

The Selection of Payment Terms for the Export-Orientated Small and Medium-Sized Enterprises in China: A Comparative Perspective

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Supported by the Research Base of Humanities and Social Sciences of Shandong Province-International Business Study Center, the Research Foundation of Shandong Provincial Bureau of Statistics (KT13032); the Teaching Research Foundation of Shandong Jiaotong University (JY201211).

Received 22 April 2014; accepted 18 June 2014

Abstract

Small and Medium-sized Enterprises are the main force in China's foreign trade. During the process of international business, payment terms are the key issue since it involves many risks and must be handled with special care. This thesis compared the three traditional payment terms in international trade and put forward the suggestions for the selection of payment terms for the Small and Medium-sized Enterprises in China.

Key Words: Small and medium-sized enterprises; Method of payment; China

Li, J., & Zhao, X. (2014). The Selection of Payment Terms for the Export-Orientated Small and Medium-Sized Enterprises in China: A Comparative Perspective. *International Business and Management*, 9(1), 62-67. Available from: <http://www.cscanada.net/index.php/ibm/article/view/4931>
DOI: <http://dx.doi.org/10.3968/4931>

INTRODUCTION

The characteristics of international trade make the process of international settlement complicated and sophisticated. Export-oriented SMEs contribute to a comparatively larger proportion of export trade volume in China's export trade. How to increase the competition power of the SMEs in international market is an issue that has been heatedly discussed in recently years. Since it is the final

goal to make profit, the right choice of payment method is of crucial importance to the SMEs who are engaged in export trade. Moreover, the security of payment, the speed of capital turnover, the bank charges and costs for payment should also be considered. SMEs should balance the advantages and disadvantages of each method of payment and choose the right payment term according to their specific conditions.

1. SMALL AND MEDIUM-SIZED ENTERPRISES

1.1 Definition of Small and Medium-Sized Enterprises (SMEs)

The *Law of the People Republic of China on Promotion of Small and Medium-sized Enterprises* came into effect in June 2002. According to the law, Small and Medium-sized Enterprises refers to the enterprises of different ownership and forms, and are set up in the territory of the People Republic of China. The establishment of SMEs should follow the national industry policy and meet the needs of the society and increase job opportunities.

The classification criteria of SMEs is formulated according to some indexes, which include the number of employees, sales volume, total assets etc. When defining the SMEs, the departments concerned in the State Council take the characteristics of the different industries into full consideration. The definition of SMEs is subject to the approval of the State Council.

According to the National Bureau of Statistics of the People's Republic of China, the scale of enterprises is determined by three indexes, namely the number of employees, and sales volume and the total asset. An enterprise that meet one of the three conditions may be termed as a SME. Table 1 better illustrated the criterion of defining SMEs.

Table 1
Classification Criterion of Small and Medium-Sized Enterprises

	Small and medium-sized enterprises		
	Number of employee (less than)	Sales volume (rmb) (less than)	Total assets (rmb) (less than)
Industry	2000	30,000	40,000
The construction industry	3000	30,000	40,000
The retail industry	500	15,000	40,000
The wholesale industry	200	30,000	
The transportation industry	3000	30,000	
The postal industry	1000	30,000	

Note. Source: National Bureau of Statistics of the People's Republic of China.

1.2 Features of Small and Medium-Sized Enterprises

1.2.1 Limited Funds

Compared with large-scale enterprises, SMEs have smaller scale, shorter life cycle, limited fund and weaker ability to resist risk. To reduce the credit risk, the banks have relatively stricter loaning requirement for them. Usually joint guarantee and property mortgage are required. But it is hard to liquidate the mortgage and the banks are not willing to accept property mortgage. Meanwhile, to avoid asset risk, some companies that have good credit standing are not willing to provide loan guarantee. All this lead to the inability of the SMEs to get credit from the banks (Wang, 2009). In responsive to this, large number of micro credit companies are immersing in China recently years and they provide relatively flexible credit conditions for SMEs. But these credit companies usually charge higher interest and this increase the cost of SMEs and weaken their competitiveness in the international market. The limited funds also lead to the slow capital turnover and low capability to resist risk.

