

FACTORING

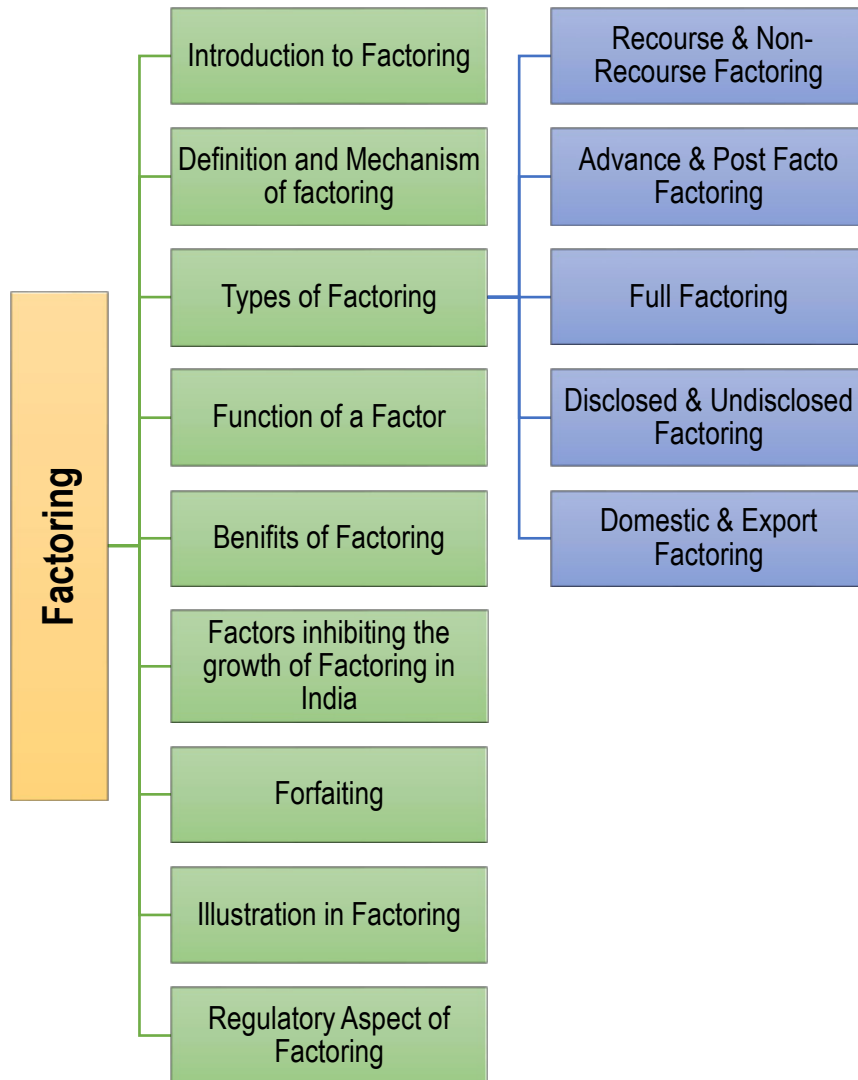


LEARNING OUTCOMES

After going through the chapter student shall be able to understand:

- ☐ Concept, Definition and Mechanism of Factoring
- ☐ Types/Forms of Factoring
- ☐ Functions of a Factor
- ☐ Benefits of Factoring
- ☐ Factors inhibiting the growth of Factoring in India
- ☐ Forfaiting
- ☐ Forfaiting vs Export Factoring
- ☐ Regulatory Aspects of Factoring

CHAPTER OVERVIEW





1. INTRODUCTION TO FACTORING

All units' particularly small or medium size units must make considerable efforts to realize the sale proceeds without much success creating functional difficulties for such units.

Many units under small-scale sector have become sick only because of delay/non-realization of their dues from large units. The introduction of factoring services will, therefore, prove very beneficial for such units as it will free the units from the hassles of collecting receivables to enable them to concentrate on product development and marketing.



