Principles of Business Credit

Eighth Edition

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PART V

FINANCING AND PAYMENT

Chapter 14: International Trade

Chapter 15: Financing and Business Insurance

Chapter 16: Negotiable Instruments

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14 International Trade

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- Country risk analysis versus international customer credit decisions.
- Common problems for the exporter.
- Different methods of international payment.
- Letters of credit.
- Commercial invoice.
- Sight drafts.
- Dated drafts.
- Incoterms®.
- The role of the freight forwarder.
- Credit insurance.
- Factoring and forfaiting.
- Bankers acceptances.
- Foreign exchange.

CHAPTER OUTLINE

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Questions for Discussion

THINK ABOUT THIS

Q. What factors must be considered while conducting business internationally versus domestically?

Q. What payment methods are used for international transactions and why?

Q. When does risk completely pass from seller to buyer, and what tools can be used to mitigate the risk of selling internationally?

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International Credit Decisions

- Country Credit Risk Factors
  - Political
  - Economic
  - Legal
  - Cultural
  - Geographical
  - Financial
- Foreign Exchange
- Customer Risk
- Export and Customer Compliance

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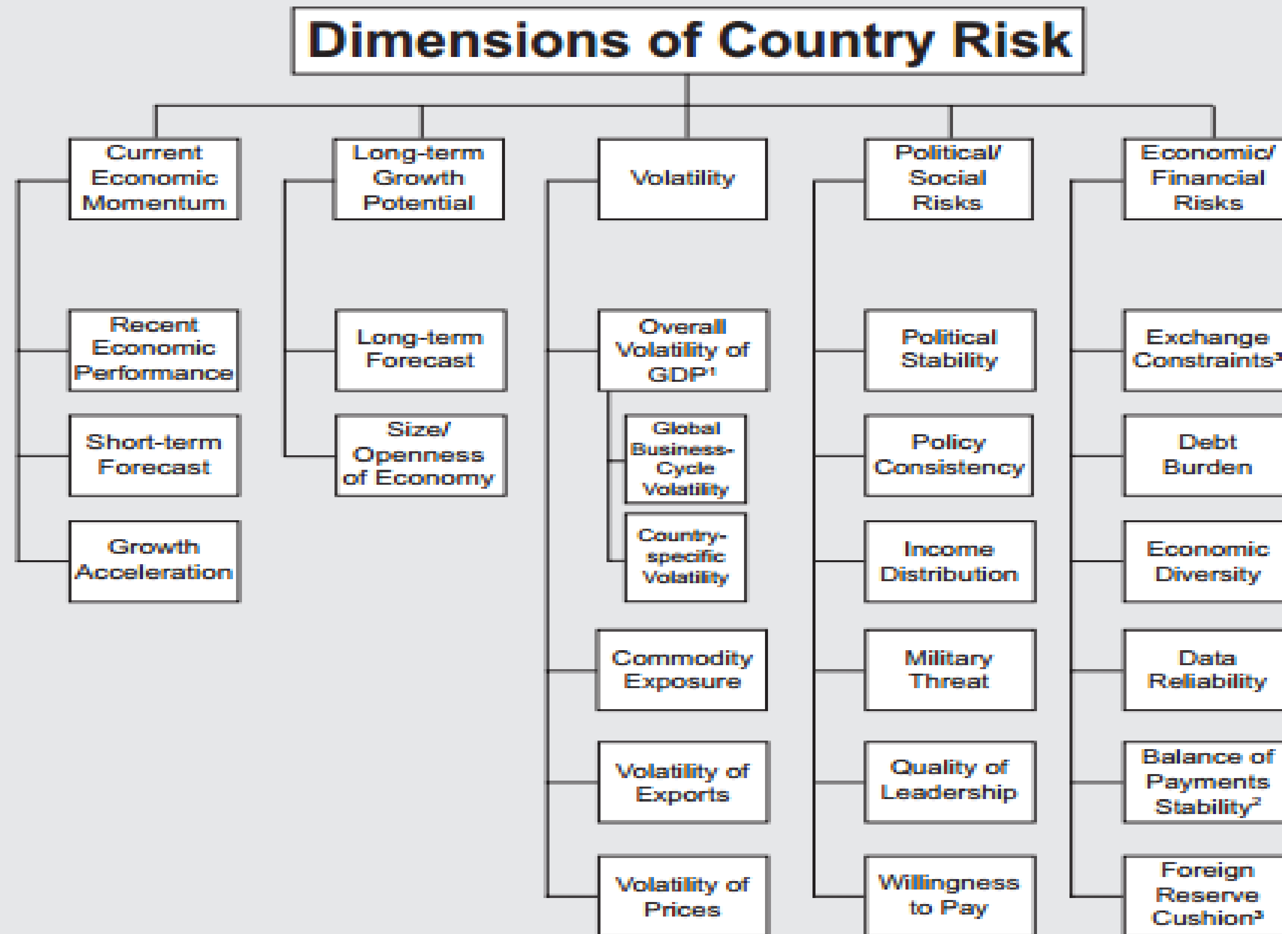
Figure 14-1 Dimensions of Country Risk



[1] **Gross national product (GNP)** *is the total of ALL economic activity in a given country, regardless of who owns the productive assets and, therefore, includes everything produced in the country by both domestic and foreign ownership.*

[2] The **balance of payments (BOP)** *is a simple accounting record of international flows.* Financial inflows, such as receipts for exports or foreign investments in a domestic stock market, are recorded as credits or positive entries. Financial outflows, such as payments for imports or purchase of shares in a foreign stock market, are debits or negative entries. The current account covers trade in goods and services, **RIPDs** *(rents, interest, profits and dividends)* and transfers.

By definition, debits must equal credits so the net BOP must equal zero. Any references to deficits or surpluses reflect imbalances in individual accounts.

[3] *See* currency convertibility under Foreign Exchange section in this chapter.

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RWP 14-1

Real World Perspectives

GET ON THE PLANE, GET CREDIT 'STREET SMART'

As credit professionals, we like to think of ourselves as being street smart. We're not just somebody behind a desk saying, "Here's your limit; here's what to do." We deal with difficult situations and how to resolve them.

When dealing with foreign countries, sometimes using our street smarts can be more difficult. Their cultures and pressures differ. One of the best ways to address this problem is through travel. Visit the country. Talk to your customers. Talk to their customers, if possible. Learn about the problems that they face. This gives you an authentic, more complete view of what's happening in the country. Having sound street smarts about a country is very important. Otherwise, people will try to take advantage of you if you don't understand the places where you conduct business.

I went to Argentina in February to become educated about the pressures our gaming customers were feeling. We talked about how the government limits how much currency can be sent out of the country in any given month. The company may have the cash, but the government sets a cap. If it pays 80% of it to you, then how does it pay their other creditors? The customer has no control over the monthly amount allowed.

