Session 8:

Export Payment Terms

How Do I Get My Money?

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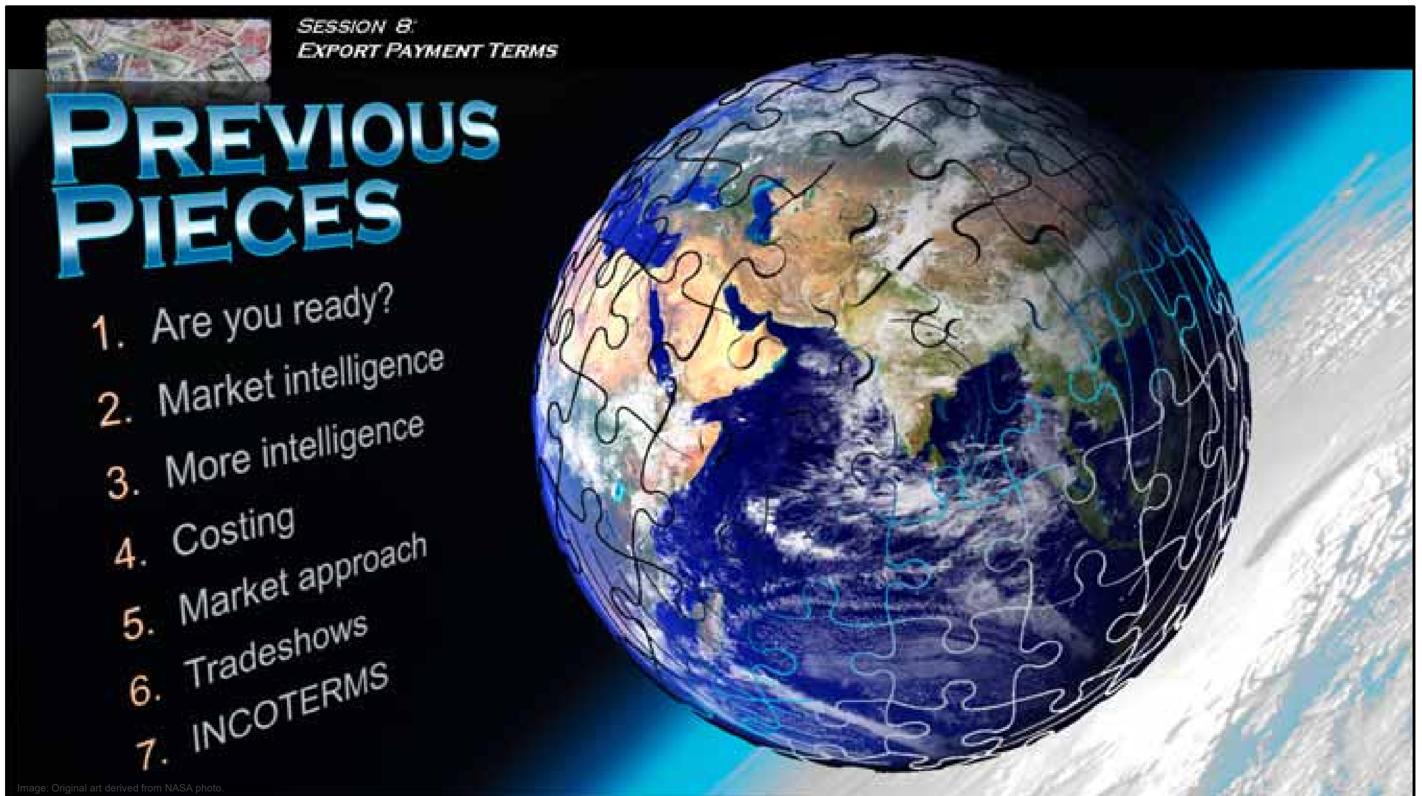
Hi, I'm Charles Boyanton and welcome to this 8th session of Export-U.

In this session we will discuss international transaction payment terms.



We have already considered several other pieces of the export puzzle.

And, …. all of these are critical to developing overseas business…..

