CHAPTER II

THEORETICAL ASPECTS OF FACTORING SERVICES
Factoring in the modern form is a new and innovative concept of providing finance against trade receivables. This chapter concentrates on theoretical aspects of policy and strategic issues involved in factoring.

1. Definition of Factoring

There is no precise and universally acceptable definition of factoring. In different countries, factoring has been defined and interpreted in different ways. However, the first attempt was made in the USA to define the term ‘factoring’ in a more organised and systematic manner. The definition given by the US laws is as follows:

A continuing arrangement between a factoring concern and the seller of goods or services on open account, pursuant to which the factor performs the following services with respect to the accounts receivable arising from sales of such goods or services:

1) purchases all accounts receivable for immediate cash;
2) maintains the sales ledgers and performs the other book-keeping duties relating to such accounts receivable;
3) collects the accounts receivable;
4) assumes the losses, which may arise from any customer’s financial inability to pay (credit loss);
5) provides further funds on a seasonal and term basis, which are either unsecured or secured;
6) assists in advisory services, marketing surveys, management and production counselling, and data processing services (See, Moore 1959, p. 705-706).

The conference of International Institute for Unification of Private Laws (UNIDROIT) on factoring (also known as the Ottawa Convention) held in May 1988 defines that factoring is an arrangement between a factor and his client which includes at least two of the following services:

1) finance,
2) maintenance of accounts;
3) collection of debts;
4) protection against credit risks (See, Sengupta et.al. 1992, p. 1).

Factoring as defined by Westlake (1975, p.1) is a device of transforming a non-productive, inactive asset (i.e. book debts) into a productive asset (viz. Cash) by selling book-debts (receivables) to a company that specializes in book-debt collection and administration. Kalyanasundaram Committee (1988, p.44), in the report submitted to the RBI, defines factoring as the outright purchase of credit approved accounts receivable with the factor assuming bad debt losses.

A simplistic interpretation of the definitions implies that factoring is an arrangement in which the receivables arising out of sale of goods or providing services are purchased by / sold to the factor as a result of which the title to the goods represented by the said receivables passes on to the factor in consideration of advance to the seller. The factor then becomes responsible for all credit control, sales accounting, and debt collection from the buyers. Moreover, if any debtor fails to pay the dues, the factor has to absorb the losses, as he normally has no recourse against the client i.e. the supplier.

2. Types of Factoring

1. The arrangement between the client and the factor primarily depends upon the needs of the clients. This could be either financing or sales ledger administration or collection of debts or credit risk coverage, etc. or all together. The type of factoring arrangement concluded at a given time depends upon the following criteria: client’s needs, nature and volume of client’s business and financial strength, type of business, cost of the services, etc. The different types of factoring arrangements prescribed by a factor can be classified as per Chart 2.1.
### CHART 2.1

**Types of Factoring**

<table>
<thead>
<tr>
<th>Types of Factoring</th>
<th>Availability of Finance</th>
<th>Protection against Bad Debts</th>
<th>Notices to Debtors</th>
<th>Sales Ledger Administration</th>
<th>Collections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Service</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Recourse Factoring</td>
<td>A</td>
<td>N</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Bulk Factoring</td>
<td>A</td>
<td>N</td>
<td>A</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Maturity Factoring</td>
<td>N</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Agency Factoring</td>
<td>A</td>
<td>S</td>
<td>U</td>
<td>S</td>
<td>N</td>
</tr>
<tr>
<td>Invoice Discounting</td>
<td>A</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Undisclosed Factoring</td>
<td>A</td>
<td>S</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
</tbody>
</table>

Any of these may be referred to as:
- 'Notification Factoring’
- OR
- ‘Disclosed Factoring’

Alternatively:
- ‘Confidential Factoring’
- OR
- ‘Non-notification Factoring’

- Any form, which includes this element, may be referred to as ‘non recourse factoring’.

**Key:**
- A = Always provided
- U = Usually provided
- S = Sometimes provided
- N = Never or rarely provided

2.1. Full Service Factoring/Non-Recourse Factoring

2.1.1. This form of factoring is also sometimes known as 'old line or standard factoring'. This is the most comprehensive form of factoring combining the ingredients of almost all the factoring services. It offers finance against book-debts, undertakes sales ledger administration including collection of the debts and assumes the credit risks against bad debts. However, it cannot prudently accept jumbo risks even with respect to customers who are apparently sound. The assumption of credit risks covers only defaults in payment arising from financial inability or insolvency of the customer. The defaulted debts resulting from disputed qualitative aspects of goods/services supplied will be reassigned or debited to the client.

2.1.2. Non recourse factoring is most suited to situations where: (a) amount involved per customer is relatively substantial and financial failure can jeopardize the client’s business severely; (b) there are a large number of customers of whom the client cannot have personal knowledge; and (c) client prefers to obtain 100 per cent cover under factoring rather than take insurance policy (Pandey 1994, p.39). This type of factoring is quite popular in most of the developed countries in the world including USA and UK. The share of the 'non recourse factoring' in the total world domestic factoring under FCI is 54.35 per cent (Press information 1998, FCI, P.3). Strong argument in favour of 'without recourse factoring' is that the real role of factoring is to take the credit risk, which is taken up by this type of factoring. However, some forms of sales namely of non-proven products, contracting and building industries, and capital goods may face considerable problems under 'without recourse factoring'.

2.2. Recourse factoring

In this method of factoring, the factor provides all types of factoring services except assumption of credit risk of the debts. The client has no indemnity against uncollected debts. If the customer of factor's client makes default in payment of the debt on maturity for any reason, the factor is entitled to recover from the client the amount advanced against such debts. This type of factoring is preferred when customers are
wide spread and relatively low amount per customer is involved or when the client is selling the high-risk customer. Maximum countries, particularly developing countries, practice recourse factoring because it is not easy to obtain credit information, and the cost of bad debt protection is also very high.

2.3. Bulk factoring

Bulk factoring provides finance to the client but no administrative or protection service. However, it includes notification to the customers calling upon them to pay the dues direct to the factor. The arrangement serves the purpose of purely financing the trade credit requirements of the client. The service provided is, therefore, no more than that obtained by means of invoice discounting.

