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Relevance of Factoring apart from other Sources of Finance

Mr. Ashok S. Luhar: Visiting Faculty at I.Y College, Mumbai

Introduction

The Latin word "factare" means "to make" or "to do." Obviously the word "factory," the place where products are made, comes from this Latin root. Likewise, "factor" comes from the same word, so a factor is someone who "makes it happen" – who "gets it done." As we'll see below, this has been true for some time.

Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash for the short term period i.e. for 15, 30, 60, 90days or maximum up to the approved trade cycle. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 70% to 90% of the amount immediately of the invoice value. Factoring company pays the balance 10% to 30%(after deducting finance cost i.e. Interest Cost & Invoice handling charges and Service Tax) to the customer when the factor received 100% amount on the due date from the client's debtors.

The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring. Contractors submit invoices to get cash instantly) etc.

Most of the time big customer takes longer time to pay the invoice amount. An unpaid receivable or invoice has value. Factors are businesses who pay cash now for the right to receive the future payments on a client's invoices to their customers. Customers are often called "debtors" in factoring parlance. Because so many customers wait weeks or even months to pay their bills, a cash flow problem can arise for the companies to whom they owe money. Instead of having to wait for payment on a product or service that has already been delivered, a business can factor – sell – its receivables for cash at a discount off the face amount of the invoice. This almost instant cash offers a number of benefits to cash-starved companies: they can meet payroll, fund marketing efforts, have working capital, pay taxes, or meet many other needs. This cash can provide the means for a manufacturer to replenish inventory and to make more products to sell without having to wait for earlier sales to be paid.

Factoring is not a "loan" – it is the sale of an asset. A loan places a debt on a balance sheet, and it costs interest. By contrast, factoring puts money in the bank without creating an obligation to pay it back. Thus having more cash on hand and fewer receivables strengthens one's balance sheet. Loans are largely dependent on the borrower's financial soundness. With factoring, it is the soundness of the client's customer that matters most – a real plus for new businesses without an established track record. Because factors do not lend money but rather buy invoices, they look at prospective clients differently than a bank. A bank makes a loan with the assumption that the

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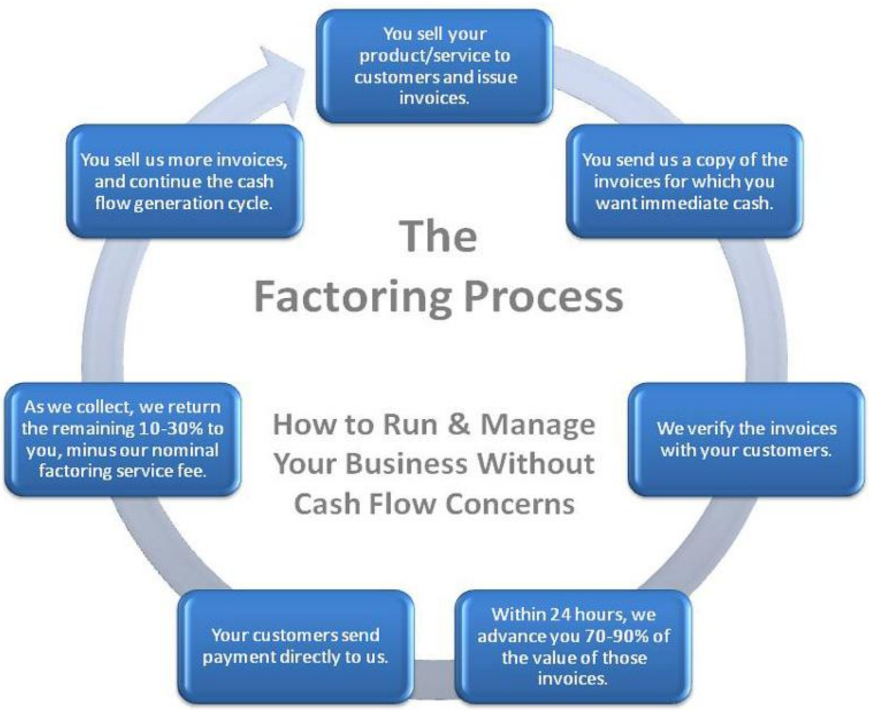
business to whom the loan is made will be stable enough to repay. Factors look to the stability of the customers of the business clients, because the customers will be paying the factor – not the client. Thus the focus is different: and because the focus is more on the customer than the client, factors often welcome clients that banks turn away. In fact, bank referrals provide factors some of their best leads.

