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Choosing the Right INCOTERMS for Letters of Credit

Why International Commercial Terms Matter And the Role They Play

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Agenda

- Understanding INCOTERMS 2010
 - What They Are
 - History
 - Role in Global Trade
 - Misconceptions
- Overview of Key INCOTERMS
 - “E” Term
 - “F” Term
 - “C” Term
- Which INCOTERMS are the Best to Use
 - For Control
 - For Payment
- Case Studies
 - Letter of Credit
 - Documentary Collection
- Conclusion



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About Chip Thomas

- 43 Years of International Trade Experience
- 22 Year Banking Career
- 27 Years Educating Exporters on How to Effectively use Payment and Financing Tools
- Lived Abroad for over 12 Years (Africa, Asia & Latin America)
- Passionate about teaching “Best Practices” in International Trade: “What You Must Know to be Successful in the International Market Place.”



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INCOTERMS 2010 History – Who Sets the Rules?

International Chamber of Commerce (ICC)

- Founded 1919 in Paris
- International representatives from over 120 countries
- Conforms with WTO, U.N., G20



Link: <http://store.internationaltradebooks.org/incoterms2010.aspx>



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INCOTERMS 2010 – What they are & What they do

3 Letter Acronyms to:

Standardize global trade terms

Define Responsibility

Outline costs included in each rule

Reveal Gaps

Determine Delivery Point





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INCOTERMS Misconceptions/Confusion

INCOTERMS Do Not:

- 1. Determine Financing**
(You Want How Many Days to Pay?)
- 2. Settle Breach of Contract**
- 3. Determine Carriage Contracts**
- 4. Provide for Intangible Goods or Services**
- 5. Transfer Legal Title or Ownership of Goods**



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Why So Much Confusion?

- **Where is there Confusion?**
 - In the USA!

- **Why?**
 - **Because for decades there were no standardized Domestic Shipping Terms!**

 - **Because freight forwarders are only concerned with Shipping related risks!**

As a result we had.....



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Typical Historic Domestic US Terms

- FOB Origin;
- FOB Origin; Freight Collect;
- FOB Origin; Freight Prepaid;
- FOB Origin; Freight Prepaid and Add;
- FOB Destination;
- FOB Destination; Freight Collect;
- FOB Destination; Freight Prepaid;
- FOB Destination; Freight Prepaid and Allowed



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Clarification of Terminology

➤ **Delivery:**

Where the risk of loss or damage to the goods passes from the seller to the buyer.

➤ **Carrier:**

The party with whom carriage is contracted.

➤ **Ship's Rail:**

The term has been eliminated for FOB, CFR and CIF.

➤ **On Board:**

This replaces ship's rail for FOB, CFR and CIF.



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INCOTERMS 2010 Overview

➤ RULES FOR ANY MODE OF TRANSPORT

- Ex Works (EXW)
- Free Carrier (FCA)
- Carriage Paid To (CPT)
- Carriage and Insurance Paid To (CIP)
- Delivered at Terminal (DAT)
- Delivered at Place (DAP)
- Delivered Duty Paid (DDP)



➤ MARITIME (WATERWAYS) RULES

- Free Alongside Ship (FAS)
- Free On Board (FOB)
- Cost and Freight (CFR)
- Cost Insurance and Freight (CIF)





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INCOTERMS 2010 – “E” Terms

➤ **EXW (EX-Works):**

➤ **Seller:**

- Informs the Buyer when and where the goods will be available.
- Provides Commercial Invoice, Packing List & Certificate of Origin.

➤ **Buyer:**

- Arranges all carriers.
 - Executes all logistics and export documents.
 - Obtains export and import licenses.
- Risk of loss or damage passes to the buyer when goods are loaded on the inland conveyance.

Question: What Transport/Shipping Document is Involved?



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INCOTERMS 2010 – “E” Terms

➤ **EXW (EX-Works):**

- Seller places goods at loading dock for “pick up” by the buyer.
- Seller supplies all needed documentation for export of goods to the buyer.
- Best used only for domestic transactions.
 - Can only be applied to the seller’s origin point.
 - Best used for domestic transportation.
 - Insurance is the responsibility of buyer after goods are loaded.

Question: What Transport/Shipping Document is Involved?

INCOTERMS 2010 – “E” Terms

➤ **EXW (EX-Works):**

➤ Major problems if used with a Letter of Credit:

- Buyer is not required to disclose any export information or details regarding the export of the goods.
- The shipper will likely be required to present an AWB or OBL.
- Conflict! The EXW term is never involved with an AWB or OBL.
- **Risk:** Seller’s inability to control the shipping document for payment.



