

FACTORING AS AN EFFECTIVE WORKING CAPITAL OPTION: A CRITICAL REVIEW

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Abstract

Purpose – The purpose of this paper was to critically review the concept of factoring, with the view to ascertain its effectiveness in ensuring that organizations have access to enough liquid funds that facilitate the smooth running of their operations.

Methodology – The Systematic Quantitative Assessment Technique (SQAT) was used to identify and review relevant peer-reviewed journal articles that had investigated factoring as a source of working capital.

Findings – Based on a critical review of extant factoring scholarship, it was deduced that factoring has been effective enough to elicit a growing rate of adoption across the continents, despite the costs of adoption, as well as the 2009-2014 global financial crisis, excluding only North America where there seems to be a constant decline in adoption rate.

Research limitations – The use of limited but high quality academic databases means that some articles were not considered for this review. *Originality/value* – The study is one of few studies to discuss the effectiveness of factoring as a source of working capital.

Keywords: Factoring, Account receivables, Working capital, FCI, Effectiveness

JEL Classification: G320

1. Introduction

Finance is seen as the elixir that enables businesses to exploit opportunities to grow (Duff, 2018). However, there has been a consensus among scholars that finance-related problems, such as access to and management of finance, are constantly rated among the major hurdles hampering organizational growth (Kumar and Rao, 2015; Chowdhury and Alam, 2018). Furthermore, while seasoned business owners are well aware that turnover and profits matter a great deal in the long run, they acknowledge that it is how cash flows in and out that makes or breaks a company in the short run (Shiao, 2018). Therefore, organizations have employed several means to optimize working capital, that is, to ensure that cash outflows are significantly less than cash inflows so that there is enough to run day to day operations (Kowsari and Shorvarzi, 2017; Abbasi et al., 2018).

As such, it is often said that cash flow is the lifeblood of any company (Edwards et al., 2017). Particularly, this applies to corporations that engage in the convention of credit sales to customers (Li and Gu, 2018), as well as construction and manufacturing companies which are more often than not, required to complete a certain proportion of, or the total project before receiving payment (Hansen et al., 2017; Nasir et al., 2017). This supply of goods and services before payment results in accumulation of accounts receivables, that is, the money owed a company by its clients (Li and Gu, 2018). It is therefore a plus that debts (receivables) have become commodities that can easily be exploited, using tools like factoring and securitization (Juutilainen, 2016). For the purpose of this study however, the focus is placed on factoring as it appears to be a trending working capital intervention option, which surprisingly dates back to the early days of civilization (RTS Financial, 2019).

Factoring refers to the phenomenon where a company (the adherent) sells its accounts receivables (the invoices showing the debts owed by its clients) to a financial service company (otherwise called factoring companies or factors) at a discounted rate (a little cheaper than the exact amount stated on the invoice), which will be paid immediately the status and creditworthiness of the debtors are ascertained by the factor. This allows for the uninterrupted running of day to day operations in the company, while passing off the burden of debt collector to the factor (Chirkunova et al., 2016; Dorfleitner et al., 2017; Protopappa-Sieke and Seifert, 2017).

As highlighted in the 2017 Organization for Economic Co-operation and Development (OECD) annual report “Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard”, it is interesting to note that despite the financial crises between 2009-2014, factoring volumes continued to expand, and served as an attractive substitute for more traditional bank lending, which greatly contracted within that period (OECD, 2017). Regardless of the decline of factoring volumes in 2015 across the continents, excluding Europe, the global factoring volume increased to EUR 2,367,790 trillion in 2016, from EUR 2,347,513 trillion in 2015, and has steadily increased ever since, confirming factoring’s role as an important financial resource for sustaining companies’ growth (FCI, 2018).

Furthermore, unlike traditional bank loans, it does not create a liability for the company since it is a sale, not a loan (except in the case of default), therefore, there is no threat of property take-over (Auboin et al, 2016). Also, the asset sale process is simple, working capital to fund the production of orders is provided, and the payment of wages and purchase of production inputs is made possible with little or no delay (Auboin et al, 2016).

Nevertheless, despite its merits, there are also demerits to adopting factoring. These include the interest rates and service fees levied on the companies, which are sometimes costly, especially depending on the tax treatment in such a country (Bernard et al., 2018). Also, how the factor handles companies’ clients may positively or negatively affect the clients’ view of the company. Hence, it is advantageous for research to be carried out to determine, first, whether or not factoring is an effective financing option and then subsequently how it can be optimized for efficiency within organizations.

