International journal of basic and applied research
www.pragatipublication.com
ISSN 2249-3352 (P) 2278-0505 (E)
Cosmos Impact Factor-5.86

Factoring services in India

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Abstract: Factoring is a popular and new source of availing finance for the small and medium size enterprises (SMEs). When a company is growing regularly and new customers are added daily and there are huge invoices available with the company, factoring gains more importance. SMEs usually have a drawback in their relationship with the capital markets and banking institutions and it's difficult for them to raise finance from these sources. This problem led to a search for alternative source of finance which ends up at factoring. At the infancy stage of the SMEs, factoring services are more commonly used as it is more difficult to avail finance from banks during this stage. In spite of the fact that commission charged by the factors is more than the interest rate charged by banks, factoring is more popular with most of the organizations. Factoring services are substitute for bank finance for the small business houses that do credit sales in large volumes. Small business lack collateral and good credit profile to avail bank finance and thus they can reap the benefits of good quality receivables to avail finance for working capital requirement. Factoring services are growing as a popular source of finance for the SMEs around the world. Those countries with weak secured lending laws and inefficient bankruptcy system, factoring services gains more importance there. This paper is based on secondary data and aims to find out the mechanics of factoring, its merits and demerits and problems faced by this service sector.

Keywords: SMEs, Small Business, Working Capital.

INTRODUCTION

Availing bank finance has always been a trouble for many small businesses. It becomes a challenge for many firms to finance their production cycle because after the goods are delivered, most buyers requires a time of 30-90 days to make payment. With the credit sales coming into force, bills of exchange or invoice is issued by the seller which is recorded as accounts payable for the buyer and for the seller as an accounts receivable. Such an invoice remains as an illiquid asset for the seller until the payment is received. Factoring is a type of supplier financing whereby a business sells its accounts receivables (i.e. invoices) to a third party (called a Factor) at a discount in exchange for immediate money with which to finance continued business. Although factoring provides working capital financing to the seller firm but it's not a loan. Factoring services differs from a bank loan in three ways that are:

a. The emphasis is on the value of receivables and not the credit worthiness of the firm.
b. Factoring is not a loan; it is purchase of financial asset (accounts receivables) as there is no debt repayment and additional liabilities on the firm's balance sheet.
c. Finally, a bank loan involves two parties whereas factoring involves three parties that are, the one who sells the receivable, the debtor and the factor.

Being a comprehensive financial service, factoring includes credit protection, accounts receivable, bookkeeping, collection services and financing.

Factoring is used around the world in developed as well as developing countries. During the period of 1996-2003, factoring services showed an impressive growth of 135% with a total worldwide factoring volume of over US$750 billion. In a financial system of weak commercial laws and inefficient bankruptcy systems, factoring gains more importance. Factoring provides working capital financing to small and medium enterprises (SMEs). Factoring involves the outright purchase of the accounts receivables by the factor unlike collateralization of a loan in case of traditional forms of working capital financing.

CHARATERISTICS OF FACTORING

- Compared to other sources of short-term borrowings, factoring is a costly source of finance.
- In factoring the factor buys the accounts receivables of the client company and usually pays up to 80% (rarely up to 90%) of the amount immediately to credit sales.
- Generally the period of factoring is 90 to 150 days. Some companies allow even more than 150 days.
- Factoring does not constitute bad debts.
- Factoring is an ideal financial solution for new and emerging firms without strong financials.
- Credit rating is not mandatory in case of factoring services.
- Indian firms offer factoring for invoices as low as INR1000.→→→
- Cost of factoring is the summation of finance cost and operating cost.
- Factoring is a method of off balance sheet financing.
- A penal charge of 1-2% per month is charged for delayed payments beyond the approved credit period.

THE MECHANICS OF FACTORING

In factoring, receivables created out of the sale of goods or services are sold to factor at a discount. The factor immediately pays up to 70-80% of the amount of accounts receivables to the client company once the agreement with the factor is entered into. The factoring company pays the remaining amount (the balance of 20% or 30% less interest and service fees) to the client

Received: 5 March Revised: 13 March Accepted: 22 March
Index in Cosmos
April 2018 Volume 8 Number 4
UGC APPROVED

when the collections are made from debts. The factoring procedure can be well illustrated with the help of an example.