So factoring is not only an excellent means for expanding a business, it may provide the only means when traditional loans aren't available…which, for many, many owners of very small businesses, is most of the time.

Factoring Works



Types

A. Domestic Factoring

In domestic Factoring, the client sells goods and services to the customer and delivers the invoices, order, etc., to the Factor and informs the customer of the same. In return, the Factor makes a cash advance and forwards a statement to the client. The Factor then sends a copy of all the statements of accounts, remittances, receipts, etc., to the customer. On receiving them the customer sends the payment to the Factor.

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Types of Domestic Factoring

1. Full Factoring/ Non Recourse Factoring

This is also known as "Without Recourse Factoring ". It is the most comprehensive type of facility offering all types of services namely finance sales ledger administration, collection, debt protection and customer information.

2. Recourse Factoring

The Factoring provides all types of facilities except debt protection. This type of service is offered in India. Under Recourse Factoring, the client's liability to Factor is not discharged until the customer pays full amount to factor on due date.

3. Maturity Factoring

It is also known as "Collection Factoring ". Under this arrangement, except providing finance, all other basic characteristics of Factoring are present. The payment is effected to the client at the end of collection period or the day of collecting accounts whichever is earlier.

4. Advance Factoring

This could be with or without recourse. Under this arrangement, the Factor provides advance at an agreed rate of interest to the client on uncollected and non-due receivables. This is only a pre-payment and not an advance.

Under this method, the customer is not notified about the arrangement between the client and the Factor. Hence the buyer is unaware of factoring arrangement. Debt collection is organized by the client who makes payment of each invoice to the Factor, if advance payment had been received earlier.

6. Invoice Discounting

In this arrangement, the only facility provided by the Factor is finance. In this method the client is a reputed company who would like to deal with its customers directly, including collection, and keep this Factoring arrangement confidential.

The client collects payments from customer and hands it over to Factor. The risk involved in invoice discounting is much higher than in any other methods.

The Factor has liberty to convert the facility by notifying all the clients to protect his interest. This service is becoming quite popular in Europe and nearly one third of Factoring business comprises this facility.

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7. Bulk Factoring

It is a modified version of Involve discounting wherein notification of assignment of debts is given to the customers. However, the client is subject to full recourse and he carries out his own administration and collection.

8. Agency Factoring

Under this arrangement, the facilities of finance and protection against bad debts are provided by the Factor whereas the sales ledger administration and collection of debts are carried out by the client.

B. International Factoring

International factoring is now universally accepted as vital to the financial needs of small and medium-sized exporters. It has the support of government bodies and central banks throughout the world and more and more large exporters are using international factoring as well, but sometimes selecting only a limited number of services rather than the complete package. As international trade continues to increase, so too do the opportunities for the factoring industry. Because international factoring works in a similar way to domestic factoring, exporters have realised that it can help them to become more competitive in complex world markets.

Types of International Factoring

The following are the important types of International Factoring. The client can choose any type of international factoring depending upon exporter - client needs and his price bearing capacity.

1. Single / Direct Factoring System

In this system, a special agreement is signed between two Factoring companies for single Factoring. Whereas in Two Factor System, credit is provided by import Factor and pre-payment, book keeping and collection responsibilities remain with export Factor.

For this system to be effective there should be strong co-ordination and co-operation between two Factoring companies. Pricing is lower when compared to Two Factor System.

2. Direct Export Factoring

Here only one Factoring company is involved, i.e., export Factor, which provides all services including finance to the exporter.

3. Direct Import Factoring

Under this system, the seller chooses to work directly with Factor of the importing country. The Factoring agreement is executed between the exporter and the import Factor. The import Factor is responsible for sales ledger administration, collection of debts and providing bad debt protection up to the agreed level of risk cover.

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4. Back to Back Factoring

It is a very specialized form of International Factoring, used when suppliers are selling large volumes to a few debtors for which it is difficult to cover the credit risk in International Factoring. In this case, International Factor can sign a domestic Factoring agreement with the debtor whereby it will be getting the receivables as security for the credit risk taken in favour of Export Factor.

