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**FACTORING OF ACCOUNTS RECEIVABLE:  
Analysis, International Perspectives and the Australian Market**

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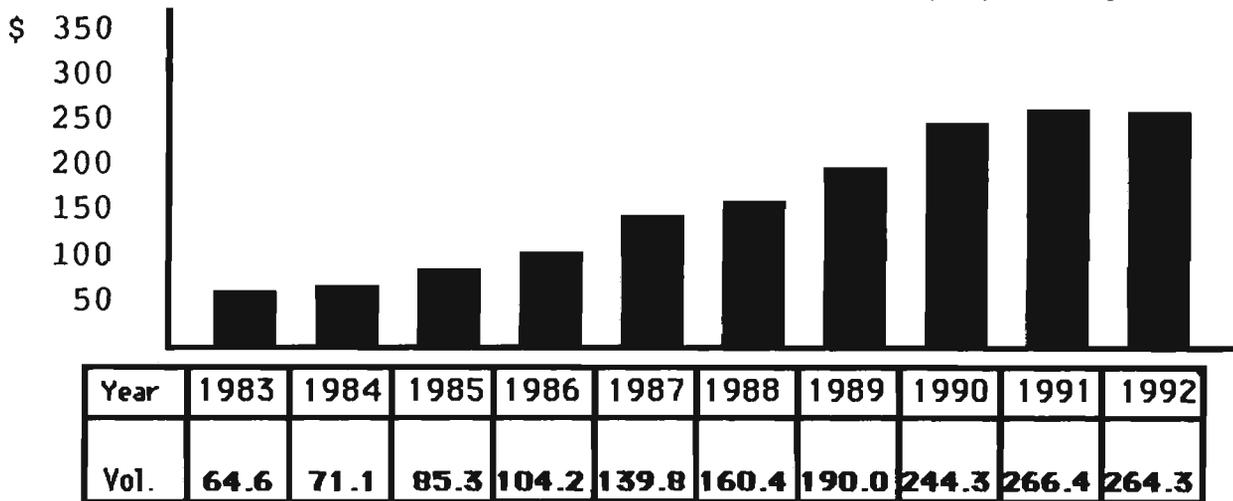
## Chapter 1

### FACTORING RESEARCH PROBLEM

#### Introduction

Factoring is the purchase of a company's accounts receivable by a financier (factor). Worldwide, in 1990 more than 88,000 businesses used factoring to settle trade transactions with some six million corporate customers (Factors Chain International (FCI) in The International Factoring Report). Total world factoring volume in 1992 was just over US\$264 billion; a 330 percent increase over a period of ten years (see Exhibit 1).

**Exhibit 1** SUMMARY OF WORLD FACTORING VOLUME (US\$ billion)



Source of Data: Factors Chain International

The volume and growth suggests a significant role for factoring in the financing of economic activity. Since it provides a competitive edge over letters of credit (James, 1993,p.31) the development and growth of international factoring, as a means of financing world trade, will further boost volume and enhance the importance of factoring.

Australian factoring volume reached an estimated US\$1.6 billion in 1992. Despite the volume it is not a favoured

means of finance in Australia. This may be partly due to the misunderstanding of its benefits, its reputation as a finance of "last resort" and, perhaps, the perceived lack of professionalism among the Australian factors. It is possible that this may also explain the lack of attention paid to factoring in academic literature and professional circles.

However, factoring has achieved such worldwide volume and growth that it demands more examination. Its volume in Australia, together with the increasing popularity of securitisation (factoring by another name for high rating corporates) are important reasons for considering factoring and re-examining its potential for financing Australian business activity. Maiden and Rogers (1990), for example, report the securitisation of \$400 million of Broken Hill Proprietary Limited's (BHP) \$1.55 billion trade receivables and suggest a probability for its expansion. The funds raised in the deal were to be used to free short-term borrowings that were supporting BHP's receivables and to retire debts.

## **Purpose and Scope of the Research**

The purpose of this thesis is to provide an in-depth analysis of factoring; a means of raising funds, and thus promoting economic activity, through the sale of a firm's accounts receivable. This is achieved by taking an international perspective in the literature review and considering the history, nature and worldwide growth of factoring.

A further aim of the thesis is to examine the nature of, and practices in, the Australian factoring market. This is achieved through research by way of questionnaires and personal interview of both Australian factors and some of their clients. Specifically, the research will provide:

- a) a brief history of factoring in Australia;
- b) details of current Australian factoring practices;
- c) details of the size of the Australian market; and

d) a summary of the attitudes of some factoring clients.

Since there has been virtually no academic research conducted into factoring in Australia the most important aspect of this research is to fill the gap by providing a base understanding of the Australian factoring market.

### **Definitions and terminology**

"Pure" factoring involves a continuing agreement that enables the financial institution to purchase a client's receivable invoices as they arise, without recourse to the client for any credit losses that may occur. At the same time the factor takes over the accounts receivable management including credit analysis, ledger maintenance and collections.

Over the years a number of factoring methods have evolved to meet client needs. These include:

- a) Non-Recourse Factoring. In this arrangement the credit risk remains with the factor. It requires the notification of the factor's interest and the management of its purchased accounts receivable ledger. It is the "pure" form of factoring described above.
- b) Factoring with Recourse. The credit risk ultimately remains with the seller of the accounts receivable. After a stipulated period, usually 90 days, if the debt remains unpaid the factor's client is required to repurchase the debt.
- c) Notification Factoring. This means that the factoring arrangement is disclosed to customers. They are advised of the sale of the receivables and are asked to pay the factor direct. While it is normal practice that notification is provided in a non-recourse factoring arrangement it may also occur when the factoring is with recourse.

Notification is usually required when the factor considers the client to be of a higher risk or when, for one reason or another, the probability of non-collection is greater if the arrangement is hidden.

- d) Non-notification Factoring. The customer is unaware of the factoring arrangement. Payment is usually either forwarded to the seller, as would normally be the case, or addressed to the seller but sent to a postal address under the control of the factor. Clients acceptable under this arrangement must be of a lower risk class and the accounts receivable would be of a better quality than under notification factoring. Also, under this arrangement, the client usually remains responsible for collection of the debt.
- e) Maturity Factoring. The factor pays the client on the date the invoice, or a batch of invoices, becomes due for payment (matures). This form of factoring is suitable for a company without a liquidity improvement need but one that desires the non-financial services of the factor. These non-financial services may include:
- (i) credit risk assessment;
  - (ii) the establishment of credit amount and terms in respect to the risk class of the customer;
  - (iii) collection of the receivable; and/or
  - (iv) the bearing of the default risk.
- f) International (or Export) Factoring. All of the services associated with factoring, that is, credit assessment, credit management and collections, risk guarantees and financing, are also available to exporters through an export factoring facility. The basic difference between it and domestic factoring is that international factoring requires both an "Export Factor" and an "Import Factor".

The Export Factor, located in the home country of the exporter, is responsible for all contacts with the exporter, providing credit approval information, advancing funds, managing the exporter's international sales ledger, remitting any funds to the exporter etc. In fact, the Export Factor is almost in a similar position to the factor in a domestic factoring situation.

Import Factors, on the other hand, are responsible for credit checking, collecting funds from the importers, remitting funds to the Export Factors, and providing the Export Factors, and through them their clients, information about the market conditions in their home markets.

- g) Forfaiting. Shapiro (1992,p.317) states that this specialised factoring technique is sometimes used in the case of extreme credit risk. He describes forfaiting as "...discounting - at a fixed rate without recourse - of medium-term export receivables denominated in fully convertible currencies (U.S Dollar, Swiss franc, Deutsche mark)." Shapiro further states that forfaiting is usually used in the case of capital-goods exports.
- h) Securitisation. Securitisation is the process whereby a firm packages a portfolio of assets into marketable securities and offers them to the market - the buyers of such securities (Vann,1991,p.6). These may either be mortgage or asset backed securities; asset backed securities include accounts receivables or financial receivables in the case of financial institutions.

According to Imhoff (1992) "a common form of asset securitization involves the transfer of trade accounts and notes receivable to receivables investment companies (RICs) on a revolving, ongoing basis"(p.6). This makes packaging of

receivables for securitisation similar to a factoring transaction. Although Imhoff (1992,p.6) tries to distinguish between factoring and securitisation the principal difference relates to the quality of the original owners of the accounts receivable; securitisation being related to highly rated corporates while the term "factoring" being used for all others. In effect, the listed differences do not describe different funding techniques.

It must also be noted that the term "client" refers to the the organisation that utilises the factoring service while the word "customer" will mean the firm which purchased the goods and incurred a debt (factoring client's customer).

### **Structure of the paper**

The remainder of the paper is divided into three parts. Part A, the literature review, contains four chapters: Chapter 2 looks at the history of factoring; Chapter 3 deals with current practices, costs and benefits; Chapter 4 specifically considers the importance of cash flows and the creation of accounts receivable, the two major elements of factoring; and Chapter 5 deals with the international perspectives of factoring.

Part B of the paper deals with the research methodology and research results. Chapter 6 outlines the research design and limitations of the study while Chapter 7 details the research results.

Part C contains the summary, conclusions and recommendations (Chapter 8).

**PART A**

**LITERATURE REVIEW**

## Chapter 2

### THE HISTORY OF FACTORING

Factoring, the purchase of an organisation's book debts by a third party, has its roots in ancient history. This chapter will explore both its origins and the modern history of accounts receivable factoring.

#### **The ancient history of factoring**

Prior to the 20th century a factor was a business agent. The functions of this agent included warehousing and selling of the commodities consigned to the agent, accounting to the principals for the proceeds and guaranteeing the credit of purchasers. Sometimes cash advances were also made to the principals before the actual sale of the goods (Encyclopaedia Britannica, Micropaedia, Vol. 4, p.652).

According to Wood ('n.d.'pp.1-2) the first record of such middleman functions was about 5000 years ago in ancient Iran when guarantees were issued to sellers of goods as security to assure the fulfilment of the buyers' obligations. These agents sold goods in their own name on behalf of a principal, issued invoices, extended credit with and without recourse to the principal and provided other trade services.

The ancient Sumerians also provided such middleman functions as did the Assyrians who extended the service to act as commission merchants and offered finance for trade caravans. The Babylonians later introduced the concept of notification to pay specific third parties. Whereas previously merchants borrowed cash and paid promptly for the goods, in ancient Greece Protagoras promoted the true credit purchase - pay by sundown.

The rising prominence of the Roman Empire saw the

middleman's function become more clearly identified. Originally the term "factor" referred to an agent for a property owner and the word arose from the Latin verb "facio" meaning "he who does things".

It was the growth of the wool industry in late fourteenth century England, however, that caused the development of commercial factoring. Serving as a selling agent the factor helped the mill to overcome the obstacles of geographical distances by advising it of local market conditions. The merchandise was shipped to the factor who sold it and assumed the responsibility for the creditworthiness of its customers.

The functions of guaranteeing credit and billing, for an additional commission, placed the factor in a position to ease the financial burden of the mill by remitting to it a relatively high percentage of uncollected amounts. A reserve was retained to cover potential disputes and claims for defective merchandise.

During the sixteenth century factoring became an important means of stimulating international trade between newly settled colonies and the respective mother countries (Johnson & Lapelosa, 1989, p.68). Thus international factoring became established for the first time.

## **History of Modern Factoring**

Modern factoring took hold in the United States of America about 150 years ago flourishing with the growth in the U.S. economy (Rutberg, 1989a, p.30). The development of the American textile mills lead to the development of factors for those mills (Woods, 'n.d.' p.3) and the growth in factoring had been largely tied to the growth in the textiles and apparel industry (Rutberg, 1989a, p.30).

Pure factoring was seen as an appropriate means of servicing the needs of textiles and apparel industry. This meant that the factor purchased outright the client's

accounts receivable without recourse to the client (Rutberg, 1989c, p.14). In such an agreement the client's customers were notified of the factoring arrangement, the factor managed the accounts receivable ledger, performed credit investigation and approval, assumed credit risks, made advances against receivables purchased and provided advisory services (Lux,1988,p.86).

The provision of such services has ensured that the heart of the factoring business in the United States is credit information and voluminous credit files had been built up on the traditional industries using factoring services (Rutberg, 1989a, p.30). Although U.S. factors have tried to free themselves from their dependence on the apparel and textile industry the major reason for their lack of success is that the credit checking function requires up-to-date financial information and a familiarity with the customer base of the factor's clients (Rutberg, 1989c, p.17). The cost of accumulating such information has ensured that diversification in the factoring industry has been extremely difficult (Rutberg, 1989a, p.30).

According to Rutberg (1989b, p.6-8,61) the first bank to enter the factoring business was the Trust Company of Georgia in 1939 and the second was First National Bank of Boston in 1945. To overcome the preclusion of national banks participating in the factoring business First Boston fashioned its contracts with clients along the lines of receivables financing (or invoice discounting) rather than receivables purchase. Thus recourse and non-notification factoring alternatives developed.

Others followed after the rules were changed in 1963 to open the market up for national banks. The first of the major city banks to buy into the factoring industry was Citibank, followed by Philadelphia National Bank & Trust (1967), Bankers Trust Co and Chemical Bank (1968), Chase Manhattan Bank (1969), and Manufacturers Hanover Trust Co (1971). Of the big five New York banks only Manufacturers Hanover remains a major player. In 1988 it produced a

volume of \$7.5 billion or 16% of the factoring market in the United States. It was followed by Heller Financial (owned by Fuji Bank) with a volume of \$4.55 billion and Irving Trust (\$4.5 billion).

Factoring was imported into Britain in the 1960s (Batchelor,1990,p.30) and quickly spread into the rest of Europe. Today the vast majority of the world's factors are bank owned. In Great Britain Lloyd's Bank, Barclay's Bank, Midland Bank, National Westminster Bank, The Royal Bank of Scotland, and Security Pacific Eurofinance are all involved in factoring through ownership of factors (Batchelor,1990,p.36).

Factoring was also established in Australia in the early 1960s and the larger and more active factors operating in Australia are bank-owned. Chapter 7 considers the development of factoring in Australia in detail.

