

Payment Terms

In the past, goods were sold primarily to the final user, and payment at the time of sale was typical. Over time, however, sales to intermediaries (merchants) became common. Those making the goods began to allow the intermediaries time to resell the goods before demanding payment. Thirty days became the standard time period allowed until payment was due. Payment terms also gave the buyer time to inspect the product and perhaps additional incentive to push for extended terms.



The date of the invoice is the date of sale.

Product sold between companies is commonly sold under pre-established payment terms. The payment terms of a sale are the agreement that the seller and buyer have for how and when payment will be made. For sales between companies, it is unusual for one company to pay the other at the time of the sale. The selling company usually allows the buying company a period of time to receive and/or resell the product to the final customer before demanding payment. This period of time is a payment term, which is listed on the invoice.

If the payment term is **Net 30**, 30 days after the product is sold, the receiving company is obligated to pay the seller for the product. This is the extended term. It is similar to the date on which payment is due on a credit card bill. Net 30 is a standard convention used by companies instead of writing the due date on the bill.

1.11

If Company A sells a product to Company B with a payment term of Net 60, payment must be...

- Put in the mail 60 days after the product is received by Company B
- Received by Company A 60 days after the product is received by Company B
- Received by Company A 60 days after the invoice date
- Put in the mail by Company B 60 days after the product is shipped by Company A or 60 days after title to the product passes to Company B

Although it is usual for one company to offer another company a payment term of 30 days or more, ideally the seller would like to be paid as soon as possible. Offering a discount for early payment gives the buyer an incentive to pay the bill before the due date so that:

- The money can earn interest in a bank for the seller.
- The money can be used to pay bills so the seller won't have to borrow money from a bank to pay bills.
- Possible exposure to the buyer's financial problems is reduced.

Suppose a seller allows the buyer to pay for the purchase 30 days after the sale but wants to offer the buyer some incentive to pay the bill early. The buyer may offer special payment terms such as "2 10 net 30." For this example, if the buyer pays the **entire bill** in 10 days or less instead of taking a full 30 days, the seller will allow the buyer to deduct 2% of the value of the invoice.

The invoice in Figure 1.7 has payment terms of net 30 (N 30). The date of the invoice is January 2. The payment is due 30 days from January 2 or February 1. If the payment terms were "2 10 net 30" and the buyer paid by January 12, a 2% discount is allowed. For the invoice in Figure 1.7, the discount would be 2% of \$4,740 or \$94.80, and the amount due would be reduced to \$4,645.20 if paid by January 12.

Although the discount is only 2%, if calculated on an annualized basis, it is the same as a 36% annualized rate.

1.12

For the invoice in Figure 1.8, ...

Invoice date is ___/___/___.

Bill is for _____ dollars if paid early.

Bill must be paid by ___/___/___ to get the discount.



Hint:

What is the amount of the early payment discount incentive for Figure 1.8?

