

## Theory about factoring service

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### Abstract

Factoring is one of the oldest and common methods of trade finance over the world with a long historical development. According to historians, Factoring is originated 4,000 years ago in the days of King Hammurabi of Mesopotamia whereby the first literate societies were developed. Although Mesopotamia no longer exists, many of its great contributions to civilization have endured, including Factoring.

The first documented-use of factoring was widespread occurred in the American colonies before the revolution to serve for trade. With the abundance of the North American landscape, colonists cultivated and traded commodities like cotton, fur and timber with the Europeans.

In briefly, Factoring is the sale and purchase a receivable with a certain discount rate. However, factoring is not simply one homogenous product because the factors also offer a range of professional financial services that might typically include: (i) Collecting payments from their customers, (ii) Pursuing late payers, (iii) Providing advice to clients on credit management, (iv) protecting the client against bad debts. The difference among these definitions is how many services to provide by the factors.

In a recourse factoring arrangement, the factor has a right to recover the funds from the seller in case of default payments as the seller takes the risk of any bad debt losses himself. The factor charges the seller for maintaining the sales ledger and debt collection services and charges interest on the amount drawn by the client (selling firm) for the period. This is the most common type factoring. Recourse factoring is offered at a lower interest rate since the risk by the factor is low. It's highly suited for factoring arrangements at high risk markets as well as for factors at the first phase of entrance into the market as they're lack of experience and meet difficulties in accessing buyer's credit- worthiness.

**Keywords:** Factoring service, Kosovo, EU.

### Introduction

Kosovo is deeply integrating into global economy, especially since it became an independent in 1999. Kosovo's position emphasizes increasingly as a light growth economy in Europe. The integration creates breakthroughs for higher development but also brings many threats to overall economy as well as each economic industry. Banking industry is not out of this trend. Diversification of services and keeping the competitive advantages is the survival for Kosovo commercial banks, especially joint stock banks (JSCBs) which have serious problems of a tiny capital base and weak operation.

The small and medium enterprises (SMEs) - the targeted customers of JSCBs are playing an important role for development of economy in Kosovo. SMEs have contributed to create increasing GDP, creating jobs and increasing national's export volume. It said that SMEs have currently contributed 60 percent of GDP and employs

about 70 percent of workforce as well as 47% of export turnover. Besides achievements and contributions as mentioned above, SMEs in Kosovo are currently facing with many serious difficulties such as low productivity and competitiveness, shortage of capital for expanding, lack of experience in terms of marketing and financial management. Of these difficulties, lack of financing resources is considering one of the most serious obstacles for SMEs in growth. Factoring not only brings benefit to CBs as a new service for diversification and increasing turnover but also supports SMEs to access financing for roll-up their business and gaining profit from achieving advantages of competitiveness. Although it has clearly evidence that factoring is well- developed over the world for a long time with the application of about 60 countries and the growth of about more than 20 percent per year, the concept of factoring in Kosovo is not only the new one with enterprises but also the banks.

### **Theory about factoring service**

In this section, the theoretical basic is built for the secondary research.

#### **II.1.Introduction of factoring:**

##### *II.1.1. Origins and growth of factoring:*

Factoring is one of the oldest and common methods of trade finance over the world with a long historical development. According to historians, Factoring is originated 4,000 years ago in the days of King Hammurabi of Mesopotamia whereby the first literate societies were developed. Although Mesopotamia no longer exists, many of its great contributions to civilization have endured, including Factoring. Almost every civilization that valued commerce has practiced some form of factoring. In Rome, it can be found the evidence of using mercantile or factor to administer the sales of goods from rich manufacturer and merchants.

The first documented-use of factoring was widespread occurred in the American colonies before the revolution to serve for trade. With the abundance of the North American landscape, colonists cultivated and traded commodities like cotton, fur and timber with the Europeans. Merchant bankers in European countries advanced funds to the colonists for the raw materials, before they reached the continent. This enabled the colonists to continue their lives and production cycle, free from the burden of receivables by their European customers. The factor, of course, was neither actually buying the goods nor 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.

In the 15<sup>th</sup> Century with the advent of the Industrial Revolution, factoring became more focus on the issue of credit and played an increasingly important role in commercial transactions. By assisting clients in determining the creditworthiness of their customers and setting credit limits, factors could actually guarantee payment for approved customers. However, it still applied in limit relationship within the factor in European countries and their agent in America.