2.4. Maturity factoring

This form of factoring is also sometimes known as 'collection factoring'. Under this arrangement, services provided are purely administrative. The factoring company: 1) monitors and maintains the sales ledgers; 2) issues and dispatches the invoices; 3) collects the debts on due date. Finance is not prepaid by the factor. The factor otherwise pays the factored amount to the client only after the respective debt is collected from the customer at the end of the credit term or on an agreed maturity date which could be different from the actual due date for payment. The main duty of a factor is to make sure that the customers pay debts by the due dates. Collection efficiency can make sure to recover collections before maturity. In such a situation, the factor enjoys the additional float of funds on early collections along with an extra income from factoring services. Maturity factoring could be either with recourse or without recourse. In case of without recourse factoring, factored amount will be paid to the client at the end of the credit term or on the agreed maturity date irrespective of whether the factor has been able to collect the debt or not. If the customer becomes insolvent, payment will be made to the client even before maturity on proof of the customer's insolvency. Clients with sound financial condition and liquidity may prefer maturity factoring.
2.5. Agency factoring

This form of factoring always extends finance against book debts, and sometimes protection against bad debts is available and besides, administration of sales ledger is taken up. The collection of book debts is always undertaken by the client. It usually includes informing the customer to pay directly to the factor. Companies, which have good system of credit administration but need finances, prefer this form of factoring.

2.6. Invoice discounting

Invoice discounting is another important service just like financing against invoices without assuming any other responsibility. The factor purchases all or selected invoices of the client. All the other works relating to sales ledger administration and debt collection are looked after by the client himself. The customer is not aware in this case that the client is availing any factoring facility. In this arrangement, the client is able to tide over his liquidity problems by availing of the advance against invoice without having to commit him to a regular factoring arrangement.

2.7. Undisclosed factoring

In ‘undisclosed factoring’, the customers are not informed about the factoring arrangements subsisting between the factor and the client. It is also known as non-notification factoring. Under this type of factoring, debts are assigned to the factor but the client maintains the sales ledger. The debt is collected by the client who makes over the payment to the factor. Moreover, the client keeps a close watch over all such factored debts, and the factor inspects the client’s sales ledger at regular intervals. Undisclosed factoring is the most risky proposition where one has to be careful in exercising continuous watch over the credit worthiness of both the clients and the customers. This type of factoring is available in the U.K., of course, extended to financially strong companies.
3. Conclusion

If the arrangement is for full factoring, a client is obliged to factor his entire turnover and if it is only for particular debtors, all invoices drawn on those debtors need only be assigned to the factor. In both the cases, it is not in the interest of the factoring company to keep the client completely free to decide whose and what to assign to the factor, as there may lie inherent risk to the factor who does not generally hold any other tangible security. In the U.K., the client must offer all debtors to the factor for factoring the debts and they draw up a very exhaustive factoring contract to firm up the relationship.

3. Services Provided under Factoring Arrangement

1. Variation exists in the factoring services. The main functions of a factor can be grouped under the following broad categories.

2.1. Finance

The financial facility is usually regarded as the prime service of a factor. All types of factoring, except maturity factoring, provide this service. It enables a client to draw upto an agreed percentage – usually 80 percent minus commission on maturity – of the value of the invoices passed on to the factor. Where there is no dispute over the delivery terms, and quality and quantity of delivered goods according to the customers’ order, full amount is also paid. But if receivables are small and spread over a period of time, factors follow conservative principle. Hence factors act as service providers of short-term funds.

2.2. Collection

The collection service is a specialised function of a factor. Three types of factoring, namely, full
factoring, recourse factoring, and maturity factoring provide the service. This service involves recovering the amounts due, after the buyers have accepted the goods. It includes such services as sending invoices, reminders, urgent telegraphic communications, legal notices, legal action, making provision for doubtful debts, and finally writing off bad debts. In the buyer-oriented market, this service relieves the seller of getting funds that are locked up in book-debts, released.

2.3. Credit service

One of the important functions of a factor is credit service. 'Without recourse factoring and maturity factoring' always provide this service and agency factoring and undisclosed factoring also sometimes render this service. This service is regarded as the assumption of credit protection as well as the determination of credit status more expeditiously and more efficiently. It involves gathering of information on potential and existing customers, screening them for credit purposes, rating customers on their credit worthiness and the formulation of credit policy, such as credit period, the rebate for prompt payment and penalties for delays, and finally, actual decision on whom to sell, and on credit lines to be given on individual customers.

2.4. Book-keeping service

Under this, the factor takes over all the functions relating to the maintenance of the sales ledger. Full service factoring, recourse factoring, and bulk factoring always, and agency factoring sometimes, provide this service. The factor sends monthly statements of accounts and informs the client about the progress of collection of debts from time to time and also informs him about overdue accounts. For this, the factor employs the most efficient business machines, modern book keeping systems and highly trained clerical personnel because the factor handles millions of invoices, credit memoranda, and cash payments each year on behalf of its numerous clients.
2.5. Advisory service

Under this, the factor provides superior advices on marketing, finance, production and sales. These include (a) providing information on prospective buyers; (b) providing financial counselling; (c) assisting the client in managing liquidity and preventing sickness; and (d) providing facilities for opening letters of credit by the client, etc. Many small and medium size clients can be benefited greatly by advices on these aspects to gain economies of scale to offset the cost of factoring.

2.6. Other facilities

The factor also stands ready to make temporary or seasonal advances, or term loans. For various useful purposes, these facilities are popular in the USA. These loans are made on a secured or unsecured basis depending upon the financial position of the client.

3. All the basic services provided by a factor can also be obtained individually from various sources. For instance, computer agencies can provide sales ledger accounting facilities. Commercial banks provide finance against receivables in various forms like purchasing / discounting of bills and granting overdraft / cash credit against book debts. The collection function is also performed by collection agencies in advanced countries, where special credit companies also exist to underwrite credit risks. But what is unique about factoring is that a factor brings all these services together in one single and convenient package.

4. International Factoring

1. The conference of International Institute for Unification of Private Laws (UNIDROIT) which is known as Ottawa (Canada) convention, 1988, defines international factoring as an agreement between an
exporter and a factor whereby the factor purchases the trade debts from the exporter and provides the services such as finance, maintenance of sales ledger, collection of debts, protection against credit risks, etc (Sengupta et al. 1999, p.3). The concept of international or cross border factoring has a much shorter history than domestic factoring. It was introduced during the 17th and the 18th centuries when there was a tremendous growth in trade between the European countries and others parts of the world. At the end of the 20th century, the real growth of international factoring has been observed. Now, America and Europe have a fully matured factoring market and, Asia and the Pacific areas have shown the most dramatic growth. But Latin America, Central Europe, Middle East and South Asia are at the beginning of a factoring boom (Kohnstamm 1999, p.2).

