

# Factoring assignment

Law



**MANAGEMENT OF FINANCIAL SERVICES LESSON 13: FACTORING –****THEORETICAL FRAMEWORK Lesson Objectives • • • • • Finance**

Maintenance of accounts Collection of debts Protection against credit risks”.

To understand the Concept of Factoring. Methodology of Factoring and

Forfeiting. Types of factoring. Introduction Receivables constitute a

significant portion of current assets of a firm. But, for investment in

receivables, a firm has to incur certain costs such as costs of financing

receivables and costs of collection from receivables. Further, there is a risk

of bad debts also.

It is, therefore, very essential to have a proper control and management of

receivables. In fact, maintaining of receivables poses two types of problems;

(i) the problem of raising funds to finance the receivables, and (ii) the

problems relating to collection, delays and defaults of the receivables. A

small firm' may handle the problem of receivables management of its own,

but it may not be possible for a large firm to do so efficiently as it may be

exposed to the risk of more and more bad debts. In such a case, a firm may

avail the services of specialised institutions engaged in receivables

management, called factoring firms.

At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram

went into the aspects of factoring services in India in 1988, which formed the

basis for introduction of factoring services in India. SBI established, in 1991,

a subsidiary-SBI Factors Limited with an authorized capital of Rs. 25 crores to

undertake factoring services covering the western zone The above definition,

however, applies only to factoring in relation to supply of goods and services

in respect of the following: i. To trade or professional debtors ii. Across national boundaries iii.

When notice of assignment has been given to the debtors. The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/ services are sold to the “ factor” as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer (s).

Glossary of Terminology The common terminology used in a factoring transaction are as follows: i. Client He is also known as supplier. It may be a business institution supplying the goods/services on credit and availing of the factoring arrangements. ii. Customer A person or business organisation to whom the goods/ services have been supplied on credit. He may also be called as debtor. iii. Account receivables Any trade debt arising from the sale of goods/ services by the client to the customer on credit. iv.

Open account sales Where in an arrangement goods/ services are sold/supplied by the client to the customer on credit without raising any bill of exchange or promissory note. v. Eligible debt Debts, which are approved by the factor for making prepayment. vi. Retention Margin maintained by the factor. vii. Prepayment An advance payment made by the factor to the client up to a certain percent of the eligible debts. Meaning and Definition Factoring may broadly be defined as the relationship, created by an

agreement, between the seller of goods/services and a financial institution called the factor, whereby the latter purchases the receivables of the former and also controls and administers the receivables of the former. Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts (account receivables) with or without recourse to the client – thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

The term "factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, 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: Nature of Factoring Factoring is a tool of receivable management employed to release funds tied up in credit extended to customers. . Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear in the books of account as book credits. 88 © Copy Right: Rai University 11. 671. 3

2. The risk associated with credit are taken over by the factor which purchases these credit receivables without recourse and collects them when

due. 3. A factor performs at least two of the following functions: i. ii. iii. iv.  
Provides finance for the supplier including loans and advance payments.

Maintains accounts, ledgers relating to receivables. Collects receivables.

Protects risk of default in payments by debtors. The Buyer 1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit. 2. He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date. 3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

MANAGEMENT OF FINANCIAL SERVICES 4. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. It acts as another financial intermediary between the buyer and seller. 5. Unlike a bank, a factor specialises in handling and collecting receivables in an efficient manner. Payments are received by the factor directly since the invoices are assigned in favor of the factor. 6. Factor is responsible for sales accounting, debt collection and credit control protection from bad debts, and rendering of advisory services to their clients. . Factoring is a tool of receivables management employed to release funds tied up in credit extended to customers and to solve the problems relating to collection, delays and defaults of the receivables. The Seller 1. The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions. 2. Sells goods to the buyer as per the contract. 3. Sends copies of invoice, delivery challan along

with the goods to the buyer and gives instructions to the buyer to make payment on due date. 4.

