Discounting, Factoring & Forfeiting

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WELINGKAR

Introduction

In India due to economic liberalisation & free trade policy the financial service sector is developing at a faster rate. Financial institution try to extend their axis trace to trading community through book debt financing. In coming chapter we are going to get information on three types of book debt financing viz. Bill Discounting, Factoring & Forfeiting.

Bill Discounting

This is a old & more usable type of book debt finance in India. A Bill Discounting is type of finance where seller draws bill on purchaser who accept it & return to seller. Seller then goes to his bank & discounted it. In this case seller gets immediate cash, purchaser have not need to pay immediately & Banks who pays the cash receives interest for the period for which the bill is drawn. So in short Bill discounting is a type of one of the most quick liquid finance.

Bill Discounting

From the banking point of view Bill discounting is very safe, secure & liquid finance. If in case of emergency the bills which has been discounted by seller, can be rediscounted with R.B.I. & Bill discounting is again superior to traditional cash credit in following ways:

a) Liquidity
b) Quick Finance
c) The bills are always drawn with recourse so all parties on instrument are liable till the bill is finally discharged.

Factoring – Meaning & Definition

The word factor has been derived from the Latin word means ‘to make or to do’. In other words ‘to get things done’. As we seen invariably in small & medium scale companies the problem of working capital. This is due to large buyers procrastination. Factor plays important role for these small & medium scale companies.Factoring is nothing but selling of trade debts at a discount to financial institution. The definition of factoring according to V.A.Avadhani, “factoring is a service of financial nature involving the conversion of credit bills into cash”.

Modus Operandi

So factor provides finance to his client known as factoring. The Modus operandi of factoring scheme are:

- There should be factoring agreement.
- The client should prepares invoice in his usual way.
- The goods are sent to buyers without Bill of exchange but but Invoice.

Modus Operandi

- The debt due by purchaser to client is assigned to factor by advising the customer, to pay to the factor.
- The client hand over the invoices to factor along with receipted delivery challans, or copies of LR/PR etc.
- Factor makes an immediate payment up to 80% of invoice value & the balance 20% after realisation of debt.

Terms of Agreement

The important part of factoring is an agreement between client & factor. Following are some main points of the same.

- Assignment of debt in favor of factor.
- Selling limits for the client.
- Condition of recourse.
- Details of services offered by factor & payment for same.
- Interest to factor on the accounts where credit allowed by seller to supplier.

Functions

The terms of agreement that lights on functions of factor. The main function of factor is to provide finance I.e. purchase & collection of debts but along with that factor provides other services those can be brief as below.

1. Sales Ledger Management: This is very important function of factoring. Because when factor offer service, it is his responsibility to maintain sales ledger & keep track of payment made by customer.

Functions

2. Purchase & Collection of Debts: Factor provides immediate finance up to 80%. Thus the collection of that invoice is his duty.
3. Undertaking of Credit Risk: This is also another function which is very important. As you learn factor provide spot finance, so he has to closely monitor customer's financial position, his past performance and his honesty etc.
4. Provision of Finance: As stated earlier factor provide immediate finance to client. The client concentrate more on additional business activities available.

Types of Factoring

After seeing functions now lets see the different types of factoring which varies on the basis of the nature of transactions between clients & his factor, volume of business. following are some of the main types of factoring.

1. Full Service Factoring: As the name suggest, it is type where factor offers all services viz.providing finance, administration of sales ledger, collection of debts. This is called a standard factoring practice.

Types of Factoring

2. With Recourse Factoring: In this type factor does not bear the credit risk. If debtors unable to pay their dues & if the same is unpaid for beyond a fixed period, the same is automatically assigned back to client.

3. Bulk Factoring: It is also called as “Notified Factoring” or “Disclosed Factoring” because factor provides finance after disclosing the fact of assignment of debts to the debtor concerned. The management of sales ledger & credit control has to be done by client himself.

Types of Factoring

4. Maturity Factoring: Under this type factor does not provide immediate cash payment to the client. He undertakes to pay as & when collection made from the debtor.

5. Invoice Factoring: In this type factor simply provides finance against invoices without undertaking any other function. The debtors are not notified about finance so it is also called as as "Undisclosed financing".

Types of Factoring

6. Agency Factoring: Under this type the work is shared by both client & factor. The client has to maintained sales ledger & collection work & factor as to provide finances assuming credit risk.

7. Invoice Factoring: As the name suggests it is nothing but service of factor extended from domestic market to international business. this factoring is facilitated with the help of import factor & export factors.

Factoring Vs Discounting

As stated earlier the venture capital took roots when comptroller of capital issues raised guidelines for the same. The some of them are:

Point	Factoring	Discounting
Coverage	Covers all debts of a client.	Covers only those debts which are backed by A.R.
Scope	The scope is vast. i.e.maintain sales ledger, credit risk, provision of finance.	The scope is limited to provide finance against the discounted bills Only.