Companies, however, feel the most pressure from something I never would have considered, and it is not something you're going to learn by reading a mainstream newspaper: the soybean crop. It's one of Argentina's major exports. A good crop will free up cash in the country dramatically. Governments will have more to spend. Companies will have ready cash. Employees will have steady work and, thus, cash to spend in places like casinos.

The conversation doesn't always have to be about the debt they owe. Ask them about what they do and how they feel. Because I sat down with customers on the ground, I'm certain this will pay dividends the next time I do a deal with a business there. It already helped my company adjust our expectations. I can perform my job better when working within that country by knowing what I can do, what kind of terms I should be setting and when they're likely to make payments. Upper management was receptive to all of this information. Perhaps, it helped that I came back with a multi-million-dollar payment.

Darrell Horton, CICP, Director of Credit and Accounts Receivable, Aristocrat Technologies Inc.

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International Methods of Payment

- Cash-in-Advance
  - Cash With Order (CWO)
  - Cash Before Delivery (CBD)
- Consignment
- Open Account
- Letters of Credit

Comprehension Check

Define **country credit risk** and list resources that can be used to analyze the risk.

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Letters of Credit

A written understanding by a bank acting at the request of its customer to:

- Make payment to a third party
- Accept and pay bills of exchange
- Authorize another bank to pay bills of exchange

Contents of a letter of credit:

- Expiry date
- Name of the seller
- Name of the buyer.
- Amount of the credit
- Tenor of the draft
- General description of the merchandise
- Shipping terms
- Documents required

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Types of Letter of Credit

- Standby Letter of Credit
- Commercial Letter of Credit
- Confirmed Irrevocable Documentary Letter of Credit
- Irrevocable Documentary Letter of Credit
- Documentary Letter of Credit
- Revocable Letter of Credit

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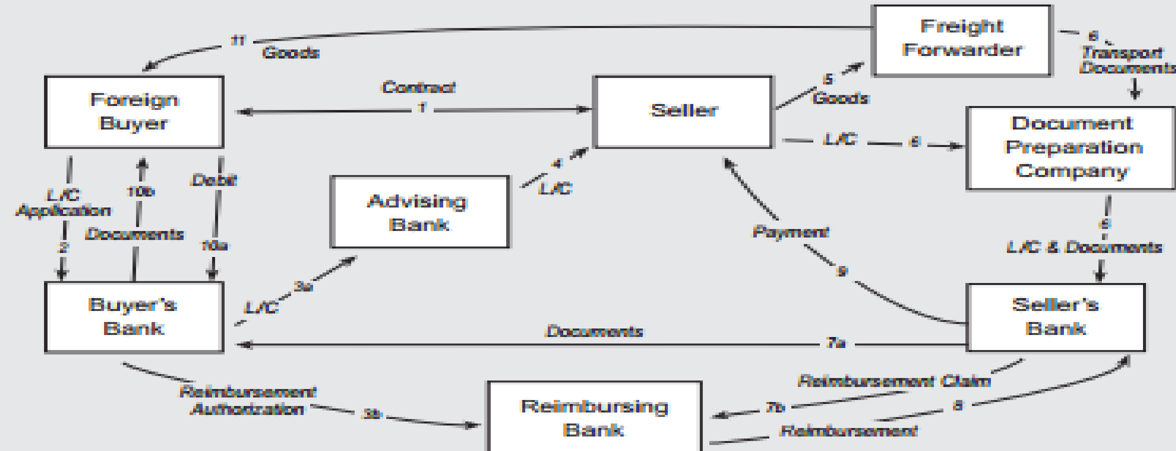
Figure 14-3 **Letter of Credit Cycle**

Although the letter of credit cycle appears quite complex at first, it is not difficult to understand. This cycle merely involves the exchange of documents for money through intermediaries.



Step 1: The buyer agrees to purchase goods from the seller using a letter of credit as the mechanism of payment.

Step 2: The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.

Step 3a: After approving the application, the issuing bank issues the actual letter of credit instrument and forwards it to their chosen advising bank.

Step 3b: At the time the L/C is sent, the issuing bank also sends a reimbursement authorization to their chosen reimbursing bank. This bank is the clearing bank the issuing bank uses when making payments in the currency of the L/C and will play a role when the time comes to pay the L/C.

Step 4: The advising bank authenticates the letter of credit and delivers it to the beneficiary (the seller). If the issuing bank has requested them to do so, the advising bank may add its confirmation to the L/C (and thereby become the confirming bank).

Step 5: Having received the issuing bank's assurance of payment (and that of the confirming bank if the L/C has been confirmed), the seller entrusts the goods to a freight forwarder, who arranges to ship the merchandise to the buyer.

Step 6: The seller, the freight forwarder, and/or a document preparation company prepares the documents called for in the letter of credit and presents them to the "nominated bank." The L/C may nominate a specific bank where documents are to be presented or it may say it is "available with any bank," giving the seller the freedom to choose where to present documents. If the L/C has been confirmed, documents must be presented to the confirming bank.

Steps 7a and b: The nominated bank examines the documents and, if they comply, obtains funds for payment to the beneficiary in accordance with the terms of the letter of credit, generally by sending the documents to the issuing bank and a reimbursement claim to the reimbursing bank named in the credit.

Step 8: The reimbursing bank matches the nominated bank's claim against the reimbursement authorizations they are holding, charges the issuing bank's account and transfers funds to the nominated bank.

Step 9: The nominated bank transfers payment to the beneficiary (seller).

Steps 10a and b: The issuing bank examines the documents. If it agrees with the nominated bank that the documents comply with the letter of credit, the issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.

Step 11: The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

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Special L/C Arrangements

- Transferability
- Assignment of Proceeds
- Back-to-Back
- Red Clause
- Installment Credit
- Revolving
- Deferred Payment

Comprehension Check

Discuss the purpose of **letters of credit** and list the types available.

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Discrepancies

All documents under a letter of credit must comply with the L/C's terms and conditions before payment/acceptance can be made. Surveys of banks in major money centers reveal that approximately half of all drawings presented contain one or more discrepancies.

When the documents presented do not conform to the terms of the L/C, the exporter has the following options:

- To ask the negotiating/paying bank to return the documents for corrections and then resubmit the documents.
- To request that the negotiating/paying bank contact the issuing bank for permission to negotiate/pay or accept despite discrepancies.
- To instruct the negotiating/paying bank to forward the documents to the issuing bank on approval, that is, for honor under the L/C.
- To request that the negotiating/paying bank honor the drawing under reserve or against a guarantee.
- Etc.

It is important to examine all the documents for compliance with terms and conditions of the credit, such as:

- Spelling, such as company name, bank or address does not agree with spelling of required letter. All names and addresses, applicant, beneficiary and bank details must match. Shipment documents are not the place to correct misspelled names and addresses.
- The bill of lading indicates damage or states goods or packaging are defective in some manner.
- Bills of lading dated after the latest shipment date; credit will have either an explicit or an implicit latest shipment date.