But,… so far, we haven't discussed

-Click- what happens when you've made the sale, …… and it's time to collect your money?

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The big questions are:

How can I make sure I will get paid by my overseas customers?

The question of payment terms is one with which every exporter must wrestle –

And, for which there is – unfortunately -- no simple answer, since in all likelihood, you will utilize a combination of the terms depending on the market, the client, and the situation.

In this session we will first look at the various available payment terms,

…..discuss some of the advantages and disadvantages of each,

…..and then consider the key factors that will help you with the selection process.

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Payment Terms

1. Cash in Advance
2. Open Account
3. Documentary Collections
   - Cash Against Documents (sight drafts)
   - Documents Against Acceptance
4. Documentary Credits (Letters-of-Credit)
   - At Sight
   - Acceptance

The payment terms used in international trading are actually no different than the terms used in domestic trading ……although depending on your business, you may not be familiar with all of them.

The four basic terms are:

-CLICK-1- Cash in Advance

-Click-2- Open Account

-Click-3- Documentary Collections, …. which come in two types:

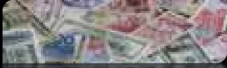
- Cash Against Documents (also referred to as "sight drafts,"…… and
- Documents Against Acceptance (sometimes known as "Time Drafts" or "Trade Acceptances"

And lastly:

-Click-4- Documentary Credits, better known as Letters of Credit…………. and which, like Documentary Collections, appear in two basic forms:

- At Sight Letters of Credit
- And Acceptance Letters of Credit ….. (which you will sometimes see referred to as time or Usance Letters of Credit)……..

The last payment term – Letters of Credit – is a subject unto itself, …. and in another session we will address it in much greater detail, but today we want to focus on the use of the terms rather than the details.



Cash In Advance

- Seller has the buyer’s money & control of product after payment
- Buyer often wonders when & if the shipment will occur

Photo: http://www.flickr.com/photos/68751915@N05/6355251231/, also Microsoft clipart.

So lets begin our discussion with that term which every seller loves: Cash In Advance….Of course Cash In Advance is also a term which most buyers loathe. And it is easy to see why:

-CLICK-1- The seller has the buyer’s money, and the sell has control of the product, for which the buyer has already paid...and...

-CLICK-2- the buyer is often left to wonder when and if the shipment will occur? …….and, if it does, will the seller ship the correct product?

No wonder this term is little used….. Most buyers find that risk unacceptable,….. and companies that rely on Cash In Advance as <u>THE</u> term….. are not likely to obtain a large market share….

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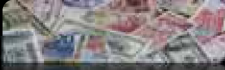

CASH IN ADVANCE

When does it make sense?

- Used equipment
- Unique or high demand items
- Small orders
- First orders

But…. When is the term appropriate to use in trading?

-CLICK-1- If you deal in used goods or equipment, the term is not unusual
(or else a large down payment is required prior to loading for shipment), and

-CLICK-2- If you have a unique product, or a product in high demand or limited production, the term can be employed. But most often the term is used when you are dealing in

-CLICK-3- small orders, such as spare parts, etc, or when you are negotiating

-CLICK-4- a first transaction …….. and you do not have sufficient credit and other information to use a term other than Cash In Advance or Letter of Credit. In this case, you might want to offer to consider offering terms once the client has completed a detailed credit application (something any businessperson ought to understand). In short, Cash In Advance is a specialized term with which you cannot hope to generate substantial international sales.

The same cannot be said of the next term we will consider: Open Account Sales!

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Open Account

or "cash in arrears"

Why so common?

- Reliable credit & country risk info
- Super competitive world market
- Insurance available for commercial and political default

Photo: Extreme motorcycle stunt., secret agents customized images.

From a risk perspective, if the one term is "Cash In Advance" then Open Account could be labeled "cash in arrears"!

All the risk is borne by you, the exporter: the product is gone and the money is due at some point in the future.

