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FACTORING: A CREDIT MANAGEMENT TOOL

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ABSTRACT

Credit management is a special activity which involves a lot of time, effort and cost to a business concern. Factoring is a mechanism of managing, financing and collection of receivables by a specialist organisation on behalf of the business enterprises, the specialist organisation may be commercial banks, industrial banks, financial institutions, cooperative banks, mutual trusts etc. Factoring is a specialised activity whereby a firm converts its receivables into cash by selling them to a factoring organisation. In factoring services, there is a scale of goods/services between the client and the customer. Factoring is a unique financial innovation. Factoring may be defined as 'a contract between the supplier of goods/services and the factor'. Factoring relates to accounts receivables management. Collection of receivables and protection against default is managed by the factor. The factor performs basic functions such as administration of seller's sales ledger, credit control, collection of dues etc. The costs of factoring are interest on advance executed by the factor and communication or fee for his services. Benefits arising from factoring are both qualitative and quantitative. All the basic services provided by a factor can be obtained individually from other sources. Thus, as a financial system combining all the related services, factoring offers a distinct solution to the problems posed by working capital tied up in trade debts.

Keywords: Factoring, Management, Working Capital, Receivables

INTRODUCTION

Credit management is a special activity which involves a lot of time, effort and cost to a business concern. Credit management involves the elements of granting credit, recording transactions, collection etc. Big concerns can assign to credit management and collection to specialist organisations, called factoring organisations. Factoring is a mechanism of managing, financing and collection of receivables by a specialist organisation on behalf of the business enterprise; the specialist organisation may be commercial banks, industrial banks, financial institutions, cooperative banks, mutual trusts etc. The real benefits of factoring are reflected in Profit and Loss Account (Bakker, Klapper & Udell, 2014).

LITERATURE REVIEW

Origin and Concept of Factoring

The word 'factor' comes from Latin word 'facore' which means 'to make or do', i.e. to get things done. Dictionary defines it as an agent, particularly a mercantile agent. It traces back through several countries. In the earlier stage factors were itinerant merchants who were entrusted with merchandise belonging to others. Factors were the 'middlemen' between countries which had advanced economies and the countries which were still in the beginning stages of development.

Factoring is a specialised activity whereby a firm converts its receivables into cash by selling them to a factoring organisation. The factor takes the risk of collection and in the event of non-payment by the customers bears the risk of bad debt losses. It is also termed as "invoice factoring" as factoring covers only those receivables which are not supported by negotiable instruments, like bills. In case of receivables backed by bills, the firm resorts to the practice of bill discounting with its bankers. With the factoring of receivables, the clients dispense away the credit department and the debtors of the firm become the debtors of the factor Hyderabad (1998).

In factoring services, there is a scale of goods/services between the client and the customer. Later the client sells his debtors to the factor and depending upon the agreement receives payment either on maturity or in advance. From the customers the factor collects the dues and bears the bad debt losses in the event of non-payment.

RESULTS AND DISCUSSION

Nature of Factoring

Factoring is a unique financial innovation. It is both as a financial as well as management support to a client. This is a process of covering non-productive assets (receivables) into a productive one (cash) by selling receivables to a company that specialises in their collection and administration (Love & Mylenko, 2003).

Factoring may be defined as 'a contract between the supplier of goods and services and the factor under which (a) the supplier and its customers/debtors other than those for the sale of goods bought primarily for their personal, family or household use, (b) the factor is to perform at least two of the following functions- (i) finance for the supplier, (ii) maintenance of accounts, (iii) collection of accounts, (iv) protection of default by the customers, (c) notice of assignment of the receivables is to be given to debtors'.

