

# Terms of Sale And Cost of AR

Gateway NACM Credit Conference  
Presented by: Curtis Litchfield, CCE  
September 11, 2024

# Welcome

**Current accounts...\$1.00**



**3 Months Overdue... \$.73**



**6 Months Overdue... \$.50**



**1 Year Overdue... \$.25**



**2 Years Overdue... \$.10**



# Opening Comment

## Thoughts for Consideration

- Nothing happens until our sales partners sell something
- If our companies don't sell on Terms, they don't need the Credit Department



# Accounts Receivables and Credit

- Traditionally one of the larger current assets and operating accounts on a company's balance sheet
- Major cash flow generator if managed properly
- One of most important financial task for any company
- A lot of companies fail to optimize their receivable cost, because carry cost is only portion of the true cost
- Either you like or hate being involvement in Credit and AR Management

# Credit Expectation

## Perfect World

- We complete our commitment, and the customer lives up to their commitment
- Customers pay on time
- Customers would not take unjustified deductions
- Customer would not take unearned discounts
- Account Receivable reflects current outstanding balance

# Credit Expectation

## Non-perfect World

- Customer asking for extended terms
- Customer tells you they are changing their terms
- Customer takes unearned cash discount and pays late
- Customer just pays beyond terms
- Customer disputes invoice when it is due instead of receipt
- List could go on and on
- These issues have been around since selling on credit has been around

# Measuring Results for Credit

## Metrics and Ratios

- Days Sales Outstanding
- Accounts Receivables Turns
- Aging Buckets
- Bad Debt Write-offs
- Days Beyond Terms
- Collection Effectiveness Index

# Terms of Sale

- Play an important role in financing the growth of a business
- Also referred to
  - Credit Terms
  - Selling Terms
  - Payment Terms
- Terms of sale are concerned solely with payment aspects of the sale.
- Important to distinguish them from other provisions of sales contract.

# Terms of Sale

- Terms used tend to be driven by industry
- Common Terms Used
  - 1% or 2% 10 Days, Net 30
  - Net 30
  - Net 60
  - Payment In Advance
  - Cash on Delivery
  - Net 10

# Legal Considerations

Laws related to Anti Trust and promoting competition

- The Sherman Act
  - Addresses monopolization
  - Prevents conspiracy in restraint of trade
- The Clayton Act
  - Price discrimination
- Federal Trade Commission Act
  - Oversees unfair and deceptive practices

# Legal Considerations

- Robinson – Patman Act
  - As important as the Sherman Act for Credit AR management
  - Prohibits all forms of price discrimination unless can justify the differences
  - Terms of sale construed as equal to price
- Consumer Credit Legislation, govern consumer credit
  - Equal Credit Opportunity Act, Fair Credit Reporting Act, Fair Debt Collection Act, Truth in Lending Law and Fair Credit Billing

# Cost of Credit and AR

Two Different Cost to consider

- Recognized Cost
  - Investment in AR
  - Credit Policy
- “Hidden” Cost
  - Administrative cost
  - Additional carrying expenses
  - Opportunity cost

# Cost of Credit and AR

## Company Recognized

- Financing of receivables based on normal terms
- Staffing of Credit Function
- Operation of cash flow
  - Use of cash
- Bad Debt expense

# Cost of Credit and AR

## “Hidden” Cost of Time

- Present value of money
- Old Adage
  - Dollar in the hand is worth 2 in the bush
- Order to Cash Process
  - Order release, Automatic vs. manual intervention
- Depending on Credit policy, additional time may be required in
  - More in-depth credit analysis and credit due diligence
  - Completing security and lien documents

# Cost of Credit and AR

## “Hidden” Cost of Administrative

- Represents the cost to administer, manage and collect
- Function of aging receivables
- As aging increase, general collection processes are cost intensive
  - Collection and legal fees
  - More follow up (letters, calls, emails etc.)
- Cost to file security and lien documents

# Cost of Credit and AR

## “Hidden” Cost of Predictability

- Without a consistency of collections, it is difficult for your company to forecast it's financing and predict cash targets
- Critical with business that has seasonality and other noncontrollable conditions
- Know your customer payment policies and practices
  - Helps manage required time for follow up
- Able to identify discrepancies

