European Journal of Accounting, Finance & Business

Volume **VI**/2018 ISSN 2344-102X
Issue (XVI) / **February** 2018 ISSN-L 2344-102X

ASSETS BASED LENDING: THE ADVANTAGES AND DISADVANTAGES OF FACTORING

Asst. prof. PhD Cristina Gabriela COSMULESE*
"Ștefan cel Mare" University of Suceava, Universității Street, no. 13, Suceava, Romania

Abstract

In the current context in which businesses are increasingly concerned with resorting to alternative sources of funding, factoring has become an increasingly used and diffused tool in the economic and financial environment. Starting from the definition of the factoring concept, the paper proposes a more comprehensive approach to this type of operations, treating and analysing the types of factoring, in particular the factoring with and without regress, the ways of deployment, the details of each stage of the operation mechanism, the costs and risks to which those involved in the operation are exposed.

Keywords: factoring, incomes and costs of the factoring operations, the factoring market, factoring with regress and factoring without regress.

JEL Classification: M00, M41

I. Introduction

In the current context in which the "survival" of a company in a dynamic economic environment and its development depend increasingly on the ways in which it finances its activity, factoring has become an increasingly used and diffused tool in the economic and financial environment.

At European level, companies finance their investments from three alternative sources, which are not mutually exclusive: "direct financing provided by capital markets in the form of joint actions; direct financing provided by capital markets in the form of

* *Corresponding author: Cristina Gabriela COSMULESE, E-mail: gabriela.cosmulese@usm.ro*

short-, medium- and long-term interest-rate loans; financing generated internally by the enterprise in the form of retained profits" (Lumby & Jones, 2003: 380).

As in most other countries, in Romania, economic entities also face a lack of liquidity on the market, which leads to a difficult collection of own debts (Mihalciuc & Steclarumi, 2017). In Romania, the most used sources of funding are bank loans and leasing, followed by equity and less by shares issues. It is well known that small businesses often use loans from associates, which become long-term loans. Shares issues are not among the preferences of domestic enterprises. Lately, however, factoring and lump-sums are some relatively new sources of financing by ensuring immediate liquidity for companies.

As far as the factoring contract and the legal regulations in force are concerned, we specify that, internationally, the factoring contract has a special legal uniform regulation, achieved through the effort of UNIDROIT and materialized in the Ottawa Convention of 1988 regarding the International Factoring Agreement entered into force in 1995, plus the 5 United Nations (UNCITRAL), adopted in New York in 2001, concerning the assignment of debt in international trade.

Since its appearance, when it was strictly limited to textile and clothing industry financing, factoring has so far expanded its sphere of coverage to extremely diverse areas. Factoring operations have been developed as a result of the more frequent use of open account payments that allow settlement to take place within a certain timeframe from the date of delivery. A recent study by the Romanian Factoring Association (RFA) shows that in terms of more than 2.2 billion euros, the factoring market registered a 13% increase in the first half of the previous year (Bellu, 2018).

Some specialists believe that this modern method of financing may represent some economic agents: new sources of cash, cash as a strategic resource, cash for operations, cash for corporate posture (Graham, 2018).

The theoretical basis of this paper is based on current ideas and concepts of leading economists, with particular consideration and analysis of the types of factoring, the ways of deployment, the details of each stage of the operation mechanism, the costs and risks to which those involved in the operation are exposed.

II. Conceptual delimitations regarding the factoring

Factoring is the "process where a customer, called "adherent", transfers the ownership of debts held at the level of commercial bills to another entity called the

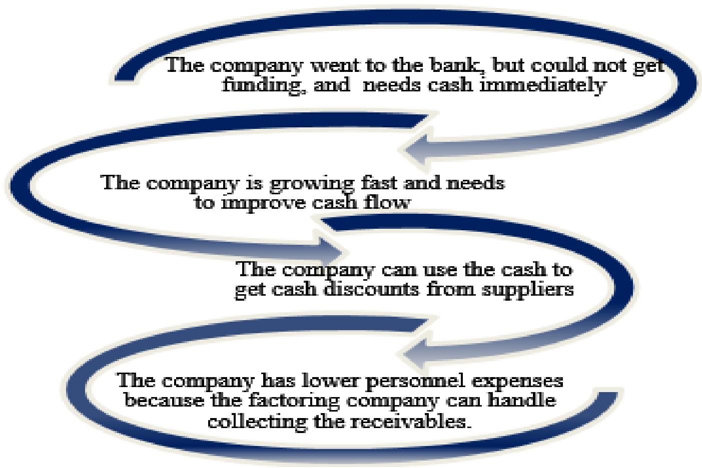
Volume **VI**/2018 ISSN 2344-102X
Issue (XVI) / **February** 2018 ISSN-L 2344-102X

