METHODS OF PAYMENT

Several basic methods of securing payment are available, that can be used in international trade to receive overseas payments for products sold into the export market. A major factor that determines the method of payment to be used, is the financial standing of the export customer and the level of trust in his ability and willingness to pay. Determining the right payment option is, therefore, dependent upon this and several other factors. Listed below and ranked in order from most secure for the Producer/Exporter to least secure, are the basic (most commonly used) methods of payments:-

1. Cash in advance.
2. Letter of credit.
3. Documentary collection or draft. (Bill of exchange or Promissory Note)
4. Open account.
5. Other payment mechanisms, e.g. such as consignment sales.

Details on the above payment options are provided in the section below. Suffice to say, getting paid in full and on time should be of paramount concern to local Producers/Exporters. In all export transactions risk is a major consideration which needs to be minimised in all business dealings. There are many factors that make exporting riskier than domestic sales; however, there are also several methods of reducing risks, especially in relation to payments. One of the most important factors in reducing risks is to know what risks exist not just at a financial level, but also in relation to commercial and technical aspects of the export business.

Payment Mechanisms

A. Cash in Advance

Cash in advance before shipment, is probably the most desirable method of all. In this case the Producer/Exporter is relieved of collection problems and has immediate use of the money if a telegraphic transfer (TT) is used. Payments by cheque, even before shipment, may result in a collection delay of four to six weeks and, therefore, frustrate the original intention of receiving payment before shipment has been undertaken. While this method of payment provides early

positive cashflow for the Producer/Exporter, however, conversely advance payment could create cashflow problems for the export customer and increases his level of risk. Generally, cash in advance lacks competitiveness and could, in some circumstances, indicate to the customer that there is a lack of trust on the part of the Producer/Exporter. It is also possible that the export customer may refuse to pay until such time as he has received the products ordered from the company.

B. Letters of Credit & Drafts

Letters of credit (L/C) and drafts are used in cases where export customers are concerned that their product order may not be sent if the payment is made on a cash in advance basis. This payment mechanism protects the interests of both Producer/Exporter and his export customer. Under this method of payment, documents are required to be presented to a nominated and agreed bank in the (confirming bank), before payment is made. Both L/C and documentary drafts may be paid immediately, at sight, or at a later date. Drafts that are to be paid when presented for payment are called sight drafts. Normally, the Producer/Exporter expects the export customer to pay the charges for the L/C or documentary draft, but it is possible that some customers may not accept terms that require this added cost. In such cases the company must either absorb the L/C/draft costs or possibly lose the potential sale. Since payment under these two methods is made on the basis of documents, all terms of sale should be clearly specified and agreed to avoid confusion and delay in payment. In the same manner, the currency of payment should also be specified - if payment is to be made in Saudi Rials or U.S. dollars. International banks can often offer other suggestions if terms cannot be agreed between the two parties to the sales contract.

Essentially, the company is usually not paid until the advising or confirming bank (KSA bank that pays the local company) receives the funds from the issuing bank (customer's bank in his home country). It may be possible for the Producers/Exporter to be able to receive his funds earlier by discounting the L/C through a bank this involves paying a fee to the bank for this service. To undertake this type of transaction, banks (both issuing and confirming banks) will charge a fee for handling letters of credit and drafts (usually a small percentage of the total amount of payment). If fees for both the foreign and local banks collection services are to be charged to the account of the Producer/Exporter (or the export customer), then this point should be explicitly stated in the company's quotation/pro-forma, and eventually in any documentary L/C.s or drafts that will be raised. In essence, a L/C adds a bank's promise to pay the Producer/Exporter (on behalf of the export customer) when the company has complied with all the agreed terms and conditions of the L/C that has been raised. Payment under a documentary L/C is based on the presentation of specifically agreed documents to the bank, and not on the Producer/Exporters terms and condition of sale for the products sold. Therefore, before any payment is made, the bank responsible for making the payment verifies that all the presented documents are exactly as required by the terms of the L/C. When they are not as required, a discrepancy exists, which must be corrected before the payment can be made. The banks role in corroborating documentary requirements is a mechanism which is mandatory to ensure the full compliance of submitted documents with those specified in the L/C. A L/C may be either **irrevocable** (this signifies that it cannot be changed unless both the Producer/Exporter and the export customer agree to make the change) or **revocable** (meaning that either concerned party may unilaterally make changes, without seeking approval from the other). A **revocable** L/C is inadvisable as changes can be made to it without first agreeing them with the company. Additionally, the L/C may be at sight, which means immediate payment upon presentation of documents to the confirming bank, or it may be a time or date L/C with payment to be made at a specified date/time in the future.

