Meaning of Factoring:

Factoring is derived from a Latin term "facere" which means 'to make or do'. Factoring is an arrangement wherein the trade debts of a company are sold to a financial institution at a discount. The factor is an agent who buys the accounts receivables (Debtors and Bills Receivables) of a firm and provides finance to a firm to meet its working capital requirements.The main advantage of factoring is that the small or big business firm receives short term finance (working capital) to meet day-to- day payments.

In a report submitted to the Reserve Bank of India, Mr.C.S.Kalyanasundaram defines factoring as "*a continuing arrangement under which a financing institution assumes the credit and collection functions for its clients, purchases receivables as they arise (with or without recourse for credit losses, i.e., the customer's financial inability to pay), maintains the sales ledgers, attends to other book-keeping duties relating to such accounts, and performs other auxiliary duties*".

It is the oldest form of financial service relating to management and financing of debts offered by financial institutions. Here a company sells its accounts receivables at a discount to a factor, which then assumes the credit risk of the debtors and receives cash as the debtors settle their accounts.

Features of Factoring:

The features of factoring have been explained below:

1. It is very costly.

2. In factoring there are three parties: The seller, the debtor and the factor.

3. It helps to generate an immediate inflow of cash.

4. Here the full liability of debtor has been assumed by the factor.

5. Factor has the right to take any legal action required to recover the debts.

The Factoring Regulation Act 2011 governs the registration of factors and regulating the assignment of receivables and the associated obligations.

Factoring Process

- The firm enters into a factoring arrangement with a factor, which is generally a financial institution, for invoice purchasing
- Whenever goods are sold on credit basis, an invoice is raised and a copy of the same is sent to the factor.
- The debt amount due to the firm is transferred to the factor through assignment and the same is intimated to the customer.
- On the due date, the amount is collected by the factor from the customer.
- After retaining the service fees, the remaining amount is sent to the firm by the factor

a. Maintenance of book-debts

A factor takes the responsibility of maintaining the accounts of debtors of a business institution.

b. Credit coverage

The factor accepts the risk burden of loss of bad debts leaving the seller to concentrate on his core business.

c. Cash advances

Around eighty percent of the total amount of accounts receivables is paid as advance cash to the client.

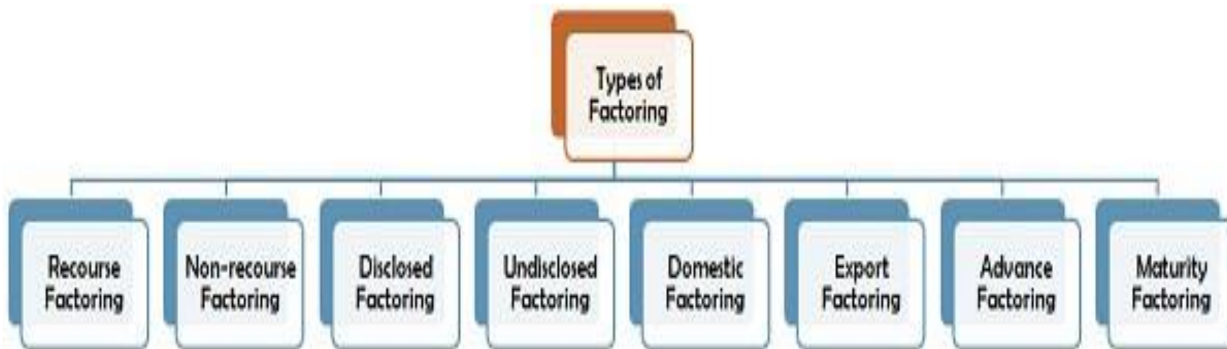
d. Collection service

Issuing reminders, receiving part payments, collection of cheques form part of the factoring service.

e. Advice to clients

From the past history of debtors, the factor is able to provide advices regarding the credit worthiness of customers, perception of customers about the products of the client, etc.

