FACTORING AGREEMENT - FINANCING METHOD FOR THE COMPANIES IN LACK OF CASH-FLOW

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ABSTRACT: The benefits of factoring apply to all the parties involved in the transaction. There are always three different parties to each factoring transaction. The first is the customer or buyer. The second is the supplier or seller. The third is the factor. All three parties have benefits when a successful factoring transaction takes place. The recent economic times have put a crimp in small business profits, so small business people nationwide are looking for ways to cut business costs, and many are suffering from the fact that their customers are not paying on time, if at all

KEY WORDS: factoring; cash-flow; market; finance; working capital; credit; business; deal

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1. INTRODUCTION

The value of the Romanian factoring market was 1.8 billion Euros last year, up by 63.64% against 2007, so that the penetration degree of these services in Romania is only 0.52%, as compared to the EU average of 7-7.5%, according to data from the International Factors Group. "Romania is on the seventh position in a ranking of the highest growth markets in 2008. But the penetration rate in Romania is far below the EU rate of 7-7.5% and the global rate of 3.45%. If we take into account only this difference between the rates of penetration, we can say that the potential of this market in Romania is a seven-fold growth, to get nearer to the world average and 15-fold to reach the EU average," the Secretary General of the International Factors Group, Erik Timmerman, said on Tuesday.

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at the seminar on "Sustainable Financing Solutions in times of crisis. The penetration level is the ratio between the turnover of factoring companies and GDP.

According to the representative of the International Factors Group, market development also depends on the people who know this area, but also on the existence of specialized structures. According to data from the association, 1600 companies operate at global level, and market value was 1.224 billion euros in 2008, of which Great Britain and Ireland contributed with 18.94%, France with 10.99% and Italy with 9.99%. The International Factors Group is an association of factoring companies, with 160 members worldwide. In Romania factoring services are mainly provided by banks, through specialized divisions, among the most important being BCR, BRD and UniCredit (Galanton, 2004).

Factoring is achieved by selling receivables (unpaid invoices) accumulated by a company, to an entity, often a bank branch, at a certain discount. This institution starts steps to recover the due amounts, making profit when it collects a bigger sum than the price paid for the receivables.

2. FACTORING: A BEST-OF-BREED SURVIVAL TIP FOR SMALL BUSINESSES

There are many businesses that have stayed in business and benefit from the working capital garnered from invoice factoring for small business in the face of tight credit at mainstream banks. First documented in the American colonies before the revolution, at a time when materials and/or goods were shipped from the colonies to the Americas, factoring is not a loan but it’s the purchase of financial assets, also known as receivables. It differs from traditional bank loans as follows. Bank loans involve two parties, and factoring involves three parties. Factoring is based on the value of the receivables. Banks base their decisions on a company’s credit worthiness.

They were not under any obligation to wait to be paid. Invoice factoring benefits businesses that do not get paid for 30 to 60 or 90 days by advancing up to 90 percent against invoices. The factor generally looks at the creditworthiness of the client’s customers and can fund within as little as 24 hours. Most companies do not expect to buy 100 percent of a company’s receivables (Mousseron, et al., 1997).

During the Industrial Revolution, factoring accounts receivables became more focused on the issue of credit, as factors guaranteed payment for approved customers. Invoice factoring became more focused on the issue of credit during the Industrial revolution. It was before 1930 in the United States when factoring occurred and it was primarily for the textile and garment industries, and then after the war years, factoring expanded to other types of businesses. When interest rates rose during the 1960's and 70's, private factors became popular and it intensified in the 80's due to the changes in the banking industry and interest rates. Small businesses were forced to find other sources of financing for expansion and growth so factoring became more widespread.
By using factoring, also known as factoring accounts receivables, it is easiest to keep your cash flow flowing, you will have the edge over the other guy, so you can order more supplies to build more products, keep your employees and sales staff on, pay all your bills, and in turn sell more. Factoring is easy. It is not a loan; rather it is the purchase of financial assets, or receivables, from a factoring company. The third step is going to give you an edge too. It is accounts receivable factoring. By using this financial tactic to keep your cash flow going, small businesses can pay their bills, keep employees or staff, keep an edge over competition, order more supplies, build more products, and in turn sell more, and make more revenues (Florescu & Pirvu, 2009).

