A LOOK AT FACTORING SERVICES

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The extent of economic development of a country depends upon its industrial and financial development. And both the industrial and financial sectors contribute towards each other's development. The financial system, particularly in developed countries, has undergone radical transformation in all its constituents, i.e., institutions, instruments and markets. With fast industrialisation and consequential growth in the volume of industrial output, we find that the management of sales, timely collection of debts and receivables are fast becoming a professional activity. Specialised institutions (called factors) have come up which efficiently and effectively collect funds locked in debts, the consideration being factorage for the services rendered. The author has examined the dynamics of factoring in modern business.

Factoring services as a tool for assisting the suppliers in the matters of short term finance and collection of receivables has been extensively and increasingly used in several economically developed countries during the last three decades. But its emergence in developing countries like India is only recent. Its importance is likely to go up appreciably as Indian economy gradually opens up under the policy of globalisation.

I. Meaning Of Factoring[1]

Factoring may be defined as a contract between a financial institution (factor) and a business concern (supplier/client of the factor) whereby the factor purchases the book debts of the client and in relationship thereto, controls the credit extended to the client's customers and also administers its sales ledger. It is, thus a short term financial assistance by specialised agents to help manufacturing and trading organisations in management of their receivables.

The factor purchases the book debts of the supplier, thus releasing the capital tied-up in accounts receivables. The book debts are assigned to the factor and he collects them as and when due. The charge for this service is in the form of a discount or rebate deducted from the bills. Thus, between the supplier and the customer, there enters an intermediary who performs a financing service as well as the service of debt collection.

Following diagram provides an easy manifestation of this relation:[2]

Factoring, thus, puts at the disposal of business enterprises an operative instrument specially conceived for a synthesis of financial, adminstrative and guarantee services.

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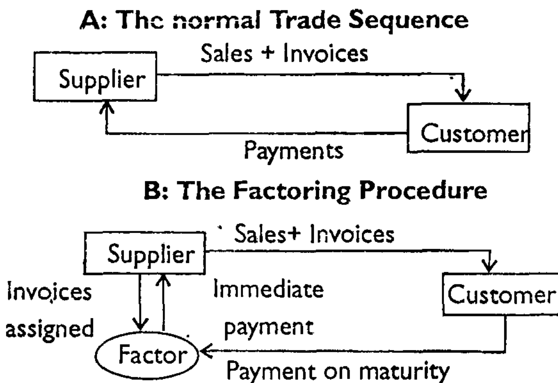

Figure 1: *The factor as a specialised intermediary*

II. Facets Of Factoring Services

1. Financing Service

Financing is the major aspect of Factoring Service. The factor improves the liquidity of the supplier by advancing a proportion of the value of debts, and the balance on maturity. Hence, the book debts of the supplier are replaced by cash. The prompt factoring of the debt reduces the product cycle or in effect, increases the circulation of capital in the business.

2. Administrative Service

The factor generally relieves the supplier of the administrative burden of maintaining the sales ledger, issuing invoices, collection of payments, when due, etc. This enables even small sized companies to get their accounts maintained by professionals.

3. Credit Protection

The factor purchases the debts from the supplier so that in the suppliers books one debt figure due from the factor takes the place of all the various debts due from the supplier's customers. And thereby, the factor relieves him of the risk or loss. In addition to this, the factor assesses credit risk and advises the supplier accordingly. He also approves the extent of credit allowed by the supplier to individual customers and monitors their accounts.

4. Advisory Services

A factor may also render various advisory services regarding economic trends and conditions, impact of impending developments in the industry and so on. Besides these, he can also advise customers on work load analysis, replacement programme on machinery and other technical problems.

III. Dynamics of Factoring[3]

Credit sales generate the factoring business in ordinary course of business dealings. Realisation of credit sales is the main function of factoring services. Once sale transaction is completed, the factor steps in and takes course to realise the sales. Thus, factor works between the seller and the buyer and sometimes with seller's banks together.

The following Fig. 2 presents a schematic view of factoring mechanism explaining therein the interaction between the different parties and flow of information between them.