Example: Small Supplier, X, sells goods worth Rs. 10lacs to its customer Big Buyer, Y, an MNC exporter. X in a competitive gesture offers Y 30-days trade credit. X records the sale as Rs.10lacs in accounts receivables and Y records the purchase as Rs.10lacs in accounts payable. Now, X, needs working capital to produce more inventories. A factor, Z, purchases X's accounts receivables. X today receives 70% of the face value of the accounts receivable (7, 00,000). Y is notified that X's receivables have been factored. After 30 days, Z receives the full payment directly from Y, and X receives the remaining 30% less interest (on the 700,000) and service fees.

The factoring procedure can be summarised as follows:

1. The buyer's creditworthiness is appraised by the factor, based on market assessment, and the factor then fixes credit limits for potential buyers of the client to whom goods are sold or services are provided on credit.
2. Once the factor is satisfied about the customer's creditworthiness and agrees to buy receivables, the client firm dispatches goods to the buyers and sends a copy to the factor.
3. The sales documents given to buyers contain the instruction to make the payments to the factor directly.
4. The factor remits the agreed amount to the client.
5. Once the full amount is collected from debtors, the balance invoice amount is paid, after deducting interest and commission as per the terms of agreement.

DIFFERENT TYPES OF FACTORING

1. RECOURSE AND NON-RECOURSE FACTORING:

RECOURSE FACTORING: In this type of factoring services, the risk of bad debts remains with the client company that is, if the debtors/customers default in payment, factor will recover the amount from the client company. This is most common type of factoring. Since the risk of factor is low, recourse factoring is offered at lower interest rate. The balance amount of Client Company is paid when the debtor pays off the amount to the factor.

NON-RECOURSE FACTORING: In this type of factoring, the factor undertakes to collect the debts from the customer and the risk of customer default lies with the factor and not with the client company. The balance amount is paid to the client company at the end of the credit period or when the customer pays the factor whichever comes first. The rate of interest and service charges are high in this type of factoring as the factor undertakes the additional risk of customer default.

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2. **DISCLOSED AND UNDISCLOSED FACTORING:**
   DISCLOSED FACTORING: In disclosed factoring, the client's customers are notified of the factoring agreement and therefore they directly pays off to the factor. It can be either recourse or non-recourse factoring.
   UNDISCLOSED FACTORING: In this type of factoring agreement the client's customers are not notified of the factoring agreement. The client company itself undertakes sales ledger administration and collection of debts. The client company will have to pay the amount to the factor irrespective of whether customer has paid or not.

ADVANTAGES OF FACTORING

1. Specialized Services: The factors provide specialized services of accounts receivables management and thus the client company is relieved from the botheration of debts collection. Thus the client can focus on other major areas of the business to improve upon their efficiency.
2. Increases Liquidity: The advance payments that the client receives from the factor against the accounts receivables increases their liquidity position. This helps the client to meet his liabilities as and when they arise which improves their credit worthiness for the client's suppliers, lenders and bankers.
3. Better evaluation of credit sales: Debt management may include formal or informal advice on the credit standing of potential buyers as the factoring firms are specialists in their field. The factoring institution also provides advice on business trends and other related matters as they possess information on the trending histories, habits and default nature of the potential buyers as they exclusively deal in this activity.
4. Better risk management: The risk of bad debts is eliminated in case of non-recourse factoring.
5. Better cash flows: Factoring is a tool to release the working capital tied up in credit extended to customers. Thus the firm can do better purchase planning with the available cash to avail cash discounts on its purchases.
6. Efficient administration: Factoring saves the management time and effort in collecting the receivables and in sales ledger management and thus the firm is relieved from credit administration.
7. Improves efficiency ratios: Factoring being an off balance sheet source of finance, it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.

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LIMITATIONS OF FACTORING

Despite all the above mentioned benefits of factoring service, the following issues stand against factoring:

1. High monetary Costs: The commission and interest charged by factors for the services they render is generally high as compared to the interest charged by commercial banks for financial assistance.
2. Lack of comfort in dealing: Factor is a unknown party for the buyers and thus they might not feel comfortable while dealing with the factoring firm.
3. Tough stance by factors: In case of non-recourse factoring, the choice of customers and their credit limits are determined by the factoring firm. Once a buyer defaults in payment, the factor takes a tough stance and may not agree to provide credit against sales made to the same buyer. This leads to discontinue the sales to such buyers which reduce the sales of the firm.
4. Lack of professionalism and competence: factoring services can become unpopular because of lack of professionalism and competence, underdeveloped expertise and resistance to change.
5. Symptom of financial weakness: Buyers have a negative perception about the firms that avail factoring services.
6. Loss of business opportunities: In case of non-recourse factoring, factors want to minimize their risk so as to maximize their own profits and that is why they adopt conservative approach while evaluating the creditworthiness of the buyers. This may affect a firm's long-term profitability as the factors overlook the growth prospects of the seller.

