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CREDIT FACTORING AND BILL DISCOUNTING

"Factoring is both a financial technique and a management service. It is a method of converting a passive asset into an active agent of commercial growth. In part, it is an answer to the increasing complexity and specialization of modern business. Developing as a response to such influences, factoring, together with other new financial techniques such as leasing, has established itself as an important tool for the husbanding of scarce resources."

— Melvyn Westlake

1. MEANING OF FACTORING

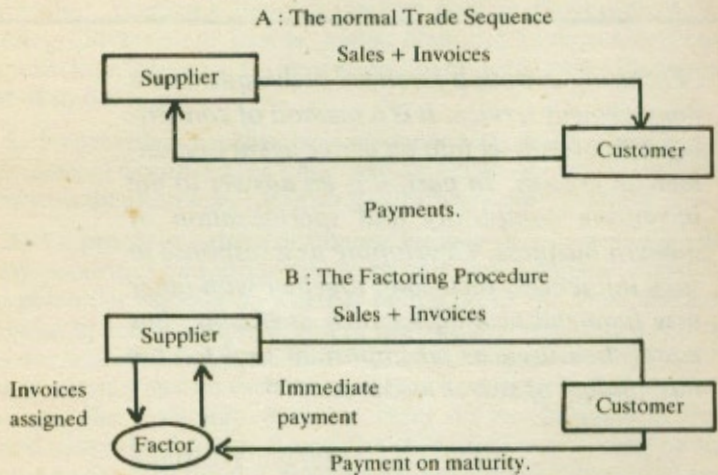
The term factor comes from the Latin Verb '*facere*' which means 'to make' or 'to do'. Literally, therefore, factor is an agent who gets things done on behalf of others. Accordingly, for years, the term factor has been used as referring to a mercantile agent who gets things done on behalf of some agent, either disclosed or undisclosed. This has been the legal interpretation of the term factor,¹ who is one of the two main classes of mercantile agents, the other being the broker. The only distinction between a broker and a factor is that the latter often sells the goods in his own name and is put in possession of the goods, and also enjoys a lien on the goods.

However, when used as "credit factoring" or simply "factoring", implying a specialised financial service, we lift the traditional form of factoring from the operating levels and put him as a specialised financier who is not concerned with the selling of goods, but only with collection of debts on

1. Halsbury's *Laws of England* (3rd edn. para 362) defines a factor as a mercantile agent who in the ordinary course of business is entrusted with the possession of goods or the documents of title thereto for the purpose of sale.

behalf of others and financing based upon accounts receivables. In the development, factoring is an asset based means of financing as well as a specialised service, being the purchase of book debts of a company by a factor, thus releasing the capital tied-up in accounts receivables and providing a financial accommodation to the company. The book debts are assigned to the factor and it is he who collects them as and when due. The charge for this service is in the form of a discount or rebate deducted from the bill. Thus, between the supplier and the customer there enters an intermediary who performs a financing service as well as the service of debt-collection. The diagram below provides an easy manifestation of this relation :

Diagram : The factor as a specialised Intermediary.



Biscoe² has thus defined credit factoring :

“Credit factoring may be defined as a continuing legal relationship between a financial institution (the “factor”) and a business concern (the “client”) selling goods or providing services to trade customers (the “customers”) whereby the factor purchases the client’s book debts either with or without recourse to the client, and in relation thereto controls the credit extended to customers and administers the sales ledger”.

What is central to the function of a factor is the purchase of the client’s book debts. With this he performs four basic services :

1. PROVISION OF FINANCE.
2. ABSORPTION OF THE RISK OF BAD DEBTS.
3. COLLECTION OF DEBTS.
4. ADMINISTRATION OF THE CLIENT’S SALES LEDGER.

