WHITE PAPER

Credit Management for Exporters

Many analysts believe that the global economy is entering a period of strong new growth. This is very promising for Canadian companies that are considering their first ventures into international trade or are already doing business abroad. In foreign markets, however, the risk of not getting paid is higher than it is at home, and companies need to allow for this when operating outside Canada. This white paper will help you understand how sound credit management can reduce your non-payment risk when you're dealing with international customers.

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INTRODUCTION

The great majority of your international customers will expect some form of credit as a condition of doing business with you, and you'll have to provide it if you want to remain competitive. That said, you'll need a carefully balanced credit policy that will protect your bottom line while satisfying your overseas customers. If your credit terms are too stringent, potential customers may look elsewhere for their suppliers. Conversely, offering very lenient terms may bring you more foreign sales, but it will also increase your risks of non-payment or late payment.

Not surprisingly, the most common reason for non-payment in foreign transactions is that the customer is in financial difficulties. Other, less frequent reasons include problems such as a customer alleging that the received goods are substandard, or simply refusing to accept a shipment at all. There are also hazards that are peculiar to international trade: restrictions imposed by a foreign government on currency exchange, for example, can delay a payment for months or even prevent it entirely.

BASIC STEPS IN INTERNATIONAL CREDIT MANAGEMENT

Regardless of the reason for non-payment, the bottom line is that you don't get your cash, or you get it far later than you expected. Added to this is the unpleasant fact that it's a lot harder to collect on a foreign debt than a domestic one. This is why good credit management should be built right into your international operations—it helps you protect your cash flow and profit margins, reduces your bad debts and keeps your company strong. Here are six basic credit management steps that will help you achieve these goals.

1. Collect basic information about the customer

You'll need basic data about a prospective customer before you can decide whether to extend credit to the company and how lenient 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. Thoroughly check the customer's credit history and establish credit limits

Next, you use the information from the credit application to dig farther into the company's credit and payment record. Unfortunately, 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 foreign receivables.

- 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. Again, it's best to get this information in writing.
- 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.

- Credit agencies can provide you with comprehensive reports on a company's past creditworthiness and its financial and payment history.
- Obtaining information about the political and economic conditions of a prospective customer's market can also be important, since these may affect the customer's ability to pay. Consulting EDC can be useful, since it has on-the-ground representatives in key foreign markets who are knowledgeable about local conditions. The **overseas offices** of the Canadian Trade Commissioner Service may also be able to help in this regard.
- 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 raise this if the customer proves to be reliable.

3. **Use that first sale to start building the customer relationship**
   Your number-one tool for managing a customer's credit risk is building a long-term, trusted relationship. This, obviously, can take years to achieve. But you can start laying the groundwork by discussing your credit terms with a new customer before you extend credit. This will help you gauge the customer's attitudes to credit and ensure that they clearly understand what you expect of them. Also consider using a "master sales agreement" with a new customer, rather than relying on purchase orders to set out credit terms.

4. **Make sure the credit and payment terms of your sales agreements are clear**
   A sales agreement that includes well-worded, comprehensive terms of credit and payment will minimize the risk of disputes and improve your chances of getting paid in full and on time. The following are three of the most common approaches.

   - The most secure form of payment—for you, the vendor—is full or partial **payment in advance**. In effect, you're refusing to extend any credit at all, so your customer must finance the purchase up front from whatever company resources it can muster. Moreover, the customer has no guarantee that you'll deliver the goods as promised. For the foreign company, consequently, payment in advance is the least desirable method of making a purchase. If you insist on it, you may lose the sale.
   - **Letters of credit** (LCs) are widely used to make payments in international transactions. Essentially, an LC is a letter from a bank guaranteeing that you will receive your customer's payment on time. If the customer can't pay you, the bank does. The bank also protects your customer by ensuring that you don't get paid until the shipment of your goods is confirmed. Using an LC is thus relatively secure for both you and your customer. Setting up an LC costs money, however, and your customer must be willing to foot the bill (unless you are).
   - With **open account** terms, you ship the goods to your customer and allow the customer to pay within 30 to 180 days of either shipment or receipt of the goods. This is ideal for your customer, but it is also the riskiest form of payment for you,

since you're effectively extending unsecured credit to your customer for the length of the payment term. However, if making the sale depends on offering open account terms, you may be able to protect yourself and close the deal at the same time by using receivables insurance or factoring, as described later.

5. Update regularly

A customer's creditworthiness can change over time, so you should establish a 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. Develop 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. If you have an established routine for dealing with late accounts, you can start the collection process as soon as you know there's a problem.

USING RECEIVABLES INSURANCE AND FACTORING

A well-designed credit management system will go a long way toward protecting your receivables and your cash flow. With some customers and in some markets, though, you may still feel more exposed to payment risk than you can comfortably accept. If you're in this situation, using receivables insurance or factoring can give you the extra layer of protection you need.

- **Receivables insurance** is very flexible in the types of risk it can cover, and will typically insure up to 90 per cent of your losses if a customer defaults. EDC, for example, offers a full suite of **insurance products** that can protect against non-payment resulting from contract cancellation, breach of contract, expropriation, currency restrictions, political violence and much more. The **Receivables Insurance Association** of Canada provides further useful information about insuring your company against non-payment.

  Insuring your receivables has several advantages. Most important, it guarantees that you'll get paid even if your customer defaults. But it also insures your payment risk, which means you can offer better credit terms (such as open account) to prospective customers. This can help you become more competitive, make more sales and grow your company faster. And when your bank knows you're insured against non-payment, it may have the confidence to increase your borrowing capacity so you can take on even more business.

- **Factoring** eliminates your dependence on your customer's ability to pay. To use it, you sell your receivable to a factoring company for the receivable's cash value, minus a discount. The factoring company pays you immediately, and the customer will eventually pay the factoring company instead of you.

  The advantage of factoring is that you get your cash (except for the discount) without waiting out the payment term of the sales contract. This can make a big difference to your cash flow if the term is up to 180 days, which isn't uncommon in international transactions. If you use factoring, though, make sure it's on a "non-recourse" basis. This means you don't have to pay the factoring company if the customer defaults.

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