Any changes made to a L/C after it has been issued is called an amendment this may arise, for example, if the Producer/Exporter is delayed, for some reason, in presenting the L/C documents to the bank or if the customer wishes to change his purchase order. The fees charged by the banks involved in amending the L/C may be paid by either the KSA company or the export customer - but who is to pay particular charges should be specified in the original L/C. Since changes can be time-consuming and expensive, every effort should be made to ensure that the L/C is correctly issued the first time.

C. Drafts or Bill of Exchange

A draft, sometimes also called a bill of exchange, is similar to receiving the export customer's cheque, issued by a bank in his country (i.e. receiving a cheque from a foreign bank). Like all cheques, drafts sometimes carry the risk that they may not be honoured by the bank. E.g. Due to lack of funds in the customer's account.

D. Sight Drafts

A sight draft is used when the seller wishes to retain title to the shipment until it reaches its destination and is then paid for by the customer. In this case, before the product shipment can be released, the original ocean bill of lading must be properly endorsed by the export customer and surrendered to the shipping carrier, since it is a document that evidences title. Air waybills (AWB) of lading, on the other hand, do not need to be presented in order for the export customer to claim the goods. For this reason, there is a greater risk when a sight draft is being used with an air shipment. In actual practice, the bill of lading or an AWB is endorsed by the shipper and sent via the shipper's bank to the export customer's bank or to another intermediary along with a sight draft, invoices, and other supporting documents specified by either the customer or required by his country's trade regulations (e.g., packing lists, consular invoices, insurance certificates, etc.). In this case, the bank notifies the customer when it has received these documents, and as soon as the amount of the draft is paid, the bank releases the bill of lading, enabling the export customer to obtain the product shipment.
When a sight draft is being used to control the transfer of title of a product shipment, some risk remains because the customer's ability or willingness to pay may change between the times the goods are shipped and the time the drafts are presented for payment. Also, the policies of the importing country may change. If the customer cannot or will not pay for and claim the shipped products, then returning or disposing of them becomes the problem of the local Producer/Exporter.
In this respect, Producers/Exporters should also consider which foreign bank should negotiate the sight draft for payment. If the negotiating bank is also the customer's bank, the bank may favor its customer's position, thereby putting the company at a disadvantage. For this reason Producers/Exporters should consult their local international bankers to determine an appropriate strategy for negotiating drafts.

E. Time & Date Drafts
If the Producer/Exporter wishes to extend credit to his customer, a time draft can be used to stipulate that the payment is due within a certain time after the customer accepts the draft and receives the goods. E.g. 60 days after acceptance. By signing and writing accepted on the draft, the customer is formally obligated to pay within the stated time agreed. When this is done the draft is called a trade acceptance and can be either kept by the Producer/Exporter until the maturity date, or sold to a bank at a discount for immediate payment. A date draft differs slightly from a .time draft. in that it specifies a date on which payment is due (e.g. December 30, 2004), rather than a time period after the draft is accepted. It should be noted that when a sight draft or time draft is used, the export customer can delay payment by delaying acceptance of the draft. A date draft can prevent this delay in payment but still must be accepted by the customer. When a bank accepts a draft, it becomes an obligation of the bank and a negotiable investment known as a banker's acceptance is created. A banker's acceptance can also be sold to a bank at a discount for immediate payment.

F. Open Account

In a foreign sales transaction, an open account is a convenient method of payment and may be satisfactory if the export customer is well established, has demonstrated a long and favourable payment record, and/or has been thoroughly checked for creditworthiness. Under an open account, the Producer/Exporter invoices his export customer, who is expected to pay, under agreed terms and within a specified and agreed timeframe in the future. Open account sales do, however, pose some levels of risk, since the absence of documents and banking channels may make legal enforcement of claims difficult to pursue. In this situation, the company may have to pursue collection of payment abroad, which can be difficult and costly. Before issuing a quotation/pro-forma invoice to an export customer, any company considering an export sale on an open account basis, should thoroughly examine the political, economic, and commercial risks and consult with their bankers if financing is needed to undertake the transaction.

