

## Factoring as an alternative way in financing small and medium-sized firms (SMSF)

### Abstract

The issue in financing firms is still raised by both professionals and academic researchers, where the degree of treatment may differ from a firm to a firm. The world of finance distinguishes between two types of firms: large, and small and medium ones. Small and Medium Sized Firms (SMSF) are still struggling to keep their activities growing and sustainable in the market place.

Historically speaking, banks were merely the only way for financing SMSFs' activities. However, new sources of finance have emerged, and have become more crucial, from which factoring is now being considered as an efficient way in financing the working capital of SMSF. The Algerian financial system is still far away from using factoring as a means of finance, although law and regulation have asserted it.

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Factoring is considered as an important means in financing firms' accounts receivable. More research in this particular type of financing may show the growing interest of factoring companies in the marketplace.

One might wonder why the focus in this paper is given to small and medium-sized firms SMSF, apparently neglecting large firms. The obvious answer is based on the findings that all surveys and studies asserted that factoring is tailored to this type of firms.

Therefore, the need for factoring is to help small and growing businesses, while large firms have more potential in managing their accounts receivable compared with small firms.

Three arguments can be traced, which are in favour of large firms in managing their accounts receivable. Firstly, they have the possibility to pool the information on the credit worthiness of their customers. Secondly, they use economics of scale for record keeping and billing purposes, especially

### ملخص

ما زالت مشكلة تمويل المؤسسات الاقتصادية تشكل جوهر اهتمام الباحثين في المجالين الأكاديمي والمهني على حد سواء، على الرغم من الاختلاف الملاحظ على مستوى المعالجة نتيجة للاختلاف الموجود بين المؤسسات، التي عادة ما تصنف إلى نوعين أساسيين، نوع يطلق عليه اسم المؤسسات الكبيرة الحجم والآخر باسم المؤسسات المتوسطة والصغيرة الحجم. فهذه الأخيرة ما زالت تصارع في السوق الاقتصادي لكسب رهان البقاء والنمو في أن واحد.

فمن الناحية التاريخية فإن البنوك تشكل تقريبا المصدر الأوحى في تمويل هذا النوع من المؤسسات، لكن ما ظهر في المقابل، مصادر أخرى بديلة في التمويل أثبتت فعاليتها وأهميتها المعتبرة في تمويل رأس المال العامل للمؤسسات المتوسطة والصغيرة الحجم، من بينها ما يعرف باسم عقد تحويل الفاتورة. أما بالنسبة للنظام المالي الجزائري، فإنه مازال بعيدا عن الممارسة الفعلية لهذا النوع من التمويل، على الرغم من التعليمات والمراسيم القانونية التي تكون قد أقرت بأحقية ممارسته.

if the process of doing so is computerised. Finally, since the debt collection is a specialised business that calls for experience and judgement, then the large firm should be favoured in doing so.

In parallel, small and medium-sized firms may not be able to have a well skilled and specialised credit manager, which may lead them to obtain some of these advantages by forming part of the job out of factor.

It has been reported according to some studies conducted by Nick Ellse (1), Terry Garrett (2), and Brealey and Myers (3), that factoring is of special interest for growing businesses because they often face the problems associated with overtrading.

With the support of a factor, a growing firm or company making good profits can confidently trade at higher level as finance is linked to sales invoices, where the cash position is always kept under control. Therefore, this facility can stabilise the timing of cash flows and make planning for it as accurate as possible.

Factoring can be viewed as giving a two part financial management package related to sales ledger administration and credit protection, plus a flexible financial facility which grows with a company's sales.

Factors are always interested in giving services to those firms that have sound management committed to growth and profitable trading. In addition, they may require the evidence that the need for extra working capital arises as a result of sales growth creating a need for additional finance to service increased levels of stock, raw materials, work in progress and debtors and not to relieve the firm from financial difficulties with banks, suppliers, or other reasons.

Factors work in a way that makes it possible for their clients (firms) to have the availability of agreed financial facility against invoices accepted for factoring, that the factor and the client agree on credit limits for each firm's customer and on the average collection period. Usually, up to 80 per cent of the firm's debtors can be paid off by the factor to the concerned firm. Meanwhile, the factor is completely paid after the agreed period.

