Factoring:

MEANING OF FACTORING:

Factoring is defined as “an outright purchase of credit approved accounts receivables, with the factor assuming bad debt losses.”

The modern factoring involves a continuing arrangement under which a financing institution assumes the credit control/protection and collection functions for its client, purchases his receivables as they arise (with or without recourse to him for credit losses, i.e., customer’s financial inability to pay), maintains the sales ledger, attends to other book-keeping duties relates to such accounts receivables and performs other auxiliary functions.

Factoring is an asset based method of financing as well as specialized service being the purchase of book debts of a company by the factor, thus realizing the capital tied up in accounts receivables and providing financial accommodation to the company.

The book debts are assigned to the factor who collects them when due for which he charges an amount as discount or rebate deducted from the bills. Thus, the factor is an intermediary between the supplier and customers who performs financing and debt collection services.

In a situation where industry is finding it difficult to obtain funds, the need for better management of book debts by companies had arisen. In this backdrop, ‘factoring’ services assumed an important role in global business and could help Indian industry overcome debt collection deficiencies in a big way.

The Managing Director of International Factors Ltd., of Singapore Mr. Eugem Tan Eu Jin, noted that “factoring business had a great potential in India and it was in the best interests of the country to develop this financial intermediary. Banks and other financial institutions can as well diversify in this area to increase their profitability.”

Factoring can be both domestic and for exports. In domestic factoring, the client sells goods and services to the customer and delivers the invoices, order documents, etc. to the factor and inform the customer of the same.

In return, the factor makes a cash advance and 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.

In case of export factoring two ‘factors’ are involved. The factor in the customer’s country is called “Import Factor” while the one in the client’s country is called the “Export Factor”. All the transactions remain similar in the case of international factoring, the only difference being that the export factor has to send the shipping documents to the import factor and the import factor has to pass on the ultimate collection to the export factor.

Salient Features of Factoring:

(i) Credit Cover:

The factor takes over the risk burden of the client and thereby the client’s credit is covered through advances.

(ii) Case advances:

The factor makes cash advances to the client within 24 hours of receiving the documents.

(iii) Sales ledgering:

As many documents are exchanged, all details pertaining to the transaction are automatically computerized and stored.

(iv) Collection Service:

The factor, buys the receivables from the client, they become the factor's debts and the collection of cheques and other follow-up procedures are done by the factor in its own interest.

(v) Provide Valuable advice:

The factors also provide valuable advice on country-wise and customer-wise risks. This is because the factor is in a position to know the companies of its country better than the exporter clients.

Types of Factoring:

The types of factoring are discussed below:

(i) Recourse Factoring

(ii) Non-Recourse Factoring

(iii) Advance Factoring

(iv) Confidential and Undisclosed Factoring

(v) Maturity Factoring.

(vi) Supplier Guarantee Factoring

(vii) Bank Participation Factoring

The detail about the Types of Factoring is as follows:

(i) In Recourse factoring the credit risk remains with the client though the debt is assigned to the factor, i.e., the factor can have recourse to the client in the event of non-payment by the customer.

(ii) The Non-Recourse Factoring also called as 'Old-line factoring'. It is an arrangement whereby he factor has no recourse to the client when the bill remains unpaid by the customer. Thus, the risk of bad debt is absorbed by the factor.

(iii) Where the payment is made by the factor immediately is called Advance Factoring Under this type of factoring, the factor provides financial accommodation apart from non-financial services rendered by him.

(IV) In confidential and undisclosed factoring the arrangement between the factor and the client are left un-notified to the customers and the client collects the bills from the customers without intimating them to the factoring arrangements.

(v) In maturity factoring method, the factor may agree to pay an amount to the client for the bills purchased by him either immediately or on maturity. The later refers to a date agreed upon on which the factor pays the client.

(vi) Supplier Guarantee Factoring is also known as 'drop shipment factoring'. This happens when the client is a mediator between supplier and customer. When the client is a distributor, the factor guarantees the supplier against the invoices raised by the supplier upon the client and the goods may be delivered to the customer. The client thereafter raises bills on the customer and assigns them to the factor. The factor thus enables the client to make a gross profit with no financial involvement at all.

(vii) In bank participation factoring the bank takes a floating charge on the client's equity i.e., the amount payable by the factor to the client in .respect of his receivables. On this basis, the bank lends to the client and enables him to have double financing.

Steps Involved in Factoring:

The steps involved in factoring are discussed below:

Step I. The customer places an order with the seller (the client).

Step II. The factor and the seller enter into a factoring agreement about the various terms of factoring.

Step III. Sale contract is entered into with the buyer and the goods are delivered. The invoice with the notice to pay the factor is sent along with.

Step IV. The copy of invoice covering the above sale is sent to the factors, who maintain the sales ledger.

Step V. The factor prepays 80% of the invoice value.

Step VI. Monthly Statements are sent by the factor to the buyer.

Step VII. If there are any unpaid invoices follow up action is initiated.

Step VIII. The buyer settles the invoices on expiry of credit period allowed.

Step IX. The balance 20% less the cost of factoring is paid by the factor to the client.

Advantage of Factoring:

1. It is help to improve the current ratio. Improvement in the current ratio is an indication of improved liquidity. Enables better working capital management. This will enable the unit to offer better credit terms to its customers and increase orders.

2. It is increase in the turnover of stocks. The turnover of stock into cash is speeded up and this results in larger turnover on the same investment.