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Discrepancies: ***Items of Consideration***

There are also other key items to consider in international trade, such as:

- A **green clause** *is very similar to a red clause in that it also allows the drawing of a clean draft, but it requires that the merchandise be stored by the paying bank until all documents are received.*
- A **telegraphic transfer clause** *speeds payments when the receiver of funds is not located in a financial center.* An **evergreen clause** *provides a periodic expiry date with an automatic extension and usually states one final date.*
- A **bill of lading (transport document)** *is issued by a carrier and serves as a receipt for the goods and as a contract to deliver the goods to a designated party or to its order.*
- *The person shipping the goods is the* **shipper** *or* **consigner.** *The company or agent transporting the goods is the* **carrier,** *and the party to whom the goods are destined is the* **consignee.**

Comprehension Check

What are the types of international methods of payment?

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Documentary Collections

- Commercial invoice
- Drafts
  - Sight Draft/Bill of Lading
  - Cash against Documents
  - Dated Draft/Documents against Acceptance

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International Shipping Terms

Incoterms® are a set of internationally recognized trading rules created by the International Chamber of Commerce (ICC).

Incoterms® establish where the passage of risk passes between the buyer and seller.

Incoterms® define the seller's obligation within an international sales contract to complete delivery. Incoterms®:

- Identify the physical point in the supply chain where the risk of loss or damage shifts from the seller to the buyer.
- Define the physical point the responsibility for all transportation, customs clearance, duties and related charges shift from the seller to the buyer; and
- The responsibility between the seller and the buyer to complete delivery obligations; under Incoterms®, delivery means transfer of risk.

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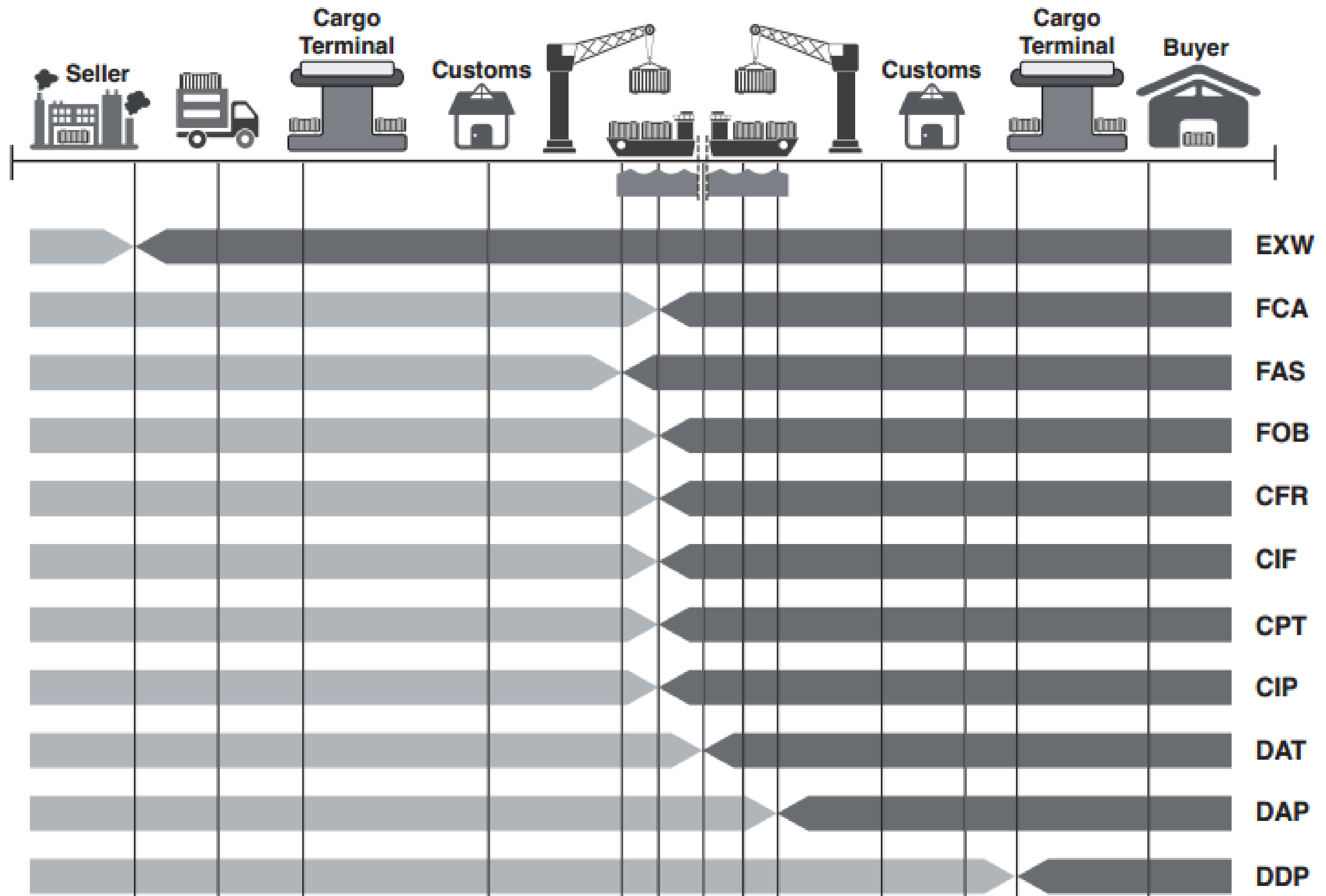

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Other Considerations

Freight Forwarders

Examples of services forwarders provide:

- Letter of credit documentation preparation.
- Air freight or ocean freight service.
- Consolidation service.
- Inland transportation service.
- Customs clearance handling.
- Warehousing and distribution service.
- Packing and crating service.

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Mitigating Risk with Trade Financing Options

- Credit Insurance
  - **Multi-Buyer Comprehensive Insurance**
  - **Country Limit (Multi-Buyer) Insurance**
  - **Political Risk (Multi-Buyer) Insurance**
- Factoring
- Forfaiting
  - Major Advantages
    - **Volume**
    - **Speed**
    - **Simplicity**
- Ex-Im Bank

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Collection Techniques

- Role of the Banking System
  - Banker's Acceptances
  - Discount Eligibility
- Foreign Exchange
- Rules Governing Collections
- Collecting Overdue Accounts

Comprehension Check
Explain how credit insurance can be used to mitigate credit risk in international transactions.

Comprehension Check
What is a **factor** and how can it be used in transacting international sales?

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Real World Perspectives

RWP 14-2

SHOW ME THE MONEY?

Several years ago, I worked in the credit department of an outdoor power equipment manufacturer. Our customer base ranged from Mom and Pop fix it shops to international distributors. There was one distributor I will never forget.

The gentleman, who we will call Rafael, was having difficulty paying his bills on time. It didn't take long before his credit limit was removed and prepayment was required for all orders. In order to get his first prepaid order, Rafael had to bring his account current. It was obvious that the distributorship was struggling when he had to give me two different credit cards (his and his brother's) to cover the low four figure balance. But payment was received so the parts shipped as promised.