-CLICK-1-
Why then, is the term so widely used today? Certainly when I began in international, several decades ago the normal small business term was "Letter of Credit." I think the prevalence of open account today is due to a few key factors: (CLICK)

-CLICK-2-
First, credit information and country risk information is more reliable and easier than ever to get than it was before the widespread use of computers and the internet, Also, the world marketplace

-CLICK-3-
is very competitive today – much to the benefit of the buyer, ……. and I suspect that many companies offer open account terms to meet the competition.

But probably the largest single factor in combination with the others is:

-CLICK-4-
The ability to insure your export accounts receivables

Overall the open account term has much going for it:

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Open Account – Upside

- Relatively safe – **IF INSURED**
  (max 95% for commercial default, 100% for political)
- Most flexible payment term
- Less costly to importer
  (& exporter)
- May lead to increased market share

Photo: NASA. Sun rising above the earth taken from the International Space Station. Microsoft clip art.

First, IF the buyer and market are insurable,

-Click-1
it is relatively safe. ……… For example, export account receivables insurance through the Export-Import Bank of the United States will provide up to 95% coverage against commercial default and 100% against default arising from political causes.

-Click-2

Secondly, it is the most flexible of terms. By that I mean that all payment arrangements can be set in negotiations with the buyer,…… and change orders can more readily be done if needed by either you or the buyer.

-Click-3

Thirdly – and a big point with your foreign customer – it is the least costly of the payment terms both to you and your buyer.

-Click-4

Lastly – and probably the most important benefit if this payment term: Because it is a preferred term with foreign buyers, it may enable you to increase sales and market share – or at least to be more competitive.

That said, before jumping to make all sales open account, you also need to be aware of the downsides to the term:

-Click-5

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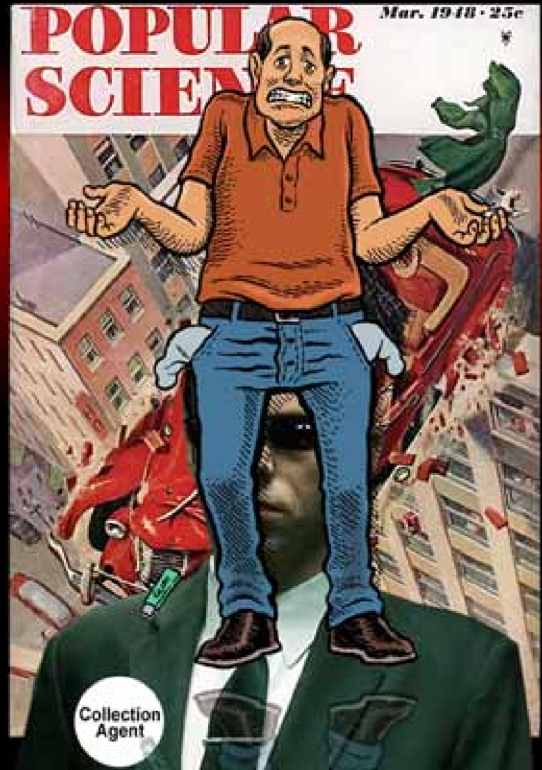
Open Account
Downsides

- Insurance doesn't cover **everything**
- Buyer may "ride his payables"
- Ultimate risk of default
- More credit management cost



Let's now consider the downsides to open account as a sales term. First, most insurance policies do not cover all possible risks.

-Highlight-

For example, most do not cover buyer/seller disputes. So, if you are in an industry where quality disputes often occur, with your clients, then you would probably prefer another term, and that term would probably be letter of credit.

Secondly, it is quite likely that you will find the collection period extended beyond the terms offered. After all, foreign buyers – just like domestic clients – have a tendency to….

-Click-1

"ride their payables,"……… That being the case, you might wish to build in 15 to 30 days of financing cost you're your quote!

