WHITE PAPER

Boost your global competitiveness with flexible payment terms

Being able to offer highly flexible payment terms can give you a competitive edge with your international customers. But if your terms are too lenient, you may increase your risk of payment problems that could undermine your cash flow. This paper examines how you can choose payment strategies that will attract overseas buyers while keeping your financial risks under control.

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INTRODUCTION

The competitiveness of any export business depends on several well-known factors—the quality of its products, its pricing strategy and its customer service, to name just three. But a less obvious ingredient in international success, and one that can strongly affect a company's ability to compete with its international rivals, is how flexible it can be when offering payment terms to its overseas buyers. To explore this question, we turned to a pair of experts in global trade: Sarah van Wolde, Senior Underwriter at Export Development Canada (EDC), and Nawshad Khadaroo, CCP, General Manager of the Credit Institute of Canada.

"The most common payment terms in international trade," says van Wolde, "are cash in advance, letters of credit, cash against documents and some form of open account. Essentially, what you want to do is offer the best terms you can without taking on an uncomfortable level of risk. For you as the exporter, the lowest-risk method is getting your cash in advance, before you even ship the goods. Conversely, your riskiest option is open account with full payment at some future date, because your customer gets the merchandise before paying for it."

The method your customers will expect can vary with the market. If you export to the United States, your buyers there will normally pay you using some version of open account, usually net 30 days, possibly with a discount for early payment. In Europe and most other foreign markets, however, letters of credit (LCs) are the most common way to handle international payments—although, says van Wolde, that is beginning to change in a few established markets. In the U.K. and France, for example, some customers are beginning to look for open account terms instead of LCs.

Using payment terms to become more competitive can be very successful, but it needs to be done with care. "You have to maintain a delicate balance in order to be competitive," says Khadaroo. "The world is a global village and everyone is competing for the same customers, so you have to find an acceptable compromise between your risk and your customer's risk. If you try to put the risk entirely on your buyers, you may scare them off and send them to your competitors."

Finding that vital compromise means choosing a set of payment terms that will be comfortable for both you and your prospective customer. If the terms are too stringent, your formerly enthusiastic prospect may walk away from the sale. But if they're too lenient, you may wait for months to get paid and end up with cash flow problems. Neither result is what you want, so it's crucial to choose the right payment method for your particular market, customer and transaction.

UNDERSTANDING PAYMENT TERMS

In most international sales, the exporter and the importer use one of the following financial instruments to manage payment.

Cash in advance

For you as the exporter, this is the least risky form of payment—you get your money at the time of the order. But for your customers, cash in advance is the *most* risky way to pay, since they have no guarantee that you'll deliver the goods as promised. It also ties up their cash or may force them to borrow the amount of the payment. As a result, few international customers will agree to a cash-in-advance purchase. Of all the common payment terms, it's the least competitive across the board.

Letters of credit

LCs provide security to both you and your buyers because they use banks to receive and check documents and to guarantee payment. Simply put, your customer obtains an LC from their bank (the issuing bank), which guarantees that you'll be paid when the conditions of the sales contract have been met. To reduce your risk even more, you can have a Canadian bank confirm the LC. Having a confirmed LC guarantees that the Canadian bank will pay you even if the issuing bank refuses to do so; such refusals are rare, but can happen if the customer's issuing bank finds errors in the LC.

Unfortunately, as van Wolde explains, LCs have a major drawback when you're trying to be competitive. "The problem is that their associated fees can be very costly for your customer. In addition, depending on the customer's banking arrangements, they may have to put up collateral with the issuing bank to support the LC, and these funds may be frozen from the day the LC is issued. So not only is the LC expensive in the first place, the customer also loses access to the cash they're using as collateral. As a result, requiring an LC in your payment terms can make you less competitive in the eyes of a potential customer."

Even so, LCs continue to be the usual method of international payment outside the United States (although, as noted earlier, this is beginning to change in some established markets).

Documentary collections

There are two basic types of documentary collections: documents against payment and documents against acceptance.

If your terms specify documents against payment, your Canadian bank sends a set of shipping documents to a correspondent bank in your customer's market. When your goods arrive at the port of entry, the correspondent bank presents the documents to your customer. The customer pays the bank, receives the shipping documents in exchange, and can then use them to release the goods from customs. The correspondent bank then sends the payment to you via your Canadian bank.

The process is almost identical for documents against acceptance, except that you allow your customer to pay the correspondent bank on some specified future date. At that time, and on the customer's payment, the correspondent bank releases the documents to the customer. You are then paid through your Canadian bank.

As a payment method, documentary collections carry less risk for the exporter than open account. They are also less expensive than LCs, so they may be a more competitive option if your customer balks at paying for an LC.

Open account

If you offer open account terms, you agree to ship your goods to your customer before you get paid. The customer promises to pay within a certain time after receiving the goods, typically within 30 to 180 days. This is a very low-risk option for the customer, since they receive the goods before paying for them. Using open account can help you land a sale, but you should know whether the buyer's credit is good before you agree to it.