The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance. 5. The seller receives the balance payment from the factor after paying the service charges. The Factor 1. The factor enters into an agreement with the seller for rendering factor services i. e. collection of receivables/debts. 2. The factor pays 80% or more of the amount of receivables copies of sale documents. 3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges. Mechanism of Factoring

Factoring business is generated by credit sales in the normal course business. The main function of factor is realisation of sales. Once the transaction takes place, the role of factor step in to realise the sales/collect receivables. Thus, factor act as a intermediary between the seller and till and sometimes along with the seller's bank together. The mechanism of factoring is summed up as below: i. An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service. Types of Factoring

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transactions is collection of receivables and administration of sale ledger. However, following are some

of the important types of factoring arrangements. 1. Recourse and Non-recourse Factoring In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, Let the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables.

Thus the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, 89 ii. The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables. iii. When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed. iv.

The factor may provide advance finance to the selling firm conditions of the agreement so require. Parties to the Factoring There are basically three parties involved in a factoring transaction. 1. The buyer of the goods. 2. The seller of the goods 3. The factor i. e. financial institution. The three parties

interact with each other during the purchase/ sale of goods. The possible procedure that may be followed is summarised below. 11. 671. 3 © Copy Right: Rai University commission or fees charged for the services in case of nonrecourse factoring is higher than under the recourse factoring.

The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called del credere commission. 2. Advance and Maturity Factoring Under advance factoring arrangement, the factor pays only a certain percentage (between 75 % to 90 %) of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of actual collection of receivables by the factor.

The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate. Sometimes, banks also participate in factoring transactions. A bank agrees to provide an advance to the client to finance a part say 50% of the (factored receivables – advance given by the factor). For example : Assume total value of the factored debt/receivable is A factor finances 80 % of the debt. Balance value of debt Say, bank finances 50% of the balance i. e. Rs. 100 Rs. 80 Rs. 20 Rs. 10. 2. Client (seller) 3. Factor (financial intermediary) All the three parties reside in the same country.

Export factoring is also termed as cross-border/international factoring and is almost similar to domestic factoring except that there are four parties to the



factoring transaction. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring, it is also called two-factor system of factoring. Two factor system results in two separate but inter-related contracts: 1. between the exporter (client) and the export factor. 2. export factor and import factor.

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language. He also assumes customer trade credit risk, and agrees to collect receivables and transfer funds to the export factor in the currency of the invoice. Export/International factoring provides a non-recourse factoring deal. The exporter has 100 % protection against bad debts loss arising on account of credit sales. 5.

Limited Factoring Under limited factoring, the factor discounts only certain invoices on selective basis and converts credit bills into cash in respect of those bills only. . Selected Seller Based Factoring The seller sells all his accounts receivables to the factor along with invoice delivery challans, contracts etc. after invoicing the customers. The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and do all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement. 7. Selected Buyer Based Factoring The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepares an approved list of them.

The approved buyers of a company approach the factor for discounting their purchases of bills receivables drawn in the favour of the company in question  
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(i. e. seller). The factor discounts the bills without recourse to seller and makes the payment to the seller. 8. Disclosed and Undisclosed Factoring In disclosed factoring, the name of the factor is mentioned in the invoice by the supplier telling the buyer to make payment to the factor on due date. However, the supplier may continue to bear the risk of bad debts (i. e. non-payments) without passing to the factor.

The factor assumes the risk only under nonrecourse factoring agreements. Generally, the factor lays down a limit within which it will work as a non-recourse. Beyond this limit the dealings are done on recourse basis i. e. the seller bears the risk. Under undisclosed factoring, the name of the factor is not disclosed in the invoice. But still the control lies with the factor. The factor maintain sales ledger of the seller of goods, provides short-term finance against the sales invoices but the entire 11. 671. 3 MANAGEMENT OF FINANCIAL SERVICES Thus, the factor and the bank will make a pre-payment of Rs. 90 (i. e. 0% of the debt) and the client's share is only 10% of the investment in receivables. In case of maturity factoring, no advance is paid to client and the payment is made to the client only on collection of receivables or the guaranteed payment data as the case may be agreed between the parties. Thus, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale. 3. Conventional or Full Factoring Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance.

