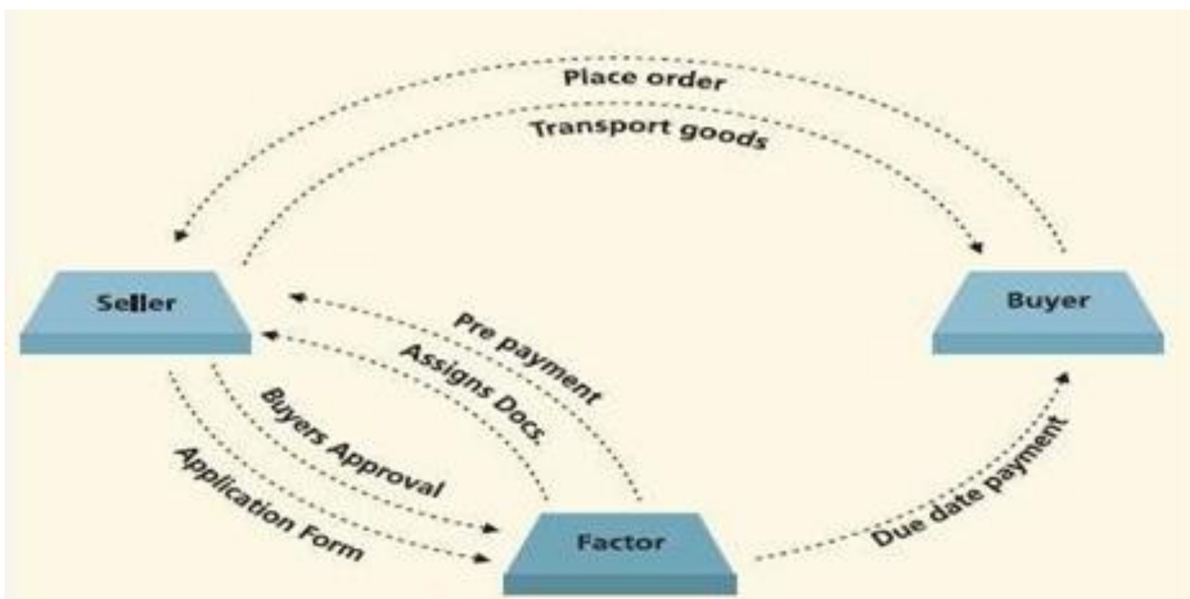
FACTORING & BILL DISCOUNTING

INTRODUCTION

- Proper financing is a crucial part of any business.
- Conventional financing methods like bank loans, equity financing etc. come with a lot of conditions and strings attached which new or small businesses find difficult to meet. For instance new firms may find it difficult to raise bank loans (since there is no proof that business will be viable, no balance sheets to show healthy profits).
- Equity participation implies a more long-term commitment and accountability towards the shareholders.
- Factoring is a ***receivables management*** and financing mechanism which is designed to improve cash flows and cover the credit risk of the seller.

DEFINITION

Factoring is the Sale of Book Debts by a firm ***(Client)*** to a financial institution *(Factor)* on the understanding that the Factor will pay for the Book Debts as and when they are collected or on a guaranteed payment date. Normally, the Factor makes a part payment (usually upto 80%) immediately after the debt is purchased thereby providing immediate liquidity to the Client.



Factoring mechanism

- Unlike other forms of receivables financing, like bills discounting and forfaiting; factoring involves a continuous relationship between a factor and a seller, to finance and administer the receivables of the latter.
- 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.
- Factoring is prevalent in business in various ways.
- For instance in retailing, the credit card business is a clear example of factoring.

INDIAN SCENARIO

- Factoring is of recent origin in Indian Context.
- ***Kalyana Sundaram Committee*** recommended introduction of factoring in 1989.
- Banking Regulation Act, 1949, was amended in 1991 for Banks setting up factoring services.
- RBI has permitted Banks to undertake factoring services through subsidiaries.
- SBI/Canara Bank first set up their Factoring Subsidiaries:-
  - SBI Factors Ltd., (April, 1991)
  - Can Bank Factors Ltd., (August, 1991).
- India's factoring turnover in 2012 was around 3500 million Euros in domestic and 3650 million Euros in total as compared to a total of 21,32,231 million Euros worldwide.
- The Indian factoring volume grew approximately 38% from 2009 to 2012. However, India's factoring volume stands at a mere 0.17% vis-à-vis worldwide factoring volume.

WHO IS A FACTOR

- Factors are ***financial companies*** which pay cash against the ***credit sales*** of the client, and obtain the right to receive the future payments on those invoices from the debtors of the client.

- Factors provide a ***vital financing service*** to mostly small and medium-sized companies who are short of working capital.

- The factor ***fills the money gap*** between the time a manufacturer or seller makes a sale and the time the customer pays the bill.