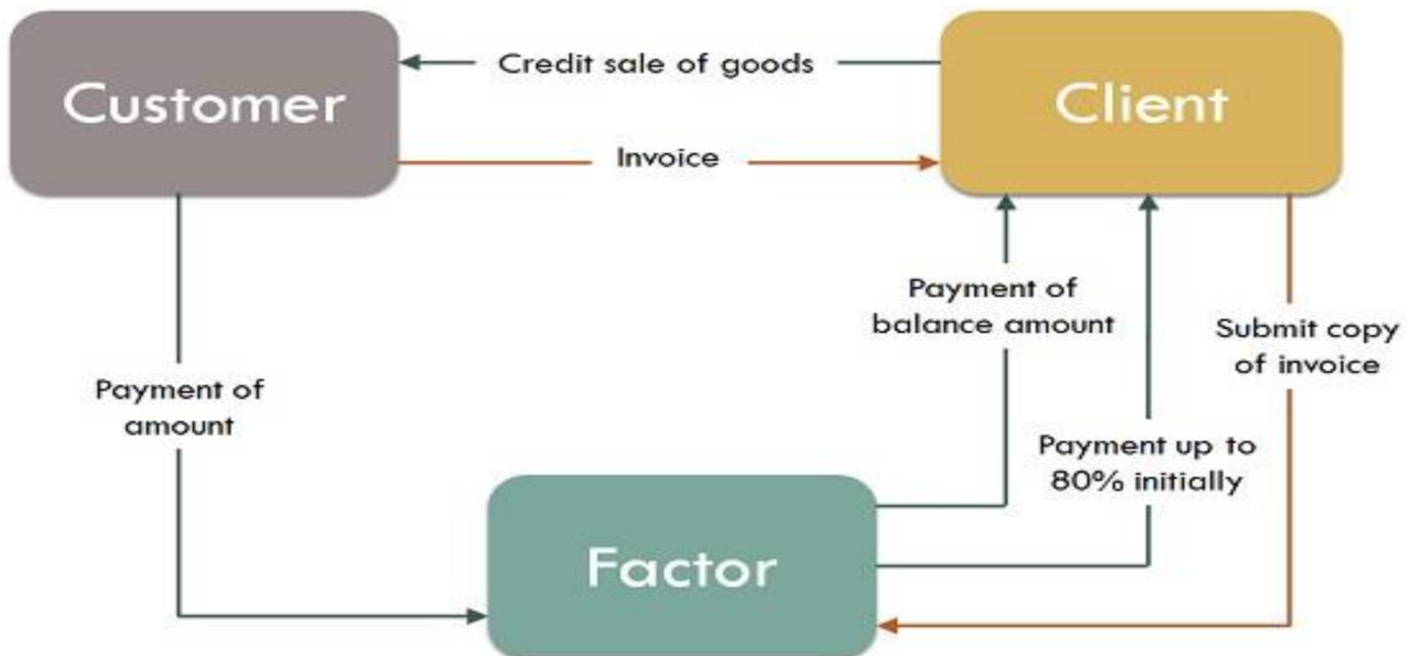
Types of factoring



- **a Recourse and Non-recourse Factoring:** In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor.
- **On the other hand, in non-recourse factoring,** the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.
- If the agreement between the borrower and lender calls for "no recourse" it means the lender has no option to turn to the business owner for any shortfall between what the company owed the lender, and what the liquidated assets provided.
- **Disclosed and Undisclosed Factoring:** The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.
- Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.
- **Domestic and Export Factoring:** When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.
- **Export factoring,** or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.
- **Advance and Maturity Factoring:** In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

- **In maturity factoring,** the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

Procedure



- The seller sells the goods to the buyer and raises the invoice on the 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 a 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 is negotiable. These are decided depending upon the financial situation of the client.

The factor gets control over the client's debtors, to whom the goods are sold on credit or credit is extended and also monitors the client's sales ledger.

Factoring vs. Forfaiting

In forfating **credit is advanced to the importer of capital goods for a certain period**. The amount of payment is receivable in any convertible currency. The letter of credit or bank guarantee is given by the importer's bank. Finance is provided on a fixed or floating interest rate. The forfaiter can be an individual or an entity, like a bank or a financial institution. The risks associated with the forfaiting are credit risk, transfer risk, foreign exchange rate risk or interest rate changes.

