

# **EXPORT MARKETING AND FINANCE**

## **WEEK 7 EXPORT CONTRACT AND FINANCING**

**DR KAMAU JOHN NJAU**

**FALL 2023**

**WEEK SEVEN**  
**EXPORT CONTRACT AND FINANCING**

**7.1 Introduction**

Welcome to week seven lecture! In the last lecture we examine how a marketer packages his goods and ships them to foreign market to the importer. We also examined the kind of insurance required to ensure goods arrive safely to the exporter. Once the goods have arrived at the port of destiny and received, it is the turn of the importer to make payment of the same through financial institution selected by the exporter. In this lesson we examine the process of making payments for export

**7.2 Intended Learning Outcomes**

At the end of this lecture, you will be able to:

- Discuss ways of determining export prices
- Describe transfer pricing in export markets.
- Examine methods of making payments for exports
- Evaluate shipment financing methods.

**7.2 Export pricing**

Pricing of exports is one of the major decisions that a business marketer makes. Pricing is especially important to an exporter in that it determines the revenue that could be generated, influences customers perception of value, determines the level of motivation that can be expected among intermediaries, have an impact on promotional spending strategy and that it compensates for weakness in other elements of the marketing mix (Cavusgil et al, 2008).

Setting of an export price is a complex activity due to factors such as environmental complexity, use of different currencies in different markets, the higher transportation costs, different payment methods among others. Pricing decisions in export markets are influenced by firm and management factors, product-related factors, industry-based factors and export market characteristics. The summary of these factors is in table 7.1.

**Table 7.1 Factors that influence export pricing.**

<b>Factors</b>	<b>Explanation</b>
<b>Firm and management related factors</b>	
Size and firm resources	Large firms can adjust their prices more easily to beat competition
International experience	More experienced firms address pricing strategies more effectively
Use of information systems	The more a firm uses IT system the easier it is for them to make pricing strategy.
Number and location of overseas productions	The more production facilities a firm have, the more it can adjust prices in the different markets

<b>Product based factors</b>	
Nature of product	Specialized/technology-based products allows firms to dictate prices
Cost volatility	The more volatile the cost of raw materials, the more challenging to fix export prices
Degree of standardization	The more standardized the product, the easier it is to set prices
Age of the product	The product lifecycle of the product in different markets will affect pricing decisions differently
<b>Industry based factors</b>	
Competition intensity	The more intense the level of competition the more the price adjustments to be made.
Impact of suppliers	The number of suppliers, availability of alternatives and fluctuation of raw material prices will affect pricing decisions
Predatory pricing	This will have great impact in export as firms seek to kick out others
Regulatory intensity	Pricing is affected by trade barriers, intellectual property rights, non-tariff barriers and anti-dumping regulations
<b>Export market characteristic</b>	
Channels of distribution	Independent channels of distribution increase price of products in export markets more compared to firms own distributors
Environmental factors	These are major factors such as climate change and political systems that will impact pricing decisions
Economic and currency related factors	Inflation, exchange rate fluctuation and economic conditions affect pricing decisions significantly.

*Adopted from: Zou S. Kim D. & Cavusgil S. T. (2009). Export marketing strategy tactics and skills that work (1st ed.). Business Expert Press. Retrieved October 10 2023 from <https://portal.igpublish.com/iglibrary/search/BEPB0000002.html>.*

#### **7.4 Export pricing objectives and strategies**

Export marketers develop pricing objectives and strategies based on overall marketing objectives of the firm. The export department will be expected to contribute to the overall firm's strategy by have clear objectives. Some of the export marketing objectives will include (Albaum et al., 2016):

- Satisfactory return on investment: the firm's investment should pay of after a certain duration.
- Maintaining market share: ensure the firm maintains its share in particular markets without losing to competition.
- Meeting a specified profit goal: this may cause the firm to adjust prices to meet its objectives.