In the latter part of the 19 century, America seized power from European colonialism and developed rapidly. According to that, the needs using overseas factors for

handling imports reduced. Domestic factors handling sales within their countries frontier appeared. Moreover, thanks to improvement in communication and transport systems, the exporters no longer needed to send goods on consignment. The goods could be sold via samples by local agents or dispatched directly to customers. Exporters accordingly no need the factors' warehouse, marketing and distribution service but they still wanted to retain the financial service. This is the basic for modern factoring.

In early 1960s, International Factor Group (IFG) established with nearly 70 members from 47 countries marked significantly development of factoring. General rules were built up and controlled factoring service, especially the firstly introduction of the two factor system. Another important organization – Factors Chains International (FCI) then was set up in 1968 to connect international factors together and led factoring to become global one.

As time passed, factoring has continued to play an important role in the business world.

#### *II.1.2. Definitions of factoring:*

The term "factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. It is not easy to find one definition that will cover the various form of factoring arrangements that occur in one country. To find one that will apply internationally is almost impossible. Each country has its own particular language, financial, business needs and law. Therefore, there are lots of factoring definitions. In this section, we will overview some typical definitions that have been widely used for factoring service.

- **Definition one:** According to article I under General Rules for international factoring of FCI: *A factoring contract means a contract pursuant to which a supplier may assign accounts receivable which expression, where the context allows, also includes parts of receivables to a factor, whether or not for the purpose of finance, for at least one of the following functions:*
  - - Receivables ledgering
  - - Collection of receivables
  - - Protection against bad debts
- **Definition two:** The study group was appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended: the definition of factoring. It was defined in simple words as under: "Factoring contract" means a contract concluded between the supplier and the factor pursuant to which the supplier will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors). Factors will have to perform at least two of four following functions: (i) finance for the supplier, (ii) receivable ledgering, (iii) Collection protection against credit default in payment by debtors
- **Definition three:** Factoring means a kind of credit in which the financial institution will grant credit term to seller via purchasing the account receivable derived from purchasing goods in which both seller and buyer negotiate in sales contract (law No.02/L-123 and 04/L- 006).

In briefly, factoring is the sale and purchase a receivable with a certain discount

rate. However, factoring is not simply one homogenous product because the factors also offer a range of professional financial services that might typically include: (i) Collecting payments from their customers, (ii) Pursuing late payers, (iii) Providing advice to clients on credit management, (iv) Protecting the client against bad debts. The difference among these definitions is how many services to provide by the factors.

### *II.1.3. Advantage and disadvantage of factoring:*

Everything has its two aspects and the factoring service is not out of this trend, it has both advantages and disadvantages

#### **II.1.3.1. For the Factor:**

##### ***Advantage***

Providing factoring service can help factor to receive interest charge and financial commission. The fee and commission income contributes an important part on annual profit for factor.

Implementing factoring also creates diversification on factor's products and services. It supports the factor to not only achieve the turnover but also improve the factor's reputation as well as its competitiveness.

##### ***Disadvantage***

The factor will be got risk due to possible fraudulent acts by the seller and Buyer in furnishing the main instrument "invoice" to the factor. Invoicing against nonexistent goods, pre-invoicing (i.e. invoicing before physical dispatch of goods), duplicate-invoicing (i.e. making more than one invoice in respect of single transaction) are some commonly found frauds in such operations.

Credit risk is the highest one with factors in case of the default payment from Buyers, especially in non-recourse factoring.

#### **II.1.3.2. For the Seller/ Buyer:**

##### ***Advantage:***

**For the seller:** The advance payments made by the factor to the seller in respect of the approved invoice under assignment increase his liquid resources. He is able to fulfill his liabilities as and when they arise hence accordingly improving his credit rating position to his own suppliers, lenders and financial institutions.

The factors provide specialized services including sales ledger administration and credit control relieves the seller from the tension of bad debt losses. The Seller can concentrate on the other major areas of his business and improve his business efficiency.

It provides flexibility to the company to decide about offering better terms to their customers to gain the advantageous competitiveness

The seller can save the management time and effort in collecting the receivables and in sales ledger management thanks to the providing these service from the Factor for factoring service.

