10 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. 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 operations 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 its receivables and exposure to losses from bad debts or disputes, must be factored into the seller's credit policies with respect to terms decisions.

THINK ABOUT THIS

Q. How can terms of sale benefit the buyer or seller? Are there occasions in which the terms benefit the seller more than the buyer and vice versa?

Q. What aspects of a product can change the terms of sale?

Q. How can terms of sale and interest rates impact a company's profitability?

Disciplinary Core Ideas

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.

Chapter Outline

Important Considerations

Application of a Seller's Credit Policies to Its Terms

There are many different payment terms, ranging from prepayment by **ACH** *(Automated Clearing House)* or 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 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, ACH or wire transfer may be required. On the other hand, if the seller believes that the customer is a good credit risk, goods or services can 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 seller's credit policies. 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.

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 The "Battle of the Forms" (*see* page 10-21).

Antitrust Implications

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.

Comprehension Check
How does the Robinson-Patman Act apply to terms of sale?

Influencing Factors

General Considerations

Once terms of sale are established, they can be quite difficult to change. Because 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 teams. 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.**

Competition

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, the implication is that sales may 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 company's products or services may be similar to those offered by competitors, sufficient diversity of product or service may be created by the company through customer relations, pre- and post-sale services, pricing policies or payment terms.

Any reference to decisions to lengthen terms includes decisions to extend credit to customers who would be required to pay in advance under more conservative circumstances. Decisions to shorten terms would also include a more conservative stance as to extending credit.

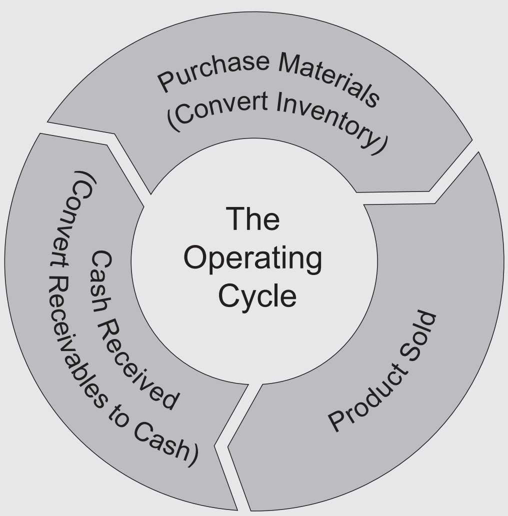
A company that contemplates offering payment terms that differ significantly from its standard terms for a product line, or from the most common industry terms, must weigh competitive aspects and the subsequent influence on profits. Unless the product holds a large share of the market or is priced much lower than competing items, terms that are shorter than standard can divert business to competitors that offer less stringent arrangements. While unusually long payment terms may help build sales, they produce higher risks, 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 because 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. 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 can 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 buyers to convert goods or acquired services into cash and the time they need to repay the debt created by the purchase of these inputs. The customer would prefer that payment terms cover their **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.*

Figure 10-1 **The Operating Cycle**



In practice, 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 frequently call for shorter terms than finished fabrics.

Many institutional lenders treat *work in process* **(WIP)** inventory differently than raw materials 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 7, 14 or 21-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 anticipation of the holiday 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 temporarily seek to shorten terms or reduce the credit risk exposure in its receivables portfolio. The latter may be accomplished by withdrawing credit from existing high-risk accounts or tightening standards for new account prospects.

Class of Customer

Companies often offer different terms to different types or classes of customers. Customers can be classified in many ways, such as 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, 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.

Comprehension Check
What factors influence credit terms? Provide an explanation for each factor.

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. Offering only these terms 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 the most restrictive terms from a buyer's standpoint since the seller assumes little or no risk:

- **Cash in Advance (CIA)** terms require the buyer to make payment via one of the cash methods (e.g., electronic transfers, 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 Cash on Delivery.
- **Cash with Order (CWO)** terms are offered when the seller requires payment before manufacturing of a product can take place.
- **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 may 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 (even though it may create a non-sufficient funds (NSF) risk for the seller) as buyers seldom have time beforehand to go to the bank to arrange a wire, certified or cashier's check.

Comprehension Check

What are the categories of credit terms?

What are **prepayment terms**?

List four types of prepayment terms.