2. The buyers are becoming more reluctant to accept that they have to purchase under only ‘letters of credit’ arrangement. On the other hand, exporters are more concerned than ever before on the issue of nonpayment. The greater the distance over which the goods are shipped, the greater seems to be the concern. This is exactly where international factoring can play a major role allowing safe exports on open account terms along with cash flow financing to support exporters.

3. Various forms of international factoring are in vogue depending upon the exporters’ needs and cost bearing capacity, and security to the factors. These forms are ‘two-factor system’, ‘single factoring’,

1. Open Account Transaction: Under this system, there is a direct agreement between the exporters and importers to complete the deal including payment with a pre-determined future date usually between 60 and 90 days from the date of invoice. This agreement is made without any formal guarantees (Sengupta et al. 1999, p.37).

2. Two Factor System: The transaction is based on operation of two factoring companies in two different countries involving in all four parties: exporter, importer, export factor in exporter’s country and import factor in importer’s country.

3. Single Factoring: Under this system, credit cover is provided by the import factor whereas pre-payment, book-keeping, and collection responsibilities remain vested with the export factor.
THEORETICAL ASPECTS OF FACTORING SERVICES

'direct export factoring', 'direct import factoring', and 'back to back factoring'. Amongst them, two-factor system offers some extra advantages. It is of great importance to the export factor to be able to offer his clients export factoring services covering a large number of countries without himself having a detailed knowledge of the trading conditions of each country. Moreover, collection through the courts of the buyer’s country can also be managed. The seller is confident that his buyers can deal with a factoring company in their own countries, in their own language, and within their legal system, conventions and customs. It is also easier for a buyer to make payment to the import factor in his own country. The disadvantages of the two-factor system are few. The speed of response on matters such as credit lines, transfer of cash and disputes can suffer, as there are more parties involved. It can also be more expensive as both the factors require covering their costs. 'Direct export factoring' most frequently occurs when handling exports to neighboring countries which is considered by the seller as his home market. ‘Direct import factoring’ is best suited, where only service of credit cover and collection handling are required by the seller and ‘back to back factoring’ is applicable where export is conducted by large exporters to their subsidiaries, or distributors, or selling agents abroad.

4. There are two associations of factoring companies, which emerged for facilitation of international factoring by formation of the concept of correspondent export and import factors, and for arousing of factoring awareness, and for promotion the concept of such business in countries where such services are not available. These two associations are (1) International Factors Group (IFG) and (2) Factors Chain 1.

1. Direct Export Factoring: Under this system, only export factor is involved and he has to collect the dues from the various buyers, directly, located in different countries. He provides all elements of services.

2. Direct Import Factoring: Under this arrangement, the exporter chooses to work directly with a factor of the importing country. The import factor is responsible for sales ledger administration, collection of debts, bad debt protection, etc.

3. Back to Back Factoring: The arrangement is normally applicable in respect of sales by an exporter, usually a large export company, to its subsidiary or distribution or selling agent abroad. Here the export factor and import factor sign an agreement with the exporter and subsidiary, respectively.
International (FCI). IFG was formed between 1960-1965 on the initiative of the "First National Bank of Boston". Subsequently, the coordination office of the group was set-up at Brussels in 1974. One of the major initial limitations of the group was the policy of close door membership wherein only one single factoring company in a country was allowed to become member of the group (Report of IFG 1989). There has, however, been perceptible relaxation in the policy since 1987. At present, IFG is represented in more than 51 major trading countries throughout the world. FCI is the largest world wide factoring chain. It was established in 1968 as a result of a cooperation agreement between Shield Factors of the UK (later to become Griffin Factors) and Svensk Factoring (now known as Handelsbanken finans) of Sweden (Introduction of International Factoring 1995, FCI, p.5). The secretariat of the group is located at Amsterdam, The Netherlands. It is now reported that the factoring companies belonging to FCI fraternity, during 1998, have served a total of 79000 businesses (clients) in their sales to 4000,000 corporate debtors. Moreover, 78,000,000 individual transactions are being handled across the globe (Press Information 1998, FCI, p.1) . As a whole, FCI's market share in the total international factoring is nearly 50 per cent.

5. When the international factoring is carried out by the members of FCI, the services involve a four or five-stage operation. Procedures of export factoring with FCI are placed in Chart 2.2 and the stages of operation are discussed below.

1st Stage: The exporter signs a factoring agreement assigning all trade receivables to an export factor.

2nd Stage: The export factor chooses an FCI correspondent to serve as an import factor in the country where goods are to be shipped. The receivables are then reassigned to the import factor.

3rd Stage: At the same time, the import factor investigates the credit standing of the buyer of the exporter's goods and establishes lines of credit. This allows the buyers to place an order on open account terms without opening letters of credit.

4th Stage: The export factor will now advance up to 80 per cent of the invoice value to the exporter.

5th Stage: Once the sale has taken place, the import factor collects the full invoice value and is responsible for the swift transmission of funds to the export factor who then pays the outstanding balance to the exporter.
CHART 2.2

Export Factoring with FCI

Source: FCI, Brochure on International Factoring Services, The Netherlands.
5. Mechanics of Factoring

A factor is a purchaser of book debts for cash both in the domestic and international factoring. This purchasing business comes to an end after following a mechanism with some steps.

1. Domestic Factoring: In domestic factoring, the mechanics is placed here by dividing into pre-factoring agreement and post-factoring agreement.

1.1. Pre-factoring agreement: A factoring relationship starts with an agreement between a client and a factor. Before entering into an agreement, factor has to ensure that the debts are valid and collectable, and the client is a trustworthy and financially sound party. Moreover, the agreement has to spell out the rights and responsibilities of each of the parties. These pre-agreement formalities follow almost fixed mechanics like Chart 2.3.

1.2. Post-factoring agreement: After entering into a factoring agreement, a client entrusts the factor the works to carry out the credit collection and the sales accounting function in a manner, which will constitute a clear improvement over the pre-factoring situation, and to pay promptly for receivables in accordance with the factoring agreement. A well-established mechanics (Chart 2.4) helps to conduct these functions smoothly.

2. International factoring

Complexities of cross border transactions and difficulties in credit assessment of the foreign buyers make the international business more tough. Factoring services make international business as easy as domestic business with different mechanics. There are different variations of mechanics in international factoring.

