International Conference "Risk in Contemporary Economy"
ISSN online 2344-5386 ISSN print 2067-0532
XIVth Edition, 2013, Galati, Romania,
"Dunarea de Jos" University of Galati – Faculty of Economics and Business Administration

FACTORING – ALTERNATIVE OF SHORT-TERM FINANCING FOR COMPANIES

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In developed countries, had been created formidable conditions for encouraging the factoring business, because using this instrument of investment and financing have grown the economic and financial stability of the company and generated a more efficient management of accounts receivable by the policy of claims recovering. Also, the factoring may be considered both a commercial and financial activity. The essential role of the factoring companies is given by taking the place of company in activities that are not referring exclusively to the commercial field. Given the importance of this financing operation, in this paper are presented different ways of defining, their importance, advantages and disadvantages for the company, the return for the factoring of accounts receivables and the real cost of factoring.

Keywords: working capital financing, policy of claims recovering, cost of factoring, trade credit, total assets turnover, insolvency risk

JEL Code: G32, G31, G33

1. Introduction

"Survival" of a company in a dynamic economic environment and its development involves the appeal to financial resources. At European level, the companies finance their capital investments from three alternatively sources (Lumby & Jones, 2003), but not necessarily mutually exclusively: finance directly supplied by the capital markets in the form of ordinary share capital; finance directly supplied by the capital markets in the form of interest-bearing medium and long-term loans; and finance internally generated by the firm in the form of retained profits. These various types of finance differ from each other in several ways, including how they are issued, the obligations that they impose on a company's management and how they are affected by the tax system. They also differ significantly in term of risk, taking into account that any funding involves a certain degree of risk (Boca, G.D., 2011).

Also, there are other sources of funding: internal and external budgetary resources and funds attracted free from employees, state, suppliers etc.

The business financing patterns registered over the past 50 years or so in developed economies shows several clear features (Pike and Heale, 2006):

- the majority of funds comes from internal sources – retained earnings and depreciation provisions, depending on company profitability and dividend policies;
- bank borrowing plays a major role but is highly volatile, even negative in some years as companies repay debts. Companies tend to use bank finance as a buffer – borrowing heavily when interest rates are low and repaying when rates rise;
- sales of shares on the New Issue Market are relatively unimportant, although many companies try to exploit high and rising stock markets by making right issues;
- long-term debt issues are also small contributors, as are preference share issues.

In our country, the most used sources of finance are bank loans and leasing, followed by own funding and less by issues of shares. Small companies widely use loans from associates, which often become long-term loans. Bond issues are not in the preferences of domestic enterprises. Lately, factoring and forfeiting constitutes a relatively new source of funding by providing immediate liquidity to companies.

In this paper we propose a presentation of different ways of defining in the literature of factoring as a short-term source of financing reflecting their importance for the companies in the section 2, advantages and disadvantages of the factoring in the section 3, the return for the factoring of accounts receivables in the section 4 and the real cost of factoring in the last section.

2. Literature review

Factoring has imposed in modern business practice as a very successful way of funding and lending of companies (Baresa *et al*., 2012). Factoring represents a transfer of short-term accounts receivables of the companies, acting in production, trade or services field, to a financial institution called *factor* resulting from goods and services supply in return for immediate payment of receivables amount (Czternasty and Mikołajczak, 2013).

Baresa *et al*., define factoring as the purchase of others receivables (debts) or financial instrument by which the factor finances companies on the basis of the future receivables that have arised from sales of goods and services in the domestic or international market for a fee (Baresa *et al*., 2012).

Also, factoring is a type of supplier financing in which firms sell their credit-worthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash (Klapper, 2005).

Factoring loans provides funding, pursuing receivables and credit-risk protection by the factor, based on disposal by the beneficiary, by way of sale or pledge, of accounts receivables arising from the sale of goods or provision of services to third parties. Usually, the service of funding requires immediate funding to a maximum of 80% of the value of each invoice for supply of goods or services provided, from which are subtracted the factor commissions; the rest of 20% is issued upon receipt, in the case of mixed factoring (Levente, 2003). There are also factoring with immediate payment and factoring with payment at some future date. The deadline for receipt of invoices presented to the factor must not exceed 180 days from the issuance.

Depending on way in which entities bears the risk in case of debtor's default we can distinguish three types of factoring (Czternasty and Mikołajczak, 2013): recourse factoring, full factoring (non-recourse) and mixed.

