examples of prepayments commonly include registration fees for training courses and seminars; rental payments in advance; and airline and hotel bookings. Prepayment for some goods and services may be industry practice and therefore no discount is available. However, where a discount is offered for prepayment, agencies should apply this discount policy.
6. In assessing whether the prepayment represents an efficient, effective and ethical use of Australian Government resources and represents value for money, agencies should ensure that the benefits of prepayment outweigh all costs, including all associated risks.
7. To calculate the whole of government cost of the interest foregone in accepting the prepayment, agencies should use the Reserve Bank of Australia cash rate target². In addition, agencies need to take into account other costs and risks that may arise due to the prepayment.
8. Agencies should consider when it is appropriate to conduct risk assessments for individual prepayments consistent with this discount policy. The rigour and effort put into risk assessments should be commensurate with the value and conditions under which the good or service are being prepaid.
9. An indication of the issues that agencies may wish to consider when assessing prepayments is at Attachment A. More information on risk management can be found in the CPGs and in Legal Briefing Number 66 *Managing Procurement Risk and Liability* issued by the Australian Government Solicitor³.

Early Payment

10. Suppliers or contractors often offer a discount for an early payment for goods and services on invoicing on delivery. As the goods or services have been delivered, this situation generally imposes no additional risk to the agency associated with the payment.
11. Examples of goods and services where discounts might be provided in exchange for early payments are purchases of office supplies, payment of electricity, gas or water bills, or contracted information technology services.
12. Early payment should only occur when the value of the discount is larger than the interest cost to whole of government of early payment. Agencies should use the RBA cash rate target to calculate the interest cost to the Australian Government.

² The Reserve Bank of Australia's cash rate target is published daily at: <http://www.rba.gov.au/>

³ Legal Briefing Number 66 *Managing Procurement Risk and Liability* issued by the Australian Government Solicitor can be found at: <http://www.ags.gov.au/publications/agspubs/legalpubs/legalbriefings/index.htm>

Other Issues

13. The cost to the Commonwealth of the discount can be calculated as follows:

$$\text{Cost to Commonwealth} = \frac{\text{Discounted purchase price}}{\text{RBA Cash Rate Target}} \times \frac{\text{Number of days the bill is paid early}}{365}$$

14. Agencies may wish to consider a threshold below which a more streamlined approach to assessing discounts could be applied. It is not likely to be efficient to assess the risks and foregone interest associated with payment of some low value invoices. It may also be considered efficient for discounts on moderate value transactions to be calculated at the RBA's cash rate target that applied at the commencement of a fixed period (i.e. quarterly), thereby avoiding the need to check the cash rate target more frequently.
15. Chief Executives may wish to incorporate policies and procedures for calculating the cost of prepayment and early payment into their Chief Executive's Instructions to ensure a consistent agency approach.

Contacts

16. If you have any queries, please contact the Banking Team, Finance and Banking Branch at Banking@finance.gov.au

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Prepayments

In assessing whether the discount is efficient, effective and ethical, and value for money, agencies may wish to consider the following.

Benefits

- What is the amount of saving offered by the supplier or contractor for prepayment?
- What are the other identifiable benefits to the Australian Government in accepting a prepayment?

Costs

- What amount of interest return does the Australian Government forego (between the date of prepayment and the date of normal payment) if the prepayment is accepted?
- Are there any other identifiable costs to the Australian Government?

Risks

- Have you considered the cost to the Australian Government in the event of failure by the supplier to deliver the good or services, including where the supplier goes into liquidation?
- Have you considered possible changes in price (including commodity prices)?

Other considerations

- Are there adverse effects on cash flows from making the prepayment?
- For large prepayments - Is a formal risk management and or risk mitigation strategy necessary? (ie. in some instances some form of security may be prudent).

In short, the discount should be accepted if the benefits are greater than the costs.