2.1. Two factor arrangement.
1) The client approaches the branch office of factoring company directly for preliminary discussion.

2) The branch writes to the client’s principal bank for confidential opinion.

3) Once the client and the factor are convinced about the need for factoring, the factor conducts an in-depth study on the various areas of operations of the client.

4) An offer is made to the client, if the facility is approved, after examining of information and assessment of credit.

5) An agreement is entered into between the factor and the client. The agreement provides for service charge, facilities, warranties, procedures, etc.

6) Thereafter, the factor visits the client and takes over all outstanding debts, feeds the data into computer, and establishes customer lines.
1. Request by seller for credit check on the buyer (customer) whose name and address are furnished to the factor.
2. Factor checks the credit credentials and approves the buyer. For each approved buyer, a credit limit and the period up to which credit can be given are fixed.
3. Clients deliver the goods and / or services on credit and issue invoices with a notice asking to pay to the factor.
4. Seller / client sends the duplicate copies of the invoices to the factor. The invoices are accounted for in the buyer’s account in the factor’s sales ledger.
5. Factor sends the notice of assignment to the buyer.
6. Factor prepays to the client say 80 per cent to 90 per cent of the invoice value.
7. Factor sends a monthly statement of account and follows up if invoices remain unpaid by due date.
8. Customer pays the factor (i.e. collects book debts).
9. Factor makes the balance payment of the invoice to the client.

If, however, the buyer defaults to pay the factor, it would still make the final payment to the seller in case of without recourse factoring.

2.2 Direct export factor.

2.3. Direct import factor.

2.4. Back to back factoring

2.1. Two factor arrangement

It is customary in international factoring to use a two-factor system. Under this system, there is an export factor in the exporters' country and import factor in the importers' country. FCI facilitates linking up of factors in various countries. Any one factoring organisation can act both an export factor and import factor with respect to any other factoring organisation from a different country. The mechanics of the operations of the two-factor system is placed in Chart 2.5.

2.2. Direct export factoring

The direct export factoring is mostly used when handling exports to countries where the corresponding factoring network does not reach. This form of direct export factoring is often provided in combination with outside credit insurance scheme and the traditional services offered by a banking network. Mechanics of direct export factoring are placed in Chart 2.6.

2.3. Direct import factor

Factors in an exporter's country are not sometimes perceived very active in marketing international factoring services. In that case, factors in importers' country offer their services directly to foreign suppliers. The exporter may also establish direct contact with factors in the importing country. The resultant arrangement will be of direct import factoring. The mechanism is placed in Chart 2.7.

2.4. Back to back factoring

This is a highly specialised form of international factoring. It is used when the supplier sells his goods through his subsidiary to the debtors in the import factors' country. This is done to avoid large volumes of
1. The seller delivers goods to his debtors.

2. The seller assigns his accounts receivable through the export factor to the import factor, who assumes the credit risk, provided this had been agreed to beforehand.

3. The export factor pays the agreed advances to the seller.

4. The import factor deals with the accounts receivable in accordance with the sales contracts existing between the seller and the debtor.

5. The debtor pays on the due date to import factor, who transfers the amount to export factor.

6. The export factor settles the advance that had previously been made and remits the balance to the seller.

CHART 2.6

Mechanics of Direct Export Factoring

1) The seller ships the goods to his debtor.
2) The seller assigns his invoices to the export factor.
3) The export factor pays the seller the agreed advance.
4) The export factor handles the accounts receivable in accordance with the sales contract between the seller and the debtor.
5) The debtor pays on the due date to export factor.
6) The export factor settles the advance with the funds received and forwards the balance to the seller.

1) The seller ships the goods to his debtor.

2) The seller assigns his invoices to the import factor, who assumes the credit risk, provided this has been agreed to beforehand.

3) The import factor handles the accounts receivable in accordance with the sales contract between the seller and the debtor.

4) The debtor pays the import factor on the due date.

5) The import factor forwards the payment to the seller, possibly deducting the agent’s commission.

sales to a few debtors for whom it is difficult for the import factor to cover the credit risk. In such a case, import factor can sign a domestic factoring agreement with the debtor. This agreement will facilitate to get debtors' receivables as security for the credit line as it has been asked to establish in favour of export factor. The mechanics of this arrangement are presented in Chart 2.8.

6. Benefits of Factoring

1. Factoring of the commercial debt is a fast growing significant service to the world business community. It is getting popularity at an impressive rate in both the domestic and international trade. Factoring actually goes a long way to help the borrowers to improve their financial discipline and to serve as a catalyst for expansion and growth of industrial and business units. All the advantages of factoring cannot be shown in a discussion of this kind, because different types of companies require different applications of factoring. Even then, an attempt is being made to present the benefits of factoring in Chart 2.9.

2. Advantages of domestic factoring

The domestic factoring dominates the market share in the total factoring business. Benefits derived from domestic factoring have been described here under two contexts namely direct benefits and indirect benefits.

2.1 Direct benefits

The direct benefits that factoring brings are best illustrated as shown in the income statement and balance sheet of a client.
Mechanics of Back to Back Factoring

1) The parent company ships goods to its subsidiary, which sells and ships the goods to the debtors in the import factor’s country.

2) The seller assigns his invoices on the subsidiary via export factor to import factor.

3) The subsidiary assigns its receivables to the import factor with or without credit risk coverage.

4) The export factor pays the parent company the agreed advances.

5) The subsidiary’s debtors pay the import factor.

6) The import factor distributes the funds according to the instructions from the export factor.

Effect on Profit & Loss Appropriation Account / Retained Earnings Statement.

1) Off-balance sheet finance.
2) Reduction of bank borrowings and other current liabilities.
3) Improved liquidity.

Effect on Balance Sheet.

1) Management time and energy saved.
2) Improved efficiency.
3) Higher credit standing.
4) Increased turnover.
5) Better relationship between customers and clients.
6) Expansion of business.

Effect on Profit & Loss Account / Income statement

1) Reduction in administrative expenses.
2) Reduction in bad debts loss.
3) Getting benefits of lower price, trade discount, and cash discount, etc.
4) Reducing the working capital needs.

1) Salary costs.
2) Telephone, stationery, postage
3) Overheads.
4) Cost of services of credit agencies

Benefits of Factoring

Domestic Factoring

1) Reduction in administrative expenses.
2) Reduction in bad debts loss.
3) Getting benefits of lower price, trade discount, and cash discount, etc.
4) Reducing the working capital needs.