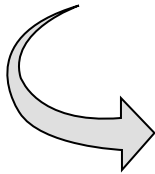
Green Paint, Inc. P.O. Box 868 Phone: (610) 444-0868 Unionville, PA 19375 Fax: (610) 444-0684		<table border="1"> <tr> <th colspan="2">INVOICE</th> </tr> <tr> <td>Invoice Date</td> <td>Invoice No.</td> </tr> <tr> <td>4/2/2009</td> <td>10094</td> </tr> <tr> <td>GP Order No.</td> <td>Account No.</td> </tr> <tr> <td>104085</td> <td>60082</td> </tr> </table>		INVOICE		Invoice Date	Invoice No.	4/2/2009	10094	GP Order No.	Account No.	104085	60082		
INVOICE															
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4/2/2009	10094														
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104085	60082														
CUSTOMER ORDER NO. P8294		PAGE 1 OF 1													
Sold To: AP Pipeline Co. Attn: Accounts Payable 1620 Industrial Way Somewhere, TX 71120		Ship To: AP Pipeline Co. Attn: PO#8294 1620 Industrial Way Somewhere, TX 71120													
PAYMENT TERMS 1 15 N45		SHIPPING TERMS: Delivered SHIP POINT: UNIONVILLE, PA													
Notes:		SHIPPING WEIGHT (LBS.) 4,500													
<table border="1"> <thead> <tr> <th>LINE ITEM</th> <th>QUANTITY</th> <th>ITEM NO.</th> <th>PRODUCT DESCRIPTION</th> <th>UNIT PRICE</th> <th>AMOUNT</th> </tr> </thead> <tbody> <tr> <td>1</td> <td>10</td> <td>EPX108</td> <td>55 gal. drum industrial epoxy gray</td> <td>\$2,000.00</td> <td>\$20,000.00</td> </tr> </tbody> </table>	LINE ITEM	QUANTITY	ITEM NO.	PRODUCT DESCRIPTION	UNIT PRICE	AMOUNT	1	10	EPX108	55 gal. drum industrial epoxy gray	\$2,000.00	\$20,000.00	ACCEPTANCE OF THE PRODUCTS COVERED BY THIS DOCUMENT SHALL CONSTITUTE ACCEPTANCE BY THE BUYER OF ALL TERMS ABOVE AND ON THE REVERSE SIDE OF THIS DOCUMENT. PLEASE SEND REMITTANCE PAYABLE IN U.S. DOLLARS WITH INVOICE NUMBER TO: Green Paint, Inc. P.O. Box 868 Unionville, PA 19375		
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Questions Call (610) 444-0868		<table border="1"> <tr> <td colspan="2">SHIPPING:</td> </tr> <tr> <td>SUB-TOTAL:</td> <td>\$20,000.00</td> </tr> <tr> <td>SALES TAX:</td> <td>\$0.00</td> </tr> <tr> <td>TOTAL:</td> <td>\$20,000.00</td> </tr> </table>		SHIPPING:		SUB-TOTAL:	\$20,000.00	SALES TAX:	\$0.00	TOTAL:	\$20,000.00				
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Where title to goods legally changes is called free on board (FOB). Invoices may show FOB the seller's location or FOB delivered or shipping terms destination. For Green Paint:

- *If the terms were FOB Unionville, PA, and paint was sold to a company in Cleveland, OH, ownership would transfer once the goods left the seller. The buyer would be responsible for shipment and any damages that occur during shipment.*
- *If the terms were FOB Cleveland, OH, the seller would be responsible for damages during shipment.*

Figure 1.8

Fixed Assets



The bottom half of the asset section of the balance sheet shows a company’s fixed assets—those that during the normal course of business should remain with the company for over 1 year. The categories that are commonly listed as current assets are:

- Property, plant and equipment
- Intangible assets
- Other long-term assets

Company Name Balance Sheet As of October 31, 2009	
Current assets	
Cash	\$ 70,000
Marketable securities	150,000
Accounts receivable	1,000,000
Inventories	835,000
Other current assets	60,000
Total current assets	<u>\$2,115,000</u>
Fixed assets	
Property, plant & equipment	
Intangibles	
All other	_____
Total fixed assets	

Figure 2.12

Property

Property (land) is shown on the balance sheet at the value that was paid for it when it was purchased. The number on the balance sheet does not reflect the value of the property in the current real estate market. Since property will not be worn out by use, the value of the property, unlike most other fixed assets, is not depreciated or written off over time.

While in most cases land value does not decrease over time, in an economic downturn it is possible for land to be worth less than the purchase price.

The one exception to this is companies that hold land for its natural resources, such as, oil, natural gas, coal, precious minerals and timber. In such cases, the cost of the purchase is allocated between the value of the land and the value of natural resources that can be extracted from the land. The land’s value will not change over time,

but as material is extracted from the land, a “depletion” charge is taken that reduces the value of the natural resources account on the company’s balance sheet. The depletion charge is taken as an expense on the income statement under cost of goods sold.

2.28



A company owns property, bought 5 years ago, on which its facility is built. The property cost was \$50,000 at the time of purchase, and today the property could be sold for \$70,000.

What value should be shown on the balance sheet to reflect the value of the property?

- \$70,000
- \$70,000 less 5 years of depreciation
- \$50,000
- \$50,000 less 5 years of depreciation

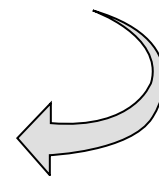
Buildings are the next major fixed asset. At the time of purchase or construction, a building is recorded on a company's balance sheet at cost. Buildings, unlike land, decrease in value each year as they age and are used. Most buildings are depreciated over 39.5 years.