Short Terms

Short terms are of limited 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 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 terms** require the customer to render payment immediately upon receipt of seller invoice or on some predefined short dating. Typically payment must be received before the next order is to be shipped, therefore making it similar 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.

- **Credit Card Payment** indicates that the seller obtains the promise of payment from a financial institution on behalf of the buyer rather than extending credit. 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. 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 used widely in consumer transactions and are widely accepted for purchasing by governmental units and in business-to-business (B2B) 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. This type of 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 whether to accept such forms of payment.

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 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. There is some risk of bank offset in several states, so the guarantee of a certified check is not perfect creating some risk for the credit grantor. 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 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 Funds Service system, to which all banks have access. Funds move in a real-time mode via Fedwire, and all Fedwire transfers are final and irrevocable. Banks handling the transfer can provide a Fedwire identification number to verify that the transfer has been completed. **Electronic funds transfers (EFTs)** 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, but require up to two business days 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 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.

Electronic payments are the typical form for international, cross-border payments, as foreign checks are not governed by U.S. banking rules and can be returned NSF long after deposit. Sellers may be able to recognize a cost savings with buyers that pay electronically, making such buyers qualify as a separate class of customer entitled to its own set of credit terms. In some industries, buyers may grant the sellers permission to electronically draft their accounts at time of shipment, usually in exchange for favorable discounts. In addition, Check 21 regulations have 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. 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 buyers render a NSF or stop payment check that they replace 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, contemporaneous exchange defenses can 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 at least 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 percentage 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 or it can be 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.

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. Second, 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 and labor and transportation scheduling. 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.

  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.

- **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

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.

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. 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 flow 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 can 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. Seek legal counsel when considering a discount program to ensure compliance with antitrust laws, 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.* 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.

Dynamic discounting allows buyers more flexibility to choose how and when to pay their suppliers in exchange for a lower price or discount for the goods and services purchased. The "dynamic" component refers to *the option to provide discounts based on the dates of payment to suppliers*. In most cases, the earlier the payment is made, the greater the discount. Dynamic discounting enables buyers and their suppliers to initiate early-pay discounts on an invoice-by-invoice basis. Dynamic discounting requires both parties to view invoices through a web-based platform and select approved invoices for early payment. The main benefit of dynamic discounting is that the buyer can use their own balance sheet or excess cash to generate additional purchasing discounts. The seller benefits by reducing working capital and getting paid earlier.

Comprehension Check

What are the types of discount terms?

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 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. 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. Therefore, 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 a completed transaction, then the options include the following:

- 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 terms, then the creditor must note in the customer's file the reason why the unearned discount was allowed in order to avoid future claims of violation made by a customer or class of customer that any antitrust violation 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 can expect a quicker turnover of funds, with reduced net working capital requirements, reduced credit and collection expenses and reduced delinquencies and credit losses. However, these 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 or have a strong need for faster turnover of their accounts receivable. Suppliers who suffer widespread or recurring abuse of discount terms 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 to help convince the buyer that a bank loan can 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.

The following are among the most compelling reasons to offer discounts:

- 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 the discount often require detailed analysis of their economic impact. In the following sections, various concepts used to determine the cost considerations necessary to make these decisions are examined.

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. 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. In addition, presuming the supplier must borrow money to service its own debts while awaiting payment, interest costs become a cost of carrying receivables. Even if borrowing does not become a necessity for suppliers, they lose the opportunity of investing the proceeds of their 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 percentage to be used in the analysis of expected profits is based on factors which are numerous and subjective, and could yield a multiplicity of answers. Therefore, most sellers use their own annual **cost of capital** (represented below as the value *k*) as the discount rate.

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

$$\mathbf{PV = FV/(1 + k)^n}$$

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:

$$\$1.00/(100 + .01015)^{12} = \$88.59$$

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

$$\mathbf{PV = FV - FV(k \times n)}$$

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 10-2 displays the present value of future receipts based on collections made in 30-day increments.

Figure 10-2 Present Value of Future Receipts Based on an Annual Cost of Capital of 12.88%

Receipts	Days	Cost of Captal	Present Value
$100	0	0	$100.00
100	30	.0107	98.93
100	60	.0215	97.85
100	90	.0322	96.78
100	120	.0429	95.71
100	150	.0537	94.64
100	180	.0644	93.56
100	210	.0751	92.49
100	240	.0859	91.42
100	270	.0966	90.34
100	300	.1073	89.27
100	330	.1181	88.20
100	360	.1288	87.12

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:

$$\mathbf{FV = V(1 + k)^n}$$

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:

$$FV = \$100 + \$100(.01073 \times 1) = \$101.07$$

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.