The factor also fixes up a draw limit based on the bills outstanding maturitywise and takes the corresponding risk of default or credit risk and <https://assignbuster.com/factoring-assignment/>

the factor will have claims on the debtor as also the client creditor. It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular but in India only a beginning has been made.

Factoring agencies like SBI Factors are doing full factoring for good companies with recourse. 4. Domestic and Export Factoring The basic difference between the domestic and export factoring is on account of the number of parties involved. In the domestic factoring three parties are involved, namely: The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language. 1. Customer (buyer) 90 © Copy Right: Rai University transactions take place in the name of the supplier company (seller). Functions of a Factor

The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as : 1. Administration of sellers' sales ledger. 2. Collection of receivables purchased. 3. Provision of finance. 4. Protection against risk of bad debts/credit control and credit protection. 5. Rendering advisory services by virtue of their experience in financial dealings with customers. These are explained as under. 1. Administration of Sales Ledger The factor assumes the entire responsibility of administering sales ledger. The factor maintains sales ledger in respect of each client.

When the sales transaction takes place, an invoice is prepared in duplicate by the client, one copy is given to customer and second copy is sent to the factor. Entries are made in the ledger on open-item method. Each receipt is matched against the specific invoice. On any given date, the customer account indicates the various open invoices outstanding. Periodic reports are sent by factor to the client with respect to current status of receivables and amount received from customers. Depending upon the volume of transactions, the periodicity of report is decided.

Thus, the entire sales ledger administration responsibility of the client gets transferred to the factor. He performs the following functions with regard to the administration of sales ledger: i. He ensures that invoices raised represent genuine trade transactions in respect of goods sold or services provided. ii. He updates the sales ledger with latest invoices raised and cash received. iii. He ensures that monthly statements are sent to the debtors, efforts are made to collect the dues on the due dates through an efficient mechanism of personal contacts, issuance of reminders, telephone messages etc. v. He remits the retention to the clients after collection of the dues. Where the factoring is operating on Fixed Maturity Period (FMP) basis, the factor is to ensure that the client is paid the retention money at the expiry of the said period. v. He establishes close links with the client and the customers to resolve the various disputes raised in respect of quantity or quality of the goods/services supplied besides the unauthorised discounts claimed or deducted by the debtors while making payment. vi.

He reviews the financial strength of the debtors at periodic intervals to ensure collectability of debts. vii. He submits at periodic intervals the reports

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containing information as to the details of overdue unpaid invoices, disputes, legal cases etc. to the client. 2. Collection of Receivables The factor helps the client in adopting better credit control policy. The main functions of a factor is to collect the receivables on behalf of the client and to relieve him from all the botherations/problems associated with the collection.

This way the client can concentrate on other major areas of his business on one hand and reduce the cost of collection by way of savings in labor, time and efforts on the other hand. The factor possesses trained and experienced personnel, sophisticated infrastructure and improved technology which helps him to make timely demands on the debtors to make payments. 3. Provision of Finance Finance, which is the lifeblood of a business, is made available easily by the factor to the client. A factor purchases the book debts of his client and debts are assigned in favor of the factor. 5% to 80 percent of the assigned debts is given as an advance to the client by the factor. a. Where an agreement is entered into between the client (seller) and the c factor for the purchase of receivables without recourse, the factor becomes responsible to the seller on the due date of the invoice whether or not the buyer makes the payment to the factor. b. Where the debts are factored with recourse- the client has to refund the full finance amount provided by the factor in case the buyer fails to make the payment on due date. 4.

Protection Against Risk This service is provided where the debts are factored without recourse. The factor fixes the credit limits (i. e. the limit up to which the client can sell goods to customers) in respect of approved customers.

Within these limits the factor undertakes to purchase all trade debts and assumes risk of default in payment by the customers. The factor not only

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relieves the client from the collection work but also advises the client on the creditworthiness of potential customers. Thus the factor helps the client in adopting better credit control policy.