-Click-2

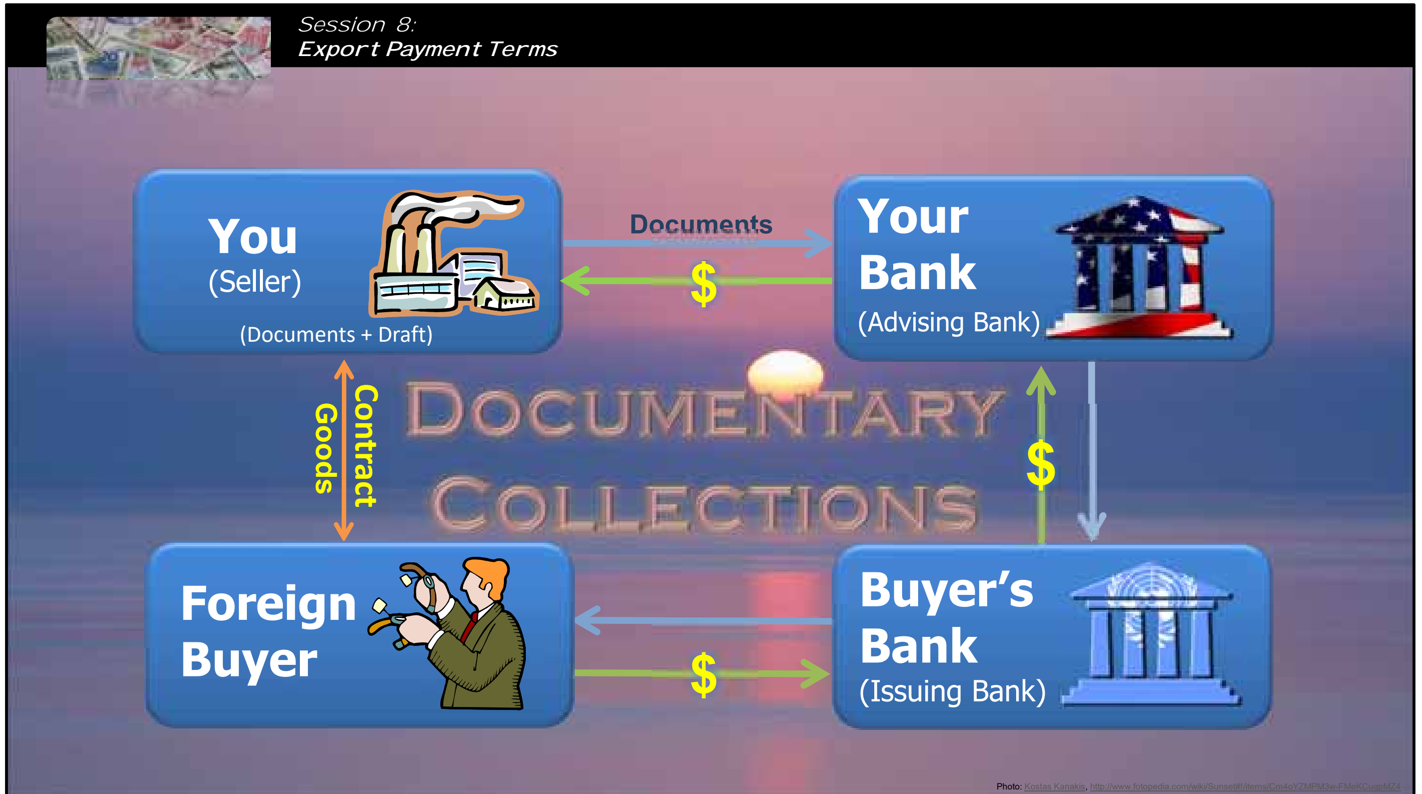
Third, you do run some risk of default, even if insured. Even a 5 to 10% loss is still a loss you would prefer not to take. And, you might remember that under most insurance coverage you cannot file a claim until the account is at least 90 days past due. And, you will be out of funds for those 90 days.

-Click-3

Finally, there will be additional account management costs that add to overhead……
However, in my opinion, this should not happen. Because, as the exporter, you should always do due diligence and good credit management when dealing with overseas customers.
Overall, I would recommend open account if insured, for most markets, particularly developed markets.

-Click-4

Next, lets look at a payment term that will not be as familiar to you: documentary collections.



