LESSON 14:
FACTORIZING AND FORFEITING – FINANCIAL EVALUATION

Lesson Objectives

- Study Financial Evaluation of Factoring.
- Understand Concept of Forfeiting.
- Position of Factoring & Forfeiting in India.

Cost-benefit Analysis of Factoring (Financial Evaluation)

The cost-benefit analysis of factoring is concerned with comparing costs and benefits associated with factoring. A firm would prefer to have factoring arrangements if the risk of default or non-payment is high and the cost involved by way of fees and service charges of the factor are less than the benefits associated with the same. The following examples illustrate the financial evaluation of factoring.

Example 1. Bharat Ltd. decides to liberalise credit to increase its sales. The liberalised credit policy will bring additional sales of Rs. 3,00,000. The variable costs will be 60% of sales and there will be 10% risk for non-payment and 5% collection costs. Will the company benefit from the new credit policy?

Solution

<table>
<thead>
<tr>
<th>Additional Sales Revenue</th>
<th>Rs. 3,00,000</th>
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<tr>
<td>Less: Variables Cost (60%) Incremental Revenue</td>
<td>180000</td>
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<tr>
<td>Incremental Revenue</td>
<td>120000</td>
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<tr>
<td>Less: 10% for non-payment risk</td>
<td>30000</td>
</tr>
<tr>
<td>90000</td>
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<tr>
<td>Less 5% for costs of collection</td>
<td>15000</td>
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<tr>
<td>Additional Revenue from increased sales due to liberal credit policy</td>
<td>75000</td>
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Factoring v/s Bill Discounting

In addition to the rendering of factoring services, banks and financial institutions also provide bills discounting facilities to provide finance to the client.

Following are the similarities and differences between the two services.

Dissimilarities/Differences

The two services differ from each other in the following respects:

<table>
<thead>
<tr>
<th>Bills Discounting</th>
<th>Factoring</th>
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<tbody>
<tr>
<td>1. It is a provision of finance against bills.</td>
<td>1. Factoring renders all services like maintenance of sales ledger, advisory services, etc in addition to the provision of finance.</td>
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<td>2. Advances are made against the bills.</td>
<td>2. Trade debts are purchased by assignment.</td>
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<td>3. The drawer undertakes the responsibility of collecting the bills and remitting the proceeds to financing agency.</td>
<td>3. Factoring undertakes to collect the bills of the client.</td>
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<td>4. Bills discounted may be rediscounted several times before the maturity.</td>
<td>4. Debts purchased for factoring cannot be rediscounted, they can only be refinanced.</td>
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<td>5. Bill discounting is always with recourse, i.e. in case of default the client will have to make good the loss.</td>
<td>5. Factoring may be with or without recourse.</td>
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<td>6. Bill financing is individual transaction oriented i.e. each bill is separately assessed on its merits and got discounted purchased.</td>
<td>6. Whereas in factoring, bulk is provided against several unpaid trade generated invoices in batches. It follows the principle of ‘whole turnover’.</td>
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<td>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.</td>
<td>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.</td>
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<tr>
<td>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.</td>
<td>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.</td>
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</table>
2. Transactions are guaranteed by a bank.
1. Forfaiting transaction is usually covered either by a documentation or by promissory note or bills of exchange.

**Forfaiting**
The forfaiting owes its origin to a French term ‘a forfait’ which means to forfeit (or surrender) one’s rights on something to one some one else. Forfaiting is a mechanism of financing exports:

a. by discounting export receivables
b. evidenced by bills of exchanges or promissory notes
c. without recourse to the seller (viz; exporter)
d. carrying medium to long-term maturities

e. on a fixed rate basis upto 100% of the contract value.

In other words, it is trade finance extended by a forfaiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount. Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfaiting usually takes place where the credit is for long date maturities and there is no prohibition for extending the facility where the credits are maturing in periods less than one year.

**Parties to Forfaiting**
There are five parties in a transaction of forfaiting. These are:

i. Exporter
ii. Importer
iii. Exporter’s bank
iv. Importer’s bank
v. The forfaiter.