## Chapter 3

### ACCOUNTS RECEIVABLE FACTORING: CURRENT PRACTICES, COSTS AND BENEFITS

One enduring perception of factoring is that it is solely a means of financing businesses that do not meet the criteria of traditional lenders (Salinger, 1991, p.25). This "last resort" characterisation (Dehler, 1990, p.46) (Batchelor, 1990, p.35) was enhanced by the high client risk rating causing extremely high, if not excessive, borrowing rates (Clarke, 1989, p.40). Clarke also states that borrowers feared the disclosure of such arrangements for the knowledge would surely have a negative impact on their organisations' images in the business community.

A further criticism of factoring, which also helped to create the negative image, is that once entered into a factoring arrangement is difficult to terminate and could lead the company into financial difficulty (Salinger, 1991, p.25). However, Salinger suggests that the lender of last resort perception clearly ignores the purpose and benefits of a facility which protects against bad debts and aids business growth. The second allegation has developed largely as a result of utilising the wrong service or the incorrect use of any one of the factoring variants.

This chapter will explore the nature of factoring including the characteristics of suitable clients, benefits, disadvantages, costs and risks of factoring.

#### **Characteristics of Suitable Factoring Clients**

##### **Financial Characteristics**

Factoring's reputation as "finance of last resort" tends to attract troubled organisations. If the business is unprofitable with little prospect of improvement the

cashflow injection that factoring provides will only delay the inevitable. Therefore, only profitable, or potentially profitable, companies should resort to factoring since these are going to truly benefit from the breathing space provided by an immediate increase in cash (Salinger,1991, p.27).

A positive enough cashflow to absorb the cost of the arrangement is also important to successful factoring (Salinger,1991,p.93). The client should also seek to avoid the full utilisation of the available funds at all times. Salinger states that such reliance may cause difficulty if a debt becomes ineligible for purchase or if planned sales don't eventuate.

A typical factoring prospect is a young growing company (Figgis,1989,p.136) with substantial investments in quality inventory and receivables. Since a great deal of investment is tied up in these assets the company requires working capital financing in order to continue the growth pattern (Cephas,1988,p.60). However, the growth will continue to be inhibited if the additional funds generated by factoring are used to purchase fixed assets (Salinger, 1991,p.27). Salinger (1991,p.28 & p.93) states that this will be a particular problem under recourse arrangements where the factor exercises his right of recourse. If the client has insufficient funds to repay the amount future factoring prepayments will be reduced accordingly and cashflow difficulties will most certainly result.

### **Product, service and industry requirements**

Factors also stipulate that the goods or services subject to factoring arrangements must have been supplied and that there should be no continuing obligations (Figgis,1989, p.137). This is because factoring was developed to "... fill the requirements of suppliers of goods for the granting of true self-liquidating short-term trade credit to their customers." It is suitable for goods that can be sold and forgotten; where debts are fully collectable, even in the absence of the supplier (Salinger,1991,p.26).

Goods subject to substantial after sales service or back-up are, therefore, not completely suitable. In order to obtain protection from such counterclaims the factor may impose additional safeguards (Salinger,1991,p.26,36) such as reduced purchase rates (increased retentions), higher fees, and shorter recourse periods. It is, in fact, normal practice for factors to have the right of recourse in respect of a debt subject to defence or counterclaim (Salinger,1991,p.37) regardless of whether the factoring arrangement is with or without recourse. This may limit the potential benefits to be derived from factoring.

For the same reason, goods and services supplied on the basis of continuing contracts may be ineligible unless by agreement between the supplier and his debtor the contract is made divisible. The potential counterclaims that could result from failure to complete such contracts may preclude factoring arrangements with any form of funding advances (Salinger,1991,p.36).

Organisations that traditionally sell to industries with high bad debt expectations will not find solutions in factoring. The risks are such that the factor will require a relatively high retention rate in order to cover the expected losses. Commensurate with the high risk level will be the high return requirement (Salinger,1991,p.29). The combination of a low purchase rate and high cost will make the factoring seem an extremely unattractive proposition.

#### **Characteristics required for recourse and non-notification factoring**

Recourse factoring should only be used by businesses with a good spread of debtors and where the debtors are of a suitable quality standard (Bartlett,1986,p.57)(Salinger, 1992,p.29). The potential recourse of high exposures and/or high levels of bad debt may cause significant cash flow difficulties. Even in non-recourse factoring arrangements high exposures by a small number of debtors may cause them to quickly reach the established credit limits. Planned cash inflows may not eventuate if these

credit limits, or uncreditworthy customers, prevent the factor from purchasing the debts.

Companies with good administration of the credit assessment, granting and collection functions will be more likely to obtain non-notification type factoring while other situations will require a full service function which includes notification, credit control and accounting (Bartlett,1986,p. 57). Of course, some young growing companies may benefit from the release of their management team from the burden of day-to-day sales ledger and credit management (Figgis,1989,p.137).

### **Companies that would enjoy cost advantages in factoring**

According to Mian and Smith (1992,p.175) scale economies in the credit-granting and credit collection functions imply that a large specialised factor is more efficient than the credit departments of several smaller firms. There should, therefore, be a cost advantage in factoring by these smaller firms.

They also suggest (p.174) that factoring is expected in industries with many manufacturers selling to many retailers and with a significant overlap in the manufacturing firms' retail customers. This is because -

- (1) the costs of subcontracting the credit risk assessment functions vary with the pattern of sales across the industry;
- (2) If the required investment in credit information is highly specialised, factoring is exposed to the costs of post-contractual opportunistic behaviour. Therefore, the greater the possibility of opportunistic behaviour the less likely is the factor to invest in credit information; and
- (3) If the repeat sale frequency with a given firm is low but across a group of firms is high, factoring can reduce the costs of credit extension because the account debtor has a longer expected business relationship with the factor than with any individual manufacturer. This lowers the credit

risk for the factor compared to the manufacturer.

### **Example of a suitable client - The United States Health Industry**

In the United States of America the health, particularly hospital, industry provides typically good factoring prospects. The need for adequate cash reserves to cover operating cash deficiencies provides a potential for initial receivables financing of between US\$50 billion and US\$60 billion. It is estimated that on a continual basis gross revenue available for periodic financing is somewhere between US\$240 billion and US\$260 billion (Ferconio and Lane,1991,p.74).

Edwards, Hamilton and Hauser (1991) conducted a study to determine, among other things, the extent to which hospitals in the United States were involved in selling their accounts receivable. The study indicated that factoring was not a popular way of fulfilling short-term cash needs in hospitals; only 13 (4.7 per cent of the 278 respondents) factored their receivables (P.86).

Of those that were not factoring 88 per cent (234 of 265 facilities) did not plan to factor in the foreseeable future. Ten hospitals (4 per cent) expected to begin factoring within the following year while a further 21 (8 percent) planned to begin factoring two or more years into the future (p.87).

Factoring has been well established in a number of industries particularly where the participating organisations meet the criteria discussed in this section. The hospital industry in the United States meets this criteria but, despite the need for cash, has not been taking the opportunity. Possibly the major reason for such reluctance is the "last resort" stigma that still seems to be associated with the factoring industry.

## **Benefits of Factoring**

### **Improved cash flow**

One of the major benefits of factoring is that it is a continuing source of operating cash. According to Lux (1988,p.86) factoring offers the special characteristic of being a long-term source of short-term funds; a type of revolving credit. The funds are short-term since the assigned invoices have short-term maturities but the arrangement is a long-term one. Funds will continue to be supplied for as long the company makes shipments and is willing to continue with the arrangement.

The receipt of immediate cash alleviates the business from having a large portion of its working capital tied up in accounts receivable (Lotz,1992,p.38). It increases the turnover of a company's working capital providing it with the ability to handle a larger volume of sales without the need to increase the capital investment (Lux,1988,p.86). Higher sales will themselves automatically create the ability to obtain greater levels of cash since the facility level normally follows the company's growth pattern (Salinger,1991,p.35). Vigorously growing companies can be assured that cash will be available to support the required purchases (Salinger,1991,p.30). Higher sales levels should lead to higher profits.

In order to improve cash flow some companies offer a discount for prompt payment. The problem occurs when the customer does not remit the funds within the discount period but still takes the discount. Not only does it not improve cashflow but the amount eventually received is reduced (Lotz,1992,p.38). Factoring solves this problem.

The benefit of factoring's ability to raise cash to support higher working capital requirements during periods of rapid growth is particularly pronounced in seasonal industries. During the short period of sales concentration the working capital requirement may be quite out of proportion to the capital resources of the business. By

being sold to a factor the relatively high value of trade debts may be used to obtain the cash required to fund the increase in activity (Salinger,1991,p.41).

Since factoring involves the outright purchase of receivables the benefits of factoring are obtained without any adverse balance sheet effects. In fact, the balance sheet of the factoring client will compare favourably to the balance sheet of a firm that uses alternative financing means (Lux,1988,p.88) with a possible improvement in some vital ratios.

Increased cash turnover can also benefit distressed companies and enable them to survive (Hill,1992,p.36). Also, in many bankruptcy workouts an analysis of previous receivables management practices usually reveals sloppy collections procedures, poor credit screening and incorrect invoicing. The use of the factor's experienced and specialised staff is not only crucial to the success of turnarounds (Hill,1992,p.38) but the expertise may be used in every day situations.

Improved cash flow is probably the most important of all factoring benefits. The importance of cash in solvency and business valuation is explored in chapter 4.

### **Professional accounts receivable management**

Factors are specialists in accounts receivable management who maintain credit, collection and book-keeping departments to serve their clients' needs. For a fee the client may dispose of these normally internal functions and the expense that results from performing them (Lux, 1988,p.88). Salinger (1991,p.39) states that the company management may then be freed to concentrate on the value-added functions of the organisation; production and sales.

In utilising the services in this manner the factoring client will have access to the factor's "open item" system with prompt allocation of payments and credits (Salinger, 1991,p.32). Collections will be performed by personnel

skilled in keeping the credit taken by customers to a minimum whilst avoiding any prejudice to customer relations (Salinger,1991,p.30). It is also more likely that a "marginal" customer will pay a factor before a non-factored supplier because factors have the power to withhold credit for other suppliers they represent (Lux, 1988,p.86).

### **Elimination of credit risk**

Shapiro (1992,p.316) states that a major benefit of factoring to many firms results from the fact that the cost of bearing the credit risk associated with a given receivable can be substantially lower to the factor than to the firm. He suggests that this is due to two principal reasons. Firstly, the factor's greater credit information makes it more knowledgeable of the actual risks involved and this reduces its risk premium. Secondly, because the factor holds a well-diversified portfolio of receivables it can eliminate some of the risks associated with individual receivables.

In some forms of factoring the factor provides credit risk insurance by assuming all the risk of the approved invoices (Frith,1988,p.92). The principal advantage of using a factor compared to credit insurer is that the money lost is immediately replaced in full (to the extent of the factor's approval) and the business does not need to await the settlement of the claim (Salinger,1991, p.33). This is particularly important where a business would fail upon the default of a major customer (the so called domino effect).

Salinger (1991,p.40) also suggests that the fear of unknown credit risks may restrain the diversification intentions of many firms. He states that such uncertainties may also arise from a simple change in the pattern of trade. In both of these circumstances the willingness of the factor to undertake credit risk and/or to provide valuable information will enable the companies to proceed without fear.

Credit risk is a significant risk, and therefore cost, to many businesses. Despite the importance of cash and the costs of credit and accounts receivable management, most businesses continue to trade on credit, thereby creating the need for a factoring service. These costs, together with the benefits of providing credit are also considered in chapter 4.

### **Increased sales, reduced costs and improved credit-rating**

It was previously stated that factoring enables a firm to acquire the working capital necessary to support increased sales activity. Factoring itself could boost a firm's sales because the factor may be able and willing to grant credit to "marginal" customers (Lux,1988,p.86). Perhaps the supplier could not afford such risk thus eliminating potential sales.

Among the profitable opportunities for funds generated from factoring transactions include taking advantage of volume discounts, discount rates, and economies of scale, thus reducing the per unit cost (Frith,1988,p.92). Other possibilities involve the capitalisation on special opportunities in which concessions may be obtained for buying for cash, increasing sales by granting longer terms, carrying a larger and more complete inventory, reducing operating costs by spreading production in advance of peak seasonal demands and saving on transport costs by buying in larger quantities (Lux,1988,p.86).

Another of the financial advantages of factoring is that it allows the business to protect and improve its credit rating (Lux,1988,p.88). The cash the firm receives from the factor will enable it to meet its accounts payable as they mature and thus maintain a high credit standing with its suppliers. This could be of enormous advantage particularly in situations of material shortages when suppliers will ration supplies. It is more likely that good paying customers will secure their share than those that are not so good. Similarly, prompt payment enables the development of good vendor relationships required by

the "Just-in-Time" (JIT) philosophy.

### **Availability of information**

Another significant advantage of factoring is that the factor, in carrying out the sales ledger administration function, is in a position to provide the client with any sort of sales analysis the client may require (Salinger, 1991,p.49). Considering the investment that factors usually make in information systems this may be significantly better than the client is likely to construct. In addition, the factor will provide aged outstanding reports, details of disputed items, current credit limit of each debtor and the like. Factors are also now in a position to provide terminals to their clients and grant them access to any account on their sales ledger (Salinger,1991,p.49).

Factors can also be a source of other valuable information for their clients. They may advise on changing market or monetary conditions, offer innovative ideas, provide counsel on financial resource management and devise customised financial plans (Frith,1988,p.92).

### **Increased borrowing capacity**

A final benefit of factoring is that it enables an organisation to borrow more than would otherwise be the case. In this manner owners are able to avoid dilution of their ownership equity and control (Lotz,1992,p.39).

### **Example of benefits enjoyed by factoring clients**

Factoring was utilised to finance a start-up operation that developed an environmentally friendly product (Planeaux,1990). The product, a disposable nappy that would bio-degrade in two years compared to the 200 years required for a typical disposable nappy, achieved sales of US\$40 million in its first year of operation with the expectation of topping US\$100 million in the second year. Inability to obtain funding elsewhere means that the business would not have existed had it not been for factoring.

Similarly, for hospitals in the United States that are under pressure to meet payroll, pay bills or reduce debt, selling accounts receivable is a new source of "low cost", readily available cash (Spiegel, 1989, p.40). Spiegel states that factoring enables hospitals to build working capital at a time when new sources of funds are limited. By selling the receivables hospitals gain flexibility, improvement in liquidity and cash flow enabling them to retire debt and hold down debt to equity ratios thus enhancing their borrowing power in the marketplace.

Another benefit is that it enables them to pay vendors more quickly, creating the opportunity to negotiate better contracts and prices (P.42).