Let's take a look now at the process of the documentary collection. In this example we will use cash against documents. Which is another way of saying that in order for the customer to obtain the documents he needs to clear customs, he has to pay the amount he owes you for the transaction.

-Click-1

The first step is to have a contract, even if it's a simple purchase agreement between you and the buyer. That is a legal basis for the transaction. Upon negotiating the contract,

-Click-2

you as the exporter ship the goods to the buyer. Then you gather up all the documents related to the shipment, and the documents he must have to clear customs. And you draw a draft on the buyer "at site."

-Click-3

You then take these documents to your bank. Your bank enters them for collection with your buyers bank. When the buyers bank has received the documents and your draft, they will contact the buyer, and inform him that he has documents to pay.

-Click-4

The buyer comes to the bank, pays the draft, the buyers bank then remits the funds to your bank. And, your bank remits the funds to your account. It's a very simple transaction, actually. What you have to remember is that although the bank does collect funds for you, they in no way guarantee that the buyer will show up to collect the goods.

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DOCUMENTARY COLLECTIONS

- Your bank delivers the documents to buyer's bank
- Foreign bank attempts to collect the money owed to you.
- **Neither bank guarantees the payment!**

If you elect to use documentary collections as your payment term, it's important that you know what the role of each bank is. Your bank's obligation is to ….

-Click-1
deliver the documents to the buyer's bank with instructions to collect the funds. The responsibility of the foreign bank is….

-Click-2
to attempt collection of the monies owed you under the collection item.

-Click-3
Neither your bank nor the foreign bank will guarantee that the client will pay the documents. That is one of the inherent risks in documentary collections term. We will return to this subject a little bit later, but for now let's look at the difference between cash against documents, and documents against acceptance.

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Documentary Collection Types

Documents Against Acceptance
(trade acceptance)

Cash Against Documents
(sight draft)

Photo: all over web.

Documentary Collections occur in two types:

In Cash against Documents --- sometimes referred to as "sight drafts" --- a draft is drawn on the buyer "at sight" (which means upon presentation).

The documents will not be released to the buyer unless the buyer pays the draft.

However,

(CLICK)

In Documents against Acceptance (sometimes referred to as trade acceptance,… or time draft), you extend terms to the buyer, ….. by drawing the draft on the buyer for "X" days sight (e.g. at 30 days sight).

Your export customer "accepts" the draft (literally writing accepted on it), at which time his bank releases the documents to him. …… 30 days later, the bank will ask him to pay the draft, and upon payment they will remit the funds to you through your bank.

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DOCUMENTARY COLLECTIONS

- **Transitional terms**
- **Documents not released without:**
  - Payment (C.A.D.) or
  - Buyer formally acknowledges his liability to pay you (D.A.A.).

Photo: all over the web.

Both types of documentary collections, whether at site or against acceptance, are often considered

-CLICK-1-

-“transitional terms”, ………. that is, they are good terms for transitioning from either Cash In Advance or Letter of Credit, ….. to Open Account.

And, while they do not offer the protection of either cash in advance or Letter of Credit, they offer more protection than Open Account. Under both terms, the documents required for import are

-Click-2-

not released unless the documents are paid (Cash Against Documents)…..**or** until the buyer formally acknowledges his liability to pay at a later date (Documents against Acceptance).

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Documentary Collections

Advantages/Disadvantages

\+ You retain title if documents not picked up (marine)

\+ Buyer's bank will know if he doesn't pick-up/ pay

\- If not picked up, goods must be returned or disposed of

\- Buyers usually wait for goods before paying

What are the advantages and disadvantages of the terms?

If you are shipping by water, the terms are particularly effective because marine bills of lading are title documents…….The buyer has to have the B/L to be able to get the goods from port.

Also, should the buyer not pay or accept, then

-CLICK-1-

you will still own the goods (of course, they may be a couple of thousand miles away, but they are still yours.) Another plus is that

-CLICK2-

the buyer's bank will know of any default or failure to honor his obligations. And, that does increase the likelihood of the transaction being completed.

