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An Analysis of Distributor Response to Credit Policy Change: Evidence from Pakistan

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ABSTRACT

This study was aimed to find out whether credit policy regime has any relation to the sales volume, a change in credit terms can affect the interests of firms and distributors. For this purpose, I selected three food processing companies, namely Shezan International, Murree Brewery, and Shakarganj Food Company. As the credit terms have direct relationship with the distribution function, the distributors of these companies located in Islamabad and Rawalpindi were interviewed to collect primary information regarding credit policies of abovementioned companies. In order to have uniformity, a questionnaire was developed and all the interviewees were requested to provide requisite information. The information so gathered was analyzed and following conclusion drawn:

The rate of discount has direct relation with the savings of the company but an inverse relation with distributors' cost of giving up discount. As the credit period increase, the possibility of bad debt losses increases. This is detrimental to company but advantageous to the defaulting distributors. Regime of credit policy has direct bearing to sales. As the credit terms are made more attractive to distributors, significant increase in sales is likely to occur. Tight credit policies impair sales level.

Keyword: Credit, Purchase Discounts, Discount Decision, Murree Brewery.

INTRODUCTION

Credit is an arrangement to buy goods or services on account. The buyer is not required to make immediate cash payment. The five C's of credit are the basic building blocks for the credit policy analysis of many companies and financial institutions:

- Character (i.e. Customer's willingness to meet credit obligations)
- Capacity (i.e. Customer's ability to meet credit obligations out of operating cash flows)
- Capital (i.e. Customer's financial reserves)
- Collateral Security (i.e. A pledged asset in the case of default)
- Conditions (i.e. General economic conditions)

Trade credit exists when one firm provides goods or services to a customer with an agreement to bill him/her later, or service from a supplier under an agreement to pay him/her later. It can be viewed as an essential element of capitalization in an operating business because it can reduce the required capital investment to operate the business if it is managed properly.

For many businesses, trade credit is an essential tool for financing growth. Trade credit is the credit extended to distributors by firms who let them buy now and pay later. Any time they take delivery of materials, equipment or other valuables without paying cash on the spot, they are using trade credit.

For many borrowers in the developing world, trade credit serves as a valuable source of alternative data for personal and small business loans. There are many forms of trade credit in common use. Various industries use various specialized forms. They all have, in common, the collaboration of businesses to make efficient use of capital to accomplish various business objectives and policies.

When they (distributor) first start their business, company does not usually offer them any trade credit. They are required to make every order c.o.d. (viz. cash or check on delivery) or paid by credit card in advance till such time it is established that they can pay firm's bills on time. This is fairly a normal practice.

Firms need to establish credit policies before orders start coming in. They need to inform customers up front that they have to prepay the amount in excess of their credit limit before shipment or scale their orders back.

The best indicator to assess client's intentions and ability to pay a new debt is his/her past payment patterns. However, if the firm is new or a smaller one, it may not have a recent payment history for some or even any of its clients. In this case, the firm makes reference checks before extending credit terms. There are other more sophisticated

methods for analyzing the credit worthiness of a customer but current payment patterns still remains the best and easiest indicator.

Purchase Discounts

Discounts and allowances are reductions to the basic price of goods or services. The purpose of allowing discounts is to increase short-term sales, move out-of-date stock, reward valuable customers, encourage distribution channel members to perform a function. Discounts and allowances are forms of sales promotion. Firms often offer a cash discount to the buyer for an early payment. Credit terms are the conditions for the payment agreed upon by the buyer and the firm. Cash discounts are stated in a fractional form with the percentage of discount in the numerator and the number of days in the denominator. The credit period, or number of days a buyer can pay without incurring a finance charge, is stated in net days or n/days. Following are some examples:

- 2/10 net 30 - this means the buyer must pay within 30 days of the invoice date, but will receive a 2% discount if they pay within 10 days of the invoice date.
- 3/7 EOM - this means the buyer will receive a cash discount of 3% if the bill is paid within 7 days after the end of the month indicated on the invoice date. It should be noted that if an invoice is received on or before the 25th day of the month, payment is due on the 7th day of the next calendar month. If a proper invoice is received after the 25th day of the month, payment is due on the 7th day of the second calendar month.

