AUTHOR
Sujata Kapoor
Lecturer,
Institute of Management Studies, Ghaziabad..

Factoring Services in India

Mechanism, Feasibility and Prospects

ABSTRACT

Factoring is a unique financial innovation. It is a popular mechanism of managing, financing, and collecting receivables. It is method of converting non-productive, inactive assets (i.e. receivables into a productive asset (viz., cash) by selling receivables to the company that specializes in their collection and administration popularly known as factor. A "factor makes conversion of receivables into cash possible. The factoring industry is an important part of many financial systems and it has established itself as a major source of finance and credit management for growing number of companies. This study would be focused to understand the mechanism of factoring services in Indian scenario, its feasibility and prospective outcomes it can bring in the Indian financial sector.

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1. INTRODUCTION

Factoring is a "continuing arrangement" between a financial institution (the factor) and a business concern (the client) selling goods or services to trade customers (the customers) whereby the factor purchases the client's accounts receivables / book debts either with or without recourse to the client and in relation there to controls the credit extended to the customers and administers the sales ledger.

Thus, factoring accounts receivable involves selling them outright, at a discount, to a financial institution. A factor is a financial institution that specializes in purchasing accounts receivable from businesses. It involves raising funds on the security of company's debts, so that cash is received earlier than if the company waited for the debtors to pay.

Basically most factors offer three services-

Sales Ledger Administration

The factor providing sales- ledger administration will take on responsibility for the sales accounting records, credit control and collection of the debts.

Credit Management / Insurance

For a fee the factor can provide up to 100% protection against non-payment on approved sales. Of course, the factor has to decide whether the debt is worth covering.

Provision of Finance

Provision of finance is the main reason why companies use the service of factors. For a small fast growing company a factor provides a good means of releasing funds tied up in debtors. It provides a good source of working capital.

The Kalyanasundram committee has heralded the entry of factoring in India, mainly to mitigate the difficulties faced by small-scale entrepreneurs, many of which are unable to collect their receivables from large corporate to which they have invoice supplies. The entry of factoring in the Indian financial arena, works the beginning of the end of bank monopoly in retailing, working creditor to the entrepreneurs.

2. FACTORING PROCESS (DOMESTIC)

~ The client invoices his customer in the usual way –only adding a notification that the invoice is assigned to and must be paid to the concerned factoring company.

~ The client submits copies of invoices to factor, accompanied by the receipted delivery challan or any other valid proof of dispatch.

~ The factor will provide pre-payment up to 80% of the invoice.

~ The factor follows up with the customers for realization of payments.

~ Balance payment is made immediately on realization.

~ To keep the client informed of factored invoices, Factor sends the monthly statement of accounts.

3. FACTORING COST

Factoring cost includes commissions and interest levied on advances. The factor deposits in the firm's account the book value of the collected or due accounts purchased by the factor, less the commissions. The commissions are typically stated as a 1 to 3 % discount from the book value of factored accounts receivable. The interest levied on advances is generally 2 to 4 % above the prime rate. It is levied on the actual amount advanced.

Comparative cost and benefits from factoring can be explained with the help of following illustration-

A Company is considering an advance factoring agreement because of its weak financial position and because of the large degree of credit risk inherent in its business. The company primarily sells large quantities of apparel to a small number of retailers, and if even one retailer does not pay, the company could experience severe cash flow problems. By factoring, the company transfers the credit risk to the factor .The factor requires 10 percent reserve for returning allowances, charges 2% factoring commission, and will advance the company (client) at an annual interest of 4 % points over prime. Assume the prime rate is 10 %. Factoring receivables will allow the company to eliminate its credit department and save about $2000 a month in administrative and clerical costs. Factoring also eliminates bad-debt losses, which average about $6000 a month. The clients average collection period is 60 days and avg. level of receivables is $1million.

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4. COMPANIES THAT CAN BENEFIT FROM FACTORING SERVICES

Traditionally, the use of factoring was confined primarily to the apparel, furniture, and textile industries. Today factoring seems to be gaining acceptance in other industries. Its use has extended to automobiles, pharmaceuticals, textiles, and garments and engineering; manufacturing and service sector industries such as traveling, telecommunications and software.

Thus, the type of companies that can benefit from factoring include-

- Rapidly growing
- Seasonal
- Start-ups

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- > Undercapitalized
- > Spin-offs
- > Concerned about adding fixed cost
- > Have a lengthy manufacturing cycle
- > Strained by slow turnover of receivables
- > Hurt by high bad-debt losses
- > Saddled with a large customer concentration

5. CURRENT STATUS OF FACTORING INDUSTRY IN INDIA

- ☐ No. Of factoring companies-08
- ☐ Domestic factoring turnover-1450 (In million EUR)
- ☐ International factoring Turnover –175 (In million of EUR)
- ☐ Total Factoring turnover –1625 (In million EUR)
- ☐ The top 8 Factoring companies are Canbank factors Ltd., Citi bank NA, India, Export Credit Gurantee Corporation Of India Ltd., Foremost factors Ltd., Global Trade Finance Ltd., SBI factors & Commercial Services Pvt. Ltd., Hong Kong & Shanghai Banking Corporation Ltd. These organizations are also the member of FCI.