Factoring Vs Discounting

Point	Factoring	Discounting
Recourse	Factor may extend credit without any recourse.	It is always made with recourse to the client.
Present-ation	It is Known as "Off-B/s finance".	It is Known as "In-B/s finance".
Ownership	Factor becomes the owner of value.	The financer is an agent not owner.

Cost of Factoring

Cost of factoring comprises of two aspects viz. finance charges & service fees. Generally, the factor charges a service fee on the total turnover of the bills, it is around 1%. If the bills paid earlier, the charges could be reduced. Finance charges are normally same as interest charged by bank. While the pricing of factoring services, following components should be taken into consideration.

1) Factoring Fees 2) Discount Charges

Former comprises of sales ledger, credit control & bad debts administration. Later is for providing instant credit to the client.

Format of Cost Sheet

The costing of factoring service is very important. Following is the format of cost sheet for the same.

A. Direct Cost

- Per Invoice amount ……..
- Per active account…….
- Per Debtor account…….
- Per Client account……. % of turnover
- Bad debt provision……. % of turnover

Total of Direct Cost

B. Administrative Cost …….. % of turnover

C. Total Factoring Cost = A + B

D. Profit = ……% of turnover

E. Required factoring charges = $\frac{(C + D) \times 100}{\text{Total turnover}}$

Accounting System & Procedure

Normally factoring company keeps following for accounts to record factoring transactions.

- Sales Ledger Control A/c
- Debt Purchase A/c
- Client Current A/c
- Bank A/c

Out of which A/c 'a' & 'b' must be maintained separately for each customer. The accounting procedure involves following main entries at different stages.

Accounting System & Procedure

- When Invoice are assigned

  Sales ledger control A/c Dr.

  To Debt Pur. A/c

- When 80% Payment made

  Client current A/c Dr.

  To Bank A/c

- When Payment made by Debtors
  - Bank A/c Dr.

    To Client Current A/c
  - Debt. Pur. A/c Dr.

    To Sales Led. Control A/c

- When Credit Note are assigned

  Debt. Pur. A/c Dr.

  To Sales Led. Control A/c

Benefits

1. Financial Service: In the current market situation & payment trend, we often see many of the traders & manufacturers being blocked their working capital in trade debts. Factoring provides instant finance & hence it gives opportunity to client to concentrate on other business activities.

2. Collection Service: This is one of the best benefits to client. It is found that total 60% of sales by SSI sector is in the from of credit sale. So collection of debts become vital for this sector. Now by factoring this tension passes from client to factor, leads to more time for client to concentrate on production etc.

Benefits

3. <u>Credit Risk Service</u>: In the absence of factor, the entire risk is on the shoulder of client. The bad debts take away the profit of concern & in some cases leads to winding up of organisation. But with the factoring, now entire risk is borne by factor. Client is assured of complete realisation of book debts without tension.

4. <u>‘Sales Ledger Management Service’</u>: Maintenance of Sales Ledger is soul of business. It requires expertise persons to do it, which the every client may not have. Factoring helps client by sending him monthly sales, collection analysis etc.

Benefits

5. <u>Consultancy Service</u>: Normally, factors are professionals in offering management services. They collects information about credit worthiness of the customers, ascertain track record etc. Thy also advice clients on import finance matters.

6. <u>Economy Services</u>: Factors are able to serve economically as they have number of clients & so they can spread their overheads between all of them. So every client get service at lower cost. The interest rate charged on 80% of amount so factoring may considered cheap source of finance compare to others.

Benefits

7. Off-Balance Sheet Financing: Factoring considered as off - B/S finance. As this finance never appear in liability side of B/S & this will improve current ratio of company. Let's take on example to make this point clear.

Suppose the B/S of Well Pack shows: total of assets side 15 lakhs, comprises of debtors Rs.6,00,000, stock Rs.6,00,000 & other assets Rs.3,00,000. The debit side shows: loan against stock Rs.4,00,000 & otter loan against Bills Rs.4,00,000, other liability Rs.3,00,000 & Net working capital Rs.4,00,000. From above, The C.R. of the firm is **1.36 : 1**

Now if debtors are purchase by factoring agent, he pays 80% instantly so company gets Rs.4,80,000, which is used to pay of bank loan. Now the revised position of Well Pack is as below:
Asset: stock Rs.6,00,000, debtors Rs.1,20,000.
The C.R. of company is **1.65 : 1**

Factoring in India

In India the idea of factoring services was first thought of by the Vaghul Working Group. The R.B.I. Constituted study group in Jan. 1988 under chairmanship of Mr. C. K. Kalyanasundaram & on recommendation of the committee, the Banking Act was amended in July 1990 with a view to enabling commercial banks to take up factoring services through their subsidiaries.