Sales (Receivable)	$100.00
Cash Discount	(2.00)
	98.00
Cost at Present Value	(86.00)
Profit at Present Value	$ 12.00

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. Therefore, 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.

Sales (Receivable)	$100.00	
Cash Discount	(2.00)	
	98.00	
Cost of Carrying Receivable		
(simple formula)	.35	($100 × 10 days (.1288/365))
Cash or Present Value	97.65	
Cost at Present Value	(86.00)	
Profit at Present Value	$ 11.65	

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.

Sales (Receivable)	$100.00	
Cash Discount	0.00	
	100.00	
Cost of Carrying Receivable	.39	($100 × 11 days (.1288/365))
Cash or Present Value	99.61	
Cost at Present Value	86.00	
Profit at Present Value	$ 13.61	

Payment on the 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.

Sales (Receivable)	$100.00	
Cash Discount	0.00	
	100.00	
Cost of Carrying Receivable	1.06	($100 × 30 days (.1288/365))
Cash or Present Value	98.94	
Cost at Present Value	86.00	
Profit at Present Value	$ 12.94	

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.

Sales (Receivable)	$100.00	
Cash Discount	0.00	
	100.00	
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	

This illustrates 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 10-3.

Figure 10-3 PV of Sales at Different Payment Dates When Discount is Offered

Payment Date	0	10	11	30	60
Sale	$100.00	$100.00	$100.00	$100.00	$100.00
Cash Discount	2.00	2.00	0.00	0.00	0.00
	98.00	98.00	100.00	100.00	100.00
Cost of Carrying	0	.35	.39	1.06	2.12
Cash or Present Value	98.00	97.65	99.61	98.94	97.88
Cost at Present Value	86.00	86.00	86.00	86.00	86.00
Profit at Present Value	$ 12.00	$ 11.65	$ 13.61	$ 12.94	$ 11.88

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. Once implemented, discount terms must be monitored and tested in relation to the creditor's cost of money (borrowed funds).

Analyzing Profits from Discounted Sales

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	
	$245,000	
Cost to Carry	-$ 882	= $250,000 × 10 days × (.1288/365)
Profit at Present Value	$244,118	

Assume that the firm changes terms to Net 30 days. If elimination of the early payment 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	$225,000	
Cost to Carry	-$ 3,178	= $225,000 × 40 days × (.1288/365)
Profit at Present Value	$221,822	

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 available. The formula to be used for this purpose is as follows:

Formula for Approximate Costs of Foregoing the Discount (annualized)

$$\frac{\textbf{Discount Percent}}{\textbf{100 – Discount}} \times \frac{\textbf{365}}{\begin{array}{c}\textbf{Number of Days Until Paid}\\ \textbf{Less Discount Period}\end{array}} = \begin{array}{c}\textbf{Approximate}\\ \textbf{\% of Costs}\end{array}$$

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

$$\frac{1}{100-1} \times \frac{365}{30-10} = .01 \times 18.25 = 18\%$$

If customers can borrow funds at a rate lower than 18%, they will generate internal profits by discounting. 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 penalties, 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 10-4. 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.

Figure 10-4 Annual Interest Rates Applicable to Discount Terms

Cash Discount Percent (X%)	X% 15 Net 30 Days	X% 10 Net 30 Days	X% 30 Net 60 Days	X% 15 Net 60 Days	X% 10 Net 60 Days	X% 30 Net 90 Days
½	12%	9%	6%	4%	3.6%	3%
1	24	18	12	8	7.2	6
1½	36	27	18	12	10.8	9
2	48	36	24	16	14.4	12
2½	60	45	30	20	18.0	15
3	72	54	36	24	21.6	18
3½	84	63	42	28	25.2	21
4	96	72	48	32	28.8	24
4½	108	81	54	36	32.4	27
5	120	90	60	40	36.0	30

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** a*ssessed 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 antitrust laws. 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.

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 open credit terms.

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 can 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.

Comprehension Check
What are receipt-of-goods terms?

