IRJC
International Journal of Marketing, Financial Services & Management Research
Vol.1 Issue 10, October 2012, ISSN 2277 3622

THE CONCEPTUAL FRAMEWORK OF FACTORING ON SMALL AND MEDIUM ENTERPRISES

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ABSTRACT

Factoring is a financial tool, which allows you to immediately get money against your credit sales instead of waiting for it to mature. It is a process followed down from hundreds of years ago and now modified to suit various types of industries. This paper explains the conceptual framework of factoring, basics of factoring, Advantages & Disadvantages of factoring, mechanism of factoring and the cause and effect of factoring on Small and Medium Enterprises.

KEYWORDS: Factoring, SME, mechanics of factoring.

INTRODUCTION

WHAT IS FACTORING AND HOW IT BENEFITS BUSINESSES?

Factoring is a financial tool, which allows you to immediately get money against your credit sales instead of waiting for it to mature. It is a process followed down from hundreds of years ago and now modified to suit various types of industries.

Basically, factoring means selling your credit invoices to a third party, called a factoring company and getting immediate payment against that invoice. The factoring company pays you the invoice amount in 2 installments. The first installment is about 60 to 90 percent of the invoice value and is posted electronically to your bank account with one or two days, and the second installment, minus the factoring company's fee is paid to you when your customer pays the invoice amount.

This fee is normally 1.5 to 5 percent of the invoice value and normally depends on factors such as your customers' credit rating with the factoring company, the number of credit days as mentioned on the invoice and the total value of business you give to the factoring company. In addition, factoring companies can also take care of your payment collection from your customers.

Factoring therefore is a boon for your business, if you have mostly credit sales to a wide range of customers. It not only improves your cash flow dramatically, enabling you to use that money for staff salaries, payments to your suppliers or even to buy in bulk quantities, but also frees up your collection staff which you can re-direct to some other department. It also frees you from the hassles of payment collection and worrying about customers not paying on time. The factoring company will give you regular updated statements of payments collected by them and the pending receivables statement.

Factoring is directly linked to your sales and hence is much better than trying to avail a bank loan, which might involve submission of many documents and collateral or guarantees and you will still have to pay interest on that loan. Through factoring, it is now possible to go in for a big order given by your customer, which previously would have locked your money. You can also make bulk purchases with the money received enabling you to get extra discount, which can be used to increase your sales and profit margins. So it is a win-win situation for you.

However, you should note that factoring is suitable only if you have a minimum of 15 percent of gross margin on your sales and that the credit period offered to your customers is not very high. Calculate your profit margin after deducting the factoring company's charges so that you can decide whether it is viable financially to employ their services. Also, since your customers will have to be informed about your arrangement with the factoring company, some of them might not be comfortable of making payments to third parties.

There are various types of factoring facilities available such as invoice factoring, purchase order factoring, etc. which have different percentage of charges. You can find different factoring companies advertising on the internet. You can even hire the services of a factoring broker to find you the right factoring company to match your needs. It normally takes a week or two to set it up. So, go in for factoring and watch your bottom line and sales improve. It's easier than it sounds.

To lend to businesses, particularly SMEs and those without a long financial track record to demonstrate their stability. Many are looking for alternative ways to ensure there is always enough money in the bank to pay suppliers and staff, buy new stock and meet all the other overheads which running a business entails.

Small business factoring is one of the most popular methods of achieving this and one which is gaining more and more popularity with businesses in virtually every sector.

HOW SMALL BUSINESS FACTORING WORKS

In its simplest terms, small business factoring involves a company selling its outstanding invoices to a factor who will give the company up to 95% of their value straight away. It then becomes the factor's responsibility to pursue full payment of each invoice from the company's customers. As each one is settled, the factor pays the outstanding balance minus the fee and interest charges it makes for each invoice. When looking for potential factors to get a quotation it can be a good idea to go via an independent broker like Touch Financial who can give you a range of options free of charge.

