

Individual Case #2 – Fall 2016
Wholesale Building Supply
Changes in Credit Terms

Rich Jackson, a recent finance graduate, owns a wholesale building supply business with his brother, Jim, who majored in building construction. The firm sells primarily to general contractors. Sales are slow during the cold months, rise during the spring, and then fall off again in the summer, when new construction in the area slows.

The brothers are concerned about the firm's current credit policy. The terms of sale are net 35, but the brothers expect only 75% of the customers (by dollar value) to pay the full amount on day 35, while the other 25% pay, on average, on Day 45. Gross sales are currently \$1,100,000 per year. Of the gross sales, 2% end up as bad debt losses.

The brothers are considering a change in credit policy. The change would entail 1) changing the credit terms to 1.5/10, net 30, 2) employing stricter credit standards before granting credit, and 3) enforcing collections with greater vigor than in the past. Thus, cash customers and those paying within 10 days would receive a 1.5% discount, but all others would have to pay the full amount within 30 days. The brothers believe the discount would both attract additional customers and encourage some existing customers to purchase more from the firm – after all, the discount amounts to a price reduction.

The net expected result is for sales to increase to \$1,250,000, for 55% of the paying customers to take the discount and pay on the 10th day, for 35% to pay the full amount on day 30, for 10% to pay late on day 40, and for bad debt losses to fall from 2% to 1.5% of gross sales. The firm's operating (variable) cost ratio will remain unchanged at 65%, and its cost for financing receivables (notes payable or required return on investments) will remain unchanged at 6%.

The company would have to purchase some new inventory to cover the additional sales. Inventory turnover averages 6 times per year. The current income statement with relevant information is given below.

Gross Sales	\$1,100,000
Less: discounts	<u>0</u>
Net Sales	\$1,100,000
Production Costs (CGS)	<u>715,000</u>
Profit before credit costs and taxes	\$385,000
Credit related costs:	
A/R Carrying costs	
Inventory Investment cost	
Bad Debt Losses	
Profit before taxes	
Taxes (40%)	
Net Income	

Case requirements:

1. Describe the four variables that make up a firm's credit policy, and **explain how each of them affects sales, DSO, and collections.**
2. Under the current credit policy, what is the firm's days sales outstanding (DSO)? What would the expected DSO be if the credit policy change were made?
3. What is the dollar amount of the firm's current bad debt losses? What losses would be expected under the new policy?
4. What would be the firm's expected dollar cost of granting discounts under the new policy?
5. What is the firm's current dollar cost of carrying receivables? What would it be after the proposed change? (Use a 365 day year)
6. Calculate the opportunity cost of the additional investment in inventory for the new level of sales with the changed credit policy.
7. What is the incremental after tax profit associated with the change in credit terms? In other words, what is the difference in profit from old to new credit terms? Use a 40% tax rate. Should the company make the change? (Hint: Construct income statements under each policy and focus on the expected change.)
8. Does your analysis up to this point consider the risks involved with a credit policy change? In other words, what are the key variables that can affect profitability? If not, how could risk be assessed and incorporated into the analysis?
9. Suppose the firm makes the change, but its competitors react by making similar changes to their own credit terms, with the net result being that gross sales remain at the current \$1,100,000 level. If this were to happen, no additional inventory purchases would be necessary. What would be the impact on the firm's after tax profitability? Should the company make the change?