Types of Businesses Which Benefit from Factoring
The list is virtually as long as the index to the Yellow Pages. Let's review the kinds of companies who can benefit from factoring and the kinds of customers they need to have. Any company, whether starting out, experiencing a growth phase, or mature in years, needs good cash flow. If a company's cash flow is good and always has enough to pay its bills, meet payroll and taxes, and can expand to its desired size unaided, factoring isn't necessary. However, if improved cash flow is needed, factoring can be one of the best ways to get it. There are following kinds of companies in which factor plays very important role, and the companies are rapidly growing, seasonal, starts-ups, undercapitalized, spin-off, concerned about adding fixed cost, have a lengthy manufacturing cost, strained by slow turnover of receivables, hurt by heavy bas debts losses, saddled with a large customer concentration.

Factoring Companies in India

1 Canbank Factors Limited: www.canbankfactors.com
2 Sbi Global Factors Limited: www.sbiglobal.in
3 IFCI Factors Limited: www.ifcifactors.com
4 India Factoring and finance Solution P. Ltd: www.indiafactoring.in
5 DBS: www.dbs.com
6 Export Credit Guarantee Corporation of India: www.ecgc.in
7 Citibank: www.citibank.co.in
8 Small Industries Development Bank of India (SIDBI): www.sidbi.in
9 Standard Chartered Bank: www.standardchartered.co.in
10 HSBC Bank Ltd: www.hsbc.co.in

The Cost of Factoring

Cost of factoring charges is varies from factor to factor and depend upon the credit period. The bifurcations of factoring cost are as given below.

Figures are approx.

Sr. No.	Name of Charges	Percentage %
1	Invoice handling charges	0.25% of each invoice
2	Service tax on handling charges	12.36% of handling charges
3	Interest	15% P.A (Variable)
4	Overdue interest	1 to 3% P.A of invoice amount

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Note

***Interest cost is depends on number of days of factoring, and it is varies from party to party.**

*****Overdue interest is charge only when the party failed to pay amount on due date, and it is charge from the due to date to the actual payment of date.

Example: Invoice amount Rs. 1,00,000/- **d**ue date is 15th September 2013 and party paid on 20th September 2013. So the factor will charge additional overdue interest of Rs.16.43/-

Calculation: 1,00,000 X 1%/365 X 6 = Rs. 16.43/-.

Illustration

ABC Co. Limited sold goods worth of Rs. 1,00,000/- to XYZ Limited on credit on 1st January 2013. ABC requires the need of urgent money so he visited to the factor and factored the invoice for 90 days. Calculate the cost of factoring for 90 days period @ 15% interest p.a. (as per recourse factoring method)

Ans.

Particular	Amount of Invoice	Handing Charges 0.25%	Service Tax on Handling Charges 12.36% P.A	Interest 15% P.A for 90 days	Overdue Interest 1% P.A on Invoice value	Total Charges	90% received at the time of factoring	10% received after deducting all charges
Case 1 If payment made on time	1,00,000	250.00	31.00	3699.00	--------	3980	90,000	6020
Case 2 If payment made 8 days after the due date	1,00,000	250.00	31.00	3699.00	22.00	4002	90,000	5998

Case 1

In case 1 everything goes perfect, debtor paid his due on time to factor. The party will receive the first 90% amount on the date when the bill is factored, assume it the date is 3rd January 2013, on this date party will receive Rs. 90,000/- and remaining amount after deducting all the finance charges will receive after 90 days i.e. on 2nd April 2013, Rs. 6020/-.

Case 2

If the debtor failed to make payment on the due date, and he made payment on 10th April 2013, so the factor will charge additional overdue interest @ 1% p.a on number of days default.

1,00,000 X 1%/365 X 8 = Rs.22/-

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Note

*Handling charges & service tax factor may be deduct at the time of factoring.

*In case of recourse factoring ultimate liability is of Client. In this case if debtor not paid 100% amount to factor on due date then factor demand money from the client, and factor gives additional 1 month grace period to debtor & client to repay his due with overdue interest. After one month if the debtor or the client not paid their dues then factor may take legal action and the party may be declar Non Performing Assets (NPA).

Conclusion

Factoring is a quick and easy way of turning your invoices into cash. For the time being or seasonal it is advantageous for the company, but regularly and highly dependence on such kind of services is not advisable to any company, because as far as benefit is concerned it is very fast and very quick for arranging short term finance. But the biggest loop holes are finance cost (which is varies with invoice amount and with the credit period), customer have to deal with the factoring companies, companies ability to borrow from other sources may be reduced.

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