The mechanics of factoring is summarised below:

(A) The buyer:

- (a) buyer negotiates terms of purchasing plant and machinery or other material with the seller;
- (b) buyer receives delivery of goods with invoice and instructions by the seller to make payment to the factor on due dates;
- (c) buyer makes payment to factor in time or gets extension of time or in the case of default is subject to legal process at the hands of factor.

(B) The seller:

- (a) memorandum of understanding with the buyer in the form of letter exchanged between them or agreement entered into between them;
- (b) sells goods to the buyer as per MOU;
- (c) delivers copies of invoice, delivery challan, MOU, instructions to make payment to factor given to buyer;
- (d) seller receives 80% or more payment in advance from factor on selling the receivables from the buyer to him;
- (e) seller receives balance payment from factor after deduction of factor's service charges, etc.

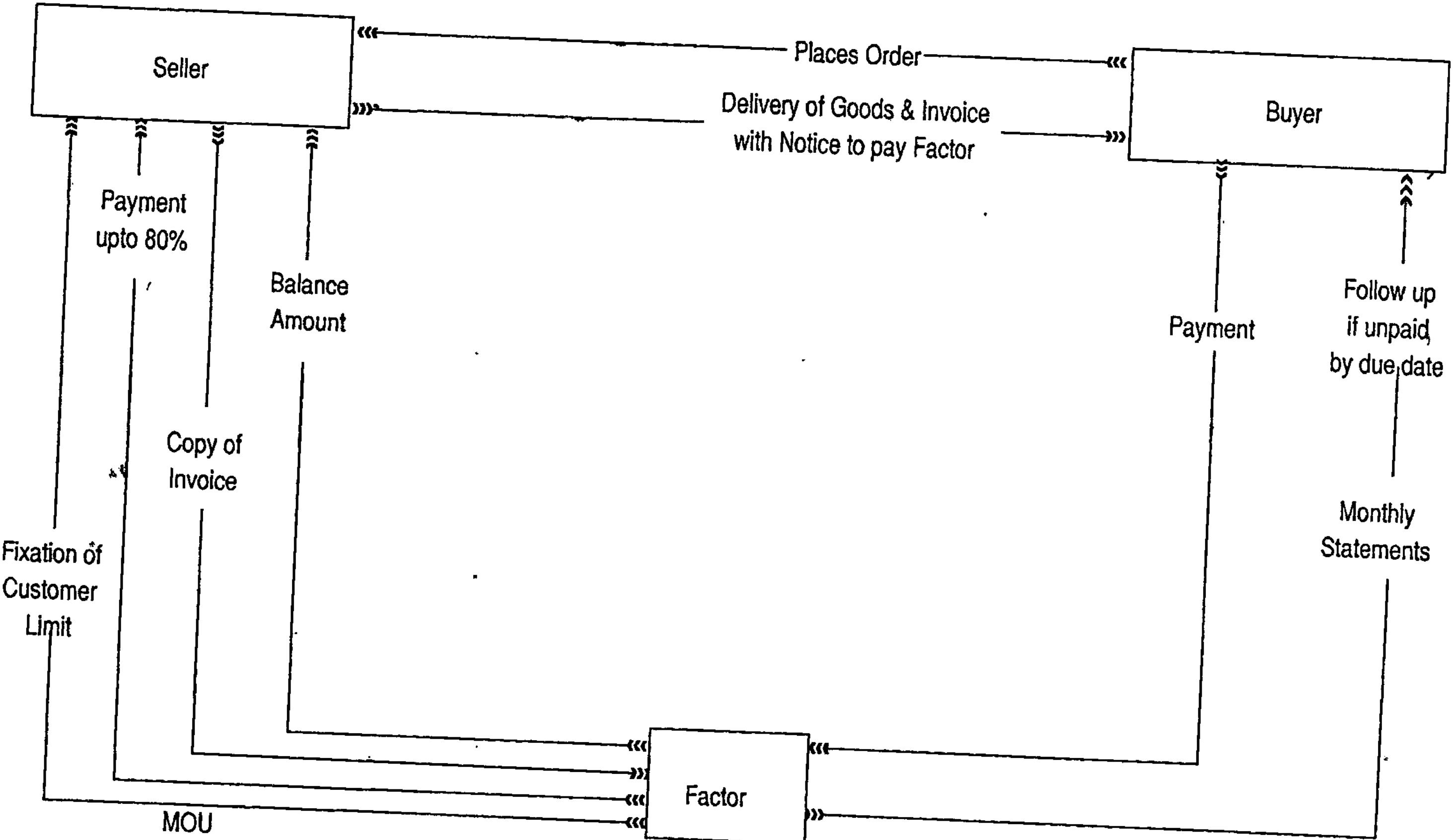

Figure 2 : Machanics of Factoring

(C) The factor:

(a) the factor enters into agreement with seller for rendering factor services to it;
(b) on receipt of copies of sale documents as referred to above makes payment to the seller of the 80% of the price of the debt;
(c) the factor receives payment from the buyer on due dates and remits the money to seller after usual deductions;
(d) the factor also ensures that the following conditions should be met to give full effect to the *factoring arrangements:—*

(i) the invoice, bills or other documents drawn by seller should contain a clause that these payments arising out of the transaction as referred to or mentioned therein might be factored;
(ii) the seller should confirm in writing to factor that all the payments arising out of these bills are free from any encumbrances, charge, lien, pledge, hypothecation or mortgage or right or set-off or counter-claim from another, etc. ;
(iii) the seller should execute a deed of assignment in favour of factor to enable the latter to recover the payment at the time or after default;
(iv) the seller should confirm by a letter of confirmation that all conditions to sell-buy contract between the buyer and him have been complied with and the transaction is complete;
(v) the seller should procure a letter of waiver from the bank in favour of the factor in case the bank has a charge over the assets sold out to buyer and the sale proceeds are to be deposited in the account of the bank.

IV. Classification of Factoring