"factor" that may be a banking corporation or a specialised financial institution with the purpose of getting quick financing" (Enciu & Ghencea, 2009: 43). The entity that assumes the right to trade receivables is the contributor to that transaction.

In other words, factoring is the short-term financing operation based on bills, without material guaranties, for companies delivering goods / services on the basis of commercial contracts or fixed-term standing orders.

Who should consider factoring? Companies use factoring for one or all of the following situations (see Figure 1):

Figure 1- Situations in which companies can resort to factoring financing



Source: own elaboration

According to some specialists (Ilie & Teodorescu, 2004; Klapper, 2006; Bărbuţă-Mişu, 2013; Molico & Wunder, 2014; Graham, 2018), factoring is a comprehensive financial process/operation/service that fulfils the following functions: financing the current activities, administration and management of commercial invoices, recovery of assigned debts, coverage of credit risk.

Following a survey, Soufani (2002) finds anecdotal evidence to support a relationship between the demographics of the factoring company's customers (such as the size of the enterprise, the type of product or service it offers, the industry/sector, the age of the market, the type of clients, the financial situation, management team, operational suitability, collectability and credit notes) and the use of factoring.

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Examining the relationship between bank corporate clients and their sources of financial services Turnbull (2007), notes that the factoring services of a bank are the least used services. Moreover, some of the respondents using this service have specified that "factoring would be the last resort of financing, saying they felt that when they use factoring they lose control over their tasks and have that uncertainty that this would disrupt the relationship between the company and their customers" (Goverde, 2016: 10). One of the drawbacks of factoring for the client may be the cost that (sometimes) is relatively high (Bărbuţă-Mişu, 2013: 576), and regarding the risk to which the entity is exposed, it is related to the risk of insolvency or other obstacles in collecting customer's debts (Spasić et al., 2012).

I consider that the lack of knowledge of the product, of the real benefits that can be gained from its use, has led to this perception that factoring would be the last way of financing used by firms when rejected by banks, a clear sign of major problems for the company concerned.

III. Typology and mechanisms

III.1 Classification of the factoring operations

At the level of specialized literature, there are several criteria for classifying factoring operations, thus, the most popular forms of factoring are presented in Table 1:

Table 1- Classification of the factoring operations

1. Depending on the field of coverage	
Partial factoring	It involves a selection of factors, without the factor fulfilling their function as administrator, the obligation to collect remains to the adherent.
Total factoring	The situation in which the factor takes over all the invoices from the adherent, also assuring the administration function, of collection from the adherent's debtors, of financing and coverage of credit risk.
2. Depending on the right of recourse a bank can exercise over the adhering	
Factoring without regress/non-recourse	Situation where the factor pays the accepted equivalent value of the invoice or invoices, usually 80% immediately after the issue, and 20% within 180 days of invoice maturity, even if it fails to collect all or part of one or more invoices.

Table 1 – *Cont.*

2. Depending on the right of recourse a bank can exercise over the adhering	
Factoring with regress/recourse	Situation in which the factor, after the expiration of 30 days from the due date of the invoice, in case of non-payment (on the part of the debtor), will recover the unrecovered amounts from the adhering by exercising the regression right.
3. After other ways of paying the debts by the factor	
Factoring with immediate payment	If the factor pays the adherent the equivalent value of the invoices when presenting them.
Factoring with an eventual future date payment	After the adherent presents the invoices.
Mixt factoring	When the factor pays upon presentation a part of the equivalent value of the invoices under the form of an advance up to 80% of their value and the difference at a certain future date after the presentation.

Source: Adaptation after Ilie, Teodorescu, 2004

Factoring can also be divided according to the territorial principle, therefore, we have internal and international factoring, depending on whether the client-factor contract is concluded in the same country or not.