3. It ensures prompt payment and reduction in debt.

4. It helps to reduce the risk. Present risk in bills financing like finance against accommodation bills can be reduced to minimum.

5. It is help to avoid collection department. The client need not undertake any responsibility of collecting the dues from the buyers of the goods.

Limitations of Factoring:

1. Factoring is a high risk area, and it may result in over dependence on factoring, mismanagement, over trading of even dishonesty on behalf of the clients.

2. It is uneconomical for small companies with less turnover.

3. The factoring is not suitable to the companies manufacturing and selling highly specialized items because the factor may not have sufficient expertise to asses the credit risk.

4. The developing countries such as India are not able to be well verse in factoring. The reason is lack of professionalism, non-acceptance of change and developed expertise.

FACTORING PROCESS:

The following steps are involved in the process of factoring:

- The seller sells the goods to the buyer and raises the invoice on customer.
- The seller then submits the invoice to the factor for funding. The factor verifies the invoice.
- After verification, the factor pays 75 to 80 percent to the client/seller.
- The factor then waits for the customer to make the payment to him.
- On receiving the payment from the customer, the factor pays the remaining amount to the client.
- Fees charged by factor or interest charged by factor may be upfront i.e. in advance or it may be in arrears. It depends upon the type of factoring agreement.
- In case of non – recourse factoring services factor bears the risk of bad debt so in that case factoring commission rate would be comparatively higher.
- The rate of factoring commission, factor reserve, the rate of interest, all of them are negotiable. These are decided depending upon the financial situation of the client.

Prospects of factoring in India:

Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral or credit profile. By having a continuous business relationship with the factoring companies, small traders, industries and exporters get the advantage of improving the cash flow and liquidity of their business as also the facility of availing ancillary services like sales ledger accounting, collection of receivables, credit protection etc. Factoring helps them to free their resources and have a one-stop arrangement for various business needs enabling smooth running of their business. The Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 to examine the feasibility and mechanics of starting factoring organisations in the country paved the way for provision of domestic factoring services in India. The Banking Regulation Act, 1949 was amended to include factoring as a form of business in which the banks might engage. Reserve Bank of India issued guidelines permitting the banks to set up separate subsidiaries or invest in factoring companies jointly with other banks. However, it was generally felt that absence of Factoring Law was one of the major impediments in the growth of factoring business of the country including the heavy stamp duty over assignment deed, ambiguity in the legal rights of Factors in respect of receivables etc. Government of India enacted the

Factoring Act, 2011 to bring in the much-needed legal framework for the factoring business in the country. It has provided definitions for the terms factoring, factor, receivables and assignment. The Act also specifies that any entity conducting factoring business would need to be registered with RBI as NBFCs; while exempting banks, government companies and corporations established under an Act of Parliament, from the requirement of registration with RBI for conducting factoring business. The Act, thus, gave clarity to the activity of assignment of receivables and granted exemption from stamp duty on documents executed for the purpose of assignment of receivables in favour of Factors thereby making the business more viable. The Act also envisages that all transactions of assignment of receivables shall be registered with the Central Registry established under the SARFAESI Act, 2002 to reduce the possibility of frauds and for strengthening the due diligence process for the clients. The Act has given powers to the Reserve Bank to stipulate conditions for ‘principal business’ of a Factor as also powers to give directions and collect information from factors. Subsequent to the passing of the Act, the Reserve Bank has created a separate category of NBFCs viz; NBFC-Factors and issued directions for their regulation. The prudential norms as applicable to NBFCs engaged in lending business, has also been extended to the NBFC-Factors. Further, the RBI also regulates bank finance to factoring companies and the factoring business conducted by banks.

CHALLENGES FACED BY FACTORING SECTOR :

Though the enactment of the Factoring Regulation Act has potentially removed all the major impediments that the factoring sec tor faced in the country, nevertheless, the sector has few other items on its wish list, the primary among which are introduction of credit insurance in the factoring business and extending the scope of SARFAESI Act to cover NBFCs for speedy enforcement of security interest. As regards credit insurance, the Finance Minister, in the Union Budget 2013-14, has made an announcement for setting up a Credit Guarantee Fund with SIDBI for factoring, with an Rs 5 billion corpus. As far as extension of the provisions of the SARFAESI Act to NBFC is concerned, the final call rests with the Government of India. Low penetration of factoring business in the country remains a challenge, which could be because of lack of awareness among the users. With the necessary law now in place, sincere attempts need to be made by the industry through its associations and other for a for articulating the benefits of factoring as not just an alternative source of finance but also an avenue for providing a bouquet of financial services vis-à-vis traditional finance, to small scale industries. They should be able to identify the untapped potential clientele, especially in various SME industry sectors, and create awareness on how the higher cost of factoring vis-à-vis the traditional finance is justifiable and cost effective for the businesses in the end. Factoring companies should also constantly endeavor to upgrade their expertise on both technological front as also on the operational level for offering cost effective services to their clientele

Factoring Companies in India:

- Export Credit Guarantee Corporation of India Limited. Mumbai, India.
- Canbank Factors Limited. Bengaluru, India.
- Hongkong & Shanghai Banking Corporation Limited.
- Penta Consulting Private Limited
- Reliance Capital Limited.
- Drip Capital Services India LLP
- Global Trade Consultancy Services.
- AVS Financial Services Private Limited.