Indirect Benefits

1) Management time and energy saved.
2) Improved efficiency.
3) Higher credit standing.
4) Increased turnover.
5) Better relationship between customers and clients.
6) Expansion of business.

International Factoring

1) Flexible form of finance and predictability of cash flows.
2) Healthier customer portfolio.
3) Efficient communication and prompt collection.
4) Maintenance of multi-currency sales ledger.
5) Hedge against foreign exchange fluctuations.
2.1.1. Effects on Income Statement.

The real benefits of factoring get reflected in the income statement. The saving which accrues from the services would enhance the profitability of the firm. The benefits of factoring reflected in income statement can be analyzed in the following ways.

2.1.1.1. Reduction in administration expenses: The factor performs some basic functions like administration of client’s sales ledger, credit control, collection of dues, etc. He can, thus, have the benefit of reduced overheads, on this count by way of saving in salary expenses, stationery, postage, telephone, and overheads of various departments.

2.1.1.2. Reduction in bad debts loss: Under ‘without recourse factoring’, the client’s credit losses are transferred to the factor. The factor makes credit assessment expeditiously. In addition to certain coverage of credit loss, the client is, thus, relieved of expenses of maintaining credit department and of collecting credit information.

2.1.1.3. Getting benefits of lower price, trade discount, and cash discount, etc: Steady and reliable cash flow enables the client to honor its obligation without any delay. Factoring helps the client to get some facilities like taking cash discount for prompt payment and trade discounts for bulk purchases, ordering for materials at the right time and at the right place, executing production schedule as planned, taking longer credit period from suppliers, and having better market standing. These result in reduction of cost of material of the client’s firm.

2.1.1.4. Reducing the working capital needs: Factoring is best applied to the normal trade and production cycle i.e. purchases, stocks, manufacturing, and sales. It helps the client to avoid disruption in the production schedule due to bottlenecks in the smooth flow of critical raw materials, etc. This reduces the operating cycle period, resulting in the reduction of working capital needs. This saves the interest on working capital.
For showing the above points for illustration, a hypothetical income statement is furnished in Table 2.1.

The income statement clearly indicates that overall profitability has increased by the TK. 3,64,600 although Tk. 1,20,000 is paid as factoring commission. This enhancement has resulted from saving on material cost, credit department expenses, interest on advances, and elimination of bad debts.

2.1.2. Effect on Retained Earnings Statement

The savings, as noted above, enable a firm to improve the bottom line of its income statement. The improved profitability enhances the return on investment and improves the retained earnings position. Thus, liberal dividend policy is followed by results in favourably influencing the market value of the firm’s shares.

2.1.3. Effects on Balance Sheet

Factoring involves change in the asset structure of the client’s balance sheet as receivables are converted into cash. The benefits of factoring that get reflected in the balance sheet are discussed below.

2.1.3.1. Off balance sheet finance: The finance provided by the factor in the form of pre-payment against purchased debts is ‘off the balance sheet’. It appears in the balance sheet only as a contingent liability in case of ‘with recourse’ factoring. In case of ‘without recourse’ factoring, it does not appear even as a contingent liability. Since factoring does not appear on the client’s balance sheet as borrowing, it does not impair the client’s ability to borrow from elsewhere.

2.1.3.2. Reduction of bank borrowings and other current liabilities: Funds from the factoring proceeds can appear in the balance sheet in a number of ways. They can be shown by a reduction in the
### TABLE 2.1

**Hypothetical Income Statement**

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Particulars</th>
<th>Before Factoring</th>
<th>After Factoring</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Sales</td>
<td>TK. 60,00,000</td>
<td>TK. 60,00,000</td>
</tr>
<tr>
<td>B</td>
<td>Cost of Goods Sold:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Material Cost</td>
<td>18,00,000</td>
<td>17,55,000&lt;sup&gt;(i)&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Labor Cost</td>
<td>10,00,000</td>
<td>10,00,000</td>
</tr>
<tr>
<td></td>
<td>Factory Expenses</td>
<td>8,00,000</td>
<td>8,00,000</td>
</tr>
<tr>
<td>C</td>
<td>Gross Profit (A-B)</td>
<td>24,00,000</td>
<td>24,45,000</td>
</tr>
<tr>
<td>D</td>
<td>Office, Administrative and Selling Expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Administrative Expenses</td>
<td>3,00,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td></td>
<td>Credit Department Expenses&lt;sup&gt;(ii)&lt;/sup&gt;</td>
<td>1,00,000</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Selling Expenses</td>
<td>8,00,000</td>
<td>8,00,000</td>
</tr>
<tr>
<td></td>
<td>Factoring Commission&lt;sup&gt;(i)&lt;/sup&gt;</td>
<td>-</td>
<td>1,20,000</td>
</tr>
<tr>
<td></td>
<td>Bad Debts&lt;sup&gt;(@ 5%)&lt;/sup&gt;</td>
<td>3,00,000</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Interest on Loan&lt;sup&gt;(iv)&lt;/sup&gt;</td>
<td>1,80,000</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Interest on Advance&lt;sup&gt;(v)&lt;/sup&gt;</td>
<td>-</td>
<td>1,40,400</td>
</tr>
<tr>
<td>E</td>
<td>Net Profit before Tax (C-D)</td>
<td>7,20,000</td>
<td>10,84,600</td>
</tr>
<tr>
<td>F</td>
<td>Net Profit Increased after Factoring</td>
<td>3,64,600</td>
<td>10,84,600</td>
</tr>
</tbody>
</table>

1) It is assumed that material cost is saved by 2.5 percent on account of lower prices, trade discount and cash discount, etc.
2) Credit department expenses will not be incurred due to factoring the debts.
3) Factoring commission is assumed as 2% on sale.
4) Interest on loan = TK.60,00,000 x 2/12 x 18/100 = TK.1,80,000
   It is assumed that: (i) The average receivables of the firm are equal to 2 months sale.
   (ii) Interest on loan and advance = 18% p.a.
5) Interest on advance: amount of advance by the factor x interest rate
   TK.(60,00,000 x 2/12 - Commission on sale @ 2% - 10% Reserve on Average Receivables) x 18%
   = (10,00,000 - 120,000 - 100,000) x 18% = TK. 140,400.