Buildings

The simplest form of depreciation is straight line depreciation. Each year the same amount is deducted from the value of the building. For example, if \$200,000 was spent to purchase a building and it was depreciated over 40 years, 1/40 (or \$5,000) of the purchase price would be depreciated each year.

For simplicity in discussing depreciation, this text assumes a 40-year depreciation period for buildings.

The value of buildings on a company’s balance sheet may be greater or less than the actual value of the buildings. A good example is a 40-year-old office building. Following the depreciation guidelines, the value of the building on the balance sheet should be zero in 39.5 years. In many cases, 40-year-old office buildings still have significant value. While land appears on the balance sheet at the purchase price, buildings are shown at their **net asset value**. If a building was built or purchased 5 years ago for \$200,000, its value on the balance sheet would be the purchase price minus 5 years of depreciation. See the example on the following page.



Cash Inflow and Outflow

Figure 3.2 shows how cash flows in and out of a company for the purpose of constructing a cash flow statement. Whether an item is considered an inflow or outflow on a cash flow statement may differ from how the value of that same item is reflected on a balance sheet or income statement.

The arrows on the left in Figure 3.2 show sources of cash inflow to a company, and the arrows on the right show uses of cash outflow. Net income, depreciation, amortization, decreases in accounts receivable, decreases in inventory, increases in accounts payable, new debt and sales of stock are considered sources of cash inflow for the purpose of building a cash flow statement. Note that some of these same items may be considered expenses on the income statement.

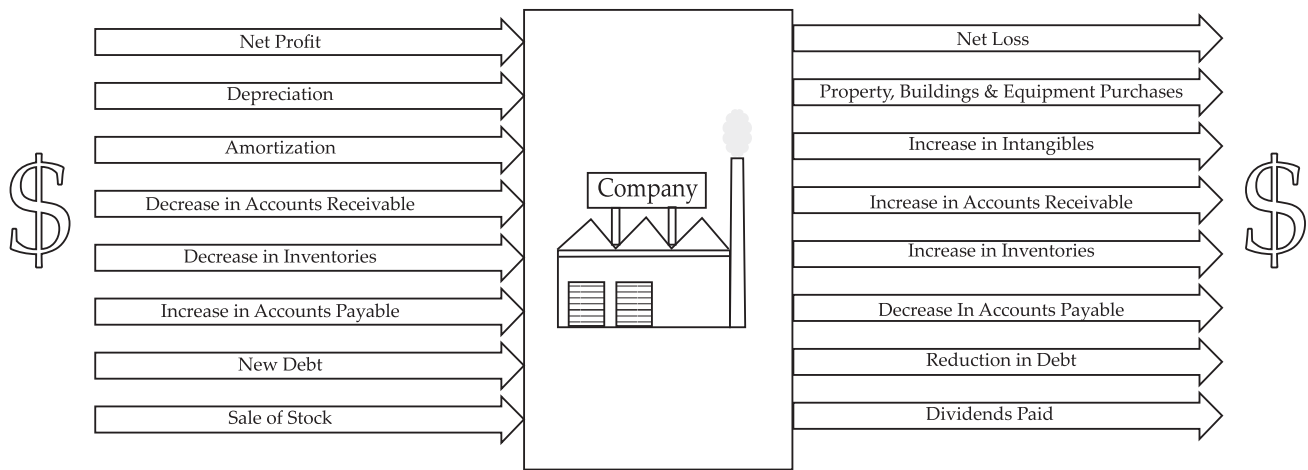


Figure 3.2

In a company, there are three primary sources/uses of cash—operations, investments and financings. Operations can be thought of as the standard/routine workings of the company. Investments are the funds spent or recovered from the purchase or sale of fixed assets. Financing is the cash obtained/paid through loans or stock (share) transactions. Each of these, particularly operations, is made up of several cash generators/users. For example, the primary source of cash in operations is net income, which is adjusted by other factors such as depreciation and change in working capital.

*Whether an item is considered an inflow or an outflow on a cash flow statement **may differ** from how the value of that same item is reflected on a balance sheet or income statement.*

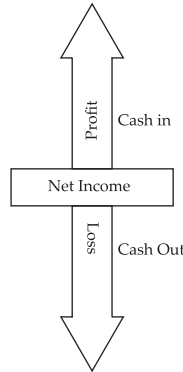
Operations

Net Income

Net income usually is shown at the top of the cash flow statement because over the long term, net income is the most important source of cash flow.

