Chapter 5

FINANCING

When negotiating a sales contract, it is important to weigh the risks inherent in the method of payment sought by the importer. Importers naturally ask for the terms most favourable to them and prefer a method of payment whereby their bank credit line is least affected. You, the exporter, want the least risk in collecting your money and want to obtain payment as quickly as possible, since your firm's cash flow depends on it. Hence, there is a conflict over financing, which must be resolved tactfully during negotiation of the contract.

First, it is of prime importance that there be a contract between buyer and seller. Depending on the particular circumstances, the custom in any particular set of circumstances and the custom in any particular trade, this contract may or may not be a very formal one. More commonly, the contract is executed by the submission of a pro forma invoice by the seller and its acceptance by the buyer.

Whatever format the contract takes, it should contain sufficient data to avoid misunderstanding or dispute regarding quantity, quality, size, colour or other characteristics of the goods. It should also state the unit price, relative trade term applicable, time of shipment and term or method of payment. The importance of this contract cannot be exaggerated. The seller has no legal recourse without it.

Export transactions are documented to assure the seller of payment and the buyer of the merchandise. The documentation provides:

1. protection from non-performance by either side;
2. transaction financing; and
3. protection from foreign exchange risk.

1. Protection from Non-Performance

Because the buyer and seller likely have limited knowledge about each other, there will necessarily be concerns over performance.

The risk of non-preformance can be largely reduced by the use of three key documents: the bill of lading, the draft and the letter of credit. The bill of lading is a receipt from the carrier of the goods, being both a contract to transport the goods and a document of title. The draft is an order written by an exporter requesting an importer to pay a specified amount at a stipulated time. The letter of credit is an instrument, issued by an importer's bank, in which the bank promises to pay the exporter on presentation of the documents specified in the letter of credit. Drafts and letters of credit are examined in more detail in the next chapter.

2. Transaction Financing

The time between order placement and payment is longer for exporting than for domestic marketing. Cost escalation, risk of non-performance and exchange rate fluctuations can all add to the cost of exporting. For these reasons, the role of banks in financing export sales is even more crucial than in domestic sales. The bill of lading, drafts and letters of credit allow the banks to engage in financing export transactions by working with the documents rather than with the goods.

3. Protection from Exchange Rate Fluctuation

If payment is in the importer's currency, the exporter can lose greatly through fluctuations in the value of that currency. Similarly, if the exporter's currency is used, the importer stands to lose. To avoid the risk, parties involved in international trade will often "hedge" or "cover" their exposed position in the foreign exchange market.

In hedging, the exporter who is expecting future payment in a foreign currency can arrange for payment at a specified future date with the current rate. This covers the exporter's open position with foreign currency and eliminates the risk of loss due to currency fluctuations. Documents detailing the transaction and date of payment are needed for this operation.