Factoring in India

In Feb. 1994 R.B.I. Permitted all banks to enter factoring business departmentally. In India the factoring services firstly started by S.B.I. in association with small Industries Development Bank,Union Bank, State Bank of Sourashtra & State Bank of Indore. The factoring company founded by SBI called SBI- Factors & commercial services Pvt. Ltd. (SBI- FACS) with capital of Rs.25 crores in 1991.

International Factoring

Just like domestic suppliers, the exporters also finds difficulty in receiving payments. That is why factoring services not only popular in domestic business but also they are gradually entering into export business. the International factoring has been define as,
“an arrangement between factor &his client which includes at least two of the following services provided by factor. i) Finance ii) Maintenance of A/cs iii) Collection of debts iv) Protection against credit risk”. Although from definition, the international factoring look same as domestic factoring, it is different in respect of type of export factoring & the arrangement made by the exporter & factor.

Types of Export Factoring

In the absence of export factoring all export transactions are backed by letter of credit. Factoring is done entirely on the basis of invoice prepared by the exporter, so it is purely an “Invoice based export finance” technique.

There are normally four types of export finance.

- Two factor system: There are two factors. One is in the exporter's country & other in importer’s country. The exporter never sends goods to importer before factoring relationship established.

Types of Export Factoring

- Single factor system: Under this system also two factors involve. But the responsibility of making payment maintaining books is with export factor. To cover credit risk export factor enter into agreement with import factor.
- Direct export factor system: In this, the agreement is made between the exporter & the export factor- no other party involved. The entire risk is to be borne by export factor.
- Direct import factor system: This is just opposite of the previous one. The agreement made between exporter & import factor in the import country. The import factor shoulders all the risk.

Factoring in Other Countries

Factoring in European countries have option to finance both domestic & export business. but though business condition & continued recession have effected the factoring business. Now more than 700 factoring companies are operating in forty countries.

Italy occupies 1st position in terms of factoring business volume, followed by USA. The U.K. stands 3rd in the rank. Japan, Marico, France, Netherlands join the suit after.

Factoring in Other Countries

The world factoring turnover is explain in the following table.

Name	No.of Companies	Factoring Turnover ($ billion)	% Share in world factoring
Italy	80	75.0	28.9
U.K.	30	28.5	11.0
U.S.A.	20	51.5	19.8
Mexico	70	18.5	7.1
Japan	43	16.5	6.4
France	17	15.0	5.8
Netherlands	5	11.0	14.2
Germany	14	10.1	3.9
South Korea	15	6.0	2.3
Sweden	20	5.0	1.9
Others	-	22.9	8.8

Factoring in Other Countries

The year wise factoring turnover shows consistent improvement in factoring. With the help of following graph it is very much clear that factoring has an upward trend in improvement, both in domestic & international. In the last 6 years, the total of factoring have been improved from 103.8$ Billion to 260.0$ Billion(estimated). Which itself a clear indication of upward trend, same the case with international factoring.

Forfeiting

As we are coming to end of the chapter, this is a third type of financing against receivables like factoring. This technique is helpful to exporter for financing goods exported on medium term deferred basis.

The term ‘Forfeit is French word means “to give something” or “give up one’s right”. In Forfeiting, exporter give up his right to receive payment in future for immediate cash payment by forfeiter.

The definition says, “the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods & services”.

Factoring Vs Forfeiting

Both factoring & forfeiting are tools of financing. Some basic differences can be made as follows.

Points	Factoring	Forfeiting
Terms	Short term financing	Medium term financing
Scope	Both domestic as well as International.	It is invariably employed In export business.
Services	Not only arrangements of finance but also sales ledger maintenance, consultancy.	Only financial aspect that to only particular export bill.
Finance	80% on the spot, balance 20% after receiving payment.	100% on the spot.

Advantages of Forfeiting

It is very clear from previous comparison, that though forfeiting & factoring are tools for financing, the actual use of them is made as per requirement. Means if you want to export some goods, you should go for forfeiting & not for factoring & vis-a-vis.

Following are some of the advantages of forfeiting.

- Profitable & Liquid: From the point of view of exporter as well as forfeiter, this is most liquid & profitable because forfeiter not only get immediate cash as from discount charges, but he can sell the same in secondary market.

Advantages of Forfeiting

- Simple & Flexible: From the point of view of exporter, this tool of finance is simple & flexible, as he & forfeiter can decide the term according to the needs of each other.
- Avoid Export Credit Risk: The exporter is completely free from credit risk, that nay arise out of possibility of interest rate fluctuations etc.
- Avoid Export Credit Insurance: If exporter does not wish for forfeiting, he has to go for export credit insurance. Which is sometime involve very rigid procedure as well as costly. But in case of forfeiting he need not bare any such expenses.