Then one day, I received an email from Rafael stating that he would be in town to pick up his parts order in person. He wanted to be sure I would be there to take his prepayment. Did I mention that Rafael was the owner of an outdoor power equipment distributorship in Brazil? I emailed him back to verify that I would be in the office. In my email, I questioned the fact that he was really coming to pick up the parts himself since the order consisted of several thousand dollars worth of parts and accessories. In his reply, he explained that it was less expensive for him to fly to the United States and coordinate purchases from several suppliers into one container load for shipping purposes than it was to order from each individual supplier and have the orders shipped separately. He also admitted that it was like a vacation for him.

So, the day arrived that I would meet my Brazilian friend. We proceeded to the office of the VP of International Sales. That is when I learned my first lesson about taking prepayment in person.

Rafael had a schedule to keep, so it wasn't long before the conversation turned to the amount due for the parts and accessories order. When I showed him the total, he politely asked where the men's room was. It seemed strange to me that he needed to use the men's room so urgently that he interrupted our conversation about the order. But I quickly showed him where it was and returned to the office. When I returned, the VP of International Sales was laughing and asked if I wanted to know why. I was afraid to ask, but did. He finally explained that in Brazil, many people keep their money on their bodies rather than using a wallet. That way, the money is safer from the pick-pockets. Rafael promptly returned from the men's room with a fist full of cash.

Has your mother ever told you not to put money in your mouth because you never know where it has been? Well, believe her.

Jill Westrich , CCE, CICP

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Real World Perspectives

RWP 14-3

CHILEAN ADVENTURES

One of my first international credit problems involved a distributor in Chile. This particular distributor purchased product from the company I was working for in the amount of $250,000. The terms offered were D/P (documents against payment) through his bank in Chile.

We shipped the cargo and presented documents through our bank in the U.S. Our bank in turn communicated with the customer's bank in Chile as to status of the paperwork. After a period of time, we were advised by our bank that the customer had not sighted the documents for the cargo we shipped. However, after investigation by our logistics department, we discovered that the customer did have control of the cargo. Not a good thing.

I placed a phone call to the distributor and inquired if he really had the cargo as we had not received the draft. He indicated that he did and there must be some mistake at the bank; he would find out what it was. While this was going on, we were performing our inquiries in the U.S. to determine what actually happened. We were able to determine, after much effort, that our customer bribed the port official and obtained the cargo without the documents. The customer finally admitted to me that he had done just that and also stated that if we pressed the issue, he could end up in jail as it was a serious problem in Chile.

At the time this order was a major portion of our export A/R and we wanted to do whatever it took to get our money as soon as possible. The receivable was deemed a risk and we needed to do something.

The customer had no money to pay for the product, and he also was pleading for time. We finally settled on a time payment but with security. The security was his mother's house. I inquired as to what the house was worth and was told it was worth more than $250,000 and was lien free. I was also told his mother would not object to the transaction. We agreed to at least look at this potential solution as an answer to our problem. I of course spoke to the mother and she reiterated her agreement with the scheme and also indicated that her son had problems but was honorable.

In my previous employment, I had made several mortgage loans and my first call was always to my local title company. Well, guess what? Chile does not have title companies (at least not at the time), but it requires attorneys to do lien searches that go back 50 years on a property. I could tell this scheme was getting complicated (hire attorney, appraise property, inspect property, generate loan papers, record lien, etc.). I booked my flight to Santiago, Chile.

The customer picked me up at the airport in Conception and offered to drive me to Los Angeles (the location of the property). I took him up on the offer as it was 200 kilometers. Los Angeles is up in the Andes; part of the road was gravel and quite desolate. It was beautiful country though.

Upon arrival I was able to hire a local English-speaking attorney who agreed to handle the transaction at a reasonable rate. I was also able to inspect the property and arrange for a representative from a local bank to provide me a value. That value met my needs, and we agreed to go forward with the transaction. It does take time to do a lien search on the property as it is all done by hand by an attorney at the local recorder's office. Therefore, the closing of the loan could not occur while I was in country and would need to be done after I had left.

I did, however, want to meet my customer's mother. She did not live in the house we agreed to mortgage but lived on a farm higher up in the mountains. I traveled to see her and over lunch we discussed the issues that brought me to Chile. She reiterated her belief that her son would repay the loan and agreed, again, to pledge her property so we could complete the deal. I thanked her for the lunch (it was at her home) and advised that our attorney would draw up the paperwork and get it to her for her signature. I also indicated that I would keep in contact so she would know the status of the loan.

I did communicate with our customer's mother a couple of times since I was in her home (once by Christmas card), and the dialogue occurred both ways. The loan was made and repaid with interest, and all of our attorney's fees were paid by our customer as well.

Success stories are not unusual in international business. This one though was very early on in my company's sales dealings in the global arena. If the outcome had been different, we might have changed sales strategy, but as it worked out, we all learned from our experiences and moved forward in a more educated manner. Knowing your customer is very important for credit managers; prior to this situation, I had not traveled. Afterwards though, I made regular trips into the marketplace, met customers, understood their business, joined FCIB and have not had any problems since.

Jay Miller, Trident Seafoods Inc.

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Summary

- When selling internationally, businesses and credit managers must take into account the international and domestic economic environment, legal, political, cultural, financial and geographic factors that may influence a sale, because they all can amount to increased risk in a sale.
- One major risk is foreign exchange rates during a sale because the revaluation of currency can impose serious costs of business internationally.
- It is important to understand that the UCC does not govern international sales as the Convention for the International Sale of Goods (CISG) does. It is also of critical importance to adhere to export and customs compliance. Currently, there are several U.S. embargoes placed on countries like North Korea and Cuba that restrict trade. Therefore, if a seller is found shipping to those countries from the U.S., they can face penalties including sanctions and heavy fines.
- When selling internationally, the terms of sale should never be more liberal then the terms of sale in domestic transactions. The following **payment methods** are most likely used in international sales:
  - **Cash-in-advance**
  - **Consignment**
  - **Open account**
  - **Letters of credit**
  - **Documentary collections**

Comprehension Check

What is the difference between **factoring** and **forfaiting?**

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Summary Continued...

- Each type of payment in an international setting holds its benefits and costs to sellers and buyers due to the varying distribution of risk between the buyer and the seller.
- The three types of **letters of credit** include:
  - **Confirmed irrevocable documentary letter of credit**
  - **Irrevocable documentary letters of credit**
  - **Standby letter of credit**
- Within letters of credit there are also several **special arrangements** to consider including:
  - **Transferability**
  - **Assignment of proceeds**
  - **Back-to-back**
  - **Red clause**
  - **Installment credit**
  - **Revolving letter of credit**
  - **Deferred payment**

Comprehension Check

What is a **banker's acceptance?**

- When documents presented do not conform to the terms of the letters of credit there are several actions that may be taken. Such as asking the paying bank to return the documents for corrections and then resubmit the documents.
- Documents should always be examined for compliance with the terms and conditions. One aspect to ensure compliance is the correct spelling of all contents including company name, addresses and applicant names.