1.2.2 Low Bargaining Power

In China, most of the export products of SMEs are from labor intensive industry and capital intensive industry. Most of the export products are primary products and products with minimum processing and low added value. These products have high homogeneity and relatively clear profit margin. Price competition is the main means of competition. In the circumstances, the SMEs have low bargaining power with their foreign partners in the selection of payment terms. This also leads to the poor adaptability to the international market and limited customers.

1.2.3 Flexibility of Decision

In China, large scale enterprises have complicated procedures and regulations and have lags in decision making. For example, in a state-owned enterprise, a decision should be passed on to different levels for approval. The small scale and small number of employee enables the decision makers of SMEs to have quick response to the fluctuation of the market condition. Unlike state-owned enterprises, the entrepreneurs who have the property of enterprises usually have the administration authority (He, 2008). The adoption of payment has close relationship to the exchange earning and profit of the enterprises and their own profit. They

have great motivation to manage and choose the right way of payment.

1.2.4 Support from the Government

In China, SMEs can get preferential and supportive measure from the government. SMEs may take full advantage of these measures in their management and development of international business. These measures include, subsidies for attending trade fairs outside China to tap the international market; financial aid or subsidy for the SMEs to purchase the export credit insurance to resist the foreign exchange risk; measures to support SMEs to expedite the technology innovation and industry escalation, for example, SMEs may be exempted from duties of technology equipment importation from the government; Banks are encouraged to make advance payment to expedite the turnover of capital to compensate for the lag of tax-refund in China.

2. METHODS OF PAYMENT IN INTERNATIONAL TRADE

2.1 Letter of Credit

Up to now, Letter of Credit (L/C) is the most complicated and sophisticated method of payment in international trade. L/C is a written undertaking by a bank given to the seller at the request of the buyer, and in accordance with the instruction, of the buyer to effect payment up to a stated sum of money, within a prescribed time limit and against stipulated documents. In a L/C transaction, banks are involved in international trade and they pay their guarantee. Thus the charges for a L/C are relatively higher and these charges are usually borne by the applicant (importer). To issue a L/C, the importer should fill in the form of L/C application and submit it to the issuing bank. To the (issuing) bank, the application of the L/C is taken as a loan and the bank will check the credit standing of the applicant. According to the credit assessment, the applicant is required to pay a certain sum of deposit or collateral. In a L/C transaction, it is the applicant who initiates the whole transaction and the applicant does not need to pay the total sum of the transaction. Sometimes, an L/C transaction is compared to a lever, with which to pry the whole L/C process.

The International Chamber of Commerce (ICC), published the *Uniform Regulations for Commercial Documentary Credit* in 1929 and it was periodically revised afterwards. Up to now, the most authorized is *Uniform Customs and Practice for Documentary Credit (2007 revision) ICC Publication No. 600(UCP 600)*, which come into effect on the July 1st, 2007. According to *UCP600*, a L/C has three main features. First, the issuing bank has the primary liability for payment. According to *UCP600* article 2, credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honor a complying presentation. According to this arrangement, the issuing bank has the responsibility to pay the beneficiary, or accept the bill of exchange drawn by the beneficiary and pay when the bill is due; or promise to pay in a deferred payment L/C and effect payment when the time falls due. It can be concluded that the issuing bank has the primary liabilities for payment, the exporter (usually the beneficiary) can get paid against the qualified documents and he does not have to contact the importer (usually the applicant). Secondly, the letter of credit is a self-sufficient instrument. According to *UCP 600*, a credit by its nature is a separate transaction from the sale

or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. The L/C is issued according to the sales contract. But once it is issued, it is a self-sufficient instrument which is not dependent to the contract. The rights and responsibilities of the two parties concerned in a L/C transaction should conform to the terms and conditions of the letter of credit, and the sales contract has no bound to them. The exporter will be dishonored if he delivers the documents that do not conform to the letter of credit, even if they conform well to the sales contract. Thirdly, the L/C transaction is pure documentary transaction. In a L/C transaction, the banks deal with documents and not with goods, services or performance to which the documents may relate. As long as the beneficiary submits the documents that conform to the L/C terms, the issuing bank should undertake the responsibility of payment. If the importer finds some defects of the imported goods, he should lodge a claim to the party concerned. The bank, however, will not be responsible for any discrepancy of the quality of goods. Figure 1 illustrates how the relationships are governed by the documents between the applicant, the issuing bank and the beneficiary.

