6 Terms and Conditions of Sale

Overview
Arrangements that specify the contractual conditions of transactions between sellers and buyers for the sale of goods or services are known as terms and conditions of sale. In other words, these arrangements are the rules that govern the sales transaction. They include payment terms, which specify whether or not open credit is to be part of the sales transaction, the length of time for which credit is to be granted and other features such as discounts. Although this chapter will focus on payment terms, terms and conditions of sale also include other nonpayment conditions, such as warranties, return privileges and insurance coverage (see Appendix 6A). From a legal standpoint, the words “terms” and “conditions” are interchangeable and will be treated accordingly in this chapter.

The impact of terms on an organization’s operation is significant. The granting of time for the customer to make payment represents a commitment of operating funds by the seller. Also, in most instances, the granting of open credit will permit the customer to receive product and/or services before payment is rendered. This situation increases the seller’s risk of loss in the event of customer insolvency or irreconcilable disputes. Both of these elements, the seller’s ability to finance his receivables and his exposure to losses from bad debts or disputes, must be factored into the seller’s credit policies with respect to terms decisions.

Learning Objectives
After reading this chapter, the reader should understand:

- The role played by terms in day-to-day business transactions
- The major factors that influence terms
- The key elements of terms
- The types of terms and how they differ
- The impact of payment timing and discounts on profitability

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Important Considerations

Application of a Seller’s Credit Policies to Its Terms

There are many different payment terms, ranging from prepayment by wire transfer to the allowance of considerable time to pay for goods or services received by a buyer. From a practical standpoint, there is a direct relationship between the terms of sale and the seller’s perception of the buyer’s ability to pay. Sellers are allowed to require cash in advance from a prospective customer or to take so-called “adverse actions” to restrict terms offered to existing accounts, based on internally developed credit standards. At one extreme, if the seller has little or no confidence in the buyer’s paying ability, the immediate payment of cash by certified check or wire transfer may be required. Conversely, if the seller believes that the customer is a good credit risk, goods or services may be delivered on an unsecured basis and a period of time will be allowed for the buyer to render payment (open credit terms). Careful thought and understanding of all of the elements of terms of sale is critical to selecting the appropriate terms for a customer.

Generally, terms decisions will be based on the application of a seller’s credit policies. The factors that enter into these policies are discussed below in the “Influencing Factors” section.

With regard to customers to whom open credit is declined and/or adverse actions are taken, conformity to the regulations of the Equal Credit Opportunity Act is essential (see Chapter 4).

Contractual Considerations with Respect to Terms

It is important to understand that not all sales transactions are governed by signed contracts, especially where there is frequent routine business activity between a buyer and a seller. In such situations, buyers, sellers and sometimes intermediaries exchange conflicting documents. The rules that govern these conflicts are discussed in Appendix 6B (The “Battle of the Forms”).

Antitrust Implications

As mentioned above, a seller’s terms will be heavily influenced by the competitive situations that have developed in the industry in which the seller operates. However, each seller must set standard terms (the basic terms offered uniformly to all accounts) independently from other sellers and without collusion or conspiracy with other sellers, to avoid violation of antitrust laws. Also, in instances where a seller offers different terms to different customers, caution must be used to ensure antitrust laws are not violated. Terms are considered an aspect of price, and many of the actions that constitute violations of antitrust laws with respect to price (e.g., the Robinson-Patman Act) also constitute violations with respect to terms. See the “Antitrust Regulation” section in Chapter 4.
Influencing Factors

General Considerations
Once terms of sale are established, they can be quite difficult to change. Since terms have both marketing and financial aspects, it is important that decisions related to establishing or changing them be made jointly by the company’s sales and financial management. Terms may vary widely according to products and marketing situations within the same industry. These variations are in the broadest sense a reflection of competition and market and product characteristics, which are two important factors that influence terms of sale.

Credit is extended in response to either direct or indirect customer demand for the firm’s products or services. Where competition exists, as it does in most situations, this implies that sales might not occur without the extension of credit. The decision to extend credit and the decision about the terms offered can be viewed as similar to a decision regarding the price of the product or service. Price is the result of a great number of market forces, some controllable, some not. Although the firm’s products or services may be similar to those offered by competitors, sufficient diversity of product or service can be created by the firm through customer relations, pre- and post-sale services, pricing policies or payment terms. (Note: any reference herein to decisions to “lengthen terms” includes decisions to extend credit to customers who would be required to pay in advance under more conservative circumstances. Conversely, decisions to “shorten terms” would also include a more conservative stance as to extending credit.)

A company that contemplates offering payment terms that differ significantly from its standard terms for a product line, or from the most common industry terms, must weigh competitive aspects and the subsequent influence on profits. Unless the product holds a large share of the market or is priced much lower than competing items, terms that are shorter than standard can divert business to competitors that offer less stringent arrangements. Conversely, while unusually long payment terms may help build sales, they produce higher costs, greater capital investment and cost of carrying accounts receivable, higher collection expenses, heavier losses from bad debts and reduced profit margins.

Any competitive advantage may only be temporary, since it can lead competitors to offer other inducements to the same customers. Shorter terms reduce the seller’s burden of financing the transaction, but buyers seek longer terms or larger cash discounts. Payment arrangements balance these opposing interests. Basically, payment terms are an element much like prices in the overall competitive scene. Uniformity of terms within an industry minimizes their competitive aspects but, even under these circumstances, a change in competitive conditions is likely to produce changes in terms. For instance, in a buyer’s market there is a tendency to offer longer terms as an inducement to buy. When demand for products or services exceed their availability, terms may be expected to shorten.
Market and Product Characteristics

Market and product characteristics range widely in impact and complexity, from production time to physical characteristics of raw materials. There is a direct relationship between the time it takes a buyer to convert goods or acquired services into cash and the time he needs to repay the debt created by the purchase of these inputs. Obviously, the customer would prefer that payment terms cover his operating cycle, which is the period of time between the acquisition of material, labor and overhead inputs for production and the collection of sales receipts.

In practice, however, a portion of the customer’s operating cycle is usually funded by its own capital, especially if there is further production involved or if the goods are not ready for resale when purchased. During the inventory conversion period, raw materials are purchased; machinery and labor transform it into a product before it is sold. The collection period is the time required to convert receivables to cash. If selling terms are shorter than the customer’s operating cycle, the supplier is said to have a favorable spread. If longer, then the buyer is said to have the advantage. In the latter case, for instance, suppliers could be furnishing a disproportionate share of funding for a customer that buys on long terms and sells on short terms.

Basic materials are sold to manufacturers on shorter terms than intermediate or finished goods, primarily because of the short period of time raw materials retain their original form in the hands of the manufacturer. Terms of sale rarely exceed the customer’s normal manufacturing cycle and storage time. Chemical products, such as agricultural oils and minerals, are normally sold on longer terms than their raw components. In the textile industry, unfinished cotton goods (so called “greige goods”) frequently call for shorter terms than finished fabrics.

It should also be noted that many institutional lenders treat “work in process” (WIP) inventory differently than raw material or finished goods. That is, a lender may make a secured loan to a buyer based on raw and finished goods values, but not WIP. This is because WIP has little or no intrinsic value while in that state. This can create problems for buyers as they seek to finance their operating cycles.

Perishable items, such as meats, fresh vegetables and dairy products, have a short shelf life, rapid turnover rate and short selling terms. It is fairly common to find 10-day terms in the food industry, and certain products allow heavy security rights to be granted to the seller under the Perishable Agricultural Commodities Act (PACA). Less perishable foods, such as canned goods and manufactured or processed foods products, have a longer turnover period, since they can be stocked in larger quantities by the retailer. They are sold on longer terms.
Merchandise having a seasonal demand often carries longer terms during the off season than during the active period. For instance, accounts receivable generated from the sale of toys builds up during the year in contemplation of the Christmas season. The supplier finances a great portion of the buyer’s needs, but maintains steadier production levels during the year and reduces storage problems that could be created by large pre-season stocks.