The recourse factoring consists in a sale of trade receivable to the factor, with no takeover of an insolvency risk of the debtor, and thus, the client is liable for payment in the event the customer does not pay.

In full factoring the factor's responsibility is much wider because in a moment of purchase the factoring client receivables towards debtors, the factor will takes all the risk of lack of payment caused by debtors e.g.: payment default or significant delay in payment. After assignment of customers' receivables the factor pays the whole amount to the beneficiary of factoring. As a result of signing non-recourse factoring agreement there is a definite transfer of customers' receivables from the company to the factor. An additional protection for financial institution can be a trade credit insurance policy. In case of debtor's payment delay disrespecting acceptable dates, the actions to recover the receivables from the debtor are taken. In case of its actual insolvency or conventional default the loss is covered by the insurance agency.

In factoring institution practise the full factoring often apply solutions in which beneficiary of factoring gets e.g. 80-90% of the invoice amount and the rest is treated as the entity's own financial contribution. However, on the theoretical basis, such solution can be recognised as a mixed factoring.

Factoring is not a loan and there are no additional liabilities on the balance sheet of the company, although it provides financing of working capital. In addition, factoring is often done "without recourse", meaning that the factor that purchases the receivables assumes the credit risk for the buyer's ability to pay. Hence, factoring is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing (Klapper 2005).

Factoring accounts receivable allow small companies to use accounts receivable as an immediate source of working capital (Borgia *et al*., 2003). The factor buys receivables for a fee before the deadline of payment, takes over billing jobs, dunning, accounting affairs and risk on receivables. In the moment when factor charge more than discounted price paid for purchased receivables, factor makes profit (Baresa *et al*., 2012).

In some economic developed countries, such as United States of America and some of Western Europe were created formidable conditions for encouraging business factoring, based on the general economic conception that using this instrument of investment and financing enhances economic and financial stability of the companies and performs a policy of administration and recirculation of the claims particularly effective (Molico and Wunder, 2004). Also, factoring can be considered an activity both commercial and financial. The essential role of factoring companies (Berceanu, 2001) is to substitute the company in operations not related exclusively for commercial field.

Borgia and Burgess (2000) describe typical factoring arrangements and the cost/benefits of this form of financing. Fees can be high, but may outweigh the cost of lost sales, ventures, opportunities, or at the extreme, going out of businesses. Also, they conducted a survey of small and medium sized companies that use factoring in order to provide a consumer profile of typical factoring arrangements. Their survey reports that majority of companies that use factoring are young, rapidly expanding companies using

factoring as a short-term financing alternative. Factoring typically affords companies access to seventy to ninety percent of cash tied up in their receivables, with the balance provided within sixty to ninety days less a ten to twelve percent fee (Borgia and Burgess, 2000).

Also, Taylor D. (1998) consider that the majority of the companies that opt for this type of financing are young, often undercapitalized or for myriad reasons can't get lines of credit from banks. Often banks will require tertiary collateral backed up by some sort of secondary assets, often personal assets belonging to the company founder, such as real estate. But many young companies don't have fixed assets to use for collateral, and the owners don't have the personal assets to satisfy loan requirements of commercial banks (Borgia *et al*., 2003). In these conditions, factoring may be the only solution to cover the necessary of funding for this type of companies.

3. Advantages and disadvantages of factoring for companies

The ***advantages*** of the factoring of financing to beneficiary enterprises are:

- cover the risk arising from a potential customers insolvency, the risk being taken over by the factor, while taking into account that the factor does not cover risks arising from commercial or technical disputes;
- it is provided the treasury supply of the company, the factor paying immediately the claims ceded, after deduction of interest, fee and possibly a collateral deposit created by the factor, elements clearly known when the contract is signed;
- the factoring companies do not provide new funding, but can accelerate the cash conversion cycle for client companies, enabling them to gain the value from debtor, much faster than if they expected to pass the normal period of trade credit, that means it transforms a sale on term within a cash sales, reducing the short-term indebtedness of the company;
- as advances obtained from factor represent a percentage of the ceded claims value, with the increase in sales, is ensured the financing of need of finance arising from the granting of credit to customers;
- the engagement of factor is similar to a trade receivables collection to the delivery of goods without this funding to appear on the liability side. So, the factoring reduces operating cycle length and the need for working capital, helping to improve the company liquidity;
- through claims collection in advance, equity and foreign capital is spared to be immobilized in receivables with different maturities and in those with arrears, allowing the use of capital to finance investments in order to develop the company's activity, to benefit of discounts from suppliers for prepayments, repayment of bank loans and gaining short-term savings to financial costs, for financial investments etc.;
- the possibility provided to the client of factoring that, regardless of funding resulted from factoring contracts, they can turn to bank loans needed for various economic and financial activities;
- following the submission of receivables to the factor, the factoring financing enables improving the financial planning for the company of factoring client;
- the receivables transfer on factor leads to simplifying the management operations, generating directly the material and personal savings, which is reflected in the company's budget and in concentration of all forces to carry out basic activities;
- companies can be informed by the factor on possible buyers, potential markets, the difficulties that can arise in a foreign country (political risk, foreign exchange risk, etc.).