The factor may render either all the above four services or various combinations of them depending upon the terms agreed upon. Provision of finance is normally the basic service which brings factoring into being. Ho

2. Biscoe, P. M: *Law and Practice of Credit Factoring*, (1975). P:3.

ever, the factor may not absorb the risk of bad-debts, as he may discount the bills subject to the term of "recourse", that is, reverting back to the client should the customer fail to pay the bills. Similarly, the collection and accounting functions may also be left to the client.

All the above services can be provided separately by different agencies. Finance may be provided on security of accounts receivables by banks and other financiers. Risk involved in bad debts may be absorbed by insurers. Debt-collection function may be assigned to common collection agencies (common abroad, though not yet developed in our country), and computer agencies may administer the sales ledger. "But the factor uniquely brings all those services together in one package. The actual purchase of trade debts—as opposed to their use as collateral—is also singular to factoring. This is because the factoring formula resolves the legal ambiguities inherent in the purchase of trade debts."³

2. FACTORING AND BILL-DISCOUNTING

Factoring and bill-discounting have a thin, though perceptible, line of distinction which is blurred quite often in parlance. Bill discounting, called in USA as "*receivables financing*" or "*invoice discounting*", is a mere financial function on a one-off basis. The factor not only provides additional services mentioned earlier, but also often purchases the client's entire turnover. In form, an invoice discounting agreement resembles a factoring agreement in that the financier purchases the debts and the client makes much the same warranties concerning their validity and enforceability.

However, the similarity goes little further. The main differences between invoice discounting and factoring are as under :

- (a) In a bill-discounting agreement, the purchase of bills is always with recourse to the clients, while factoring may be both recourse and non-recourse (*see later*).
- (b) In bill-discounting practice, notice of assignment of the bills is not given to the customers, although the financier reserves the right to give notice in cases of risk.
- (c) In bill-discounting, it is the client who collects the bills and remits the proceeds to the financier. The factor himself renders the service of bill collection.
- (d) The bill-discounting agreement is purely financial. The financier provides no non-financial services. A factoring is a service agreement as well as a financing agreement.

3. TYPES OF FACTORING ARRANGEMENTS

3.1 Recourse and non-recourse factoring

In non-recourse factoring, also called "*old-line*" factoring, the factor

3. Westlake, M : *Factoring*, (1975) P. 2.

has no recourse to the client in the event of non-payment of the bill by the customer. The factor thus assumes the risk of bad debts. However, the risk absorbed by the factor is only credit-risk. That is, if the customer fails to pay the bills for any reason other than financial incapacity, the factor does have a recourse to the client.

In recourse factoring, although the debt is assigned to the factor, the credit risk still remains with the client. This is afforded by keeping a recourse provision permitting the factor to take recourse against the client in the event of non-payment by the client.

The only difference between recourse factoring and bill discounting is the non-financial services rendered by the factor. Apart from this, since the credit-risk is with the client both in recourse factoring and bill-discounting, the two almost resemble, and therefore, recourse factoring is often said to be a specie of bill-discounting rather than of factoring.

3.2 Advance factoring and maturity factoring

Like the variation of the absorption of risk element, the factor may also vary the financing involvement. He may agree to pay to the client for the bills purchased by him either immediately or on maturity or collection. "Maturity" date is an agreed-upon period after which the factor makes the payment of the bills to the client. When the factor makes immediate payment to the client, it is called "advance" factoring and the other case is called "maturity" factoring.

In advance factoring, the factor provides financial accommodation apart from the non-financial services rendered by him. Advance payments normally range up to 80% of the invoice value. The balance is known as the *client's equity* or the *factor's reserve* and is payable on maturity or on actual collection.

Maturity financing is more uncommon. It is mostly resorted to by such of the clients who have substantial capital build-up and are interested only in the non-financial services offered by the factor.

3.3 Bank participation factoring

In a bank participation factoring, the bank takes a floating charge over the *client's equity*, that is, the amount that the factor has yet to pay to the client, which is obviously a transformed receivable for the client. On the basis of this floating charge, the bank agrees to lend an amount to the client. The client, thus, has a double financing.