Goods protected by trademarks or those in very high demand enjoy widespread consumer acceptance and frequently turn over more rapidly than unknown brands. This may translate into shorter terms for the more popular products. Inexpensive items tend to be sold on shorter terms than more costly products. For example, terms for drug items are shorter than terms for floor coverings and many furniture items. Diamonds and expensive jewelry, which generally have a longer operating cycle than any of the above products, are purchased by retailers on terms that range from four to six months. Automobiles and other products may be sold under “floor plan” arrangements requiring extensive financing by the seller.

A seller’s internal situation with regard to order bookings may also influence credit policy with respect to payment terms. For example, a manufacturer operating at full capacity may, at least temporarily, seek to shorten terms and/or trim the credit risk exposure in his receivables portfolio. The latter may be accomplished by withdrawing credit from existing high-risk accounts or tightening standards for new account prospects.

**Type of Customer**

Companies often offer different terms to different types or classes of customers. Customers can be classified in many ways, for example by size of order or by type of buyer. Retailers may receive one set of terms, wholesalers another and institutional buyers still another. For example, a paint manufacturer may grant longer terms to retailers than to industrial accounts purchasing for use rather than resale.

**Profitability**

Products with higher profit margins may allow longer terms than products with lower margins. Selling terms should take this factor into consideration. In practice, however, competition may nullify short terms on low margin items by forcing a seller to lengthen terms for lines where depressed prices yield little or no profit. An example of this scenario would be “commodity” products, such as aluminum, petroleum or grain.

**Categories of Terms of Payment**

Terms of sale can be separated into three different categories: **cash**, **open** and **special**. Regardless of the kind of terms used by a seller, they should be clearly communicated in writing and agreed to by the buyer.

**Cash and Prepayment Terms**

**Cash terms**, also referred to as **prepayment** or **closed terms**, call for payment **before the transaction or at the time of the transaction**. Cash terms do not ordinarily offer any
discount or anticipation rights (see appropriate sections below). The offering to a customer of these terms, and these terms only, usually indicates that the seller does not wish to extend credit to the buyer. However, cash terms are sometimes simply the standard terms offered to all customers for a given product such as certain raw materials. The following terms are examples of cash terms:

- **Cash in Advance (CIA)** terms require the buyer to make payment via one of the cash methods (wire, company check, certified check, cashier’s check, etc.) before an order will be shipped. CIA terms are most often used for very weak credit or when unsatisfactory, limited or no credit information is available.

- **Cash Before Delivery (CBD)** terms are synonymous with CIA: no delivery is allowed until the buyer has made payment. Otherwise, the seller could bear the same risks as described in COD below.

- **Cash with Order (CWO)** terms are offered when the seller requires payment before production or manufacture of a product or order can take place. The seller requires that a check be included with the order or that some form of cash payment be received at the time the order is placed.

**SPECIAL NOTE**

1. CIA, CBD and CWO are the most severe terms from a buyer’s standpoint since the seller assumes little or no risk. In some industries, such as custom made heavy machinery, a portion of the order is required to be paid according to these terms regardless of the customer’s credit standing. This helps protect the seller from the risk of making customized product and then having the order cancelled.

2. If a company check (an uncertified check drawn on the customer’s account) is accepted, the seller bears the risk of the check being returned due to non-sufficient funds (NSF) or “stop payment.” This creates a “forced credit” because the creditor never intended to extend open credit terms. The creditor is forced to then treat the transaction as a collection matter before advancing in the order-to-delivery process.

- **Cash on Delivery (COD)** terms require payment to the transportation company for the full invoice amount at the time of the delivery. There is the risk that the buyer will not accept the shipment or cannot pay for the shipment at time of delivery, which means that the seller will have to bear the costs of freight to and from the buyer’s location, preparation and packaging costs and possible deterioration of the product. Also, in the case of seasonal products, such “non-acceptance” might cause the seller to lose the opportunity to resell the goods to others. Another risk is that the delivery agent may fail to pick up payment. These risks may encourage the seller to consider CIA terms. COD terms are used extensively where credit has not been established, where deliveries are frequent, where products are perishable and where the merchandise is standard. It should also be noted that acceptance of a company check is the normal method of COD payment, since buyers seldom have time beforehand to go to the bank to arrange a wire, certified or cashier’s check. This creates a NSF risk for the seller, as described above.
“Short” Terms

Short terms are of extremely truncated duration and are usually offered as a matter of industry practice (for example, highly perishable goods); in situations where credit limits are very tight; or in situations where the seller wishes to provide some token amount of credit support. Despite the shortness of terms, the customer may at least gain the advantage of quickly examining the product before payment is rendered.

- **Bill-to-Bill terms** are also called “drop-ship,” “drop-delivery” or “load-to-load” terms and require payment for the previous shipment when a new delivery is made. These terms are often found in lines involving weekly deliveries. Perishable foods sold to retail stores and gasoline sold to retail service stations are representative of this type of credit term.

- **Receipt of Invoice (ROI) terms** require the customer to render payment immediately upon receipt of seller invoice or on some predefined short dating (i.e., five days). Payment often must be made by wire to allow it to be received before the next order is to be shipped, therefore making it akin to Bill-to-Bill in its intent.

With credit card and purchasing debit card transactions, the seller receives payment quickly but the structure of the sale differs from other types of “short terms,” as explained below.

- **Credit Card Payment**—Rather than extending credit to a buyer, the seller obtains the promise of payment from a financial institution on behalf of the buyer. That financial institution extends credit to the buyer and renders payment to the seller. The duration of payment timing is determined by the contractual agreement with the institution involved, but usually payment is made within a few days. The institution must issue, to the buyer, advance approval of the transaction. The payment received by the seller will involve a discount, from the sales price, taken by the financial institution as a fee for its handling of the transaction. Sellers should be aware that most credit card transactions permit the buyer to deduct for disputes at a later date; therefore, the risk of loss through dispute is not eliminated. Credit cards are, of course, used widely in consumer transactions but are finding increasing acceptance in purchasing by governmental units and in business-to-business transactions.

- **Purchasing Debit Card**—“P-cards” are used extensively in industries characterized by high volume, spontaneous purchasing. These purchases often occur in market locations distant from the home offices of buyers and sellers. Unlike a credit card, the p-card purchase is funded directly by the buyer’s bank account; the transfer of funds occurs from the buyer’s bank account to the seller’s bank account. Like credit cards, most transactions require the “pre-approval” of the funding institution. In industries where these terms are used, the buyer’s accounts payable departments have essentially been eliminated. As with credit card payments, later deductions for disputes may be an issue for the seller. **Consider use of a Credit, or Purchasing Debit, Card Authorization Agreement when determining to accept such forms of payment. See Appendix 6C for an example form.**

Except in the few cases where cash or short terms are an industry standard, these terms indicate the seller’s unwillingness to accept a credit risk, or at least much of one.
The advantage of prepayment terms is that they do offer the seller an alternative way to make a sale when extending credit is not an option. When prepayment terms are used, there is little risk of nonpayment, except as explained above.

As mentioned above, there are several kinds of cash; cash can mean a buyer’s company check, a certified check or a cashier’s check. A cashier’s check is drawn by a bank on its own funds. In assessing risk, the seller/creditor looks to the bank’s financial stability. Therefore, the risk to the creditor is the credit risk of the bank itself when a cashier’s check is accepted. Courts have held that payment cannot be stopped on a cashier’s check because the bank, by issuing it, guarantees the check in advance. Where a certified check is involved, a bank guarantees that funds are on deposit when the check is certified. At the request of either the depositor or the holder, the bank acknowledges and guarantees that sufficient funds will be withheld from the drawer’s account to pay the amount stated on the check. Certified checks are virtually guaranteed, but there is some risk of bank offset in several states, so the guarantee is not perfect. This is rare, but it does create some risk for the credit grantor. In addition, more banks are encouraging the use of cashier’s checks for these purposes and discouraging the use of certified checks.