**Mechanism**
1. The exporter and importer negotiate the proposed export sale contract. Then the exporter approaches the forfaiter to ascertain the terms of forfaiting.
2. The forfaiter collects details about the importer, supply and credit terms, documentation etc.
3. Forfaiter ascertains the country risk and credit risk involved.
4. The forfaiter quotes the discount rate.
5. The exporter then quotes a contract price to the overseas buyer by loading the discount rate, commitment fee etc. on the sale price of the goods to be exported.
6. The exporter and forfaiter sign a contract.
7. Export takes place against documents guaranteed by the importer’s bank.
8. The exporter discounts the bill with the forfaiter and the latter presents the same to the importer for payment on due date or even sell it in secondary market.

**Documentation**
1. Forfaiting transaction is usually covered either by a promissory note or bills of exchange.
2. Transactions are guaranteed by a bank.

3. Bills of exchange may be 'availed by' the importer's bank. 'Aval' is an endorsement made on bills of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.

**Costs of forfaiting**
The forfaiting transaction has typically three cost elements:
1. Commitment fee, payable by the exporter to the forfaiter 'for latter's' commitment to execute a specific forfaiting transaction at a firm discount rate with in a specified time.
2. Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfaiter from the amount paid to the exporter against the availed promissory notes or bills of exchange.
3. Documentation fee.

**Benefits of forfaiting**
Forfaiting helps the exporter in the following ways:
1. It frees the exporter from political or commercial risks from abroad.
2. Forfaiting offers 'without recourse' finance to an exporter. It does not effect the exporter's borrowing limits/capacity.
3. Forfaiting relieves the exporter from botheration of credit administration and collection problems.
4. Forfaiting is specific to a transaction. It does not require long term banking relationship with forfaiter.
5. Exporter saves money on insurance costs because forfaiting eliminates the need for export credit insurance.

Problem areas in forfaiting and factoring where legislation is required.
1. There is, presently, no legal framework to protect the banker or forfaiter except the existing covers for the risks involved in any foreign transactions.
2. Data available on credit rating agencies or importer or foreign country is not sufficient. Even exim bank does not cover high-risk countries like Nigeria.
3. High country and political risks dissuade the services of factoring and banking to many clients.
4. Government agencies and public sector undertakings (PSUs) neither promptly make payments nor pay interest on delayed payments.
5. The assignment of book debts attracts heavy stamp duty and this has to be waived.
6. Legislation is required to make assignment under factoring have priority over other assignments.
7. There should be some provisions in law to exempt factoring organization from the provisions of money lending legislations.
8. The order 37 of Civil procedure code should be amended to clarify that factor debts can be recovered by resorting to summary procedures.

Thus, the existing legal framework governing the transactions of factoring business is not adequate to make the functioning simple, inexpensive and attractive in the market. In order to
ensure that the functioning of a factor is with ease and confidence the legal framework should:

a. define the rights, liabilities, duties and obligations of the parties involved, in a clear and comprehensive manner, so that the parties can plan their affairs with certainty, and

b. be supportive of the transactions and procedures involved, so that they may be undertaken and completed simply and inexpensively.

In short, areas like ‘assignment’, ‘stamp duty’, ‘priorities of factoring assignment’, ‘liabilities of the debtor’, ‘obligations of banks’, realisation of debts through simple legal process etc. require focused attention. A draft bill on the factoring of debts due to industrial and commercial undertakings has been prepared which awaits clearance by the Government of India. Once this bill is passed majority of the constraints will be eliminated.

**Factoring in India**

Banks do provide non-banking financial services such as housing finance, leasing and hire-purchase, factoring and forfaiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either through their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries. Factoring and forfaiting services were of recent origin following the recommendation of the Kalyansundaram Committee, set up by the RBI in 1988.

The Committee was constituted to examine the feasibility of factoring services in India, their constitution, organisational setup and scope of activities. The group recommended setting up of specified agencies or subsidiaries for providing the factoring services in India.

