

Credit Risk Policy

(Management of Trade Receivables, terms of Credit and Discount)

APPROVED BY BOARD OF MANAGEMENT
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1. INTRODUCTION

Archroma is a multinational specialities chemicals group based in Switzerland with more than 35 group companies. The trade receivables resulting from sales to unrelated parties (other than Group) bear the risk of non payment or late receipt of payment. These risks insert a degree of uncertainty into Archroma's operative (bad debts) and financial results (costs of net working capital). While such risks never can be fully avoided, they must be quantified, evaluated as to their acceptability and kept to an acceptable level whenever possible.

Credit Management includes all procedures to guarantee that realized sales are turned into cash or liquidity in a timely manner under maximum avoidance of risks associated with debtors

The objective of this policy document is to outline the Credit Management of the Archroma Pakistan Ltd (APL). It addresses how Archroma protects itself against risk of bad debts and costs of net working capital.

All inquiries on this policy should be addressed in accordance with the list of contacts (Appendix 1)

A glossary of the main definitions is enclosed in Appendix 3

2. SCOPE OF CREDIT MANAGEMENT

2.1 Objectives of Credit Management

The degree of risk Archroma is willing to take on trade receivables is determined by the sales strategy. This strategy and the targets to be reached are set by the Country Management Committee. Credit Management will support these targets and Company's sales strategy.

Credit Management's objectives are to

- *Minimize losses on Trade Receivables*
- *Optimize Net Working Capital requirements*

2.2 Organization

Credit Management has credit risk and collection responsibility for its respective credit control area. Credit Management report to the Country President. Credit Management consists of Country Head of Finance (CHOF) and Head of Businesses (HB). CHOF is responsible for setting up an appropriate Credit Management Guidelines in accordance with the Group Credit Risk Policy, notify any change or any new requirement prescribed by the Group Risk Management and will provide information to Group Credit Management proactively and on request. Head of Businesses will provide information to Regional Credit Management, if it is required.

Credit Management also includes Area Managers (AM) / Regional Managers (RM), Product Line Managers (PLM) & Distribution Manager(s).

2.3 Types of Credit Risk

2.3.1 Customer Risk

Customer Risk is defined as delayed payment or non-payment due to an individual debtors' inability or unwillingness to pay trade receivables on maturity.

2.3.2 Country Risk

Country Risk is defined as country specific events such as government action, by civil unrest, by war (political risk) or by natural disaster which delay or prevent the cross border payment of trade receivables on maturity.

Monitoring and payment terms restriction up to 120 days in Most Critical Countries apply to both domestic and export sales.

- Risk Mitigation Instrument for reducing country risk
- Classified in order of security level for selling country
- Secured Payment Terms: Advance payment or cash collateral/ deposit Confirmed Letter of Credit Bank Guarantee and Letter of Indemnity by Banks rated as above
- Parent Company Guarantee and Letter of Indemnity provided that the parent is rated 'investment grade' and located outside MCC

- Reflection of Country Risk in Balance Sheet
- Payment Terms exceeding 120 days

Unsecured sales both domestic and exports to most critical countries over 120 days pay term will be fully provisioned

2.4 Validity of the Credit Risk Policy

2.4.1 Scope of application

The Credit Risk Policy applies to sales to third party customers in order to protect trade receivables and provide for their timely collection.

It does not cover intragroup receivables from fully consolidated and fully controlled Archroma affiliates.

2.4.2 Risk Rating

The Risk Rating consists in assessing the customer's ability or willingness to pay on due date and assign them Standard Credit Rating Categories. The purpose is to identify potential risks on Trade Receivables at all stages of the sales process.

The rating of the Credit Risk of a customer is a financial decision made by the Credit Management alone.

The Risk Rating should be modified whenever a change in the financial condition of a customer so warrants. The Risk Rating is to be taken into account when establishing the amount and duration of the credit exposure.

2.4.3 Risk Mitigation

The partial or full coverage of Credit Risks on Trade Receivables through securities such as credit risk insurance, trade finance instruments (Letters of Credit, Documentary Collection, etc) or other. Such risk mitigation tools must be verified and approved by Credit Management even if other departments are responsible for processing.

2.4.4 Risk Associated with the Credit

Since risks (customer risk & country risk) is the most important factor in determining the extent of credit to be granted to any customer, it is essential that the assessment of risk associated with the credit is done in a highly professional manner and shall be based on objective elements and remain independent of any business opportunity consideration. Business shall provide all information at hand which is relevant for the credit rating of customers.