Other cash payment methods include wire transfer and electronic funds transfers (EFT). In a wire transfer, the buyer arranges to move funds electronically from its bank account to the seller’s bank account electronically. The most common method to do this is via the Federal Reserve’s Fedwire system, to which all banks have access. Funds move in a real-time mode via Fedwire, and all Fedwire transfers are final once they have been made. Banks handling the transfer can provide a Fedwire identification number to verify that the transfer has been made. Electronic funds transfers (EFT) are made via the Automated Clearing House (ACH). In an ACH transaction, customers can initiate the transfer by instructing their banks to use the ACH, or they can allow their supplier to automatically debit their bank account by using an ACH debit transfer. ACH transfers are not real-time, however, and require up to two business day to be completed. They are also not final and can be returned, much like a check that does not have enough funds on deposit to cover the clearing. ACH transfers are substantially cheaper than Fedwire transfers. Many financial institutions offer software that can be used to alert the seller immediately as to the receipt of wires, which facilitates release of orders. Third-party service providers that are recognized by the Federal Reserve System offer commercial and non-commercial (retail) credit grantors the opportunity to initiate EFT payments via the Internet or proprietary software. Customers can make one-time payments for cash/COD/CIA sales, for past due collection purposes of open account receivables and for recurring payments of accounts.

In more and more industries, there have been concerted efforts to shift from payment by check to an electronic form of payment, usually through the ACH network. Check “float” time given up by the paying firm is often added to the seller’s terms to induce conversion to ACH. ACH transfers are usually much more economical than checks. Receipts are more predictable when made electronically because the uncertainty of mail time is eliminated. Electronic payments are the typical form for international, cross-border payments, as foreign checks are not governed by U.S. banking rules and may be returned NSF long after deposit. Sellers may be able to recognize a cost savings with buyers that pay electronically, thus making such buyers qualify as a separate class of customer entitled to its own set of credit terms. In some industries, the buyer may grant the seller
permission to electronically draft his account at time of shipment, usually in exchange for favorable discounts. The advent of “Check 21” regulations, discussed earlier in Chapter 1, has created expedited clearing of electronically initiated payments.

Another important consideration for cash terms involves the exact timing of the funds transfer and its impact on possible preferential payments should the buyer file bankruptcy subsequent to the sale (see Chapter 19). If the seller’s intent is to receive cash before shipment or cash on delivery, and somehow the funds are actually received by the seller at a later time, the contemporaneous exchange defense to a preference may be invalid. This can happen if the seller ships on CIA terms on promise of payment or delivers on CBD terms on promise of payment, and the wire or check is received after shipment or delivery respectively.

A problem also exists when the buyer renders a NSF or stop payment check that he replaces with “good funds” at a later date. Under current bankruptcy law, where a check is involved, the date of receipt of payment is considered to be the date a check for “good funds” was received by the seller. Therefore, as above, contemporaneous exchange defenses may be negated because shipment occurred before receipt of payment. These instances of “forced credit” create a serious credit risk problem for open account credit grantors.

**Open Account Terms**

Open account terms include as many as three elements: the net credit period and, if terms include a discount option, the cash discount and the cash discount period. Therefore, Credit Terms = Net Credit Period + Cash Discount Elements.

The net credit period is the length of time allowed for payment of the face amount (non-discounted amount) of the invoice. Cash discount elements, if any, include (a) the amount of the discount, usually expressed as a percent (%) of the invoice face amount excluding freight and other third-party charges and (b) the length of time allowed for the buyer to pay on a discounted basis. In other words, credit terms provide the buyer with information that indicates the due date for payment on a discounted basis, the amount of the discount and the due date for payment after the discount period passes (i.e., 1% 10, net 30 days).

The most common open terms category is known as Terms Based on Invoice Date. That is, the net credit period is a certain number of days from the date the invoice was billed (although in a few industries, it is computed from the date the goods are received by the customer). An example of such a term is “net 30”: payment must be made in full within 30 days of the date of the invoice. (Note: In this text, an effort is made to cover the most common open credit terms. Due to the vast array of possible terms offered in different industries, it is not feasible here to define all terms offered worldwide.)

In some industries, Single Payment Terms are observed. That is, purchases made over a period of time, usually a month, are assigned a single due date, usually in the following month. While these arrangements can simplify bookkeeping for both seller and buyer, they can create at least two problems for sellers. First, disputes can sometimes arise wherein the buyer claims goods and/or invoices were received too late to be paid in the current cycle, thereby delaying payment until the next cycle. Such disputes can delay the seller’s cash receipts by 30 days or more, whereas under terms based on invoice date,
the delay would merely be a few days. Secondly, to maximize the total time for payment, buyers often request that all shipments be concentrated at the early end of the cycle. These requests can create numerous difficulties for the seller, such as inventory management, labor and transportation scheduling, and so forth. Examples of single payment terms are as follows:

- **End-of-Month (EOM) Terms**—Shipments made during a given month are billed as of the last day of that month and assigned a single due date in the following month (usually the tenth of the following month). This term is expressed as “Net 10 EOM.” A single statement, rather than individual invoices, is rendered to the buyer (although the statement does reflect actual shipment dates and amounts for matching purposes). Where a discount is offered, the cash discount period and net credit period are identical. That is, any payments made after the single due date are delinquent and must be made at face value with no discount applied. (See examples of Discount Terms below.)

  In some industries, the “cut-off” date for EOM billings is changed from the last day of the shipping month to (for example) the 25th day (i.e., from March 30 to March 25). This permits the buyer several extra days to receive and process the invoice and merchandise prior to the due date. However, this usually does not alleviate the “shipment concentration” issue mentioned above.

- **Middle of the Month (MOM) Terms**—Shipments made from the 1st through the 15th of a given month are invoiced as of the 15th of that month; shipments made from the 16th through the end of a given month are invoiced as of the end of that month. The credit and discount period is normally 10 days after each of these invoice dates. Note that whereas EOM terms approximate 25 or 30 days on average, MOM terms approximate 17 days and are therefore shorter.

- **Proximo Terms**—Proximo, abbreviated “prox,” is Latin for “next” or “next following.” Net 10th Prox terms are similar to Net 10 EOM terms except that, under prox terms, individual invoices are usually billed at time of shipment rather than on a monthly basis. Also, prox terms may offer a net period that is different from the discount period. For example, while terms of “2% 10th Prox” are identical to “2% 10 EOM,” terms of “2% 10th prox net 30th” permit the undiscounted payment to be delayed until the 30th day of the month following shipment.

  In the automotive industry, a special form of prox terms is sometimes used: the combination of Net 10th prox and Net 25th prox. In other words, invoices dated from the first through the 15th of a given month are due on the 10th of the following month, and those dated from the 16th through the end of the month are due on the 25th of the following month.

**Discount Terms**

As illustrated above, a cash discount is calculated from the invoice amount if the customer pays within a specified period of time called the **discount period**. The discount is usually expressed as a percentage but can also be stated as a dollar amount. Terms of **1% 10 net 30**, for example, allow the buyer to deduct 1% from the face amount if the invoice is paid within 10 days. If the buyer does not take the discount, the full amount of the invoice is due within 30 days. The discount rate is 1% and the discount period is 10 days.
As mentioned previously, the offered discount normally will not apply to common carrier freight charges added to the invoice or any other third-party add-on charges (such as insurance) for which the seller may not reap a corresponding benefit.

The following are examples of payment timing for various discount terms:

- **8% 10 EOM**—An 8% discount is earned if payment is made by the 10th of the month following shipment. If paid later, discount is forfeited and the invoice is also past due.

- **8% 10th Prox**—Similar to 8% 10 EOM.

- **2% 10 MOM**—Shipments made from the first through the 15th of a given month are due on the 25th of the month; those made from the 16th through the end of the month are due on the 10th of the following month, with the credit period being the same as the discount period.

- **2% 10th Prox, net 30th**—A 2% discount is earned if payment is made by the 10th of the month following shipment. The full, undiscounted amount is due by the 30th of the month following shipment.

Policies vary in the credit community as to the date used for receipt of payment. Some sellers use the envelope postmark date; some use the date payment is received. Clarification of the seller’s discount policy, on contract documents or policy releases, is a necessity and should be spelled out on the credit application agreement or contract in the terms and conditions section.