2. DEFINITION AND MECHANISM

2.1 Definition and Concept

Basically, factoring is a kind of financial service in which a business organization sells its Account Receivables to another person, called a factor, at a discount to raise money.

Factoring is different from bill discounting. In bill discounting invoice are discounted at a certain rate to get the funds, whereas the concept of factoring is broader. In the factoring process, the Account Receivables are sold to an outside agency.

Example - The seller sold goods on credit and raised the invoice. However, the seller needs immediate money to meet its working capital requirements i.e., meeting day to day expenses of the business. For this purpose, he sold the goods to an outside agency i.e., a factor. The factor pays the required amount to the seller after deducting some amount. So, the entire invoice amount is not paid by the factor. Rather, about 70-80% of the bill amount is paid by the factor. The remaining amount is paid after the factor receives the entire bill amount from the customers (debtors). The factor charges some commission for providing these services.

The study group appointed by the International Institute for the Unification of Private Law (UNIDROIT), Rome, during 1988, recommended, in general terms, the definition of factoring as under:

"Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:

- Finance
- Maintenance of debt
- Collection of debts

- Accounting and reconciliation
- Protection against credit risk”.

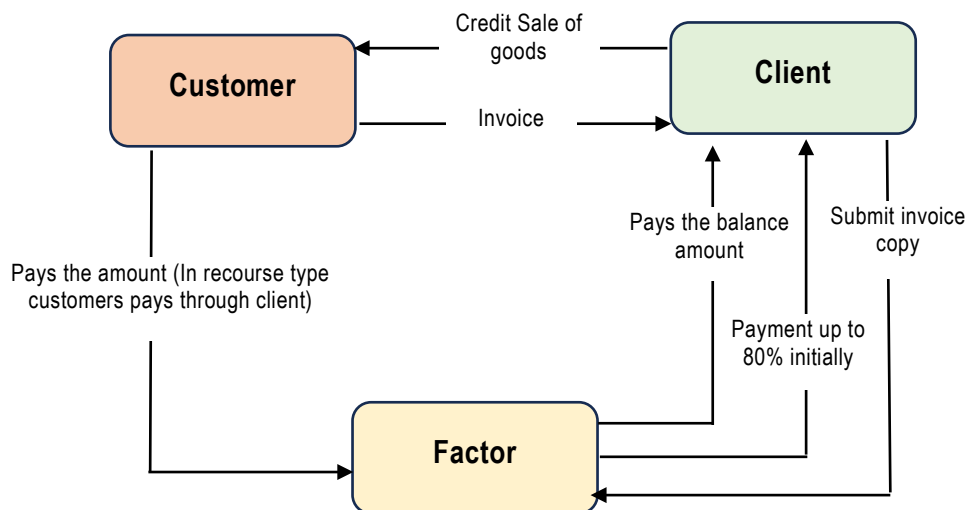
However, the above definition applies only to factoring in relation to supply of goods and services: (i) across national boundaries; (ii) to trade or professional debtors; (iii) when notice of assignment has been given to the debtors. Domestic factoring is not yet a well-defined concept and it has been left to the discretion of legal framework as well as trade usage and convention of the individual country.

In India factoring is undertaken by different bank subsidiaries like SBI Factors and Commercial Services Ltd. Promoted by SBI and Canara Bank Factors Ltd. promoted jointly by Canara Bank, Andhra Bank and SIDBI.

2.2 Mechanism of Factoring

In a factoring transaction, there are three parties – the factor, the client, and the customers of the client. The client is the person who is availing the factoring service. The factor provides the factoring services and the customers are the persons who purchases the goods and services on credit.

The mechanism of the factoring process has been depicted in the following diagram.



The following steps are involved in the process of factoring as shown in the above diagram:

- Customer places an order with the client for purchase of goods and/or services on credit.
- On the basis of agreement, the client delivers the goods and sends the invoice to customers.