Result: Possibility of a Total Loss!

Question: What Transport/Shipping Document is Involved?



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INCOTERMS 2010 – “F” Terms

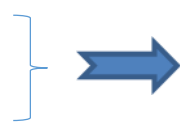
FCA: Free Carrier



Any Mode of Transport, All Packaging

FOB: Free on Board

FAS: Free Alongside



Waterway Only – LCL, Breakbulk,
Barge or Charter

- Main carriage and all logistics is contracted by the buyer.
- Less responsibility for seller, more control for the buyer.



Question: What Transport/Shipping Document is Involved?



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INCOTERMS 2010 – “F” Terms

➤ **FCA (Free Carrier) Named Place:**

Any Mode of Transport

- SELLER must deliver the goods to the CARRIER provided by the BUYER at a named point/location.
 - Seller documentation, costs & risks provided to named carrier.
 - Revenue recognition available to seller at named point/carrier.
 - Risks pass from seller to buyer upon delivery to first carrier.
 - Buyer is responsible for transport costs, insurance and risks upon delivery of goods to the named carrier.

Question: What Transport/Shipping Document is Involved?



FCR



AWB



OBL



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INCOTERMS 2010 – “F” Terms

➤ **FOB (Free on Board):**

WATERWAY Term LCL, Breakbulk, Barge or Charter

- SELLER must deliver goods “on board” named vessel.
 - Documentation, costs & risks up to goods “on board” are seller’s.
 - Revenue recognition is available once B/L is released to seller.
- BUYER must give seller ample notice of vessel loading details.
 - Transport costs, insurance and all risks are the responsibility of the buyer once the cargo is “on board.”
 - Insurance is the responsibility of buyer after goods are loaded.

Question: What Transport/Shipping Document is Involved?





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INCOTERMS 2010 – “F” Terms

➤ **FAS (Free Along Side):**

WATERWAY Term LCL, Breakbulk, Barge or Charter

- SELLER must deliver goods “along side” named vessel.
 - Documentation, costs & risks up to goods “along side” are seller’s.
 - Revenue recognition is available once DR is released to seller.
- BUYER must give seller ample notice of vessel loading details.
 - Transport costs, insurance and all risks are the responsibility of the buyer once the cargo is “along side.”

Question: What Transport/Shipping Document is Involved?





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INCOTERMS 2010 – “F” Terms

➤ **FAS (Free Along Side):**





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INCOTERMS 2010 – Container Shipment Terms

FAS, FOB – Not Suitable for Containers

WATERWAY TERM **LCL, Breakbulk, Barge or Charter**

➤ Waterway terms are **not suitable for containers.**

➤ Why?

- Because with FAS, containers would be subject to penalties for delays of loading, holding charges, vessel delays, etc.
- Since 2001 ports have implemented strict security, so FOB really can't occur with containers since the port or carrier will actually do the loading "on board."



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INCOTERMS 2010 – “C” Terms

CFR: Cost of Goods & Main Freight

CIF: Cost of Goods, Main Freight & Insurance

CPT: Carriage Paid to Main Point

CIP: Cost of Goods, Carriage & Insurance Paid to Named Point



WATERWAY ONLY

- Main carriage and all logistics is controlled by the seller.
- More responsibility and control for the seller.
 - Documentation, bank presentations, logistics, insurance & revenue recognition.

Question: What Transport/Shipping Document is Involved?



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INCOTERMS 2010 – “C” Terms

➤ **CFR (Cost & Freight) – Named Port:**

WATERWAY only LCL, Breakbulk, Barge or Charter

- SELLER delivers goods to carrier for transport to named port.
 - Revenue recognition passes upon seller receiving B/L.
 - Risk transfers to buyer when goods are “on board” the vessel.
- BUYER is responsible for insurance, vessel unloading & all importation formalities and costs.

Question: What Transport/Shipping Document is Involved?





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INCOTERMS 2010 – “C” Terms

- **CPT (Carriage Paid to) – Named Point:**
Any Mode of Transport
 - SELLER arranges & covers all costs up to named destination point.
 - Revenue recognition passes upon seller receiving B/L.
 - Risk transfers to buyer on delivery to the 1st carrier.

Question: What Transport/Shipping Document is Involved?





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What is the Best Rule to use for Your Transaction?