- 3/7 EOM net 30 - this means the buyer must pay within 30 days of the invoice date, but will receive a 3% discount if they pay within 7 days after the end of the month indicated on the invoice date. It should be noted that if an invoice is received on or before the 25th day of the month, payment is due on the 7th day of the next calendar month. If a proper invoice is received after the 25th day of the month, payment is due on the 7th day of the second calendar month.
- 2/15 net 40 ROG - this means the buyer must pay within 40 days of receipt of goods, but will receive a 2% discount if paid in 15 days of the receipt of goods by the purchaser. (ROG is short for "Receipt of goods.")
- 3/15, n/60 means a buyer will receive a 3% cash discount if paid within 15 days of the invoice date, and the buyer has a maximum of 60 days to pay the entire debt amount.

Depending on the terms available from firm, cost of trade credit can be quite high. For example, assume you make a purchase from a supplier who decides to extend credit to you. The terms the supplier offers you are two-percent cash discount with 10 days and a net date of 30 days. Essentially, the firm saying that if you pay within 10 days, the purchase price will be discounted by two percent. On the other hand, by forfeiting the two-percent discount, you are able to use your money for 20 more days. On an annualized basis, this is actually costing you 36 percent of the total cost of the items you are purchasing from this supplier! (360/ 20 days = 18 times per year without discount; 18 * 2 percent discount = 36 percent discount missed).

Cash discounts are not the only factor you have to consider in the equation. There are also late-payment or delinquency penalties should you extend payment beyond the agreed-upon terms. These can usually run between one and two percent on a monthly basis. If you miss your net payment date for an entire year, that can cost you as much as 12 to 24 percent in penalty interest.

Effective use of trade credit requires intelligent planning to avoid unnecessary costs through forfeiture of cash discounts or the incurring of delinquency penalties. But every business should take full advantage of trade discount that is available without additional cost in order to reduce its need for capital from other sources.

1.2 Discount Decision

Firm can or should offer, given a set of assumptions about cash flow timing, change in sales volume, fraction of credit sales expected to be paid with the discount, and changes in bad debt losses that would arise from having offered the discount. For firms that do not currently offer a cash discount, introduction of a cash discount would probably induce some portion of existing customers to pay early and take advantage of the discount. The remaining customers would pay later without the discount. This may have the effect of changing the firm's distribution of cash receipts from a unimodal distribution to a bimodal distribution. One mode for early payers and the other for later payers who chose not to take advantage of the cash discount.

Benefits and Costs of a Cash Discount

There are several benefits and costs associated with cash discounts. Cash discounts typically induce some customers to pay early in exchange for a pre-specified discount. To the seller, cash is received sooner, thereby reducing the need to borrow. An

early payment discount is in effect a price reduction. If buyers are price elastic, cash discounts may generate greater demand for the firm's products. Thus, cash discounts can be used as a tool in the process of fine tuning product price. Earlier payment may reduce the possibility of bad debt losses as less time would be available for buyers to develop payment problems. Firms impose subjective trade credit limits as a way of controlling bad debt risk exposure.

On the negative side, a cash discount may directly reduce total sales revenue if unit sales volume does not increase sufficiently to offset the unit revenue loss. This may occur if buyers are price inelastic and therefore are not induced to buy proportionally more units of product in response to a price reduction. They say that a 2 percent cash discount can reduce profits by as much as 28 percent. However, this relationship would depend on customers' price elasticity and the firm's degree of leverage.

Research Objectives

The objectives of this study are twofold. The first objective is to find out whether the distributors are satisfied with present level of credit terms. If not, what possible changes they would like the company to make in credit policy regime. The second objective is to assess the benefits that are likely to accrue to the firm in the form of increase in sales, reduction in bad debt losses, and savings in opportunity costs for early payment by distributors.