It may be doubted as to what could be the purpose of the bank financing on the basis of the client's equity; the bank could finance directly on an assignment of the client's debts. However, it may be noted that the arrangement of bank participation in factoring enables the bank to finance more than what should otherwise have been possible. This is because the bank is, in the latter case, lending on the basis of the factor's credit strength and because of the fact that the factor is policing the accounts receivables of the client through effective administration and monitoring.

3.4 Supplier guarantee factoring

Supplier guarantee-factoring, also known as *drop shipment* factoring, occurs when the client is a mediator between the supplier and the customers. For example, the client who is distributor or wholesaler, in such a case, the factor guarantees to the supplier against the invoices raised by the supplier upon the client. The goods may be delivered directly to the customers. The client thereafter raises bills on the customers and assigns them to the factor. The factor has thus enabled the client to make a gross profit with no financial involvement at all.

3.5 Confidential factoring

When the fact of a factoring arrangement is kept confidential, and the client himself collects the bills without intimating to the customers that the bills have been assigned to the factor, it is a case of confidential factoring. The considerations for choosing this form of factoring may be many.

4. BENEFITS OF FACTORING

The vast significance and immense potentialities of factoring need hardly be stressed. Any businessman by sheer instinct may understand how the irregular and not-wholly warranted expansion in trade credit has resulted into bulging working capital requirements. Further, indiscipline in the trade credit market has made the collection department's job as difficult as of public enforcement agencies. It was against this backdrop that the Tandon Committee⁴ recommended the creation of a *Bill market* in the country by developing the habit of bill discounting among the commercial banks. While commercial banks can be pioneers in the field of factoring as in bill discounting the procedural snags and slackness which experience has associated with this sector of the finance market has reinforced the necessity of private sector factoring firms.

In words of Westlake,⁵ "in a mature industrialised society there are many ways by which an enterprising company can raise capital, but each has its price, which may in some cases, be geared to ultimate use of the funds. For its part, factoring offers a distinct solution to the problems posed by capital tied-up in trade debts. When money is outstanding for 60 or 80 days this means either that more capital is deployed in the business than would be dictated simply by the production cycle, or that expansion is being retarded because insufficient funds are left for production".

The services rendered by a factor may be classified under two heads—financial and non-financial. The non-financial services include the real operational services provided by the factor. The financial services indicate the benefits which are likely to accrue to the client as a result of the release of the capital tied-up in accounts receivables.

4. Study Group to Frame Guidelines for Follow-up of Bank Credit.

5. Westlake, M: *op. cit.* P. 2.

4.1 Financial benefits

1. Improves current ratio : The amount tied up in accounts receivables released by factoring may be used to pay-off the current liabilities. This may have the effect of improving the current ratio position of the client. An example shall illustrate this :

Balance-Sheet before factoring

Current Liabilities:			Current Assets:		
			Cash	..	10,000
Sundry Creditors	..	80,000	Debtors	..	1,00,000
Other Liabilities	..	20,000	Stock in trade	..	50,000
		<u>1,00,000</u>			<u>1,60,000</u>

Current Ratio = 1.6 : 1

Balance-Sheet after factoring

Current Liabilities:			Current Assets:		
Sundry Creditors	..	Nil	Cash	..	10,000
Other liabilities	..	20,000	Due from factor	..	20,000
		<u>20,000</u>	Stock-in-Trade	..	50,000
		<u>20,000</u>			<u>80,000</u>

Current Ratio = 4 : 1

In the above example, the client has simply discounted the accounts receivable of Rs. 1,00,000 at 80% and used the proceeds to pay off the creditors. This has had a dramatic effect on the current ratio.

2. Prompt payments and improved credit standing : With the accelerated cash-flows *via* factoring, the client is in a position to avail of prompt payment discounts from suppliers. It may be noted that prompt payment discounts often have a return in terms of interest of as much as 36%. Promptness in making payments also increases the market credit of the firm.