- For this the factor charges a fee equal to percentage of the invoices purchased.

FEATURES

- Factoring is a ***money market*** instrument.
- Book debts represented by invoices are assigned in favor of a factor.
- Since, factoring is ***not a negotiable*** instrument; ***customer's consent*** is required about the factoring arrangement under which he will make a repayment directly to the factor but not to the client.
- ***Dual pricing structure*** comprising discount charges and services charges is followed.
- Under without recourse factoring credit insurance facility is offered to the client. In view of this cost of factoring services is more under without recourse factoring as against with recourse factoring.
- Remaining amount of the value of invoice is paid to the client after collection of money from the customer and after deducting his own charges.
- Margin is kept in the range of 5% to 20 %.

SERVICES DELIVERED BY FACTORS

- ***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.
- ***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.
- ***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.
- ***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.
- ***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.

TYPES OF FACTORING

There are four types of factoring:

- Recourse Factoring
- Non-recourse Factoring
- Maturity Factoring
- Cross-border Factoring

RECOURSE FACTORING

- Upto 75% to 85% of the Invoice Receivable is factored.
- Interest is charged from the date of advance to the date of collection.
- ***Factor purchases Receivables on the condition that loss arising on account of non-recovery will be borne by the Client/Company.***
- **Credit Risk/Default Risk is with the Client/Company**.
- Factor does not participate in ***the credit sanction process***.
- In India, factoring is done with recourse.

NON-RECOURSE FACTORING

- ➔ Factor purchases Receivables on the condition that the Factor has **no recourse** to the Client, if the debt turns out to be non-recoverable.

- ➔ **Credit risk/Default Risk is with the Factor.**

- ➔ **Higher commission is charged.**

- ➔ Factor participates in ***credit sanction process*** and approves credit limit given by the Client/company to the Customer.

- ➔ In USA/UK, factoring is commonly done without recourse.

MATURITY FACTORING

- ➔Factor does not make any advance payment to the Client.
- ➔Pays on guaranteed payment date or on collection of Receivables.
- ➔Guaranteed payment date is usually fixed taking into account previous collection experience of the Client.
- ➔Nominal Commission is charged.
- ➔No risk to Factor.

CROSS - BORDER FACTORING

- ➔ It is similar to domestic factoring except that there are four parties, viz.,
  a) Exporter,
  b) Export Factor,
  c) Import Factor, and
  d) Importer.

- ➔ It is also called two-factor system of factoring.
- ➔ Exporter (Client) enters into factoring arrangement with Export Factor in his country and assigns to him export receivables.
- ➔ Export Factor enters into arrangement with Import Factor and has arrangement for credit evaluation & collection of payment for an agreed fee.
- ➔ Notation is made on the invoice that importer has to make payment to the Import Factor.
- ➔ Import Factor collects payment and remits to Export Factor who passes on the proceeds to the Exporter after adjusting his advance, if any.
- ➔ Where foreign currency is involved, Factor covers exchange risk also.

ACCORDING TO ANOTHER CLASSIFICATION FACTORING CAN BE CLASSIFIED INTO TWO TYPES

- Full service factoring
- Agency discounting

FULL SERVICE FACTORING

- Also known as without recourse factoring service.

- It is the most comprehensive type of factoring arrangement offering all types of services, namely:

- (a) Finance, (b) Sales ledger administration, (c) Collection, (d) Debt protection, and (e) Advisory services.

- The factor will absorb the losses arising from insolvency or bankruptcy of the client's customers.

AGENCY DISCOUNTING

- Under this arrangement, the facilities of finance and protection against bad debt are provided by the factor.

- As against this, sales ledger administration and collection of book debts are carried out by client himself.

COST OF FACTORING

These are two types of costs in factoring services

- **<u>Service Fee or Charges</u>**

  Service fee is levied for the work involved in administering the sales ledger as well as protection against bad debts, it is calculated as a ***percentage of gross value*** of the invoices factored.

- **<u>Discount Charges</u>**

  Discount Charge (interest charge): The discount charge is levied on the advance provided by the factor and is computed on the basis of prime lending rate of banks plus premiums for credit risk basis.

ADVANTAGES

- ***Improve cash flow position*** which enables have better flexibility in managing working capital funds in an efficient and effective manner.
- Improves the ability of the client to develop ***sales to credit worthy customers***.
- Helps in substantial ***saving in time and cost*** of maintaining own sales ledger administration and collecting receivables from the customer.
- The client can spare substantial time for improving the quality of production and tapping new business opportunities.
- The client can ***eliminate the losses*** on account of bad debts.