Other things being equal risk ranking would be as follows for the different types of ownership structures:

- a) Individual, sole proprietors.

- b) Partnerships.
- c) Private limited companies.
- d) Public limited companies but not listed on Stock Exchange.
- e) Quoted public companies.

2.4.5 Determination of Customer's Credit Worthiness

Risk has a direct relationship with customer's credit worthiness. It is, therefore, imperative that no credit should be extended unless the credit worthiness has been assessed. Until that is done, or even after having done it, if indicators point to a possible default, care should be taken. That is to say, if in doubt always favour the Company.

While no hard and fast rules exist, prudence demands that some time bound practices be followed to achieve objectivity and avoid irrational and open grant of credit. These are:

(i) Customer's own financial strength:

Not easy to determine unless the prospective customer is a public limited company because the general public is not privy to the financial information.

(ii) Parent's support:

Applies to limited companies only. Parent's name is a good indicator of the security for an outsider to assume.

(iii) Banker's report:

Not entirely reliable but is a good source of having an independent opinion.

(iv) Own investigation:

Nothing better than own investigation to determine the credit worthiness. It is important however, that this investigation should be done as thoroughly as possible.

Following points have to be considered:

- a) Discreet inquiries in the market / territory where the customer operates.
These should include the opinions of neighbours, customers, competitors, and, wherever possible, suppliers because their experience is most relevant. Competitors who are also the suppliers to the party may give misleading information but other suppliers' opinion is important to obtain.
- b) Assessment of his assets e.g. property, other assets etc.
- c) Pedigree i.e. known in his existing business, new in this business but otherwise an acknowledged businessman, a new entrant e.g. from agriculture into commerce etc.
- d) Lifestyle in relation to the size of the business i.e. balanced or spendthrift. In the latter event, his joy rides are most likely at the suppliers' cost.

e) Existing payment practices :

Delays in payment of invoices on dues dates, delays becoming longer, bouncing of cheques, initially once but later requiring repeated presentation to the bank etc are clear warning signals for curtailing credit. If not acted promptly or sales per se (sales for the sake of sales to achieve target) are considered more important, than the quality of business suffers and the probability of a dent in the profit arises. Company's records provide many such examples.

3. CREDIT MANAGEMENT GUIDELINES

A policy fully supported by the will of all concerned and an effective harmonized credit control mechanism has proven to be the backbone for minimizing the risk. If the will to minimize the risk exists then any shortcomings will be covered through classroom or on the job training, persuasion and other means as and when necessary. The harmonized wherever practical and justified credit controls mechanism will be implemented as follows.

3.1 Responsibilities

Credit Management is in the responsibility of Business Head. The respective functional responsibilities of each person of credit management and approval authority is attached in the Annexed Credit Control (Annexure – 1). Country President will authorize any exception to Credit Management Guidelines.

3.2 Standard Credit Rating Categories:

A - LOWEST CREDIT RISK

Typically financially strong, registered, publicly traded, investment grade corporate where financial information is conveniently available, i.e. published financial reports.

B – LOW TO MEDIUM CREDIT RISK

Excellent reputation but smaller size or slightly lower than excellent financial ratios, financial information not published in case of privately owned companies

C – MEDIUM TO ABOVE AVERAGE RISK

Typically: unknown financial data, neither positive nor negative, or customers recovering from past difficulties. Rating indicates non-material credit exposure as long as payment performance remains satisfactory.

D – HIGH CREDIT RISK

Ongoing unresolved financial difficulties, declared insolvency or bankruptcy procedure, legal case ongoing with Archroma or other material creditor, critical financial ratios (if available)

O – GROUP LEGAL ENTITIES

Archroma Legal Entities do not represent a credit risk and should be exempted from credit check. Intragroup relations are subject to separate guidelines published in eCAM.

The criteria to assess individual customers' risk and allocate the customer to one of these categories may vary from country to country.

Z – Inactive customers

This risk category includes only inactive customers.

The latter are defined as customers for whom you have

- No sales in the past two years (last 24 months)
- No open balance or pending orders/deliveries
- No postings in the customer account for the last two years

Each customer of the legal entity's portfolio has to be assigned to one of these above credit risk category. A blank credit risk category is not permitted.