Factoring can be classified into six broad categories:

1. Notified and Non-notified Factoring

In the case of notified factoring, the customer is informed about the assignment of the debt to the factoring agent and also directed to make payments to such agents instead of to the firm. However, in non-notified factory the customer is not intimated about the factoring contract and is directed to make payment to a changed address, usually the address of factoring agent. Non-notified factoring is also known on confidential factoring'.

2. Recourse and Non-Recourse Factoring

Factoring, whether notified or confidential can again be sub-classified as

recourse and non-recourse factoring. Under a 'with-recourse' arrangement, the supplier will carry the credit risk in respect of receivable he has sold to the factor. The factor will have recourse in the event of non-payment for whatever reason, including the financial inability of the customer to pay. Effectively, the factor has the option to sell back to the supplier any receivable not paid by a customer, regardless of the reason for nonpayment. In 'without-recourse' factoring, the bad debts are borne by the factoring agent or factor. However, the factor commission would be higher in 'without-recourse' factoring.

3. Advance and Maturity Factoring

Under advance factoring, the factoring agent provides advance to the firm on uncollected and non-due accounts receivables at an agreed rate of interest. The advance payment may range upto 90% of invoice value. The balance is known as the supplier's equity or the factor's reserve and is payable on maturity or on actual collection. On the other hand, under maturity factoring, payment is effected to the firm at the end of the collection period or the day of collecting the account, whichever is earlier.

4. Bank Participation Factoring

In bank participation factoring, the firm creates a floating charge on the factoring reserves in favour of banks and borrows against these reserves. For example, if the factoring agents reserve is 30%, the firm borrows to the extent of 70% of this reserve from bank, thereby bringing down its investment on receivables.

5. Invoice Factoring

Under this type of factoring, the factor purchases a particular number of debts due to client, thereby improving his liquidity position. This is simply a one time operation and does not cover the entire sale ledger of the client. And, therefore, this type of factoring is usually not considered to be an integral part of the present day factoring organisation.