3. Elimination of discounts paid : With factoring facility the client shall be in position to provide credit to its customers and thus eliminate the discounts paid to them at the same time increasing its own returns.

4. Accelerating expansion : The cash flows released from the accounts can be deployed in fresh expansion plans.

5. Increases operating leverage⁶: By relasing the funds tied in operating assets, the factoring mechanism facilitates more investments in fixed assets,

6. For meaning of the term, see Chapter 10 in Part I.

thus increasing the degree of operating leverage.

6. Avoids increased debt : As a result of factoring the firm is able to raise short-term funds out of its own assets. This avoids the necessity to knock at the doors of lenders.

7. Increases return on capital : Factoring increases the return on capital, if the general returns in the business are more than the service charges paid to the factor. This may be understood by the simple reason that with the finance provided by the factor, the client shall be able to do more business, which can again be factored. This increases the volume of business. Thus, net gains accrue to the client if his general business returns are more than the cost of factoring.

8. Flexibility and free from legal problems : Factoring is a remarkably flexible form of financing and is tied directly to sales. There are no constraints to the extent of factoring facility used. There are no legal constraints either, both for the giver and the taker. Recently, the Dept. of Company Affairs has issued a clarification indicating that inter-corporate deposits shall be covered within the scope of sec. 370 of the Companies Act. This has made difficult for companies to lend to other companies. FACTORING MAY PROVIDE A VERY EASY AND CONVENIENT AND ALSO SECURED ALTERNATIVE FOR INTER-CORPORATE DEPOSITS, AS THE AMOUNT PROVIDED ON DISCOUNTING OF BILLS IS NEITHER A LOAN NOR A DEPOSIT.

4.2 Non-financial benefits

1. Credit security : "The ugly cloud of bad-debt losses hovers over every business trading on credit threatening a deluge in which it may either drown or emerge severely sodden. Many would say that herein lies the most important benefit of factoring; it is a dam guarding a client from the flood through effective credit control, and, in the case of old-line factoring where the factor assumes the credit risk, it is a lifeboat carrying the client to safety should the dam of preventive measure burst."⁷

2. Effective administration of sales journal : On assignment of the book debts to the factor, the sales journal shall be administered by the factor. In businesses where there are number of customers, the administration of sales ledger takes a lot of attention. This saves the client time who may devote more attention to production and other functional areas.

3. Credit discipline : The factor's professional approach in collection of debts inculcates a discipline among the customers which becomes the client's permanent asset.

5. EMERGENCE OF THE CREDIT FACTOR

The emergence of the credit factor was from its parent *specie*—the agent factor which exists even today in quite common practice. It is said that it was in America by the end of the 19th century that for several reasons the

7. Biscoe, P. M : *op. cit.*, P. 11.

business of agent factoring (commission agency) sharply declined. The erstwhile factor changed from mercantile agency to merely financing against receivables. It is said that in 1889, the New York agent factors, Oelbermann Donmerick & Co. was the first to drop its selling and storage functions and to continue merely the financing function. Factors were traditionally associated primarily with the textile industry. Even the newly developed breed of credit factors remained associated with textile industry only.

In 1904, the first accounts receivables financing company was formed in Chicago making loans on assigned accounts. Till this time factoring had extended beyond the textile industry only very timidly. But in the great depression of 1930's, the textile industry was greatly crushed, thereby forcing the excursion of the factors to wider pastures.

In 1963, the Controller of Currency gave the ruling permitting commercial banks to enter into factoring. This led to the entry of commercial banks, and by 1970, the turnover of total business transacted by the factors had reached about \$ 12000 million.

In England, Germany, Australia, New Zealand, Israel, Japan, South Africa, Philippines, Hongkong, Singapore, etc., factoring got established between 1970 to 1975. In England, factoring is today a rather prospering business.