As far as the Algerian economics is concerned, it is more than important to diversify means of financing for the SMSF, where this type of firms constitutes the cornerstone of development. In practice, there is a complete lack in using this package of finance. However, deregulations in terms of laws have been established since 1993, (4) where factoring is recognised and defined by law to be introduced into the Algerian financial system, especially banks. Therefore, the aim of this study is to analyse factoring as a means of financing SMSF and arise its importance. This could be treated as follow: firstly, the historical background should be emphasised on understanding the role of factoring; secondly, the factors' services are exposed. Thirdly, the cost and the charges of factoring are taken into account. Finally, some of the types of factoring are exposed.

## **I- HISTORICAL BACKGROUND**

Factoring, as a matter of fact, was instituted a long time ago. It was of a considerable contribution in the sixteenth century to stimulate the international trade between newly settled colonies and the respective mother countries. At that time, factoring concentration was on the textile trade, which continues to make up a major portion of factor's business.

Surveys, reports, and academic researches have asserted the historical role of factoring though it was confined to a particular type of industry, one of which is already mentioned. Gradually, the role of factoring since that time started to become more crucial where now it is adopted almost all over the world **(5), (6)**.

As far as factoring for financing firms is concerned, it has always been perceived as a financier of last resort. In the US economy, for instance, Donald F. Clark **(7)** mentioned that some thirty-plus years earlier, borrowers, using factoring, tried to keep such financing arrangements secret from both customers and suppliers alike, fearing that its revelation would have a negative impact on their firms' image in the business community.

In practical terms, using factoring by firms in a real world was being so because of a lot of constraints that were facing SMSF in having access to credits offered by banks. This was due to the conservative bank lending policies that avoid credit risk from such types of firms that their interests were being concentrated on financing the growth by means of working capital, whereas for larger firms, banks' lending policies were not the case as SMSF.

In recent decades, since the last century, the perception towards factoring has been changing in so many countries in the world, even within those considered as less developed countries. Adopting and accepting factoring as a new alternative in the financial industry for financing firms was due to both new and exciting opportunities that could be brought for the benefits of economy as a whole and SMSF which became the main concern of development and a part of integration in doing business with larger firms. The reaction of banks, especially commercial ones in the US, which experienced the high pressure of factoring earlier than elsewhere in the world, was to change the marketplace of financial system by both acquiring and disposing factoring companies. As a result, banks were obliged to introduce new package of financial services because of declining demand for term lending, instability of interest rates and financial increased default risk of loans **(8)**.

Nowadays, the structure of factoring companies is divided into two important sectors, those that are exercising the activity completely independent, and those that are working as subsidiaries for and within banks.

Under the asset based umbrella, banks are promoting the desirability of factoring as a substitute for the traditional financing methods and provision. Within the British market, for instance, there are studies which state that the encouragement of factoring was backed up by the interference of banks, where nowadays the Association of British Factors (ABF) is one of the established companies groups where most of which are subsidiaries of banks such as Alex Lawrie Factors, Barclays Commercial Services, and

Kellock Factors, that belonging to Lloyds Bank; Barclays Bank, and the Bank of Scotland respectively (9).

Obviously, the above statement shows that factoring companies had taken the first risky initiative for financing firms before banks. This point of view was supported by Donald F. Clarck (10, p. 69) who stated that "while finance companies and entrepreneur lenders gave a birth to and nurtured the asset based lending industry through its early crucial years, banks in the last ten years have totally redefined this type of lending".

In addition, banks have managed to adopt factoring by attracting the strong performing firms' balance sheet, whereas finance companies used to support any firm without taking into account firms' performance. As a result, some of such companies went out of business while banks acquired others. In the US, today, it is reported that ninety per cent of finance companies are undergirded by banks.