- (iii) The client then assigns the invoice to the factor. This is generally called, "Call sale of book debts by the client firm to the factor".
- (iv) The factor, then, makes prepayment up to 80 per cent of the invoice value to the client.
- (v) The client pays interest on advances of amount received until the cash is collected from customer.
- (vi) The factor maintains accounts receivable of the client and sends periodical statements to the customer to accelerate the collection.
- (vii) On the due date, the factor collects the invoice amount from the customer.
- (viii) After that, the factor releases the remaining amount to the client after adjusting his commission/fees.

*Aforesaid steps can be explained with the help of an **example**:*

Suppose the Customer/Client has raised an order with an invoice value of ₹ 5,00,000; basis that order business delivered the product on credit basis for 90 days. After this, the business sells the invoice to a factoring company to get at least 80 per cent realized value i.e., ₹ 4,00,000.

This realized value can be used for further business expansion or any product development.

The business pays interest i.e., 5% on the advance of ₹ 4,00,000 until amount realized from client. Then the factoring company collects the invoice amount from customer i.e. ₹ 5,00,000 after 90 days. After this the factoring company releases the reserve amount i.e., ₹ 1,00,000 less 5% interest charged on 4,00,000 upto the day of receipt of payments.

In this Debtor financing process, factoring charges also played a vital role in providing the services. The following factoring charges are levied:

- **Finance charges** – Computed on the prepayment outstanding in the client's a/c at monthly intervals. Finance charges are only for financing that has been availed by the client. These charges are like interest levied on the cash credit facilities in a bank.
- **Service fee** – It is a nominal charge at monthly intervals to cover the cost services namely - collection, MIS reports, sales ledger management, other administrative overheads etc. Service fee is determined on the basis of total gross value, no. of customers, degree of credit risk etc.



3. TYPES/FORMS OF FACTORING

Depending upon the features built into the factoring arrangement to cater to the varying needs of trade/citizens, there can be different kinds of factoring:

(i) **Recourse and Non-recourse Factoring:** Under a recourse factoring arrangement, the factor has recourse to the client (firm) if the debt purchased/receivable factored turns out to be irrecoverable. In other words, the factor does not assume credit risks associated with the receivables.

In the case of non-recourse factoring, the factor does not have the right to recourse. The loss arising out of irrecoverable receivables is borne by the factor, as a compensation for which he charges a higher commission after considering the probability of default, credit worthiness etc. However administrative support from client is still required by factor to recover the amounts.

(ii) **Advance and Post facto Factoring:** In advance factoring, the factor paid a pre specified portion, ranging between three-fourths to nine tenths of the factored receivables in advance, the balance being paid upon collection/on the guaranteed payment date. A drawing limit, as a pre-payment, is made available by the factor to the client as soon as the factored debts are approved/the invoices are accounted for. The client must pay interest (discount) on the advance/repayment between the date of such payment and the date of actual collection from the customers/or the guaranteed payment date, determined on the basis of the prevailing short-term rate, the financial standing of the client and the volume of the turnover.

In the case of post facto factoring, the amounts are collected by factors from the customer before the original credit period. The same is then passed on to the client as factoring amounts. However, for early payment, customer gets a discount from factor which is later charged back to the client alongwith some spread because of commission.

(iii) **Full Factoring:** This is the most comprehensive form of factoring combining the features of all the factoring services, especially those of non-recourse and advance factoring. It is also known as Old Line Factoring.

(iv) **Disclosed and Undisclosed Factoring:** In Disclosed Factoring, the name of the factor is disclosed in the invoice by the supplier-manufacturer of the goods asking the buyer to make payment to the factor.

However, in Undisclosed Factoring, the name of the factor is not disclosed in the invoice although the factor maintains the sales ledger of the supplier-manufacturer. The entire realization of the business transaction is done in the name of the supplier company but all control remains with the factor.