DISADVANTAGES

- While the advantages of factoring can be great, for some companies the cost would outweigh the value of the services extended by factoring companies. ***For example***, a company serving a few major customers with excellent credit ratings would probably not benefit from factoring.
- Image of the client may suffer as engaging a factoring agency is not considered a ***good sign of efficient management***.
- Factoring may not be of much use where companies have just ***one time sales*** with the customers.
- Factoring increases cost of finance and thus cost of running the business.
- If the client has ***cheaper means of finance and credit*** (where goods are sold against advance payment), factoring may not be useful.

Bill Discounting

→Bill discounting, is a short term financing facility of up to 90 days that allows the business to access funds based on the value of outstanding invoices.

→ It involves effectively selling a bill to a bank or similar entity for an amount that is slightly less than the par value before the maturity date.

Definition:

A commercial bill discount is an act by which the legal holder of a commercial bill transfers it to bank or other intermediaries to acquire cash before its maturity date.

Types:

The different types of Bills are prevalent

- Demand Bill – Payable immediately on presentment.
- Usance Bill – Time period recognized for payment of bills.
- Documentary Bill – These B/E are accompanied by documents that confirm trade has taken place.
- Clean Bills – These Bills are not accompanied by any documents. Interest rate charged is higher than documentary bill.

Features

- Finance up to 80% of face value
- Competitive interest rates
- The bank will only discount trade bills
- Repayment of the advance is from the proceeds of the bill
- Payment is with recourse to the customer
- Maximum discount period of 90 days

Advantages:

Advantages of Bill Discounting to Investors

- ***Short term sources of finance*** are widened as Bills discounting being in the nature of a transaction is outside the purview of Section 370 of the Indian companies Act 1956, that restricts the amount of loans that can be given by group companies;
- Rates of discount are better than those available on ICDs and
- Flexibility not only in the quantum of investments but also in the duration of investments.
- Banks usually ***discount bills at a rate lower*** than the rate charged for cash credit.
- Bills seem to have certainty of payment on due dates and this helps to have efficient working capital management.
- Since it is a lending ***no tax at source*** is deducted while making the payment charges which is very convenient not only from the cash flow point of view, but also from the point of view of companies that do not envisage tax liabilities.

Advantages of Bill Discounting to Banks

- **Safety of Funds:** The greatest security for a banker is that a B/E is a negotiable instrument bearing signatures of two parties considered good for the amount of bill; so he can enforce his claim.
- **Certainty of payment**: Thus, bill finance obviates the need for maintaining large, unutilized, ideal cash balances as under the cash credit system. It also provides banks greater control over their drawals.
- **Profitability**
- **Evens out Inter-bank Liquidity Problems:** The development of healthy parallel bills discounting market would stabilize the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.
- **No change in the value of the bill:**

Disadvantages:

- **Lack of Genuineness**

.

- **Lower Limits:**

The financial limit provided by banks through the scheme of bill financing was very limited. Further, the financial facility provided by them was inadequate to meet production expenses.

- **Lack of Appraisal:**

No proper appraisal is carried out by banks to determine the credit worthiness of the parties concerned. This resulted in finance being provided to dealers/stockiest of /large manufacturing companies without any clue of their repaying capacity.

Similarities

1. Both provide short-term finance.

2. Both get the account receivables discounted which the client would have otherwise received from the buyer at the end of credit period.

Bill Discounting	Factoring
1. It is a provision of finance against bills.	1. Factoring renders all services like maintenance of sales ledger, advisory services, etc in addition to the provision of finance.
2. Advances are made against the bills	2. Trade debts are purchased by assignment.
3. The drawer undertakes the responsibility of collecting the bills and remitting the proceeds to financing agency.	3. Factor undertakes to collect the bills of the client.
4. Bills discounted may be rediscounted several times before the maturity	4. Debts purchased for factoring cannot be rediscounted, they can only be refinanced
5. Bill discounting is always with recourse, i.e. in case of default the client will have to make good the loss.	5. Factoring may be with or without recourse.

6. Bill financing is individual transaction oriented i.e. each bill is separately assessed on its merits and got discounted purchased.	6. Whereas in factoring, bulk is provided against several unpaid trade generated invoices in batches. It follows the principle of 'whole turnover'
7. Bill finance is always 'In Balance Sheet' financing i.e. both the amounts of receivables and bank credit are reflected in the balance sheet of the clients as current assets and current liabilities respectively. This is because of the 'with recourse' nature of the facility.	7. In full factoring services facility is 'off balance sheet' arrangement, as the client company completes his double entry accounting by crediting the factor for consideration value.
8. The drawee or the acceptor of the bills is in full knowledge of the bank's charge on the receivables arising from the sale of goods and services	8. Factoring services like 'undisclosed factoring' are confidential in nature i.e. the debtors are not aware of the arrangements. Thus, the large industrial houses availing such facility can successfully claim of running business of their own without any outside financial support.