Nevertheless, even with the acquisition of factoring companies by banks, there is still evidence that factoring companies are being badly treated. Stuart Parker (11) claimed that "clearing bank linked factors have often been heard to complain that their bank colleagues keep the good customers for themselves and only introduce the less successful ones to their factors" (11, p 18). Furthermore, Independent factors can be exposed by banks, which use certain techniques to hinder the factoring function. For instance, when a greater spread of risk results from the second source of finance that is the independent factor, a bank is most likely to be more flexible in managing the overdraft facility. Thus, it appears that a separation between these two financial services providers would be desirable.

Indeed, recent years have shown that the structure of the UK factoring industry has evolved into four main streams. The biggest one is factoring companies that are been owned by banks, and which account for nearly 90 per cent of industrial turnover. In the second place, there are smaller groups, which exploit niche markets. Venture capital, leasing, and stock lending, form the third group offering factoring or invoice discounting. Finally, the private-owned factoring companies, which belong to the Association of Invoice Factors (AIF), are another small group of factoring companies' (12).

## II- FACTORS' SERVICES

Although the prime motive in using factoring is to give a financial support to firms, the value of service elements of factoring as essential administrative support and protection have been recognized.

The service elements of factoring can be divided into two integrated parts: sales accounting, and credit management and collection. Within the latter element most factoring companies offer a non-recourse service under which they provide 100 per cent protection against bad debts on approved sales.

In more detail, sales accounting services can be better viewed in terms of the following benefits (13):

- The improvement of cash flow and interest saving.
- Saving on management time previously spent for supervising sales accounts or

chasing slow paying customers.

- More time will be devoted to the production management, sales, and business development.
- The enhancement of the relationships between customers and sales.
- Staff by avoiding repetition of requesting payment.

Furthermore, the credit management services can be summarized as follows:

- The elimination of any expenses spent in investigating customer credit standing.
- Poor quality, risky customers can be avoided.

Factoring is exercised by using one of the two following types: recourse and non-recourse factoring. In the case of the non-recourse service the factor provides 100 per cent protection on all approved sales, whereas for the recourse service the company will not have the offer of credit protection as part of the service, where the factor can recourse to his client in the event of a customer defaulting on payment. To choose between these two types comes after the company trades off between the relative costs and the benefits presented by the two alternatives.

The services scope of factoring can be extended to overwhelm overseas trading (14). In fact, trading in the overseas market is not an easy task for the company to do it on its own, especially if it is a small or medium-sized firm because of many reasons such as remoteness, language, and currency. Factoring companies can overcome the currency risk by converting all currency sales to only one convenient currency, at agreed rates, where copies of invoices are received immediately. The exporter, therefore, knows exactly how much he will receive in that agreed currency and his own account with the factor is maintained in the same currency. If exporters prefer to receive proceeds of sales invoiced currencies, or indeed, take prepayments in these currencies, this can be arranged by some factors. Alternatively, factors can account to their exporter clients in certain currencies in which they invoice. Unlike the traditional procedure, where cover must be negotiated on each shipment or order, factoring provides automatic blanket cover in respect of foreign exchange on sales in all the major currencies.

Factoring services are not only beneficial in removing the risk of exporting to markets with irksome trading restrictions and a fluctuating exchange rate, but also in providing finance for short term leasing or capital equipment. Therefore the elegance of factoring is in providing a broadly based package of financial options which can be tailored to a company a specific need.

Despite the benefits that can be stemmed from factoring, the most frequent argument cited against it is the extra cost. However, if the borrowing rates are closely related to bank rates, the only true on cost then is the factoring charges.

### **III- CHARGES OF FACTORING**

The factoring charges are composed of two elements: service and finance. A fee is charged for the service element. This can be expressed as a percentage of the client's sales and is usually between 0.5 per cent and 3.5 per cent. The charge for finance is

dependent on the current base rate, which will be very close to the cost of a bank draft facility.

There are two broad opinions concerning the acceptance of factoring as another option of financing working capital. The first one is against the use of factoring since it is very expensive compared with other bank's facilities such as overdrafts.