6. FACTORS WHICH ACT AS STUMBLING BLOCKS FOR THE GROWTH OF FACTORING INDUSRY IN INDIA

While foreign banks eye "Factoring" as the future finance product for India, corporate operating in this space for last 13 years are not quite upbeat about the prospects, despite sensing the potential.

"The industry has been moving at snail's pace since inception. This is basically because there is no legal framework to protect Factoring services"

- > First of all, we don't have a legal framework to protect factoring services. The Bill was drafted six Years back, but is yet to see the light of the day.
- > There is the need for legal protection for factoring organizations because all our advances are "clean advances". The factors take an undertaking from the buyer and make the prepayment.
- > Debts are assigned to them. In event of buyer making the payment directly to the seller or deciding to set of against an earlier due, the factor cannot proceed against the buyer.
- > The factoring companies are categorized as a non- banking finance company. Therefore, a factor can't go for summary proceeding. There is no legal protection of Debt Recovery Tribunal pr Securitisation Act.If factoring companies are recognized as financial institutions, they will be able to approach DRT and be covered under Securitisation Act.
- > Last but not the least the issue is of stamps duty. When a debt is assigned, the stamp duty has to be paid. This duty is decided by the respective state Governments, which are neither willing to waive the duty nor have a uniform structure.

Considering the risk exposure, it is certain that factoring companies cannot grow without legal protection.

7. SELECTD ISSUES ON REGULATION AND SUPERVISION OF FACTORING COMPANIES

In some countries, factoring is recognized as a commercial activity and is, therefore, regulated by commercial law, but it is not unusual in certain countries to see factoring companies undertake the functions of financial intermediation without authorization. A key issue for factoring is whether a financial systems commercial law views factoring as a sale and purchase transaction rather than as aloan. If it is a sale and purchase transaction creditor rights and loan contract. enforcement are less important for factoring because factors are not creditors –that is , if a firm went bankrupt , its factored receivables would not be part of its bankruptcy estate because they would be the property of the factor.

Still creditor rights and loan contract enforcement are not irrelevant to factoring for at least two reasons. First, they define the environment in which the factoring company engages in collection activities. The strength of the regime for creditor rights will affect underwriting standards because factors must consider the anticipated cost and efficiency of their collection activities when they make credit decisions about which invoices to purchase. Second, under recourse factoring, the factoring company has a contingent claim against the borrowing firm if there is deficiency in the collection of a receivable. This contingent claim can be secured or unsecured depending on whether the factoring company filed a security interest in some or the entire firm's assets as a secondary source of repayment.

The regulatory environment has an important effect on factoring industry. In some countries, factoring operates entirely outside the purview of any regulatory structure or authority, and in others it is regulated along with others financial services such as banking and insurance. For countries where factoring is developing, a law setting out minimum standards for the management of factoring companies an specifying the tools to be used to manage key risks in factoring operations could be envisaged. Some countries simply restrict market entry to formally registered financial institutions such as banks or other specialized financial institutions. However, those restrictions could hinder competition by excluding the emergence of independent factors. To address the potential lack of discipline in some markets, International Finance Corporation (1998) recommends that governments consider requiring minimum capital and prudential guidelines as barrier to entry into the market.

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8. HOW FACTORING DIFFERS FROM CREDIT INSURANCE

Credit insurance is an insurance policy. Like car insurance, it typically has an annual premium and a deductible. Companies that use credit insurance may need to maintain in-house bookkeeping, credit and collections departments as well as credit files and information systems necessary to support these departments. Both factoring and credit insurance protects against credit losses. Factoring covers 100% credit risk while credit insurance covers negotiated % after applicable deductible. Incase of factoring the frequency of premium payment is monthly while in latter it is paid annually. The benefits that factoring provides over credit insurance is that it improves cash flow, sales ledger administration and buying of accounts receivables. In credit insurance the firm has to maintain internal credit and collection staffs. In terms, of cost credit insurance usually costs less than factoring.

9. CONCLUSION AND ANALYSIS

The secondary data gathered would be analyzed visa-a viz. the factoring services in India. The effect of various price indices would also be analyzed. A comparative assessment would also be made among various companies providing factoring services in India.

Thus, factoring benefits all- client, customer and factor. Credit management is a specialized activity and factoring organizations being a specialist organization in credit management goes a long way in accounts receivable management specifically for small and medium enterprises. Factoring, by ensuring the credit collection, helps the firm to concentrate on production and marketing. But the Indian factoring industry lags behind the International scene. This is primarily due to lack of legislation for factoring industry. The market for factoring companies is essentially unregulated. Securitisation, which is a close associate of factoring, has legal framework to protect it as suggested by securitisation Act 2002.The efficiency and productivity of Indian factoring industry need to be enhanced.

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