Understand the INCOTERM Rules:

- **Shipping Perspective**
- **Risk and Insurance Perspective**
- **Cost Perspective**
- **Control Perspective**
- **Revenue Recognition Perspective**
- **Documentation Risk Perspective**
- **Payment Risk Perspective**



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Exporting is a Cash Flow Business

This is Principal No. 1

So.....



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An Important Question for All Exporters

**If you are an international seller of merchandise,
when do you want payment and when does your
buyer want to pay?**

Answer:

- 1. You: ASAP**
- 2. Buyer: As Late as Possible!**

So how to resolve this disparity of needs?



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Understand Your Payment Options

- **Cash in Advance**
(No Documentation Risk)
- **Letter of Credit**
(Major Documentation Risk)
- **Documentary Collection**
(Major Documentation Risk)
- **Open Account**
(No Documentation Risk)



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Impact of INCOTERMS on Payments & Contracts

- **Documentary Letters of Credit (DLC)**
- **Documentary Collections (DC)**



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A Documentary LC is.....

- **A Payment Method**
- **A Written Payment Arrangement**
- **A Written Payment Contract**
- **It Assures Payment to Beneficiary if Beneficiary Performs Correctly by Presenting “Complying Documents” to the Banks After Shipment (Documentary LC)**



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What is a Documentary Collection?

- **A method of Collecting Funds from international buyers by utilizing the services of banks.**



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Documentation & Payment Issues

- **Incorporate Incoterms into Sales Agreements / Contracts**
- **What delivery / transport document should be in the contract?**
- **What delivery / transport document should be in a DLC or DC?**
- **Does it matter?**



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Why are these Questions Important?

- **INCOTERMS is only concerned with the movement of goods.**
- **INCOTERMS isn't concerned with payment arrangements or contracts.**
- **Misuse of INCOTERMS impairs sales and payment contracts.**



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2 Key UCP 600 Articles for Exporters

UCP Article 5

Documents vs. Goods, Services or Performance:

- **“Banks deal with documents and not with goods, services or performance to which the documents may relate.”**
- This means that the only thing a beneficiary needs to focus on is to properly prepare and submit its documents to the Advising Bank for payment that are “in total compliance with the LC terms.” Sounds easy?
- Globally, 75%-85% of documents presented for payment to banks are found to be discrepant. This either delays payment or potentially eliminates the LC payment.



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2 Key UCP 600 Articles for Exporters

UCP Article 4

Credits (LCs) vs. Contracts:

- **“LCs by their nature are separate transactions from the sales or other contracts on which the LCs may be based. Banks are not concerned with or bound by such contracts even if a reference to the contract is included in the LC...”**
- This creates a huge problem for companies that put a lot of time, effort and money into negotiating contracts that specify payment will be made via LCs. Since the LCs are created after the contract, and the beneficiary doesn't negotiate the critical terms of the LCs, the LCs aren't set up to benefit and protect the Beneficiary.



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Case Studies

Use of INCOTERMS in a DLC:

Case I:

A US Exporter shipped goods to a Chinese buyer, using the services of the buyer's freight forwarder. The terms of sale were FOB. Payment for the goods was secured by a Letter of Credit.

The seller relied on the buyer's freight forwarder to supply the required export documents to the bank. The freight forwarder failed to present the documents to the bank in a timely manner and there were multiple errors on the documents. As a result, the bank refused to pay under the DLC.

What remedies, if any, does the seller have?



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Case Studies

Use of INCOTERMS in a DC:

Case II:

A seller ships to a buyer on a DC basis, agreeing to ship goods FOB to the buyer. After shipment, seller presents documents to its bank to be sent to a bank in the buyer's country on a collection basis. The seller never gets paid because the buyer never goes to the bank to honor its payment commitment.

What should the seller have known about INCOTERMS and what other options did it have?



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INCOTERMS 2010 Rules...

What You Need to Know:

- How will the goods be shipped?
- Who will pay the costs of transport and insurance?
- Have I included all of the necessary costs into my sales offer bottom line total?
- What risks am I taking with the rules I am using?
- What is the exact location or point I want to provide the goods and risks to?
- Am I aware of the financial risks I am taking with each INCOTERM I may decide to use?



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Summary and Conclusion

- Remember, it's a Cash Flow Business.
- You must understand your risks.
- Understand the critical role of INCOTERMS 2010 and how they directly impact payments under LCs.
- Understand why and how you should control the goods and documents during shipment in an LC transaction.



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So What are the Next Steps?

Attend the Next 2 Webinars!

1. Letter of Credit Documentation-How to Avoid Discrepancies: March 21
2. Roles and Responsibilities of Banks in the Payment Process: April 18