The other side which supports the use of factoring, based on the benefits which should outweigh the costs, sees that factoring is more than necessary for small and medium-sized firms since banks never accept to be risk takers in dealing with those growing businesses that are supposed not to be in a healthy financial situation and therefore there are insufficient guarantees for them. Their point of view is based on the principal, which stipulates that better to lend to a firm with rapid payment of invoices than a growing business with a book full of debt.

However, as in most professional relationships a factoring agreement is a long term business arrangement which depends on mutual benefits. Whatever the argument to be accepted factoring depends on the general costs, and their ability in outweighing the banks' facilities.

In addition, firms, which do not accept a factoring facility usually, hesitate to enter such arrangements for fear that they may find it difficult to discontinue the service. In other words, they may wish to discontinue the service for a variety of reasons:

"- Replacement from another source of funding.

-Change in pattern of the business, resulting from a significant reduction in customer.

-Generation of increased profits rendering factoring unnecessary.

-The setting up of a sales ledger system and the acquisition of necessary sales ledger administration, credit control and collection staff to be effective from the agreed handing over date.

-Credit insurance arrangement to replace the credit cover at present, provided by the factor in the case of the non-recourse agreement" (15, p. 123).

Prior to discussing credit insurance, since it is of a considerable importance, factoring should be distinguished from other terms carrying out basically the same function. Invoice discounting is an example. It is a means of generating cash by selling to a factoring company or finance house at a discount, either a selection of invoices on a firm's larger debtors or an entire sales ledger. Furthermore, on the assignment of invoices the client immediately receives an agreed proportion up to 75 per cent of the gross amount due on the assigned invoices. In all, invoice discounting is a simple flexible source of finance enabling a business to increase its working capital temporarily while maintaining a normal relationship with customers, who do not need to know the arrangement.

Furthermore, forfeiting is another term, which is similar to the services of the Export Credit Guarantee Department (ECGD) in the U.K. Forfeiting, for instance, incorporates discounting overseas trade bills or promissory notes by a finance house, without recourse to the exporter if the overseas customer does not honour its debts.

#### **IV- TYPES OF FACTORING**

The most important elements of growing businesses SMSF in terms of short term

finance are: adequate working capital and efficient cash flows. In addition, fast growing firms are more likely to be in need of additional working capital over time. Banks that seem to be the most obvious source of lending facilities are mostly not geared to support the need for additional working capital parameter, because the overdraft facility is often based on last year's trading performance. Since starting SMSF are not supposed to have a high quality of performance as a result of growth stage thus, the bank is usually reluctant to support such type of firms. Rather it would require security of up to three or four times the value of the facility.

However, other alternatives that can be used to support such growing businesses are available. The table below shows all types of possible factoring that can be employed by factoring companies.

**Features of the various types of domestic and international factoring**

Types	Features				
	Finance	Credit cover	Notification	Ledger keeping	Collection
Full service factoring	A	A	A	A	A
Recourse factoring	A	N	A	A	A
Bulk factoring	A	N	A	N	N
Maturity factoring	N	A	A	A	A
Invoice factoring	A	N	N	N	N
Undisclosed Factoring	A	S	N	N	N

Source: (16)

NB: **A**: Always Provided, **S**: Sometimes Provided, **N**: Never or rarely provided.

**IV.1- Full service factoring**

The above table has already showed the features of this service type. It operates with client passing copies of invoices to the factor, which then makes available up to 85 per cent, in practical terms, of their gross value. The Factor has the right to collect the amount owed to the customers and takes over the entire running of the clients' sales ledger, issuing statements and remainders, and work for progressing the whole collection process.

For SMSF, this type of service is most likely to be appropriate because factors are sufficiently experienced in administrating and collecting the debt accounts. As a result, firms using factoring will benefit from having savings or cost effectiveness compared with those that already have their own established administration. Stuart Parker (17) , chief executive with trade indemnity-Heller Commercial Finance Ltd reported that " only few small to medium sized companies have the time or expertise to monitor the creditworthiness of their customers on a continuing basis" ( 17, p 18).

Savings or cost effectiveness is particularly marked in times of high interest rates. John Butterworth (18) stated that in 1989, a year of rising interest in the UK, the

factoring industry as a whole reduced the number of sales (days) outstanding for its full service clients. The amount of bad debt absorbed by factors on behalf of their clients also increased, as insolvencies became more common.