Factoring invoices doesn’t work like traditional bank loans involving two parties, as factoring involves three parties. Banks base their decisions on a company’s credit while factoring invoices is about the value of the accounts receivables for a company. There are no minimums or maximums, and no long-term commitments. Factoring companies like the Interface Financial Group, Inc. (IFG) are finding that single invoice factoring is a popular new tactic allowing its clients to factor one invoice at a time. Projections ahead for the year 2010 include the fact that businesses will be factoring accounts receivables- less for survival and more for stability and growth.

3. THE DEFINITION AND HISTORY OF INVOICE FACTORING

Factoring by definition is the sale of a company's receivables, otherwise known as its assets, or invoices, at a discount to a factoring company who pays the business a discounted amount off of the face value amount of these invoices, and then receives payment for the invoices from the company's customers directly. The practice known as factoring has been evolving over 4,000 years, or since the beginning of commerce. More specifically, it was first used in the day of King Hammurabi of Mesopotamia, also known as the "cradle of civilization" in history books. Historically it was the Mesopotamian people first developed writing and they also structured business codes and government.

However it was the Romans who began selling promissory notes at a discount - yet another form of factoring. Then, the first documented use of factoring occurred in America some time before the revolution, when animal furs, cotton, and even materials such as timber were shipped from the colonies to Europe. Merchant bankers in London advanced funds to the colonists so that the Americans could continue to harvest their new land. In other words, these factors during the colonial times made advances against the accounts receivable of their clients, the Americans, enabling them to continue with their work. Soon it was during the Industrial Revolution when factoring became more focused on credit when they assisted clients in determining the creditworthiness of their customers and setting credit limits. It was the factor who could then guarantee payments for customers that had been approved, speeding up the process (Stănescu & Sitaru, 2008).

The beginning of factoring dates all the way back 4000 years to the time of Hammurabi and the Mesopotamians. This was when the first written invoices were used
and business lending and Government regulation all seem to date from this time. The first evidence of factoring can be found among these ancient stone tablets. The history of factoring is very much the history of business itself (Jacquet & Delebeque, 1999).

There is evidence of factoring in every culture where there are remains of written invoices and ledgers. In Rome, the first evidence of the purchase of promissory notes at a discount can be found. There is little doubt that factoring has been around for as long as business has existed. The history of factoring is very much the history of business itself.

The type of factoring that exists in the United States today had its origins in the colonial days. Colonials were producing goods that were being sold in England. The finished goods had to be sent to a port and put on one of those creaky wooden sailing ships to be carried to the Mother Country for sale. The poor Colonial was not extending generous payment terms to be competitive, they were not going to be paid for quite some time simply because it took a long time to sail across the ocean, sale the goods, and sail back across the ocean with the money (Rovența, 2006).

The factor solved this time problem. They were actually providing payment to the supplier so they could continue with their business and survive while the boat was crossing the ocean. The factor, of course, was not actually buying the goods. They were not the same as exporters. They were advancing the funds at a discounted rate. Although there seems to be a fine line here, it was the assumption of the risk of non-payment that made the major difference.

As time passed and we moved into the modern era of instant communication and a shrinking world, factoring has continued to play an important role in the business world. The need for cash flow is still a major part of any business and the buying and selling of accounts receivables has remained a viable answer to this problem. The increasing interest rates that marked the 1980's and 1990's led to an increase in the number of new companies turning to the factoring business. Factoring was a way to raise quick capital in a manner that was called "off the balance sheet" financing. Since accounts receivables are an asset account, factoring was a way to raise quick cash without adding the liability of a loan.