While attempting to assess the potential demand for factoring services in India, the study group under the leadership of Mr. C. S. Kalyansundram estimated the value of outstanding open account credit sales available for financing during 1989-90 at Rs. 12,000 crores in respect of SSI and Rs. 4500 crores for medium and large scale sector. Assuming only 50% of the above business will be available for factoring, the aggregate potential demand for factoring was expected to be around Rs. 4000 crores per annum mainly emerging from the SSI and large and medium companies.

**Major Players**

The first factoring company was started by the SBI in 1991 namely Factors and Commercial Ltd. (SBI FACS) followed by Canara Bank and PNB, setting the subsidiaries for the purpose. While the SBI would provide such services in the Western region, the RBI has permitted the Canara Bank and PNB to concentrate on the Southern and Northern regions of the country, for providing such services for the customers. The major players since 1991 are Canbank Factors, SBI Factors and later Foremost Factors. The new entrants in the market include ICICI, HSBC and Global Trade Finance. Canback Factors leads in the domestic market with about .65%-70% of the share.

The Vaghul Committee Report on Money Market Reforms has stressed on the need for factoring services to be developed in India as part of the money market instruments. Many new instruments had already been introduced like Commercial Paper (CP), Pm1icipation Certificates (PC), Certificates of Deposits etc. but the factoring service has not developed to any significant extent in India.

**Factoring in India - A Note**

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The paper traces the genesis of factoring service in India, which is still in its infancy. It brings out the advantages and disadvantages of factoring. The potential for factoring has also been stated.

The eighties in India was witness to a virtual deregulation of capital market a number of innovative financial instruments and schemes was born. The policy of the power- that - be also helped in the development of money market. The capital market mutatis mutandis tried to transplant some of the successful schemes of the west. The working group (1987) on the money market, headed by Vaghul, observed: “Despite various measures taken over the years to enable the small-scale sector to recover its dues from the medium and large industries (and in particular the public sector) the small-scale units face a liquidity bind because of their inability to collect the dues”.

Since the earlier efforts to popularise a bill market in India did not have the desired results an alternative had to be found. Available data reveal that funds locked up in book debts have been increasing at a faster rate than growth in sales turnover or build-up in inventories (Anantha Krishnan, 1990).

Thus, factoring as a remedy became a fait accompli. A committee was constituted under the chairmanship of Kalyana Sundaram (198-) to examine the feasibility of factoring services in India and suggest operational modalities of launching such a service.

This note discusses the salient features of factoring and tries to analyse its relevance in the context of the changing financial scenario and the development of financial services industry.

Factoring is essentially a management (financial) service designed to help firms better manage their receivables; it is, in fact, a way of offloading a firm’s receivables and credit management on to some one else - in this case, the factoring agency or the factor. Factoring involves an outright sale of the receivables of a firm by another firm specialising in the management of trade credit, called the factor. Under a typical factoring arrangement a factor collects the accounts on the due dates, effects payments to its client firm on these days (irrespective of whether or not it has received payment or not) and also assumes the credit risks associated with the collection of the accounts. For rendering these services, the factor charges a fee which is usually expressed as a percentage of the total value of the receivables factored. Factoring is thus an alternative to in-house management of receivables. The complete package of factoring services includes (1) sales ledger administration; (2) finance; and (3) risks control.

**Sales ledger administration:** For a service fee, the factor provides its client firm professional expertise in accounting and maintenance of sales ledger and for collection of receivables.
Finance: The factor advances up to a reasonable percentage of outstanding receivables that have been purchased, say, about 80 percent immediately, and the balance minus commission on maturity. Thus, the factor acts as a source of short-term funds.

Risk Control: The factor having developed a high level of expertise in credit appraisal, reduces the risk of loss through bad debts.

Depending upon the inherent requirements of the clients, the terms of factoring contract vary, but broadly speaking, factoring service can be classified as (a) Non-recourse factoring; and (b) recourse factoring. In non recourse factoring, the factor assumes the risk of the debts going “bad”. The factor cannot call upon its client-firm whose debts it has purchased to make good the loss in case of default in payment due to financial distress.