- Largest possible market share: often the firm will lower its prices to attain this objective.
- Meeting a specific sales goal: this may call for raising or lowering prices to meet the objectives.
- Profit maximization: this will often be achieved by raising prices.
- Pricing at the high end of the price range. This is pricing within acceptable price range but focusing on the higher end.
- Highest return on investment: the firm will determine expected return on investment and adjust prices to gain maximum return on its investment.
- Prices are set at a high level and then lowered after a certain period has elapsed: the aim is to meet its return on investment and increase its market share.
- Meeting competition: the firm prices to ensure its competing fairly in the market

The various export marketing pricing strategies will include (Albaum et al., 2016):

1. Skimming the market: This involves getting the highest possible price out of products distinctiveness in the short-run without worrying about long-run company position in the foreign market.
2. Sliding down the demand curve: A company pursuing this strategy has the objective to become established in foreign markets as an efficient producer at optimum volume before foreign or domestic competitors can get entrenched. This is primarily used by companies introducing product innovations.
3. Penetration pricing: This strategy involves establishing a price sufficiently low to rapidly create a mass market. Emphasis is placed on value rather than cost in setting the price.;
4. Pre-emptive pricing: This strategy involves setting prices so low as to discourage competition. Prices may even be set below total costs.
5. Extinction pricing: The purpose of extinction pricing is to eliminate existing competitors from international markets. It may be adopted by large, low-cost producers as a conscious means of driving weaker, marginal producers out of the industry.
6. Full cost versus variable cost pricing: In variable pricing, the firm is concerned with the marginal or incremental cost of producing goods to be sold in overseas markets. These firms price very competitively in foreign markets and sell at lower net prices than they sell domestically.

## **7.5 Transfer pricing**

Transfer pricing also known as intra-company pricing is the fair value placed on goods and services exchanged among subsidiaries or between parents and their subsidiaries. the prices at which units of the same company sell to each other have a far-reaching effect on the company's success as they influence everything from foreign subsidiary performance to executive compensation tax obligation (Zou, 2009). Transfer pricing is important to a firm in that it is a vehicle for repatriating profits from those countries that have remittance controls and is also a way to shift profits out of high-tax countries to low-tax ones (Fowler, 1978)

Zou et al (2009) identify the following as bases commonly used for transfer pricing:

- Actual cost: a firm's transfer price uses its actual manufacturing cost where manufacturing facilities are treated as cost centers rather than profit centers as means of resolving internal dispute in allocation of profits as well as identifying efficiencies in the supplying unit.
- Standard cost: this approach facilitates management by exception decision making in which variation from standard cost signals the need for additional investigation and attention by management.
- Modified cost: it is useful in promoting the achievement of strategic objectives where sometimes actual and standard costs are adjusted to encourage more extensive use of certain products or services.
- Market price: prevailing external market prices are often viewed as the better transfer pricing mechanism for external reporting but the approach requires that transfer prices are lower than market prices to equitably have the advantage of lower prices.
- Modified market prices: market prices can be adjusted to reflect specific characteristics of the goods and services involved which help resolve perceived inequities among supplying and receiving business units, however, supplying units with no excess capacity may be unfairly penalized.
- Negotiated price: it is determined by bargaining between the buying and selling units but its use in evaluating the performance of subsidiaries poses some risks.
- Contract price: is a price agreed upon at the time the firm's business plan is adopted and it eliminates variations that result from centralized sourcing decisions beyond the control of the managers of foreign operations.