Furthermore, this type of service usually allows a firm to grow in line with its order book. In contrast to firms which rely on bank loans for much of their working capital, the finding in practical terms showed that their bank manager will not advance funds to finance incoming orders because he is up against the limits of the security he has taken out on the business's assets. On the other hand, it should be possible for firms involved in using factoring to take on large orders without fear of using up its working capital and to be able to take advantage of cash discounts and bulk deals when buying raw material.

Within the British factoring markets, the full factoring service need to come from firms which have the eligibility of turnover not less than £75,000, (19) though some factors set a higher threshold. Moreover, the condition under which the eligibility will be fully accepted is that the firm must have a spread for customers so that no single debtor is responsible for the suppliers' outstanding debt. Nevertheless, since it is expensive to administer a large number of very small invoices, factors often stipulate a minimum average invoice size of £100 or more.

A recourse factoring, as it is shown in the above table, means the same procedure of full factoring service except that there is no credit protection that can be given by the factor. "This arrangement is best suited for businesses which already have taken out credit insurance or which deal with a wide spread of small customers, none of which would seriously damage the supplier if the debt were not paid" (19, p. 27).

## **IV.2- Invoice factoring**

Invoice factoring can take place on either a disclosed or a confidential basis. It is a simple and cost effective service. Further, it provides credit without any notice to the customers concerned with the factoring company's involvement. Customers' remittances are collected by the client and paid into the factor's own bank account.

Invoice factoring does not work for all firms. Certain of which are excluded by virtue of their annual turnover and others by the nature of their business.

Historically, larger companies have used invoice factoring with an annual turnover in excess of £750,000. In practice, statistical data shows that 56 per cent of all companies using a factor have an annual turnover of less than £250,000. This is because most of these companies do not have their own accounting systems to run their own sales efficiently; as a result of which using a factor is more cost effective.

The cost-effectiveness of invoice factoring makes Alan McLaren (21) ask why all companies, without any distinction between them, do not use only that type of factoring. However, it has already been mentioned above, that the nature of the business is crucial to array those that really comply with the invoice factoring employment.

In general terms, early clients for factoring services were concentrated on manufacturing industry, followed by distributors, service sector, transport industry and construction. As far as invoice factoring is concerned, industries that are unsuitable for that type are businesses that operate principally on a contractual basis, such as building

or civil engineering firms, or those involved in the computer industry or exporting.

### **IV.3- Other types of factoring**

Again, the above table shows all possible types of factoring. The names of terms provided can be different, depending on the terminology of the service name adopted by the Factor. For instance, invoice factoring and undisclosed factoring both means under Griffin's (British Factor) terminology, invoice discounting with recourse, and non-recourse invoice discounting, respectively.

Moreover, full service factoring and recourse factoring, mentioned in the table, both mean full service factoring, where the first one is considered as none recourse factory while the second is with recourse. Nevertheless, maturity factoring that is credit management, shows only the role of factoring provided to firms that are in a mature stage of their product development; they do not need additional working capital to be financed.

Bulk factoring can also be called in different names, such as sales finance or agency factoring. As already described, full factoring is not quite appropriate for firms with a large number of customers in relation to sales and small average invoice values. Since the cost of full factoring in such case would be high, then the bulk factoring would be the optimal solution for the concerning firms.

In addition, bulk factoring provides access to up to 80 per cent of trade debts whilst the client controls fully the day-to-day sales ledger and credit control function, sending out statements and collecting outstanding amounts. All statements bear a notation to the effect that payments should be made to the factor. This service is available with or without credit cover.

To conclude with, the table below shows the two different types of factoring costs, service charge and finance charge, used by the major types of factors; full factoring, sales finance and invoice discounting.

**Costs of factoring**

<b>Types</b>	<b>Service charge</b>	<b>Finance charge</b>
Full factoring	0,7%-2,5% of turnover	2,5%-3,5% over base
Sales finance	0,3%-1% of turnover	2,5%-3% over base
Invoice discounting	0,1%-0,3% of turnover	2,5%-4% over base

Source: (22)

NB: Service charge is considered as a fixed sum per month.

