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How To Manage Costs & Risks Using INCOTERMS In International Trade

In international trade, cargo movement is the essence. It involves costs and risks which are often unforeseeably huge. Most business managers apply various measures to mitigate risks as well as manage costs and one of the primary starting point is often International Commercial Terms (or INCOTERMS) which for most businessmen, immediately gives a sense of control on costs & risks that they are about to incur should they sign on the dotted line.

INCOTERMS, for those who are new to this, are a nifty shorthand means of agreeing on who is responsible for the costs and risks associated with the international sale of goods. It is usually written with a three letter acronym (see table below) that confirms when risk in the goods passes from the seller to the buyer, and who is responsible for transporting, insuring, and paying duties on them. They also define the point of passage of risk with regards to cargo loss or damage. There are currently 11 Incoterms, 7 of which can be used for any mode of transportation, and 4 of which only apply to transport by water.So why are Incoterms so relevant to cross-border trade; take a look at the below pictogram to understand the stages of cargo movement from seller to buyer.

All points marked above represents a milestone in international trade, the responsibility of which (including costs & risks) needs to be agreed upon between parties. To reduce the burden of negotiations for every single stage, the three letters Incoterm acronym is used which comes with pre-defined accountabilities between the parties. Depending on the nature of trade, specific Incoterm can be used which will specify where does the risk transfers and who bears the costs.

For instance, FOB rule specifies that risk & costs transfers to buyer when the goods have been loaded on board the vessel. However FAS rule specifies that risk & costs transfers when the goods have been placed alongside the vessel on the quay (or in lighters).

The above may appear not to be very complicated but when you factor in the costs involved in getting the goods cleared for export and additional stevedoring charges involved in FAS compared to FOB, the difference between the two would suddenly seem very evident.

In my experience, business managers often do not delve into the finer text of these terms and end up negotiating without fully realizing the impact these terms have on the overall costs/risks. Even more, I have noticed that due to lack of awareness business managers are unable to strategize their available resources to extract maximum benefit during negotiations. Understanding the supply-chain of the cargo is the key because it helps selecting the appropriate Incoterm that would be most suitable and would enable businesses to reap the benefits of low hanging fruits by which costs can be managed, such as: -

1. Cost Efficiency – negotiating the right Incoterm helps you control your shipping costs. For instance if a buyer has a dedicated shipping network and FOB/FAS is chosen, then the shipping fees can be procured directly with the main carrier which will most likely be cheaper compared to one provided by the seller because it is often marked-up.

2. Route Optimization – if an Incoterm is selected where the sellers are to arrange delivery they will often choose the most economical routing of the cargo which may not be aligned with your business timelines. Choosing your own shipping route may not only be cheaper but delivery would prove to be faster.

3. Control & Visibility – while booking shipping through your preferred agent, it will give you more control and visibility on real-time status of your cargo. You will have the flexibility to optimize the route to suit your business needs.

4. Insurance – depending on the point of transfer of risk in the goods, you will have the option to procure the right insurance for your cargo which will become effective with the passage of risk. Being handed-over a foreign insurance by seller (which may or may not be from a reputable insurer), may be a challenge especially when there is a loss or damage to goods involved.

Although the above highlighted points are few benefits of choosing Incoterms smartly, you will find online many materials that are dedicated to academic discourse on Incoterms which I highly recommend for reading. In the meantime, following are few tips that can be handy:

1. Understand the supply-chain of the cargo; if you chose Incoterms based on convenience then costs will definitely be higher. Collate your resources and strategize how to deploy those resources vis-à-vis Incoterms to ensure cost efficiency.

2. Be realistic with the expectations from the counter-party (& yourself). Issues such as whether the seller can undertake all the necessary formalities in the buyer's country, e.g. paying GST or VAT while using DDP or using EXW without thinking through the implications of the buyer being required to complete export procedures can create unnecessary (& expensive) delays.

3. If more than one carrier is involved in transportation, ensure that the implications of risk transfer by the first carrier which in all likelihood will be a small haulage firm, are

adequately addressed.

4. Always double check how terminal handling charges (THC) are going to be treated at the point of arrival. Some carriers absorb these costs while some do not.

5. Incoterms state when risk in the goods passes, **but not title**. Please bear in mind that Incoterms is not a substitute to a contract therefore contractual issues such as price, consequences of breach, termination rights, governing law etc. must be incorporated in a separate contract.

6. Always clearly specify which Incoterm is being used and also define the edition you are using. For instance, '[*Incoterm, delivery point*] *Incoterms® 2010'.*

7. When naming a specific delivery point or port, be specific – simply mentioning 'USA' could mean your goods end up in Houston when you want them in Long Beach.

8. In general, Incoterms are silent on the matter of insurance (except CIF and CIP) and the buyer/seller each decides insurance of the cargo for that part of the journey for which they bear the risk of loss or damage. Ensure that adequate insurance terms are defined and agreed beforehand.

9. Adding qualifications or variation to an Incoterms rule is generally acceptable but extra caution should be applied to avoid introducing ambiguity which often comes from different interpretation applied to common terms in market practice.

10. Incoterms are quite extensive, therefore always seek legal help when you feel you are getting out of your comfort zone.