"In most markets," says van Wolde, "offering open account terms is going to make you more competitive. You'll likely see frequent repeat business from your open-account customers, which will help you build both market share and customer loyalty in the country. There's also a good chance that you'll expand your customer base, because once it's known that you offer open account terms, more customers will be interested in buying from you. However, don't assume that the longer the payment term you offer, the more competitive you'll be. It's better to find out what payment terms are most common for your industry in the target market, and remain within them."

The biggest risk with open account, of course, is getting paid late, or not getting paid at all. "If the customer doesn't pay," says van Wolde, "you'll not only be out of pocket for the sale itself, but you'll also incur costs as you try to collect on the debt. But if you carry out proper due diligence into your customer and your market, you'll significantly lower your risk of non-payment, especially in established markets like the United States and much of the EU."

BALANCING COMPETITIVENESS AND RISK

The basic question exporters have to ask themselves is this: How can I offer highly competitive payment terms to international customers while minimizing my risk of late payment or non-payment?

The credit manager's dilemma

"This is a dilemma that credit managers always face," says Nawshad Khadaroo. "Selling to international customers is a good growth strategy for many small businesses, but you need to be aware of the trade-off between opportunity and risk. But if you carry out your proper due diligence and do everything you can to verify the customer's creditworthiness, the balancing act becomes a little easier."

Van Wolde agrees, with a further observation. "You may have found a good overall balance between risk and payment terms in a particular market. However, the situation may be different with specific customers within that market. For example, suppose your credit investigations into a prospective buyer reveal a consistent pattern of late payment or other payment difficulties. In cases like that, you'll be safer asking for cash in advance or a confirmed LC, even if your usual terms for that market might be open account."

In other words, identifying the most competitive terms for a particular market doesn't necessarily mean you should use them for every transaction. If the market is a new one for you, for instance, your risk appetite may not extend to offering open account. In such cases, you might want to make the initial sale under an LC or a documentary collection arrangement. Later, once you've built up a good relationship with the customer, you can consider offering more flexible payment terms. In general, though, a good beginner's approach is to offer the payment terms that most companies in your industry use in the local market.

Other factors can affect the exporter's risk appetite and, consequently, the company's choice of payment terms. One such factor is how fast it wants to grow. "Let's say your growth is so aggressive that you need guaranteed cash from your customers as quickly as possible," says van Wolde. "If you're in that position, you'll likely prefer to use cash in advance or ask for LCs. On the other hand, if you have the financial capacity to grow without needing fast infusions of cash, and if you're also operating in a lower-risk, established market, you may be comfortable with more flexible payment terms."

The role of credit insurance

Suppose you're negotiating a sale with an important company in an overseas market. It's a deal you want very much to secure—it could lead to a profitable, long-term relationship with the customer, or it could give you a vital foothold in a new market. But your prospect won't commit unless you offer very flexible payment terms, and you're worried that this is simply too risky. On the other hand, you really don't want to lose the sale.

The solution may be to insure your receivable using trade credit insurance, such as the suite of insurance products offered by EDC. This form of insurance (also known as export credit insurance) is a type of commercial insurance that protects your accounts receivable against losses when a customer doesn't pay. This means you can offer your overseas customers highly competitive payment terms, such as open account, without risking major financial losses. And that ability can spell the difference between making an important sale and losing it.

"This kind of insurance helps companies mitigate their risks when they need to provide flexible terms for their international clients," says van Wolde. "If the customer doesn't pay, you'll still receive most of your funds. As a result, using trade credit insurance can make you more competitive—it means you can offer better terms without increasing your risk to uncomfortable levels."

Finding credit information

In the Canadian and U.S. markets, it's relatively easy to obtain credit data about most companies. Overseas, however, it can be a challenge to assess the financial stability, credit standing and payment records of potential customers. So when you're trying to decide on the right payment terms for a buyer, where do you go for information?

The Canadian Trade Commissioner Service (TCS) is an excellent place to start, since they can give you a good idea of the standard payment terms used by your industry in your target market. The TCS office in your market will also be familiar with local business conditions and may be able to advise you on the reputation of a prospective customer within that market.

For its part, EDC offers a wide range of up-to-date business intelligence. You can access detailed Country Info files about markets around the world, visit the Knowledge Centre for in-depth economic analysis and reports, or browse the events calendar for upcoming seminars, webinars and trade missions.

Your industry trade association may also have resources and information you can use, and there are numerous international credit agencies that will provide credit reports on a fee-per-company basis.

COMPETITIVENESS AND CREDIT MANAGEMENT

As we've established, being competitive in your payment terms means being able to manage risk, particularly the credit risks presented by your customers. In practice, offering flexible terms without exceeding your risk threshold depends on setting up and maintaining an effective credit management program.