6. International Factoring

International factoring houses deal with export sales. Apart from providing financial service, these institutions provide service for completing legal and procedural formalities pertaining to export.

V. Charges of Factoring Services

The factor charges are the charges claimed by the factor from the firm for the services rendered. It includes three major components :

1. the risk component
2. the administrative cost, and
3. the interest cost

The costs depend on factors like nature of product, annual sales turnover, average size of sales, credit policy, credit worthiness of customers, interest rate prevailing in market scale of operation of factoring agency etc. Normally, the factor charges 1 to 3 per cent of the face value of the receivables managed. Interest cost is payable only if the firm wishes to receive payment for the sale of its receivables before they are actually collected. If the firm receives amount from the factor beyond the time when the receivables are collected, interest is received for the same from the factor but the interest payable is comparatively low. The relevance of factoring cost is important when the firm is to decide whether to use factor's services or to have its own receivable network and the ease with which funds are available in market. It is the experience of European countries that factoring is advantageous for small sized businesses.

VI. Post Factoring Scenario : Benefits of Factoring

The vast significance and the immense potentialities of factoring need hardly be stressed. The expansion in trade credit results in bulging working capital requirements. And besides, in the face of indiscipline in the trade credit market, the job of the collection department becomes extremely difficult. Professional bodies like factoring agencies relieve the supplier of the debt collecting responsibility, besides offering him numerous financial and non-financial benefits.

Consider (Table 1) the financial structure of a client in a pre-factoring scenario.

TABLE 1 : Balance Sheet (Pre-factoring)

Rs. in lakh

Current Liabilities			Current Assets
Sundry Creditors	100	Cash	80
Other Current Liabilities	150	Stock in trade	150
		Debtors	150
Net Working Capital	150	Other Current Assets	20
	400		400

Let the client enter into a contract with the factor on the following terms :

(i) Debtors of Rs. 150 lakh be purchased by the factor.
(ii) Prepayment by the factor to the extent of 80 per cent of the total debt.
(iii) Remaining 20 per cent of the debt to be retained by the factor.

Table II gives the Balance Sheet of the client after incorporating the factoring transaction :

TABLE 2 : Balance Sheet (Post-Factoring)

Rs. in lakh

Current Liabilities			Current Assets
Sundry Creditors	—	Cash	80
Other Current Liabilities	130	Stock in trade	150
——		Due from factor	30
Net Working Capital	150	Other Current Assets	20
	280		280

The impact of factoring on the balance sheet of the client in particular and on his entire business in general, will be multifold. It will be prudent to classify the benefits of factoring into *financial* and *non-financial* benefits.

Financial Benefits

1. **Provision of Finance off the Balance Sheet**

As the client's debts are purchased by the factor, the finance provided by the factor in form of pre-payment against such purchased debts will be off the balance sheet and will appear in the balance sheet only as a contingent liability in the case of "with Recourse" factoring. In the case of "Without Recourse" factoring, it will not appear in the balance sheet as a contingent liability since the client will have no liability in respect thereof even if the customer fails or makes default in payment of the debt, except in the case of default debts resulting from disputed qualitative aspects of goods/ services supplied or trade discounts, where they will be reassigned and debited back to the client. In the above example, the client makes a prepayment of Rs. 120 lakh against the debts purchased aggregating to Rs. 150 lakh. The amount prepaid gets converted into cash off the balance sheet and only the balance of Rs. 30 lakh due from the factor, being 20 per cent margin retained, remains in the Balance Sheet.

2. **Reduction in Sundry Creditors and Other Current Liabilities**

From the factoring proceeds of Rs. 120 lakh, the client just liquidates the sundry creditors to the extent of Rs. 100 lakh. This leaves Rs. 20 lakh with the client, which he uses to pay off other current liabilities.

3. **Improvement in Current Ratio**

Since the factoring transaction is off the Balance Sheet, it reduces debtors on the current assets side, to the extent of prepayment and on the current

liabilities side, it knocks off borrowings and other current liabilities. This results in an improvement in the current ratio.[4], from 1.6:1 in the prefactoring scenario to 2.15:1 in the post-factoring scenario.