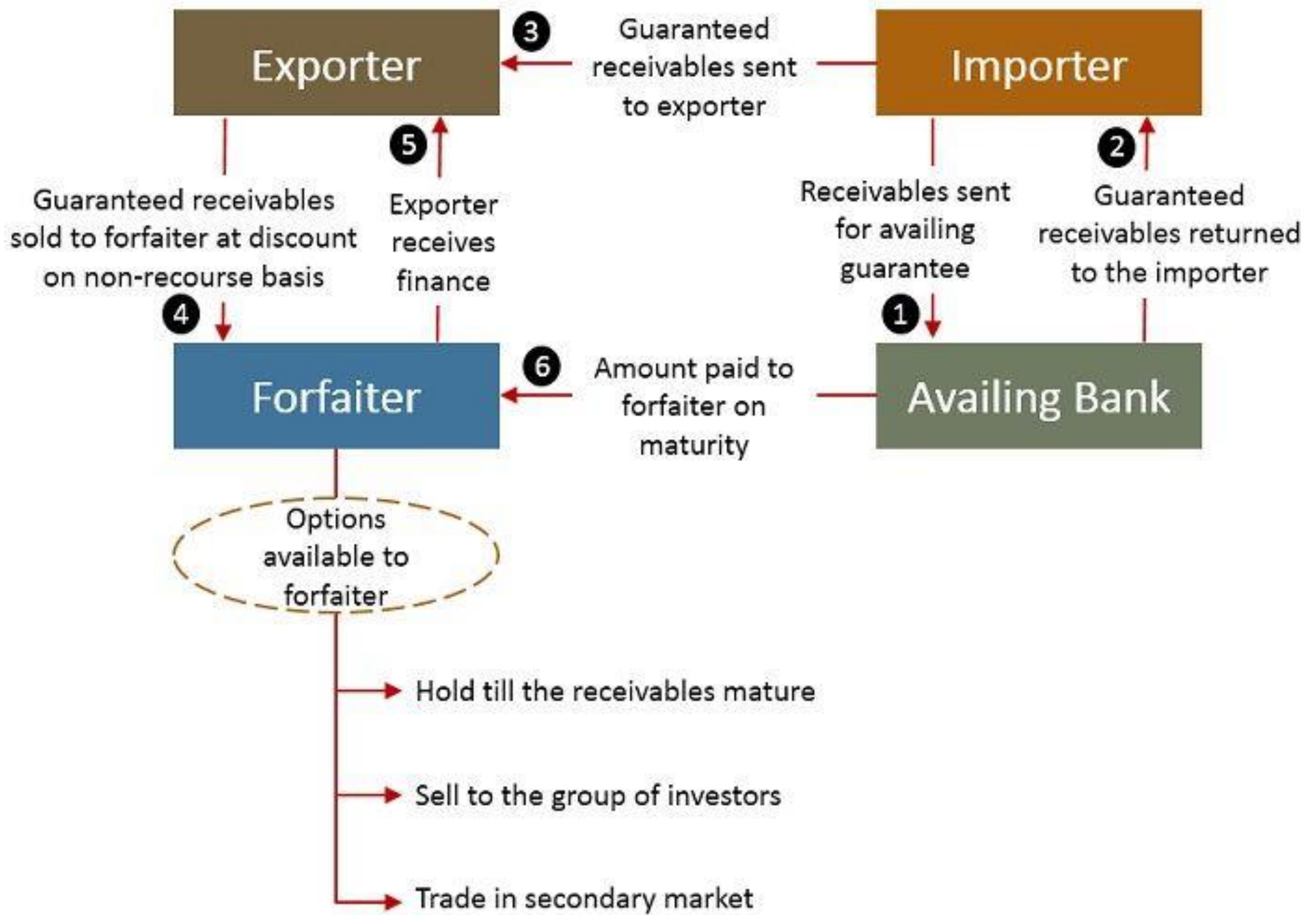
Forfaiting is defined as **"the non-recourse purchase by a bank or any other financial institution of receivables arising from an export of goods and services".**

Moreover, it involves buying of international trade receivables such as the bill of exchange or promissory notes at a discount, on a **100% without recourse** basis. This means that the seller (client) is eligible for complete credit protection and the exporter has no liability if the importer defaults in the payment.

PROCESS OF FORFAITING

1. Goods are sold by the exporter (seller) to the importer (buyer), based on deferred payment distributed over three to five years.
2. A series of promissory notes are drawn by the importer in favour of the exporter, for the amount to be paid in future, which includes the amount of interest.
3. Further, the promissory notes issued are guaranteed by a recognized international bank, often importer's banker. The guaranteeing bank assures that it covers the failure in payment of the buyer if any.
4. The notes so availed, are sold by the exporter to the forfaiter (exporter's banker), at a discount on a non-recourse basis to the seller.
5. Now, when the forfaiter buys those notes, it can hold these notes until it gets matured or he can sell them to the investor's group, who may be interested in buying an unsecured note having high-yielding potential or freely trade the debt instrument in the secondary market.

6. The unconditional trade bills and notes hold legal enforceability, which ensures security to the forfaiter or next buyer of the instrument. The maturity of these instruments may lie between one month to ten years.



S. No.	Characteristics	Factoring	Forfaiting
1.	Basis of financing	Financing is dependent on exporter's credit standing	Financing is dependent on the availing bank's financial standing
2.	Cost	Cost is borne by the seller	Cost is borne by the overseas buyer
3.	Suitability	For transactions of short-term maturity period	For transactions of medium-term maturity period
4.	Extent of financing	Only a certain per cent of receivables factored is advanced	Full finance is available
5.	Risk	Risk can be transferred to seller	All risks are borne by the forfeiter

Conclusion

Factoring helps smooth running of business by getting short term credits from financial institutions against accounts receivables. Forfaiting is a variation of factoring with focus on international exports.

Advantages of Factoring:

Factoring has several advantages, some of which are:

The company receives advance payment from the factor which improves its immediate cash inflows. Factoring does not require to chase the debtors for collecting outstanding amount and consequently the management may concentrate on other important issues.

Disadvantages of Factoring:

Factoring is also associated with some disadvantages such as:

i. It is very costly, as a huge discount is to be paid to the factor.

ii. Factors may adopt some harsh techniques for the recovery of debt which is not always acceptable to the debtors and ultimately the relationship between company and debtors deteriorates.

iii. Factors only purchase the invoices of a reputed company; a new company does not get the benefit of factoring.