### **Disadvantages of Factoring**

There are two main disadvantages that are commonly associated with factoring (Hampton, 1989b, p.315):

1. Implication of financial weakness. In factoring the firm gives up future cash that is to be provided by its accounts receivable to generate today's liquidity. This may indicate a weakness in its financial structure (that is, lack of capital). This implication has led to a common belief that factoring is finance of last resort; and
2. High cost. Factoring is generally considered to cost more than other forms of finance.

However, it must be emphasised that factoring is not finance; it is the sale of assets. When considering the fact that factors provide services that minimise the costs of credit administration, eliminate the necessity to provide early settlement discounts, provide the liquidity which enables the firm to significantly reduce costs by taking early settlement discounts, and enables it to take advantage of profitable opportunities, perhaps the costs of factoring are not so great after all. When all these

things are considered it may also be possible that there is a net benefit in factoring.

Factoring is particularly suited to companies experiencing growth in sales because it provides the cash to satisfy their increased working capital requirements. Survival and growth of these organisations often cannot be assured otherwise. The costs of such assurance, therefore, can be considered relatively minor.

### **Costs of factoring**

Different levels of perceived risk ensure that costs of factoring vary considerably from one business to another. The factor considers the nature of the organisation, the industry and the economy in general, the quality of the accounts receivable ledger, average debt turnover, the potential for bad debts, and other like matters, in setting the fees and charges. Also, since factors bear all the credit risk in non-recourse factoring, it is also likely that this form will cost more than the alternative. Furthermore, because it does not involve an advance it is expected that maturity factoring will cost less than other forms of factoring.

The extent of the fee charged is a function of the level of service provided by the factor. Generally, the factoring fee is a flat rate and may range between 2.5 per cent and 5 per cent of the face value of the invoice or debt. This fee may be generally between 0.5 per cent and 2.5 per cent for maturity factoring (Salinger, 1991, p.58).

In certain circumstances the factoring fee may be reduced significantly with an addition of an interest charge. This may vary between 0.5 per cent and 5 per cent above the factor's cost of borrowings or a published indicator such as AMBA (Australian Merchant Banker's Association) or bank prime rate, and would be charged on the outstanding advances.

Other potential fees include: administration fees, facility fees, commission (factoring fees), establishment fees, transaction fees, activity fees etc.

## **Factors' Risks in Factoring**

### **Traditional risks**

The traditional risk that any factor faces is the non-payment of the invoices purchased. There are a number of ways to ensure that the debts purchased are payable at the value notified or offered to the factor (Salinger, 1991,p.43). These include:

- a) Review the initial debtors ledger to assess their credit standing and to determine the level of approvals - set credit limits. This is particularly appropriate in non-recourse factoring (Salinger,1991,p.44);
- b) Requirement that invoices bear a notice that the debts have been purchased by, are assigned and only payable to, the factor. This will only be the case in non-recourse/notification type arrangements (Salinger,1991,p.46); and
- c) Reliance on a good spread of client's business and protect itself against undue concentrations in sales and debtors (Salinger,1991,p.50).

Factors want to avoid any possibility of the dilution in the value of accounts receivable that have been purchased (Johnson & Lapelosa,1989,p.69). This dilution of value can occur in cases of disputed accounts, credits and returns. They will ensure that the retention amount is sufficient to cover such possibilities and the factoring agreement, regardless of the factoring method, will usually provide for the transfer, to the client, of the credit risk associated with disputed accounts (Salinger,1991,p.53).

The avoidance of risk associated with the dilution of accounts receivable value also requires the factor's rejection of debts of the following type:

- a) debts arising from sales to the client's suppliers that may result in set-offs or contras;
- b) purported debts arising from delivery on a sale or return basis;
- c) debts arising from sales on terms more liberal than approved by the factor;
- d) sales to associates of the client or to individuals for their personal or domestic use (Salinger,1991,p.56); and
- e) sales subject to bill and hold conditions whereby the merchandise is sold and invoiced but will not be paid for until it has been called by the customer (Johnson & Lapelosa,1989,p.69).

The first opportunity to ensure a good and honest relationship with the client, and to minimise the risk potential, is the initial survey (client assessment). According to Salinger (1991,p.104) the purposes of the survey are:

- a) to assess the quality of the debts and the likely risks of failure to collect payment;
- b) to determine the charge for bearing the credit risk in non-recourse arrangements;
- c) to assess the administrative function to be taken over by the factor and the charge for the performance of this function (if applicable);
- d) to assess the strength of the client's business and the prospect of its profitable operation during the factoring period;
- e) to ensure that the factor will obtain ownership of the debts purported to be sold to him free of any charge, encumbrance or claim by any third party; and
- f) to determine the extent to which the factor's ability to collect the debts will be frustrated by disputes, returns, allowances and other cross claims.

Another one of the traditional risks faced by factors is the client's inability to pay (Johnson & Lapelosa,1989,

p.69)(in situations where debts have been recoured for whatever reason). In addition to the assessment of company financial strength this risk may be reduced by requiring guarantees and indemnities from all companies within a group and personal guarantees from directors and shareholders of private companies (Salinger,1991,p.99).

The most serious risk that a factor faces is the possibility of fraud. According to Rutberg (1990,p.20) frauds fall into five well-defined categories:

- \* Fictitious receivables and forged shipping documents;
- \* Assigning the same accounts to more than one factor;
- \* Not reporting credits for returns of merchandise, discounts, trade allowances etc.;
- \* Not turning over funds collected on receivables assigned to the factor; and
- \* Creating non-existent inventory or equipment.

The second type of fraud caused the formation of a trade association (National Commercial Finance Association) in the United States to enable the industry to exchange information on what is being pledged to whom. In the same paper Rutberg outlines a situation where the assignment of the same security to more than one financier cost the industry \$24 million. Another fraud used the false invoice caper to get away with \$41 million.

Some of the measures usually undertaken to prevent fraud include invoice/delivery verification in non-notification type arrangements and regular audits of client records.

#### **New risks in the factoring industry**

Johnson and Lapelosa (1989,p.70) also describe some relatively new factoring industry risks which include:

- \* Higher advance ratios lessen profit margin and increase the total costs of nonpayment;

- \* Increased costs lead to more relaxed client monitoring standards;
- \* Greater reliance on collateral security that is not monitored, verified, and valued regularly;
- \* Competition has forced the factors to accept receivables that in the past were thought to be inappropriate;
- \* Factors have sought involvement in new industries in which they may not have the desired expertise;
- \* The continued fight for increased market share will inevitably lead to the assumption of higher risk; and
- \* International factoring adds foreign exchange risk and political risk to the portfolio of risks undertaken by factors.

#### **Audit of factors**

Johnson and Lapelosa (1989,p.71) suggest that, as a result of these risks the audit team responsible for auditing factors need to understand the factoring industry and they should be concerned with the factor's "early warnings" system. These are indicators of potential trouble and include: a client's pattern of delinquent payments; frequent requests for overadvances; the pledging of unusual types of collateral; increased dilution; high total exposure; and the discovery that the client is financing their inventory with another financier.

Furthermore, they state that audit of factors must include reviews of -

- \* the factor's credit policies and account monitoring procedures;
- \* Industry/geographic/client concentrations that leave the factor exposed to potential risk;
- \* Collateral monitoring procedures to ensure regular review;
- \* The credit grading system that segregates accounts on the basis of credit risk. This enables verification of management's concentration on higher risk accounts;

- \* Advance percentages to determine their accuracy and appropriateness for the particular circumstances;
- \* The factor's field audit and confirmation procedures. Lack of direct contact between the factor and the client's customers makes regular visits to client sites and verification processes key control techniques;
- \* Strict adherence to limits on advance procedures and the formal review processes; and
- \* Status and history of the factor's accounts for items such as liens, ageing, turnover, timing of overadvances, late payment frequency etc.

Suitable factoring clients should find that the benefits of factoring include; improved cash flow; professional accounts receivable management; elimination of credit risk (in some circumstances); increased sales, reduced costs and improved credit rating; improved access to valuable information; and an increased borrowing capacity. These benefits can be obtained for a relatively small cost (sometimes no more than the discount offered for prompt payment of sales invoices).

The cost of factoring (and all other financial products) takes into account the risks faced by the factor. These risks may include: the non-payment of purchased invoices; dilution of accounts receivable value; clients' inability to repurchase recourse debts; and, the most serious of all risks, fraud. Therefore, effective auditors of factors must understand these risks and the nature of the factoring industry.

## Chapter 4

### CASH FLOWS AND THE CREATION OF ACCOUNTS RECEIVABLE

The most important and highly valued benefit of factoring is its improvement of cash flow. Cash is not only of value in maintaining business solvency but it affects organisational value. Both of these circumstances have recently been recognised by accounting standard setters who now require the inclusion of a "Statement of Cash Flows" in financial reports.

Despite the importance attached to cash, organisations continue to trade on credit and thus create accounts receivable. The true value in factoring is, therefore, that it converts receivables into cash, improving firm liquidity and enhancing its value. At the same time it eliminates the costs of creating and managing accounts receivable.

This chapter will examine both the importance of business cash flows for business solvency and value, and the costs and benefits of credit sales. It will conclude with the outline of the relationship between cash, accounts receivable and factoring.

#### **The Importance of Business Cash Flows**

##### **Business solvency and failure prediction**

A well-known definition of insolvency, which Altman (1983, p.6) calls "equity insolvency", is cash flow based and relates to the inability of the business organisation to pay its obligations "as and when they fall due". Altman further states that in 1957 James Walter advanced the theory that technical insolvency should be ascertained primarily from the relationship between net cash flows and current liabilities (p.6).

In the performance of their duties auditors have some responsibility in detecting solvency problems. Since it impacts on the "true and fair" presentation of financial statements and asset valuations Statement of Auditing Practice AUP 7 requires the auditor to be "...satisfied that it is appropriate, based on all reasonably foreseeable circumstances facing the entity during the relevant period, for management to prepare the financial report on the going concern basis"(para.11). Two of the financial indicators of going concern problems provided in Appendix 2 of AUP 7 are a lack of sustainable profits or cash flows from core business activities and the inability to pay creditors on the due dates.

Considering the above definition of solvency it should be of no surprise that ratios concerning cash flows figure prominently within many corporate failure prediction models. Beaver (1967,p.101) concluded that cash flow to total debt ratio was the best predictor of corporate failure, as did (according to Altman,1983,p.152) Deakin in 1972 and Marais in 1979 (Altman,1983,p.342).

In Australia Lincoln (1984) found that cash flow before tax to current liabilities, a ratio that measures the firm's ability to meet its short-term commitments from cash flows, was among those that best predicted financial risk of manufacturing and retail firms (p.2). He also established that a high risk manufacturing or retail firm was "...close to its borrowing capacity because of: (a) a decline in cash flow from trading operations... (b) a build up of stock and debtors caused by inefficient management, which requires an increase in borrowings to cover the slower turnover of these assets, (c) a policy of placing greater reliance on debt finance than is normal for the industry"(pp.3-4). High risk firms also "...lack(s) accumulated profits because of a poor profit record or of a policy of high-dividend payouts."(p.4)

Most of the other models, including Altman's Z score (p.106) and Zeta (p.132), use earnings as a surrogate for

cash flows and working capital as a determinant of liquidity. However, Charitou and Ketz (1991,p.52) have stated that the relevance of the working capital concept must be questioned "...since positive (negative) working capital does not necessarily indicate liquidity (illiquidity)."

Furthermore, whether or not earnings can be considered as a substitute for cash flows must depend on their quality. Defining the quality of accounting income in terms of its correlation with cash flows (Wolk, Francis and Tearney, 1989,p.337) it follows that "quality earnings" are highly correlated with cash flows and, therefore, substitutable. However, using low quality earnings as a surrogate for cash flows may lead to an incorrect interpretation. An obvious example is Hooker Corporation whose profitability and funds from operations were increasing steadily over a period of five years but its cash flows from operations were estimated to be negative for at least three years before it failed (Soper,1991,p.21).

Cash flows are vital to the long-term survival of any business organisation. This importance is recognised in the technical definition of insolvency and in the many business failure prediction models. However, cash flows also help to determine the amount and nature of organisation's risk. Together with anticipated timing this forms the basis for business valuations.

### **Cash flows in business valuations**

The valuation of Australian listed companies has often been based on the multiple of earnings per share (the price/earnings ratio). However, the problem with such an approach is that it does not identify "...milking or growth (spending on marketing, research and development) strategies and does not take account of risk - principally associated with gearing...- or differing accounting policies" (Allen,1989,p.88) which may in themselves produce different values.

An approach that is more theoretically sound is to discount the expected future cash flows by the cost of capital. This is consistent with the view that positive net present values of projects will increase firm value.

Quite apart from the benefits of discounting, the use of cash flows allows for the consideration of the servicing of borrowings. It also has the advantage that different accounting policies and differences in international accounting standards will have little effect on cash flows compared to the traditional profit and loss statements (Pollard,1988,p.5).

In Standard and Poor's 400 companies index between 1983 and 1985, Copeland, Koller and Murrin of McKinsey & Co found little correlation between earnings growth and the firm's share price (James,1990,p.60). They found that high earnings growth companies had low price/earnings ratios and those companies that depressed their reported earnings through heavy investment in research and development had high price/earnings ratios.

Charitou and Ketz (1991,p.53) state that Lawson's (1981) study also found an association between cash flows and stock market valuations. Lawson's examination of the operating cash flows and accrual earnings of the United Kingdom manufacturing sector for the period 1954-76 indicated the relevance of cash flows for stock market valuations and that accrual earnings were less relevant than cash flows for market valuation purposes.

Similarly, in the case of Hooker Corporation in Australia, Flanagan and Whittred (1992) state that "...in the years preceding its collapse, Hooker's share-price performance was more consistent with its underlying cashflow experience than its reported profits"(p.50).

Charitou and Ketz (1991) themselves developed a model that included cash available after investment and dividends but before external financing (CAAI) as a significant aspect

of a firm's market value. The results of their study suggest a positive relationship between CAAI and the market value of the firm.

Risk also plays a significant part in the valuation of a business organisation. Business and financial risk reduce the probability of achieving planned cash flows.

Therefore, the lower the probability of achieving a particular pattern of cash flows the higher is the risk, and the lower will be the firm's value, and vice versa. Similarly, the more distant the cash flows the greater is the risk that they will not be achieved. Together with lower present values this will usually be responsible for lower firm values than would otherwise be the case.