Since many companies don't get paid right away after they have delivered a product or a service, it can negatively impact their cash flow, making it hard for the business to produce new orders. After all, supplies need to be on hand to continue making the products. Invoice factoring can benefit a business that doesn't get paid for 30, 60 or 90 days. How? Factors advance up to 90 percent of an invoice total, and they can often provide funding in as little as 24 hours. Keep in mind, factoring is not a loan - it is the purchase of receivables otherwise known as financial assets, from a factoring company. Factoring is different from traditional bank loans because bank loans typically involve two parties, while factoring involves three parties. A bank bases its decisions on a company's credit worthiness. Factoring companies base their decision on the value of the receivables. There are no minimums, no maximums, no long-term commitments and no lengthy application processes when using an invoice factoring company (Mousseron, et al., 1997).
Make spot factoring, a newer type of invoice factoring, part of your business growth strategy today.

4. SPOT FACTORING COMPANIES HELP SMALL BUSINESSES GET CASH FAST

The recent economic times have put a crimp in small business profits, so small business people nationwide are looking for ways to cut business costs, and many are suffering from the fact that their customers are not paying on time, if at all. But the good news is that invoice factoring is another way for small business owners to stay ahead of the game. Have you ever heard of a company factoring receivables? Also known as spot factoring, single invoice factoring allows companies to obtain short-term working capital to grow their businesses, improve cash flow and stay afloat during tough economic times (Vartolomei, 2006).

Banks have become even more strict about credit these days, and small businesses often find it difficult to attract conventional funding. It is sad to say, many new business owners end up having to take out a home equity loan or worse, they must use credit cards to pay off their bills.

That's why if you have outstanding invoices that are up to 60 or 90 days, spot factoring allows you to get the money now, so you can use it for business expenses that are critical. It's basically an advance on the money that is owed to you by your customers.

Factoring companies like The Interface Financial Group (IFG) will typically do a credit check on the client, make sure the sale represented has been satisfactorily completed and then they will notify the creditor that they have purchased the invoice, and then you will get your funding. At the end of the credit period the debtor pays the factoring company directly, thereby completing the transaction (Macovei, 2006).

Most companies have very competitive rates, and each and every client's circumstances vary, which could have an impact on the fees charged for spot factoring, also know as single invoice factoring.

5. BENEFITS OF FACTORING

Business owners have always been aware of the basic benefits of factoring. In the modern era, the number of benefits has increased as factoring has taken advantage of technology. The benefits of factoring apply to all the parties involved in the transaction. There are always three different parties to each factoring transaction. The first is the customer or buyer. The second is the supplier or seller. The third is the factor. All three parties have benefits when a successful factoring transaction takes place (Jacquet & Delebeque, 1999).

The customer benefits because factoring allows the offering of generous payment terms. The idea of invoices that are payable at a future date has always been a lure to
customers who often have their own cash flow problems. A customer who is buying merchandise with the intention of reselling it would appreciate terms because it allows them to begin to realize some cash flow from the sale of the merchandise before the invoice is due.

The seller also enjoys the benefits of factoring. Although he might be willing to extend terms in order to lure customers, this creates cash flow problems for him as well. In some cases, the process of determining credit worthiness and collecting the accounts receivable can be assumed by the factor. This frees the seller to concentrate on more important aspects of their business such as seeking more customers. Even organizations that are already geared up for these functions still benefit from having the ability to transform their accounts receivable asset into ready cash if needed (Mousseron, et al., 1997).

The factor enjoys the benefits of factoring, also. The factoring company is basically in the business of using capital to generate capital. Factoring is a form of investment. Like any other investment it has its risks, but the risks can be covered by the pricing scale of the factoring purchases. It is usually assumed that a factoring company has available cash. This represents their cash flow problem. They need to get this cash out working for them. So, the cash flow problem is pointing outward, and makes a perfect match for the supplier and customer whose cash flow arrows must point inward.

There is much the same in factoring as in any other type of business that makes cash available to those that need it in return for a profit. However, the benefits of factoring go beyond the benefits to the businesses involved. Factoring benefits everyone indirectly by being something that encourages business and spurs economic growth (Galanton, 2004).

When a deal works successfully between a buyer, seller, and a factoring company everyone benefits to some degree. It is possible that all the parties involved might have their individual downsides and they may view these as cons of the factoring process itself. However, a closer examination will reveal the fact that the complaints are not really substantial.

