

Problems with solutions for practice in factoring

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2. A company is considering engaging a factor, the following information is available:

i) The current average collection period for the Company's debtors is 80 days and $\frac{1}{2}\%$ of debtors default. The factor has agreed to pay money due after 60 days and will take the responsibility of any loss on account of bad debts.

ii) The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be Rs. 1, 00, 000 per annum.

iii) Annual sales, all on credit, are Rs. 1, 00, 00, 000. The variable cost is 80% of the sales price. The Company's cost of borrowing is 15% per annum.

Assume the year is consisting of 365 days. Should the Company enter into a factoring agreement?

3. MSN Ltd. has total sales of Rs. 4. 50 crores and its average collection period is 120 days. The experience indicates that bad debt losses are 2 percent on sales. The expenditure incurred by the company in administering its receivable collection efforts is Rs. 6, 00, 000. A Factor is prepared to buy the company's receivables by charging a 2 percent commission.

The factor will pay an advance on receivables to the company at an interest rate of 18 percent per annum after withholding 10 percent as a reserve. You are required to calculate the effective cost of factoring to the company.

4. The turnover of PQR Ltd. is Rs. 120 lakhs of which 75 percent is on credit. The variable cost ratio is 80 percent. The credit terms are 2/10, net 30. On the current level of sales, the bad debts are 1 percent. The company spends Rs. 1, 20, 000 per annum on administering its credit sales. The cost includes

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salaries of staff who handle credit checking, collection, etc. These are avoidable costs.

The experience indicates that 60 percent of the customer's avail of the cash discount, the remaining customers pay on an average 60 days after the date of sale. The Book debts (receivable) of the company are presently being financed in the ratio of 1 : 1 by a mix of bank borrowings and owned funds which cost per annum 15 percent and 14 percent respectively. A factoring firm has offered to buy the firm's receivables. The main elements of such deal structured by the factor are:

- (i) Factor reserve, 12 percent
- (ii) Guaranteed payment, 25 days
- (iii) Interest charges, 15 percent, and
- (iv) Commission 4 percent of the value of receivables.

Assume 360 days in a year. What advice would you give to PQR Ltd. - whether to continue with the in house management of receivables or accept the factoring firm's offer?

5. A firm has total sales of Rs. 12, 00, 000 and its average collection period is 90 days. The experience indicates that bad debt losses are 1. 5% on sales. The expenditure incurred by the firm in administering receivable collection efforts is Rs. 50, 000. A factor is prepared to buy the firm's receivables by charging a 2% commission. The factor will pay an advance on receivables to the firm at an interest rate of 16% p. a. after withholding 10% as a reserve.

Calculate the effective cost of factoring to the firm. Assume 360 days in a year.

6. The credit sales and receivables of M/s M Ltd. at the end of the year are estimated at Rs. 3, 74, 00, 000 and Rs. 46, 00, 000 respectively. The average variable overdraft interest rate is 5%. M Ltd. is considering a proposal for factoring its debts on a non-recourse basis at an annual fee of 3% on credit sales. As a result, M Ltd. will save Rs. 1, 00, 000 per year in administrative costs and Rs. 3, 50, 000 as bad debts. The factor will maintain a receivables collection period of 30 days and advance 80% of the face value thereof at an annual interest rate of 7%.

Evaluate the viability of the proposal.

Note: 365 days are to be taken in a year for the calculation of receivables

7. Junio Limited is a small manufacturing company that is suffering cash flow problems. The company already utilizes its maximum overdraft facility. Junio Limited sells an average of Rs. 4, 00, 000 of goods per month at invoice value and customers are allowed 40 days to pay from the date of invoice. Two possible solutions to the company's cash flow problems have been suggested.

They are as follows:

- Option 1: Junio Limited would factor its trade debts. A factor has been found who would advance Junio Limited's 75 percent of the value of the invoices immediately on receipt of the invoices, at an interest rate of 10 percent per annum. The factor would also charge a service fee

amounting to 2 percent of the total invoices. As a result of using the factor, Junio Limited would save administration costs estimated at Rs. 5, 000 per month.

- Option 2: The company could offer a cash discount to customers for prompt payment. It has been suggested that customers could be offered a 2% discount for payments made within ten days of invoice.

You are required to:

(a) Discuss the issues that should be considered by management when a policy for credit control is formulated.

(b) Identify the services that may be provided by factoring organizations.

(c) Calculate the annual net cost (in Rs.) of the proposed factoring agreement.

(d) Compute the annualized cost (in percentage terms) of offering a cash discount to customers.

(e) Discuss the merits and demerits of the two proposals.

Policy for Credit Control for Junio Limited

(a) When a policy is being formulated, management should consider the following issues:

(i) The average period of credit to be given. Whether this should be longer than average to encourage sales or less than average, to speed up sales.

(ii) Policy for making decisions on granting credit to individual customers:

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- How customers are to be investigated for the creditworthiness? (e. g. by direct assessment by the company, or indirect assessment using credit references from banks, or other assessment agencies)
- How the amount and timing of credit are to be decided? (e. g. whether a credit is to be increased progressively).

(iii) Debt collection policies: Whether to employ specific people for this work.

Issue of debtors' statements, reminder letters, whether and when to make use of professional debt collectors, and when to consider legal action.

(iv) Accounting reports required: Aged debtors lists etc.

(v) Policies on persuading debtors to pay promptly: Discount schemes.

(vi) Whether to make use of factoring services. For all the above, it will be necessary to consider the costs and benefits of the alternative course of action. This will include considerations on how credit is to be financed.

(b) A factor normally manages the debts owed to a client on the client's behalf.

Services Provided by Factoring Organisations

(i) Administration of the client's invoicing, sales accounting, and debt collection service.

(ii) Credit protection for the client's debts, whereby the factor takes over the risk of loss from bad debts and so 'insures' the client against such losses.

The factor may purchase these debts 'without recourse' to the client, which

means that if the client's debtors do not pay what they owe, the factor will not ask for the money back from the client.

(iii) 'Factorfinance' may be provided, the factor advancing cash to the client against outstanding debts. The factor may advance up to 85 percent of approved debts from the date of the invoice.

(iv) A confidentiality agreement may be offered to conceal the existence of the arrangement from customers.

(c) Calculation of Annual Cost of Factoring

It is assumed that the factor finance will not replace any existing credit lines, and therefore, the full interest cost of the agreement will be relevant when determining the cost of factoring.

Annual Sales = Rs. 4, 00, 000 ? 12 = Rs. 48, 00, 000

Daily Sales = Rs. 48, 00, 000/365 = Rs. 13, 151

The annual cost of factoring can now be found

(e) Key Issues in the Discounting Option

(i) The proposal is expensive.

The company should be able to get cheaper overdraft finance than this, and longer-term debt should cost even less.

(ii) The company may need to offer a discount to make its terms competitive with other firms in the industry.

(i) The level of take-up among customers is uncertain and will affect the cash flow position.

(ii) Problems may arise when customers take both the discount and the full forty-day credit period. This will increase administrative costs in seeking repayment.

Key Issues in the Factoring Option

(i) The factor may be able to exercise better credit control than is possible in a small company.

(ii) The amount of finance that will be received is much more certain than for the discounting option as 75 percent of the value of the invoices will be provided immediately.

(iii) The relationship with the customers may deteriorate partly due to the reduction in the level of the contract with the company, and partly due to the historical view of the factor as the lender of last resort. Thus, the final decision must take into consideration all the above issues. However, the most important points to consider are the ability of each proposal to meet the financing requirements and the relative costs of the different sources of finance.