The disadvantages are that

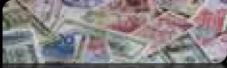
-CLICK-3-

if the goods are not picked up, you will have to arrange for their return or disposal – which can be quite expensive. Also, even with "at sight" transactions,

-CLICK-4-

the buyer will normally await arrival of the goods before picking up documents, so your collection will be lengthened by the transit time to port.

Even so, both terms, but particularly cash against documents, offer good alternatives to open account that provide some additional security and assurance of payment.



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Documentary Collection

Factors to Consider

Generally good term
(particularly with marine shipment)

Apply due diligence in checking out buyer and market

Consider requiring a substantial down payment
(to assure buyer compliance)

Image: NASA

In general then, documentary collection offers better terms than open account, and, with a bit more security – especially for marine shipments. But, like open account, it does require

-Click-1

applying due diligence in checking out the buyer and the market… Also, since you must rely on the buyer to pay or accept the documents, and since there is no bank guaranty of payment, you may want to have your overseas customer

-Click-2

make a substantial down payment. Now lets look at the payment term most closely associated with international trading: Letters of Credit

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LETTER OF CREDIT

(Definition 1)

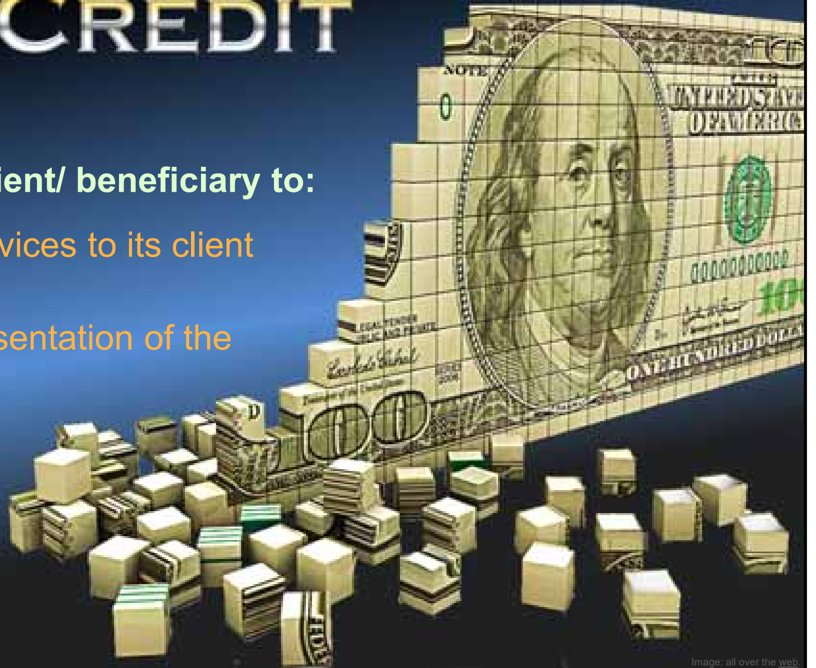
"A Letter of Credit is a bank instrument by which a bank substitutes its credit-worthiness, which is both well-known and good, for that of its client, which may be good but is not well-known."

Image: All over the web.

Basically, a letter of credit is a bank instrument by which a bank substitutes its creditworthiness, which is both good and well-known, for that of its client, which may be good but not as well-known.

------ For example you might feel a lot better if you are guaranteed payment by the Royal Bank of Scotland, than by a small Scottish manufacturer.

LETTER OF CREDIT
(Definition 2)



- **Bank instrument calls for recipient/ beneficiary to:**
  - Provide commercial goods/services to its client (the account party), and
  - Evidence such delivery by presentation of the documents,
  - Within the time frame set
- **Carries "*conditional*" bank guaranty for compliance with the instrument.**

Image: all over the web.

Here's a more formal definition of a letter of credit.

A Letter of Credit is

-CLICK-1-

an instrument issued by a bank on behalf of its client, and calling for the seller to

-CLICK-2-

provide its client with commercial goods or services ……….. (Just to clarify, the client may also be called the Account Party, and seller may be referred to as the Recipient or the Beneficiary).