THE HISTORY OF FACTORING

Factoring is one of the oldest forms of commercial finance. Some scholars trace its origins to the Roman Empire (Rutberg 1994)– -and some even further back to the Hammurabi, four thousand years ago (Papadimitriou, Phillips, and Wray 1994). The term factor comes from the Latin verb facio, which means "he who does things." As the Latin verb suggests, the history of factoring is the history of agents doing things for others.

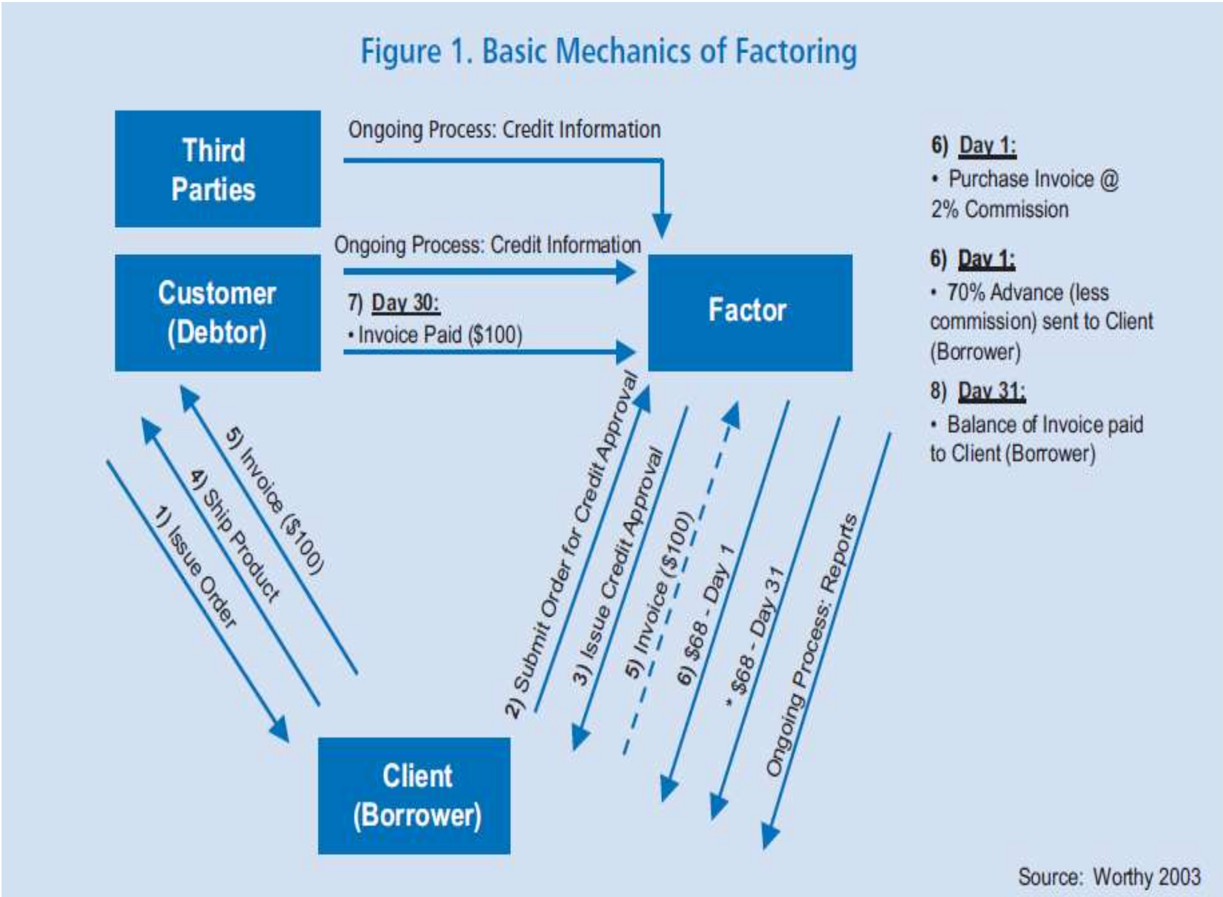
For example, factoring was a well-developed activity in England in the 14th century, where it evolved with the growth of the wool industry.