Given the number of participants in the factoring business, it is possible ”to divide the direct and indirect factors, in the latter, having in mind its international character, two factors appear to be the export and import one; some of these divisions may overlap each other” (for example, indirect and international) (Spasić, 2012, 198).

III.2 Factoring mechanism and specific risks

As far as the mechanism of the factoring operations is concerned, it is carried out through specialized organizations established as a result of the financial market globalisation and the increasing use of modern financing methods. We can therefore speak of factoring organizations established at an international level (Factors Chain International) and national level (Romanian Association of Factoring).

In Romania, the factoring operations are regulated by the National Bank and, from an accounting point of view, the factoring is recorded taking into account the provisions regarding the assignment of debt from Order no. 4160/2015 with subsequent

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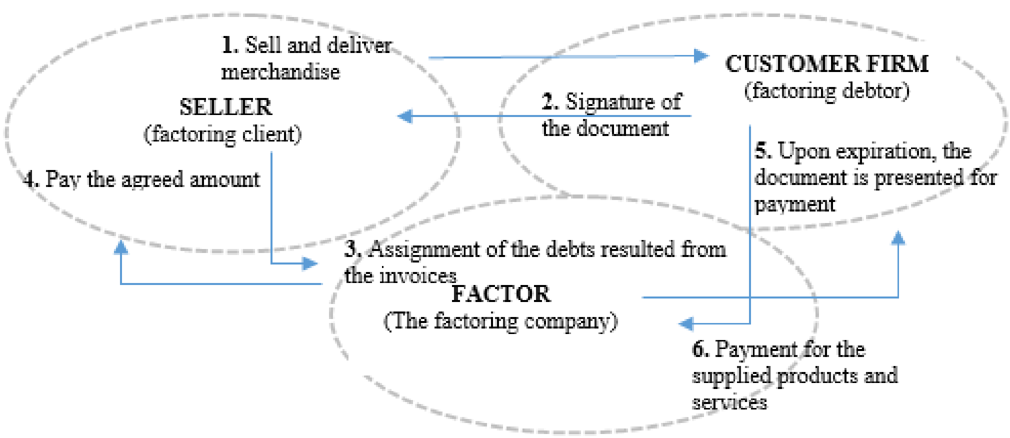
amendments and additions (Oprean, 2015: 30). At the level of pertinent analysis, it is very important to determine which are the most important risks in order to make the existing connections between them transparent. Knowing these risks specific for the factoring process facilitates the decision making of contractual partners and the concrete measures that are required to limit and eliminate them.

In this section I will focus on the explanation of factoring with regress and without regress, these two forms of financing being the most common in the economic and financial environment.

Factoring involves not only invoicing, but also tracking the collection and ensuring the risk of default by the debtor (Rus, 2010:10).

Non-recourse factoring is ”associated with a higher level of risk, thus, generally speaking, interest rates and factoring fees can be included in total costs” (Goverde, 2016: 60). As it can be seen from Figure 2 and 3, each factoring operation is attended by several parties, namely: the adhering, the factor and the debtor, some notions which will be presented below.

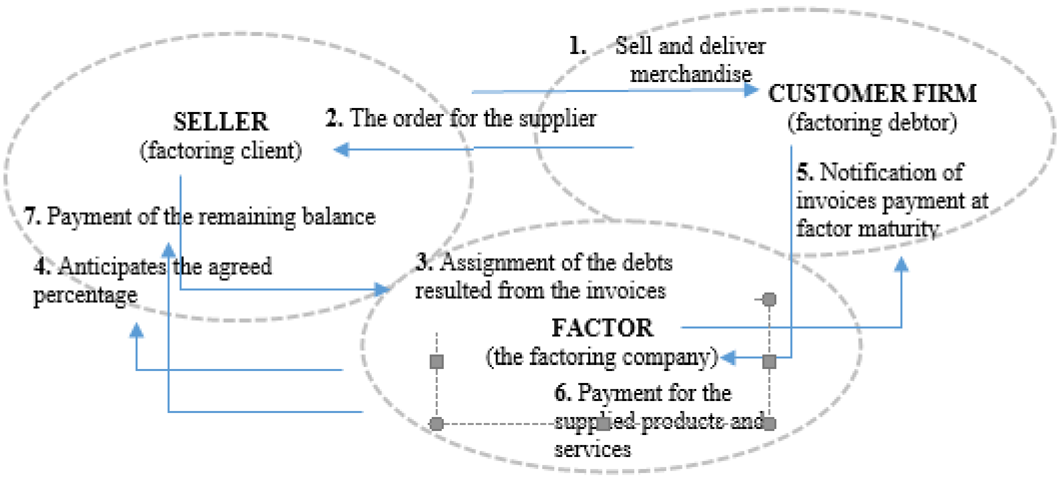
Figure 2-The parties involved in the factoring mechanism (without recourse)