Special Condition

Considering the local industrial payment practices, we should have only 2 categories rather A B C D as mentioned in credit policy (applicable with prior Credit Management Approval) i.e.

1. BCR on receipt of cheques "A" Category and
2. BCR on clearance of cheques "B" Category. (stop supplies till the clearance of cheque and in case of any overdue)

In case, if cheque of any "A" category customer gets bounce, it should be transfer to "B" category.

To ascertain the categorization, the credit management review last 6 months performance (history from bank reconciliation and aging analysis) and prepare list which should be followed religiously.

3.3 Risk Rating

To start a rating process on new customers, Credit Management needs from Business all the information available on the customer. It is recommended that this information is sent by the Business representative responsible for the sale using a credit application form CC1, mentioning at least following information:

- full name, address and legal form of the client,
- credit limit required
- required payment terms and conditions

Credit Manager is to define criteria to rate the Credit Risk of a customer by him/herself. However, Credit Risk criteria must be understandable and rational. Following data may be used as Credit Risk rating criteria:

- financial ratios: if business reports are available (Appendix 3: Financial Ratios)
- payment history with Archroma (if any)
- trade references or recommendations received from banks or other partners
- Country of the customer: critical or non critical, etc.

3.4 Credit Limit allocation and credit period

The credit limit is the amount which APL is willing to put at risk as Trade Receivable with a customer at any given time. The credit limit allowed must be made on tangible reasons and be economically justified. The objectively determined credit limits and credit periods for individual customers, existing or new ones will take into account the following factors:

- a) Potential business volume.

- b) Financial strength of the customer, and
- c) APL's own strength in the market emanating from the quality or uniqueness of the product, customer
- d) Service, market share etc.

While (c) is an internal self-assessment, common to all customers within a Business Unit / Division, (a) and (b) above are unique to each customer and must be determined with greatest care and caution. A recommendation to give credit is like giving a clean bill of health (i.e. a medical certificate of good health). Therefore, such recommendation should be made only after verifying all important aspects described earlier.

A standard form (Form CC-1) will be used by all Businesses / BU to define the maximum credit limit per customer allocated and approved. Appendix 4 is attached which define function, which function can request and which function can perform them.

Upward hierarchy and across the organization, input from all concerned will be taken by Head of Businesses before committing the Company's resources for a given customer.

3.5 Payment Terms and Conditions

Sales will not be allowed to take place if any of the following conditions exist:

- a) Previous outstanding plus the proposed supply will exceed the credit limit inclusive of the tolerance; and/or
- b) Invoice(s) remain unsettled beyond the authorized credit period inclusive of the tolerance.

The Payment Conditions refer to the method of payment and its level of security. For high level of security, Payment Conditions may require Cash Collateral, Bank Guarantees, Credit Insurance, Letters of Credit, or other trade finance instruments. The acceptance of Payment Terms offering adequate security to Archroma is subject to the negotiations with customers and availability on the market.

It will be the Credit Managers' responsibility to assess if a guarantee/collateral/trade finance instrument offered by the customer can be considered as secure and valid.

The above situations warrant a close look at the transaction and need authorization by Head of Businesses depending upon their individual financial authorities. These dispensations must always be in writing on the Delivery Order that will show a complete picture of outstanding and a detailed analysis of overdue outstanding.

In view of stringent control on DSO and overdue by the Finance, it is becomes very important to strictly follow the following rules:

- i) All cheques received at the end of the month shall be cleared latest by 15th of subsequent month.

- ii) Unless previous months cheques are not cleared, no BCR shall be prepared for the current month.
- iii) Deliveries shall not be made unless all cheques deposited are cleared and outstanding balance of the customer is within the approved limit.
- iv) Cheques remaining un-cleared by 10th of subsequent month will not be considered as collection of the previous month for calculation of DSO's.

Under no circumstances, further supplies will be allowed until reasons for releasing the previous supply have been actualized or special dispensation has been obtained from the CEO or in his absence CHOF.

3.6 Increase in existing Credit limit or Period

A permanent increase in existing credit limit or credit period must be fully justified before entering into the accounting system. The recommendation must be supported by history and verifiable data about the future potential and/or change in circumstances that warrant a change in the existing status. Form CC-2 provides a standard format for use in such cases.