(v) **Domestic and Export/Cross Border Factoring:** If the three parties involved, namely, customer (buyer), client, (seller-supplier) and factor (financial intermediary) are domiciled in the same country then it is known as domestic factoring. There are usually four parties involved in a cross-border factoring transaction. They are:

- a) Exporter (client)
- b) Importer (customer)
- c) Export factor
- d) Import Factor

It is also known as a two-factor system.



4. FUNCTIONS OF A FACTOR

The main functions of a factor could be classified into five categories:

- **Maintenance/administration of sales ledger:** The factor maintains the clients' sales ledgers. On transacting a sales deal, an invoice is sent to the customer and a copy of the same is sent to the factor. The factor also gives periodic reports to the client.
- **Collection facility:** The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection and enables him to concentrate on other important functional areas of the business. It also enables the client to reduce the cost of collection by way of savings in manpower, time, and efforts.
- **Financing Trade Debts:** The unique feature of factoring is that a factor purchases the book debts of its clients at a price and the debts are assigned in favour of factor who is usually willing to grant advances to the extent of 80% of the assigned debts.
- **Credit Control and Credit Protection:** Assumptions of credit risk is one of the most important functions of the factor. This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers.
- **Advisory Services:** By virtue of their specialized knowledge and experience in finance and credit dealings and access to extensive credit information; factors can provide the following information services to the clients:
 - (i) Customer's perception of the client's products, change in marketing strategies, emerging trends etc.

- (ii) Audit of the procedures followed for invoicing, delivery and dealing with sales returns.
- (iii) Introduction to the credit department of bank/subsidiaries of banks engaged in leasing, hire-purchase, merchant banking.



5. BENEFITS OF FACTORING

The benefits of factoring have been discussed as follows:

- Factoring provides immediate cash flow in the form of 80% of the invoice value, which helps in building the liquidity position of the client. Also, this proportion of finance is higher than bank finance against credit sales.
- It also plays an important role in a client's working capital finance.
- The cash realized by receiving an advance amount from the factor can be used to accelerate the production cycle.
- The client need not have to spend time on sales ledger maintenance, follow-up and collection of receivables as this can be done by factoring company who buys such receivables. This helps in saving the precious time of the client as it can concentrate on its core activities such as production, marketing etc.
- This provides a comprehensive credit control system which helps in assessing the quality of debtors and monitoring their financial health.

The factoring process helps in reducing the average receivables collection period. As a result, the total operating cycle time of the client is also reduced. This will ultimately lead to efficient working capital management.



6. FACTORS INHIBITING THE GROWTH OF FACTORING IN INDIA

The factoring industry has grown rapidly around the world. More than one lakh businesses are currently using factoring to settle their trade transactions. However, the factoring market in India is minuscule.

There are various factors which inhibits the overall growth of factoring markets in India which are described as below:

- (i) Lack of credit appraisal system and authentic client database have restricted the growth model of factoring and its arrangements.
- (ii) Higher stamp duty while assigning the invoice to the factor will increase the cost of the client which leads to reduction in factoring arrangements.

To remove the above limitations and expand the factoring market in India, the following can be suggested:

- (i) Do away with stamp duty or at least reduce it.
- (ii) Incorporate a separate company which will give a true and fair credit appraisal report, and which will cover all aspect of client's information and their accounts.
- (iii) Factoring companies should expand their network and branches especially to those localities where small scale units are located.
- (iv) Workshop and seminars should be organized by factoring companies to enhance awareness and usefulness of the factoring process.

7. FORFAITING

Forfaiting is a form of financing of receivables pertaining to international trade. It denotes the purchase of trade bills/promissory notes by a bank/financial institution without recourse to the seller. The purchase is in the form of discounting the documents covering the entire risk of non-payment in collection. All risk and collection problems are fully the responsibility of the purchaser (forfafter) who pays cash to the seller after discounting the bills/notes.