### **V- FINANCING SMSF BY FACTORING MEAN**

Considering the firm's suitability for factoring, the composition of its balance sheet is of considerable importance. The effect of factoring as an alternative way in financing SMSF, specifically working capital, can be viewed from the balance sheet of the firm that exercising factoring as part of its activity as follows:

Balance Sheet	Before factoring (£)	After factoring (£)
<b>Current Assets</b>		
Debtors	220,000	047,000
Stock and WIP **	170,000 <b>390,000</b>	180,000 <b>227,000</b>
<b>Current liabilities</b>		
-Bank overdraft	095,000	045,000
-Trade creditor	190,000	090,000
-Other creditors	038,000    323,000	025,000    160,000
<b>Difference</b>	<b>067,000</b>	<b>067,000</b>
<b>Total</b>	<b>390,000</b>	<b>227,000</b>

Source : (23)

\*\* WIP means Work In Progress

The above table shows the extent to which SMSF could finance their working capital by the use of factoring as a source of finance. Before factoring the firm's debt situation was heavily seen as a real burden, where creditors (especially bank overdraft) constitute the only way in financing current assets represented by stocks and debtors. However, using factoring facility for financing the use of working capital means that a great relief could be given to the concerning firm which its balance sheet will be off set completely different. Therefore, the effect of factoring on the firm's balance sheet is as follows:

After an initial near 80 per cent prepayment of..... 173,000  
 \* Creditors were immediately reduced by.....100,000  
 \* Stocks were increased by.....10,000  
 \* Bank overdrafts were reduced by.....50,000  
 \* Preferential creditor (VAT, PAYE) were brought up to.....13,000  
**Total : 173,000**

### CONCLUSION

Based on the above discussion, it should be noted that the fierce competition between financial institutions is quite remarkable, especially between banks and other sources of finance.

As far as factoring companies are concerned, it has been proved that small and medium- sized firms (SMSF), regardless of their perceptions of factoring, rely on them. In earlier times, factoring had been considered as a last resort. However, this view has been gradually changing over a period of time when organisations started to recognise the role of factoring not as a last resort but as a new way of financing and filling the gap that had been left by banks.

Alternatively, banks are still playing a leading role in providing different packages of finance, contributing to the development of the economy. However, from the point of financing working capital view, most of the evidence shown above illustrates that there are limitations to the success of the bank's contribution to the improvement of SMSF that are usually in need of financing their growth.

In contrast, large firms that is supposed to be in a mature stage of growth seem not to be in need of bank overdrafts for financing working capital. This means to have

enough liquidity to support short-term needs of finance purposes. In addition, these firms could rely on their self-financing by using two alternatives: Firstly, they have access to capital market through the issuance of equity, and secondly through bank overdrafts. Both accesses, and to a large extent, are much easier for large firms than SMSF. Banks ease the facility for large firms because they have several and sufficient guarantees that cannot be provided by SMSF.

Therefore, this argument supports the study that was conducted by Moss and Stine (24), asserting that liquidity decreases as the firm's size becomes larger.

Furthermore, banks which are concerned with offering services on international scale beside the domestic one then are not so attractive to tailor their services to financing SMSF needs. In parallel, to have access to capital markets requires from SMSF to have a good reputation, whether in terms of a strong balance sheet performance which lenders can rely on, or in terms of its shares prices in the market. Thus, these indices are probably strong evidence for lenders to guarantee their money and claim them back in cases of financial distress or bankruptcy, which might happen to these types of firms.

Finally, it could be argued that factoring as an alternative financing means is effective for SMSF. Meanwhile, it can not be the exhaustive way for financing working capital. Asselbergh (25) stated that factoring can be fully related to the phenomenon of trade credit, where suppliers play a great role in overcoming financing problems by creating an additional source of finance. In this context, the Algerian economic system that should be based on SMSF, needs to tailor its banking services, in terms of finance, by the use of factoring.

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