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Summary Continued…

- Other **key terms** to consider in international trade includes:
  - **A green clause**
  - **A telegraphic transfer clause**
  - **Evergreen clause**
  - **Bill of lading**

- **Incoterms®** establish international trade rules when shipping, and establish when risk passes from the seller to the buyer. Given the globalization of today's economy, Incoterms® have been updated every ten years since 1980. Common rules for any mode of transportation include:
  - **EXW: Ex Works (Named Place)**
  - **FCA: Free Carrier (Named Place)**
  - **CPT: Carriage Paid To (Named Place of Destination)**
  - **CIP: Carriage and Insurance Paid To (Named Place of Destination)**
  - **DAT: Delivered At Terminal (Name Place of Destination)**
  - **DAP: Delivered At Place (Named Place of Destination)**
  - **DDP: Delivered Duty Paid (Named Place of Destination)**

- Rules for sea and land water transport include:
  - **FAS: Free Alongside Ship (Named Port of Shipment)**
  - **FOB: Free on Board (Named Port of Shipment)**
  - **CFR: Cost and Freight (Named Port of Shipment)**
  - **CIF: Cost, Insurance and Freight (Named Port of Destination)**

Comprehension Check

There are several special challenges associated with collecting international accounts. Discuss these.

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Summary Continued…

- Freight Forwarders can be an excellent third-party resource to assist in international trade as they have a host of services that include, but are not limited to, air or ocean freight service and warehousing and distribution service.

- Four ways to **mitigate the risk** of selling internationally include:
  - **Credit Insurance**
  - **Factoring**
  - **Forfaiting**
  - **Ex-Im Bank**

- Forfaiting normally deals with capital goods and commodities that typically have extended credit periods. The minimum U.S. transaction size is $100,000. The major advantages of forfaiting include:
  - Volume
  - Speed
  - Simplicity

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Summary Continued...

- The main role of the Ex-Im Bank is to assist U.S. exporters by providing direct loans, or by guaranteeing repayment of commercial loans to creditworthy foreign buyers for purchases of U.S. goods and services. There is no maximum or minimum limit to the size of the export sale that may be supported by the Bank's foreign buyer financing.

- A bank plays the role of a collections agent for an exporter in documentary collections like drafts and letters of credit. They also serve as a vehicle to transfer funds and as a source of foreign exchange.

- International rules of collection are governed by the International Chamber of Commerce, Uniform Rules for Collections (URC 522). It is essential to have uniform collection procedures and systems to ensure timely recognition of potential problems of international accounts. As a last resort, legal remedies may become necessary to collect debts.

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15 Financing and Business Insurance

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The basic reasons for borrowing.
- Types of loans and lines of credit from banks.
- Different forms of leasing and leasing arrangements.
- Aspects of leveraged buyouts and what a creditor should know about them.
- How finance companies work and what a creditor should know about them.
- Accounts receivable factoring.
- Types and features of trade credit insurance.
- How a trade receivable put options can protect a single account.

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CHAPTER OUTLINE

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Questions for Discussion

THINK ABOUT THIS:

Q. What financial tools may be used to reduce the credit risk of marginal customers?

Q. How can a creditor reduce its risk exposure without denying a marginal account?

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Financing Needs

- Reasons for Borrowing
  - Purchase property, plant and equipment
  - Build inventory in advance of heavy selling seasons
  - Tax incentives
  - Payment discounts
  - Protect ownership positions
- Choice of Lender
- Lending Relationships
  - Amounts outstanding.
  - Terms of repayment.
  - Costs involved.
  - Collateral pledged.
  - Existence of loan covenants or promises, that certain conditions or activities will or will not be met or done, and the possibility of defaults.

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Banks

Types of Bank Lending

- Loans based on borrowing base certificate
- Unsecured loans
- Mortgage loans
- Lines/loans secured by misc. assets
- Equipment loans
- Revolving lines of credit
- Short and long terms loans
- Restrictive Covenants

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Figure 15-1 Typical Covenants in a Borrowing or Loan Agreement

The borrower may not pay excessive dividends, borrow from other sources, sell business assets, guarantee the debts of other companies, merge or consolidate with other companies, or buy back any outstanding shares of stock.

The borrower generally is required to maintain an acceptable relationship between current assets and current liabilities (often as a minimum financial ratio, such as the current ratio), maintain the physical and real assets of the company in good condition, employ the proceeds of the loan in the way prescribed, provide adequate insurance coverage on the business, maintain accounting records and have them available for review and submit periodic financial statements to the lender.

Property acquired by the borrower after the agreement is signed may become subject to the terms of the loan agreement by the **after-acquired clause**. *This means that the property is automatically pledged, although the borrower did not own it at the time the loan was made.*

The interest rate may change during the life of the agreement through the use of an escalator clause.

The entire loan may become due immediately if the borrower fails to live up to the agreement. This is called an **acceleration clause.** Where the borrower cannot meet the terms of the note, the lender may institute foreclosure proceedings. The court renders a judgment and orders the property sold to satisfy the claim. If the proceeds of the sale satisfy the amount owed to the creditor, any excess is returned to the debtor. Should the proceeds be insufficient to pay the claim, the creditor may seek a deficiency judgment against the personal assets of the debtor for the difference.

There will also be a **cross-default clause,** *which states that if the borrower defaults on any long-term borrowing agreement, all such agreements will be in default (including the one being negotiated).*

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U.S. Small Business Administration

- Assists small businesses in financing capital needs for growth
- All funds come from private lenders
- SBA guarantees a portion of the loan
- **7(a) loan program** is the most common

Comprehension Check
List types of loans provided by banks and explain the key points of each.

Comprehension Check
Explain **restrictive covenants.**

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Leasing

- Background
- Types of leases – (FASB)
  - Operating leases
  - Capital leases
  - Sale-Leaseback Arrangement

Comprehension Check

Explain the purpose of the U.S. Small Business Administration and what it offers.

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Leveraged Buyouts

A special acquisition process that uses borrowed money to acquire a company

Figure 15-2 Evaluating Leveraged Buyouts

1. The company must have proven products and markets. Unlike venture capital financing, leveraged buyouts aim for reliability and staying power.
2. Key management personnel must have a proven track record. They must be experienced in production, sales, finance and operating the company or a similar one.
3. Management should have enough of their own cash invested in risk equity to ensure their total commitment.
4. The company must have a steady and reliable cash flow to support the purchase price, carrying charges and related debt.
5. The physical plant should be reasonably modern so that heavy capital expenditures can be avoided during the payback period.
6. The company's industry should not be vulnerable to sudden technological shifts that can cause obsolescence.
7. Preexisting debt should be minor because the leveraged buyout will add a major layer of new debt.
8. The company should be willing to supply sufficient detailed financial information to creditors, to reassure them that the company can handle the heavy debt load.
9. Suppliers should be consulted so that previous trade terms will continue after the buyout. Harsher terms can cause liquidity problems.