Ismail and Kim (1989) conducted a study to determine the association between cash flow and market risk. They found that cash flow beta had the highest correlation with market risk and that earnings beta had the lowest. The conclusion thus drawn was that cash flow data has the potential of providing additional information on the firm's risk, beyond that provided by earnings. This provides further evidence on the affect of cash flows on firm value.

A theoretically sound approach for determining the value of business enterprises is through the discounting of expected future cash flows. Probabilities of achieving the planned cash flows determines the risk and this, in turn, affects the rate required for the discounting process. This makes cash flow of fundamantal importance in business valuation.

### **Statements of cash flows**

Accounting standard setters have finally realised that "...ex post and ex ante cash flow reporting is valuable to those seeking to assess enterprise liquidity ..." (Staubus,1989,p.161) and that the "...concept of cash flow potential...(embodies) the amount, timing, risk and

cost of capital features that determine the market value of a prospective cashflow stream."(p.162)

In order to better satisfy the requirement of paragraph 43 of the Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" that general purpose financial reports should provide information useful for decision-making, Australian standard setters have issued Australian Accounting Standard AAS 28 "Statement of Cash Flows". The standard states that a statement of cash flows will assist in assessing the entity's ability to (a) generate cash flows in the future; (b) meet its financial commitments as they fall due; (c) fund changes in the scope and/or nature of its activities; and (d) obtain external finance where necessary (para.9).

The standard requires the identification of cash balances at the beginning and end of the reporting period (para.26) and the presentation of the statement of cash flows in such a way so as to provide relevant information about the firm's operating and other activities (para.28).

Business solvency and market valuation of firms relies heavily on cash flows and information on cash flows. But despite the benefits of cash, the associated costs and the increase in risk, most business organisations continue to trade on credit. The creation of accounts receivable will, therefore, be considered next. Its importance in this paper results from the fact that it is the cause for the existence of factoring.

## **The Creation of Accounts Receivable**

### **Costs of Providing Credit**

There are a number of costs associated with granting credit. According to Hampton (1989a,p.211) these include (1) administrative expenses; (2) financing the receivables; (3) collection costs; and (4) bad debt losses.

### **Administrative expenses**

Administrative costs include those associated with the formulation of credit policies, recording credit sales and payments, setting credit standards and assessing the credit worthiness of potential customers.

These costs are aimed at eliminating (or at least reducing) bad debt expenses. A major aspect of this process is assessing the credit capacity of potential customers. This is usually accomplished by considering the five C's of credit (Hampton, 1989b, pp. 323-325) which include:

- a) **Character** - reflects the willingness of the customer to pay in accordance with the credit terms (or at all);
- b) **Capacity** - refers to the ability of the customer to pay on the due date. This depends on the customer's profitability and liquidity;
- c) **Capital** - refers to the overall financial position of the customer in terms of total assets and equity position;
- d) **Conditions** - relates to the general economic factors, or factors peculiar to the industry in which the customer operates, that may have an impact on the customer's ability to pay; and
- e) **Collateral** - refers to the assets pledged to support the credit sale.

### **Financing the receivables**

Accounts receivable tie up a portion of the firm's financial resources. They must be financed from either retained earnings, share capital or debt, all of which are of some cost.

Scarcity of resources often means that investing in accounts receivable prevents the possibility of investing in something else. This presents the concept of opportunity cost which may include the inability to reduce input costs through the taking of early settlement

discounts. According to Shapiro (1990,p.859) there is usually a high implicit interest cost of not taking discounts which can be calculated as follows:

$$IAIC = [1 + CD/(100 - CD)]^{365/N} - 1$$

where:

- IAIC = Implicit annual interest cost
- CD = Cash discount percentage
- N = Number of days that payment can be delayed by forgoing the discount.

The greater the investment in accounts receivable the greater is the expected carrying cost. Factors that affect the size of receivables include the level of sales, the firm's credit policies (lax or rigid), the terms of trade or credit terms and the collection activity. This can be summarised as being determined by the volume of credit sales and the average collection period (Weston and Brigham,1990,p.462) as follows:

$$\text{Accounts Receivable} = \frac{\text{Credit Sales}}{\text{per day}} \times \text{Length of Collection period}$$

Any changes in the volume of credit sales or the length of the collection period will result in changed levels of accounts receivable. This will also affect total cost of holding accounts receivable.

### **Collection costs**

Collection costs include the salary of a collection officer, the fees charged by a collection agency, and legal fees.

They may also include the discount provided to obtain early settlement of the account; that is, to collect cash earlier than would otherwise be the case. A particular problem results when customers take discounts without remitting funds within the specified period.

### **Bad debt losses**

These costs are potentially the greatest of all costs associated with the granting of credit. The avoidance of these costs is the reason for incurring administration and collection expenses.

Losses associated with bad debts involve two elements. They are (1) the profit forgone on the sale, and (2) the inability to collect the cost of the sale. The avoidance of these costs are, therefore, the primary function of credit management.

### **The benefits of providing credit**

Considering the costs associated with maintaining accounts receivable and the importance of cash to business solvency and firm value, why do organisations continue to delay cash collections by granting credit? The answer simply relates to the perceived benefits of so doing.

According to Shapiro (1990,p.870) profit-maximisation applies to credit extension so that credit will be granted if the profit from doing so is likely to be positive; that is, the expected revenue from the sale exceeds the cost. The probability of collection is a major factor in assessing the likely profitability of the sale. Credit will be extended, therefore, if:

$$pS - C > 0 \quad \text{or} \quad P > C/S$$

where:

p = the probability of customer paying;  
S = the present value of the collected sale;  
C = incremental cost of the sale.

The benefits of selling on credit terms simply relate to the expectation of stimulating sales revenues and profits, and, as a result, increasing the returns on investments in fixed assets. Also, in order to remain competitive and maintain market share, participants must oblige if it is the practice within the industry to extend credit.

Even besides the potential loss of sale Mian and Smith (1992) believe that there are several incentives for a firm to extend credit rather than requiring the customer to pay cash after obtaining finance elsewhere. They suggest (pp.172-173) that trade credit is more likely to be extended if:

- a) the seller has a cost advantage over competing lenders which would make the cost of supplying both merchandise and credit lower than if they were supplied through separate transactions; and
- b) there are greater returns to be obtained from exploiting market power through effective price discrimination. Granting different credit terms to different customers is tantamount to selling at different prices.

Shapiro (1990,p.868) further notes that the extension of trade credit allows "...firms to continue to earn returns on the sizeable nonsalvageable firm-specific investments they often make in their customers" and "it provides information that allows sellers to design procedures to better protect these investments". Without trade credit risky customers would be unable to purchase products from the seller thus sacrificing nonsalvageable investments in relationships that may be potentially profitable. Even if the buyers were able to finance the purchases the seller, by not granting credit, is forgoing the opportunity to obtain information about the buyer that he may otherwise be unable to obtain.

Trade credit may often be a guarantee of sellers' promises (Shapiro,1990,p.869). It can thus be used to screen sellers and "reduce contracting costs between buyers and sellers." In the case of cash sales, costly legal action may be required to recover the amounts paid for faulty goods. Credit sales can often eliminate the need for such action because the buyer would simply refuse to pay on the due date (but only in cases of legitimate disputes).

## **The relationship between cash, accounts receivable and factoring**

The importance of cash has been previously established. Nevertheless, as a result of industry requirements and strategic objectives of competing firms, trade credit is an expected and favoured means of financing sales. The competing objectives of cash and credit has provided the foundation for factoring and accounts receivable finance. Factoring may turn a credit sale into cash thus increasing the liquidity of the firm.

The requirements to disclose beginning and ending cash balances in the "Statement of Cash Flows" leads to the presumption the more cash is better than less. If so, factoring, because it converts accounts receivable into cash, also provides the possibility of reducing perceptions of risk and, therefore, increasing firm value.

Firm value may also be increased as a result of appropriate utilisation of the cash released through factoring. That is, the cash increase may be used to generate greater sales and improve future profits.

Additionally, some forms of factoring eliminate the activities, and therefore costs, of providing credit and managing accounts receivable. These activities, which include administration, finance, and collection, can be transferred to specialists who can effectively reduce the total cost of performing these functions. In some circumstances the credit risk may also be transferred to the factor; a specialist who, through possession of relevant information and the ability to diversify, can reduce the credit risk and therefore the credit cost.

## Chapter 5

### INTERNATIONAL PERSPECTIVES ON FACTORING

This chapter covers discussions on the worldwide growth of factoring, issues related to international (or export) factoring and the future of factoring.

#### Growth in Factoring

Worldwide factoring turnover since 1985 is summarised in Exhibit 2.

Exhibit 2.: FACTORING TURNOVER BY COUNTRY									in millions of US Dollars
Country	1992	1991	1990	1989	1988	1987	1986	1985	
Italy	64600	75000	71280	51180	36700	27078	15550	9525	
U.S.A	53173	51100	49012	46747	45900	44700	40000	37527	
United Kingdom	24113	28350	29234	20780	18995	14825	9300	7425	
Mexico	22544	18346	7240	4006	1005	300	40	50	
Japan	18084	17203	14846	12387	10146	6967	5530	4239	
France	17613	15774	14325	10778	8443	7475	4859	3500	
Germany	11680	10644	10343	7818	6611	7700	5466	3577	
South Korea	10965	6200	4206	2600	1525	1210	652	550	
Netherlands	9600	11000	10000	6900	6100	5500	4200	2900	
Belgium	3912	3810	3452	2423	1850	1785	1459	976	
Spain	3705	4325	2785	1520	1060	727	431	176	
Sweden	3298	4445	5366	3710	4368	4191	4318	4530	
Norway	2377	3015	3000	2610	3340	4320	2835	2300	
Portugal	2108	1560	1569	535	155	37	37	25	
Finland	2030	2505	5030	5173	4703	4267	3335	3020	
Others*	14507	13093	12639	10857	9505	8729	6150	5000	
<b>Total</b>	<b>264309</b>	<b>266370</b>	<b>244327</b>	<b>190024</b>	<b>160406</b>	<b>139811</b>	<b>104162</b>	<b>85320</b>	
<b>Source: Factors Chain International (FCI)</b>					<b>* Includes Australia</b>				
<b>Data obtained by FCI from FCI members in each country. Includes Domestic and International volumes</b>									

World factoring volume increased by around 210 percent in the last seven years; from US\$85 billion in 1985 to US\$264 billion in 1992. It seems that the world recession has had some effect on factoring volume during 1992; falling by

some \$2 billion from the amount recorded in 1991. This is not surprising since factoring clients are directly affected by swings in consumer demand. If their clients are affected then factors will tend to be hit harder by business cycles but they will also recover sooner (Basile,1991,p.38).

Italy leads the world in factoring volume recording US\$75 billion in 1991. This fell by about 14% in 1992 to just under US\$65 billion as a result of the world recession. Nevertheless Italy's factoring volume grew rapidly (578 percent) during the last seven years; from US\$9.5 billion in 1985.

According to the secretary-general of Factors Chain International (FCI) ("...global network of leading factoring companies...(formed) to facilitate international trade through factoring and related financial services (The International Factoring Report, 1991, Factors Chain International)) Italy's economy is ideal for factoring. There are many small firms being run by entrepreneurs who generally are not very strong on administration and welcome the factoring services. Also, the Italian economy had been growing rapidly during the 1980s creating a large demand for working capital provided by factors (Rutberg, 1989a,p.30).

The development of factoring in Italy was initially encouraged by the credit restrictions that characterised Italian monetary policy at the end of the 1970s and early 1980s. Italian banks were limited in their ability to finance the business sector as a result of the Bank of Italy's imposed lending ceilings. Factoring offered a new instrument that did not fall foul of the rules (Lane,1990,p.38).

BNL Holding (whose factoring subsidiaries dominate the Italian market) suggest that, in addition to the strong economic growth, factoring business continued to expand rapidly because of the wider awareness of factoring and

its advantages (Lane,1990,p.38). There is a growing recognition that factoring is not a sign of weakness and incapacity but that it is another financial instrument that allows its users to raise liquidity and satisfy their working capital needs. It has been accepted in all sectors, particularly wholesale distribution, agriculture, mechanical engineering and pharmaceuticals.

Large corporations use the factoring service for organisational reasons; to cut office workload by giving the factors the task of credit checking and collecting accounts. Firms in mature sectors, tackling customers at the margins of their market, are also significant users of factoring, as are firms in rapidly expanding markets where limited experience creates problems in customer evaluation. Italy's cash strapped public sector is considered to offer excellent opportunities for growth (Lane,1990,p.38) and Italian factors are now positioning themselves to serve as conduits of credit between Eastern Europe and the West (Hill,1992,p.38).

Factoring is also becoming respectable in France, growing by some 400 per cent in the last seven years; from US\$3.5 billion in 1985 to just under US\$18 billion in 1992. According to Thierry Dehesdin, managing director of Soge-factoring, a subsidiary of Societe Generale, it is expanding faster than short-term bank credit, which proves that the industry is providing a real and needed service. He also states that in the past companies were only interested in the financing but are increasingly interested in the management services (Cassassus,1990,p.38). Most of the 15 biggest factoring firms in France are wholly-owned subsidiaries of large banks.

In the United Kingdom factoring has also experienced rapid growth; from US\$7.4 billion in 1985 to US\$24 billion in 1992, a seven year growth rate of 225 percent. Attracted by this growth new players have been crowding the factoring market. The most recent arrivals include Allied Commercial Finance (Allied Irish Bank), De Lage Landen

Financial Services (Robobank Nederland) and Venture Factors (United Bank of Kuwait) (Batchelor, 1990, p.36). The major area of growth has been non-notification and recourse arrangements (invoice discounting).

Other major factoring growth has been in Mexico (from US\$50 million in 1985 to US\$22.5 billion), Germany (by 226 percent in seven years, from US\$3.5 billion in 1985 to just under US\$12 billion in 1992), and Netherlands (from US\$2.9 billion in 1985 to US\$9.6 billion in 1992, a growth of 231 percent).

According to Asian Finance (Hong Kong) (March 15, 1990, pp.26-29) Asia's rapid growth in foreign trade makes it an ideal market for the concept of transferring risks as provided by factoring. However, factoring seems to be of significant volume in only two Asian countries; Japan and South Korea. In Japan factoring volume was US\$4.2 billion in 1985 and US\$18 billion in 1992 (a growth of 326 percent) and in South Korea the growth was even more impressive; an increase of just under 2000 percent from US\$550 million in 1985 to US\$11 billion in 1992.