**Anticipation** is a form of early payment allowance wherein a discount is allowed based on the number of days an invoice is paid early, using a pre-established annual rate converted to a daily rate. Such discounts are usually based on the prime rate or the prime rate adjusted by a certain number of basis points (i.e., prime less 100 basis points = prime less 1%). The discount amount is the annual rate divided by 365 days multiplied by the number of days paid early. Anticipation is usually offered by sellers who are trying to maximize cash flows due to (a) an attractive opportunity for their own investments, (b) a need for improved liquidity to meet their own debt obligations or (c) a need to expand to meet demand for their products. One disadvantage is that the seller may face problems communicating a change in rate to the buyer when the prime rate changes, or other disputes may develop as to the exact offered rate. However, as compared to other discounts, anticipation offers the advantage of better flexibility in changing the offered rates.

**Trade discounts** are allowances offered to purchasers because of industry custom or the volume of purchases. They should not be confused with cash discounts, since trade discounts bear no relationship to time of payment and may be deducted regardless of when the bill is paid. Trade discounts may consist of (a) a standard percentage offered to all customers in a given trade class or (b) a standard set of volume discounts offered to all such customers. For example, manufacturers may offer trade discounts to wholesalers or retailers: wholesalers may offer trade discounts to retailers, etc. [Note: Seek legal counsel when considering a discount program to ensure compliance with the Robinson-Patman Act as a discount term is an element of pricing and must be offered to all like customers.]

**Chain discounts**, or successive discounts from the original price, represent a manner in which a trade discount and a payment discount can be combined in a single set
of terms. Obviously, in such instances, the sequence of the discounts can change the outcome if the buyer takes the trade discount but fails to earn the payment discount. In other words, for a buyer forfeiting payment discount, offering a 10% trade discount and a 5% payment discount produces a higher total discount to the buyer than does 5% trade and 10% payment.

Enforcement

If cash discounts are to serve their purpose, the seller is discouraged from allowing unearned discounts because of their influence on cash flows and profits. However, enforcement of discount terms varies widely; implementation of any grace period and collection of a chargeback should be guided by company policy developed for consistent treatment for all customers.

Unearned Discounts

From time to time, customers send in a check for the amount due less the discount even though the discount period or terms have expired. This is commonly referred to as unearned discounts. In these cases, a decision whether to accept payment as a completed transaction must be determined before depositing the payment.

Inconsistent treatment of unearned discounts and enforcement of terms will create the potential for antitrust claims under the Robinson-Patman Act. The principle behind a claim of violation of this type involves preferential pricing, which according to the Act, is a form of discrimination and can lead to a competitive advantage for the customer who receives an unearned discount. For example:

Customer “A” pays its open account credit invoice within stated terms and takes a discount. Customer “B” (a “like-customer” to customer “A”) does not pay its open account credit invoice within stated terms but takes the discount nonetheless. The creditor allows the discount taken by customer “B” by not enforcing policy to disallow the “unearned discount.”

In this example, customer “B” receives a price advantage by the fact that the creditor allowed a discount that was not “earned” or, in other words, was taken by the customer outside the stated terms. Under Robinson-Patman, a price advantage was given to customer “B” that was not provided to customer “A.” Based on the time value of money, customer “B” basically paid less than customer “A” because customer “B” was allowed to hold onto its money for a longer period of time. Thus, customer “B” gained a competitive advantage over customer “A” when the creditor allowed customer “B” to take a discount that was not “earned.” The creditor in this example has likely violated the Robinson-Patman Act based on the concept of price advantage.

If the creditor chooses not to accept the payment as completed transaction, then the options are to

- Notify the customer by phone immediately and follow up in writing
- Invoice the customer for the unearned discount amount
- Return the check and demand full payment
If a discount is allowed by a creditor outside the discount term, then the creditor must notate in the customer’s file the reason(s) why the unearned discount was allowed in order to avoid future claims of violation made by a customer or class of customer that an antitrust violation(s) occurred.

In cases where a creditor receives payments directed to a lockbox, the check is already accepted by the time the bank advises the creditor of the payment. Therefore notification and the generation of an invoice for the unearned discount are the only available options.

**Factors Influencing Offering of Discount Terms**

The necessity and value of cash discounts is controversial. Cash discounts offer substantial financial advantages to buyers. Assuming that a majority of customers pay within the discount period, the seller may expect a quicker turnover of funds, with reduced net working capital requirements, reduced credit and collection expenses and reduced delinquencies and credit losses. However, advantages are sometimes disputed, with the argument being that prompt payment may at least partly be a matter of habit or fulfillment of agreement upon terms. This presumes that collections would be as prompt on terms of net 10 days as on 1% 10 net 30 days. This assumption may be valid if the seller’s customers are all strong financially and if competitors also sell on terms of net 10 days.

Competitive conditions often dictate that sellers conform to the standard industry terms. If such terms include a discount structure, any given seller may likewise feel compelled to offer an equal discount.

If cash discounts shorten the average collection period, they could be a very real advantage to suppliers who have exhausted most of their possible sources of financing and/or have a strong need for faster turnover of their accounts receivable. Conversely, suppliers who suffer widespread abuse of discount terms (discounts consistently taken after the discount period) may not benefit and may choose to terminate discount programs.

The credit manager should play an important role in determining discount terms. By using a time value of money approach to capture relevant cash inflows and cash outflows associated with selling the firm’s products or services, the credit manager can show whether or not offering discounts can enhance the firm’s value. For slow paying customers to whom a firm has offered a cash discount, the credit manager can use the cost to the buyer technique (see below) to help convince the buyer that a bank loan may be less expensive than trade credit. In this way, the credit manager helps the buyer add value to the buyer’s firm. The result may be a more loyal and timely paying customer.

In summary, some of the most compelling reasons to offer discounts are:

- To meet competitive conditions in the market
- To reduce total credit exposure, and to reduce delinquencies and credit losses by shortening the payment cycle
- To reduce credit and collection expense
- To reduce borrowing costs of the seller’s firm
- To improve the ability to put collected funds to use more quickly in the seller’s firm.

The opportunity cost represents the return that the seller can obtain by investing funds elsewhere at comparable risk or by investing funds in corporate growth.
through acquisitions or other means. Opportunity cost should be compared to the costs of offering discounts as calculated below.

**Analyzing the Cost of Offering Cash Discounts from the Seller’s Perspective**

The credit manager, together with the seller’s management team, must not overlook the issue of whether a cash discount will add economic value to the firm. Decisions to offer early payment discounts or to change the amount of discount often require detailed analysis of their economic impact. In the following sections, we will examine the various concepts used to determine the cost considerations necessary to make these decisions.

**Analysis of the Time Value of Funds**

**Net Present Value**

The seller’s price should take into account three factors: the required profit, the risk of possible nonpayment (risk premium) and the cost of carrying the receivable until maturity. While the first two factors are usually included in a seller’s overall pricing strategy, the latter is often overlooked. The cost of carrying receivables requires using present value formulas to translate future dollars to current dollars.

As time passes, receivables lose value for two reasons: the cost of the lost use of the money and the possible increasing likelihood of the failure of the debtor. The cost of lost use includes several concepts, as follows. First, in times of inflation, customers who are granted time to pay bills will be paying with “deflated dollars,” and the supplier will have to replace sold inventory at a higher price. Secondly, presuming the supplier must borrow money to service his own debts while awaiting payment, interest costs become a cost of carrying receivables. Thirdly, even if borrowing does not become a necessity for the supplier, he loses the opportunity of investing the proceeds of his sales in interest-bearing instruments, corporate growth, etc. If the costs of carrying receivables are ignored, the oversight could force the seller to absorb a cost not considered when setting prices.

To analyze the costs of carrying a receivable, the concept of net present value can be used. The value of any receivable to be paid in the future must be discounted backwards in time to determine its present value. The discount rate (in %) to be used in the analysis of expected profits is based on the factors described in the paragraph above. Since these factors are numerous and subjective, and could yield a multiplicity of answers, most sellers use their own annual cost of capital (represented below as the value $k$) as the discount rate. Please refer to the Chapter 22 appendix for this calculation and more information.

