Volume : 1 | Issue : 12 | September 2012 ISSN - 2249-555X

Research Paper Management

Factoring- Financial Stamina For Working Capital

*Manju Jayakumar

*Ass.Professor,AMC Engineering College,Department of MBA,18th km, Baneerghatta Road,Kalkere, Bangalore

ABSTRACT

A concise view of debt factoring. Its history, meaning and mechanics are explained. How important it is for business and sources of factoring are identified. The difference between bank loan and factoring is specified with different players in factoring in market.

Keywords :Factor—sub-limit —prepayment—invoice—credit protection—SMEs—Sales Ledger—MIS.

Introduction:
Money is blood of business. Financing for working capital is difficult task for small and medium scale industries. Day-to-day working capital can suddenly fall short of day-to-day requirements. That's where we come in Account Receivable Factoring which acts as a backbone of working capital. It is one of the best modes of financial tool that can assist to scrutinize financial problems that will assist to enhance the business.

Debt factoring
The act of a business raising operating capital or other capital by borrowing. Most often, this refers to the issuance of a bond, debenture, or other debt security. In exchange for lending the money, bond holders and others become creditors of the business and are entitled to the payment of interest and to have their loan redeemed at the end of a given period. Debt financing can be long-term or short-term. Long-term debt financing usually involves a business need to buy the basic necessities for its business, such as facilities and major assets, while short-term debt financing includes debt securities with shorter redemption periods and is used to provide day-to-day necessities such as inventory and/or payroll.

What is Factoring?
Factoring is a form of receivables finance whereby a business sells or assigns its accounts receivables (i.e. invoices) to a finance company (called a factor) at a discount in exchange for immediate money with which to finance continued business. Factoring differs from a loan in three main ways. First, the emphasis is on the quality of the receivables and not only on the firm›s credit worthiness. Secondly, factoring is not a loan – it is an advance on your outstanding invoices. Because of this, factoring is easier to obtain provided that you do business with reliable customers.

It is true that the debt factoring service provider will purchase the accounts receivable/invoices from the business owner. As a businessman, you will be able to sell the invoices to companies who are dealing in providing the receivable factoring services. You will come across many business owners who are not aware about debt factoring options. It is one of the best modes of financial tool that can assist you to scrutinize financial problems that

Will assist you to enhance your business.

History
Almost since the dawn of civilization, there has been factoring. Invoice factoring is a way of advancing funds for expected payment. In the earliest times of civilization, 4,000 years ago, the Mesopotamians used factoring in their business dealings. However, factoring was not terribly regular. The ancient Romans used a form of invoice factoring by selling promissory notes on a secondary market at a discount.

Invoice factoring gained true popularity in trade between the American colonists and their European buyers. This eased cash flow and created a streamlined process for ensuring that trade continued unabated.

Before the 1930s, the most popular industries for invoice factoring were the garment and textile industries. These are industries that rely on raw materials. However, it soon became evident, after World War II, that invoice factoring could work effectively for any business that invoiced others.

During the 1960s, 1970s and 1980s, interest rates were on the rise and banks were increasingly regulated. Invoice factoring became even more popular, since it did not require the same sort of credit checks. Small business, start-ups and rapidly growing businesses benefitted especially from this increase in factoring. Invoice factoring grew as a service as business people found their options contracting.

Today, invoice factoring remains a viable alternative to more traditional financing. Thousands of businesses sell their accounts receivable to factors every year – amounting to an industry representing billions of dollars. And nearly any business with reliable customers and an invoicing system can take advantage of invoice factoring.

Mechanism of factoring
Three parties involved are

1. Company or the seller
2. Customer or the buyer
3. Factoring company (factor)

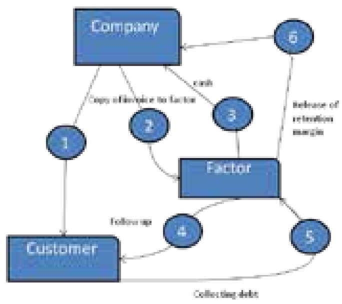

Figure 1

The mechanism of factoring (figure 1) can be explained:
Mechanics of Factoring shown in figure is explained below:

1. Firstly, the customer places an order with the company. The company supplies the goods or services to the customer and sends the invoice. (It may be noted that the company is the seller and customer is the buyer of goods).
2. Then the company forwards a copy of the invoice to Factor and enters into Factoring arrangement with the Factor. The pre-payment limit, service charges, and discount charges and other terms and conditions of the arrangement are agreed upon. The company has to obtain a "LETTER OF DISCLAIMER "from the bank holding charge on his receivable.
   This is required because in many cases the receivables may have been assigned to the bank for credit facility extended by it. After obtaining this letter, the Company executes the Factoring documentation.
3. The factor advances the cash or cheque at agreed prepayment rate to the company. The Factor purchases the invoice subject to the overall limit and the Customer limit. The Factor arrives at a sub-limit for each customer of the company within the overall limit.
   The drawing power is calculated taking into account the prescribed margin (usually around 20%). The prepayment limit is generally around 80%-85% of the eligible debt. The Company is now free to draw any amount up to the drawing power.
4. The factor sends the custom statement and letter & chase payment on behalf of company to the customer and directing the customer to make all payments to the Factor.
5. The factor then collects the debts from the customer. Periodical statements and MIS (Management Information System) reports are furnished to the Company and the Customer. If monthly instalments are not paid within the due date, follow-up letters are sent.
6. When the payment is cleared by the Customer to Factor, a notice is sent by the Factor to the Client. This is followed by the release of retention margin held by the Factor to the Client.