Bill and Hold

Bill and Hold (B&H) terms are used 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 minimizes 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. 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.**

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

The execution of a consignment agreement between the parties helps avoid misunderstandings about the terms. 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, such as the following:

- 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.

Comprehension Check
What is a consignment term?

Floor-Plan Financing

Floor-plan financing *involves an inventory financing company, called the floor-plan creditor, that has contractual arrangements with both the 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 (e.g., 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.

Comprehension Check
What is **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. A **contra account** *offsets the balance in another, related account with which it is paired. If the related account is an asset account, then a contra asset account is used to offset it with a credit balance. If the related account is a liability account, then a contra liability account is used to offset it with a debit balance.* 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 can 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

Comprehension Check
What are **extra dating arrangements**?

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 can sometimes be expressed as follows: 3% 10, 2% 10 60 extra. This indicates that 3% can 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 more consistent sales and production throughout the year and 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 buildup of accounts receivable for the seller and can create substantial additional credit risk.

Comprehension Check
What are **seasonal dating terms**?

Security Interest

Creditors may enhance their position by taking a secured position in assets such as inventory, bank accounts and real estate. 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.

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 can 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.

Other Terms and Conditions of Sale

These are usually found on the reverse side of purchase orders and acknowledgments. 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.

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.

Comprehension Check
What is a **pro forma invoice**?

Barter Arrangements

Barter arrangements as a 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.*

The “Battle of the Forms”*

Let’s think again about the way modern commerce works. Material suppliers send offers and contractors send back purchase orders. Both offers and purchase orders often have detailed “fine print.” The fine print terms on the offer often conflict with the fine print terms on the purchase order.

This is the Battle of the Forms, and it determines what provisions exist in the contract between a buyer and a seller. The first thing to remember is that these parties have a contract on the terms on which there is agreement—It doesn’t matter that some terms are missing or in complete conflict, according to the Uniform Commercial Code (UCC).

Firm Offers and Price Quotes

The terms of the offer will be an enforceable contract, if the offer is accepted. It can be important in establishing the terms of the contract whether the buyer or seller made the initial offer. Once an initial offer is made, the recipient must object to terms in the offer or those terms will be part of the contract. Additional or different terms in a response do not become a part of the contract if there is an objection or if those additional or different terms “materially alter” the agreement.

Accordingly, it is easier to establish terms in an initial offer than via a response. All buyers and sellers would prefer to “fire the first shot” in the Battle of the Forms by making the first firm offer. It is sometimes difficult to tell whether a correspondence is a firm offer or simply conversation. An offer must be sufficiently detailed regarding the product, quantity and price so that an acceptance would result in an enforceable contract.

Some prejudice seems to exist in the courts regarding seller quotes as firm offers. Price quotes are not typically considered offers, but rather a “mere invitation to enter into negotiations.” Submission of a purchase order by a buyer is generally viewed as an offer. Sellers should be particularly careful to include all important terms in proposals or quotes and clarify that the documents are an “offer” that can be accepted by acknowledgment or calling for delivery.

A seller should either sign the offer or ensure there is no signature line for the seller. An offer should not state that all orders are subject to review and acceptance at seller’s place of business, as this would mean that there was no offer ready for acceptance. A seller can overcome prejudice offers by making sure an offer is clearly expressed and ready for acceptance.

Responses and Confirmations

When the second party (buyer or seller) sends the return document (which is definitely accepting or confirming an agreement), the parties will have a contract even though the confirmation contains provisions adding to or differing from the original offer.

Under common law prior to the UCC, the “mirror image” rule required that the buyer’s acceptance be the same as the seller’s offer. If the acceptance is not a mirror image of the offer, it rejects the initial offer and operates as a counteroffer. This is still the rule for most contract negotiations unless the contract involves the sale of goods. In that event, the UCC controls.

The UCC rejects the mirror image rule and converts a common law counteroffer into an acceptance even if it states additional or different terms.” It states:

A definite and seasonal expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.

This means that if there is a timely response to an offer that indicates an acceptance, the parties have a contract even if the response has additional or different terms than the offer. In a response, there is a difference between “additional” terms (that add some new term to the offer) and “different” terms (that conflict with a term in the offer).

