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To Receive is Better Than Not to Receive:
The Cost of Offering Credit Terms

About 12 years ago an article I wrote was published in a journal. Thankfully the concepts I discussed seem to be holding up over time, and I have even posted the article to my web site. It is titled "Discount Terms: A Framework for Negotiation" and it was published in The Credit and Financial Management Review.

The article analyzes the costs of offering discount terms to customers. The conventional wisdom then (and now) is that discount terms are so expensive to offer that they should be avoided in most instances. The article takes a hard look at the math behind discount terms and offers a framework for negotiating with customers.

My Personal Obsession

The last several newsletters I've sent out focus on performance measurements and the cost of carrying assets. The article I wrote so many years ago about accounts receivable fits nicely in this series of newsletters, and you can see a continuing interest (obsession?) on my part. Carrying assets has a cost that we can, and should, measure.

The discount terms article is interesting for managers because it reconciles the cost of offering discount terms to a company's weighted average cost of capital ("WACC"). And as the prior newsletters have shown, knowing and working with your WACC is an important part of building value in your company.

"The word 'invoice' is too soft and friendly. We need a new word that means 'pay up or die'."

Corporate Value Partners, Inc.

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- Assisting with the acquisition or sale of a business, business unit or product line;
- Assisting with the placement of debt financing;
- Preparing business valuations;
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The conventional wisdom is that discount terms are too expensive; that offering 2/10, net 30 terms results in a 37.2% implied cost. But it is important to note that a company's WACC is stated on an after-tax basis, while the conventional wisdom reflects a pre-tax cost. Also, the conventional wisdom assumes that customers actually pay on the 30th day, which is a rare occurrence for many customers. By adjusting the traditional view for taxes and assuming that an account is outstanding for 45 days, the cost of offering 2/10, net 30 terms drops to 13.2% after-tax. Suddenly it doesn't sound too far out of line compared to the WACC for many small, privately-held companies.

Negotiating With Customers

Good accounts receivable management is an important part of managing a company's cash flow potential, and therefore its value. Customers and suppliers alike know this fact, and it is common that negotiations explicitly include payment terms along with production, quality and delivery issues. Changes in communications and payment systems (as an example, EDI) have increased the likelihood that companies will end up negotiating or renegotiating payment terms.

In the best of circumstances the decision to offer customers discount terms is done on a customer-by-customer basis. The specifics of a customer's situation and their relationship with your company should be elements of your analysis. However, a number of practical concerns should be considered, not the least of which are the legal, competitive and strategic implications of offering discount terms to any customer.

The article shows how to use the math in a variety of situations, with the goal of getting to a "win-win" conclusion (hopefully more of a "win" for my clients!). Standard negotiations, dealing with a distressed customer and bargaining with a customer when there is a large differential in each company's WACC is demonstrated. Understanding how discount terms affect the value of your company provides you with greater strength in negotiations with customers - which can hopefully translate into greater corporate value.

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporate-valuepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

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