(In the USA, the advances a factor provides are equal to the amount of factoring receivables less the sum of (i) the factoring commission (ii) the reserve that factor requires for bad debt losses.).
bank borrowing or in other current liabilities. Other current liabilities comprise of a) sundry creditors; b) installments payable under term loans / deferred payment guarantees and other long term liabilities; c) statutory liabilities; and d) provisions. The net result is the reduction of current liabilities, other things remaining the same.

2.1.3.3. Improvement in liquidity: Factoring makes qualitative changes on the asset structure of the balance sheet by making it more liquid. The amount tied up in accounts receivable released by factoring can also add to the existing cash balance. The result is a desirable improvement in the client’s liquidity. The cash ratio, calculated by dividing cash balance by current liabilities is, thus, improved from otherwise precarious position.

A hypothetical balance sheet (before and after factoring) is given in Table 2.2 to substantiate the above points.

The analysis of the balance sheet (Table 2.2) clearly reveals that factored debt is not placed here because of ‘Off-balance-sheet’ item. In the case of after factoring (A), creditors are reduced by the amount received against factored debt. Secondly, in case of after factoring (B), amount received against receivables is placed simply under cash. In both the cases, cash ratio, calculated by dividing cash balance by current liabilities, improves from around .08 times to .15 times and .53 times, respectively, without any corresponding increase in any of the liability items or sale of fixed assets.

2.2. Indirect benefit

In addition to these direct benefits as stated above, factoring also offers many incidental and indirect benefits. The following are the incidental and indirect benefits flowing from factoring.
### Hypothetical Balance Sheet

**As on**

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Particulars</th>
<th>Before Factoring (A) TK.</th>
<th>After Factoring (B) TK.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Assets:</td>
<td>Cash: 50,000</td>
<td>316,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Stocks: 270,000</td>
<td>270,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Debtors: 380,000</td>
<td>114,000</td>
</tr>
<tr>
<td></td>
<td>Non-Current Assets:</td>
<td>Debtors (Factor) 30%</td>
<td>210,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total Assets (A+B):</td>
<td>644,000</td>
</tr>
<tr>
<td></td>
<td>Current Liabilities:</td>
<td>Creditors: 210,000</td>
<td>210,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank Overdraft: 910,000</td>
<td>910,000</td>
</tr>
<tr>
<td></td>
<td>Non-Current Liabilities:</td>
<td>Share Capital: 3,50,000</td>
<td>3,50,000</td>
</tr>
<tr>
<td></td>
<td>Shareholders Equity:</td>
<td>Shareholder Equity: 84,000</td>
<td>84,000</td>
</tr>
</tbody>
</table>

**TABLE 2.2**
2.2.1. Management time and energy saved: By shifting the function of credit control, sales ledger administration, and debt collection problem, the client saves time and energy. They can concentrate more on managerial functions like planning, organizing, controlling, etc. Better planning improves quality and marketability of the products, morale of the employees and excellence in the performance.

2.2.2. Improved efficiency: Factoring is designed to place small and medium sized units on the same level of efficiency in the areas of credit control and sales ledger administration like most sophisticated large companies. Factoring does this at a reasonable cost. Moreover, the factor on account of his experience and specialization, advises the firm on critical areas like product design, production method, product mix, marketing mix, machinery replacement, technology, etc. These advices go a long way in improving efficiency.

2.2.3. Higher credit standing: Dandekar (1991, p.128) has mentioned four reasons why a client’s credit standing improves: (a) in the case of ‘without recourse factoring’, the factor’s assumption of credit risk replaces the credit responsibility of the client’s customers of varying credit strength; (b) ‘Without recourse factoring’ also enables the client to minimise bad debts reserve; (c) with cash flow accelerated by factoring, the client is able to meet the liabilities promptly as and when these fall due; and (d) the factor’s acceptance of a client’s receivables for factoring itself speaks well of the quality of his receivables. This can also increase the client’s credit rating because of the client’s higher credit standing with the factor.

2.2.4. Increased turnover: Much important is the opportunity of incremental sales, which can be achieved because of an increased working capital. Moreover, since the factor has access to almost unlimited credit information, the factor may be willing to accept new or higher credit risks over that which the client individually may not be willing to accept.
2.2.5. Relationship between the customer and the client: The relationship could be jeopardized in any possible way. Factoring can enhance this relationship. Since the factor is responsible for accumulating credit data and for collections, the clients' relationship with their customers remains excellent even if the customers are unable to make payments when due.

2.2.6. Expansion of the business: The factor enables a company to get on with its profitable and predictable expansion without the inherent worries of 'where does the next cash come from?' and how do we collect our money to get on with the jobs?

3. Advantages of international factoring

In international factoring, there are always two parties other than the exporter and importer namely the export factor and the import factor. The role of the factoring organisation is likely to alternate between as export factor and import factor, depending on the nature of transactions. The distinct advantages over other methods of finance can be summarised as follows:

3.1. Flexible form of finance and predictability of cash flows: It provides an immediate finance up to a certain percentage of the eligible export receivables. This prepayment facility is available without letters of credit – simply on the strength of the invoices representing shipment of goods. Moreover, bad debt protection upto full extent on all approved sales to identified debtors ensures reliable predictability of cash flows.

3.2. Healthier customer portfolio: The factor checks all the prospective debtors in importing countries. They do it through their own database or by taking assistance from their counterparts in importing countries known as import factors or established credit rating agencies. Hence, the exporter can be sure that he has healthier customers' portfolio.
3.3. Efficient communication and prompt collection: The factors maintain efficient and fast communication with import factors as well as importers. They do this through letters, telex, fax, e-mail and telephone or in person in the buyer’s language and in line with the national business practices. The prompt payment is, thus, handled in a diplomatic and efficient manner.

3.4. Maintenance of multi-currency sales ledger: Factor provides a multi-currency sales ledgering system. It enables local exporters to keep track of their sales in various currencies.

3.5. Hedge against foreign exchange fluctuations: Factor can arrange for appropriate forward exchange covers to protect the exporters against currency fluctuations.

7. Forfaiting and Factoring

1. The term forfait is a French word, which means to give something or give up one's right. Forfaiting refers to non-recourse financing of receivables similar to factoring. While a factor normally purchases a company's short-term receivables, a forfait bank / financial institution purchases trade bills/ promissory notes that are long-term receivables with maximum maturities of eight years (Woelfel 1994,p.491). It is only pertaining to international trade. Forfaiting had originally developed in Switzerland after world war II in response to felt need for financing exports to the Eastern Europe for which financing was not available through the normal banking channels (Gurusamy 1995, p..35). Now, globally, forfaiting volume stands at around US $ 25 billion. It accounts for 4 –5 per cent of the total international trade (Murthy 1997, p.82).