The buyer is aware that, in most cases, he is the one bearing the cost of the factoring arrangement. It is not uncommon for suppliers to raise prices passing along the cost to the buyer. One indication of this is the willingness of many suppliers to offer discounts to buyers who pay cash or accept terms calling for a shorter term. This is usually a case of the discount amounting to the cost of the factoring that would be involved in a long term invoice. It is possible that a buyer would consider the fact that he is bearing the cost a con of factoring (Florescu & Pirvu, 2009).

The seller is not going to get the full sale price when he sells the invoice at a discount. The discount is actually a reduction in his total assets. It is possible that the seller would view this discount as a con of factoring, but there is also no gun to his head. The factoring deal provides him with cash that he can use now, rather than an account in his
books that can not be used until a later date. This is what the seller needs and he knows that any other method he uses to provide cash flow will also have a cost.

The factoring company is assuming the risk and the hassle of collection. If the deal goes bad, the factoring company is the only one that is actually out of cash. Even in the case of the recourse factoring method, the factoring company is still the one that must take the first action when things do not turn out as they were intended. However, again, all investments have risks. The factoring company "factors" the risk into the discount it offers when purchasing accounts.

It is only when the deal goes bad that the factoring arrangement can be problematic for the involved parties. Each party has a set of responsibilities and must live up to them in order for it to work. If one party is dishonest, or attempts to "con" the other, it will share the fate of any business transaction that goes bad because it is not done in good faith. It may be the only real con of the argument for factoring in business finance. It is a business transaction between three parties, rather than just two. This fact alone increases the amount of trust and the risk. Compared to the benefits of factoring, the cons of factoring are few, indeed (Vartolomei, 2006).

6. ALTERNATIVES TO FACTORING

For the seller or supplier, the alternatives to factoring can fall into two major categories. Either you can eliminate the cash flow problem or you can solve it through a more conventional method. The first is fairly simple on paper, but not as easy to do in the real world of business. If all customers are expected to pay at the time of delivery and accounts receivables are held to an absolute minimum, there is no need for factoring. It should be noted that this could easily lead the company into an unfavourable competitive position against companies offering more generous terms of sale.

Conventional business financing can be used as one of the alternatives to factoring. If it is possible to get a start-up loan or a revolving line of credit that is sufficient to handle any short term cash flow problems, this could be seen as an alternative. In many cases, it is the rejection by conventional lending institutions that leads a business to a factoring company in the first place. When it is possible to get conventional business financing, why would one chose factoring? (Mousseron, et al., 1997)

There is an answer. A conventional loan has a repayment expectation based on future performance. A company makes a loan, for instance, purchases inventory, and begins to sell it off. A portion of the revenues of the sales would be designated to satisfy the loan repayments. This works fine as long as sales meet expectations. If they do not, the business just has increased debt and hurt their cash flow positions as the repayment funds would have to come from elsewhere. At least when the factoring method of financing is used, the “loan” is being prepaid by already existing sales and not future expectations that may or may not come true.
The Small Business Administration sponsors some loan programs that are intended to help small and new business avoid the need for factoring. They do this by offering a program called the Small Asset-based CAPline or SMBA. This program helps the small business owner get a revolving line of credit that is secured by assets that they actually have rather than anticipated sales. This is a good program and it certainly can help a new small business owner set up a revolving line of credit type account. It still is not based on sales already in the books though, and so the risk to the assets that are securing it still exists.

There are plenty of alternatives to factoring. It is rarely something that is done because absolutely nothing else can be attempted. There are times and situations where it is the best and most sensible way to go. A good business planning process will recognize and be aware of alternatives in every step. Factoring is just another example, and when it is the right solution, knowledge of the alternatives will just help point you in the right direction.

7. CONCLUSION

During this present international economic crisis and given the limited access to the traditional financing schemes and the financing procedure for the factoring operation, factoring can be an appropriate alternative to some Romanian companies, especially for those specialised in providing goods and services.

Invoice factoring services can be a beneficial resource tool for business owners worldwide, especially during a difficult economy. Why? Because obtaining a loan from traditional financial institutions such as banks can be a difficult and slow process. Invoice factoring services from factoring companies provide short-term working capital to growing businesses who often find it difficult to get conventional funding.

REFERENCES: