GETTING PAID

A Guide to Methods of Payment

CONNECTING SASKATCHEWAN BUSINESS WITH THE WORLD

This manual was created as resource guide for members of the Saskatchewan Trade and Export Partnership (STEP). For more information on these manuals or on STEP membership please contact the Saskatchewan Trade and Export Partnership at the following locations;

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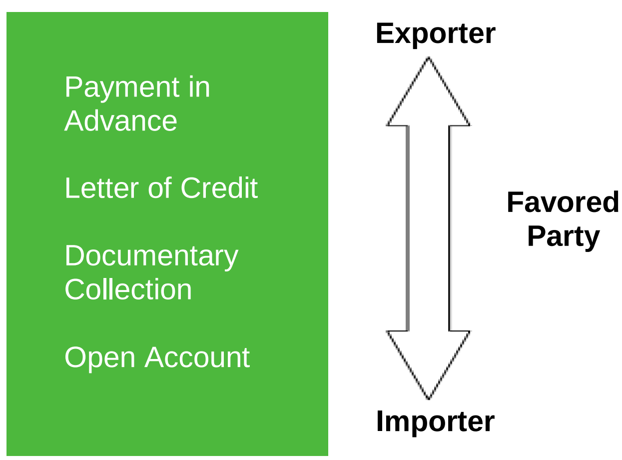
Methods of Payment

There are several options of receiving payment for products or services sold abroad. As with domestic sales, a major factor that determines the method of payment is the amount of trust in the buyer's ability and willingness to pay. For sales within Canada, if the buyer has good credit, sales are usually made on open account; if not, cash in advance is required. For export sales, these same methods may be used, however, other methods are also often used in international trade. There are four main options for getting paid and each are explained in detail in this guide:

- Cash in Advance
- Documentary Credit (commonly called Letters of credit)
- Documentary Collections
- Open Account

Understanding Risk

Since getting paid in full and on time is of utmost concern to exporters, risk is a major consideration. Many factors make exporting riskier than domestic sales; however, there are also several methods of reducing these risks. Ranked in order from least risky for the exporter to the highest risk option, the basic methods of payment can be summarized in the following diagram.



One of the most important factors in reducing risks is to know what risks exist. Consider the following:

<u>Commercial Risk</u>: This is your Buyer. What do you know about their credit quality? Is this the first transaction you will be completing with them? Also consider:

- Size of the company
- Reputation
- Payment history

- Size of the transaction

Country/Political Risk: This is the information about the country into which you are selling. Consider:

- Economic Performance and level of development
- Payment record
- International Monetary Fund (IMF) status
- Political unrest or instability

For these reasons it is important to understand each transaction and use the appropriate method of payment to help mitigate the risk for the transaction.

Cash in Advance

Cash in advance or prepayment presents the least amount of risk to the exporter. This method is used when selling to those countries where other methods are unavailable, have unacceptable risk or is prohibitively expensive. The buyer/importer completes the payment to the seller/exporter and then goods are shipped. It is recommended that the payment be made by wire transfer as the funds are usually deposited in a timely manner. The use of a cheque will take time to clear (generally 4 – 6 weeks), therefore frustrating the original intention of “payment before shipment”.

From the importer’s point of view, advance payment has many disadvantages, such as the risk of non-delivery of goods and it could put a strain on the company’s cash flow. From the exporter’s perspective, they have all the advantages, as they have been paid, and have not yet shipped the goods and retain the title to the goods. Because the buyers/importers are aware of their disadvantage they may want an alternate method of payment.

Letter of Credit (Documentary Credit)

A Letter of Credit is a written undertaking, by a bank, at the request of its customer, the importer (applicant/buyer), whereby the bank promises to pay the exporter (beneficiary/seller) for goods or services, provided that the exporter presents all documents called for, exactly as stipulated in the Letter of Credit, and meets all other terms and conditions set out in the Letter of Credit.

There are numerous options and terms associated with Letters of Credit of which several of the common features are listed below. For further details on Letters of Credit please review the STEP Manual: Letters of Credit.

Revocable and Irrevocable Letters of Credit:

Revocable Letter of Credit: A Revocable Letter of Credit can be revoked without the consent of the exporter, meaning that it may be cancelled or changed up to the time the documents are presented. A Revocable Letter of Credit affords the exporter little protection therefore is rarely used.

Irrevocable Letter of Credit: An Irrevocable Letter of Credit cannot be cancelled or changed without the consent of all parties, including the exporter. Unless otherwise stipulated, all Letters of Credit are irrevocable.

Confirmed and Unconfirmed Letters of Credit:

When a Letter of Credit is advised to you by your local bank, the bank is telling you that they have authenticated the Letter of Credit, and are passing it on to you, "without responsibility or engagement". This means your risk of payment rests with the bank that has issued the Letter of Credit. This is an ***Unconfirmed Letter of Credit***.

It may be the case, however, that the Issuing Bank is not considered as an acceptable risk and/or the country where it is located has high political or economic uncertainty. In this situation, the exporter may consider requesting a Confirmed Letter of Credit.

With a ***Confirmed Letter of Credit*** another bank, the "Confirming Bank", will add its "confirmation" to the Letter of Credit. By adding its confirmation, the Confirming Bank undertakes to honour the exporter's claim under the Letter of Credit, assuming all terms and conditions of the Letter of Credit are met. The Confirming Bank is usually located in the same country as the exporter. The risk of payment is now assumed by the Confirming Bank, as well as the Issuing Bank, thereby, providing more protection for the exporter. When requesting a Confirmed Letter of Credit, the exporter should first check with his local banks (International Department) to determine whether or not they have the ability or availability to confirm a Letter of Credit issued by the importer's Bank.

Once they determine which bank can handle the request (Confirm the Letter of Credit), they will direct the importer to have their bank issue a Confirmed Letter of Credit through the local bank who has indicated their interest in the transaction.

It is essential to note the key principle underlying Letters of Credit is that ***banks deal only in documents and not in goods***. The decision to pay under a Letter of Credit will be based entirely on whether the documents presented to the bank appear on their face to be in accordance with the terms and conditions of the Letter of Credit. It would be prohibitive for the banks to physically check all merchandise shipped under Letters of Credit to ensure merchandise has been shipped exactly as per each Letter of Credit.

It is imperative that the terms of the Letter of Credit are reviewed meticulously to ensure all terms can be met and that there are no discrepancies between what the Letter of Credit says and what was agreed to by the parties.

Standby Letter of Credit:

The basis of a Standby Letter of Credit is that it may be drawn on by the Exporter when the Buyer has failed to perform (pay) in accordance with the underlying contract between the Exporter and Buyer.

In simple terms, a Standby Letter of Credit is “standing by” to protect the Exporter in case the Buyer defaults on an agreed-upon sales contract. Standby Letters of Credit are commonly issued in favor of suppliers as security for goods purchased on open account. The Standby Letter of Credit, once issued, will secure shipments made up to the amount of the Standby Letter of Credit and before the expiry date. Therefore the Exporter ships his goods, and sends his invoices (open account basis), the importer makes payment, and the cycle begins again.

If the Buyer defaults in payment under the terms of the sales agreement, (i.e. the exporter has shipped his goods, but the payment is not made), the Exporter would generally stop further shipment and make a claim for payment under the Standby Line of Credit.

Other Types:

Differentiation is also made between Letters of Credit depending on the payment terms. If payment is to be made when specified documents are presented, this is referred to as a ***Sight Letter of Credit***. Alternatively, if payment is to be made at a future date, this is referred to as a ***Term, Usance or Deferred Payment Letter of Credit***.

A Simple Letter of Credit transaction:

After the exporter and customer agree on the terms of sale, the following is typically the scenario that will follow in a Letter of Credit transaction.

1. After the exporter and customer agree on the terms of a sale, the customer arranges for its bank to issue a Letter of Credit in favor of the exporter. The importer will need a line of credit or other credit facility with the issuing bank.

2. The Issuing Bank issues the Letter of Credit and sends it to the Advising Bank by telecommunications or registered mail in accordance with the importer’s instructions. A request may be included for the Advising Bank (exporters) to add its confirmation. The exporter may request that a particular bank be the confirming bank, or the foreign bank selects one of its correspondent banks.

3. The Advising and/or Confirming Bank will verify the Letter of Credit for authenticity and send a copy to the exporter and add it’s confirmation if requested.

4. The exporter reviews carefully all terms and conditions in the Letter of Credit. The exporter’s freight forwarder or internal logistics should be contacted to make sure that the shipping date can be met. If the exporter cannot comply with one or more of the conditions, an amendment to the Letter of Credit should be requested at once.

5. The exporter arranges for shipment of the goods, prepares and/or obtains the documents specified in the Letter of Credit and makes demand under the Letter of Credit by presenting the documents within the stated period and before the expiry date to the Bank. This may be the Advising/Confirming Bank. That bank checks the documents against the Letter of Credit and

forwards them to the Issuing Bank. The drawing is negotiated, paid or accepted as the case may be.

6. The Issuing Bank examines the documents to ensure they comply with the Letter of Credit terms and conditions. The Issuing Bank obtains payment from the importer for payment already made to the exporters Bank. Documents are delivered to the importer to allow it to take possession of the goods from the transport company. The trade cycle is complete as the importer has received their goods and the exporter has obtained payment.

Documentary Collections

A Documentary Collection is a payment instrument that consists of a financial document that is accompanied by the commercial, and/or transport document(s) pertaining to the transaction. Usually these documents confer, fully or partially, title of the goods to the holders. Generally the documents are handled by both the importers' and exporters' banks, with neither bank accepting liability.

There are two types of Documentary Collection with different risk associated with each:

1. ***Documents Against Payment (D/P)***: Much like a Letter of Credit, the buyer and seller agree on the terms and conditions of a sale, including necessary documentation, who will be responsible for what, and what is being shipped, how, and when. The exporter ships the goods as agreed, prepares and obtains all necessary documentation, and presents it to the International Department of his local bank, with instructions to send the Draft and documents to its correspondent abroad with explicit instructions to surrender the Documents Against Payment. The advantage to this system, over open account, being that the exporter has physical control over the goods by way of documents. There is, however, the possibility of the Buyer/Importer not being able or willing to pay, in which case the exporter finds himself with his goods sitting on a foreign shore subjected to deterioration or theft and accumulating storage charges. Alternative arrangements would then need to be made by either selling to another party in that region or shipping the goods back home.

2. ***Documents Against Acceptance (D/A)***: If the exporter has a good relationship with his buyer, he may want to provide the buyer with payment terms, (i.e. 60 days Bill of Lading date), and allow the buyer to obtain the Documents Against Acceptance (i.e. the buyer in the foreign country must provide his acceptance to pay the Draft amount at the maturity/due date (60 days Bill of Lading date, 30 days sight, etc.) by signing the Relative Draft.

   This provides higher risk than Documents Against Payment, as in this case, the buyer not only has not paid for the goods, but by virtue of his acceptance on the Draft, has obtained the documents necessary to obtain possession of the goods. In the event of default of one of the parties under the above-mentioned collections, buyer or seller can take legal action, albeit an expensive and frustrating proposition in a foreign country.

Open Account

In an open account transaction, the exporter ships the goods, sends the corresponding title documents to the buyer and invoices them for payment with no recourse if payment is not received.

This method is a convenient method of payment and may be satisfactory if the buyer is well established, has demonstrated a long and favourable payment record, or has been thoroughly checked for credit worthiness, and the country is economically and politically stable.

Open account can be the least attractive method of payment for the exporter if the risks associated are not mitigated. One way to mitigate the open account risk would be to use a Standby Letter of Credit or perhaps investigate the possibility of insuring those foreign receivables through an insurer such as the Export Development Corporation, or a private insurer. Accounts Receivable insurance can protect the exporter against buyer non-payment or insolvency for up to 90% of invoice value. Many banks will not use foreign receivables, other than those from the United States which are discounted, for operating line of credit margining purposes.

Consignment Sales

In international consignment sales, the same basic procedure is followed as in Canada. The material is shipped to a foreign distributor to be sold on behalf of the exporter. The exporter retains title to the goods until they are sold by the distributor. Once the goods are sold, payment is sent to the exporter.

Under a consignment arrangement, the exporter has the greatest risk and least control over the goods and may have to wait lengthy time periods to be paid.

When this structure is contemplated, it may be wise to consider some form of risk insurance. In addition, it may be necessary to conduct a credit check on the foreign distributor. Furthermore, the contract should establish who is responsible for property risk insurance to cover merchandise until it is sold and payment is received.

Countertrade and Barter

International countertrade is a trade practice whereby a supplier commits contractually, as a condition of sale, to undertake specified initiatives that compensate and benefit the other party. The resulting linked trade fulfills financial (e.g., lack of foreign exchange), marketing, or public policy objectives of the trading parties. Not all suppliers consider countertrade an objectionable imposition: many Canadian exporters consider countertrade a necessary cost of doing business in markets where Canadian exports would otherwise not occur.

Simple barter is the direct exchange of goods or services between two parties; no money changes hands. Pure barter arrangements in international commerce are rare. This is because the parties' needs for the goods of the other seldom coincide and because trade practiced today involves contractually linked, parallel trade transactions each of which involves a separate financial settlement. For example, a countertrade contract may provide that the Canadian exporter will be paid in a convertible currency as long as the U.S. exporter (or another entity designated by the exporter) agrees to export a related quantity of goods from the importing country.

Canadian exporters can take advantage of countertrade opportunities by trading through an intermediary with countertrade expertise, such as an international broker, an international bank, or an export management company. Some export management companies offer specialized countertrade services. Exporters should bear in mind that countertrade often involves higher transaction costs and greater risks than simple export transactions.

Service Providers

Examples of factoring service providers:

Montcap Financial Corporation	www.montcap.com
Maple Trade Finance	www.mapletradefinance.ca
Liquid Capital Corporation	www.liquidcapitalcorp.com
Mercantile Finance	www.mercantilefn.com

For links to financial service providers, please visit Saskatchewan Trade and Export Partner- ship's membership showcase at www.sasktrade.sk.ca.