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Figure 15-3 Analyzing Financial Statements for a Leveraged Buyout

1. Examine cash to uncover any seasonal peaks and valleys.
2. Check trade receivables for the average age of past-due receivables and their rate of change. Significant customers that provide 10 percent of sales should be listed. The probability of collecting long overdue accounts needs to be evaluated.
3. Check notes receivable from customers as to nature of loan, terms and history of collection.
4. Examine inventories to determine the current market value, pricing sensitivity and obsolescence factor.
5. Evaluate plant and equipment to assess their remaining useful life by comparing the appraised value with the remaining book value.
6. Check short-term borrowing requirements for peaks and valleys beyond the debt service associated with the buyout.
7. Analyze accounts payable to determine whether there are any payment problems arising from a reduced inventory turnover or slowdown in accounts receivables turnover.
8. Review operating income by product lines, industry segments, geographic locations, trend of major customers, pricing strategies, sales agreements and customer base.
9. Review operating expenses to establish the stability of cost structure by looking into each major element of expense. Lease rates, labor and fringe costs should be checked. Leases need to be examined to see if they are assignable and if they are economically advantageous to the buyer.

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Finance Companies

- Functions
- Accounts Receivable Financing Procedures
- Loans against Inventory by Financing Companies
- Evidence of a Financing Arrangement

Comprehension Check

What is an **operating lease?**

Comprehension Check

What is a **capital lease?**

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Figure 15-4 Questions to Ask about Arrangements with a Finance Company

An understanding of a customer's arrangement with its finance company may be reached by obtaining answers to the following questions:

1. Is the arrangement normal? With a normal financing arrangement, there is no notification to the client's customer that receivables are being pledged to secure a loan. If the agreement differs from the normal arrangement in that it provides for notification, this should act as a warning that the finance company considers the client a higher than ordinary risk.
2. What is the contract percentage advanced by the finance company against pledged receivables?
3. What is the customer's overall line with the finance company? A finance company will advance a contract percentage against pledged assets, although there is an overall dollar limit to the loan.
4. Does the customer draw the full amount available? Are there any arrangements for advances above the contractual percentage? If the customer does not draw the full loan amount available, this is probably a favorable sign. If it is doing so, it either signals full dependency on the finance company or possibly indicates that finances are in a strained position. On the other hand, overadvances may indicate a great deal of confidence by the finance company. A conclusion as to which way the scale is balanced can only be drawn after all the facts and circumstances are weighed.
5. What is the customer's gross receivables amount and its current loan balance with the finance company? The difference between these two items is the customer's equity. Equity can be diluted by discounts and reserves, contras and concentrations, or delinquent accounts receivable. Discounts and reserves are direct reductions of the face amount. Contras are potential reductions, in that the client's customer may offset an amount owed by the client to the customer. Concentration of receivables from a few large companies poses a danger to those receivables and the market position of the seller. Finally, delinquent accounts are potential bad debts.
6. What is the usual delinquency percentage? The quality of the accounts receivable gains in importance because the company is contingently liable for them.
7. What is the accounts receivable turnover experience?
8. Is there any pledge of the accounts receivable equity to the finance company, the finance company's affiliates or subsidiaries, or to any other third party?

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Factors/Factoring

***Factoring** is a transaction whereby a business (seller) sells its accounts receivable to a third party, usually a financial institution (a **factor**) at a discount in exchange for immediate payment to finance continued business operations.*

- *Features*
- *Business Case*
- *Factoring Procedure*
- *Timing of Payment to Seller*
- *Advanced Arrangements*
- *Notification*
- *Loans against inventory by Factors*
- *Ledger Lines*
- *Factor Guarantees*
- *Consideration by Credit Analysts*

Comprehension Check

Define the term **leveraged buyout.**

List nine factors to consider when evaluating an LBO.

List nine important items to analyze when reviewing the financial statement of an LBO.

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Figure 15-5 Questions to Ask about a Factoring Arrangement on an Advance Basis

It is important to determine whether the factoring arrangement is on an advance basis. If so, the balance sheet of the customer may hide more meaningful data than it reveals, and any figure shown as Due from Factor should not be taken at face value. If the arrangement calls for advances on accounts receivable, the credit department should ask the factor the following:

1. What is the contractual advance percentage? Is it fully used?
2. Are there any arrangements for unsecured overdrafts? If so, what are they? An **overdraft** *is a verbal agreement by the factor to provide funds in excess of the contractual advance percentage on receivables, usually to a stated limit for a specific period of time.*
3. Are there any overdrafts outstanding? If so, how much?

   When an arrangement calls for overdrafts in addition to advances, the reason should be determined. It could indicate that the customer is financially strained, because inordinately high sales would necessitate increased purchases of merchandise. Therefore, it is essential to obtain profit and loss figures to ascertain whether this increased activity yields commensurate profits and does not weaken the firm. In addition, interim trial balance figures are an aid in determining the current profitability of operations.
4. Are the overdrafts stated as an amount over 100 percent of the purchased receivables or over the contractual advance percentage?
5. Have overdrafts been requested but refused or restricted?
6. If the maturity arrangement calls for payment on the average due date, it is essential to determine the following:
   - Is the item Due From Factor pledged to a third party, such as a bank, to secure a loan?
   - Is there an intercompany offset situation?
   - Does the factor have other affiliates or subsidiaries that are suppliers of credit to the customer?

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Insurance

- Trade Credit Insurance
  - Limits
  - Terms
  - Cost
  - Policy Purchasers
  - Policy Coverage
  - Cancelable Versus Non-Cancelable Limits

Comprehension Check

What purpose do **finance companies** serve?

Comprehension Check

Briefly describe what a **factor** is.

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Trade Receivable Put Options

- Distinguishing Factors
  - The ideal purchaser of accounts receivable put options is either:
    1. An experienced in-house credit team that doesn't use credit insurance or factoring and doesn't want to lose profit from sales to a risky customer, which would otherwise be avoided or limited due to credit risk (e.g., distressed, concentration, in bankruptcy); or
    2. A seller desiring to supplement its factoring arrangement or credit insurance (e.g., credits not covered/dropped by factoring/insurance, seasonal spikes).

Comprehension Check

Describe the advantages of **factoring** and how it works.

Comprehension Check

List the important questions to ask about a factoring arrangement.

How do factors differ from finance companies?