Sample of the Study

I have selected following domestic soft-drinks manufacturing companies:

- Shakarganj Food Products Limited (SFPL)

- Shezan International Ltd.
- Murree Brewery Company Limited

Shakarganj Food Products Limited (SFPL) is a public limited company (unquoted) set up by the Crescent Group. The group has been conducting business in the region for over 100 years and has a varied industry portfolio in sugar, textile, steel and farming. Shakarganj is working hand in hand with the Dairy Industry of Pakistan to improve milk productivity and animal health.

Shezan International Ltd. is owned by Shahnawaz Group. It manufactures juices, squashes, sharbets, jams, pickles and preserves farm fruits and vegetables.**Murree Brewery Company Limited** is one of the oldest public companies of the sub-continent. Its shares were traded on the Calcutta Stock Exchange as early as 1902. In 1997-1998 and 1998-1999, the company was judged among the top 25 performing public companies by the Karachi Stock Exchange. It manufactures liquors, beverages, vinegar and malt.

Data Collection

The three sample companies are private limited companies and are not listed on any stock exchange of the country. The research is based upon primary data that has been collected through personal interviews with the distributors and managers of the three sample companies.

LITERATURE REVIEW

Credit policy regime has always been a matter of great concern to management and customers. Researchers, too, have been exploring its different aspects. Following are some of the excerpts from such researches:

In his article "*Trade Credit Terms offered by Small Firms*" **Wilson** (2002) writes that that trade credit has been shown to be an important source of short-term finance for smaller firms but small firms are also suppliers of trade credit. There is little empirical evidence on the credit granting decisions of small firms. In this paper he looks at the influences on credit granting for the smallest firms, using a sample of firms with an average of 10 employees. Moreover, he finds evidence that firm size, affects credit extension choices directly by setting limits on the possibilities for economies of scale, but it also impacts indirectly by affecting the firm's access to finance and its bargaining strength suppliers. The dominant position of larger customers in bargaining with small suppliers constrains the impact of other factors on the firm's choice of credit terms. Small firms are also under pressure to conform to industry norms, although lack of resources can be a limiting factor. Constrained firms may make use of two-part terms in an attempt to improve their cash flow.

Michalski (2007) in his research paper "*Value Based Trade Credit Decision Making*" says that the basic financial aim of an enterprise is maximization of its value. At the same time, both theoretical and practical meaning is researched for determinants that increase the enterprise value. Financial literature contains information about numerous factors that influence enterprise value. Among those contributing factors is the extent of the net working capital and the elements shaping it, such as the level of cash tied up in accounts receivable, inventories, the early settlement of accounts payable, and operational cash balances? The greater part of classic financial models and proposals relating to optimum current assets management have been constructed with net profit maximization in mind. This is the reason why these models need reconstruction in order

to make them suitable to firms that want to maximize their value. The decision regarding the extent of the trade credit terms is, in fact, a compromise between limiting the risk of allowing for the payment delay from unreliable purchasers and gaining new customers by way of a more liberal enterprise trade credit policy. This decision shapes the level and quality of accounts receivable. The question discussed in this article concerns the possibility of using value-based approach in making decisions about selecting which customers should be given trade credit.

Bockhorn and Harris (2006) in their article "*Are cash discounts in the farm supply industry profitable?*" tells us that the profitability of cash discounts offered by farm supply firms in Southern Illinois is determined using a net present value model. Results suggest that cash discounts may reduce the profitability of farm supply firms: The researchers analyzed cash discounts of 33 agribusinesses. They observed that over one-half firms had unprofitable cash discounts. The average cost to the firms with unprofitable cash discounts was $38,800. Firms with profitable cash discount policies added, on average, about $67,600 to their firms' total profits. It was found that reducing cash discount rates is a major way to improve the profitability of cash discount policies.