## **7.6 Factors that Influence Transfer Pricing**

For most companies, the decision involves some combination of the considerations discussed below (Zou et al, 2009):

- Local taxes: one of the most significant concerns in setting transfer prices are the local tax rate and pertinent tax regulations. An effective transfer pricing system should deal with change in import duties, income taxes etc. to minimize overall tax exposure.
- Currency fluctuations: transfer pricing should effectively consider fluctuations in currency exchange rates to minimize the impacts from volatilities on the profitability of the entire organization.
- Inflation: transfer prices can be adjusted to balance the effect of local inflation in which case, a low transfer price helps minimize the loss in value from inflation.
- Subsidiary profits: transfer pricing can be used to manipulate the profit position of a subsidiary such as a startup that may require corporate assistance to either lower purchase prices or raise sales prices to other company units.
- Expense accounting: transfer prices can be used to advantage when the government places restrictions on allowable deductions for expenses in such services that cannot be charged

because of restrictions to recoup their costs by increasing the transfer price of components sold to the units.

- Joint venture support: transfer price can be used to recoup expense from a joint venture, especially if there are restrictions on repatriation of profits.
- Output capacity: subsidiaries with substantial excess production capacity can set transfer prices low enough to encourage additional internal consumption but high enough to cover the supplying unit's variable.

### **7.7 Potential Problems of Transfer Pricing**

The ability to control internal price charged to subsidiaries affords the global corporation significant flexibility and overall efficiency. These benefits come at a cost as discussed below (Zou et al, 2009):

- Complication of internal control measures where manipulating transfer prices make it difficult to determine the true profit contribution of a subsidiary.
- Morale problems typically surface at a subsidiary whose profit performance has been made worse artificially.
- Due to cultural differences, some subsidiary management may react negatively to price manipulation.
- Concerns about local regulations where subsidiaries as local businesses, must abide by the rules to overcome legal problem such as subsidiary following accounting standard not approved by host government that often require review of the transfer pricing practice by local authorities

### **7.8 Export contracts**

An export contract (sales contract) is a consensus document between two parties who intend to go into export trade. It is a legal document that can be enforced by the law (Gopal, 2006). Gopal (2006) further notes that there are three types of contracts that can be used by exporters: Ex works contract, Free on-Board contract and CIF contract.

- a) Ex Works Contract:** under this arrangement the seller fulfills his obligation by delivering the goods at his factory/shop/warehouse. The buyer bears all the costs and risks in taking the goods from that place to the desired destination. This term represents the minimum obligation on the part of the seller. In ex works contract the passing of title to the goods takes place at seller's plant contract price is always the lowest.
- b) Free on Board (FOB):** under this arrangement the seller fulfills his obligation when he delivers the goods on the ship rails at the named port of shipment. The buyer has to bear all costs and risks from that point of time. Carriage up to the port, inland insurance, port dues and loading charges into the ship are to be borne by the seller. In In FOB contract the passing of title of goods takes place at the Port of Export.

*Duties of the Exporter under FOB contract include (Gopal, 2006).*

- Supply the contracted goods in conformity with the contract of sale and deliver the goods on board the vessel named by the buyer at the named port of shipment.
- Bear all costs and risks of the goods until such time as they shall have effectively passed the ship's rail.
- Provide at his own expense the customary clean shipping documents as proof of delivery of goods.
- Provide export license and pay export duty, if any.
- Pay loading costs.

***Duties of the Importer under FOB contract include (Gopal, 2006)***

- Reserve the necessary shipping space and give due notice of the same to the exporter.
  - Bear all costs and risks of the goods from the time when they shall have effectively passed the ship's rail.
  - Pay freight.
  - Pay unloading costs.
  - Pay the price as provided in the contract to the exporter.
- c) **Cost Insurance Freight (CIF):** under this arrangement the exporter takes responsibilities associated with FOB contract, arranges shipping space, bear the ship freight and marine insurance charges from his contract price.

***Duties of the Exporter under CIF contract include (Gopal, 2006)***

- Supply the goods in conformity with the contract of sale, arrange at his own expense, for shipping space by the usual route and pay freight charges for the carriage of goods.
- Obtain at his own risk and expense all documentation regarding government authorization necessary for the export of goods.
- Load the goods at his own expense on board the vessel at the port of shipment.
- Procure at his own cost in a transferable form a policy of marine insurance for a value equivalent to C.I.F. plus 10%.
- Bear all risks until the goods shall have effectively crossed the ship's rail and furnish to the buyer a clean negotiable bill of lading.
- Provide export license.
- Pay export duty if any.
- Insure the goods.