4. **Increased Operating Leverage**

By releasing the funds tied in operating assets, the factoring mechanism facilitates more investments in fixed assets, thus increasing the degree of operating leverage. Operating leverage is the firm's ability to use fixed operating costs to magnify the effect of changes in sales on its earnings before interest and taxes. In other words, with fixed costs, the percentage change in profits accompanying a change in volume is greater than the percentage change in volume.[5]

5. **Flexibility and Freedom from Lengthy Legal Procedures**

Factoring is a remarkably flexible form of financing as there are no constraints to the extent of factoring facility used. Moreover, there are no legal constraints, both for the factor as well as for the client. Thus, factoring provides an easy, convenient and also secured alternative for inter corporate deposits, as the amount provided on discounting of bills is neither a loan nor a deposit.

Non-Financial Benefits

1. **Credit Disciplines**

The factor's professional approach in collection of debts inculcates a discipline among the customers which becomes the client's permanent asset.

2. **Effective administration of sales journal**

On assignment of the book debts to the factor, the sales journal shall be administered by the factor. In businesses where there are number of customers, the administration of sales ledger takes a lot of attention. This saves time of the client who may devote more attention to other functional areas.

3. **Credit Security**

"The ugly cloud of bad-debt losses hovers over every business trading on credit threatening a deluge in which it may either drown or emerge severely sodden. Many would say that herein lies the most important benefit of factoring : it is a dam guarding a client from the flood through effective credit control, and, in the case of old-line factoring where the factor assumes the credit risk, it is a lifeboat carrying the client to safety should the dam of preventive measure burst."[6]

Looking at the advantage of factoring services one may fully agree with Westlake[7] that :

"For its part, factoring offers a distinct solution to the problems posed by capital tied-up in trade debts. When money is outstanding for 60 or 80 days this means either that more capital is deployed in the business than would be dictated simply by the production cycle, or that expansion is being retarded because insufficient funds are left for production."

VII. Conclusion

The growing volume of trade, both domestic and international, is making factoring an indispensable service throughout the world. The factoring system which has many advantages as a source of finance and as an adviser to all sizes of enterprises over and above banking facilities has developed to a considerable extent in the West. Domestic factoring in U.S.A. amounts to US $ 33 billion. Other countries like U.K., Sweden, Italy, Norway, Germany, Belgium and Netherlands are also making substantial use of factoring services. However, factoring business in India is of very recent origin and is limited mostly to bill-discounting.

In the present business scenario and prospects of fast growth of business in India, one can confidently say that the scope for factoring in India is unlimited, and not only for the bankers but also for specialised financial institutions. Looking from a macro-economic standpoint, the development of factoring shall be one step forward towards financial specialisation.

NOTES AND REFERENCES

1. (i) Biscoe in *Law and Practice of Credit Factoring (1975)*, p.3 defines factoring as, "Credit factoring may be defined as a continuing legal relationship between a financial institution (the "factor") and a business concern (the "client") selling goods or providing services to trade customers (the "customers") whereby the factor purchases the client's book debts either without or with recourse to the client, and in relation thereto controls the credit extended to customers and administers the sales ledger").
   (ii) According to C.S. Kalyan Sundaram, Chairman, Expert Committee set up by RBI to study the feasibility of starting factoring services is the outright purchase of credit approved accounts receivables with the factor assuming bad debt losses."
2. Kothari: *Lease Financing and Hire Purchase.*
3. Verma, J.C. : *Manual of Merchant Banking.*
4. Current ratio is calculated as follows :
   Current Ratio = Current Assets ÷ Current Liabilities
   Prefactoring current ratio = 400/250 = 1.6 : 1
   Post-factoring current ratio = 280/130 = 2.15:1
5. Khan, M.Y. and Jain, P.K. : *Financial Management*, (1988) Tata Mcgraw-Hill Publishing Company Ltd.
6. Biscoe, P.M. : Law and Practice of Credit Factoring, (1975)
7. Westlake, M. : *Factoring.*