# Cost of Credit and AR

## “Hidden” Cost of Opportunity

- If the company didn't have to invest in AR, what could they do
  - New product development
  - Increase Marketing and Sales Activity
  - Improve profitably, by reducing their borrowing cost and reduction bad debt expense
  - Take advantage of supplier discounts and promotions
- Meet required Rate of Return

# Cost of Credit and AR

## “Hidden” Cost of Financing

- How does the company get necessary funds to offset any increase in receivables?
  - Take on more debt until receivables are collected
  - Cover with other operating funds
  - Delay payment to their vendors

# Cost of Credit and AR

## “Hidden” Cost of Bad Debt

- There is a direct correlation between age of receivable and the likelihood of collecting 100%
- Increase in legal and collection expense if 3<sup>rd</sup> party intervention is required
- May impact how Allowance for Doubtful Accounts is calculated which has direct impact to profitability

# Cost of Credit and AR

“Hidden” Other Cost

- Any others specific to your company or industry?

# Cost of Credit and AR

## EXHIBIT 1: COST OF ELEMENTS OF ACCOUNTS RECEIVABLE

*Percentage carrying cost to receivable dollar*

| Cost element      | 30 days      | 60 days       | 90 days       | 120 days      |
|-------------------|--------------|---------------|---------------|---------------|
| 1. Time           | 0.82         | 1.63          | 2.44          | 3.22          |
| 2. Administrative | 0.00         | 0.50          | 1.50          | 2.00          |
| 3. Opportunity    | 0.00         | 2.50          | 7.50          | 12.50         |
| 4. Predictability | 0.00         | 1.00          | 1.00          | 1.00          |
| 5. Financing      | 0.00         | 0.66          | 1.30          | 1.99          |
| 6. Bad debt       | 1.00         | 4.00          | 6.00          | 10.00         |
| <b>Total cost</b> | <b>1.82%</b> | <b>10.29%</b> | <b>19.74%</b> | <b>30.71%</b> |

*\*Harvard Business Review, August 2009 edition*

Even though this study is dated, the valuation method to determine the cost of each element is still fairly accurate

# Cost of Credit and AR

## Other Programs

- Factoring
  - Pricing depends on customer
  - Rates range from 0.5% to 5.0%
- Supply Chain Finance
  - AKA Reverse Factoring
  - Allows you to decide term of sale
  - Allows you to decide when and how much you want

I Will Gladly Pay You Tuesday For  
A Cheeseburger Today!



# Cost of Past Due AR

- Simple Calculation to determine the cost of past due AR
- Information needed
  - Invoice Amount
  - Interest Rate
  - Days Paid Late
- Formula  
(Invoice Amount times (Interest Rate / 365)) times Days Late

# Cost of Past Due AR

| Carry Cost per \$1,000 |       |               |       |       |       |       |       |
|------------------------|-------|---------------|-------|-------|-------|-------|-------|
|                        |       | Days Past Due |       |       |       |       |       |
|                        |       | 30            | 60    | 90    | 120   | 150   | 180   |
| Interest Rate          | 4.00% | 3.29          | 6.58  | 9.86  | 13.15 | 16.44 | 19.73 |
|                        | 4.50% | 3.70          | 7.40  | 11.10 | 14.79 | 18.49 | 22.19 |
|                        | 5.00% | 4.11          | 8.22  | 12.33 | 16.44 | 20.55 | 24.66 |
|                        | 5.50% | 4.52          | 9.04  | 13.56 | 18.08 | 22.60 | 27.12 |
|                        | 6.00% | 4.93          | 9.86  | 14.79 | 19.73 | 24.66 | 29.59 |
|                        | 6.50% | 5.34          | 10.68 | 16.03 | 21.37 | 26.71 | 32.05 |
|                        | 7.00% | 5.75          | 11.51 | 17.26 | 23.01 | 28.77 | 34.52 |
|                        | 7.50% | 6.16          | 12.33 | 18.49 | 24.66 | 30.82 | 36.99 |
|                        | 8.00% | 6.58          | 13.15 | 19.73 | 26.30 | 32.88 | 39.45 |
|                        | 8.50% | 6.99          | 13.97 | 20.96 | 27.95 | 34.93 | 41.92 |
|                        | 9.00% | 7.40          | 14.79 | 22.19 | 29.59 | 36.99 | 44.38 |
|                        | 9.50% | 7.81          | 15.62 | 23.42 | 31.23 | 39.04 | 46.85 |