***Duties of the Importer under CIF contract include.***

- Accept the documents when tendered by the exporter if they are in conformity with the contract of sale and pay the price.
- Receive the goods at the port of destination and bear all costs except freight and marine insurance, incurred in respect of carriage of the goods.

- Pay unloading costs.
- Bear all risks of the goods from the time they shall have effectively passed the ship's rail at the port of shipment.

## 7.9 Methods of payment for exports

There are five methods of receiving payment from overseas buyers. Choice of method largely depends on the bargaining muscle of the trading partners. Different methods of payment carry varying degrees of risk to the exporter. The methods of payment include payment in advance (cash payment) letters of credit, documentary bills, Open Account with Periodic Settlement and Shipment on Consignment Basis (Gopal, 2006 and Zou et al, 2009). Factors which are considered in Determining Terms of Payment will include the following.

- Exporter's knowledge of the Buyer.
  - Buyer's financial ability.
  - Degree of security of payment if advance payment is not considered.
  - Speed of Remittance.
  - Cost of remittance, which normally depends on speed of remittance.
  - Competition faced by the exporter.
  - Exchange restrictions in the importer's country.
- a) **Cash in advance (advance payment):** with this mode of payment, money is received before the goods are delivered and accordingly no risk is involved for it is used on product that are heavily on demand or custom made. When the importer is unknown or his creditworthiness is doubtful and not acceptable to the exporter and the importer requires those goods, there is no alternative to the importer, other than making advance payment. It is the cheapest mode of contract to the exporter (Gopal, 2006).
- b) **Letter of credit:** letter of credit establishes trust between the parties by involving both the buyer's and seller's bank which acts as a third party, examining documents to ensure that they are in order prior to payment. Letter of Credit has been defined as "any arrangement whereby a bank acting at the request and in accordance with the instructions of a customer (the importer) undertakes to make payment to or to the order of a third party (the exporter) against stipulated documents and compliance with stipulated terms and conditions. It is the most popular form of payment in international transactions. It is used by exporters for two main reasons: first the importer may not meet the credit standard of the exporter and therefore the exporter may demand bank obligation to eliminate credit risk and secondly, if the exchange situation in the importer's country indicates that a delay might occur in the transfer of payment to the exporter's country, the exporter may insist on irrevocable letter of credit. The exporter is not concerned with the creditworthiness of the borrower while entering into the contract (Gopal, 2006 and Zou, 2009). The different types of letters of credit include: documentary letter of credit, revocable and irrevocable credit, with recourse or without recourse letter of credit, confirmed and unconfirmed letter of credit, transferable and non-transferable letter of credit, fixed and revolving letter of credit, freely negotiable

and restricted letter of credit, red clause and green clause letter of credit, back-to-back letter of credit, assignable and non-assignable letter of credit, deferred period of credit and standby credit.

- c) **Collection draft/documentary bill:** this method is like letter of credit where the bank acts as intermediary between the parties to minimize the risk incurred. banks act as a media to reconcile the conflicting requirements of the exporter as well as importer. The exporter ships the goods, and the exporters' bank sends the bill of landing and other specified shipping documents to a bank in the importer's country, but the transfer of merchandise title will take place only upon receipt of full payment. Documentary Bills can be in the form of Sight Bill and Acceptance Bill. In both the cases, documents against payment and acceptance, there is a common risk-transfer risk-if there is shortage of foreign currency or exchange control restrictions in the importer's country.
- d) **Open account periodic settlement:** it is a procedure where an exporter ships goods to a buyer for payment later and the method is only used when the seller has adequate credit data about the importer. This form of payment is made when the exporter and importer are interconnected companies like the holding company and subsidiary company or where the relationship between them is long-standing and absolute trust exists between the two. This method of payment is simple and involves no additional costs and is possible only when the exporter is financially strong as he is meeting the credit requirements of the buyer.
- e) **Consignment sales:** in this method, the exporter retain the goods and agrees to wait for payment until the goods have been sold in the consignee's country. It is a risky method and some critical factors to consider when making consignment sale abroad that include Creditworthiness of the consignee, stability of the country and ensuring the party who is responsible for property risk ensures the merchandise until it is sold, and payment is received.