Cash Flow Statement Jan. 1 - Dec. 31 2010	
Operations	
→ Net income	
Depreciation	
Change in accounts receivable	
Change in inventory	
Change in other current assets	
Change in accounts payable	
Investments	
Capital expenditures	
Short term investments	
Financing	
Increase (decrease) debt	
Stock sales	
Dividends	
Net cash inflow (outflow)	

Inflow



If the company is earning money (making a profit), its net income is a positive source of cash.

When the net income is negative (that is, the company is losing money), this loss is a cash outflow from the company. The income statement is the source for the net income number (that is, the profit or loss number after taxes) used as the first input on the cash flow statement.



3.10

A company that consistently generated net losses on its income statement would most likely have...

- Some years where there was net cash inflow and some years when there was net cash outflow
- A cash outflow even in a year when there was a large depreciation charge
- A cumulative net cash outflow over the long run
- A cumulative net cash inflow over the long run

Adjustments

Depreciation

Depreciation is considered an expense on the income statement, but for the cash flow statement, it is a cash inflow. In reality, of course, depreciation does not create an actual cash inflow. It is a number that reduces income on the income statement for which there was no cash expended. (See page 1.18 of Section 1.)

Cash Flow Statement Jan. 1 - Dec. 31 2010	
Operations	
Net income	
→ Depreciation	
Change in accounts receivable	
Change in inventory	
Change in other current assets	
Change in accounts payable	
Investments	
Capital expenditures	
Short term investments	
Financing	
Increase (decrease) debt	
Stock sales	
Dividends	
Net cash inflow (outflow)	

Objectives

When you have successfully completed this section, you should:

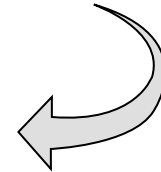
- Have reviewed the major concepts covered in Part I of Basic Financial Concepts
- Be prepared for the completion exercise at the end of Part I

Neither the Review Exercise nor the Completion Exercise covers all the information in Part I. The following questions are the **types** of questions and the **level** of difficulty you can expect on the completion exercise. The questions on the completion exercise, however, **will not** be these exact questions. As with the rest of the course, answers for the Review are given in the answer sheets that come with your workbook. Complete the exercise and then check your answers. Go back and restudy sections of material for which you miss answers.

Each question has **only one correct answer**. Choose the single best answer. The questions are not intended to be tricky, but it is very important to read each question carefully and give attention to all the information given.

Questions

- 1.1 Which of the following is not true about financial reports?
- a. They help lenders judge the soundness of a business.
 - b. They describe a company's performance to shareholders.
 - c. They contain key strategies employed by the company.
 - d. They are necessary to manage a business and its parts.
- 1.2 Most businesses prepare an income statement...
- a. Hourly
 - b. Daily
 - c. Weekly
 - d. Monthly



Answers a-e are listed in the right column in a standardized format for every question even though questions may not always have that many choices. Be sure your selected letter choice matches your answer.

1.1
a b c d e

1.2
a b c d e

- | | |
|--|------------------|
| 1.3 The sum of all of the numbers by revenue category for each of the company's products and or businesses equals...
a. The projected results for the company
b. The total company's reported income statement
c. The company's business plan
d. Total company sales | 1.3
a b c d e |
| 1.4 Which of the following is typically not shown on an income statement?
a. Assets
b. Sales
c. Earnings
d. Costs | 1.4
a b c d e |
| 1.5 If the line on the top of the income statement shows dollars in thousands or (000s), then a reported revenue of \$1,200 is equal to...
a. \$1,200
b. \$1,200,000,000
c. \$1,200,000
d. \$12 million | 1.5
a b c d e |
| 1.6 The period of time for which an income statement may be prepared is...
a. A month
b. A quarter
c. Three quarters
d. A year
e. All of the above | 1.6
a b c d e |
| 1.7 Which information is not usually included on an invoice?
a. Invoice date
b. Name of the buyer and seller
c. Total value of the sale
d. Cost to make the product | 1.7
a b c d e |