In the United States of America, the home of modern factoring, volume has not grown as rapidly. It only recorded a growth of 42% over the last seven years; from US\$37.5 billion in 1985 to US\$53 billion in 1992. The major reason for the more modest growth in the United States has been the result of factoring's traditional ties to the clothing and textile industry; about 80 percent of annual business is apparel related (Zager, 1990, p.38).

It's roots in clothing and apparel industry makes factoring subject to the industry's problems. Uncertainty about the retail climate which stems from the financial difficulties experienced by a number of U.S. retail giants, often acquired in costly leveraged buy-outs (LBOs), has made the factoring industry extremely nervous (Zager, 1990, p.38). U.S. factors are now faced with growing risks of the business and are desperately trying to

diversify into other industries.

It has been claimed (Hill,1992,p.36) that the solution to the LBO problems will absorb much capital and that start-up firms will, therefore, have no other option but to explore more innovative financing techniques. As they do, factoring should find an avenue for diversification.

## **Issues in International Factoring**

International (export) factoring is similar to domestic factoring. It offers the following services (Essig,1991,p.60):

- \* Credit investigation and approval;
- \* Protection against bad debts (100%);
- \* Accounts receivable bookkeeping on a multi-currency basis;
- \* Foreign collections on a multilingual basis;
- \* Protection against exchange risk losses;
- \* Payment to the exporter through varied methods of client accounting;
- \* Improved cash flow; and
- \* Methods of immediate finance.

The exporter will have the opportunity to expand sales in foreign markets by offering competitive conditions and terms of payment. He will find it possible to sell on open account or deferred payment terms. According to Asian Finance (Hong Kong)(March 15,1990,p.29) importers may also enjoy advantages such as the expansion of their purchasing power without recourse to costly bank finance or buying products without the delays related to establishing letters of credit.

One of the biggest problems in international or export factoring is the different laws that apply in each participating country. Even in the European community there has not been any attempt to harmonise the various

laws that apply to factoring (Carsella,1992,p.53) despite the move towards unification.

The development of uniform codes to overcome the differing laws of each country was the purpose of the International Factoring Convention held in May 1988 in Ottawa, Canada. It was a project conducted under the auspices of the Institute for the Unification of Private International Law (UNIDROIT), an organisation based in Rome, Italy whose members are the governments of more than forty nations (Reisman,1988,p.26).

The UNIDROIT governing council concluded that factoring was a desirable means of facilitating and financing international trade but that its growth was impeded by a lack of uniformity of applicable law, uncertainty as to the rights of the parties, the difficulty of adapting a relatively new financing technique to old legal rules and the drastic differences in law relating to the assignment of accounts receivable (Reisman,1988,p.26). It is not known how many of the 55 participating nations have adopted the uniform code and what changes they have made to their laws.

Export factoring is "...still only a fraction of the industry's total turnover..." (Montagnon,1990,p.37). According to Factors Chain International, of the total factoring volume of US\$264 billion in 1992, only US\$15 billion was international factoring. Germany's international factoring turnover was the highest with US\$3 billion, followed by The Netherlands with US\$2.8 billion, Italy with US\$1.2 billion, Belgium with US\$1.1 billion and France and United States both with US\$1 billion. The others were relatively minor.

Kellock Factoring (Bank of Scotland) in the United Kingdom state that half of those that ask about export factoring require services other than finance. They state that the clients want someone else to take on the hassle of chasing up payments from abroad, build in foreign exchange

protection and provide credit protection against bad payers overseas (Melly,1990,p.36). Perhaps when more clients understand these benefits and the benefits of working capital finance, together with increased uniformity of laws, then international factoring will become a major method of financing world trade.

### **The future of Factoring**

In order to control costs and obtain economies of scale there has been a trend of consolidation in the U.S. factoring industry. The number of major factors had fallen from 30 to 17, as of 1990, and 90 percent of factoring volume is controlled by the top ten (Matthesen,1992,p.54). This has been seen as necessary to meet future challenges where success in building market share and profitability will depend on the delivery of a quality product through quality people and systems (Basile,1989,p.28) and being a low cost provider of these services (Basile,1991,p.39).

Effectively competitive factors of the future will have to thrive on creativity in serving their clients' needs while at the same time balancing the need for prudent credit and receivables management (Matthesen, 1992,p.58). In addition to the reduction of costs through economies of scale Matthesen states that as factors grow they will be able to play a stronger role in dealing with large key customer accounts; a larger organisation carries more credit clout (p.56).

Matthesen (1992,p.56) also suggests other matters that will determine factor competitiveness. These include:

- \* the ability to offer low cost service through "economies of scope". These arise from offering a range of products under one operating system and will be available mainly to the bank-owned factors (p.56);
- \* Technology investment. This provides the impetus for growth and cost-effective management. Faster information processing enables factors to provide

faster credit service and to make credit decisions on more timely information. Technology also improves the factor's ability to process and apply cheques and invoices. This provides clients with a quicker turnaround on their accounts receivable and a more effective use of their working capital funds (p.56);

\* Commitment to quality of service. A competitive factor must seize every opportunity to add value in the distribution of the service. A "value-added" service is only achieved through an effective use of the factor's people and technology. Effective use of people requires significant effort in training (p.58);

\* Responsiveness to clients' needs and problems. The issue is not just one of speed and efficiency but involves the idea that each instance of client contact should be viewed as an opportunity to deliver service in a manner that has a positive impact (p.58); and

\* Flexibility and adaptability. This is the key to developing business in new industries and involves finding creative ways to serve new client needs rather than ways to avoid new challenges (p.58).

Factoring volume has grown by 210 percent over the past seven years. The continuation of such growth will require a world economic recovery. International (or export) factoring, in particular, will benefit from improvements in world trade. However, this will also require the worldwide harmonisation of laws relating to factoring.

The effectively competitive factor of the future must provide a cost effective, quality service. Factor flexibility, adaptability, and responsiveness to client needs are further requirements.

**PART B**

**RESEARCH STUDY**

## Chapter 6

### RESEARCH DESIGN AND LIMITATIONS OF THE STUDY

- The empirical component of this research paper involved:
- a) an information request (Survey of Factors) sent to Australian factors (copy provided in Appendix A);
  - b) personal interview with some of the responding factors. Two primary purposes for the personal interviews were to obtain additional information and clarification of points raised in their survey responses;
  - c) personal interview with users of factoring services; and
  - d) confirmation of statistical information received through the consultation of external sources such as Australian Bureau of Statistics and Factors Chain International (an industry association located in Amsterdam that represents factors worldwide).

It is estimated that around 20 factors actually operate in Australia (FCI) most of these are small, local and relatively unknown organisations. The information request was, therefore, sent to five of the largest and most active in the Australian market. The purpose of the information request was to obtain as much information as possible from the market participants and to utilise this information for further personal discussion/clarification if it was deemed necessary.

Three replies were received (60 percent response rate), including that of the market leader, Australian Guarantee Corporation Ltd (AGC). The other two respondents were Carrington Confirmers Pty Ltd and Scottish Pacific Business Finance Pty Ltd. Despite the small sample size the respondents, by their own estimations, account for the majority turnover in the Australian factoring market. They therefore, represent market practice and experience.

Furthermore, economic theory relating to the competitive

behaviour of firms in an oligopoly is also relevant in determining whether three respondents are sufficient to generalise about market practice. Firstly, the theory states that the firms will jointly behave to maximise industry profit (like a monopoly). This eliminates price competition since the protection of market share will require all other firms to meet price reductions. This has a detrimental effect on firm and industry profits.

Additionally, any gains in market share by one firm are obtained at the expense of another. Since no firm wishes to lose market share it is likely that they will also provide the same products or services. Competition will, therefore, mainly relate to the establishment of perceptions about product (or service) differences.

The natural conclusion is that in an oligopoly the firms will generally provide the same products or services, at the same price. This being so, the experience of one firm will also tend to be the experience of the industry. Since the Australian factoring industry displays characteristics of an oligopoly (the market volume being dominated by a few large firms) the experience of three firms will almost certainly represent that of the industry; particularly if the study includes the market leader (AGC), as this does.

Additional information and clarification was obtained through telephone and personal contact with the "contact" person named by the factor. Most of these were personally known to the writer.

The survey sought to obtain a large amount of information some of which was quite sensitive. It was considered probable that the more sensitive aspects would remain unanswered. This certainly turned out to be the case with the major part of the section headed "The Australian Market" and all of "Market Trends" remaining unanswered.

A relatively small Australian market precluded the provision of information such as customer profiles

because, even in aggregated form, competitors may be able to deduce the nature of the others' customers. This is particularly so for the market leader. Furthermore, the information requested under market trends has particular relevance to the business strategy of the factors. The respondents were thus wary of providing this data for fear that revelation would expose their business strategy.

Nevertheless, enough information was provided by the factors to fulfill the purpose of the study; the outline of the nature of the Australian factoring market. History and nature of market participants, description of the factoring variations provided, the risks, approval criteria, documentation, securities, and pricing were all supplied by the factors while market size was obtained from data supplied by the Australian Bureau of Statistics and Factors Chain International.

The protection of the source of the information requires its presentation in a manner that would prevent it being used to advantage by the supplier's competitors. However, the small and highly competitive nature of the Australian market means that there is a high probability of equality in the types and prices of services provided. This certainly turned out to be the case. All of the factors provided similar products but under different names. The pricing was also very competitive.

A further requirement for the study was the interview of factoring clients. The purpose of these interviews was to confirm the type and cost of the factoring services they received and to record their attitudes to factoring. Appendix B lists the basic questions used as prompts in the discussions undertaken.

Partly because factors did not wish to provide access to many of their clients and partly because the non-notification nature of much of factoring prevented them from revealing names, only ten factoring clients were interviewed. Some names were obtained from factors, others

from accounting firms and still others were known to the writer. It must be emphasised that not all of the factoring clients interviewed were clients of the factors that responded to the information request.

### **Limitations of the Study**

Despite the fact that the information provided by factors serves the purpose of this study, it is possible that the relatively small sample did not provide enough information about general market practice. It is also possible that the small market size may have prevented participating factors from being completely truthful and generous with their responses.

The small sample, in this case, is adequate since they account for the major share of the market. It is true, however, that the small market prevented the supply of some information. However, for the purpose of this study the information received was adequate and the interviews with factoring clients sought to confirm the information supplied by the factors.

The small size of the sample of factoring clients lends itself to the criticism that it is not truly representative of their attitudes. Weight is added to this criticism when considering that most of the client names were provided by the factors themselves. It is an extremely high probability that they only chose the better and more satisfied client.

While recognising the limitation that such a small group may not represent the views of factoring clients in general, this aspect of the study still adequately served two major purposes. Firstly, it obtained some client attitudes to the service. More importantly, the clients were used to confirm the accuracy of the statements made by the factors. Confirmation was received on all major aspects of factoring including pricing, documentation, securities etc.

## Chapter 7

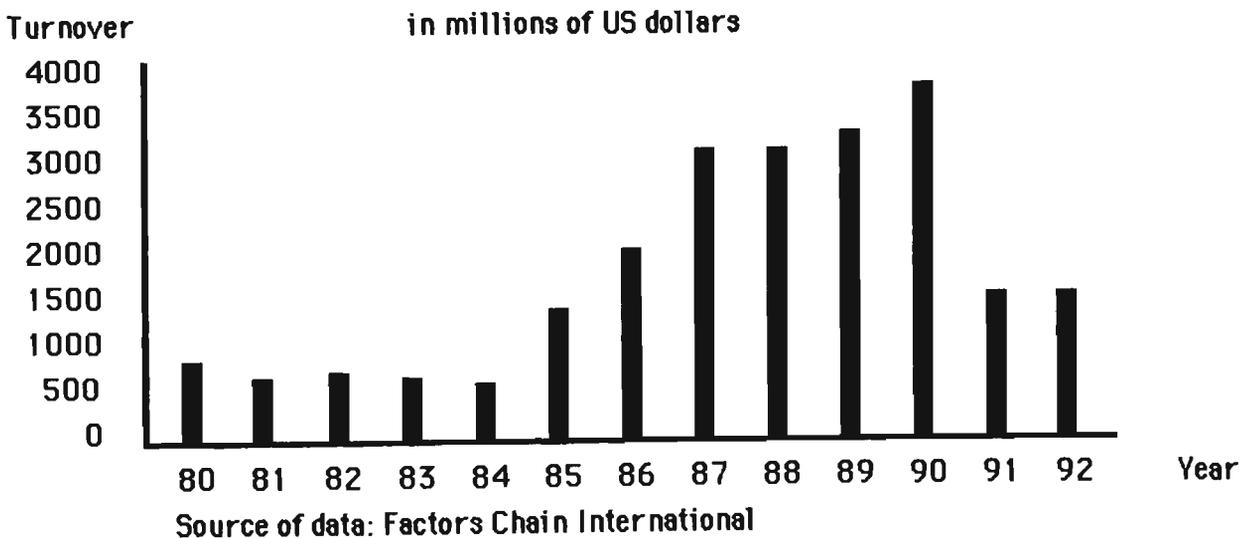
### RESEARCH RESULTS AND COMMENTARY

The purpose of this chapter is to provide an outline of the results of the research into the Australian factoring market. The size of the Australian factoring market will be dealt with first, followed by the factor responses and the results of client interviews.

#### The Size of the Australian Factoring Market

Australian factoring volumes since 1980 are graphically expressed in Exhibit 3. From 1980 to 1984 factoring volume in Australia remained relatively steady going from a high for the period of US\$850 million in 1980 to a low for the period of US\$600 million in 1984, no doubt the result of the recession of the time. After 1984 factoring showed a dramatic increase peaking at US\$3.6 billion in 1990. Volume again fell in 1991 to US\$1.55 billion and showed little improvement in 1992 reaching US\$1.56 billion.

**Exhibit 3. AUSTRALIAN FACTORING VOLUME (1980 TO 1992)**



This volume places Australia among the 20 largest factoring nations in the world (see page 40 for others).