FACTORING IN INDIA AND ROLE OF RBI

Factoring is a new financial concept in India and is still in the stage of infancy here. In keeping pace with the growing need for credit, the necessity to develop more and more asset-based financing agencies has become imperative. In small scale industry units, that have serious liquidity problems, these agencies are of much importance. The potential for factoring services in the SSI sector alone is estimated around INR45, 000 crore.

Kalyanasundaram Committee that was set up by the Reserve Bank of India under the chairmanship of C S Kalyanasundaram, the former MD of State Bank of India (SBI), introduced the concept of Factoring in India in 1991. The objective of the committee was to examine the feasibility of factoring services and mechanics of starting factoring organisations in India. The committee report recommended the setting up of specified agencies or subsidiaries to provide factoring services in India. SBI Factors and Commercial Services Private Ltd (SBI FACS) was the first factoring company in India that was started by SBI in 1991.

Received: 5 March Revised: 13 March Accepted: 22 March
Index in Cosmos
April 2018 Volume 8 Number 4
UGC APPROVED

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FACTORING REGULATION ACT, 2011

Factoring Regulation Act, 2011 regulates the factoring services in India. There was no statue to provide the legal framework to factoring services in India prior to the passing of the act. The act states that any entity that want to carry on factoring business must get themselves registered as non-banking financial companies with RBI. Requirement for registration as a factoring organisation does not hold true in case of banks, statutory organisations and government companies. Banks can act as factors departmentally provided their exposure do not exceed 10% of the total advances as per RBI norms. To set up a centralised database so as to eliminate the possibility of frauds, every factor is required to file the particulars of every transaction within 30 days with the Central Registry under SARFAESI Act, 2002. RBI is empowered by the Act to issue regulations and directions for the factoring business. RBI can call for information from the factors and it can restrict the NBFCs from undertaking the factoring business if they fail to comply with the directions issued to them.

PROBLEMS FACED BY FACTORING SECTOR

Despite the enactment of the Factoring Regulation Act, 2011, there are certain issues that still stand in the way of development of factoring services in India, which are as follows:

1. **IGNORANCE:** Many business firms are not aware of the factoring agencies and the services offered by them. Since there are only few factoring firms available in the country, it's not easy to find them.
2. **NO ACCESS TO DEBT RECOVERY PLATFORM:** Since there is no availability of debt-recovery platform as under the SARFAESI Act, it is one the major limitations of factoring sector in India. The new entrants are hesitant to enter this segment for this reason.
3. **FAKE BILLS:** The problem of fake bills is very common with the factoring companies that pose a serious challenge for the growth of factoring business in India.
4. **LIMITED REACH:** Small and Medium enterprises(SMEs) are the major clients of factoring companies as they cannot afford finance from banks because of their collateral requirement. So the factoring companies basically end up serving the SMEs.
5. **BANKS BETTER PLACED COMPARED TO FACTORS:** Generally, banks charge lower rate of interest as compared to factors because banks take collateral security while advancing loans whereas the factors do not charge such additional security. So banks look more attractive to customers who prefer lower rate of interest.

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ROLE OF FACTORING IN INDIAN SMEs

The role of SMEs for any developing country like India is incredible. After agriculture, SMEs generate second largest employment opportunities in India with more than 48 million SMEs currently operating in the country that contributes 45% of India's industrial output and 40% of the country's total export. Credit and finance issues are the major hurdle that the SMEs face in India. Factoring services comes as rescue to this bottleneck problem of finance in SMEs. India Factoring provides financial assistance to more than 200 SMEs all over the country. Some of the Indian factoring companies are as follows:

- Canbank Factors Limited
- SBI Global
- Small Industries Development Bank of India
- Standard Chartered Bank
- IFCI Factors Limited
- India Factoring and Finance Solutions Pvt Ltd.
- Export Credit Guarantee Corporation of India Ltd.
- Citibank NA, India

CONCLUSION

Factoring services are growing as a popular source of finance for the SMEs around the world. Those countries with weak secured lending laws and inefficient bankruptcy system, factoring services gains more importance there.

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