NB/Collection Problems: In exporting, collection problems involving bad debt can be more easily avoided than corrected once they arise. Exporters should try to avoid these problems through method such a credit check, safe payment (cash in advance, LCs) and credit risk insurance. In the case of credit checks, banks are often able to provide credit reports on foreign companies, either through their own foreign branches or through a correspondent bank.

### 7.10 Shipment finance

This may take two different forms: pre-shipment and post-shipment finance. Pre-shipment finance is financial assistance extended to the exporter before the shipment of goods and post-shipment finance is concerned with the financial assistance extended after shipment of goods. Use of effective finance techniques provides additional export marketing advantages such as need for pre-shipment financing or post-shipment financing.

**Pre-shipment finance:** this may take form of Packing Credit, Advances against incentives receivable from Government and Pre-shipment credit in Foreign Currency. The purpose of pre-shipment finance is to enable the exporter to purchase raw materials and supplies for

manufacturing or produce goods or purchasing goods, processing costs, packing, packaging and warehousing etc. This is a short-term advance that helps firms to get ready to service an export order. this type of financing is generally for small and medium size exporters who may have insufficient internal financing. This financing is usually in the form of a bank advance, overdraft, or loan against confirmed orders from the customer (Gopal, 2006 and Zou et al 2009).

**Post-shipment financing:** it is the financing done after the shipment and can be arranged through various financing institution such as commercial banks, merchant bankers, insurance companies and other financing institutions. Post-shipment financing can be short term, medium or long term. Post-shipment finance may be defined as loan or advance granted by the bank to the exporter after the date of shipment of goods till the date of realization of export proceeds. It includes any advance granted on security or in consideration of the amount of duty drawback or any kind of receivable in the form of incentives to be received from the Government.

An exporter can finance his international transaction through internal and external source. however, mall and medium size exporter usually need external export financing mechanism. Post-shipment finance may take the form of negotiation of export documents under letters of credit, purchase/discount of foreign bills, purchase/discount of foreign bills, advance against export bills sent on collection, advance against exports sent on consignment basis, advance against export incentives, advance against undrawn balances, advance against retention money, post-shipment credit in foreign currency, buyers' credit, and line of credit (Gopal, 2006).

### 7.11 Review questions

1. Citing relevant examples, discuss the various factors that influence export pricing?
2. Discuss main pricing objectives of new exporters.
3. What are the various pricing strategies that the new exporter may adopt?
4. When do firms use and transfer pricing and why?
5. Distinguish between FOB and CIF export contracts.
6. Which is the safest and riskiest method of making payment in export business and why?

### References

- Albaum G. Duerr E. & Josiassen A. (2016). International marketing and export management (Eighth). Pearson.pg 483-489
- Branch A. (2006) Export Practice and Management, Thomson Learning pg-287-330
- Cavusgil S.T, Knight G.A & Riesenber J.R (2008) International business news, strategy, Management, and the new realities. Upper Saddle River NJ Prentice Hall.
- Fowler D.J (1978) Transfer prices and profit maximization in multinational enterprise operations, Journal of International business studies 9(3) 9-16
- Gopal R.C (2006) Export Import Procedures New Age International Publishers Ltd pg 32-59
- Zou S. Kim D. & Cavusgil S. T. (2009). Export marketing strategy tactics and skills that work (1st ed.). Business Expert Press pg. 231-252