It must be noted that the data was obtained from FCI who, in turn, receive the information from its members. Since Scottish Pacific is the only Australian member of FCI these figures are, by consequence, Scottish Pacific's estimate of the size of the Australian market. Since none of the other respondents provided their estimates of the turnover in the Australian factoring market, it was considered necessary to test the information by obtaining independent and official statistical information from the Australian Bureau of Statistics.

The Australian Bureau of Statistics (ABS) publish data of Commercial Finance Commitments (Catalogue No. 5643) in Australia. Factoring commitments data has only been collected and recorded separately since July 1991; before July 1991 it was included in "other" finance commitments. Exhibit 4 is a table of data obtained from ABS.

**Exhibit 4**                      **FACTORING COMMITMENTS BY AUSTRALIAN FACTORS**  
(in A\$ millions)

Period	Total	NSW	Vic	Qld	SA	WA	Tas
November 1992	<b>53.1</b>	14.4	13.4	13.2	7.0	5.1	0.0
October	<b>49.9</b>	14.3	13.6	11.1	6.3	4.6	0.0
September	<b>52.3</b>	15.7	14.8	10.2	6.5	5.1	0.0
August	<b>47.4</b>	13.8	13.4	9.3	6.1	4.8	0.0
July	<b>45.8</b>	12.8	12.8	8.9	6.7	4.6	0.0
June	<b>40.1</b>	10.7	12.2	7.2	5.3	4.7	0.0
May	<b>40.8</b>	11.9	11.1	7.7	4.5	5.6	0.0
April	<b>43.3</b>	13.8	12.3	7.7	4.3	5.2	0.0
March	<b>47.2</b>	14.9	13.1	8.0	4.9	6.3	0.0
February	<b>28.9</b>	11.0	0.1	7.3	4.4	6.0	0.1
January	<b>32.8</b>	9.7	8.6	6.2	3.7	4.6	0.0
December 1991	<b>50.7</b>	16.0	14.1	8.9	4.0	7.7	0.0
November	<b>48.1</b>	12.9	14.1	10.9	4.3	5.9	0.0
October	<b>57.6</b>	23.2	16.2	8.5	3.7	6.0	0.0
September	<b>48.7</b>	14.3	14.9	10.2	4.1	5.2	0.0
August	<b>47.7</b>	12.1	16.2	8.3	5.0	6.1	0.0
July	<b>61.3</b>	16.1	20.9	11.8	5.0	7.4	0.1

Source: Australian Bureau of Statistics (Catalogue No. 5643)

Average monthly factoring commitment during the period under consideration (July 1991 to November 1992) is A\$46.81 million. This equates to around A\$562 million annually and differs significantly from the amount provided by FCI (or Scottish Pacific through FCI) of A\$2229 million (US\$1560 million based on a conversion rate of AUD1= 70 cents US). Besides the possibility of an incorrect estimate by Scottish Pacific, there are two possible explanations for this difference (or two possible means by which the differences may be reconciled). These differences include the definition of factoring commitments for ABS purposes and the coverage of the ABS data.

For the purpose of collecting the data of commercial finance commitments the ABS defines a lending commitment as "...a firm offer to provide finance which has been or is normally expected to be accepted" (Explanatory Notes to Cat. no. 5643). According to ABS this refers to the establishment of new factoring accounts (or commitments to establish new factoring accounts). It does not include invoices purchased by factors from their existing customers during the period in question. Therefore, the FCI estimate and the ABS data serve two different purposes; the former is an estimate of factoring volume or invoices sold to factors while the latter provides details of commitments to establish new factoring accounts.

Another possible explanation for the difference between the two sets of data is the coverage of the ABS statistics. The explanatory notes to Catalogue No. 5643 state that the following types of lenders fall within its scope: "...banks, corporations registered under the Financial Corporations Act 1974, insurance companies, superannuation funds and providers of consumer finance registered with State credit tribunals..." It is further stated that the statistics cover only those lenders considered to be "significant lenders". According to ABS it is, therefore, possible that despite the

aim of 100 percent coverage the commitments made by some factors, particularly the smaller ones, are not included.

The amounts provided by FCI and ABS measure different types of facts. There is no other way, however, to verify the factoring volume. It can, nevertheless, be suggested that an experienced participant in the market should be able to accurately estimate the market volumes. This means that the FCI figure of US\$1.56 billion, provided by Scottish Pacific, could be considered accurate and that, although it measures something different, it is at least partially supported by the ABS data.

### **Survey of Factors**

The factor information request was divided into four sections: Background information; Factoring details; The Australian Market; and Market trends. None of the three factors responded to the market trends section because it would reveal details of their business strategy. The results of all sections, except market trends, will, therefore, be discussed on the basis of the important issues raised. Since market size has already been covered, the balance of the section dealing with the Australian market is included under factoring details.

### **Background Information**

The three respondents to the survey were: Australian Guarantee Corporation Limited (AGC); Scottish Pacific Business Finance Pty Ltd (Scottish Pacific); and Carrington Confirmers Pty Ltd (Carringtons).

AGC, considered to be the market leader in Australia, began factoring in 1962 after taking over the Australian business of International Factors Ltd., a company that operated from the United Kingdom but with registration in Switzerland. This is during the same period that the literature suggests factoring was exported to Europe. The factoring arm of AGC became known as AGC Factors.

AGC is a wholly owned subsidiary of Westpac Banking Group and operates in all Australian states and territories. In addition to factoring it provides property finance, equipment finance including leasing and asset purchase, fleet finance and management and business loans.

During the 1970s CAGA Business Services, the factoring arm of Commercial and General Acceptance Ltd (CAGA, part of CBC Bank) also began in the factoring business. It wasn't until 1982 that Custom Credit (subsidiary of the National Bank) started factoring.

Merger between National and CBC banks to form the National Australia Bank also saw a merger between their respective finance subsidiaries: Custom Credit Corporation and CAGA. The combined finance company operated in all states of Australia providing the full range of finance company services including property finance, equipment finance (leasing, hire-purchase), fleet leasing, and personal loans. The factoring operation then became known as Custom Factors.

Problems developed during the 1980s and towards the end of the decade Custom Factors ceased accepting new factoring business. The only factoring work that was being undertaken was the "work-out" of the problem accounts. However, in the early 1990s, having eliminated the problem accounts, it was decided that there were significant opportunities in the factoring market. This resulted in the full resumption of Custom Credit's factoring operations.

The restructuring instituted by the National Australia Bank created enormous changes for the finance company. They stopped offering personal loans and other parts of the business were being integrated into the bank. In 1992 the factoring business was merged into Carrington Confirmers (another National Australia Bank subsidiary), a specialist trade financier concentrating on import and export financing. Carrington Confirmers operate in New

South Wales, Victoria, Queensland, and Western Australia offering trade finance, factoring and other forms of working capital loans. Further restructuring will see the closure of Carringtons and the possibility of integrating the factoring business into the direct operations of the bank.

The third respondent, Scottish Pacific Business Finance Pty Ltd, is a subsidiary of the Bank of Scotland. It began operating in Australia some 10 years ago and grew by acquisition of the Mercantile Credits factoring business and a relatively small factor named Hallmark. It specialises in factoring, both domestic and international and trade finance and operates in New South Wales, Victoria, Queensland and Western Australia.

Exhibit 5 summarises the extent of the operations of Australian factors.

<b>Factor</b>	<b>NSW</b>	<b>VIC</b>	<b>QLD</b>	<b>SA</b>	<b>WA</b>	<b>TAS</b>	<b>NT</b>
<b>AGC</b>	<b>Yes</b>						
<b>Carrington Confirmers</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>No</b>	<b>Yes</b>	<b>No</b>	<b>No</b>
<b>Scottish Pacific</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>No</b>	<b>Yes</b>	<b>No</b>	<b>No</b>

**Exhibit 5. Extent of operations of responding factors**

It must be emphasised that a lack of representation in any state or territory does not necessarily mean that the respondent does no business there. Tasmania and South Australia, for example, are administered by the Victorian office of Carringtons.

Other participants in the Australian factoring industry, but who did not respond to the survey, include Heller Financial Services Limited (Heller) and Cash Resources Australia Pty Ltd (CRA). Heller was a major player during the 1970s and 1980s and was then known as Walter E. Heller Australia Limited. It had stock exchange listing in Australia until it became a wholly owned subsidiary of Heller International Inc., (head office in Chicago, US) one of the largest factors in the world. Heller

International is a subsidiary of Fuji bank, one of the largest banks in the world.

The stock market crash of 1987, the economic downturn, and financial problems saw Heller close down most of their Australian operations. Only the New South Wales office remained in operation. However, they again seem to be on the expansion trail opening a sales office in Victoria. CRA are a private, non-bank owned operation with offices in all states of Australia.

AGC states that their factoring operations have not experienced any major changes or interruptions apart from some internal restructuring and downturns as a result of the prevailing economic conditions. Scottish Pacific have not experienced any interruptions either although they have a relatively short history in Australia and they grew as a result of acquisition (purchase of unwanted operations). Carringtons have experienced a major interruption, ceasing the acceptance of new business until the resolution of problem accounts. It was always intended, however, that they would resume factoring operations eventually. This occurred towards the end of 1990.

### **Business Associations**

The literature suggests that in the United States the assignment of the same accounts to more than one factor caused the establishment of the National Commercial Finance Association. This enabled the industry to exchange information on what is being pledged and to whom. In Australia, however, the fact that all charges over book debts are registered with the Australian Securities Commission means no such reasons exist for the establishment of an industry body.

The Australian Finance Conference (AFC) is an association and government lobby group that represents the Australian finance industry (or its members) in general. It does not represent sectional interests such as factoring and, it

seems, that the Australian factoring industry does not have a representative specifically concerned with its needs. Both AGC and Custom Credit are members of the AFC and, through Custom Credit, Carringtons obtains representation with that body.

Scottish Pacific is a member of Factors Chain International (FCI), an international factoring industry association based in Amsterdam, which specifically exists for the purpose of serving the needs of factors. Through its membership it is particularly involved in the promotion of international or export factoring.

FCI has around one hundred members worldwide although it estimates that there are over seven hundred companies that perform factoring services; a 13 percent membership rate. Scottish Pacific is the only Australian member of FCI.

## **Factoring Details**

### **Factoring types, pricing and purchase rates**

The respondents to the survey provided a variety of factoring services. Because they were designed to suit the needs of different customers, competitiveness in the industry has ensured that all of the factors offered similar services. However, they were distinguished from each other by being provided under different names. Exhibit 6 summarises the services provided by the respondents.

Despite the fact that different terms were used to describe the services there were a number of items that remained common to all of the respondents: the purchase rate; the fact that none provided non-recourse factoring (all the services were on a recourse basis); the standard recourse period (adjustable for risk rating); and all provided a non-notification factoring service.

Purchase rate refers to the amount made immediately available upon the sale of an invoice to the factor. Under

all of the factoring varieties the maximum purchase rate was 80 per cent of invoice value; the balance is a form of security and is made available only after the collection of the funds. Risk assessment is an important consideration in this respect in that the purchase rate may be lower (the retention rate is higher) for higher risk customers.

<b>Exhibit 6 Summary of Services</b>	<b>AGC</b>	<b>Carrington</b>	<b>Scottish</b>
Purchase Rate	80%	80%	80%
Non-Recourse Factoring	No	No	No
Recourse Factoring	Yes	Yes	Yes
Recourse Period	90 days	90 days	90 days
Notification Factoring	Yes	No	Yes
Non-notification (Confidential Factoring)	Yes	Yes	Yes
Maturity Factoring	Yes	No	No
Insurance Factoring	Yes	No	No
Export (International Factoring)	No	No	Yes
Accounts Receivable Management	Yes	No	Yes

None of the respondents provided what in the literature is termed "pure" factoring; that is, factoring where the factor assumes the credit risk or where the debt is not subject to recourse (except insurance factoring provided by AGC as described below). The maximum recourse period offered in Australia is 120 days although 90 day recourse was the most common. This recourse period is also common to all of the factoring variations. It can also be used to adjust for risk; that is, the higher is the risk the shorter will be the recourse period (120 days is only available to customers considered to be low risk).

AGC offers a service it calls "standard factoring" in which it purchases the trade debts at the established purchase rate, maintains the debtors ledger and sends out monthly statements, assesses credit and collects accounts. This it does for an up-front factoring fee of between 2 percent and 5 percent of invoice value. "Standard

factoring is offered by AGC on a notification or non-notification basis.

AGC's "standard factoring" is similar to "Full Service Factoring" offered by Scottish Pacific except that the Scottish Pacific facility is only provided on a notification basis and the fees are structured differently. Instead of a single up-front fee there is an administration charge of between 0.5 percent and 2 percent of invoice value and an interest charge of bank prime rate plus 2% (although this is negotiable) on amounts outstanding.

The administration fee covers the cost of performing the "full service" and is based on the complexity of providing the service. Its determination requires the consideration of things such as the number of accounts, debt turnover and average invoice size. "Full Service Factoring" also attracts a once only establishment fee of around .25 percent of invoices initially purchased. This covers the costs of setting up the ledger on Scottish Pacific's system.

Carrington Confirmers also provide what they call "Standard Factoring" for an up-front purchase fee of between 2 percent and 4 percent of invoice value. However, they only provide it on a confidential (non-notification) basis and offer none of the other services. It is called "standard" only because of the up-front fee.

These up-front factoring fees can be determined using the following formula:

$$\frac{A - B}{365} \times \frac{C}{100}$$

where

A = Purchase Rate x Debtors Turnover (days)

B = (100 minus the Purchase Rate) x 10

C = Return required by the factor

Therefore, if the purchase rate is 80 percent, average debt turn is 60 days and the required return is 20 percent, the up-front factoring charge will be -

$$A = 80 \times 60 = 4800$$

$$B = 20 \times 10 = 200 \quad \text{Therefore } A - B = 4600$$

$$\begin{array}{r} 4600 \\ \text{----} \end{array} \times \begin{array}{r} 20 \\ \text{----} \end{array} = 2.52\% \\ \begin{array}{r} 365 \\ \text{----} \end{array} \times \begin{array}{r} 100 \\ \text{----} \end{array}$$

This formula may also be used if the charge is split between an up-front purchase fee and an interest charge. Deducting the interest charge from the required return will provide a net amount sought from the institution of the fee. This net amount is substituted for the required return in the formula thus obtaining the size of the fee required to achieve a particular total return.