Trade receivables posted on the ledger are deemed to be due by the customer and payable on maturity. Disputes on trade receivables must either be solved before due date or invoices cancelled in part or in full by Business before maturity. Credit Management will not exclude any receivables from dunning and collection procedure on grounds that claims from customers is justified; such invoices must be cancelled or corrected instead by business responsible.

Form CC-3 – New form is introduced to notify inactive customers & Form CC-4 is also introduced to authorize the exception to Credit Management Guidelines.

3.7 Order Blocking/Release

NB: “Order” refers to incoming customer orders and delivery of goods to customers.

Violation of Credit Management Guidelines (exceeded credit limits, unpaid overdue Trade Receivables, etc.) must trigger an order block upon credit check. The release of orders in violation with the Credit Management Guidelines should be considered as an exceptional procedure. Such exceptions may be requested by Business to Credit Management for acceptance. If both parties fail to agree, the case is considered in dispute.

An escalation procedure must be defined for such disputes concerning the release of blocked order. This procedure should provide that disputes between Credit Management and Business are escalated to the next respective management level in Finance and Businesses / BU.

All persons and function having the release rights must be named in the Guidelines. It is recommended to give the release rights of blocked orders to Credit Management alone (transaction CBS in BPCS).

3.8 Dunning and Collection

Business must provide all assistance necessary and required by Credit Management to allow a timely collection of trade receivables.

It is recommended that customers approve Archroma's general terms and conditions of sales. This should help avoiding disputes about payment terms, conditions and applicable jurisdiction.

Dunning is considered as "soft" collection. Credit Management decides if customers may be exempted from dunning on case by case basis.

Blocking the customer's account for new orders and delivery and taking legal action against the customer are considered "hard" collection. The CHOF and Businesses including Distribution manager are authorized for blocking customer's account and order legal action against customer.

If customer requests for debt rescheduling, it must be approved by CHOF before acceptance.

Dunning Process:

- Send customer statement of accounts at month end highlighting payments due for the next month.
- Send first reminder for overdue at the beginning of the month.
- Control / block supplies in co-ordination with Business Managers, if no positive response after 1 month.
- Discuss reasons & if need be negotiate for settlement of delayed payments & continuity of business.
- In case of long overdue initiate process for legal proceedings.

3.8 Provisions for Bad Debts

Provisions must be created for bad debts according to the [Accounting Manual on eCAM](#). Such provisions are the responsibility of the Country Head of Finance. It is recommended that Credit Management follows up and coordinates the provisions with the Country Head of Finance on a monthly basis. If special situations (declared bankruptcy, etc.) provides for an earlier bad debt provision than stipulated on eCAM, Credit Management is to trigger such provisions.

Credit Management must be consulted before any exemption of provision for bad debt.

4. REPORTING AND BENCHMARKING

Following information and reporting can be adapted to individual needs of Businesses and Country Management committee.

It should consist at least of:

- Receivables KPI Days Sales Outstanding based on MFR per BUS
- Trade Receivables Ageing List / per customer
- Overdue 4, 5, months and Bad Debt List per BUS / per customer

5. ASSURANCE OF COMPLIANCE

The prime responsibility for ensuring that the credit policy is operated as per laid down procedures rests with the BU and Division Heads who will assure compliance in a note to the Head of Finance in the first week of every month.

6. ADVANTAGES OF IMPLEMENTING A CREDIT POLICY

Experience has shown that in their eagerness to show higher performance members of the sales team sometimes avoid financial discipline which may lead to loss for longer term business prospects. However, through effective communication and disciplined credit management, damages arising from the following can be avoided.

- a) Insufficient investigation into the credit worthiness of the customer.
- b) Circumventing the procedures and continuing sales despite warning signals issued by the system.
- c) Abrupt increase in credit limit or credit period to cover own inefficiency e.g. to hide overdue Outstanding or to effect sales to meet targets for bonus and rewards.
- d) Fixing unrealistically high credit limits and not changing them well in time to reduce exposure. In
- e) Most such cases, not only the amount due becomes doubtful the customer is also lost.
- f) Setting objectives for total credit without any resemblance to the customer portfolio and the weighted average of credit days of customers assigned to a sales person or located in a territory.

6.1 Training of staff

Training of staff plays an important role in appreciating the need for credit control and the positive contribution made by it in ensuring the good quality of business. Bad debts and provisions for write-offs due to overdue outstanding is not looked at kindly by the shareholders and bankers who may withdraw support if it is sensed that unscrupulous practices have led to the reduction in profit on this account.