# Cost of Past Due AR

Using the previous table of Carrying Cost Per \$1,000, you can calculate the carrying cost of your credit portfolio

## Aging Example

| Total         | Current | 1 - 30 | 31 - 60 | 61 - 90 | 91 - 120 | 121 - 150 |
|---------------|---------|--------|---------|---------|----------|-----------|
| 100,000       | 70,000  | 15,000 | 10,000  | 3,000   | 1,500    | 500       |
| Carrying Cost |         |        |         |         |          |           |
| Days          |         | 30     | 60      | 90      | 120      | 150       |
| 258.90        | 0.00    | 73.97  | 98.63   | 44.38   | 29.59    | 12.33     |

# Value of Future Payments

## Use of Present Value

- There are Net Present Value Tables available or use Excel to calculate it
- Method of determining the current value of all future cash flows (A dollar is not the same a dollar tomorrow)
- Can be useful if you are trying to determine if you should take a lump sum settlement offer today verse payments over time
- Information needed to calculate Net Present Value
  - Current Value
  - Interest Rate
  - Time Period

# Value of Future Payments

## Net Present Value Table

| <u>N</u> | <u>1%</u> | <u>2%</u> | <u>3%</u> | <u>4%</u> | <u>5%</u> | <u>6%</u> | <u>8%</u> | <u>10%</u> | <u>12%</u> |
|----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|------------|------------|
| 1        | 0.9901    | 0.9804    | 0.9709    | 0.9615    | 0.9524    | 0.9434    | 0.9259    | 0.9091     | 0.8929     |
| 2        | 0.9803    | 0.9612    | 0.9426    | 0.9246    | 0.9070    | 0.8900    | 0.8573    | 0.8265     | 0.7972     |
| 3        | 0.9706    | 0.9423    | 0.9151    | 0.8890    | 0.8638    | 0.8396    | 0.7938    | 0.7513     | 0.7118     |
| 4        | 0.9610    | 0.9239    | 0.8885    | 0.8548    | 0.8227    | 0.7921    | 0.7350    | 0.6830     | 0.6355     |
| 5        | 0.9515    | 0.9057    | 0.8626    | 0.8219    | 0.7835    | 0.7473    | 0.6806    | 0.6209     | 0.5674     |

**((Current Value minus (Current Value times Net Present Value Factor)) divided by 365) Equals "N"  
"N" times Number of Days**

# Value of Future Payments

## Using Table and Example

- Using the previous table which is based on annual Net Present Values, you can estimate the value which is less than a year.
- Current Value equals \$1,000
- Interest Rate equals 8.00%
- Time Periods equals 120 days

# Value of Future Payments

Using Table and Example

| Days | NPV Adjustment | Net Present Value |
|------|----------------|-------------------|
| 30   | 6.09           | 993.91            |
| 60   | 12.18          | 987.82            |
| 90   | 18.27          | 981.73            |
| 120  | 24.36          | 975.64            |
| 150  | 30.45          | 969.55            |
| 180  | 36.54          | 963.46            |

# Cash Discount

## Supplier benefits of offering Cash Discounts

- Incentive to get paid quicker
- Financial benefit

## Customer benefits to being offered Cash Discounts

- Lower price for goods and services
- Can be significant savings

# Cash Discount

Formula

$$\text{Cost} = \frac{\text{Discount Percent}}{100 - \text{Discount Percent}} \times \frac{360}{\text{Final Date} - \text{Present Period}}$$

# Cash Discount

## Example

|          |        |       |
|----------|--------|-------|
| 2.00%    | X      | 360   |
| 100 - 2  |        | 30-10 |
| 2.00%    | X      | 360   |
| 98       |        | 20    |
| 0.020408 | X      | 18    |
|          | 36.73% |       |