Another type of factoring provided by all of the respondents is on a confidential or non-notification basis. This is called the "Trading Line of Credit" (TLC) by AGC, "Split Fee Factoring" by Carringtons, "Invoice Discounting" by Scottish Pacific and "Availability Factoring" by some others. The basic features of this type of factoring are:

- \* The purchase rate of up to 80 percent of invoice value provides a drawing facility which, depending on the client's requirement for funds, may or may not be fully utilised;
- \* The full control of the debtors ledger remains with the customer. This includes credit assessment, establishment of credit limits and collections; and
- \* Up-front purchase fees of between 0.25 percent and 1 percent are charged, as is interest on amounts which have been drawn down and which remain outstanding.

The determination of this interest rate varies among the respondents. At AGC it is tied to the Westpac

Indicator Lending Rate while at Scottish Pacific it is usually determined at 2 percent above the bank prime rate, as published. Carringtons fix the rate at around the market and review it every three months.

AGC provides two other factoring variations. The first is "Maturity Factoring" which is suitable for customers that do not necessarily require funding at all times. This type of factoring can be either notification or non-notification and provides funds at a predetermined future maturity date (maturity date may be fixed in line with debtor payment history, or open, maturing as debtors pay). AGC provides debtor maintenance, credit assessment, and collections for a fee of between 0.5 percent and 2 percent. If funds are required prior to maturity up to 80 percent of invoices sold may be drawn and interest charged on the balances so drawn.

The other type of facility offered by AGC but not by any of the other respondents is called "Insurance Factoring". This is a facility for smash repairers which gives them immediate payment for insurance company invoices on a non-recourse basis. Insurance factoring is always notification and for a fee of between 2.5 percent and 4 percent of invoice value the smash repairer obtains 100 percent for each invoice purchased by the factor (no retention) and 100 percent credit insurance (non-recourse).

While no other factoring variations are provided by Carringtons, Scottish Pacific is the only one among the respondents to offer Export or International Factoring. Contacts in the overseas markets in this case are extremely important and these are obtained through its FCI membership.

The service attracts an administration charge of between 1 percent and 2 percent of invoice value which covers credit management and guarantee. There is also a finance charge of around 2 percent above bank prime rate.

According to Scottish Pacific the benefits of export factoring include the following:

- \* 100 percent guarantee against non-payment by the overseas customer;
- \* Finance up to 80 percent of invoice value, provided in the currency of invoice and converted to Australian dollars;
- \* Increased sales in foreign markets through the ability to offer competitive terms;
- \* Open account trading;
- \* Eliminating the delays associated with the negotiation of letters of credit;
- \* Reduction of administration problems associated with collecting from overseas debtors; and
- \* Full multi-currency sales ledger administration.

### **Risk**

As discussed in chapter 3, the literature suggests that of all of the possible risks associated with factoring, fraud is the most serious. This was certainly the case in Australia since all of the respondents considered fraud to be the major risk faced by factors. While they would not provide details, for fear of outlining the means by which future fraud may be perpetrated, it usually involved the creation of false invoices. All of the respondents have experienced, or have heard of, some fraudulent activity. One manager stated that he knew of frauds where one account caused a loss of \$800,000 while three others resulted in losses of around \$1 million (combined).

There is greater risk in non-notification type facilities. In addition to the creation of false invoices fraud includes the retention by the client of funds belonging to the factor. To reduce the possibility of such losses factors require regular customer audits (usually every three months), delivery and balance verifications are performed (at random), recourse period is established and retention is held. For this reason non-notification type facilities are usually provided only to the most credit-

worthy of clients.

In recourse factoring arrangements (the vast majority of Australian factoring business is on this basis) the other major consideration is client credit risk. Credit assessment and continuous monitoring of the client's business activities is a major means by which this type of risk is reduced. Of course retentions and other types of security may assist in the minimisation of credit risk.

### **Acceptable client criteria**

The criteria for acceptable clients is very much the same among the three respondents and is in accordance with those outlined in the literature. The only variation between the respondents seems to be in the short-term flexibility with which the lending guidelines are applied. Factoring customers must be either manufacturers, wholesalers, distributors or in the service business and meet the following "minimum" criteria:

- \* three year continuing profit and clear credit history;
- \* sales of tangible goods or provision of service on credit terms;
- \* the debts purchased must be of a commercial nature;
- \* annual turnover in excess of \$1 million;
- \* location where a viable factoring service may be provided;
- \* minimum average invoice value of \$400;
- \* the debtors ledger should not contain major concentrations. No one debtor must exceed around 30 percent of total accounts receivable;
- \* they should not conduct any of the following types of sales - to individual consumers
  - with deposits
  - on consignment
  - subject to progress claims or payments
  - on sale or return
  - complex capital equipment
  - to subsidiaries or associates

It must also be noted that Australian factors will establish client limits (or debtor limits in full service type arrangements) which must be adhered to or renegotiated. Also, if a significant dispute is raised by a debtor they will usually require the immediate re-purchase of the debt.

### **Securities and documentation**

Securities required for the implementation of factoring facilities include a debenture charge over the company (or at the very minimum a floating charge over the book debts of the business), guarantees of directors of private companies, cross guarantees if there are subsidiaries or associated companies, and in some higher risk situations, security deposits or property mortgages may be required.

The establishment of factoring facilities requires the following documentation : factoring deed or factoring facility agreement; document of directors' guarantees; cross guarantee document; debenture charge or floating charge; and, if required, charges over security deposits and mortgages of properties. If other facilities are also involved, discharges or releases, priority agreements and other legal documents may also be required.

### **Recourse/Non-recourse and Notification/Non-notification**

Respondents to the factor survey state that all of their factoring business (except for AGC's insurance factoring) is on a recourse basis. The notification/non-notification situation, however, differs widely. Exhibit 7 summarises the response to this question.

**Exhibit 7 NOTIFICATION VERSUS NON-NOTIFICATION FACTORING**

FACTOR	NOTIFICATION	NON-NOTIFICATION
AGC	30%	70%
Scottish Pacific	80%	20%
Carringtons	0%	100%

AGC state that approximately 30 percent of their volume is notification factoring (70 percent non-notification) while Scottish Pacific state that full service (notification) is probably 80 percent of their business (20 percent invoice discounting or non-notification). Carringtons, on the other hand, only undertake confidential or non-notification factoring.

### **Customer profiles**

None of the factor respondents would provide a detailed customer profile as requested by item 19 of the survey. However, they did provide a listing of industries from which their clients originate. They include: engineering (fabricators and equipment suppliers); clothing and footwear manufacturers and importers; carpet importers and manufacturers; wholesalers of electrical equipment; automobile component manufacturers and importers; plastics manufacturers; pharmaceutical, cosmetic and chemical suppliers and manufacturers; toy importers and distributors; furniture manufacturers and importers; printers; advertising agencies; professional persons hire agencies; accountants; material handling supplies manufacturers; commodity processors and traders; and others.

Factoring clients come from a diverse range of industries, as opposed to the U.S. experience. Some factors stated that this minimises the risk of exposure to any particular industry. Although factors did not wish to disclose their future intentions they did suggest that they wish to maintain this diversity and, therefore, have no intentions of concentrating in particular industries.

It is also estimated that the annual turnover of factoring clients ranges from around \$500,000 to \$20 million per annum although it has been noted that the largest factoring client in Australia had an annual turnover of around \$80 million.

## **OTHER AUSTRALIAN FACTORS**

It was previously stated that the Australian factoring market includes many small local and relatively unknown organisations (p.49). Some of these perform the same services as the respondents but, due to the limited nature of their resources, on a much smaller scale. Others specialise in the smash repair industry conducting what has been previously termed "insurance factoring" (p.64).

Two of these specialists were contacted in order to determine the nature of their operations. It was established that reasons for specialising in panel beating are their knowledge of the industry and the relatively low risk. Furthermore, both stated that AGC (a respondent to the survey) is their main competition.

These factors will purchase only invoices subject to insurance claims. In order to effect a purchase they require and obtain from the panel beater, the invoice, the insurance company's authorisation to perform the work and a clearance from the customer that the work has been satisfactorily completed.

Like AGC these factors will notify the insurer of the factoring arrangement and that the insurance company's settlement should be effected with the factor. Their similarity to AGC's service also extends to a 100 per cent purchase rate (less the factoring fee of between 2 and 3 per cent).

If the insurer fails to pay, these specialist factors will require the panel beater to repurchase the invoice (recourse factoring). For this reason guarantees are obtained and invoices purchased only from creditworthy panel beaters. However, AGC's insurance factoring is non recourse; that is, they accept the credit risk. The only circumstances in which AGC requires invoice repurchase is in cases of problems with the initial invoice or in cases of disputes. This is in accordance with the literature on the subject of "pure" or non-recourse factoring.

## Customer Reaction Survey

Interviews with ten factoring clients were conducted in order to determine their attitudes. All of the clients operated in Victoria, nine were manufacturers or otherwise added value to another product, one called itself a wholesaler or dealer but who conducts some manufacture, and the products in question varied from simple commodities to complex "hi-tech" equipment. The questionnaire in Appendix B was used as a prompt for discussions and this section outlines their responses.

Exhibit 8 details the length of time the clients have been involved in factoring. The client with the longest history has been using the service over the last 12 years. It must be mentioned that in the initial stages this client did not use the service to its fullest extent; that is, did not factor all the invoices. Typically, however, clients have been involved with factoring between one and three years. There were also two clients that have been factoring for four and five years, respectively.

**Exhibit 8 LENGTH OF TIME CLIENTS HAVE BEEN INVOLVED WITH FACTORING**

Years	No. of Users
1	2
2	4
3	1
4	1
5	1
5 to 10	0
10 plus	1

No correlation was found between firm size and the length of time in factoring. The data was so dispersed that it was difficult to tabulate (eg. two clients with sales of \$12 million, but one had been factoring for 12 years while the other for two). There was also no correlation between the age of firm and factoring time period.

Six clients said that their accountants initially introduced them to factoring (two internal and four external accountants). Three factoring clients could not recall but stated that they have always known about it while one was introduced to it by the then parent company.

All of the clients interviewed named cash flow as their only reason for factoring. This supports the claims that improved cash flow is a major benefit of factoring (as discussed in chapter 3). Nine of the respondents required this cash to pay for day to day expenses and purchase the stock required to meet growing levels of sales. Contrary to the outline of acceptable uses for funds obtained by factoring (chapter 3), however, one client, required the cash to pay for the acquisition of another company.

Sales levels of the interviewed factoring clients ranged from \$500,000 to \$12 million. Average annual sales growth during the period of factoring varied, however, from zero to 200 percent per annum. Exhibit 9 outlines the growth levels experienced by the clients interviewed.

#### **Exhibit 9 SALES GROWTH OF FACTORING CLIENTS**

(During the factoring period.)

Growth Rate	No. of Users
0%	2
1% to 9%	0
10% to 29%	3
30% to 50%	3
51% to 100%	0
100% plus	2

The clients experiencing no growth are relatively new to factoring. One stated that some restructuring (closure of a sales office) caused static sales levels but expected significant increases in the future. The other company did not go into factoring to finance growth but to obtain cash for the purchase of another manufacturing company.

Five of the firms interviewed had only been involved with

the current factor while the other five had previously factored with another company. Of the five that changed factors only one had experience with two factors prior to the current one.

The stated reasons for changing factors were:

1. Closure of factor operations in Victoria (2);
2. Problems with security requirements (1);
3. Factor was too slow and hard to deal with (2);
4. Problem of debtor concentrations prevented the use of the service to the extent required (2);
5. The factor did not understand the business and did not care about the client (3); and
6. The factor did not understand business realities and, therefore, could not see beyond their "hard and fast" rules (2).

In some cases there was more than one reason for changing factors. Also, the client that changed factors twice had a number of reasons for doing so. Therefore, the number of reasons and statements add to more than five (the number of customers that used another factor previously).

Notification factoring was provided to six of the clients interviewed while the rest (4) obtained non-notification factoring. In all cases the factoring was subject to recourse (90 days for nine customers and 120 days for one) and purchase rate was 80 percent of invoice value; the balance is obtained in the month following collection of the invoice). This is summarised in Exhibit 10.

**EXHIBIT 10: FACTORING METHOD EMPLOYED**

	Recourse		Notif.	Non-Notif.	Purch. 80%
	90 days	120 days			
<b>No. of Clients</b>	9	1	6	4	10

The companies provided with non-notification facilities collected their own accounts, were subjected by the factor to regular audit (usually every three months) and delivery

and balance verifications. They also had to provide periodical financial statements (quarterly), monthly reports summarising activity during the period, and aged debtors trial balances. Limits were also established for the non-notification factoring clients and this was reviewed when required, and/or annually.

The notification (or full-service) clients were not required to provide monthly reports because the factor had all the required information. Delivery verifications were still performed and factor audits were still conducted on two of the clients; four stated that they had never seen an auditor. The clients did not believe that there were any factoring size limits placed on their companies although one stated that the factor established a limit on their dealings with customers.

In all but one case the factor obtained a floating charge over the company. In that one instance a charge over the accounts receivable was established as the security for the factoring service. In all instances Directors' guarantees were required, and were obtained, as security for the factoring services, regardless of the type of service provided by the factor.

The fees, although obtained, will not be disclosed in detail for the fear of revealing confidential information. It may be stated, however, that the fees charged for the factoring services were, in all cases, in accordance with the range provided by the factor and usually within the ranges disclosed in the literature. In some cases factoring charges were based on a fee on face value of the invoices while in other cases it was a combination of fees and interest charge.

In all cases the benefits of factoring (with the current factor) met with the initial expectations. Typically it was stated that without the cashflow generated by factoring the company could not have grown (in some cases they would not have survived) or, in the case where

factoring was utilised to provide cash for the purchase of another company, the purchase would not have proceeded without factoring being available.

None of the clients were experiencing any major problems with the current factor or the factoring service now being provided. Little things may cause concern every so often. These include: problems with debtor concentrations; poor communications from the factor; inflexibility of some factors (particularly when cash is tight); slowness in processing and paying for the purchase of invoices; and in some cases the factor may charge a penalty if customer wishes to cease factoring. However, it was stressed that these were minor complaints which did not cause any real problems between the factor and the client.

Considering the above comments it came as no surprise that the clients suggested that the factor's service could be improved by: increasing factor flexibility; taking greater steps to understand the business; increasing processing speed (reducing the lead time between the remittance of invoices and the deposit of cash into the client's bank account); employing more experienced and efficient staff; better treatment of clients; and, in notification type arrangements, assisting (training) the client's customers to understand the factoring service. These comments were made by five of the clients while four suggested there was nothing that can be done because the service is extremely good.