The bank

-CLICK-3-

confirms product delivery by presentation of the shipping documents. The LOC (or instrument) may call for presentation of these documents

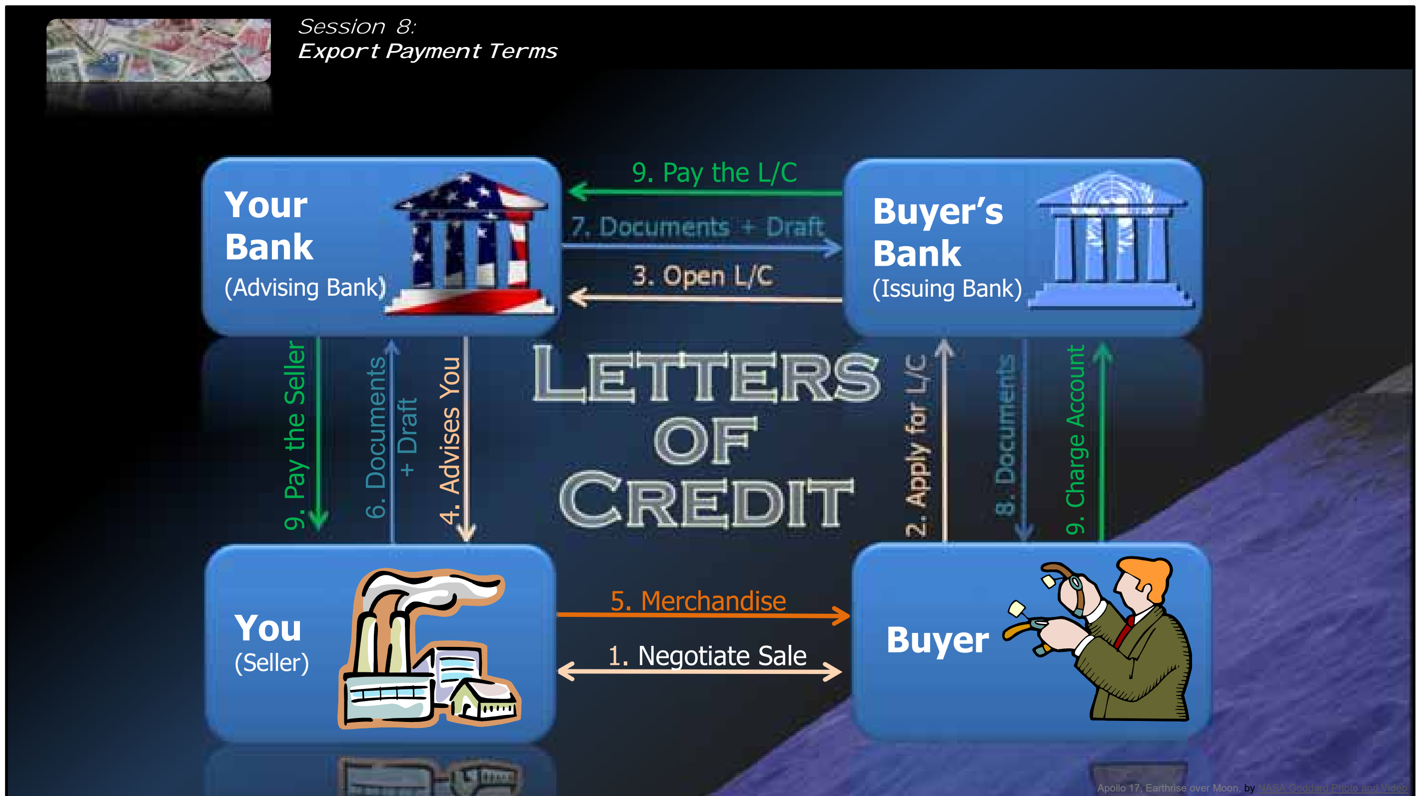
-CLICK-4-

within a specified time frame. Letters of credit carry the

-CLICK-5-

conditional guaranty of payment by the bank (conditioned on compliance with the instrument). This requirement for documents to be presented to show compliance ….. gives the Letter of credit its other name: "Documentary Credit"

Let's chart how a typical Letter of Credit transaction works.