The UCC considers “additional terms” to be “proposals for addition to the contract.” If the transaction is between merchants, these additional terms will become a part of the contract unless the additional provisions: (1) “materially alter” the agreement, (2) the other party objects to the new terms or (3) the original offer was expressly limited to the terms of the offer. The UCC states that:

The additional terms are to be construed as proposals for additions to the contract. Between merchants, such terms become part of the contract unless:

- the offer expressly limits acceptance to the terms of the offer;
- they materially alter it; or
- notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

Courts have disagreed on the fate of “different” terms that conflict with terms in the offer. Some courts follow the same rule as for additional terms and the different terms become a part of the contract if there is no objection. The majority view, however, is the “knockout” rule.” The conflicting terms in the offer and acceptance eliminate each other from the contract. **UCC gap fillers** are terms used to fill in the gaps. The contract would be the terms agreed by the parties, which would be the terms in the offer and acceptance that do not conflict, plus the contract terms added by the UCC.

It is important to join the “Battle of the Forms” within the meaning of the UCC. It is not enough to respond with a confirmation that is silent about the terms in an offer. The recipient must expressly reject or object to any objectionable terms of sale or propose different terms. Sending purchase orders that only acknowledge the material and pricing, but were otherwise silent, constitutes an acceptance of a supplier’s proposal and cannot be a “counteroffer” proposing a sale with no terms. Telephoning a supplier and verbally requesting shipment of materials, as often happens, also constitutes an acceptance of a supplier’s proposal and would not be a counteroffer. Even terms limiting the seller’s liability may be included in an initial offer and will become a part of the contract unless the buyer expressly objects.

A response or confirmation can be made conditional on an agreement to the additional or different terms. A buyer could respond to an offer by stating, “I will agree to this only if you agree to remove your limitations of liability and extend your payment terms to 90 days.” This would not be an acceptance. This is a counteroffer and even though courts differ on the exact wording required to make one, there is no contract unless the additional or different terms are accepted.

If additional or different terms are added in a response or confirmation (and the response or confirmation is not made conditional on an agreement to the additional or different terms), it becomes relevant whether the additional or different terms were “material.” Lawyers can spend a long time and a lot of a company’s money arguing about whether the additional provisions “materially altered” the contract. This exception is possible protection if a return purchase order has a very important and costly provision in the fine print. It is normally better and easier, however, to limit acceptance of an offer and object to any new terms added later.

Terms that would not be material alterations in a response or confirmation would include provisions for reasonable interest on unpaid invoices, limiting remedies for delays outside the seller’s control, or a clause fixing a reasonable time for complaints. Courts have held that addition of an attorney’s fee provision is a material alteration. An indemnification clause or a “no damage for delay” clause would materially alter the terms of an agreement. If the offer had included warranties, then a confirmation containing a disclaimer of warranties and limitation of remedies would “materially alter” the agreement. On the other hand, if the offer had excluded warranties, then a confirmation adding warranties would “materially alter” the agreement. This difference exemplifies the importance of making the first firm offer.

Establishing Limitations

It is important to be first to make a firm offer. Changing terms later is more difficult. It is also easier to limit acceptance of an offer than to make a response acceptance conditional. A signed agreement from the other party may be necessary, or is at least advisable, to change the terms of an offer. Sellers should clearly express any offers as a definite offer to buy or sell, with enough detail regarding the goods and the price to be an enforceable contract and including strong terms of sale.

There is an opportunity in an initial offer to establish limitations on the warranties and liability, establish venue for any dispute or establish the right to attorney's fees on default. These terms will be established, unless the other party affirmatively objects. Adding or changing any of these terms in a response, however, would be a "material alteration" that would not be effective and there is no need to affirmatively object.

It is also always preferable to get a signed agreement, rather than depending on a "Battle of the Forms" to establish terms. A signed agreement will eliminate much uncertainty and make it much harder for the other party to add or modify terms.

Perhaps the best advice is to expressly limit acceptance of all proposals, offers, purchase orders or confirmations. Offers sent out should state that "This proposal is subject to the terms and conditions on the reverse and any acceptance of this proposal shall be limited to the terms described in this proposal." This would make it more difficult for the return "acceptance" to change the terms of the agreement.