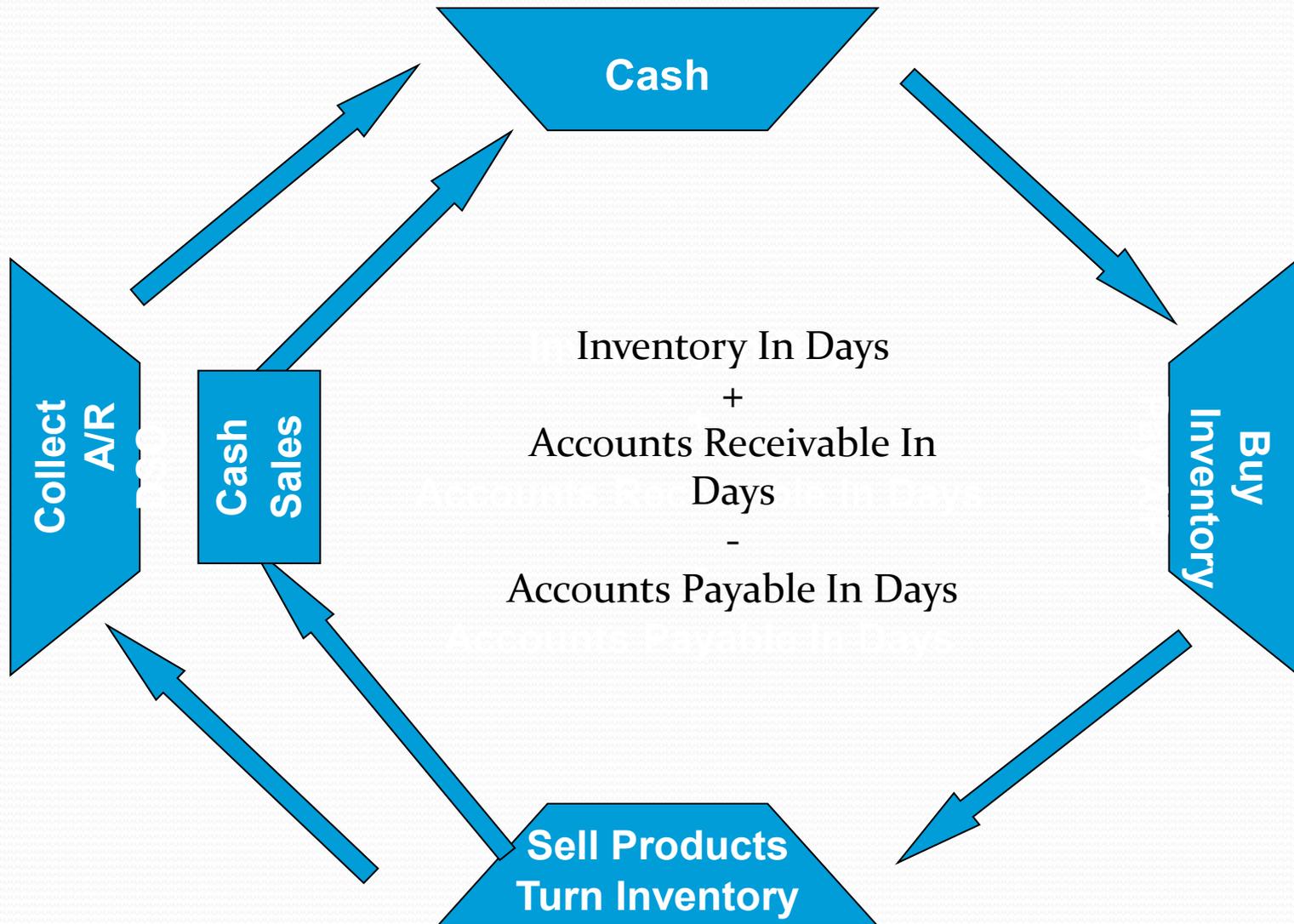
# Cash Discount

| Credit Terms | Interest Saving |
|--------------|-----------------|
| 1/10 Net 20  | 36.36%          |
| 1/10 Net 30  | 18.18%          |
| 2/10 Net 20  | 74.47%          |
| 2/10 Net 30  | 36.73%          |

# Accounts Receivables and Credit

- Cash is King
- You have to understand your cost of managing receivables
- Do you offset the cost of past due receivables with assessing finance charges?
- Should sales partners understand why receivable manage is so important to a company?
- Think of the Cash Conversion Cycle

# Cash Conversion Cycle





# Accounts Receivables and Credit

Questions

Thank You