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Figure 15-6 Comparison of the Features of Factoring, Trade Insurance and Put Options

	Factoring	Trade Insurance	Put Option
Flexibility	• Normally, requires entire portfolio of accounts receivable • Retail and consumer goods focused • Minimum receivables thresholds for primary factors • Caps and limits for maximum exposure to particular companies • Only protects prospective (new) accounts receivable incurred after the coverage becomes effective	• Normally, requires entire portfolio of accounts receivable • Caps and limits for maximum exposure to particular companies • Only protects prospective (new) accounts receivable incurred after the coverage becomes effective • Usually limited to annual policies with limits decided by the insurer (annual cycle renewal constraints open clients to undesirable pricing to market risks upon renewal)	• Available on a single customer basis, rather than a portfolio of accounts receivable • Focus on high-risk and distressed accounts receivable • Effective immediately on all outstanding accounts receivable to the customer (not just new receivables incurred after put option is purchased) • Range of variables for put options (e.g., expiration date, amount, etc.)
Modification and Termination	• Generally, factor may modify or terminate coverage	• Normally, cancelable on notice at the will of the insurer • Triggered on a default (bankruptcy) or failure to pay	• Non-cancelable • Triggered on a bankruptcy filing
Product Availability	• Not normally available in bankruptcy	• Not normally available in bankruptcy	• Available before bankruptcy and during (in) bankruptcy
Pricing/Cost	• Only available to fully cover outstanding receivables (cannot protect cost only) • Surcharge or deductible added to high-risk accounts	• Only available to fully cover outstanding receivables (cannot protect cost only) • Deductible costs must be considered. Surcharge added to high-risk accounts	• Can be structured to protect sale-price (with your profit), or to cover only cost of goods sold • No deductibles or surcharges or other additional costs

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Summary

- Customers often borrow money as a means of financing their operations. These sources of financing such as banks, finance companies, factors and other institutional lenders, usually have first claim on a significant portion, if not all, of the customer's assets by becoming a secured creditor through filing under the UCC.
- There are a variety of reasons why a business may **borrow money**. Here are a few:
  - **Purchase of property or equipment**
  - **Build inventory before a heavy selling season**
  - **Tax advantages**
- The securitization of loans gives lenders an advantage over trade creditors.
- Important aspects of the lender relationship that a creditor should be aware of include:
  - Amount outstanding
  - Terms of repayment
  - Costs involved
  - Collateral pledged
  - Existence of loan covenants or promises

Comprehension Check
What are the advantages of **trade credit insurance?**

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Summary Continued…

- Loan types differ greatly, and if a bank feels as though they are taking on more risk, it may include restrictive covenants in the agreement. Types of **bank lending** include:
  - **Loans based on borrowing base certificates**
  - **Unsecured loans**
  - **Mortgage loans**
  - **Loans secured by miscellaneous assets**
  - **Equipment loans**
  - **Revolving lines of credit**
  - **Short-term loans**
  - **Long-term loans**

Comprehension Check

What is a trade **receivable put?**

- The **U.S. Small Business Administration (SBA)** assists the growth and expansion of small businesses in the United States. The SBA helps small businesses to obtain loans from financial institutions and in many cases insuring the banks from any defaults on those loans.

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Summary Continued...

- **Leases** come in several forms. The major difference between a capital lease and a operating lease is that operating leases are shorter and the lessee does not record the equipment as an asset or payment stream as a liability. However, the FASB is in the process of updating the accounting standards associated with leases. A sale-leaseback arrangement is another type of lease that a creditor should be aware of because of its effect on the balance sheet, which may look favorable, but may ultimately spell out a greater risk to the creditor.

- **Leveraged buyouts (LBOs)** were very popular tools used by financial institutions in the late 1980s. A leveraged buyout is when a company borrows money in order to acquire another company. Leveraged buyouts should be evaluated in depth using financial statements of at least three years prior to the buyout.

- **Finance companies** make loans against pledged or assigned collateral, such as accounts receivable, inventory or fixed assets. There are several questions a creditor may want to ask such as, is this a normal arrangement?, or what is the contract percentage advanced by the finance company against pledged receivables?, but ultimately signs of borrowing against receivables should show up in the balance sheet or in its accompanying footnotes.

- **Factoring** can occur on a recourse or non-recourse basis. Typically sellers are required to factor their entire accounts receivable portfolio. Some benefits of factoring may include:
  - Insulating the seller from bad debt losses on factored receivables
  - Avoiding some costs with the collection process

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Summary Continued…

- Fees that are paid to the factor are determined by many considerations including the volume of the business factored, the degree of risk and the seller’s terms of sale. Timing of payment may either be upon collection or at maturity. Advanced arrangements can be made with the factor in accordance with the various payment methods.

- Because the financial condition of a business can change overnight, it is important for the credit manager to know the types and amounts of insurance carried by the customer. **Credit insurance** is a risk transfer mechanism. Policies have evolved to where companies can insure individual customers. The ideal purchaser is:
  - Protecting itself from catastrophic events
  - Unable to afford in-house credit management

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Summary Continued…

- Several **endorsements** can be made to the credit insurance policy to cover specific circumstances, including:
  - **Bank endorsement**
  - **Construed coverage**
  - **Interim claim settlement**
  - **Claim settlement**
- Trade insurance may also have cancelable or non-cancelable limits.
- Another option to protect the account receivables for a single account is **put options.** These are non-cancelable and tend to be more expensive than factoring or credit insurance. Ideal users include:
  - Experienced credit staff that do not use credit insurance or factoring
  - Those using it as a supplement to factoring or credit insurance

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16 Negotiable Instruments

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The concept of negotiability.
- Various kinds of negotiable instruments.
- The difference between special types of checks.
- Certificates of deposit.
- What negotiation of commercial paper means.
- Various types of endorsements.
- What checks marked "Paid in Full" mean.

CHAPTER OUTLINE

1.	The Concept of Negotiability	16-2
2.	Kinds of Negotiable Instruments	16-5
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6.	Check Writing Alternatives	16-13

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Questions for Discussion

THINK ABOUT THIS

Q. In your company's line of business, what are the most frequently used negotiable instruments and why?

Q. How can endorsements or notes change the negotiability of an instrument?

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The Concept of Negotiability

A **negotiable instrument** *is a written document, signed by the maker or drawer, containing an unconditional promise to pay, or order to pay, a certain sum of money on delivery or at a definite time to the bearer, or to the order of. It can be transferred from party to party and accepted as a substitute for money.*

UCC 3-104(a) specifies that in order for an instrument to be negotiable, it must:

1. **Be in writing.**
2. **Be signed by the maker or the drawer.**
3. **Be an unconditional promise or order to pay.**
4. **State a specific sum of money.**
5. **Be payable on demand or at a definite time.**
6. **Be payable to order or to bearer.**

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Kinds of Negotiable Instruments

1. Drafts
2. Checks
3. Notes
4. Certificates of deposit

Comprehension Check

Define the term **negotiable instrument.**

Comprehension Check

Give a brief explanation of the elements of a **negotiable instrument.**

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Special Types of Checks

- Bank Drafts
- Cashier's Checks
- Certified Checks
- Money Order
- Traveler's Checks
- Postdated Checks
- Sight Drafts, Time Drafts and Trade Acceptances
- Domestic Bill of Exchange

Comprehension Check

List the basic types of negotiable instruments.