Boyer (2007) in his article "*Why Are Trade Credits so Damn Expensive? It's a Commitment Problem"* writes that trade credits represent an important source of financing for all corporations. Rajan and Zingales (1995) report that accounts payable represents on average 14% of the book value of assets of G7 firms, which is comprised mostly of trade credits. Given that debt financing represents almost 40% of the book value of assets, it can be estimated that close to 40% of debt financing occurs through the use of trade credits. Trade credits are a very expensive form of debt financing. For

instance traditional 2/10, n/30 contracts represent an equivalent 45% annual interest rates. His paper presents a new theory as to why trade credits are so expensive compared to bank financing and why trade credits are such important sources of financing. According to this theory, non-financial firms are unable to commit credibly to an auditing strategy when the borrowing firm declares bankruptcy. In a world where entrepreneurs have private information as to the state of the world, we show that being unable to commit to verifying the true state of the world generate a higher interest rate on the loan than if the creditor could commit.

Hsu and Wee (2006) in their article *"Discounting Decision for Enterprises with High Fixed Cost and Low Variable Cost"* tell us that higher sales are the key to increased profit, especially for low variable cost industries. The use of quantity discount to promote business is an important way to increase sales. This study evaluates the use of discount, prepaid, multiple-purchase credit to increase sales. The purpose of the research is to develop a strategy to maximize the unit revenue by simultaneously determining the discount rate and utility.

Souza, *et el* (September 2003) in their research on the topic "*Coordinating Sales and Raw Material Discounts in a Global Supply Chain***"** say that suppliers are key component to a global manufacturer who offers a one-time price discount; they study the firm's optimal response to the discount under two different strategies. In the first strategy, the firm does not pass along the discount to its customers (sales subsidiaries); the firm simply coordinates purchasing and production among the different factories to take advantage of this one-time price discount. In the second strategy, the firm offers price discounts for its most profitable products in different sales subsidiaries to increase their demand. They

carried out experiments for the two strategies based on a mathematical programming model, built around Toshiba's global notebook supply chain. Model constraints include, among others, material constraints, bill-of-materials, capacity and transportation constraints, minimum lot size constraints, and a constraint on minimum fill rate (service level constraint). Unlike most models of this type in the literature, which define variables in terms of single arc flows, we employ path variables, which allow for direct identification and manipulation of profitable and non-profitable products.

Zeelenberg and **Putten (**2005**)** in their research article "*The Dark Side of Discounts: An Inaction Inertia Perspective on The Post-Promotion Dip***"** write that after a product has been on promotion, the sales of that product may temporarily decrease. This post-promotion dip is normally explained in terms of forward buying or stockpiling. This article offers a third explanation in terms of brand switching. The results of two experiments show that after missing a discount on their regular brand, consumers may switch to another brand. Switching behavior is much more pronounced when a large discount is missed in comparison to when a small discount is missed. This finding is consistent with recent social psychological research on inaction inertia, and the results are discussed in relation to this phenomenon.

Wort and **Zumwalt (2021)** in an article titled "*The Trade Discount Decision: A Markov Chain Approach***"** write that economic theory indicates that higher returns are required from investments that have higher risk. Two major reasons for offering trade discounts are to stimulate sales and to speed up cash receipts. Both sales increase and the earlier receipt of cash impact the risk/return characteristics of a firm. This study uses

Markov Chain Model to demonstrate how alternative trade credit policies impact the risk and required returns of a firm. The amount of risk and return per credit sale is calculated, and the coefficient of variation is used as a risk/return measure per credit sale. The study concludes that trade discounts can have a favorable impact on the risk/return characteristics of a firm, even in the absence of increased sales volume. Other discount decision factors that are either directly or indirectly determined in this paper include:

- The average number of periods for which an account is outstanding,
- The probability of collection and bad-debt losses over the average account period,
- The average speed of payment,
- The average amount of cash tied up in accounts receivable.