**For the Buyer:** The Buyer will gain the advantage of deferred payment granted from Seller so that he can use goods without payment at time of goods receipts. In case of international commercial, the importer no needs to secure deposit for opening L/C under each consignment. These will support the Buyer grant credit to his own customers as well as widen his business to gain more profit.

##### ***Disadvantage:***

Factoring is considered a kind of trade finance with high price. Cost of factoring is normally calculated the sum of finance charge and factoring commission:

- Finance Charge: This is also known as “interest charge”. It is the same as the current overdraft rate or a little bit higher than interest rate for short term bank loans. It depends on the quality of debts, and the time to collect debts from buyer.
- Factoring Commission: This covers the service elements and is generally charged as a flat rate percent of the total gross factored turnover. It's normally fluctuated around 0.5%-2.5% including VAT. Some factors charge a flat rate plus a fixed amount per invoice/credit note, for example: 0.85% plus EUR 10 per invoice/credit note. This is more common in international factoring when the import factor cannot be certain of the workload. Some factors will include a minimum charge or even a fixed amount per month to guard against the possibility that the factored turnover is less than an acceptable minimum. In international factoring, it will involve the service fees of both IF and EF.
- In general, the cost of international factoring is higher than domestic one and the cost of non-recourse factoring is also higher than recourse one. There are a number of costing systems in use for calculating the exact price of the factoring commission and generally, these will take into account the following:
  - Workload - the number of invoices, credit notes and buyers
  - Volume (sales turnover) - generally the greater the volume, the more attractive the business and the lower the percentage rate. However, if there are many buyers and many small value invoices, this could make the price too high and the business unattractive both to factor and seller. Most factors set a minimum volume below which it would be unprofitable to do business.
  - Buyer Credit Risk - the credit department will assess the portfolio of buyers and set a price (a percentage of turnovers) which will cover the expected credit losses plus a margin for administration costs. This assessment is based on the industry sector, the strength of the buyers and their spread.
  - In the past, when an enterprise employed the services of a factor, it was considered a sign that the respective enterprise was in financial difficulties. These days, however, the perception has changed, and factoring is considered a normal way to do business and a viable cash management technique.

#### *1.1.4. Classifications of factoring:*

As shown above, the scope of the embedded credit management services defines the various factoring products that are typically available in the marketplace. Following are some of the important types of factoring:

##### ***1.1.4.1. Recourse and Non-Recourse Factoring***

- In a recourse factoring arrangement, the factor has a right to recover the funds from the seller in case of default payments as the seller takes the risk of any bad debt losses himself. The factor charges the seller for maintaining the sales ledger and debt collection services and charges interest on the amount drawn by the client (selling firm) for the period. This is the most common type factoring. Recourse factoring is offered at a lower interest rate since the risk by the factor is low. It's highly suited for factoring arrangements at high risk markets as well as for factors at the first phase of entrance into the market as they're lack of experience and meet

difficulties in accessing buyer’s credit- worthiness.

- Non-recourse or without recourse factoring: Factor has to bear for all risks of default payments. Factor cannot claim back the fund and even pay the remains at due date of invoice. Commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse one. The advantage of non-recourse factoring is that continuous factoring will eliminate the need for credit and collection departments in the organization.

**II.1.4.2. Full Factoring**

It can be known as “Old – Line” or “standard” factoring. It is made up of all the factoring services: finance, collection of receivables, maintenance of sales ledger and credit risk cover. The factor takes control of the A/R ledger of a seller and the seller in effect has only one debtor - the factor. Although it is a non-recourse service in principle, some certain A/R will be "with recourse" to the seller in practice. The factor only carries the credit risk for approved accounts that are not disputed. For any non-credit covered and disputed A/R, the factor has right to chase back reimbursement from seller. This type is most appropriate with SME which are growing quickly and which need not only additional finance but also the administrative supports and protection.