The credit standing of the customer is assessed by the factors on the basis of information collected from credit rating reports, bank reports, trade reference, financial statement analysis and by calculating the important ratios in respect of liquidity and profitability position. 5. Advisory Services

These services arise out of the close relationship between a factor and a client. Since the factors have better knowledge and wide experience in field of finance, and possess extensive credit information about customer's standing, they provide various advisory services on the matters relating to :

a.

Customer's preferences regarding the clients products. b. Changes in marketing policies/strategies of the competitors. c. Suggest improvements in the procedures adopted for invoicing, delivery and sales return.

MANAGEMENT OF FINANCIAL SERVICES d. Helping the client for raising

finance from banks/financial institutions, etc. 11. 671. 3 © Copy Right: Rai

University 91 The factor provides his client with a periodical statement on the sanctioned limit, utilised credit and balance outstanding. The following data is provided regularly: a. List of book debts taken over b. Book debts realised c.

Age-wise classification of the debts d. Debts collected and due for collection

e. Debts purchased with recourse or without recourse etc. (Rs. crores)

Current Liabilities (CL) Bank borrowing against i. Inventory ii. Receivables

Other current liabilities Net Working Capital (CA-CL) Total Current Liabilities  
 120 30 150 50 200 Total Current Assets 200 Current Assets (CA) Inventory  
 Receivables 100 80 MANAGEMENT OF FINANCIAL SERVICES 50 Other current  
 assets 20 Cost of Services The factor provides various services at some  
 charge in the form of a commission expressed as a value of debt purchased.  
 It is collected in advance.

The commission is in the form of interest charged for the period between the  
 date of advance payment and date of collection/guarantee payment date for  
 short term financing as advance part payment. It is also known as discount  
 charge. The cost of factoring services primarily comprises of the following  
 two components: 1. Administrative charges /factoring fees This is charged  
 towards providing various services to the clients namely (a) sales ledger  
 administration (b) credit control including processing, operational overheads  
 and collection of debts (c) providing, protection against bad debts.

This charge is usually some percent of the projected sales turnover of the  
 client for the next twelve months. It varies between 1 to 2. 5 percent of the  
 projected turnover. The quantum of charged depends upon the following  
 factors. a. Type of industry b. Financial strength of the client as well as of the  
 debtors c. Volume of sales d. Average invoice value e. Terms of trade f.  
 Type(s) of service(s) offered g. Required profit margin to the factor h. Extent  
 of competition i. Security to the factor etc. 2. Discount charges This is levied  
 towards providing instant credit to the client by way of prepayment.

This is normally linked with the base rate of the parent company or the bank  
 from which the factoring institution is borrowing money, say, 1 to 2. 5

percent above the said rate. Original Current Ratio 1: 33: 1 (200 : 150) The requirement of net working capital is Rs. 50 crores (Current Assets – Current Liabilities). As the borrower carries other current liabilities to the extent of Rs. 30 crores he is eligible for a maximum bank borrowing of Rs. 120 crores divided into cash credit limit of Rs. 70 crores against inventory and Rs. 0 crores against receivables, taking into account the stipulated margins for inventory and receivables and also the proportion of individual levels of inventory of Rs. 100 crores and receivables of Rs. 80 crores. On the basis of above data, the borrower is eligible for working capital limits aggregating Rs. 120 crore under the second method of: lending as recommended by the Tondon Committee. Assume the borrower decides to factor his debts. The Receivables aggregating Rs. 80 crore are purchased by a factor who in turn makes advance payment of 80% i. e. Rs. 64 crore.