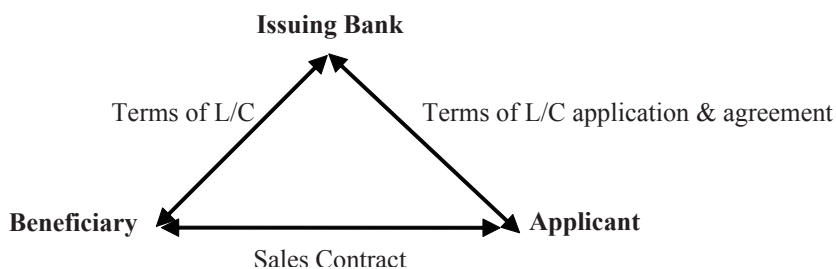


Figure 1
Parties Involved in an L/C Transaction

2.2 Remittance

Remittance means the transfer of money from one party (the debtor) to another party (the creditor) through banks. It is the simplest method of payment. Unlike the L/C payment, remittance is purely commercial credit and the exporter will rely on the promise from its trading partner. According to how the remittance instruction is delivered from the remitting bank to the paying bank, there exist three types of remittance: Telegraphic Transfer (TT), Remittance by Banker's Demand Draft (DD) and Mail Transfer (M/T), among which TT is the most frequently used method. SWIFT (Society for Worldwide Inter-bank Financial Telecommunications) has made the TT easier, cheaper and quicker, as most international banks are SWIFT members.

According to the time of payment, TT can be divided into "Payment in Advance" and "Deferred Payment". Under "Payment in Advance", the seller is paid before he delivers the consignment and he should ship the goods in the time stipulated in the contract. While if "Deferred Payment" is used, the seller should deliver the contracted goods first and he will get paid when the buyer received the goods. It is a method of payment which is similar to open account. The buyer may subject to great risk if "Payment in Advance" is used, since whether the buyer will receive the right goods depends on the sellers' credit. "Payment in Advance" is used especially for some customer-made products. On the other hand, if "Deferred Payment" is used, the seller may have great risk since whether the buyer will pay or not depends on the buyer's integrity.

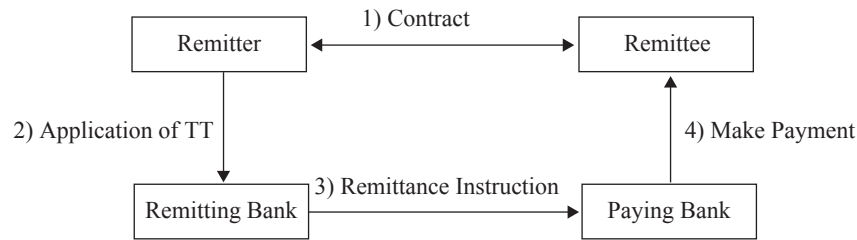


Figure 2
TT Flow Chart

2.3 Documentary Collection

Documentary Collection is a means of ensuring that goods (the title documents) are only handed over to the buyer when the amount shown on a bill of exchange is paid or when the customer accepts the bill as a contract to pay by a specified date. Banks, in documentary collection, act as collectors of funds on behalf of the seller and do not provide any promise in the payment. They have no obligation to examine the documents beyond verification that they appear to be as listed in the collection order.