The factoring agreement between the supplier and the factor specifies the factoring procedure. Usually the firm sends the customer's order to the factor for evaluating the customer's credit worthiness and approval, once to the factor after satisfaction about the customer's credit worthiness and agrees to buy receivables, the firm despatches goods to the customer. The customer will be informed that his account has been sold to the factor and he is instructed to make payment directly to the factor. To perform his functions of credit evaluation and collection from many clients, a factor may maintain a credit department with specialised staff. Once the factor has purchased a firm's receivables and if he agrees to own it he will have to provide protection against any bad debt losses to the firm (Sopranzetti, 1998).

Essentials of Factoring

(I) Factoring relates to accounts receivables management.
(ii) A separate institution is entrusted with the management of debtors account receivables, called factor. Usually, commercial banks, financial institutions are associated with such task.
(iii) The factor takes all possible risks in management of debtors. For such service, they get commission. The commission consists of two types, ordinary and del-credere commission.
(iv) Factors perform the task of 'ledgering' of client's business.
(v) The client assigns the work of factoring to the factor.
(vi) There is an agreement between client and factor detailing all terms and conditions.
(vii) Factor purchases the client's book debts by giving advance money. On his advance he may charge interest.
(viii) The client gets money/working capital immediately for business. Thus, he saves time and burden is less.
(ix) The factor is maintaining accounts in clear manner which is useful in finalising the accounts of the company.
(x) Audit will be easier.
(xi) Collection of receivables and protection against default is managed by the factor.

Mechanics of Factoring

The procedure of factoring starts when the seller makes an agreement with the factor. After signing the agreement regarding the terms and conditions, the client passes all credit sales to the factor and informs their customers that the payment must be made to the factor. The factor purchases the invoices and makes the advances, generally up to 80% of the invoice amount. Once the customer makes payment to the factor, the balance amount due to the client is paid by the factor. The factor also conducts a follow up if the customer does not pay by the due date (Thripathy, 1995).

The agreement between the factor and the seller specifies the procedure as under:

(I) Seller negotiates with the factor for establishing factoring relationship.
(ii) Request by seller for credit check on the buyer whose name and address are furnished to the factor.
(iii) Factor checks the creditworthiness and approves the buyer.
(iv) Seller sells goods to the buyer
(v) Seller sends invoice to the factor. The invoice is accounted for in the buyer's accounts in the factor's sales ledger.
(vi) Factor sends copy of invoice to the buyer.
(vii) Factor advises the amount to which seller is entitled after retaining margin, say 20 percent, the residual amount being paid later.
(viii) On the expiry of the agreed credit period, buyer

makes the payment of the invoice to the factor. At the point the Factor pays to seller margin money retained as per above. If, however, the buyer defaults to pay the Factor, it would still make the final payment to the seller.

Factoring and Short-Term Financing

Although factoring provides short term financial accommodations to the client, it differs from other types of short-term credit in the following way:

(I) Factoring involves 'sale' of book debts. Thus, the client gets advance cash against the expected debt collection and then not incurs a bad debt.

(ii) Factoring provides flexibility about the credit facility to the client. He can obtain cash either immediately or on the date or from time to time, as and when he needs cash. Such flexibility is not available from short term financing.

(iii) Factoring provides credit to the client and undertakes the total management of client's book debts.

Factoring and Bill Discounting

Factoring should be distinguished from bill discounting. Bill discounting consists of the client drawing bills of exchange for goods and services on buyers and discounting it with bank for a charge. Thus, like factoring, bill discounting is a method of financing. But Factoring is all of bill discounting plus much more. Bill discounting has the following limitations in comparison to factoring:

(I) Bill discounting is a sort of borrowing while factoring is the efficient management of book debts along with enhancing the client's liquidity.

(ii) The client must undertake the collection of book debts and he must bear bad debt losses.

Benefits of Factoring

Factoring involves change in the asset-structure of the firm as receivables are converted into cash. It makes the structure of the firm more liquid and increases its capacity to more maturing financial obligations (Fisman & Love, 2003).