Difference between Forfaiting vs Export Factoring

- (a) A forfafter discounts the entire value of the note/bill. In a factoring arrangement the extent of financing available is 75-80%.
- (b) The forfafter's decision to provide financing depends upon the financing standing of the availing bank. On the other hand, in a factoring deal the export factor bases his credit decision on the credit standards of the exporter.
- (c) Forfaiting is a pure financial agreement while factoring includes ledger administration as well as collection.
- (d) Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.



8. SOME ILLUSTRATIONS IN FACTORING

Illustration 1

A Ltd. has annual credit sales of ₹ 219 lakh and its average collection period is 50 days. The experience indicates that bad debt losses are around 2% of credit sales. The factoring is expected to save ₹ 2 lakh in administration costs and to eliminate all bad debt losses. The factor has agreed to advance 80% of the receivables at 15% p.a. Compute the net factoring cost if factoring commission is 2%.

Solution

Average receivable = $(₹ 219\text{lakh}/365) \times 50 = ₹ 30 \text{ lakh}$

Factoring Commission = 2% on ₹ 30 lakh = ₹ 0.6 lakh

Amount available for advance = 80% of ₹ 30 lakh – Factoring commission (₹ 0.6 lakh) = ₹ 23.4 lakh.

The factor will actually remit the advance net of interest for 50 days.

The annual rate of interest is 15% and so rate of interest for 50 days = $(15/365) \times 50 = 2.05\%$

Interest for 50 days on ₹ 23.4 lakh = 2.05% on ₹ 23.4 lakh = ₹ 0.48 lakh

The advance remitted to client = ₹ 23.4 lakh – ₹ 0.48 lakh = ₹ 22.92 lakh

Factoring cost for 50 days = Factoring commission + Interest

= ₹ 0.6 lakh + ₹ 0.48 lakh = ₹ 1.08 lakh

Factoring cost for year = $(₹ 1.08 \text{ lakh}) \times (365/50) = ₹ 7.884 \text{ lakh}$

Net Factoring Cost

Particulars		₹ lakh
Factoring cost per year		7.884
Less: Costs saved per year		
Bad Debt = 2% on ₹ 219 lakh	4.38	
Administration cost saved	2.00	6.380
Net Factoring cost per year		1.504
Advance		22.920
Net Factoring cost per year (%) = $(1.504/22.92) \times 100$		6.56%

Illustration 2

A Ltd. has total sales of ₹ 3.2 crores and its average collection period is 90 days. The past experience indicates that bad-debt losses are 1.5% on Sales. The expenditure incurred by the firm in administering its receivable collection efforts is ₹ 5,00,000. A factor is prepared to buy the firm's receivables by charging 2% Commission. The factor will pay advance on receivables to the firm at an interest rate of 18% p.a. after withholding 10% as reserve.

Calculate the effective cost of factoring to the Firm.

Solution

	₹
Average level of Receivables = $3,20,00,000 \times 90/360$	80,00,000
Factoring commission = $80,00,000 \times 2/100$	1,60,000
Factoring reserve = $80,00,000 \times 10/100$	8,00,000
Amount available for advance = ₹ $80,00,000 - (1,60,000 + 8,00,000)$	70,40,000
Factor will deduct his interest @ 18%:-	
Interest = $\frac{₹ 70,40,000 \times 18 \times 90}{100 \times 360}$	= ₹ 3,16,800

∴ Advance to be paid = ₹ 70,40,000 – ₹ 3,16,800 = ₹ 67,23,200

Annual Cost of Factoring to the Firm:	₹
Factoring commission (₹ 1,60,000 × 360/90)	6,40,000
Interest charges (₹ 3,16,800 × 360/90)	<u>12,67,200</u>
Total	<u>19,07,200</u>

Firm's Savings on taking Factoring Service:	₹
Cost of credit administration saved	5,00,000
Cost of Bad Debts (₹ 3,20,00,000 × 1.5/100) avoided	<u>4,80,000</u>
Total	<u>9,80,000</u>
Net cost to the Firm (₹ 19,07,200 – ₹ 9,80,000)	<u>9,27,200</u>
Effective rate of interest to the firm = $\frac{₹ 9,27,200 \times 100}{67,23,200}$	13.79%

Note: The number of days in a year has been assumed to be 360 days.