G. Other Payment Options

There are a number of other export payment methods that are used less often, but they could be utilised by the Producer/Exporter in certain specific circumstance. However, in all cases the levels of risk should be assessed before agreeing on a specific mechanism. Details on these other payment options are provided below:-

1. Consignment Sales

In international consignment sales, the product is shipped to a foreign distributor to be sold on behalf of the local company. The Producer/Exporter retains title to the products until such time that they are sold by the distributor. Once the products are sold, payment is sent to the company by the distributor. With this method of payment, the Producer/Exporter has the greatest risk and least control over his products and it is possible that he may have to wait quite a while to obtain payment from the distributor. When this type of sale is contemplated, it may be wise to consider some form of risk insurance. In addition, it may also be necessary to conduct a credit check on the foreign distributor. For further security for the company, the contract between the two parties should establish who is responsible for property risk insurance covering the products until they are sold and payment for them is received by the Producer/Exporter.

2. Foreign Currency

One of the worries relating to exporting is the uncertainty of the future exchange rates between currencies. The relative value between the Saudi Rial and the export customer's currency may change between the time the sales contract is made and the time payment is received for it. If the Producer/Exporter is not properly protected, a devaluation in the foreign currency could cause him to lose money in the business deal. One of the simplest ways for a KSA company to avoid this type of risk is to quote prices and require payment in either Saudi Rials or in US Dollars (as both the currencies are .pegged. to each other). Then the burden and risk of currency exchange is placed on the export customer to arrange the currency conversion. In some countries, the Producers/Exporters should also be aware of the problems relating to currency convertibility, as not all currencies are freely, easily or quickly convertible, due to government regulations in that country. In the event that the export customer requests to make payment in a foreign currency, the company should consult its international banker before negotiating the final sales contract. Banks can offer advice on the foreign exchange risks that exist and how to mitigate against them. Additionally, some international banks can also help the Producer/Exporter to hedge against such a risk if necessary, by agreeing to purchase the foreign currency at a fixed price regardless of the value of the currency when the customer pays. For this service the bank charges a fee or discount on the transaction. If this payment option is used, then the fee should be included in the Producer/Exporters price quotation/pro-forma invoice.

3. Counter Trade & Barter

Counter trade can be a risky venture and should be undertaken only when the Producer/Exporter has a clear understanding of the obligations and risks involved. In essence, counter trade is a trading mechanism by which a Producer/Exporter (to generate sales) contractually commits to undertaking agreed and specified initiatives that compensate and benefit another party - as a condition of sales. The resulting linked trade fulfils certain specific financial, commercial and/or policy objectives of both the trading parties. Many Producers/Exporters consider counter trade a necessary cost of doing business in markets where exports would otherwise not be possible due to some level of financial problems in the target market, such as the potential export customer and/or the importing country is lacking foreign exchange or does not readily have availability to funds , or some similar/related problem. In these circumstances, the Producers/Exporters can take advantage of counter trade opportunities by trading through an intermediary with counter trade expertise i.e. an international broker, an international bank, or an export management company (some export management companies offer specialised counter trade services). Ultimately before taking on counter trade commitments, the company should bear in mind that counter trade often involves higher transaction costs and greater risks than just simple export transactions. In its simplest form, a barter transaction is the direct exchange of goods or services between two parties , where no money changes hands. Pure barter arrangements in international trade are rare. The main reason for this is because one trading party's needs for the goods of the other party seldom coincide. The other important factor is that the need for the two participating parties to agree on the financial valuation of the goods to be purchased - which may pose problems. For this reason the most common form of compensatory trade practiced today involves contractually linked, parallel trade transactions each of which involves a separate financial settlement. To ensure a profitable conclusion to such trade, it is imperative to have a reliable third party who is a specialist in the product sector(s) and who can act as both a buying and selling intermediary in the parallel transactions.

4. Credit Cards

Many Producers/Exporters of consumer and other products (generally of low value) that are sold directly to the end-user accept Visa, or MasterCard, or another known credit card in payment for export sales. International credit card transactions are typically placed by telephone or fax or over the internet - methods that can facilitate fraudulent transactions. In all cases the Producer/Exporter should determine the validity of transactions and obtain proper credit authorisations from the card issuing authority before shipping the concerned products.

Disclaimer:

This content has been compiled from various sources from internet. The purpose of this document is to give knowledge of various Commodities to the user.