The real benefits of factoring are reflected in Profit and Loss Account. The savings which arises from the services would enhance the profitability of the firm. The improved profitability will enhance divided payment and overall financial health (Agarwal & Rao, 1996)

Factoring and Balance Sheet

The Balance Sheet of XYZ Co. Ltd. before and after factoring is given below:

Table 1: Balance Sheet of XYZ Co. Ltd. (Before Factoring)

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Share Capital	2,00,000	Fixed Assets	3,00,000
Reserve & Surplus	1,00,000	Current Liabilities, Stock	1,00,000
Long Term Debt	2,00,000	Bills Receivables	1,50,000
Current Liabilities	1,00,000	Cash	50,000
Total	**6,00,000**	**Total**	**6,00,000**

Net Working Capital = Current Assets less Current Liabilities
= Rs.3,00,000- Rs.1,00,000= Rs. 2,00,000

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Rs. 3,00,000}}{\text{Rs. 1,00,000}} = 3:1$

Liquid Ratio = $\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{\text{Rs. 2,00,000}}{\text{Rs.1,00,000}} = 3:1$

Table 2: Balance Sheet of XYZ Co. Ltd (After Factoring)

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital	2,00,000	Fixed Assets	3,00,000
Reserve & Surplus	1,00,000	Current Assets, Stock	1,00,000
Long Term Loan	2,00,000	Bills Receivables	1,50,000
Current Liabilities	1,00,000	Cash	50,000
Total	**6,00,000**	**Total**	**6,00,000**

Net Working Capital = Current Assets less Current Liabilities
= Rs.3,00,000- Rs.1,00,000= Rs. 2,00,000

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Rs. 3,00,000}}{\text{Rs. 1,00,000}} = 3:1$

Liquid Ratio = $\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{\text{Rs. 2,00,000}}{\text{Rs.1,00,000}} = 2:1$

An analysis of the above Balance Sheet clearly depicts that factoring makes qualitative changes on the assets structure of the balance sheet by making it more liquid. The cash position of XYZ Co. Ltd. improved from Rs. 50,000 to Rs.1,50,000 without any corresponding increase in any of the liability items or sale of fixed assets. There is no change in the net working capital position and current and liquid ratio as factoring affects only the composition of current assets.

Factoring and Profit and Loss Account

The benefits of factoring from the point of Profit and

Loss Account are analysed as under:

(I) The factor performs basic functions such as administration of seller's sales ledger, credit control, collection of dues etc. This would save the administration costs.
(ii) The factor by providing payment on the purchase of receivables contrasts the length of operating cycle period and reduces the working capital needs. It would save the interest on capital (Deolalkar, 1994).
(iii) The improved liquidity position enables the firm to pay obligations without any delay. The firm saves time and energy by shifting the functions associated with credit management. The savings would enable a firm to improve profitability. The improved profitability enhanced the return of investment and market value of the firm (Demirguc-Kunt & Maksimovic, 2002).

Cost of Factoring

Factoring services have both cost and benefits. The costs of factoring are:

(i) Interest on advance executed by the factor.
(ii) Communication or fee for his services.

The commission is usually charged in the range of 2.5% to 3% on the gross value of invoices. In fact, the factoring commission depend upon the total value of bill receivables, size of individual receivables and the quality of receivables. The commission is expected to be higher without resources factoring since the factor assumes the entire credit risk (Pandey, 2016).

CONCLUSION

Benefits arising from factoring are both qualitative and quantitative. Qualitative benefits like advice on market and product mix, financial counselling, advice on technology and production methods etc. go long way in minimising costs. Forwarding benefits, the client but the overall benefits in the long run occur from the good management of production and marketing.

All the basic services provided by a factor can be obtained individually from other sources. For instance, computer agencies can provide sales ledger accounting facilities. Commercial banks provide finance against receivables in various forms like purchasing/ discounting of bills and granting overdraft/cash credit against book debts. The collection function is also performed by collection agencies. But what is unique about factoring is that a factor brings all these services jointly. Thus, as a financial system combining all the related services, factoring offers a distinct solution to the problems posed by working capital tied up in trade debts.

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