

**Title: "Best Practices and Pitfalls when Paying Chinese Suppliers - Lessons Learned over 8 years as a China-based purchasing manager"**

**Author: Mike Bellamy**

**Key Terms:**

PO = Purchase Order

Net 30 = buyer pays 100% of PO value 30 days after delivery

3<sup>rd</sup> Party QA = independent quality inspection/ quality assurance agents

RMB = Currency used in China, also called "Yuan"

**Note on the Target Audience for this Article:**

Useful for small to mid-sized buyers interested in managing financial risk while using fairly simple payment methods, such as Bank Transfers and even Cash, for purchases generally under 50K USD. The reader may be facing the dilemma of "how to limit financial risk while not compromising the bottom line with excessive bank fees for letters of credit or sophisticated exchange rate risk avoidance tools".

**Lessons Learned**

Over the past 8 years as a purchasing manager based in China I have placed thousands of Purchase Orders (PO) and structured Sourcing programs in over 150 different production classifications, ranging from rubber ducky bathtub toys to electronic devices used in nuclear power plants. Here are some of the lessons I learned along the way:

**1. Payment Terms**

In most cases, especially if it is an initial PO, China suppliers will rarely offer "net terms" Keep in mind that for the Chinese factory, net 30 terms really mean 120 days of project finance- 30 days to buy the material, 30 days to process, 30 days to ship across the pacific and 30 more days to wait for payment. It certainly is possible to achieve net terms in China, but it will probably be easier for you to move to better terms with your supplier after both sides have established a working relationship and trust. Be prepared not to have terms during the initial phases of the relationship.

Don't be surprised if a supplier asks for 100% payment in advance. Realize this is negotiable, just as you wouldn't necessarily accept the first offer of price with out a negotiation. I have found that "30-40-30 terms" are often an acceptable middle ground on payment terms, fair to both parties.

Under 30-40-30 terms, the initial 30% of PO value is placed as a deposit. This allows the supplier to buy materials and lock in the price (especially important if you have a long lead time or deal in materials which face great price fluctuations, or example metals.) The second payment, of 40%, occurs at shipping upon confirmation of quality. The final 30% is paid upon receipt and inspection at the final destination. Let's look at this 30-40-30 from both the buyer's and seller's perspectives to find why it was an acceptable middle ground.

The seller is worried that the buyer will default on payment, so getting 70% (40+30) before the goods leave port limits their exposure. As the average factory in China makes between 10 and 30% mark up, the 70% covers at least the majority of his internal costs, so even if the buyer defaults it won't put him out of business.

The buyer's biggest concern is that the goods will have quality issues or not arrive at all. By holding out on the final 30% until delivery, the buyer has leverage if quality problems require rework or replacement parts. It is also important to remember that the 40% is not paid until after the goods are inspected in China, so quality confirmation must be a key part of the payment process, and that brings us to the next point:

## 2. Financial Exposure is really Quality Exposure

Quality problems are the #1 source of payment friction between buyers and sellers. New-to-China buyers may think they are protected by good payment terms, but if you want real protection, you need to see that quality risk and financial risk are one in the same. Let us assume you were able to extract some great payment terms, for example Net 30. So you have plenty of time to inspect the product at your warehouse before making final payment. BUT, what happens if you find a problem? Who pays for rework, costs to ship back defects, and/or delays to the customer? What many new-to-china buyers don't realize is that 3<sup>rd</sup> party QA firms are readily available and inexpensive (a few hundred USD per shipment) in China. Utilizing 3<sup>rd</sup> Party QA agents to inspect the goods before the buyer pays the 40% (under a 30-40-30 system) is an excellent way to mitigate your financial and quality risk.

## 3. Currency

You may have heard your supplier say "sorry, we can't accept USD payment, we must have RMB." This is especially true these days, as the RMB is no longer linked to the USD at a fixed rate. To accept USD, your supplier may ask you to send funds to a private account (often the GM) or to a 3<sup>rd</sup> party trading company.

My point is two-fold:

- a) Bring up currency early in the negotiation process rather than after the PO is placed.
- b) Due to currency regulations and business licensing, it may be true that the factory can't accept USD. But if you must send money to a 3<sup>rd</sup> party, only do it if you get the vendor's seal on an official document stating that payment to the 3<sup>rd</sup> party equates to making payment directly to the vendor and the vendor bears the risk if things go wrong for the 3<sup>rd</sup> party. Having said that, this should only be applied to small value orders. Anything over 10,000 USD should go to a formal business account.

## 4. Traditional Financial Risk

There is a concern that the supplier will "run away with your deposit" or not be in business long enough to ship your goods. Luckily there are tools to manage this risk.

- a) Ask for references. If they can't give you a number of happy clients, then a red flag should be raised.

- b) Financial Due Diligence is affordable (a few hundred USD per audit) and readily available from providers like [www.Glo-bis.com](http://www.Glo-bis.com) and Verify. Use it to learn the ownership and financial stability of your supplier.
- c) Most important is visiting the factory to ensure they are not a trading company. Trading companies can disappear into thin air more easily than a legitimate factory, which has physical assets, a real address and employees. See related article entitled "Avoiding Middlemen" for details on how to determine if your supplier is a trading company or not.

### About the author

For the past decade Mike Bellamy has been based full-time in Asia. Fed up with the inability of middlemen/ trading companies to control quality and tired of having intellectual property (IP) knocked off, he decided to do something about it by forming PassageMaker in 2002. Mike developed a system to extract the best pricing in China and protect IP without compromising quality and service. PassageMaker's 100% US owned and operated Assembly Center in S. China serves as the client's "black box" where inspection, final assembly and branding takes place behind closed doors. In this fashion, Intellectual Property is physically secured and full quality inspection is conducted before product leaves China. Mike has structured sourcing investments in over 150 production classifications for US and European clients during his time in China. He has an International MBA from the University of South Carolina, which included course work in Harbin and Beijing.

Recognized as expert on China sourcing, Mike is has been a featured presenter for Global Sources Asia Expo HK, Global Sources Dubai, Boat Tech China, Rotary Foundation, US Chamber of Commerce, British Chamber of Commerce and State Bar of California among others. A former Rotary Foundation Ambassadorial Scholar, Mike speaks Chinese and Japanese. Based full time in Shenzhen China.

**Learn more about Mike and PassageMaker at [www.PSSchina.com](http://www.PSSchina.com). This website includes free educational material such as sourcing seminar videos and tools of the trade.**

With written approval from the author you are welcome to reprint and publish this article.