**II.1.4.3. Domestic and International Factoring**

The basic difference between the domestic and international factoring is on account of the number of parties involved. Whereas, it is only appearance of only 1 factor in domestic factoring, it’s simply 2 factors joining in international factoring (be discussed more detail in next section: I.1.5. Mechanic of factoring)

The brief comparison between domestic and international factoring can be shown as follows:

Table 1: Comparison Domestic and International factoring

DOMESTIC FACTORING	INTERNATIONAL FACTORING
a) The Factor will often operate the sales ledger in one currency only, against which advances can be made.	a) The Factor may operate in more than one currency, if that is how the seller is making sales. Advances will generally be made in the currency of the invoice.
b) The Factor can be responsible both for credit control and acceptance of credit risk.	b) Under the two-factor system the Export Factor provides credit risk protection to the seller, this is underwritten by the Import Factor who is also responsible for local credit control.
c) It can be common for the business to be transacted on a recourse basis i.e. without the Factor assuming the credit risk.	c) Most business is transacted on a non-recourse basis with the Factor assuming credit risk on behalf of the seller.

d) The Factor, seller and buyer are all covered by one legal system.	d) The law of at least two countries will be involved in the relationship.
e) The Factor, seller and buyer will all be familiar with local trading conventions and language.	e) The local trading conventions and language will vary from country to country. The two-factor system allows the seller to make use of the local market skills of the Import Factor.
f) The Factor is responsible for collection of payments from the buyer.	f) In the two-factor system, the Import Factor is responsible for collections.
g) The quality of service provided to the seller depends upon the Factor alone.	g) In the two-factor system, the quality of service provided to the seller is to a large part dependent upon the Import Factor, which illustrates perfectly the need for an agreed set of rules or code so that both Import Factor and Export Factor can establish a consistent level of service to the seller.

Source: Jeroen Kohnstam – Secretary General of FCI – International factoring workshop 2005, pg 3.

#### **II.1.4.4. Disclosed and Undisclosed Factoring**

- In disclosed factoring, the buyer is notified about the factoring contract and effect payment directly to factors on due date. Disclosed type can either be recourse or non- recourse.
- Undisclosed factoring, which is often undertaken on recourse factoring, does not involve buyer. Ledger administration and collection of the debts are undertaken by the seller, and then pay the money direct either into the factor's own bank account or into an account, which is in the seller's name but is controlled by the factor.

#### **II.1.5. Mechanics of Factoring:**

Factoring has variety of characteristic as mentioned in above section, however it is mainly based in two mechanics: the one factor system and the two ones system.

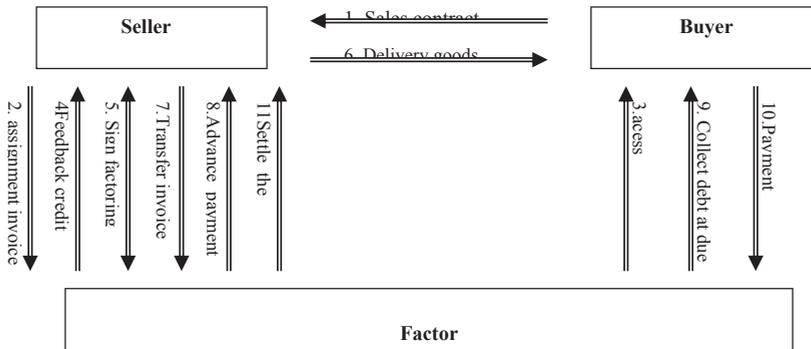
##### **II.1.5.1. The one factor system:**

The typical feature of this system is that only one factor joins in factoring transaction. In addition, it is mainly applied for domestic one.

#### **Table II. The one factor system**

- (1) Buyer places order to the seller
- (2) Seller requests Factors to assign the invoice
- (3) Factors access buyer's creditworthiness
- (4) Factor approve for financing the invoice.
- (5) Seller and Factor signs the factoring contract
- (6) Seller supplies goods to Buyer and issues invoice

- (7) Sellers transfer his invoice to Factor
- (8) Factor make agreed financial advance again approve invoice to the Seller
- (9) The factor collects outstanding invoice from Buyer at the invoice's due date
- (10) The Buyer pays to Factor
- (11) Factor settles the pre- payment by remitting the remains to the Seller less the agreed charge.