As always the transaction begins with a contract/purchase order negotiation between the buyer and you (step 1).

(CLICK)

Since the payment term calls for the importer to open a Letter of Credit in your favor, he applies to his bank for the same, telling the bank what documents and timeframes applies to the Letter of Credit.

(CLICK)

In step 3, his bank opens a Letter of Credit naming you as beneficiary and sends it to your bank which

(CLICK)

advises you that the letter has been issued (step 4).

(CLICK)

Working with your freight forwarder you ship the goods to the buyer per the terms of the Letter of Credit (Step 5), then

(CLICK)

You present all the required documents plus a draft drawn on the foreign bank to your bank (step 6).

(CLICK)

Now, your bank checks the documents to see that they are in order. If they are in order, your bank forwards the documents to your overseas customer’s bank requesting payment of the L//C. (step 7)

(CLICK)

And finally, in step 9, the foreign bank charges your customer’s bank account for the funds,….. pays your bank the proceeds under the L/C, ….. and your bank remits the funds to your account less its charges.

WOW! Sounds worse than it is really…

Now lets consider a few other important points about letters of credit:

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L/C Pointers

- Irrevocable
- May be "at sight" or "time" drafts (e.g., "At 30 Days Sight")
- Time drafts may be discounted if you need cash-flow
- Advised vs. Confirmed L/C
- Know your buyer!

Letters of Credit are "irrevocable instruments."… that is they cannot be altered or cancelled without your consent. And, that is the wonderful thing about a letter of credit; once you have it in your hands, you know exactly what you must do in order to be assured of payment.

Letters of credit

-Click-1- may also be drawn "At Sight" or "At time," for example, "At 30 day sight." (just like Documentary Collections). The primary difference here is that the promise to pay is made by the bank (and not by your client).

Also if you offer terms to your customer by agreeing to draw a

-Click-2- time draft (for example, "at 60 days sight") you can ask the bank to "discount the proceeds to you" and pay you even before the end of the specified time (less any discount charges the bank may charge). In the previous flowchart we demonstrated

-Click-3- an "Advised" letter of credit. This means that payment was guaranteed by the foreign bank, not by your bank. But, if you are not comfortable with the foreign bank risk, you can request that the letter be "Confirmed" by a U.S. bank. By confirming a Letter of Credit… the U.S. bank guarantees payment, should the foreign bank not honor its obligation. In other words, the U.S. bank substitutes its creditworthiness for that of the foreign bank. But, lastly,

-Click-4- know your buyer. Use due diligence. Should the bank find that your documents do not comply with the terms of the L/C, you will be in essence in the same position as if you were operating under open account. You will be totally dependent upon your client to waive the discrepancy and to pay the letter of credit. A letter of credit is not a substitute for good credit practices……. So having looked at the normal payment terms, how do we rank the payment risks?

There is really a full range of risk options with international payment terms. The least risky is, of course, cash in advance. …….. Followed by

-confirmed L/C, …..

-advised L/C, …..

-Cash against Documents, …..

-Documents against acceptance, and finally Open Account.

-CLICK-1- (Balloons and jumper in)

Which is the best payment term to use? The best answer is "it depends". We will address "risk mitigation" in a later section, ….. but for now know that your choice depends on a number of factors (such as the competition you face in the market and your risk appetite).

-CLICK-2- (jumper out)

In my experience, you may eventually use every one of these terms, if you conduct substantial international business.

Meanwhile if you face that decision, please contact your local SBDC, U.S. Export Assistance Center, or banker for assistance in making the best decision…
……….and the best of luck in your export endeavor!

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For more information on payment terms please see our Web Links

Photo: Chain link sculpture, by Airripav, Flickr photo sharing.

In this session we have briefly introduced the topic of payment terms.

If you wish to learn more, please refer to the links page of this web site.

Finally, thank you for viewing this session of Export-U.

I hope you found it helpful.