According to how the documents are released to the buyer, documentary collection can be divided into Documents against Payment (D/P) and Document against Acceptance (D/A). In D/P, documents can only be released to the buyer when he has paid the amount on the draft. According to when the buyer should make payment, D/P can be divided into D/P at sight and D/P after sight. At sight means that payment should be made when the

buyer is presented the draft. However, after sight means the buyer will pay the draft amount a specified number days after the draft is presented and accepted. To the seller, D/P at sight and D/P after sight is equally safe. In D/A, documents representing the title to the goods will be released to the buyer once the buyer has accepted the draft. D/A should be used with caution, since when the usance period is due, whether the buyer will pay the draft or not depends on his credit and integrity. It is not as secure as D/P since the seller may not be paid at all. What should be noted is that in some countries, D/P after sight is usually interpreted the same way as D/A. The buyer may cheat by signing a D/P after sight contract but refuse to pay after he gets the documents. In this sense, the SMEs should be aware of the local commercial customs, regulations and laws of the buyer's country if case some buyer may take advantage of the seller's ignorance. Figure 3 illustrates the flowchart of a D/P transaction.

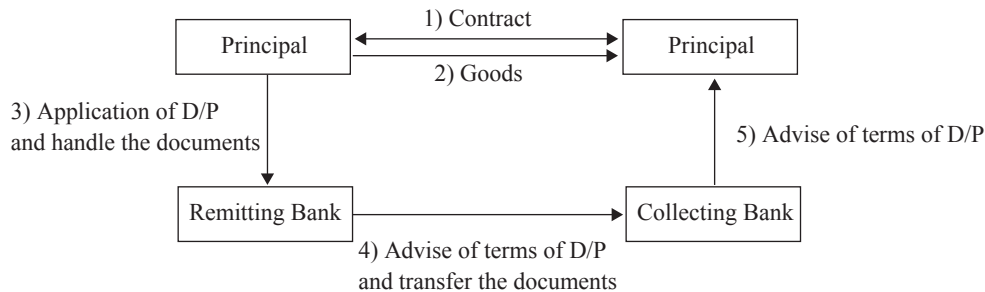


Figure 3
D/P Flow Chart

3. THE SELECTION OF PAYMENT METHOD FOR SMALL AND MEDIUM-SIZED ENTERPRISES

3.1 The Use of Letter of Credit

L/C transaction is used when the two parties have not established trade relations. For SMEs, the adoption of L/C ensures him to get prompt payment and possible financing availability and reasonable assurance of payment. Sometimes, the sellers accept lower selling price based on L/C transaction since money involved in the L/C is safe.

On the other hand, complicated formalities and documents are involved in a L/C transaction. For its high cost and complicated procedures, it is advisable for the

importers and exporters to adopt other forms of payment terms when they have a long business partnership and mutual trust.

If L/C is used, it is of crucial importance for SMEs to check the received L/C to make sure the L/C is in strict accordance with the previously signed sales contract as the SMEs have weak consciousness for the L/C procedures. Theoretically, any discrepancy can cause delayed payment or even rejection although banks usually will not reject payment for documentary discrepancies that will not materially affect the transaction. It is advisable for the SMEs to consult the bank about the matters that need special attention and the requirements for related documents. For those SMEs who are engaging in import business, it is comparatively difficult for them to apply a

Letter of Credit as they have to undergo the examination of the banks for their property and capital.

3.2 Documentary Against Payment

For the export-oriented SMEs in China, D/P is the most frequently used method of payment. For the simple procedures and less bank charges, payment under D/P is more prompt and less expensive than a letter of credit. If the two parties of a transaction have long business relationships, D/P is an ideal way of payment for SMEs. But sometimes the seller may be subject to the buyer's refusal of collection of goods at the port of destination. For example, if the exporter is selling perishable goods like fresh garlies, or goods with low value, or the value of the goods is almost the same with the freight, or the price is likely to go down or the economic condition is deteriorate in the importing country. The buyer may refuse, with excuses perhaps, to pay or to pay a lower price or even claim for compensation. In this case, the seller will be in a passive position. It is advisable for the seller to reduce the risks by controlling the documents.