In practice, there are different variations of this type business financing which, however, is based on the same idea. Note, however, that if the factor buys firmly the invoice, the factoring fee is much higher, but the company will not be liable for any unpayment of the bill (Berceanu, 2001).

Factoring is most used in industries that are characterized by many small producers and retailers that do not have long-established relationships with each other. Because a factor may be employed by a number of manufacturers, it sees a larger proportion of the transactions than any single company and therefore is better placed to judge the creditworthiness of each customer (Myers *et al.*, 2003).

The ***disadvantages*** of the factoring are:

- relatively high cost due to the multiple services they provide. Factoring costs are usually higher than the costs of the bank loans (Ivanovic *et al*., 2011);
- the use of factoring gives the impression of a delicate financial situation of the customer company, but this observation is unfounded because factoring companies do not accept, in principle, than the companies with a very good financial situation. Also, factoring is contracted only when a certain factor knows that client is solvent;

- client of the factoring may suffer a substantial loss of income, taking into account all fees and risk of loss which is involved;
- by remission of a portion of the commercial relations to a factoring company, the beneficiary company might also lose some contracts, whether with customers because the factor is more exigent with debtors as regards the compliance of maturities, or banks because the factoring exclude the recourse to banks for mobilization of trade receivables. That means some customers do not want the involvement of third parties (Ivanovic *et al*., 2011).

4. Return for the factoring of accounts receivable

Considering the fact that factoring has many advantages and disadvantages, their analysis is needed, after which it proceeds to determining the profitability of this technique (Ilie and Teodorescu, 2004).

Let us consider the following example (Bărbuță-Mișu, 2009): an enterprise presented at the end of the year, the following simplified balance sheet (Table 1):

Table 1
EUR

Balance sheet before factoring			
ASSETS		LIABILITIES AND OWNERS' EQUITY	
Fixed assets	95.120	Owners' equity	118.440
Inventories	7.350		
Accounts receivables from customers	72.315	Accounts payable to suppliers and other operational debts	64.350
Other receivables	5.165		
Cash	25.120	Short-term banking loans	22.280
Total assets	**205.070**	**Total liabilities and owners' equity**	**205.070**

Source: Performed by the author

We suppose that the company uses mixed factoring that into the contract provides advances to 80% of trade receivables, i.e. 57.852 EUR. These amounts will be used to pay off some debts to suppliers (35.572 EUR) and to repay the short-term banking loan (22.280 EUR). Statement of assets after factoring is shown in Table 2.

Table 2
EUR

Balance sheet after factoring			
ASSETS		LIABILITIES AND OWNERS' EQUITY	
Fixed assets	95.120	Owners' equity	118.440
Inventories	7.350		
Accounts receivables from factor	14.463	Accounts payable from suppliers and other operational debts	28.778
Other receivables	5.165		
Cash	25.120		
Total assets	**147.218**	**Total liabilities and owners' equity**	**147.218**

Source: Performed by the author

It is observed that claims to customers are replaced by the accounts receivables from factor amounting to 14.463 EUR, which is the difference between customer receivables of 72.315 EUR and advances receivable from the factor of 57.852 EUR.

Table 3 shows some rates calculated before and after the use factoring, having regard the turnover of the company of 185,000 EUR.