Company growth is still limited by the fact that the costs of manufacture (materials, labour and overhead) had to be met prior to shipment of goods and the subsequent factoring of the invoice. In one case it was suggested, therefore, that the provision of "pre-shipment" finance would improve the factors' service. This could be done by factoring "firm orders" or forward sales contracts, particularly in industries where such contracts were common practice and firms were of very good credit standing.

Four of the clients stated that they would not prefer another method of financing growth; factoring serves its purpose. As discussed in chapter 3, an additional benefit in full-service type arrangements is debtors ledger administration. These four companies also stated that they valued this service. In all other cases the clients would prefer another, less costly, means of finance. Other reasons for preferring to change are: the elimination of monthly reporting, administration and reconciliation work (3); preference for keeping all facilities with the bank (2); and reputation, because factoring is still considered as finance of last resort (1).

It is interesting to note that all those who would change if another means of finance became available stated cost to be the main reason. The literature also suggests this to be a major disadvantage of factoring. However, the combination of fees and interest charges meant that none of the clients could provide an estimate of the total interest cost on the funds utilised (for comparison with other sources). It seems, therefore, that clients are aware of factoring's high cost reputation.

Six of the firms interviewed stated that they intend to continue factoring indefinitely and have no current plans to cease. They all wish to keep expanding and factoring will continue to provide them with a means of financing that growth. Two of these six did say, however, that if their respective companies stopped growing they would consider "easing" themselves out of factoring.

Of the four that plan to cease factoring one stated that it would be done as soon as possible, two stated that they will cease within 12 to 18 months (cash flow permitting) and one, being the one that used the cash flow to purchase another company, said that they will cease factoring as soon as the investment is paid off.

Finally, in order to obtain a general impression of the factoring service, the clients were asked about the level

of their satisfaction with the factoring service. Six said that they were very satisfied while the other four said that they were satisfied.

## **Summary**

The main findings of the research into the Australian factoring market are as follows:

- a) The Australian factoring volume in 1992 was US\$1.56 billion (FCI data) although this could not be confirmed by the ABS because ABS does not measure factoring volume.
- b) All of the responding factors offered non-notification and recourse factoring. The recourse period was, in most cases, 90 days although 120 days was also possible.
- c) None of the respondents offered non-recourse or "pure factoring" except AGC's insurance factoring.
- d) Notification factoring, maturity factoring, insurance factoring, export factoring, and accounts receivable management were all available but were not being provided by all factors.
- e) The pricing of factoring services, risks faced by factors, and characteristics of suitable clients, were all in accordance with the literature.
- f) Factoring clients in Australia operate in a diverse range of industries. The literature suggests that this is also the case in Europe. In the United States, however, factoring seems to be concentrated in the clothing and textiles industries.
- g) Clients have a generally favourable attitude to factoring and the majority intend to continue factoring indefinitely.
- h) Clients suggested that factors' services could be improved through increased efficiency, flexibility, and investment in longer-term client relationships.

**PART C**

**SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

## Chapter 8

# SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

### Summary

Factoring, the purchase of an organisation's accounts receivable by another party, the factor, has a long history. Modern factoring began at the turn of the century in relation to United States' textile mills and, in many countries, it has grown to become a significant means of financing economic activity. It is also a growing means of financing world trade.

The major benefits of factoring relate to its purpose of improving cash flow which not only aids in the survival of many firms but enhances firm value. Additionally, it provides a means by which the company can pass on the function of sales ledger administration, including credit assessment, credit control and collections.

It is a service business and its reputation, acceptance and growth will depend on how well the service is performed. Prior perceptions of its "last resort" status is largely the result of the poor performance of this service function. Therefore, efficiency, investment in technology and staff training, responsiveness to client needs, service quality and good business skills should be of paramount importance to those that wish to compete in the factoring market. Also, access to cheaper funding, through ties with banks, should enable the factoring service to become cheaper and rival most other sources of business finance.

Risk assessment, management and risk-sharing will also be important considerations for successful factors. Competition will increase the risk dimension so the adherence to proper lending principles, and risk return ratios, will be essential for longer term survival.

## Conclusion

The purpose of this research paper was to describe factoring, its worldwide significance and the description of the Australian factoring market. It can be concluded that factoring is much the same throughout the world, although the Australian market differs from many other markets in two significant aspects; it does not provide "pure factoring" and the market is much smaller than in the United States and many European nations.

In the United States of America the term "pure factoring" refers to non-recourse, notification and full service factoring. While it remains a significant component of factoring in the U.S. (Rutberg, 1989c, pp.14,16) the European and Australian markets are more interested in non-notification and recourse arrangements. In fact, apart from "insurance factoring" non-recourse arrangements do not exist in Australia.

The use of factoring in the United States and some European countries like Italy, France, Germany, United Kingdom, together with Japan, Mexico, and South Korea, is quite significant. Factoring in Australia is not utilised to the extent that it is in those countries, although at \$1.56 billion it is still sufficient to place Australia into the world's 20 largest factoring markets.

Possible impediments to further factoring growth include: the lack of an industry representative to promote the benefits of factoring; relatively poor service quality (compared to other more advanced factoring nations) due to the lack of any significant investment in technology and staff training; and a general lack of understanding of customers' business that leads to reduced flexibility in the provision of factors' services.

Another possible reason for the relatively low levels of factoring in Australia is that none of the factors provides the risk-taking capability of "pure-factoring".

However, the generally favourable reaction from factoring clients suggests that it does have a good future in Australia. It will be a challenge for factors currently competing in the Australian market to ensure that this not only spreads to other clients (those whose attitude is not so favourable) but that the "last resort" lending label is finally removed. This will only be achieved through the provision of quality service at a reasonable cost.

The expansion of the Australian market will certainly depend on factor quality. It will also depend on the reaction of the Australian finance and banking sectors to the Federal Government's call for increased "cash flow lending". This has provided a significant opportunity for the factoring industry since factoring is closer to "cash flow lending" than any other form of finance.

A final determinant of the growth in the Australian factoring volume is the international competitiveness of Australian industry. While this is outside the control of the factors they are able to assist in improving the competitiveness of Australian industry through their abilities to provide information relevant to their clients' business and export performance (particularly those with international affiliation).

## **Recommendations**

Securitisation has been used by major "blue-chip" corporations to finance some of their economic activity. Since accounts receivable securitisation is virtually the same as factoring an excellent opportunity exists to promote this similarity; the benefits of factoring for smaller to medium sized organisations are the same as those that were recognised by major corporates that securitised their debtors.

In order to achieve a coordinated effort these similarities and benefits should be promoted by a factoring industry association. This association should

also promote the general awareness and understanding of factoring. This would eliminate the confusion that often arises between factoring clients and their customers at the commencement of notification factoring facilities.

Significant competitive advantage could accrue to factors willing to accept credit risk; that is, provide non-recourse factoring. Investment in technology and information would be quite large although providers should be able to demand a premium for such a service.

Furthermore, investment in technology and staff training should be undertaken to provide the means to improve productivity and flexibility in the provision of service. Staff should be able to totally understand the client's business, the industry in which the client operates and the types of problems which the client experiences. In other words, significant investment should be made in long-term client relationships.

Pre-shipment finance has been mentioned as a valuable service that would enable some companies to expand to a much larger extent. This may take the form of factoring of forward supply contracts. Of course, the performance of both sides of the contract is a significant risk element in this type of situation. However, risk assessment of both parties, lien over the acquired stock, and an industry with strong "my word is my bond" culture, as experienced in commodity trading markets, for example, would be firm requirements.

### **Suggestions for further study**

The "client reaction survey" results may be biased because of the strong probability that factors have only provided access to those clients that were unlikely to be critical of their performance. Therefore, further research opportunities exist to ascertain the attitudes of an unbiased group of factoring clients.

Another possible research opportunity is to analyse country differences; the characteristics of high volume factoring countries (such as Italy) and comparing these with the characteristics of the Australian market.

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## **APPENDICES**

## Appendix A

# FACTORING OF ACCOUNTS RECEIVABLE: The Australian Market and Experience

## SURVEY OF FACTORS

### Background Information

1. When did your company first start factoring in Australia?
2. In what States and Territories of Australia does the company operate?
3. What proportion of your total finance business (TOTAL INCOME and RECEIVABLES) is represented by Factoring?
4. What other categories of finance does your organisation provide? Please advise the proportions of TOTAL INCOME and RECEIVABLES outstanding represented by these finance products.
5. Please provide the name(s) and location(s) of your parent company and ultimate parent company.
6. Is there an industry association that represents the interests of Factors? If so, is your organisation a member?
7. Has your organisation experienced any major changes/interruptions in the Factoring business in the last 10 years? If yes, please describe the nature of the change/interruption and the cause/reason.

### Factoring Details

8. Please provide DETAILED descriptions of ALL the FACTORING products (variations) provided/marketed by

- your organisation. In doing so, outline the major differences in the administration of each of these products/factoring variations.
9. What are the RISKS of Factoring in general and those specifically related to each of the Factoring products described above?
  10. What major losses/frauds has your organisation experienced (if any) as a result of the risks described above? Please provide a brief outline of how they came about and the methods being used to prevent their recurrence.
  11. Please outline the requirements of a suitable Factoring customer (approval criteria). How does this suitability criteria change in relation to each of the Factoring variations/products described above?
  12. What documents are required to implement the Factoring facility? Please name the documents and briefly describe their intent.
  13. What securities are usually required to support the Factoring finance facility?
  14. Please describe the FEES and INTEREST CHARGES associated with each of the various Factoring products/variations described above. In doing so please state the -
    - a) Name of the FEE or INTEREST charge;
    - b) How it is calculated (general formula if applicable);
    - c) The range of the FEE or INTEREST charge (eg. Fee of 1% - 4% of invoice or Interest Uplift between 1% and 5% above AMBA);
    - d) The purpose of the Fee or Charge;
    - e) How is the fee or interest charge affected by the perceived risk associated with the customer and/or other items such as the DEBT TURN ratio?; and
    - f) Any other matters relating to the pricing of the Factoring products described.

Note: Provide formulae for calculating the fees and charges. If, AMBA or Cost of Funds used as a basis, please state so. The amount not needed.

## The Australian Market

15. What do you consider to be the size of the Australian Factoring market in terms of -
  - a) Invoices (total Value) sold annually; and
  - b) Factoring Receivables outstanding.
16. What is your market share of the above?
17. What proportion of your factoring business is RECOURSE/NON-RECOURSE?
18. What proportion of your factoring business is NOTIFICATION and NON-NOTIFICATION?
19. Please provide your CLIENT PROFILES, as follows:
  - a) For each of the states in which your organisation operates, and total for Australia, please state -
    - \* The number of Factoring clients on the books;
    - \* Value of Invoices purchased in the last 12 months; and
    - \* Factoring Receivables balance as at 31 October, 1992.
  - b) For each of the states in which your organisation operates, and the Australian total, please state the numbers of clients with annual turnover in the following ranges -
    - \* \$ 0 to \$ 100,000
    - \* \$ 100,001 to \$ 500,000
    - \* \$ 500,001 to \$ 1,000,000
    - \* \$ 1,000,001 to \$ 5,000,000
    - \* \$ 5,000,001 to \$10,000,000
    - \* \$10,000,001 to \$30,000,000
    - \* \$30,000,001 plus.
  - c) For each of the states in which your organisation operates, and the total for Australia, please state the NUMBER OF CLIENTS and the level of OUTSTANDING RECEIVABLES as at 31 October, 1992 classified according to CLIENT BUSINESS TYPE.

- d) For each of the states in which your organisation operates, and the total for Australia, please state the NUMBER OF CLIENTS and the OUTSTANDING RECEIVABLES as at 31 October, 1992 classified according to how long the client has been in business, as follows:
- \* 0 to 1 years
  - \* 1 to 2 years
  - \* 2 to 5 years
  - \* 5 to 10 years
  - \* 10 plus years.

### **Market Trends**

18. What do you expect will be the size of the Australian Factoring market in 5 years and 10 years?
19. In terms of VALUE OF INVOICES SOLD annually and OUTSTANDING RECEIVABLES what do you expect will be your share of the market in 5 years and 10 years?
20. What growth areas do you consider will be particularly relevant for Factoring business in terms of client size, client business type, length of business operation, client state of origin etc.?
21. What do you expect will be the client profiles (as described in item 17 a) to d)) in 5 years time and in 10 years time?

### **Client Attitude Survey**

In order to complete this section I wish to interview a number of your clients. It is expected that this will provide valuable information about their attitudes to factoring and their future intentions.

Prior to the interviews your organisation will be provided with a list of questions to be asked at the interview and an officer of your company will be most welcome to attend.

**Contact:**

Please provide the Name, Telephone Number, and Facsimile Number of an officer from your organisation who may be contacted for any further information or clarification.

**THANK YOU FOR YOUR PARTICIPATION!**

Please be assured that the information you provide will be strictly confidential. Your participation will be acknowledged (unless you wish to have that suppressed) and only aggregate data is to be included in the thesis. **No confidential information will be disclosed!**

## **APPENDIX B**

### **QUESTIONNAIRE For Factoring Clients**

- 1. When did you first start factoring?**
- 2. How did you come to hear about, and become involved in, factoring?**
- 3. What were your main reasons for factoring? What benefits did you expect?**
- 4. With whom do you factor?**
- 5. Have you factored with anyone else? If yes, with whom, for how long and why did you change?**
- 6. What are the main features of the factoring service you currently obtain? Include here a description of the administration procedure of this service.**
- 7. What security have you provided for this factoring?**
- 8. What were the charges for the establishment of this factoring service and what are the ongoing costs (fees, interest, other)?**
- 9. Do the benefits of this service meet with your initial expectations?**
- 10. Are there any problems that you are experiencing with the factoring service, the factor etc.? If yes, what are they?**
- 11. How could the factor improve its service to you, the customer?**
- 12. Would you prefer a method other than factoring to finance your business growth? If so, why?**
- 13. How long do you expect to factor? At what stage do you expect, or would like, to cease factoring?**
- 14. Generally, would you consider yourself Very Satisfied, Satisfied, Unsatisfied, Very Unsatisfied, with you current factoring arrangements?**