The job of factors centered on their functions as sales agents, or commission merchants, for textile mills. The distances between customers and manufacturers made commerce problematic—given the primitive forms of transportation and communication—so factors assumed complementary functions to address the business challenges that arose because of these distances.

At the center of these functions was the factors' role as the sales force for the textile mills. As a byproduct of this activity, factors assumed other marketing and distribution functions, including offering advice on customer tastes, product demand, and warehousing services– -so that mills could ship merchandise to the factors, who would then ship to the final customers.

Factors also assumed some critical financial functions on behalf of the mills. They offered credit advice on how much to sell on account to potential customers. They also guaranteed payments to the mills, assuming full responsibility for the creditworthiness of the mills' customers. To protect themselves, factors established reserves to cover claims for defective merchandise and any disputes that arose out of those claims. Finally, and equally important from an historical perspective, factors advanced funding to the mills based on the value of the merchandise sold.

Thus, in essence, factoring was fully reflected economically in the financial component of the factoring business as it existed 600 years ago. The difference between today and 600 years ago is that the sales, or "agenting," component has been purged from the factoring relationship. But factoring as it is typically practiced in both developed and developing economies can still be viewed as a bundle of activities. In addition to financing, factors typically provide their clients with two other services: credit and collections.



THE ADVANTAGES OF FACTORING

There are a wide range of reasons why small business factoring can be a sound financial decision.

- **IMPROVED CASH FLOW.** Because payment will be made by the factor within 24 hours of receiving an invoice it will give almost immediate access to cash which might otherwise take up to 60 days to receive.

- **SAVES TIME:** Because responsibility for billing and chasing payment is taken by the factor it frees time which the small business can spend more profitably servicing existing clients or pursuing new ones.

- **CREATES GREATER FINANCIAL STABILITY:** Long term debts are avoided. A factor will also probably look into the financial security of customers and bring to attention any which might present a risk.

- **HELPS TO FOCUS ON FINANCIAL PLANNING:** Because a business will have to keep a close eye on money owed each month it can help it to concentrate on financial efficiency.

THE DISADVANTAGES OF FACTORING

Like everything, small business factoring does have a few disadvantages which should be taken into consideration before embarking on it for your company.

- **REDUCES PROFITS:** The fees and interest paid to the factor will inevitably reduce the profit margin. Although if the factoring company manage the process of collecting payments, credit control etc. You could actually end up saving money as you don't require headcount and expensive management systems to manage this process.

- **POTENTIAL CHANGE IN BUSINESS PRACTICES:** A factor may insist on a business changing the way they work and even recommend that they stop dealing with certain customers. This highlights the importance of ensuring you work with a lender which understands your business and can help it grow.

- **CHANGE IN CUSTOMER RELATIONSHIPS:** The factor will be the company controlling the financial dealings with customers and that may affect the supplier/client relationship. That said some businesses in the UK like this process as it distances the 'cut-throat' payment collection process from the people doing the business.

- **IT'S A LONG TERM COMMITMENT:** Some factors have a long notice period for companies wishing to terminate the arrangement. Which again highlights the importance of working with the right lender straight off the bat. There are also a couple of lenders which offer a 'trial service' allowing customers to terminate the facility within the first 28 days.

CONCLUSION

Factoring was fully reflected economically in the financial component of the factoring business as it existed 600 years ago. The difference between today and 600 years ago is that the sales, or "agenting," component has been purged from the factoring relationship. But factoring as it is typically practiced in both developed and developing economies can still be viewed as a bundle of activities. Particularly in Small businesses, factoring is one of the most popular methods of achieving this and one which is gaining more and more popularity with businesses in virtually every sector.

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