He retains Rs. 16 crore (factor reserve) which will be repaid on payment by the customer. , Balance Sheet: Post-factoring Position (Rs. Crore)

Current Liabilities (CL)	Bank: borrowing against Inventory	Other current liabilities	Net working capital (CA;-CL)
50	136	136	50

Current Assets (CA)

Inventory	Other current assets	100	20	Receivables (Due from factor)	16	New Current Ratio
16	16	16	16	16	1.581: r-(136 : 86)	

The impact of factoring on balance sheet may be stated in terms of :

1. Improvement in Current Ratio. The current ratio improves from 1. 33: 1 (before factoring) to 1. 58 : 1.

The new current ratio is better for the client and his credit rating goes up before public eye. 2. Reduction in Current Liabilities. An advance payment of Rs. 64 crores (i. e. 80% of 80 crore) is utilised in repaying the bank borrowings against receivables to the tune of Rs. 50 crores and for meeting

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other current liabilities to the tune of Rs. 14 crores. The net effect of factoring transaction is that the current liabilities get reduced by Rs. 64 crore. Impact on Balance Sheet Factoring, as a financial service has a positive impact on the Balance Sheet as can be illustrated with the help of an example:

Balance Sheet: Pre-factoring Position 92 © Copy Right: Rai University 11.

671. 3 3. Off-Balance Sheet Finance. Since the client's debts are purchased by the factor and amount is paid to the client, it serves as off the balance sheet finance and appears in the balance sheet only as a contingent liability in the case of recourse factoring. Because in case of default by the buyer, the client will have to refund the finance amount to the factor. But in case of non-recourse factoring, it does not appear anywhere in the financial statement of the borrower. Thus factoring services help the client to improve the structure of balance sheet. Operational and managerial capabilities whether his debts are collectable and viability of his operations. He also assesses the debtor regarding the nature of business, vulnerability of his operations; and assesses the debtor regarding the nature of business, vulnerability to seasonality, history of operations, the term of sales, the track record and bank report available on the past history. MANAGEMENT OF FINANCIAL SERVICES Limitations The above listed advantages do not mean that the factoring operations are totally free from any limitation. The attendant risk itself is of very high degree.

Some of the main limitations of such transactions are listed below: 1. It may lead to over-confidence in the behavior of the client resulting in over-trading or mismanagement. 2 The risk element in factoring gets accentuated due to <https://assignbuster.com/factoring-assignment/>

possible fraudulent acts by the client in furnishing the main instrument “ invoice” to the factor. Invoicing against nonexistent goods, pre-invoicing (i. e. invoicing before physical dispatch of goods), duplicate-invoicing (i. e. making more than one invoice in respect of single transaction) are some commonly found frauds in such operations, which had put many factors into difficulty in late 50’s all over the world. . Lack of professionalism and competence, underdeveloped expertise, resistance to change etc. are some of the problems which have made factoring services unpopular. 4. Rights of the factor resulting from purchase of trade debts are uncertain, not as strong as that in bills of exchange and are subject to settlement of discounts, returns and allowances. 5. Small companies with lesser turnover, companies having high concentration on a few debtors, companies with speculative business, companies selling a large number of products of various types to general public or companies having large number of debtors for small amounts etc. ay not be suitable for entering into factoring contracts.

Advantages of Factoring Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services ranging from bill discounting facilities offered by the commercial banks to total take over of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, provision of finance and rendering of advisory services to their clients.

Thus factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables. A firm that enters into

factoring agreement is benefited in a number of ways, some of the important benefits are outlined below: 1. The factors provides specialised services with regard to sales ledger administration and credit control and relieves the client from the botheration of debt collection.

He can concentrate on the other major areas of his business and improve his efficiency. 2. The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor's assumption of credit risk relieves him from the tension of bad debt losses. The client can take steps to reduce his reserve for bad debts. . It provides flexibility to the company to decide about extending better terms to their customers. 4. The company itself is in a better position to meet its commitments more promptly due to improved cash flows. 5. Enables the company to meet seasonal demands for cash whenever required. 6. Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchases. 7. As it is an off balance sheet finance, thus it does not affect the financial structure.

This would help in boosting the efficiency ratios such as return on asset etc.

8. Saves the management time and effort in collecting the receivables and in sales ledger management. 9. Where credit information is also provided by the factor, it helps the company to avoid bad debts. 10. It ensures better management of receivables as factor firm is specialised agency for the same. The factor carries out assessment of the client with regard to his

financial, 11. 671. 3 © Copy Right: Rai University 93

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