In India, while bill-discounting has existed with commercial banks and local financiers all along, factoring as such, has begun only in the recent wake of financial companies. Only some of the financial companies have announced plans to carry on factoring business, but what is being transacted currently is mostly a bill-discounting on one-off basis. Non-recourse factoring hardly exists at all. However, as credit needs grow, the necessity to develop more and more asset-based financing instruments becomes felt. FACTORING IN INDIA HAS AN UNLIMITED AND UNTAPPED SCOPE, NOT ONLY FOR THE BANKERS, BUT ALSO FOR THE SPECIALISED FINANCIAL INSTITUTIONS, PARTICULARLY THOSE WHO ALREADY HAVE TAX-SHELTER FROM ACTIVITIES LIKE LEASING. LOOKED FROM A MACRO-ECONOMIC STANDPOINT, THE DEVELOPMENT OF FACTORING SHALL BE ONE STEP FORWARD TOWARDS THE FINANCIAL SPECIALISATION AND WILL BE CRUCIAL IN BRINGING OUT OF TEXT-BOOKS THE RARER SKILLS OF SPECIALISED CREDIT ANALYSIS. Plus, what is very significant as envisaged by the Tandon Committee, is a credit discipline in the market, which is as of now very peculiarly absent.

6. THE LEGAL ASPECTS

Legally speaking, a factor is like any other trader who buys receivables. The legal relations between the factor and his client shall be governed by a factoring agreement⁸ (often called *master agreement*), which regulates the terms upon which the factor will purchase receivables due to the client from those to whom he supplies goods or services. Receivables which the factor is prepared to purchase on a non-recourse basis are termed approved receivables. These denote receivables arising from transactions specifically

8. A model agreement is given in Appendix to this Chapter.

approved by the factor or falling within a credit limit authorised by the factor to be given out to a particular customer. Unapproved receivables in so far as purchased by the factor are taken with recourse to the client if the relevant customers default.

The factoring agreement has the following main contents :

1. An undertaking by the client to sell its accounts receivables and agreement by the factor to take the same.
2. The client warrants that the debts are valid, enforceable, undisputed and recoverable. This is to avoid the problems of disputes, damages deductions, etc., from bills, which if arise, shall have to be settled by the client.
3. In case the agreement is non-recourse, the client undertakes the risk of bad debts. In case of unapproved receivables, a right of recourse is usually kept.
4. Stipulation that the client shall serve a notice of assignment in a required form to be sent to the customers. Such a notice is also usually stamped on the invoices.
5. A stipulation that invoices, credit notes, receipts, etc., are to be sent to the factor.
6. Period of agreement and mode of its termination.
7. A clause giving the factor power of attorney to assign the debts further, and to draw negotiable instruments in respect of the debts.
8. Accounting and administrative matters are also mostly set out for convenience.

In respect of accounts which have already been assigned to the factor, sometimes the customers pay directly to the client. Most factoring agreements clearly stipulate that such mistaken payments shall belong to the factor, but even without such provision, it has been held in *International Factors Ltd. v. Rodriguez*⁹ that it is clear that the client is a trustee for the factor as to cheques and money so received. If the client wrongfully retains or deals with them in defiance of the factor's title, it commits a conversion and is liable for the face value of any cheque so converted. On the other hand, the customer is not discharged of his obligation to pay to the factor, which arises immediately after the notice of assignment has been served on him.¹⁰

As between the factor and the customers the factor as an assignee of the debt stands on the same footing as the original client. Thus, if the goods or services supplied by the client are not in conformity with the contract, the customer may assert against the factor the same defences as he would have had against the client.

The purchase of bills or book debts at a discount is not lending of money, even where the seller gives a collateral security which has the effect

9. 1979 1 All E.R. 17.

10. *Brice v. Bannister*, (1878) 3 Q B D 56

of making him personally liable for the amount raised.¹¹

Thus, the factoring company is not hit by the provisions of section 370 and the client is not hit by section 58A or 125 of the Companies Act, 1956.

11. *Olds Discount Co. Ltd. v. John Playfair Ltd.* (1938) 3 All E.R. 275.