The following formula is used to calculate the net present value of a receivable due at a future date, assuming monthly compounding:

\[ PV = \frac{FV}{(1 + k)^n} \]

$PV$ is the resultant net present value to be derived, $FV$ is the given future value, $k$ is the monthly compound equivalent of the annual cost of capital, and $n$ is the time period in months.
For example, assume that the supplier has an annual cost of capital of .1288 (.01015 compounded monthly for 12 months), and expects to collect $100 at the end of the 12-month period. The present value of that $100 would be:

\[
1.00/(100 + .01015) = 88.59
\]

The following is a simpler formula that can be used to approximate present value:

\[
PV = FV - FV(k \times n)
\]

Using this formula, if the firm’s annual cost of capital (k) is .1288, the monthly cost of capital is .01073 (.1288/12), and if the receivable expected to be collected is $100 due in 12 months, the approximated present value is:

\[
PV = 100 - 100(.01073 \times 12) = 87.12
\]

Using the same formula, the present value of a $100 invoice due in 30 days is:

\[
PV = 100 - 100(.01073 \times 1) = 98.93
\]

And the present value of $100 due in 60 days is:

\[
PV = 100 - 100(.01073 \times 2) = 97.85
\]

A seller wishing to recover the profit erosion caused by the time value of the funds in the 30-day example could add $1.07 to the price and in the 60-day example could add $2.15 to the price.

Using the simple formula, assuming a $100 net scale, with monthly cost of capital of .01073, Figure 6-1 displays the present value of future receipts based on collections made in 30-day increments.

**Future Value**

To recover the profit erosion caused by the time value of funds, a seller would determine the present price at the required profit, then project the resulting value forward to the maturity date by applying the cost of capital factor. The formula used to determine this required future value is:

\[
FV = V(1 + k)^n
\]

Assuming that the seller wishes to establish a price equal to $100 plus the cost of carrying the receivable for 30 days, the calculation is:

\[
FV = 100(1 + .01015)^1 = 101.02
\]

As with present values, a simpler model may be used by which the future value may be approximated, i.e.:

\[
FV = PV + PV(k \times n) \text{ where } k = \text{annual cost of capital divided by 12}
\]
Using this formula, the selling price for the 30-day example above becomes:

\[ FV = $100 + $100(0.01073 \times 1) = $101.07 \]

Where relatively short time periods are involved, the simple model provides a workable alternative. For longer periods, which stretch into years, significant variances develop in the results of the two formulas and the compound model should be used.

**Effect of Discount Terms on Profit**

The concept of time value of funds is useful for understanding how cash discount terms offered by the firm affect its receivables, cost of capital and profit. For instance, if regular selling terms are 2% 10 net 30 and \( k \) is .1288, then the firm’s profit on any particular receivable will vary according to when the buyer pays the invoice.

This may be shown by a series of comparable sales situations. In all instances that follow, selling price is $100, terms are 2% 10 Net 30, and the costs of goods or services sold (except \( k \)) are $86.

**Immediate Payment:** When a customer pays cash and takes the discount, the invoice price is reduced by the discount amount. The other figures require no time value adjustment, since they are in the present. Costs of $86 are subtracted from the $98 received and the profit is $12. In this instance, there is no capital cost of carrying the receivable.

<table>
<thead>
<tr>
<th>Sales (Receivable)</th>
<th>$100.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Discount</td>
<td>2.00</td>
</tr>
<tr>
<td></td>
<td>$98.00</td>
</tr>
<tr>
<td>Cost at Present Value</td>
<td>$86.00</td>
</tr>
<tr>
<td>Profit at Present Value</td>
<td>$12.00</td>
</tr>
</tbody>
</table>
Payment on the 10th Day: When payment is received on the 10th day, or the last day of the discount period, the firm sustains two types of profit reduction: the customer is entitled to deduct the discount, and the seller’s firm has incurred the capital cost of carrying the receivable for 10 days. Thus, while receipts are $98, the cash or present value of the receipt is $97.65 because it has cost 35 cents to carry the $100 for the 10 days. With the deduction of $86 in costs, the profit becomes $11.65.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (Receivable)</td>
<td>$100.00</td>
</tr>
<tr>
<td>Cash Discount</td>
<td>2.00</td>
</tr>
<tr>
<td><strong>Cost of Carrying Receivable</strong></td>
<td><strong>98.00</strong></td>
</tr>
<tr>
<td>(simple formula)</td>
<td>0.35</td>
</tr>
<tr>
<td>Cash or Present Value</td>
<td>97.65</td>
</tr>
<tr>
<td>Cost at Present Value</td>
<td>86.00</td>
</tr>
<tr>
<td>Profit at Present Value</td>
<td>$11.65</td>
</tr>
</tbody>
</table>

Payment on the 11th Day: If the customer pays on the 11th day but does not take the discount (admittedly, an unlikely situation, since once discount is lost the buyer would probably carry the item to full maturity), the seller firm gains the cash discount at the expense of one more day’s capital cost of carrying the receivable. This sets the cash or present value of the receivable at $99.61 and the profit at $13.61.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (Receivable)</td>
<td>$100.00</td>
</tr>
<tr>
<td>Cash Discount</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Cost of Carrying Receivable</strong></td>
<td><strong>100.00</strong></td>
</tr>
<tr>
<td>(simple formula)</td>
<td>0.39</td>
</tr>
<tr>
<td>Cash or Present Value</td>
<td>99.61</td>
</tr>
<tr>
<td>Cost at Present Value</td>
<td>86.00</td>
</tr>
<tr>
<td>Profit at Present Value</td>
<td>$13.61</td>
</tr>
</tbody>
</table>

Payment on 30th Day: When payment is received on the maturity date of the receivable, the seller has carried the receivable for one month and incurred the corresponding cost of capital of $1.06. However, the payment is for the full amount of the invoice, or $100, and the profit is $12.94.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (Receivable)</td>
<td>$100.00</td>
</tr>
<tr>
<td>Cash Discount</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Cost of Carrying Receivable</strong></td>
<td><strong>100.00</strong></td>
</tr>
<tr>
<td>(simple formula)</td>
<td>1.06</td>
</tr>
<tr>
<td>Cash or Present Value</td>
<td>98.94</td>
</tr>
<tr>
<td>Cost at Present Value</td>
<td>86.00</td>
</tr>
<tr>
<td>Profit at Present Value</td>
<td>$12.94</td>
</tr>
</tbody>
</table>

Payment on the 60th Day: For the last illustration, it is assumed that payment is received on the 60th day, or 30 days past due, and no interest for the late payment is charged. No discount cost is applicable, but it has been necessary to carry the receivable for 60 days making the cost of capital $2.12. This reduces the cash value of profit to $11.88.
The figure shows the undiscounted payment on the 11th day after invoice date as yielding the greatest profit to the seller. The next most profitable is payment on the maturity date (30 days). Immediate payment is the third most profitable. The analysis also shows that the firm makes higher profits on the payment received 30 days slow than it does on the discounted payment received on the last day of the discount period. The examples described above are illustrated in Figure 6.2.

It is a simple exercise to repeat these calculations for different terms of sale and different costs of capital. By doing so, the firm can determine the cost/profitability tradeoffs when it is studying its discount terms or the possible use of late payment charges.

### Figure 6-2  PV of Profit at Different Payment Dates When Discount Is Offered

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>0</th>
<th>10</th>
<th>11</th>
<th>30</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale</td>
<td>$100.00</td>
<td>$100.00</td>
<td>$100.00</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>Cash Discount</td>
<td>2.00</td>
<td>2.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Cost of Carrying Receivable</td>
<td>98.00</td>
<td>98.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Cash or Present Value</td>
<td>98.00</td>
<td>97.65</td>
<td>99.61</td>
<td>98.94</td>
<td>97.88</td>
</tr>
<tr>
<td>Cost at Present Value</td>
<td>86.00</td>
<td>86.00</td>
<td>86.00</td>
<td>86.00</td>
<td>86.00</td>
</tr>
<tr>
<td>Profit at Present Value</td>
<td>$12.00</td>
<td>$11.65</td>
<td>$13.61</td>
<td>$12.94</td>
<td>$11.88</td>
</tr>
</tbody>
</table>

Sales (Receivable) | $100.00
Cash Discount | 0.00
Cost of Carrying Receivable | 2.12 ($100 × 60 days (.1288/365))
Cash or Present Value | 97.88
Cost at Present Value | 86.00
Profit at Present Value | $11.88

### Analyzing Profits from Discounted Sales

#### If Sales Increase or Decrease As a Result

Profits resulting from discount terms will also vary in relation to the increase or decrease in sales that result in any change of discount terms. A firm planning to change the
percentage of discount or eliminate the discount should calculate the estimated effect of
the terms change on total sales and resulting profits.