In addition, the SMEs can get free export credit insurance supported by the government in China. Exporters can get compensation from non-payment from Export Credit Insurance. In light of the *Agreement on Subsidies and Countervailing Measures* in WTO, SMEs are allowed to get support from the exporting government. Export Credit Insurance is a non-profit insurance practice provided by the Chinese government to increase the competitiveness of the products in the international market and boost the export business and insure the safeness of foreign exchange earning of exporters. It is a policy advocated by the Chinese government. These measures help the SMEs avoid the payment credit risks and political risks. China Export Credit Insurance Company undertakes the credit risks of the importer and the political risks of the country or region where the importer lives. In this way, the exporter can get the payment assurance. This may help speed up capital turnover of SMEs and better solve the problems of shortage of funds.

In addition, exporters may take advantage this measure to offer importer more favorable delayed payment conditions. They can accept the settlement manners such as Sale On Account (O/A) or Document against Acceptance (D/A), to boost their competitive power, enhance the price negotiation ability, seek for more trade opportunities, and increase the market share. Thus provide the exporters with more trade opportunities.

3.3 TT

Compared with L/C and D/P, TT has the features of simple procedures, quick remittance, low bank cost and little money tied up in the transaction. Thus TT is very popular among SMEs in international trade practice. But it is a commercial credit and if "Deferred Payment" is used, the exporter may subject to higher risks. In such case, sea

transport is encouraged when TT is used since the Bill of Lading is a title document and the exporter can control the goods by regulating the documents.

To avoid the risks in TT, SMEs can purchase the export credit insurance and transfer the risks to the insurance institutions. Then, SMEs should check the importer's credit standing through professional consulting companies and banks and establish credit file for all the corresponding clients. Finally, the paying bank should be selected to avoid the collusion between importer and local banks (Shen, 2009). The blind pursuit of orders without paying attention to the safety of collection of fund may lead to the delayed payment and higher risks.

3.4 A Combination of Payment Terms

For the flexibility of operation, SMEs can make use of different method of payment in export trade and use a combination of payment terms.

3.4.1 Part D/P and Part TT

The most popular may be the "part D/P and part TT". The SMEs should take the risks of TT into consideration when quoting the price. The money under TT should preferably be "Payment in Advance" and this can be used as the deposit. When the exporter received the advance payment, he should deliver the goods and deduct the amount from the total payment. The remaining should be settled by D/P. In case the importer refuse to pay under the D/P terms, the seller can ship the goods back and deduct the freight, premium and interest and reasonable cost and loss from the deposit. This enables the SMEs to have the initiative when some circumstance occurs.

Another option of "Part D/P and Part TT" is "D/P first, Deferred Payment later". The exporter may ship the goods and forward the documents (including Bill of Lading) to the collecting bank and collect the funds from the importer. Then the remaining payment may be settled by "Deferred Payment" upon the approval of the importer. In this way, the exporter can increase the profit, in case the fund under TT sustain loss, he can offset the loss from his profit.

3.4.2 Part D/P and Part L/C

This is a combination of irrevocable letter of credit and D/P. In this way of payment, the exporter issues two bills of exchange, one is attached to L/C transaction, another one is attached with the full set of documents to D/P. The importer prefers this method of payment for the sum of deposit for the application of a L/C is reduced and less fund is tied up in a single transaction. For the export-oriented SMEs, the funds from the L/C can be seen as deposit for the safety of L/C transaction. The shipping documents accompany the collection term, the issuing bank will only release the documents after full payment of the invoice value. In this way, the money under D/P is guaranteed. If the importer fails to pay full invoice value, the shipping documents shall be held by the issuing bank at the exporter's disposal. It should be noted that in "part

D/P and Part L/C” term, L/C item should be carried first, then the collection, and the documents should accompany to the collection item.

CONCLUSION

SMEs are placing an increasingly important role in the development of China’s foreign trade. The right selection of payment terms is an issue of particular importance to the export-oriented SMEs. Besides the traditional payment terms listed above, Standby Letter of Credit, Banker’s Letter of Guarantee and Factoring can also be considered. To reduce risk and gain more profit, it is advisable for the SMEs to fully understand the advantages and disadvantages of each kind of payment terms and take their own characteristics into consideration when making decisions.

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