Even if the initial offer limited acceptance to the terms of the offer, the other party could send a response or confirmation that expressly rejects the terms of the offer and states that any contract must be on the terms of the response. Although some court rules differ, this is typically considered a "counteroffer," and no contract exists unless there is agreement to the changes. If shipping or accepting product at this point, however, seller is taking a risk that the initial offer will not apply and that the response terms do apply. This is another instance where it is important to read any mail and send written objections if a confirmation is received that does not accurately describe an agreement. A final signed agreement is also advisable to eliminate doubt regarding terms.

It is important to have strong and clear forms available for offers, proposals, purchase orders and confirmations. The provisions a seller has in the fine print of a firm offer will be a part of the contract unless they are expressly rejected. A fairly low-cost, one-time investment to establish these can considerably reduce a company's risks and costs for years to come.

A sample supplier proposal could state:

Acceptance is limited to terms of this Proposal. Seller objects to any different or additional terms contained in any purchase order, offer or confirmation sent or to be sent by Buyer, which are expressly rejected. The price offered will be held firm only if acknowledgment is received by Seller or Buyer calls for delivery within 30 days of this Proposal, either of which shall be an acceptance of all terms herein. This Proposal is conditional on Buyer's agreement to all terms and Seller is otherwise unwilling to proceed with this transaction. This is the final expression of this agreement and here will be no waiver or modification of any of these terms unless in writing signed by both parties. If Seller does expressly make any further agreement regarding these goods, all terms of this Proposal shall be incorporated into and shall become a part thereof.

If sending a return document or "confirmation," a company has an opportunity to change or neutralize some of what it perceives to be harsh terms of the original offer it received. To effectively change terms, a response acceptance or confirmation must be expressly conditional on assent to those different terms. It is not enough to say that "acceptance is limited to the different terms and conditions." A response acceptance or confirmation must clearly express an unwillingness to proceed with the transaction unless there is assurance of assent to the different terms. It is advisable to both parties to get an actually signed contract at this point if it is important to know the terms of the final agreement.

A buyer purchase order should state something similar the following:

Acceptance is limited to terms of this Purchase Order. Buyer objects to any different or additional terms expressed or implied in any quote, proposal, offer or confirmation sent or to be sent by Seller, which are hereby expressly rejected and superseded by this Purchase Order. This Purchase Order is expressly conditional on Seller's assent to all terms herein and Buyer is unwilling to proceed in this transaction without that assent. The first to occur of Seller's acceptance of this order or shipment of goods shall constitute Seller's agreement to all of the terms and conditions in this Purchase Order. This is the final expression of this agreement and there will be no waiver or modification of any of these terms unless in writing signed by both parties.

Credit Agreements or Master Supply Agreements

A buyer or seller may have a “Master Agreement” that applies to all sales for years, followed by quotes or purchase orders for each individual sale. For most material suppliers, this takes the form of a “Credit Agreement,” which should affirmatively state that it will apply to all future sales to this customer.

A Master Agreement or Credit Agreement can be modified in a subsequent agreement for any particular sale, including agreements established through a battle of forms. Terms could be extended for one project, for example. Staff reviewing offers and responses need to notice that they modify Master Agreement terms and consider whether the company is willing to do that.

It may be tempting to state in a Master Agreement or Credit Agreement that it cannot be modified in a subsequent agreement. However, that is probably ineffective. Any agreement can be modified by unanimous consent, even the part of the agreement that says it cannot be modified. It also would seem that any business would want the flexibility to modify existing agreements in some instances.

Modification of Contracts

Provisions can be added or subtracted from a contract after that original contract exists. These additions or subtractions are “modifications to the contract.”

Modifications may occur in long-term contracts with successive, repeated deliveries. For example, a concrete ready mix plant may take set deliveries of cement or stone each week for months or years. The price may be set for long periods of time or it may fluctuate with the market. Such price changes would be modifications to the supply contract. Modifications can also occur in short-term or single-delivery contracts.

Modifications to contracts for the sale of goods need no consideration to be binding. This means seller could modify a contract, even inadvertently, without receiving anything in exchange. It can be important to read any mail and object to any suggestions or assertions that would change the contract detrimentally.

End of the Battle of the Forms

So, when does the Battle of the Forms end? It does seem clear that an actually signed and complete agreement would be final. Subsequent letters and emails cannot change the terms of the agreement, unless they qualify as modifications to the agreement.

In the absence of a signed and complete agreement, it is not clear that the Battle of the Forms ever ends.