Assume that total monthly sales are $250,000 in a firm whose annual k is .1288. If
terms of sale are 2% 10, Net 30 and the supplier is being paid in 10 days, the profit less
discount and carrying costs would be:

Sales $250,000
Cash Discount -$ 5,000
$245,000

Cost to Carry
Profit at Present Value

$244,118

Assume that the firm changes terms to Net 30 days. If elimination of the early pay-
ment discount results in a 10% loss of total sales, and if customers who paid promptly at
10 days begin to pay on an average of 40 days (10 days beyond the terms of sale since
there is less incentive to pay on time) the profit, less carrying costs (no reduction for
discounts allowed) would be:

Sales $225,000
Cost to Carry
Profit at Present Value

$221,822

Obviously, under this scenario, the elimination of the discount produced unfavorable
results.

This exercise can be repeated for different terms of sale, changes in sales volume,
and different costs of capital. In this way, the firm will be able to understand the cost
and profitability tradeoffs of anticipated changes. It should also be noted that if increases
or decreases in sales volume also result in changes in the costs of goods sold, these cost
changes will also result in changes to the firm’s profits.

Analyzing the Cost to the Buyer of Not Taking Cash Discounts

The seller’s credit team can use the Cost to the Buyer Formula to help convince the
buyer that a bank loan may be cheaper than trade credit when discount terms are avail-
able. The formula to be used for this purpose is as follows:

Formula for Approximate Costs of Foregoing the Discount (annualized)

\[
\frac{\text{Discount Percent}}{100 - \text{Discount}} \times \frac{365}{\text{Number of Days Until Paid} \ - \ \text{Less Discount Period}} = \text{Approximate % of Costs}
\]

A customer who previously paid in 30 days, forgoing discount, would receive the
following annual benefit by paying in 10 days:

\[
\frac{1}{100 - 1} \times \frac{365}{30 - 10} = \cdot01 \times 18.25 = 18%
\]
If the customer can borrow funds at a rate lower than 18%, he will generate internal profits by discounting.

Conversely, customers who pay beyond terms—and who would have to spread the discount benefits across a longer timeline—may see little incentive to discount. Assume that the customer in the example above has been paying 30 days slow.

\[ \frac{1}{100 - 1} \times \frac{365}{30 - 10} = .01 \times 7.3 = 7\% \]

In the second example, the equivalent annual benefit is significantly lower and may not provide sufficient incentive for the customer to borrow funds to take advantage of the cash discount. Unless the creditor charges late payment interest, holds shipments or services or uses other means to shorten the payment cycle, the slow customer will continue to benefit from paying late.

The equivalent annual interest rates applicable to various discount terms are shown in Figure 6.3. The first column lists the various cash discount percentages, ranging from ½% to 5%. Various terms are shown in the remaining six column headings. Below each is the cash discount equivalent annualized rate for that set of terms. For example, under terms of ½% 15, net 30 days the equivalent annualized rate is 12%; with 1% 15, net 30 the rate is annualized at 24%; and so on. The same procedure is used in the other columns.

### Late Charges

When goods or services are purchased on credit, the supplier finances the purchase during the time provided by the credit terms. This financing is regarded as a necessary cost of business and is included in determining the selling price. However, unless the bill is promptly collected at maturity, the cost for carrying the account thereafter is an additional cost of business. **Late charges** assessed upon receipt of late payments represent a way in which the seller can recover these costs. Late charges should be clearly distinguished from **interest payments**, which are charges made by financial institutions for loans. The credit application agreement should identify these charges and how they will be assessed.
Reasons for imposing and enforcing late charges include the recognition that late payments may cause one or more of the following situations:

- Use of the supplier’s capital without consent
- Allows delinquent customers an unfair net price advantage
- Increases the supplier’s collection expenses and, usually, bad debt expenses

Reasons for not imposing late charges include:

- Fear of losing customer goodwill
- Belief that competitors do not impose or enforce similar charge
- Difficulty in collection of late charges
- Heavy administrative costs for businesses that generate significant numbers of invoices at relatively low invoice amounts
- Costs of carrying overdue accounts are considered to be comparatively small

Like unearned discounts, late charge policies must be applied uniformly to all customers or to like groups of customers, or they may be interpreted as a form of price discrimination under the Robinson-Patman Act. The premise is exactly the same interpretation as unearned discounts. It is recommended that credit grantors seek the advice of legal counsel before instituting a late charge program to make sure it is applied properly under the law. The issue is not the validity of using late charges but, rather, proper implementation and enforcement of the policy once it is instituted. In some states, late charges may constitute a violation of the usury laws if:

- a credit sale is made for products or services primarily for personal, household or family use; and
- the interest rate charged is in excess of the maximum permitted by state law.

Chapter 5 provides additional details about usury issues, including language that can be included on a credit application agreement.

Special (Other) Terms

The following are examples of special terms primarily used in specific situations or in certain industries. Some of these terms are simply variations of the open credit terms described above.

Receipt of Goods

Receipt of Goods (ROG) terms permit the buyer to compute the cash discount period or net credit period from the date the merchandise is received rather than from the invoice date. A distant buyer experiencing lengthy transit time receives a compensating benefit and is not pressed to remit before examining the shipment, as may happen when the terms begin on the invoice date. In some industries, the net credit period is calculated from the invoice date while the discount date is based on receipt of goods. ROG terms are common
in the importing of raw sugar and other occasions where long transit times exist. With these terms, enforcement places a burden on the seller to determine when the merchandise arrived at the buyer’s facility. In some industries, regularity and predictability of transit times permit the use of a standardized matrix which calculates delivery dates.

**Bill and Hold**

**Bill and Hold (B&H) terms** are utilized in some industries, such as textiles, to permit sellers to invoice buyers under normal payment terms on the agreed-upon completion date, whether or not shipment has actually occurred. This provides protections to the seller, which minimize inventory risk, especially where fashion or customized products are concerned. The customer is required to render payment on the normal due date regardless of the actual shipping schedule of merchandise. In several states, the UCC provides further protection to sellers in certain industries by providing for a seller’s lien on any B&H inventory still in the seller’s possession. In the event of nonpayment by the buyer, the seller may liquidate this inventory to others and use the proceeds to reduce the buyer’s debt. The regulations of the Securities and Exchange Commission contain many provisions that apply to B&H transactions, and these should be carefully observed before rendering a B&H invoice.

**Consignment**

**Consignment terms** offer an alternative to an open account sale. Consignment is not a true sale until the buyer, called the **consignee**, actually sells the goods to a third party or moves them from consigned inventory into the buyer’s own inventory. Until the goods are thus sold or moved, title remains with the supplier, usually the manufacturer, who is called the **consignor**. By definition, a consignment sale has the following elements:

- The consignee takes possession of the merchandise to be sold
- Title is retained by the consignor until the time of sale to a third party (or movement to buyer inventory as noted above)
- Payment to the consignor is not due until the merchandise is sold or so moved

The consignee’s reward for handling the sale is either (a) a commission or (b) the goods may be sold at regular markup with the profit being retained by the consignee.

The execution of a consignment agreement between the parties helps avoid the possibility of misunderstandings about the terms of the consignment. While it is often true that consignees are permitted to return unsold goods to the seller, such issues, and the timeframe permitted for returns, are spelled out in a consignment agreement.

Consignment terms are often used for other than credit reasons, i.e., as marketing or selling tools for:

- Penetrating new market segments
- Introducing new or more costly product lines
- Displaying inventory for sale prior to an expected seasonal demand
- Attempting to sell goods that are out of season or style or for which there is no current market
There is an obligation for the consignee to account for the proceeds when the goods are sold or to return the goods according to the terms of the agreement if they are not sold. The seller may also require the consignee to maintain adequate insurance on all consigned goods with the seller as beneficiary.