Rashid and **Mitra** (1999) in their research article "*Price Elasticity of Demand and An Optimal Cash Discount Rate in Credit Policy*" tell us that the provision of a cash discount is equivalent to a reduction in price, the role of price elasticity of demand in determining credit terms has been neglected in the extant literature. In this paper, this role is investigated and it is shown that the optimal cash discount rate is affected by the price elasticity of demand for the firm's product. The comparative effects on the optimal cash discount rate with respect to exogenous changes in the fraction of credit sales paid after taking cash discount, the cost of short-term funds and the bad debt loss ratio are investigated. A trade-off between the time value gain and the price elasticity of demand is established. As per their findings, firms which sell in locations having different price elasticities for their products and/or which face various costs of short-term funds in

different locations should vary their cash discount terms accordingly. *Ahmed & Khan (2023)* and *Rahman & Siddiqui (2023)* both explore how credit policies directly affect distributor performance metrics like profitability, sales growth, and operational efficiency. *Iqbal & Malik (2022)* delve into the broader supply chain implications of credit policy changes, examining factors like inventory management and supplier relationships. *Hussain & Shah (2023)* focus on the financial aspects, analyzing how different financing options and credit terms influence distributor behavior and business growth. *Khan & Ali (2024)* provide insights into how distributors adapt their strategies in the face of financial policy shifts within the FMCG sector, emphasizing the importance of proactive measures and technological adoption. By synthesizing these studies, our literature review present a comprehensive overview of how credit policies influence distributor performance and behavior in Pakistan, supported by empirical evidence from recent research.

METHODOLOGY

The research involves interviews with the distributors and managers of the three sample companies. In order to bring consistency in the interview, a questionnaire (Annexure-A) will be constructed and all the interviewees would be requested to answer the questions in as much clear terms as may be possible.

The changes to be proposed by the distributors would be discussed with the management of the companies to get their opinion. As a researcher, I would also evaluate the cost of extending credit terms as per distributors' proposals.

The credit terms will be valued for the company and the distributors both. The cost of giving up discount by the distributors will be calculated by the formula:

$$\text{Cost of giving up discount} = \frac{CD * 365\,\text{days}}{(100 - CD) * N}$$

Where,

CD = Stated cash discount in percentage terms

N = Number of days payment can be delayed by giving up the cash discount.

DATA ANALYSIS

The results of the information gathered through interviews are summarized as under:

Present Annual Sales Level:

- Shezan International Rs.25, 000,000
- Murree Brewery Rs. 1,700,000
- Shakerganj Rs. 1,000,000

Shezan International products (squashes, jams, pickles, ketchup, fruit juices) are very popular among consumers because of their quality and farm-purity. Except squashes and fruit juices, all other products have regular consumption. It is because of this that their sales level is very high.

Murree Brewery The sales level does not include revenues generated from the sale of liquors. This figure comprises of sales of fruit juices (Tops, Apple Sidra) and malts (Lemon). These products of Murree Brewery are not very much popular because of other

similar good products by international companies such as Nestle, Coca-Cola, and Pepsi Cola Company.

Shakerganj Company is new in this sector. The sales of its products are seasonal and consumers usually prefer to buy products of other known brands.

Existing Credit Policies

- 80% sales of Shezan International are on cash basis. The trade discount varies from 2 percent to 5 percent depending on the value of purchase orders. The distributors are required to pay in advance before their orders are executed. Credit sales (20%) are made to distributors who have been in business with Shezan International for over 10 years and whose creditworthiness is established. However, this group is allowed credit sale up to 90 percent of their deposits as distribution dealership. For any order exceeding this limit, they are required to make down payment through cash/bank drafts.
- Murree Brewery does not allow any cash discount. Instead, a credit period of 30 days is allowed to those distributors only whose creditworthiness over the past period has been proved. Distributors may place orders up to the amount of their initial deposit.
- Shakerganj is new in this area. It does not have adequate record of credibility of distributors. Usually all sales are cash sales on wholesale trade prices. A credit period of 5-7 days is allowed in very seldom cases.

Distributors' Opinion

- The distributors of Shezan International were of the view that all sales should be on credit basis and that credit terms of 5/10; n/30 be allowed to them.