**Submitted by James D. Fullerton, Esq. of Fullerton & Knowles, PC.*

Key Terms and Concepts

Comprehension Check

1. How does the Robinson-Patman Act apply to terms of sale?
2. What factors influence credit terms? Provide an explanation for each factor.
3. What are the categories of credit terms?
4. What are **prepayment terms**?
5. List four types of prepayment terms.
6. What are the types of **discount terms**?
7. What are **receipt-of-goods** terms?
8. What is a **consignment** term?
9. What is **floor-plan-financing**?
10. What are **extra dating arrangements**?
11. What are **seasonal dating terms**?
12. What is a **pro forma invoice**?

Summary

- There is a direct relationship between the terms of the sale and the seller's perception of the buyer's ability to pay. In an extreme example, if a seller has no faith that a buyer will pay, the immediate payment in cash, or in other forms, may be required
- It is important to note that not all sales are governed by signed contracts, especially when there is frequent activity between the buyer and the seller.
- When changing terms, or when changing **standard terms** for a particular buyer, the seller must ensure that they are not in violation of antitrust laws, particularly price discrimination laws set by the Robinson-Patman Act. Legal counsel in these circumstances is suggested.
- Two major influencing factors for terms of sale are **competition**, and **market and product characteristics**.
- When there is competition in the market, a sale may not take place without the extension of credit. Price is an extension of various factors including competition, and it is necessary to view the terms of a sale as a component of price.
- Customers prefer terms that cover their **operating cycle**. Having terms that are shorter or longer than a buyers operating cycle may indicate more favorable terms for either the buyer or the seller.
- Terms differ widely by industry. Common terms for perishable items are 7, 14, or 21-day terms, while chemical products that have a longer storage time generally have longer terms of sale.
- Class of customer or profitability of a product may also lend itself to different terms.
- The three categories of terms of payment are as follows
  - Cash and prepayment terms
    - **Cash in advance (CIA)**
    - **Cash before delivery (CBD)**
    - **Cash with order (CWO)**
    - **Cash on delivery (COD)**
  - Short term
    - **Bill-to-bill**

        - **Receipt of invoice terms**
        - **Credit card payment**
        - **Purchasing Debit Card (P-cards)**
        - **Cashier's check or certified check**
        - **Wire transfer**
        - **Electronic funds transfers (EFTs)**
    - Open account terms
        - **End-of-month (EOM) terms**
        - **Middle of the month (MOM) terms**
        - **Proximo Terms**
- **Open account terms** include at least three elements: **net credit period, cash discount a**nd the **cash discount period**.
- Electronic payments are the typical form for international, cross-border payments.
- It is a necessity to spell out any discount policy on the credit application or in the contract in the terms and conditions section.
- Types of discounts include:
    - Anticipation
    - Trade discounts
    - Chain discounts
    - Dynamic discounting
- Enforcement of discounts varies widely. However, it is essential to create a company policy that is used consistently on all customers, because unearned discounts can create potential antitrust claims under the Robinson-Patman Act.
- The credit manager should play an important role in determining discount terms. Some of the most compelling reasons to offer discounts include:
    - Competitive conditions
    - Reduction of credit exposure, delinquencies, credit losses
    - Reduction of credit and collection expense
    - Reduction of borrowing costs
    - Improvement of cash flow and investment opportunity
- Decisions to offer early payment discounts or to change the amount of the discount often require a detailed analysis of their economic impact. This includes an analysis of how the net present value affects the profitability of terms.
- The seller's credit team can also use the **cost to the buyer formula** to convince a buyer that taking a bank loan may be a cheaper option for the buyer. This allows a buyer to generate internal profits, but also improve the speed of payment for the seller.
- If a bill is not collected at maturity, it may be necessary to institute **late charges**, because late payments incur costs that have not been accounted for by the seller.
- Special terms may be beneficial for certain industries or special circumstances that a buyer and seller may find themselves in. **Special terms** include:
    - **Receipt of Goods**
    - **Bill and Hold**
    - **Consignment**
    - **Floor-Plan Financing**
    - **Contra Account**
    - **Extra Dating**

  - **Seasonal Dating**
  - **Advances**
  - **Progress Payments**
- There are also special terms for international trade known as **export terms**. Some export terms are as follows:
  - **Pro Forma Invoice**
  - **Barter Arrangements**
  - **Incoterms®**

References and Resources

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