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Notes

- Demand Notes
  - Time note
  - Installment note
- Promissory Notes
  - Single-name paper
  - Double-name paper
  - Straight note
  - Serial note
- Collateral Notes
- Judgment Notes

Comprehension Check

What is a **check**?

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Certificates of Deposit

Acknowledgment by a bank of receipt of money and promise to pay it back on the due date, usually with interest

Comprehension Check
What are some of the types of payment?

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Negotiation of Commercial Paper

- Assignment
- Negotiation
- Endorsements

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Common Types of Endorsements

- Blank or general
- Special
- Restrictive
- Conditional
- For deposit or collection
- Qualified
- General

Comprehension Check

Define the concept of **negotiation.**

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Checks Marked “Paid in Full”

- Before accepting, make sure there is no dispute
- Retention and deposit may constitute an accord and satisfaction
- Stamp checks with special legend

Comprehension Check
List and describe the types of **endorsements.**

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Check Writing Alternatives*

- Corporations remain slow to adopt electronic payments for the following reasons:
  - Checks are easier to initiate and have perceived float advantages.
  - Cash management and accounting systems do not provide the features desired to send and receive payments electronically.
  - For wire transfer payments, no standard exists for sending remittance information that allows efficient reconciliation and posting of electronic payments once they are received.

Comprehension Check

What is the general rule for handling a check marked "Paid in Full"?

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Real World Perspectives

RWP 16-1

EFT/ACH BECOMING THE NEW BAD CHECKS?

As the ratio of business-to-business transactions increasingly moves away from paper checks and surface mail toward technology-fueled options like electronic funds transfer (EFT) and automated clearing house (ACH), problems generated by bad actors are becoming more frequent. Creditors familiar with bad check writers in the past are now finding more rejections of EFT and ACH transactions because of insufficient funds, especially in high-turn/frequent-delivery industries related to food products and other perishables.

The vast majority of NACM members polled in an NACM survey (78%) indicated that customers have increased their EFT and ACH payments over the last few years. Those working for companies slow to adopt, noted expanded plans to accept electronic payment with greater efficiency, usually at the company's request.

"We do more and more with EFT and ACH every day; and for the most part, we have great success with it. But, as with checks, there are returned items, and there are more issues simply because this is where the industry is going," said Michael Castania, controller and former credit manager at McAneny Brothers, Inc.

Though far from widespread, bad EFT/ACH payment incidents have become more frequent. Statutory language from state to state typically addresses "bad check" situations, but it rarely specifies or defines EFT or ACH protocol and can be wildly inconsistent. In addition, enforcement at the local level can be even more unpredictable.

"With EFT, the laws are kind of nebulous," said Sam Rousseau, of Liberty USA, Inc. "With bad checks, in states including Pennsylvania, you'd traditionally go to your magistrate, which is the lowest level of the judiciary, and present your case to an assistant district attorney. They're not quite sure of the position they can take [on electronic payment] and the law on this. It leaves us hanging out there."

In addition, ill intent is difficult to prove, significantly more so than with bad checks. According to NACM business partner United Tranzactions (UTA), a check is a legal binding contract with a signature, and there is definite intent to pay somebody; with ACH, most often you don't have a signature. Because of this, all you can do in a lengthy dispute is go to court and make your case and explain your agreement with the debtor. But you won't have much case law behind you and intent is harder to prove. For that reason, UTA has always been careful to remind that you don't necessarily have that legal binding contract with ACH and EFT.

Rousseau noted that laws in many states don't even cover bad checks well, let alone iterations like EFT. "It would be nice on a state or federal level to get it defined because EFT is the future of payment," he noted.

In the absence of widespread statutory language changes or demands from state or federal officials for greater enforcement, consider the following:

- Look at your forms/documents. "With the right documents and forms, you can more easily get legal professionals involved," said PACM President Harold Booth, CGA.
- Document relationships with customers thoroughly and early. "The better-worded and more clear-cut your documentation is, the better your chances are," said Castania.
- Try to reach out/work with the customer first. "If they're willing to work with us, it doesn't need to go further," said Castania.
- Change access to certain payment methods. "Require checks or wire transfers or some other form of payment for a habitual offender," said Rudet Fountain, NACM-National.
- If not resolved quickly, try using bad check precedent with the customer and "send a Notice of Dishonor saying they need to make good," said Nick Krawec, Esq., partner at law firm Bernstein-Burkley, PC. Payment will often follow, despite legal statute vagaries.
- If all else fails, go to court. "The only way to find out if bad check law applies to EFT is to take it to court ... Maybe it takes a court decision or two to show what the appetite for this issue is," said Krawec.
- Contact state or federal elected representatives. Tell lawmakers, "I couldn't get a judgment because of the way the statute is written. What are you going to do about that?" Remind them that you vote, said Krawec.

Business Credit *magazine*, *October/September, 2015*

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Summary

- A negotiable instrument is basically a piece of paper that can be transferred multiple times from one person/entity to another without the use of actual cash.
- Each time it is endorsed and given to another, it represents payment to that party, which makes it a highly trusted instrument used by millions of people.
- The elements of a negotiable instrument include:
  - Be in writing
  - Be signed by the maker or drawer
  - Be an unconditional promise or order to pay
  - State a specific sum of money
  - Be payable on demand or at a definite time
  - Be payable to order or to bearer
- A drawer is the person or company who makes or executes a draft
- A draft is a written order by the first party, instructing the second party to pay money to a third party.

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Summary Continued…

- **Negotiable instruments** include
  - Drafts
  - Checks
  - Notes
  - Certificates of deposit
- Checks are the most **common form of draft.** Special types of checks include:
  - Bank drafts
  - Cashier's checks
  - Certified checks
  - Money orders
  - Traveler's checks
  - Postdated checks
  - Sight drafts, time drafts or trade acceptances
  - Domestic bill of exchange

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Summary Continued...

- **Notes** are a written promise by one party to pay money to the order of another party. Types include:
  - Demand notes
  - Promissory notes
  - Collateral note
  - Judgment notes
- A certificate of deposit is an acknowledgement by a bank of the receipt of money and its promise to pay money back at a future date, normally with interest. It normally pays more interest because the money cannot be withdrawn by the depositor before the due date without a penalty.
- Commercial paper does not meet all of the requirements of negotiability and may only be transferred by assignment.
- Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder.

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Summary Continued…

- An instrument becomes endorsed when it is signed by the holder, thereby transferring the ownership to another. **Common endorsements** include:
  - **Blank endorsement**
  - **Special endorsement**
  - **Restrictive endorsement**
  - **Conditional endorsement**
  - **Endorsement for deposit or collection**
  - **Qualified endorsement**
  - **General endorsement**

- The general rule for receiving a check labeled “Paid in Full” is as follows: an account is not considered settled even if labeled as “Paid in Full” and the check is for a lesser amount than the claim. The creditor may keep the check and sue for the balance. However, there are benefits and costs associated with the steps taken by the creditor depending on whether they decide to liquidate the payment or send the payment back to be paid in full.

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Principles of Business Credit

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