- The distributors of Murree Brewery were not satisfied with the present policy. Instead, they were of the opinion that all sales should be on credit and that net credit period be extended to 45 days e.o.m if no discount is allowed.
- Shakerganj sales policy was considered quite hard. Distributors expressed their opinion that the level of its sales would drastically fall if a competitive credit policy is not formulated.

Change in Present Sales Level

- If Shezan International revises its credit policy as proposed, their sales volume is likely to boost by 15 percent per annum on the average.
- If credit period is extended to 45 days e.o.m with no cash discount, the sales level of Murree Brewery is likely to increase by 7-8 percent per annum.
- The sales of Shakerganj are likely to increase by 10 percent on the average if all sales are made on credit basis and a credit policy competitive with the market is allowed to them.

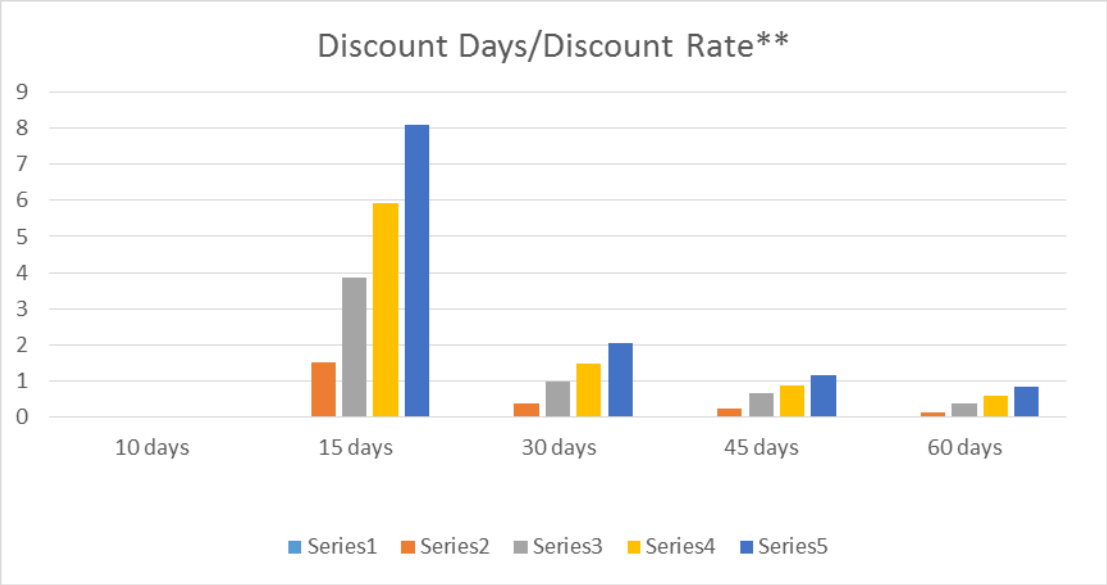
Based on the proposed credit policies, increase in sales volume, and alternate credit policies, the cost-benefits accruing to distributors and companies are estimated to be as under:

Table 4.1 Associated cost of giving up cash discounts

Discount Days/Discount Rate**	Associated costs of giving up cash discount				
	0%	2%	5%	7.5%	10%
10 days	0%	0%	0%	0%	0%
15 days	0%	149%	384%	592%	811%
30 days	0%	37%	96%	148%	203%
45 days	0%	21%	64%	85%	116%
60 days	0%	11%	38%	59%	81%