### II.1.5.2. The two - factor system :

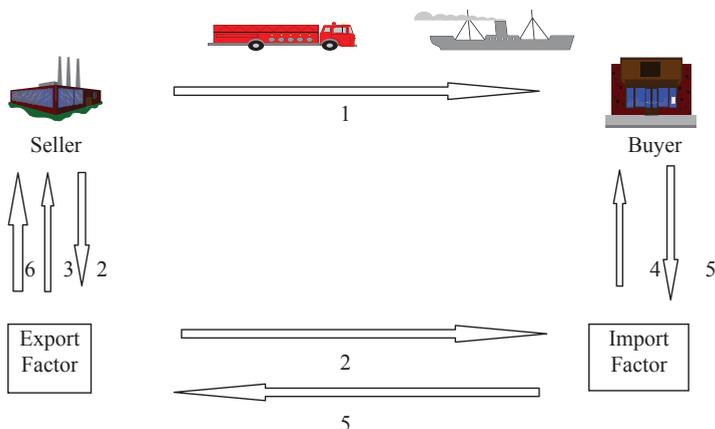
An international factoring transaction involves a number of elements that differentiate it from a domestic factoring transaction. The most important differentiations are the possibly different languages of the parties to the sales contract and the difficulty in assessing the credit standing of a foreign party. In answer to these considerations, the two factor system was developed. The two factor system popularly used in international factoring means cooperation between the two factoring companies, one in the seller's country – export Factor and one in the Buyer's country – Import factor. The system involves three agreements, one between the exporter and the importer, one between the export factor and the exporter and one between the factors themselves. It is important to bear in mind that the import factor's obligations are to the export factor only and they include determining the importer's credit rating as well as the actual collection of the debts. The import factor assumes the credit risk in relation to approved debts and is responsible for the transfer of funds to the export factor. On the other hand, the export factor is responsible to the import factor for the acceptance of any recourse.

**Table II.4: The two factor system**

Source: FCI

- (1). The seller delivers goods to his buyers based in their sales contract.
- (2). The seller assigns his invoices through the Export Factor to the Import Factor, who assumes the credit risk (provided this has been agreed beforehand).
- (3). The Export Factor advance cash against approved invoices to the seller.
- (4). The Import Factor collects the outstanding invoices in accordance with the sales contract's term existing between the seller and the buyer.
- (5). The buyer pays to the Import Factor, who then transfers the amount to the Export Factor.

(6). The Export Factor then settles the pre-payment by remitting the remains to the seller less the agreed charges.



The two-factor system has various advantages. The main ones concentrate in efficiency and speed. The import factor is in a better situation to assess the credit capabilities of the importer and communicate effectively with him. Moreover, he knows the legal and business environment in the country so that he can handle the collection through the Courts of the buyer's country in case of any default. The elements make the system preferable to the exporter is that he can receive local expertise in each of his export countries and can be confident as his buyer can deal with a Factoring in their own countries with their own language. Further, use of this system can help in reducing the exchange risk involved in international trade by speeding up the circulation of funds. The speedier the flow of funds from the buyer to the seller, the smaller the risk of exchange rate fluctuations between the date of shipment and the date of payment. As there are more parties involved than the one system factor, the speed of response on matter such as credit lines, transfer of cash and dispute can suffer. The high cost due to the charges required from 2 both factors is mentioned as one of its disadvantage. However, the real benefit of local collection as well as credit cover should not be overlooked when calculating the true cost of the service.

In short, it is surely said that the Two - factor system is a simple, flexible and cost effective method of managing cross border accounts receivables.

## Conclusions

Occurring around the world for centuries, factoring presents a very good manner for both customers and financial institutions. Like traditional commercial lending, factoring provides SMEs with working capital. However, factoring is quite different from traditional commercial lending, where credit is primarily based on the borrower's creditworthiness rather than the value of the borrower's underlying assets

In a traditional lending relationship in emerging financial markets, factoring offers several advantages over other types of lending. First, factoring may be particularly useful in countries with weak secured lending laws, inefficient bankruptcy systems,

and imperfect records of upholding seniority claims, because factored receivables are not part of the estate of a bankrupt SMEs. Second, in a factoring relationship the credit is primarily based on quality of the underlying accounts-not quality of the borrower. Factoring can mitigate the problem of borrowers' informational opacity in business environments with weak information infrastructures if factors can develop proprietary databases on account payment performance and if the underlying accounts are the obligations of relatively transparent firms. The latter condition holds when a borrowing SME has receivables from larger enterprises or has foreign receivables from firms in countries with a stronger information infrastructure.

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