2. Forfaiting is well compared to export factoring with the difference that the former finances notes/ bills arising out of deferred credit transactions for capital goods spread over 3-8 years whereas factoring is essentially a short-term financing deal relating to the export of consumer goods. The forfaiting is a
hundred per cent financing arrangement on non-recourse basis. But the extent of advance against receivables with a factoring arrangement is only partial, ranging between 75-85 per cent on recourse or without recourse basis. The forfaiter’s decision to provide financing depends upon the financial standing of the availing bank whereas factor’s decision, particularly in non-recourse, depends on the credit standing of the exporter. Moreover, cost of forfaiting is eventually borne by the overseas buyer whereas in case of factoring it is usually borne by the seller.

3. The mechanics of operation of forfaiting are presented and discussed in Chart 2.10.

4. The benefits accruing to the exporter are numerous. The exporter receives the full export value minus the cost of forfaiting for credit transactions from the forfaiter. With forfaiting, the exporter can easily avail credit periods of 4-7 years (Murthy 1997, p.23). The finance is provided without recourse. This means that the fluctuations in interest rates and exchange rates do not matter during the commitment period. The exporter has, therefore, an assurance of receiving payment notwithstanding the risks regarding the buyer, the buyers’ bank and the buyer’s country. The exporter’s botherations about administering the sales ledger and collection of payments are also taken over by the forfaiter. This gives considerable relief to exporters. Moreover, the forfaiter does not insist on getting credit insurance from official agencies.

5. Forfaiting concludes the deal for the medium and large export contract. The international forfaiting agencies do not accept contracts to forfait bills less than 0.5 million US dollars on a single deal (Masarguppi 1994, p.16). It is mostly limited to capital goods. It is estimated that 80 to 85 per cent of the forfaiting market today involves the capital goods exporting (Mohanty 1993, p.2). However, with growing exports, products like commodities, leather, dyes, etc. are also coming under the forfaiting umbrella. Forfaiting can be used when Government export credits or credit guarantees are not available. Woelfel (1994, p.492) notes that forfaiting is an important method of financing for small and medium
Mechanics of Forfaiting Transactions

1) Commercial contract between the exporter and the importer.
2) Commitment to forfait bills of exchange / promissory notes (Debt instruments).
3) Delivery of goods by the exporter to the importer.
4) Delivery of debt instruments.
5) Endorsement of debt instruments without recourse in favour of the forfaitee.
6) Cash payment of discounted debt instruments.
7) Presentation of debt instruments on maturity.
8) Payment of debt instruments on maturity.

sized companies because it enables them to negotiate transactions that normally exceed their financial capabilities.

6. Forfaiters are quite active in Paris, Geneva, Vienna, Brussels, etc (Gurusamy1995, p.35). In India, the EXIM bank has already received green signal from the RBI to facilitate export financing through forfaiting. Moreover, Hong Kong Bank, Meghraj Financial Services, Natwest Bank, Indo Aval and ABN AMRO Bank offer forfaiting services (Murthy1997, p.83). According to their annual reports, they have already facilitated forfaiting services for commercial vehicles, printed cotton fabrics, mechanical power transmission, gems, etc. In Bangladesh, forfaiting is yet to catch up. The main reasons may be lack of awareness among the exporting community, and little volume and low amount of capital goods export. Moreover, neither Government nor banks have taken any step to launch this export-promoting tool.

7. For forfaiting to be successful, existence of the secondary market is an essential condition. A forfafter may not be inclined to hold the discounted bills / notes upto maturity because of its own cash flow consideration. In the secondary market, forfaiters buy and sell these bills in the usual manner in which the traditional securities are traded. However, every transaction in the secondary market is done on without recourse basis. In that case, the holder of the paper (forfafterd bill) can go only to the original guarantor (the bank) and not to the previous forfait owner, or to the exporter.

8. Bill Discounting and Factoring

1. Bills discounting/ invoice discounting is a means whereby firms with short-term cash problem can improve liquidity by obtaining cash against bills / invoices, commonly up to 80 per cent of value of the accounts receivable. Here, the accounts receivable are pledged to the financing institutions, the customers are not notified of this transfer, and the business concerns collect the amount from customers and turn over to the lender all amounts which they receive on the pledged accounts receivable. To the business
concern where requirements are exclusively of financial nature and who is either not eligible for banks’ loan or can obtain it in only limited amounts, bill discounting might well prove to be the most desirable method of financing to employ.

2. Factoring is somewhat similar to bills discounting in the sense that both these services provide short-term finance. Both of them discount accounts receivable, which the clients would have otherwise received from the buyer at the end of the credit period. However, these two receivables financing arrangements also differ in important respects, which are illustrated in Table 2.3.

3. Despite growth of factoring, some people still feel that there is a requirement for bills discounting. The prime advantages are:

3.1. Confidentiality: Bills discounting avoids the notification to the customers. The client’s customer remains unaware of the presence of an invoice discounter.

3.2. Flexibility: The client can look after his own sales ledger, and select suitable invoices for discounting only when funds position necessitates this action.

3.3. Costs: The client incurs charges only when the invoices are discounted to obtain finance. The policy is ‘no payment – no charge’.

9. EDIFACToring

1. EDIFACT (Electronic Data Interchange for Administration, Commerce and Transport) is a universal set of standards and guidelines for communication by electronic data interchange. It was organized in 1985 as a result of cooperation between the North American and European standards organisations. EDIFACT is adopted by the United Nations Organisation as the preferred method of EDI (Electronic Data Interchange) and it is the only true, worldwide, open global communication standard, and available in any part of the world to the organisation, which wishes to use it. Anticipating the widespread use of
### TABLE 2.3