Illustration 3

A Ltd is in the factoring business and is currently evaluating a proposal for entering a factoring decision with FMCG company as a client. FMCG company operates at 30 days' standard credit with an average delay of 5 days in the first half of the year and 10 days in second half of the year. The business size is 40% in the first half versus 60% in the second half.

There is a probability of default @ 2% of the average receivables outstanding. The annual turnover is around 1000 crores.

The weighted average cost of capital for arranging the funds by A Ltd. is around 12% p.a. A Ltd. expects around 10% markup on the cost of factoring proposal to cover for profits and other overheads.

Please compute all in one quote to be shared by A Ltd. to FMCG company considering above facts?

Solution

Average Credit period = 30 days + (5x40% + 10x60%) = 38 days

Average Credit outstanding = (1000 cr /365 days) x 38 days = Rs 104.1096 crores

Default receivables = 2%x104.1096 = 2.082192

Cost of capital basis the capital structure of A Ltd = 12%x104.1096 = Rs 12.49315 crores

Overall cost of factoring = Rs 14.57534 crores (2.082192 + 12.49315)

After markup = 14.57534*1.1 = Rs 16.03288 crores

All in one quote = 16.03288/104.1096 = 15.4%

Hence A Ltd can quote a minimum of 15.4% for factoring.

**9. REGULATORY ASPECTS OF FACTORING**

In India, Regulatory Aspects of Factoring can be referred from Factoring Regulation Act, 2011 and Non-Banking Financial Company - Factors (Reserve Bank) Directions, 2012.

9.1 Provisions in brief from the Factoring Regulation Act, 2011

(i) No factor shall commence or carry on the factoring business unless it obtains a certificate of registration from the Reserve Bank to commence or carry on the factoring business under this Act.

For the removal of doubts, it is hereby clarified that a non-banking financial company engaged in factoring business shall be treated as engaged in factoring business as its "principal business" if it

fulfils the following conditions, namely: —

- (a) If its financial assets in the factoring business are more than fifty per cent. of its total assets or such per cent. as may be stipulated by the Reserve Bank; and
 - (b) If its income from the factoring business is more than fifty per cent. of the gross income or such per cent. as may be stipulated by the Reserve Bank.
- (ii) The Reserve Bank may, if it considers necessary in the interest of business enterprises availing factoring services or in the interest of factors or interest of other stake holders give directions to the factors either generally or to any factor or group of factors in respect of any matters relating to or connected with the factoring business undertaken by such factors. If any factor fails to comply with any direction given by the Reserve Bank, the Reserve Bank may prohibit such factor from undertaking the factoring business.

The person who must receive any amount from the debtors or who is owner of any receivable shall, at the time of entering an agreement with the factor disclose to the factor any defences and right of set off that may be available to the debtor. Upon entering the agreement, any security created to secure the payment of receivable shall vest in the factor and he is eligible to exercise all the rights and remedies whether by way of damages or otherwise which would otherwise be available to the owner of receivable.

Before demanding any payment from the debtors, the factor shall give proper notice to him. After receiving the notice, the debtors shall make the required payment to the factor, and this will fully discharge the liability of the debtor.

In case no notice for payment is received by the debtor, and he makes the required payment to the owner of receivable, such amount shall be paid forthwith by him to the factor. So, the owner of the receivable acts as a trustee in this situation and he holds the amount received from the debtor in trust for the factor.

If any modification in the original contract takes place between the owner of receivable and the factor, will not be binding against the factor unless he consents to it. If the owner of receivable commits any breach of original contract with debtor, the debtor can claim any loss or damage caused to him in consequence of that.

Every factor shall for the purpose of registration, file the particulars of every transaction of assignment of receivables to the Central Registry to be set up under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 within 30 days from the date of such assignment or from the date of establishment of such registry.