For rendering the services of collection and maintenance of sales Ledgers, the service charges usually vary between 0.4% to 1% of the invoice value, depending on the volume of operations. This service charge is collected at the time of purchase of invoices by the Factor.

For making an immediate part payment to the Client, the Factor collects discount charges from the Client. The discount charges are comparable to bank interest rates at these charges are collected monthly.

Factoring and Services

The Company has the option to select a combination of these components to suit his financial needs.

Factoring constitutes a suite of financial services offered under a factoring agreement, which includes receivables financing, credit protection, accounts receivables collection and management, sales ledger administration and advisory services.

I. Receivables financing: The factoring institution advances a proportion of the value of the book debts immediately to the client and the balance is paid on maturity of the book debts. This improves the cash flow position of the client, by replacing the credit sales for cash.
II. Credit protection: The factoring institution takes over the credit risk of the client, and agrees to bear the loss in case of default by the debtor. Credit protection is provided by the factor only in case of non-recourse factoring.
III. Accounts receivables collection and management: The factoring company collects the receivables of the client and also manages the credit collection schedule. By reducing the time invested by the client in such activities, it allows the client to focus on business development.
IV. Sales Ledger management: The factor undertakes sales ledger management, including maintenance of credit records, collection schedules, discounts allowed and ascertainment of balance due from all debtors.
V. Advisory Services: A factoring company advises the client on its export and import potential, and also helps the client in identification and selection of potential trade debtors, based on the credit information available with it. The factor also advises on the prevailing business trends, policies, impending developments in the commercial and industrial sector etc.

Importance of Factoring in business

Regardless of intensely low rates, today's companies are still finding it hard to lower their costs of business financing. Unfortunately, an enormous bit of these financing costs are driven by late client payments. The longer it takes customers to cover their invoices, the higher the corporation's costs to finance its business, and more significantly, the bigger the corporation's price of capital. This is ultimately why a significant number of companies are looking towards alternative forms of business financing. Unfortunately, a company will always see their costs increase when clients take too long to pay. But invoice factoring removes this as a going concern.

There is an easy solution to a cash flow deficit is the only way that a company can pay its debts in the short term, such as justice. These solutions include short-term loans or bonds and factoring accounts. Factoring accounts can be used for accounts that must be received by the company during a given period are made.

Factoring is a simple way to obtain additional financing for companies compared to traditional financing methods that require a lot of paperwork and long waiting times. With a small amount of credit agencies deduct the amount of the invoice, usually 1-6 percent, small businesses can increase your cash flow and manage its operations and effectively.

Difference between bank loan and factoring

Factors make funds available where bank will not do it, because factors focus first on the credit worthiness of the debtor, the party who is obligated to pay the invoices for goods or services delivered by the seller. While bank lending is cheaper than factoring, the key terms and conditions under which the small firm must operate differ significantly.

1. Unlike bank finance, Factoring is usually an open account facility which means that your credit limit increases as your sales grow provided you have had a satisfactory record of payments. So for fast growing SMEs who would require more and more funding year on year- factoring is an extremely beneficial option.
2. Bank Finance often requires additional collateral in the form of mortgage whereas Factoring normally does not. It is the quality of receivables and the buyer profile that are the key concerns. Hence, small SMEs with good buyers but no collateral to place may find factoring very useful.
3. Factoring is not a loan- it is an advance against receivables. Hence, a factoring facility while providing liquidity does not add to the debt of the company. SMEs with fully used bank funding and well leveraged may look at Factoring as a viable option.
4. Bank finance is a "funding only" facility while Factoring offers collection services wherein the factor will collect on your behalf and also maintain the sales ledger leaving you to focus on your core activity.

Factoring companies in India

- Canbank Factors Limited
- SBI Factors and Commercial Services Pvt. Ltd
- The Hongkong and Shanghai Banking Corporation Ltd
- Foremost Factors Limited
- Global Trade Finance Limited
- Export Credit Guarantee Corporation of India Ltd
- Citibank NA, India
- Small Industries Development Bank of India (SIDBI)
- Standard Chartered Bank

Conclusion:

At the end to be concluded, Factoring is the preeminent solution for SME's to do business resourcefully without any break off in cash flow i.e. working capital. It is gradually getting hold of its significance with increase in customer's easy access to benefits of factoring. Unlike bank, factoring is easiest way to get money for small business which needs lot of cash flow for further years. Factoring needs to increase in one's country to fight back against economic crisis and self development.

REFERENCES

Books: | 1."Factoring and Finance" by Martin Forman & John Gilbert from Wiley publish,1976. | 2."Indian Financial System", 2E by Dr. Gurusamy published by Tata McGraw-Hill Education. | Websites: | www.financial-dictionary.thefreedictionary.com/Factoring | www.factoringfinance.org/ | www.indiafactoring.in/ | www.wikipedia.org/wiki/Factoring_(finance) |