However, the factor can insist on payment from its client if a part of the receivables turns bad for any reason other than financial insolvency.

In recourse factoring, the factoring firm can insist upon the firm whose receivables were purchased to make good any of the receivables that prove to be bad and unrealisable. However, the risks of bad debts is not transferred to the factor.

Legal Aspects
The legal status of a factor is that of an assignee. Once the factor purchases the receivables of a firm and this fact is notified to the customers, they are under a legal obligation to make all remittances to the factor. A customer who by mistake remits the payments to the firm is not discharged from his obligations to the factor until and unless the firm remits the proceeds to the factor. The factoring agreement governs the legal relationship between a factor and the firm whose receivables are to be factored, and is so drawn as to suit the various needs specifying the period of validity of the contract and modalities of termination.

Financial Aspects
Factoring involves two types of costs: (a) factoring commission; and (b) interest on funds advances.

Factoring commission represents the compensation to the factor for the administrative services provided and the credit risk borne. The commission charged is usually 2-4 per cent of the face value of the receivables factored, the rate depending upon the various forms of service and whether it is with or without recourse.

The factor also charges interest on advances drawn by the firm against uncollected and non-due receivables. In the U.K., it is the practice to advance up to 80 per cent of the value of such outstanding at a rate of interest which is 2-4 per cent above the base rate. This works out to near the interest rate for bank overdrafts.

The cost of factoring varies, from 15.2 to 16.20 per cent (Singh, 1988), 15.6 to 16.0 per cent (SBI Monthly Review, 1989), and the margins in which the factors will have to operate would be extremely narrow. The strategy of factors, therefore, must be to carve out a niche in the services segment namely, receivables management and generate revenues by way of commission rather than concentrate on lending and financing activities where the margins are low.

Factoring offers the following advantages from the firm’s point of view:

Advantages
Firms resorting to factoring also have the added attraction of ready source of short-term funds. This form of finance improves the cash flow and is invaluable as it leads to a higher level of activity resulting in increased profitability.

By offloading the sales accounting and administration, the management has more time for planning, running and improving the business, and exploiting opportunities. The reduction in overheads brought about by the factor’s administration of the sales ledger and the improved cash flows because of the quicker payments by the customers result in interest savings and contribute towards cost savings.

Disadvantages
Factoring could prove to be costlier to in-house management of receivables, specially for large firms which have access to similar sources of funds as the factors themselves and which on account of their size have well organised credit and receivable management.

Factoring is perceived as an expensive form of financing and also as finance of the last resort. This tends to have a deleterious effect on the creditworthiness of the company in the market.

Potential
In the Indian context, factoring is being viewed as a source of short-term finance. The estimated aggregate potential demand for factoring (finance) would be about Rs 4,000 crores (SBI Monthly Review, 1989). There seems to be a tendency to view factoring primarily as a financing function - a source of funds to fill the void of bank financing of receivables for small-scale industries and others. This attitude is fraught with dangers and could lead to a “catch 22” situation.

In launching factoring service, the thrust should be in the twin areas of receivables management, and credit appraisal; factoring agencies should be viewed as vehicles of development of these skills. Since the small-scale sector lacks these sophisticated skills, factors should be able to fill the gap. Giving priority to financing function would be self-defeating as receivable management would be given the back-seat. It is for the factors to generate the necessary surpluses to mop up the additional resources and then embark on financing function. However, for policy reasons, should these go hand in hand, then the accent should be on receivable management otherwise, these agencies would end up as financing bodies.

From the firm’s point of view, factoring arrangements offer certain financial benefits in the form of savings in collection costs, reduction in bad debt losses, and reduction in interest cost of investment in receivables. On the other hand, the firm incurs certain costs, in the form of commissions and interest on advances. Therefore, to assess the financial desirability of factoring as an alternative to in-house management of receivables, the firm must assess the net benefit of this option, using the profit criterion approach. The factors have to establish their credibility in offering better management of receivables and financing at competitive rates to the clients.