**Major Difference between Factoring and Bills Discounting**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Factoring</th>
<th>Invoice Discounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client’s entire turnover affected?</td>
<td>Usually yes, except for cash transactions.</td>
<td>No, clients and banks negotiate as to which invoices to be discounted.</td>
</tr>
<tr>
<td>Clients allowed to administer own sales ledger?</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Clients’ customers aware of presence of factors/ discounters?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Bad debts responsibility of factors/ discounters?</td>
<td>Usually</td>
<td>No</td>
</tr>
<tr>
<td>Maximum cash advance against invoices?</td>
<td>80%</td>
<td>80%</td>
</tr>
<tr>
<td>Financing charge?</td>
<td>2% - 4% over banks’ or finance houses’ association base rate.</td>
<td>3%-5% over banks’ or finance houses’ association base rate.</td>
</tr>
<tr>
<td>Service Charge?</td>
<td>0.75 - 2.5 % of sales turnover</td>
<td>Not usually</td>
</tr>
<tr>
<td>Minimum annual charge?</td>
<td>Usually</td>
<td>No</td>
</tr>
</tbody>
</table>
EDIFACT, FCI decided in 1990 to monitor closely the trends in trade information exchanges so that the factors could continue to handle information in an optimal manner in the coming paperless environment. Thus, the EDIFACToring project was born (Deolalkar 1997, p. 16). It links with correspondent factors across the globe through satellite. The scope of EDIFACToring covers factoring communications at large: domestic factoring, international factoring, factors, sellers, debtors and banks. In India, SBI Factors and Commercial Services Limited, and Foremost Factors Limited have adopted EDIFACToring system (Foreign Trade-trends and Tidings 1998, p. 22).

2. By adopting the EDIFACToring system, factors gain both in the domestic and international factoring markets. Factors make the communication standards and guidelines available to their clients and help them to implement the EDIFACT environment in their organisations. That, in turn, is able to approach large purchasing organisations and become more competitive in their pricing by cutting administration and organisation costs. Moreover, in an environment where sellers and buyers exchange their communications by standard EDIFACT message (purchase order, invoice, payment and remittance), it is unthinkable for a factor to request for paper invoices.

3. Business features of EDIFACToring

The business features of EDIFACToring include the following:

3.1. All messages of EDIFACToring are customized for sending and receiving all factoring transactions.

3.2. EDIFACToring system includes gateways to all important private and public telecommunication networks and includes most of the common communications protocols. This feature allows each member of FCI to select the most appropriate network with each partner, based on consideration of cost, network
availability, and national standards. Moreover, there is no need for additional investment in communication software, irrespective of the network or protocol selected each time.

3.3. With regard to FCI inter factor communications, one network is selected in order to make use of the central message switching function and of a common audit and back-up facility. Maximum operating and cost efficiency can, thus, be achieved.

3.4. For members located in countries not yet covered by the selected network (if any) or where the telecommunications infrastructure is not yet reliable, and for members with little volume of two factor business, the new system includes the possibility to write data to and read data from a diskette which can be sent by mail or courier services.

3.5. The EDIFACToring system can be used as a stand-alone PC application or interfaced with the mainframe system application. The flexibility allows each user to adopt the solution most suitable to his business volume, to his internal organization, and to the sophistication of his mainframe application.

10. Documentation Involved in Factoring Arrangement

The main documents that are executed in a factoring arrangement are as under:

1. Factoring agreement

The master factoring agreement is normally executed between a client and a factor. It spells out the legal obligations, rights and responsibilities of the parties, and procedural arrangement. This agreement can be of three types. The main difference between the three types of agreement is in relation to the time of passing of the ownership right to the factor.
(i) Offer and acceptance;
(ii) Facultative type; and
(iii) Whole turnover type.

Under ‘offer and acceptance’, the client makes the offer of sale of debts (Receivables) through an invoice. The moment the same is accepted by the factor, the trade debts pass on to him. Each invoice offered and accepted matures into a specific contract.

There is no formal acceptance of debt by the factor in ‘facultative type’ of agreement. If he does not expressly reject a debt offered, acceptance is considered to have taken place and the debt vests in the factor.

In ‘whole turnover agreement’, all the debts remain vested with the factor after execution of the agreement. However, by inclusion of certain covenants in the agreement, the factor reserves his right to make prepayment only against the approved debts. The ‘whole turnover agreement’ is the most appropriate and convenient mechanism from a prudent financial and operational angle.

2. Letter of waiver

This is a very important legal and operational document. The client company may already be enjoying credit facilities from a bank and the entire movable and immovable assets - both existing and future including receivables/trade debts—are charged to it. Since after execution of the factoring agreement, the
ownerships of trade debts vests with the factors, obtaining of a 'letter of waiver' from the financing bank is necessary. The financing bank relinquishes its rights/set off/ lien/ charge over trade debts.

3. Deed of guarantee

The factor procures personal guarantees of the directors, partners, and other persons in a form acceptable to him. The factor normally grants factoring facilities at the request of the guarantors.

4. Agreement of hypothecation of book-debts and other assets

The factor creates charge by way of hypothecation and/or pledge over the client's goods, debts and assets in favour of the factor. It is agreed and declared that all present and future book debts of the clients shall stand assigned to the factor by way of first charge. The factor can also waive assignment in its sole discretion or at the specific request of the client.

5. Submission of annual accounts

The client supplies to the factor a copy of the financial statements including annual audited balance sheet and accounts, and the directors' report before the expiration of six months from the end of the accounting year. The client also allows the factor to access record/files for examining transactions/entries, inspecting, and making extracts from his books and records.
6. Registration by an appropriate authority

In order to remove the confusion and the probable risk of double financing in future, it is appropriate to file the notice of agreement between the factor and his client for recording in a central register to be maintained by an appropriate statutory authority. The Uniform Commercial Code (UCC) in the USA, registers any document denoting public interest. In India, loan agreements of any kind are filed with the Registrar of Companies, when the organisation happens to be ‘limited liability company’.

7. Notification letter

It is necessary to intimate the debtors regarding change (introduced by factoring arrangement) whereby all future payments of trade debts are to be made to the factor.

8. Resolution

The board of directors of a client company is the authority for deciding to enter into a factoring agreement. Necessary resolutions are passed in ‘board meeting’ for the purpose. Resolutions regarding the following matters are necessarily required to be passed by the board of directors.

8.1. Entering into a factoring arrangement.

8.2. Execution of documents on behalf of the company along with names and designations of the persons authorized to execute the factoring agreement with the common seal.

1. In case of two assignments of debts giving rise to double financing, problems arise regarding knowledge about assignments of debts both for the debtors and the subsequent assignees.
11. References


2. Deolalkar, G.H. (1997), 'Electronic Data Interchange (EDI)' (paper presented in a workshop on 'factoring services' held in NIBM in collaboration with the SIDBI, February 7 - 8).