** The Cash Discount Period is assumed to be 10 days, i.e. Discount Rate/10 days,

Source: Made by the researcher



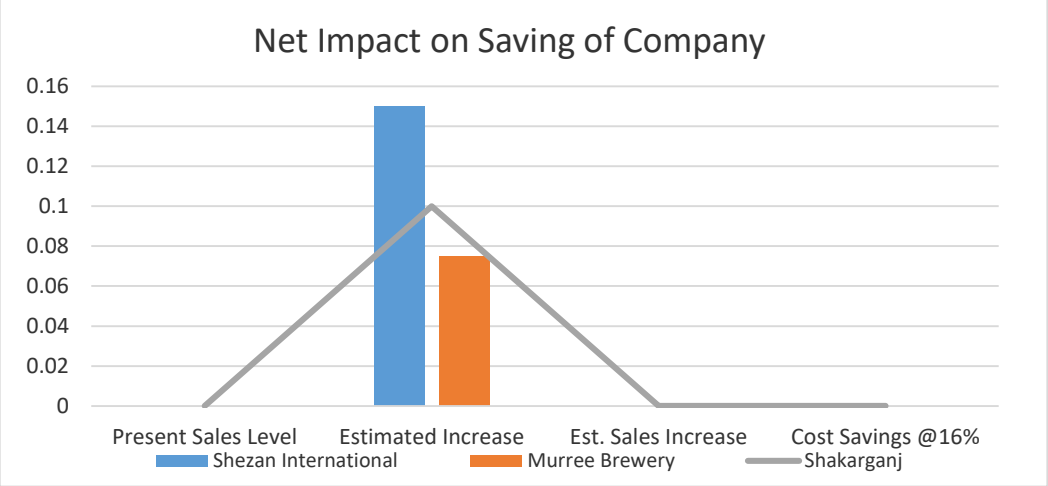
Net/Credit Days

Depending upon the credit policy terms, the net impact on savings to the company is explained below:

Table 4.2 Net impact on saving of company

	Shezan International	Murree Brewery	Shakarganj
Present Sales Level	Rs.25,000,000	Rs.1,700,000	Rs.1,000,000
Estimated Increase	15.0%	7.5%	10.0%
Est. Sales Increase	Rs.3,750,000	Rs.127,500	Rs.100,000
Cost Savings @16%	Rs.60,0000	Rs.20,400	Rs.16,000

Source: Made by the researcher



The costs associated with the credit terms are zero when no discount is allowed. However, when the credit period is expanded to 60 days, i.e. the credit term is 2/10, n/60, the cost of giving up is 11 percent per annum which is minimum in comparison to all remaining credit terms. But as the credit period expands, the expected bad debt loss is likely to increase. If this loss is assumed to be 1 percent, then total associated cost would be 12 percent. In other words, the net savings accruing to Shezan Int., Murree Brewery, and Shakarganj would be Rs. 528,00, Rs.18,000, and Rs.14,100 respectively. This level of savings would go on decreasing as the credit period decreases or discount rate increases.

CONCLUSION

From the above analysis, the following conclusions are drawn:

- The rate of discount has direct relation with the savings of the company but an inverse relation with distributors' cost of giving up discount.
- As the credit period increase, the possibility of bad debt losses increases. This is detrimental to company but advantageous to the defaulting distributors
- Regime of credit policy has direct bearing to sales. As the credit terms are made more attractive to distributors, significant increase in sales is likely to occur. Tight credit policies impair sales level.

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ANNEXTURE

Questionnaire for Distributor

Q1. What is your approximate sale level yearly?

Q2. What kind of credit policy you are having at the moment:

- Are In terms of discount percentage:
- In terms of credit period in days:

Q3. Are you satisfied with the present credit policy? If not, why?

Q4. What credit policy would you propose?

- In terms of discount percentage:
- In terms of credit period in days:

Q5. If your proposed policy is accepted by the company, will it affect sales level? To what extent?

Q6. In case if the company does not accept your proposed policy, but instead offers you the following alternate policies, what change in sales level would you expect?

- Discount 0 percent; credit period: 15 days; 30 days; 45 days; 60 days
- Discount 5 percent; credit period: 15 days; 30 days; 45 days; 60 days
- Discount 7.5 percent; credit period: 15 days; 30 days; 45 days; 60 days
- Discount 10 percent; credit period: 15 days; 30 days; 45 days; 60 days
- Above 10 percent; credit period: 15 days; 30 days; 45 days; 60 days