RESEARCH ARTICLE

FACTORING: A FINANCIAL INSTRUMENT

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Abstract
Factoring is a three-party transaction. In consideration of a commission (also known as a discount fee), on an ongoing basis, the factor’s client sells to the factor current (not overly aged) accounts owed to the client by third-party customers (account debtors), arising from goods sold or services rendered by the client to the account debtor. Depending on the form of factoring chosen, the factor may finance its client by making a cash advance to the client on the date of purchase of the subject accounts.
The paper is aimed to give an overview of factoring and will give a brief of its historical development. The paper will focus on the meaning of the factoring as a financial instrument, its classification and the advantages/disadvantages of it.  
Keywords: Factoring, financial instrument, classification, benefits.

Introduction
Factoring is used in developed and developing countries around the world. In some developed economies such as the United States, its importance as a primary source of working capital finance tends to be concentrated in selected industries. In other developed economies, its importance as a primary source of working capital appears to be much more widespread.
The global pattern of factoring suggests that it may have an advantage compared to other types of lending, such as loans collateralized by fixed assets, under certain conditions. Factoring is quite distinct from traditional forms of commercial lending where credit is primarily underwritten based on the creditworthiness of the seller rather than the value of the seller’s underlying assets. In a traditional lending relationship, the lender looks to collateral only as a secondary source of repayment. The primary source of repayment is the seller itself and its viability as an ongoing entity. 
The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the “factor” as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s).

Historical view of factoring
Factoring in the modern sense of the word can be traced in lang syne. First evidences of existing factoring appear 4.000 years ago in the acient civilization of Mesopotamia, during the region of king Hammurabi¹, some of its tracks are located in the Roman empire². First terminology for agents and factors appears in the 15th century in trade settlements organized by European traders in the colonial countries where they were buying goods. It was a primitive type of factoring, which initially had the form of commission sales because factors, guaranteeing their clients that, buyers will pay goods or that they will pay in advance before the ultimate buyer pays to them. As a special form of financing, factoring is being developed in the late 19th century, on the Anglo- American territory, and especially in

²Ibid
the textile industry, where 95% of turnover was done was done by factoring.

Through history, factoring evolved and took different forms and adapted for the needs of participant in the factoring business—first, business entity–client, second, factor, third, buyer–debtor, on the international level fourth, correspondingly factoring company in the country of the debtor, special activities, general economic and political situation and circumstances, that resulted with various forms and types of factoring, which is applied today in business practice.

The Meaning Of Factoring

Factoring is a contemporary and specific form of short-term financing based on the selling short–term unsecured assets of the company to a specialized financial organization or company that specializes in factoring (factor) to pay certain fees or charges. In other words, factoring is the purchase of others' claims (debt) that is a financial instrument that factor (factor-house, factor-company, factor-organization, a bank that has a separate department) financed by the business entity on the basis of future (outstanding) claims arising from the sale of goods or services on the domestic or foreign market for a fee. The factor buys the receivables for a fee before the expiry date of payment, takes over the activities of collection, warnings, account transactions and the risk of collection of receivables. At a time when it charge more than the discounted price which he paid for the purchased receivables, the factor profits. The term “factoring” has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, the definition of factoring as under: “Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:
1. Finance
2. Maintenance of accounts
3. Collection of debts
4. Protection against credit risks.

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

1. To trade or professional debtors
2. Across national boundaries
3. When notice of assignment has been given to the debtors.

Factoring may broadly be defined as the relationship, created by an agreement, between the seller of goods/services and a financial institution called the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former. Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client’s book debts (account receivables) with or without recourse to the client, thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

Classification Of Factoring

Following are some of the important types of factoring arrangements:

Recourse and Non-recourse Factoring

In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad. Let the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus, the factor acts as an agent for collection of bills and does not cover the risk of customer’s failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse factoring.

Advance and Maturity Factoring

Under advance factoring arrangement, the factor pays only a certain percentage of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the

References

5See UNIDROIT website http://www.unidroit.org /english/impliment/1-88-f.htm#NR11
client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of actual collection of receivables by the factor. The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate.

**Conventional or Full Factoring**
Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance. It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular.

**Limited Factoring**
Under limited factoring, the factor discounts only certain invoices on selective basis and converts credit bills into cash in respect of those bills only.

**Selected Seller Based Factoring**
The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and does all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement.

**Selected Buyer Based Factoring**
The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepares an approved list of them. The approved buyers of a company approach the factor or discounting their purchases of bills receivables drawn in the favor of the company in question. The factor discounts the bills without recourse to seller and makes the payment to the seller.

**Advantages and disadvantages of factoring as a financial instrument**

**Advantages**
- Availability of funds, as opposed to short-term bank credits factors consider sales invoices as safe asset, while banks consider fixed asset as safety
- Less time in the realization of factoring application process and fund insurance through factoring is much more faster, than it takes time to establish a line of credit through short-term bank credit lines
- Better cash flow and faster access to liquid capital
- Better financial position, credit worthiness and solvency
- Improving the reputation, the growth of credit standing because of liquidity improve and timely execution of liabilities, the company has a reputation as a reliable-increases sales and competitiveness
- Better conditions for new customers (it is important for the export companies)
- Reducing the risk (bad debts are eliminated in the non-recourse factoring)
- Reducing the credit risk in dealing with customers and increased profitability

**Disadvantages**
- Over-reliance on a factoring company can result in excessive trading and mismanagement.
- Over-reliance on a factoring company can also result in loss of direct customer relations.
- Some types of company are not attractive for factoring, such as small low-volume companies, companies whose accounts receivable originate from only a few customers, companies with many small customers, companies with speculative business.
- Factoring costs are normally higher than those of bank loans, so the price of the final product will be higher as well.
- Exporters must insure there are no disagreements with buyers over product quality.
- Some buyers do not like parties other than the seller to be involved.
- Factoring is short-term financing and cannot meet all business needs.
- Factoring occurs only when the factor is quite sure of the client’s solvency.
- Factoring companies prefer customers with larger businesses.

**Conclusions**
Factoring is one of the oldest and most common methods of receivables financing. Factoring is explicitly linked to the value of a supplier’s accounts receivable and receivables are sold, rather than collateralized, and factored receivables are not part of the estate of a bankrupt firm.
Factoring may allow a high-risk supplier to transfer its credit risk to higher quality buyers. Some advantages of factoring include:
- No time wasted on comprehensive loan applications
- Better cash flow and quicker access to working capital
- Better liquidity through on-time cash injections (advances from the factor)
- Better financial standing, creditworthiness, and solvency
Operating expenses reduced (for the reasons listed above)

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Even a start-up or young company can obtain financing quickly
Better information management (especially under full factoring)
Factoring is larger in countries with greater economic development and growth and developed credit information bureaus.
Factoring may also be particularly attractive in financial systems with weak commercial laws and enforcement.
Like traditional forms of commercial lending, factoring provides small and medium enterprises (SMEs) with working capital financing. However, unlike traditional forms of working capital financing, factoring involves the outright purchase of the accounts receivable by the factor, rather than the collateralization of a loan.
The virtue of factoring in a weak business environment is that the factored receivables are removed from the bankruptcy estate of the seller and become the property of the factor.

Bibliography
6. UNIDROIT website http://www.unidroit.org/english/implement/i-88-f.htm#NR11