In addition to defining returns and insurance issues, consignors should also take care to ensure that consignment agreements allow them to receive regular inventory reports. Consignors should also consider perfecting a security interest under the UCC. Compliance with the perfection requirements of the UCC protects ownership of inventory in the event of a dispute over goods.

Consignment terms are often used where inventory is expensive and/or slow moving, such as the fine jewelry trade.

**Floor-plan Financing**

Floor-plan financing involves an inventory financing company, called the floor-plan creditor, that has contractual arrangements with both the supplier/seller and the buyer. In some cases, the seller can serve as the financing company. The supplier ships the product to the buyer but sends the invoice to the financing company. The financing company pays the supplier, and the buyer pays the financing company over a longer period of time, with interest. A floor-plan agreement, which states all terms (such as repayment terms, repurchase agreements and recourse), must be developed and signed by all parties involved. Floor-plan financing is used when individual goods or items are very expensive. For example, motor vehicle and boat dealers and retailers and distributors of furniture and household appliances commonly use floor-plan financing.

UCC security agreements are often used with this form of financing. The manufacturer, as the secured party, can protect its interest by filing a **blanket financing statement** and/or a **purchase money security interest** covering the goods and proceeds without having to execute new agreements as more items are sold.

**Contra Account**

Some companies find themselves in the position of having reciprocal seller/buyer relationships with their customers. In such situations, the parties maintain contra accounts so only the net amount due to one party or the other needs to be paid regularly. In certain industries, such as energy, netting arrangements of this sort facilitate payments without the need to move large amounts of offsetting funds. The technique of contra account settlement may be perfectly natural between two strong companies, but it can also be useful in cases where a strong supplier wants to protect itself against a customer that is financially weak. A contractual agreement acceptable to both seller and buyer will clarify the contra account arrangements. It is important for a creditor to know if a customer has made such arrangements with other suppliers, since the supplier with the contra account arrangement has a potentially stronger claim to the customer’s assets.

**Extra Dating**

Extra Dating terms can be used to extend the net period and/or the discount period. For example, terms of 2% 10, **60 extra** extend both the discount period and the net credit
period to 70 days from the date of the invoice. Since these extra terms have identical discount and net credit periods, there is no inducement for the buyer to pay prior to maturity. To overcome this, extra terms are sometimes expressed as (for example) 3% 10, 2% 10 60 extra. This indicates that 3% may be deducted if payment is made within 10 days, but only 2% is deductible if payment is made by the end of 70 days.

**Seasonal Dating**

**Seasonal Dating terms** are used when there is a high seasonal demand for a product and sellers wish to encourage off-season purchases. Seasonal terms postpone payments to coincide with the buyers’ heavy selling seasons. These terms are common in the toy (December dating) and agricultural (crop terms) industries, among others. The customer benefits from having the goods on hand without an immediate investment of funds for the purchase of inventory (although warehousing expenses are still a factor). The seller benefits by having (a) more consistent sales and production throughout the year and (b) production cycles with lower storage requirements. The seller usually bills at date of shipment to the buyer—but with a single due date based on a predetermined date during the peak selling season. Incentives may be offered to the buyer in the form of anticipation for early payment. Seasonal dating creates the problem of a build up of accounts receivable for the seller and can create substantial additional credit risk.

**Security Interest**

Creditors may enhance their position by taking a secured position in assets such as inventory, bank accounts, real estate (mortgages) and so on. Secured interests can be useful when a sale is made to a new business, a high-risk account, if the terms of payment are long, if a large dollar amount is involved or if material is going to be at the customer’s location for an extended period of time. *(See Chapters 8 and 13.)*

**Advances**

When work is done to the customer’s specification, it is customary to ask for a partial payment with the order to provide the seller with some working funds for the job and to offer some protection in case the customer cancels the order. Where advances are not the customary practice, they may nevertheless be requested for partial protection when a customer is not in a strong financial condition, when there is the possibility of refused shipments on COD or sight draft, and similar situations.

**Progress Payments**

Partial payments are sometimes made on a contract as it progresses, especially when manufacturing or construction time is long and the creditor cannot afford to finance production. These are examples of progress payment terms used in the machinery industry:

- In the engineering industry: 15% upon receipt of drawings, 20% upon receipt of curves; 15% upon receipt of motors or partial shipment, 40% upon receipt of the complete shipment; 10% retention not to exceed 180 days upon inspection of material.
For machinery: 30% in advance, 30% upon initiation of production, 30% upon delivery and 10% upon acceptance.

**Export Terms**

**Pro Forma Invoice**

Widely used in the export trade, a *pro forma invoice* is an abbreviated invoice sent in advance of a shipment, usually to enable the buyer to obtain an import permit, an exchange permit or both. The invoice closely approximates the weights and values of the shipment, but it is not binding on the seller until the order is confirmed. This device enables the buyer to receive goods without unusual delays and the exporter to receive payment without lengthy exchange restriction delays. It can be used domestically when sent in advance of shipment and treated as a memo item. It does not become the seller’s account receivable until the shipment is made at which time an actual invoice is sent to the customer.

**Barter Arrangements**

This form of payment allows a buyer to pay with merchandise instead of currency, often using a third party clearinghouse as an intermediary. The intermediary facilitates the transaction and collects a fee for its services. The intermediary can also function as a broker, working with buyers and sellers that wish to take part in barter arrangements. Barter is often used when a country does not have a fully convertible currency or is in an early stage of development and the country risk is significant.

**Incoterms**

Because of additional risks often encountered with export and import business throughout the world, standard terms related to freight, insurance, clearance of goods through customs, and other such costs have been standardized by the International Chamber of Commerce. These terms, known as Incoterms, short for International Commercial Terms, are a set of internationally recognized trading terms, defined by the International Chamber of Commerce (ICC), and are used for the purchase and shipping of goods in the international marketplace. Refer to Chapter 15 and its appendix for more information.

Please refer to the chapters listed for more information on the following export terms:

- Letters of Credit (see Chapters 7 and 15)
- Cash Against Documents (see Chapters 7 and 15)
- Documents Against Acceptance (see Chapters 7 and 15)
- Dated Drafts (see Chapters 7 and 15)
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Comprehension Check

1. Terms of sale have an exact meaning. Provide an explanation.
2. How does the Robinson-Patman Act apply to terms of sale?
3. Explain how a company could extend different terms to competing purchasers.
4. What factors influence credit terms? Provide an explanation for each factor.
5. What are PREPAYMENT TERMS?
6. What other expressions are used to describe prepayment terms?
7. List four types of prepayment terms.
8. What are DISCOUNT TERMS?
9. Give three examples of discount terms.
10. What are TRADE DISCOUNTS?
11. Why are discounted credit terms offered?
12. What are RECEIPT-OF-GOODS terms?
13. What is a CONSIGNMENT term?
14. What is FLOOR-PLAN FINANCING?
15. What are EXTRA DATING ARRANGEMENTS?
16. What are SEASONAL DATING TERMS?
17. What is a PRO FORMA INVOICE?
References and Resources

*Business Credit.* National Association of Credit Management. Columbia, MD. (This 10 issues/year publication is a continuous source of relevant articles and information.)


*Credit Executive Handbook.* The Credit Research Foundation, 1986.