Source: Adaptation after Mazzeo, Moyano Ruiz & Nara, 2012: 34

Factoring with regress "applies when the factor finances the buyer's invoices, but does not assume the buyer's default risk - that is, he finances without pledge and other bank procedures, but if he does not pay after the due date, he is given a certain term in which this money must be reimbursed." (Roller & Zubic, 2015: 96). This type of financing is called the financing of current debts, in case of liquidity shortages, the client can apply to the factoring company for the credit.

Figure 3- The parties involved in the factoring mechanism (with recourse)



Source: Adaptation after Grigoroi & Covaliov-Rusu, 2017: 10

In the attempt to understand the profit making mechanism of a factoring company, it is very important to analyse the income resulting from the factoring operations, on the one hand, and on the other hand, the purchase price of the receivables and the value of the fees and commissions related to the factoring operations. In order to determine the basis of calculation of the earnings obtained from factoring operations, we must remember that factoring operations are characterised by three main functions: the financing function, the trust function, the services function.

How can the real cost of factoring be calculated? To calculate the real cost of factoring, we need the following information:

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Issue (XVI) / **February** 2018 ISSN-L 2344-102X

1. Advance rate: The percentage (%) of the face value amount of accounts receivable the "Factor" will advance to you. *(Example: $100,000 (A/R) x 80% advance rate = $80,000 (Advance))*
2. Discount rate (or factoring fee): The percentage (%) of the face value amount of accounts receivable the Factor will charge you for processing these receivables for an agreed upon term.*(Example: $100,000 (A/R) x 3% discount rate (for 30 days) = $3,000 (Discount Fee))*
3. Term: The number of days your advance remains outstanding. The discount fee increases for each day your receivable remains outstanding past the agreed upon term.
**Using this information, you can calculate the true cost of factoring. Your annual interest rate appears to be 36% based on the discount fee of 3% for 30 days. However, when you consider that you only received $80,000 not $100,000, your APR is actually 45% (and even higher if your receivables take longer than 30 days to pay). Make sure to use this APR to compare factoring to other financing options that may be available to you.*

*Example taken from https://www.excelsiorgrowthfund.org/business_resources/True-Cost-of-Factoring-as-a-Short-Term-Business-Loan_78_resource.htm

IV. Conclusion

Funding, the need for capital is one of the most important problems that any economic agent is constantly facing from the smallest trading companies, to multinational banks and corporations and even states as distinct entities represented either by governments, municipalities or central banks. From the funds users' point of view, the funding opportunities available to most economic agents evolve from simple to complex according to their size.

Currently, through this tool, small and medium-sized businesses have the opportunity to a better control of the portfolio risk, minimising the collection risk and eliminating credit risk. In recent years, there have also been "exotic" financing options, represented by hybrid solutions or even instruments that have not been used so far for financing, such as insurances.

So surely the factoring contract is not the only financing alternative that solves all the company's problems today; but if we think better, in fact it can solve one of the biggest if not the biggest problem, such as financing. For any company, opting for factoring is like opting for smart credit management.

Given the importance of factoring as a source of funding for SMEs, I support the idea that governments in all countries should try to reduce barriers (legislative or other) that may stand in the way of developing this sector. Factoring is a reliable product for SMEs, and its costs are comparable to other financing products. However, the advantage of factoring is that it does not require negotiating times as high as other products, ensuring the amounts in due time. For this reason, I believe that the parties involved in this sector need to take extensive action to promote this product and the benefits it presents.

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European Journal of Accounting, Finance & Business

Volume **VI**/2018 ISSN 2344-102X
Issue (XVI) / **February** 2018 ISSN-L 2344-102X

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