"Doing this is critical," says van Wolde. "With a good credit management program, you can set credit terms and policies that are shared throughout the company, so that your staff knows how they work and what the repercussions will be if they aren't honored. This also allows you to communicate your terms clearly to your customers, so they are aware of what will happen if they don't meet their payment commitments. Your credit management program also helps you to track how well your customers are doing. This can allow you to spot any changes in payment patterns that might signal a risk to your cash flow."

Khadaroo emphatically agrees. “A strong credit management program is imperative for any company that wants to do business internationally. Moreover, managing international trade requires specialized skills because it involves risks that don’t appear in the domestic market. This means that a company’s strategy for overseas growth should include developing the skills of its personnel so they can manage credit and payment risks at an international level.”

For many small to medium-sized firms, one good way to obtain these skills is external staff training through specialized institutions. The Credit Institute of Canada, for example, offers a variety of courses, seminars and modules for people who want to learn how to manage international credit transactions at basic, intermediate and advanced levels.

THE BASICS OF INTERNATIONAL CREDIT MANAGEMENT

The basis of an effective credit management program is a carefully developed policy that governs how you offer international credit and handle overseas transactions. This policy should be set down in a document that will be the foundation for your international credit management program.

Once the policy is in place, you can build on it to assign staff responsibilities, fill in procedural details and set up the processes that will make the program work as it should. You should also provide ways to monitor the program to make sure it adapts to changing economic and business conditions. If you already have a solid credit program that you use with your domestic customers, much of what you need will already exist and can likely be adapted to the circumstances of your overseas business. As mentioned above, specialized staff training should be part of this development.

While the details of the credit management process vary from company to company, most programs are based on some variation of the following steps:

1. Collect basic information about the customer

   You’ll need basic data about a prospective customer before you can decide how flexible your terms can be. Your standard credit application should ask the company for the following information:

   - Corporate data, including the company’s legal and trade names (getting the exact legal name is vital), its head office address and the contact information for the person(s) responsible for purchasing and payment.

   - Basic bank information, including the legal name of the company’s bank, the company’s account manager at the bank, its borrowing capacity with the bank and its current credit balance.

   - The names and contact information of at least three businesses that have extended credit to the company, together with the credit limits provided by these businesses and the dates of the company’s most recent transactions with them.

2. Check the customer's credit history and establish credit limits

Next, use the information from the credit application to dig farther into the company's credit and payment record. Unearthing this kind of information about foreign companies can be difficult, especially in emerging markets. But making the effort can pay off in better protection for your cash flow. To do this, you should:

- Contact the suppliers listed on the company's credit application. Ask each supplier to verify the company's credit limits and its balances, and request a rundown of its payment record. Try to get the information in writing.
- Talk to the prospective customer's bank to find out how long the company has been banking there and how closely it works with the bank. Ask the bank to verify the company's credit capacity, how much of this capacity it regularly uses and what kinds of credit instruments it can access.
- If you can, obtain the company's financial statements. These should be less than a year old. Audited statements are more reliable than unaudited ones, and can provide a good view of the business's liquidity, profitability and cash flow. If you can get an overall picture of the firm's accounts payable turnover, this will suggest how quickly you'll get paid. It will also help you assess the company's long-term reliability.
- If it seems appropriate, have a credit agency provide you with comprehensive reports on a company's past creditworthiness and its financial and payment history.
- Use the information you've collected to decide whether the customer will be an acceptable credit risk, and to establish the credit limits for the customer. A good rule of thumb, when deciding on a limit, is to keep to the lower end of the amounts extended by the other suppliers. You can always increase this if the customer proves to be reliable.

3. Build customer relationships

Your number-one tool for managing a customer's credit risk is building a long-term, trusted relationship. You can start laying the groundwork by discussing your credit terms with the customer at the time of the first sale. This will help you gauge the customer's attitudes to credit and ensure that they clearly understand what you expect of them.

4. Establish clear credit and payment terms in your sales agreements

A sales agreement that includes a clear, comprehensive description of the terms of credit and payment will minimize the risk of disputes and improve your chances of getting paid in full and on time. Having all the conditions fully documented in the agreement is vital, especially if the customer fails to pay.

5. Regularly update your customers' credit standing

A customer's creditworthiness can change over time, so you should establish a monitoring routine for keeping your credit information up to date. In addition, you should review a customer's credit file if:

- The company asks for an increase in its credit limit.
- The company asks for a major change to its usual payment terms.
- It has been more than a year since the company has made a purchase from you.
- The structure, management or ownership of the company changes.
- You spot red flags such as a change in payment habits over time.

6. Use a standard process for handling overdue accounts

Your chances of collecting on a delinquent account are highest in the first 90 days after the due date. Be sure you have an established routine for dealing with late accounts, so you can start the collection process as soon as you know there's a problem.

"While selling to international customers is a good growth strategy for many small and medium-sized businesses," says Khadaroo, "you always need to be aware of the risks involved as well as the opportunities. But if you have a good credit policy and a good credit management program, and do everything you can to assess the customer's creditworthiness before making the sale, then balancing your competitiveness versus your risk will definitely become easier."

For more information, please visit **edc.ca**

Ce document est également disponible en français.

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