Appendix 6A

Other Terms and Conditions of Sale

These are usually found on the reverse side of purchase orders and acknowledgments as explained more fully in Appendix 6B. Some of the more common items include:

- Warranties—Seller’s obligations to the buyer for the products or services
- Delivery—Conditions that constitute valid delivery of the product
- Termination of Contract—Conditions that provide the parties with the right to terminate the obligations of the order
- Title/FOB point—At what point does title pass from the seller to the buyer?
- Force Majeure—“Acts of God” that may release the parties from complying with the terms of the order
- Indemnification—The seller’s assumption of the buyer’s liability for specified occurrences under the order
- Liability—Obligations of the seller and buyer
- Conditions Precedent to Buyer’s Obligation—Conditions that must happen or be performed by the parties before any obligation or liability attaches to the parties
- Arbitration Clauses—Language that binds parties to the use of arbitration in lieu of a judge and/or jury in resolving a dispute
- Conditions of Default—These define what acts or failures to act constitute defaults of the agreements spelled out in the order
- Applicable Law—Defines which state or international laws will regulate the transaction
Appendix 6B

The “Battle of the Forms”

Ideally, the buying and selling of goods and services will always be accomplished by signed contracts in which buyers and sellers each agree to all relevant contract terms. However, in the actual course of daily business, the parties involved often exchange conflicting documents. Buyers issue purchase orders containing one set of terms and conditions designed to protect their interests and sellers issue acknowledgments with different terms and conditions designed to protect their interests. These documents usually contain language that addresses essentially every aspect of the transaction (terms and conditions of sale), some immediate (such as time of payment, date of delivery, price) and some “non-immediate” (such as warranties and returns privileges). The “non-immediate” terms are usually dealt with by the “fine print” (also known as “boilerplate”) on the backside of the documents.

When disputes arise involving these contradictions, which document prevails—the buyer’s, the seller’s or some third party instrument? This question of law is addressed by Section 2-207 of the UCC, which replaced earlier common law concepts.

Generally, there are two main questions to be addressed; when was a contract actually considered to be created (at time of order, of acknowledgment or some other point) and which set of terms and conditions will take precedence? In common law, these questions were decided by the “mirror image” and “last shot” concepts. If, for example, the seller’s acknowledged terms were not identical to (“mirror images” of) the buyer’s purchase order, contract formation did not occur upon rendering of the purchase order. Rather, the seller’s acknowledgment would constitute non-acceptance of the contract defined by the purchase order and a counteroffer under different terms. If the buyer then performed in a manner that indicated acceptance (for example, made payment), the seller’s acknowledged terms prevailed (hence the “last shot” concept).

The flaw of the “mirror image” concept was that a buyer could invalidate a contract by failing to perform (i.e., by withholding payment), although courts often saw through this ploy and ruled against abusers. Likewise, the flaw of the “last shot” doctrine was that it seemed arbitrary—why should the last document sent constitute “winner take all” for the sender? Section 2-207 sought to deal with both of these shortcomings.

Section 2-207(1), essentially, limited instances where non-acceptance could exist; the mere existence of differing or additional terms from the offered terms no longer constituted non-acceptance and counter-offer. Therefore, contract formation could now occur even if the purchase order terms and the acknowledged terms differed. This is not always the case; where terms are significantly divergent (i.e., buyer offers to buy bowling balls and seller offers to sell ping pong balls), non-acceptance may still exist. Also, counter-offer will be created in those instances where the following “magic language” appears in a contract: “Acceptance is expressly made conditional on the offeror’s assent to the additional or different terms contained in the acceptance.”

If a contract has been formed despite differences, which terms prevail? In situations where there are additional terms in the acceptance document, those terms become part of the contract (unless offeror has included “magic language” similar to that above).
If acceptance contains different terms, the courts will ignore both conflicting portions of the terms, and so-called “UCC gap fillers” will prevail. UCC gap fillers are the provisions of the UCC that cover the specific issue.

In cases where the terms are materially divergent, or both parties use the “magic language,” there is no contract formation. However, in such cases, if both parties proceed to perform, a “conduct-formed contract” has been created and the prevailing terms will be those in which both sets of documents agree. Where there is disagreement, the gap fillers prevail.

Obviously, most attorneys will recommend their clients include “magic language” in all contracts so as to negate the other party’s conflicting terms. This elevates the importance of the gap-fillers as the deciding instruments. Therefore, it is especially important for both sides to know how the appropriate sections of the UCC will impact them if a dispute should arise.

(Note: The sellers’ terms of sale can also be set in its credit application, provided that the application is also a contractual agreement.)
Appendix 6C

Credit Card Authorization Form

The following form was originally developed by NACM MidAmerica of Oklahoma City, OK. All rights reserved.

[VENDOR] COMMERCIAL CREDIT CARD PAYMENT PROGRAM

[APPLICANT] agrees to the following terms and conditions regarding payment by credit card.

AGREEMENT TO PAY

[APPLICANT] agrees to honor all credit card charges for product purchased from [VENDOR]. Should the credit card be declined, [APPLICANT] may demand payment, prior to any further shipments.

PAYMENT OF OBLIGATIONS

[APPLICANT] agrees to pay to [VENDOR] at such place designated by it, obligations evidencing credit extended by [VENDOR] in accordance with the applicable payment, finance and service charge schedule in effect from time to time.

CHARGEBACKS

[APPLICANT] agrees that any disputed charge, request for chargeback or adjustment, will first be reported to [VENDOR]. [VENDOR] will have 10 business days to resolve the dispute with [APPLICANT].

[APPLICANT] has 30 days to dispute, or request a chargeback, any credit card charge. [APPLICANT’s] failure to dispute the charge, or request a chargeback, 30 days after payment constitutes a waiver of any right to chargeback the payment.

AUTHORIZATION FOR PAYMENT

[APPLICANT] hereby authorizes [VENDOR] to charge its credit card for any and all purchases. The following representatives of the [APPLICANT] are authorized to use the [APPLICANT’s] credit card.

Credit Card Number: ____________________________________________________
Expiration Date: _______________________________________________________
Address of Account Holder: _____________________________________________
Phone Number of Account Holder: _______________________________________
Email Address of Account Holder: _______________________________________
Individual/Personal Card _____   Corporate/Company Card _____
Cardholder authorizes payment of/up to: ____________________________________

A legible enlarged photocopy of the front and back of the credit card must accompany this authorization request.

All payments on credit cards will be charged upon receipt.
Representative               Title
Representative               Title
Representative               Title

[APPLICANT] agrees to inform [VENDOR] within 10 days of any changes to those authorized to use its credit card.

WARRANTIES AND REPRESENTATIONS
[APPLICANT] warrants and represents that the signature on the claim slip will be genuine and authorized by cardholder and not forged or unauthorized.

TRANSACTIONS COSTS
[APPLICANT] is not entitled to a cash discount for payments by credit card.

TRANSFERABILITY
This agreement is not transferable by [APPLICANT] without [VENDOR’S] consent. Any attempt by [APPLICANT] to assign the Agreement in violation of this paragraph shall be void.

FAILURE OF CUSTOMER TO FULFILL OBLIGATIONS
Should [APPLICANT] fail to fulfill any of the obligations under this agreement, [VENDOR] may declare the entire balance due and immediately payable, and may proceed to enforce the full payment of such balance, including finance and service charges. In event of suit to collect such payment balance, [VENDOR] shall pay all reasonable attorney fees and actual court costs.

GOVERNING LAW
All transactions involving the credit extended under this agreement shall be governed by the laws of the State of [                    ], which are expressly adopted to control all transactions under this agreement.

WAIVER OF STATUTE OF LIMITATIONS
[APPLICANT] expressly waives the defense of the statute of limitations for the period permitted by law.

AGREEMENT OF CUSTOMER
[APPLICANT] expressly agrees to the provisions contained in this agreement and manifests this agreement by his/her signature.

RECEIPT OF COPY OF AGREEMENT
[APPLICANT] acknowledges receipt of a copy of this agreement.

Date: ____________________,
By: ______________________________

[APPLICANT]

Date: ____________________,
By: ______________________________

[VENDOR]
Individual Personal Guarantee

Date ____________, 20xx

I, (name) _________________________, residing at address _____________________ _______________________, for and in consideration of your extending credit at my request to (company) _______________________, (hereinafter referred to as the “Company”), of which I am (title) _______________________, hereby personally guarantee to you the payment at _________________________ in the state of _________________________ of any obligation of the Company and I hereby agree to bind myself to pay you on demand any sum which may become due to you by the Company whenever the Company shall fail to pay the same. It is understood that this guarantee shall be a continuing and irrevocable guarantee and indemnity for such indebtedness of the Company. I do hereby waive notice of default, non-payment and notice thereof and consent to any modification or renewal of the credit agreement hereby guaranteed.

Signature _____________________________________________________________
Social Security No. _____________________________________________________
Witness ______________________________________________________________
Address ______________________________________________________________