Staff must be trained in all aspects of credit policy affecting their work and performance as individuals and collectively for the company. The sales force must be educated to appreciate the real meaning of profit and growth that can be sustained year after year. A growth curve that is smooth is preferred over the one, which represents a mountainous territory with high peaks and low ebbs. The most effective tool is company's own history and citing of cases where losses were suffered due to non-judicious credit management within an existing credit policy or the total non-existence of a policy. The continuation of this practice will stimulate the field force to itself come out with 'bad' cases and workable suggestions to avoid them.

Credit policy avoids these pitfalls through training and effective communication at all levels.

7. APPENDIX

Appendix 1: List of APL Credit Risk Management Contacts

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Appendix 2: Financial Ratios for Customer Credit Rating

NB: the list is non-restrictive list of ratios that can be used for Risk Rating of Customers. Others may be used as well.

Name of Ratio	Definition	Meaning
Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Cash, Trade Receivables, inventory, and other assets which are likely to become cash within short term. Ratio indicates capacity to honour short term financial obligations.
Quick Ratio (also called Acid Test)	$\frac{\text{Cash and Trade Receivables}}{\text{Current Liabilities}}$	<i>(Financial Data should be recent i.e. less than 6 months old)</i> This assessment of a company's ability to meet short-term obligations is also known as the acid test. A high quick ratio is usually a sign of a solid, conservatively run company in no danger of liquidity problems.
Interest Coverage Ratio	$\frac{\text{EBIT}}{\text{Interest Costs}}$	Interest coverage is a measure of a company's ability to handle debt service, and is a measure for indebttness. EBIT should be several times annual interest expenses, but the higher this ratio the better.
Debt/Equity Ratio	$\frac{\text{Total Debt}}{\text{Total Equity}}$	The debt/equity ratio is a measure of the extent to which a firm's capital is provided by owners or lenders. A greater reliance on debt can mean greater profitability but also greater risk

Appendix 3: Glossary (alphabetical)

Accounting Manual on eCAM

Archroma's Accounting Manual on the e-CAM database on group share point published by Group Accounting.

Credit Management

All procedures to guarantee that realized sales are turned into cash or liquidity in a timely manner under maximum avoidance of risks associated with debtors

Credit Risk: composed of Customer (Counterparty) Risk or Country Risk.

Customer Risk = individual debtors' inability or unwillingness to pay trade receivables on maturity.

Country Risk = country specific events which delay or prevent the cross border payment of trade receivables on maturity.

Risk Mitigation

Risk Mitigation is the partial or full coverage of Credit Risks on Trade Receivables through securities such as credit risk insurance, trade finance instruments (Letters of Credit, Documentary Collection, etc) or other.

Risk Rating

Assessing the customer's ability or willingness to pay on due date and assign them Standard Credit Rating Categories

Terms of Reference

Set of guidelines defined the modus operandi and the financial limits of the legal entities. The terms of reference are approved by the Country Management Committee.

Appendix 4:**1. Credit Control Form CC1- for opening of New Account and Fixing of Credit Limit.**

1.1	Proposed by	TSO / Area Manager
1.2	Recommended by	Regional Manager
1.3	Verification of document attached risk mitigation factor etc.	Distribution Manager
1.4	Approval of Credit limited / Credit Tolerance	Head of Business
1.5	Comments: Agree / Disagree	CHOF
1.6	Authorized by (if disagreed by CHOF)	CEO
1.7	Entry of 1.4	Distribution Manager

2. Credit Control Form CC2 – for Change in Credit Period / Credit Limit

2.1	Proposed By	TSO / Area Manager
2.2	Recommended by	Regional Manager
2.3	Approval of revised Credit Limit / Credit Tolerance	Head of Business
2.4	Comments : Agree / Disagree	CHOF
2.5	Authorised by	CEO
2.6	Enter of 2.3	Distribution Manager

3. Credit Control Form CC# - to notify inactive customers

3.1	Proposed By	Distribution Manager
3.2	Comments from	Head of Business / CHOF
3.3	Authorised by	CEO

4. Credit Control Form CC4 – Exception to Credit Management Guidelines

4.1	Quarterly Prepared by	Distribution Manager
4.2	Quarterly Submitted by	CHOF
4.3	Comments from	Head of Business
4.4	Authorised by / without Comments	CEO

Appendix 5:

1. Customer Classification