Table 3

Rates		Results	
Indicator	Formula	Before factoring	After factoring
Patrimonial solvency	$\frac{\text{Owners equity}}{\text{Liabilities} + \text{Owners equity}}$	$\frac{118.440}{205.070} = 0{,}58$	$\frac{118.440}{147.218} = 0{,}80$
Current liquidity	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{109.950}{86.630} = 1{,}27$	$\frac{52.098}{28.778} = 1{,}81$
Total asset turnover	$\frac{\text{Sales}}{\text{Total assets}}$	$\frac{185.000}{205.070} = 0{,}90$	$\frac{185.000}{147.218} = 1{,}26$

Source: Performed by the author

It follows improving overall solvency and liquidity (with 37,93% and respectively 42,52%) due to faster payment of short term debt and accelerating the total capital invested turnover (with 40%), which increases the profitability of the company, in order to compensate the cost of factoring.

5. The real cost of factoring

Costs of factoring are moving in different proportions and they are structured by most of the factors in the same way: first the factoring fee (0.2–4.0% assigned claims), second annual interest (7–11% funded amount), and third, administrative fees. Final costs of factoring depend upon the type of services, creditworthiness of customers, volumes and average amount of the invoice (Ivanovic *et al*., 2011).

Financial evaluation of factoring is to compare the cost of this technique with all savings due to it. Specifically, should be identified and quantified all the financial implications of factoring. *Additional costs* occasioned by factoring concern in: factoring fee or receivable commission; interest paid to the factor; the cost of insurance concluded to cover the risk of insolvency of unauthorized debtors (Ilie and Teodorescu, 2004). There are also expenses incurred with study related to the profitability of using factoring, the transfer of receivables to the factor, reorganization of company departments, reporting to the customers about using factoring (Bărbuţă-Mişu, 2008).

The *savings* usually come from: partial or total waiver of the customer receivables accounting; reducing the number of disputes with customers; decrease of insurances to cover the risk of insolvency of the customers; the recovery of receivables from the long-time customers, even in the event of payment default; obtaining discounts for paying suppliers or reducing the financial expenses (Ilie and Teodorescu, 2004). To assess economies must take into account by the advantages: simplification the management of trade receivables, preparation easily of budgets and financial forecasts, improving the structure of the current assets in the balance sheet, reducing the cost of organizing accounting and of tracking the cashing from the customers.

To show the ***actual cost of factoring***, we present the following example (Pike and Heale, 2006):

At the beginning of March, a company sells goods for a total value of 200.000 EUR to regular customers, but decides that it requires payment earlier than the agreed 60 day trade credit period for these invoices. A discounter agrees to finance 80% of their face value, i.e. $200.000 \times 80\% = 160.000$ EUR. Interest is set at 12% per year. The invoices were due for payment on April 30, exactly 60 days after the initial transactions. The service charge is set at 1,2%. As usually applies, a special account is set up with bank, into which all payments are made. The sequence of cash-flows is as follows:

- 1st March: the company receives cash advance of 160.000 EUR;
- April 30th: customers pays 200.000 EUR, invoice discounter receives the full 200.000 EUR and the company receives the balance less charges of 5.556 EUR, representing the following expenses:
  - Service fee: $1{,}2\% \times 200.000 = 2.400$ EUR;
  - Interest $D = 12\% \times 160.000 \times \frac{60}{365} = 3.156$ EUR.

Net receipts at maturity are: $(20\% \cdot 200.000) - 5.556 = 34.444$ EUR and the total receipts by the company is $160.000 + 34.444 = 194.444$ EUR.

In effect, the company has settled for a discount of $\frac{5.556}{200.000}=2,78\%$ over 60 days for early receipt of 80% of accounts payable. As there are about six 60 day periods in a year, this corresponds to an annual interest rate of: $(1+0.0278)^6-1=0.1788$, i.e. 17,88%.

Also, we can approximate the ***real cost of factoring*** (k_{Cs}) using the following formula: $k_{Cs}=\frac{5.556}{194.444}\times\frac{365}{60}\times 100=17,38\%$ that is higher than annual interest established in the contract because of service fee.

5. Conclusions

In conclusion, the factoring generates improving of overall solvency and liquidity due to much faster collection of accounts receivables and therefore to faster payment of accounts payable. The total capital invested turnover increases, determining the increase in profitability of the enterprise, in order to compensate the effective cost of factoring.

The real cost of factoring is higher than the nominal cost, especially because of banking services occasioned by this operation. However, most of the time, the return of assets and activity effectively covers its effects.

Also, through accounts receivables collection in advance, owners' equity and foreign capital is protected from being immobilized in claims with different maturities, including in those with arrears, allowing the use of capital for financing investments in order to develop the company's activity, to benefit of discounts from suppliers for prepayments, repayment of short-term banking loans and gaining savings in financial expenses and for short-term financial investments.

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