9.2 As per the Non-Banking Financial Company - Factors (Reserve Bank) Directions, 2012

Following additional points may be noted with relation to factoring in this regard:

- (i) An entity not registered with the Reserve Bank of India (RBI) may conduct the business of factoring if it is an entity mentioned in Section 5 of the Act i.e., a bank or any corporation established under an Act of Parliament or State Legislature, or a Government Company as defined under section 617 of the Companies Act, 1956.
- (ii) Every company seeking registration as NBFC-Factor shall have a minimum Net Owned Fund (NOF) of ₹ 5 crore. Existing companies seeking registration as NBFC-Factor but do not fulfil the NOF criterion of ₹ 5 crore may approach the Bank for time to comply with the requirement.
- (iii) A new company that is granted Certificate of Registration (CoR) by the RBI as NBFC-Factor shall commence business within six months from the date of grant of CoR by the RBI.
- (iv) An NBFC-Factor shall ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and the income derived from the factoring business is not less than 50 per cent of its gross income.

TEST YOUR KNOWLEDGE

Multiple Choice Questions (MCQs)

- (1) Which of the following is not referred to as factoring:
 - (a) Bill discounting
 - (b) Selling of a trade receivable on recourse basis
 - (c) Selling of a trade receivable on non-recourse basis
 - (d) Arranging working capital through selling of trade receivables
- (2) State which of the following statement is false?
 - (a) The factor purchases entire trade receivable and pays 100% of the invoice amount upfront
 - (b) The factor purchases trade receivables from client
 - (c) The client has trade receivable from customer
 - (d) The factor pays amounts to client after purchase of trade receivables

- (3) In the case of non-recourse factoring, the credit risk in terms of non-recoverability is borne by which party?
 - (a) Client
 - (b) Factor
 - (c) Customer
 - (d) Bank
- (4) Which of the following characteristics does not create a distinction in forfaiting from factoring?
 - (a) Financing
 - (b) Credit worthiness
 - (c) Legal administration of the dues
 - (d) Financing of receivables
- (5) Which are certain factors specific to Indian context which are currently challenges to the factoring market?
 - (a) Lack of credit appraisal system
 - (b) Stamp duty payable on factoring
 - (c) Both a and b
 - (d) Short term financing deal.
- (6) Which form of factoring is known as “Old Line Factoring”?
 - (a) Recourse Factoring
 - (b) Non-Recourse Factoring
 - (c) Full Factoring
 - (d) Cross Border Factoring
- (7) Identify the incorrect statement.
 - (a) A forfaiter discounts the entire value of the note/bill. In a factoring arrangement, the extent of financing available is 75%-80%.
 - (b) The forfaiter’s decision to provide financing depends upon the financing standing of the availing bank. On the other hand, in a factoring deal the export factor bases his credit decision on the credit standard of the exporter.

- (c) Factoring is a pure financial arrangement while forfaiting includes ledger administration as well as collections.
 - (d) Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.
- (8) Which form of factoring is known as “Two Factor System”?
- (a) Recourse Factoring
 - (b) Non-Recourse Factoring
 - (c) Full Factoring
 - (d) Cross Border Factoring

Theoretical Questions

1. Briefly explain the mechanism of factoring.
2. Discuss the various types of factoring.
3. What are the functions of factoring?
4. Explain the primary reasons inhibiting the growth of factoring in India.
5. What is forfaiting? How can you differentiate it from export factoring?

ANSWERS/SOLUTIONS

Answers to the MCQ based Questions.

1.	(a)	2.	(a)	3.	(b)	4.	(d)	5.	(c)
6.	(d)	7.	(c)	8	(c)				

Answers to the Theoretical Questions

1. Refer to the paragraph 2.2
2. Refer to the paragraph 3
3. Refer to the paragraph 4
4. Refer to the paragraph 6
5. Refer to the paragraph 7