As such, this study reviews extant journal and news articles that have discussed this field of interest, and also evaluates the highest ranking factoring body, Factors Chain International (FCI) 2018 Annual Review, in order to answer the central research question “Is factoring an effective financing option?”. Recommendations and areas for further research are also provided.

The subsequent sections of this study are as follows: the methodology section, review section where related literature are appraised, the current trends in the factoring world are discussed, and the answer to the central research question is provided; followed by the recommendations section, and then the conclusion section where limitations of the study are presented as gaps for future research.

2. Methodology

The “systematic quantitative assessment technique” (SQAT) developed by Pickering and Byrne (2013) was utilized for this study. SQAT is systematic in the way papers are assessed to determine their inclusion or exclusion in the review process, and the focus is on peer-reviewed original journal publications so as to maintain a high quality of

papers (Pickering & Byrne, 2013). SQAT enabled the researcher to identify “important geographic, scalar, theoretical and methodological gaps in the literature” (Pickering & Byrne, 2013, p. 11). The researcher found SQAT to be logical, simple to use, and easily replicated, which are all important components of a systematic review. SQAT recommends five important steps in conducting an effective systematic review. Each step and how it was applied in this study is described in Table 1.

Table 1: Description and application of SQAT

	Step	Application in current study
1.	Define topic	Factoring as a financing option
2.	Formulate research questions	One central research question: <i>“Is factoring an effective working capital option?”</i>
3.	Identify key words	<i>“factoring” + “finance”</i>
4.	Identify and search databases	1. 10 databases utilized: Elsevier; Springer; Wiley; Taylor and Francis; JSTOR; Emerald; Sage; Inderscience; Cambridge Journal; HeinOnline; 2. “All in title” search: Factoring + Finance
5.	Read and assess publications	1. Abstracts of papers found were read to ensure that they were dealing with factoring as a financing option. 2. Literature reviews book chapters and conference proceedings were not included; only peer-reviewed conceptual and empirical papers.

Nevertheless, given the paucity of research on factoring within the years under review in the study, the journal articles are augmented with the analyzed content of Factors Chain International (FCI) 2018 Annual Review so as to gain a critical overview of the concept of factoring, in order to ascertain whether or not it has been effective as a working capital solution.

3. Discussion and Findings

This section provides an overview of the opinions of scholars and professionals on factoring as a working capital option, its benefits and costs, as well as trends in the industry, in order to gain a comprehensive outlook of the effectiveness of factoring so far. The section also outlines the challenges militating against successful factoring transactions, both in emerging and emerged economies, with a view to recommending possible solutions.

3.1. Factoring as a Working Capital Solution

The recent global economic crises has caused a serious problem of insufficient liquidity and working capital for small and medium ventures, including a significant increase in the cost of corporate borrowing from banks (Song et al., 2018). These, combined with the absence of accurate or substantial financial records and bankable collateral (Rao et al., 2017), as well as the slow processing and disbursement of funds, have made traditional bank lending less attractive (Amoah et al., 2017). A possible solution would have been equity financing, however, many companies are not connected to the capital market and, as such are not allowed to sell titles through the capital market (Bogdan et al., 2018).

Therefore, seeing as debt is a tradable asset in the dynamic, global market arena of today (Juutilainen, 2016), factoring has been highlighted as a quick solution to ease the working capital crunch faced by many corporations (Bogdan et al., 2018). This is supported by the fact that factoring releases finance that might be stuck in account receivables for a long time, immediately, in form of advances. This ensures that the firms can manage the required level of liquidity, while transferring the difficulties associated with debt collection to a financial institution (Tanrisever et al., 2012).

3.2. Benefits and Costs of Factoring

Entrepreneurial firms are often characterized as having insufficient acceptable tangible assets, such as buildings, landed property, and others, to offer as collateral. They are also seen as lacking in the track record necessary to establish their reputation. Therefore, factoring is considered more doable for them, as the collateral itself (accounts receivable) is readily available to entrepreneurs, and serves as the primary source of repaying the factor. As such, factoring can be used to complement bank loans, or, as the case may be, substitute them entirely (Mol-Gómez-Vázquez et al., 2018).

Like other traditional forms of commercial lending, factoring also provides corporations, especially service companies which grow faster than their credit line, and tend to be payroll intensive, with the funds needed to run their day to day operations (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012). However, unlike most other forms of commercial lending, factoring supplies the needed funds speedily, in such a way that enables the sale of goods and services to continue with minimal interruption, thus encouraging productivity and profitability (Mugarura, 2016). Furthermore, financing large scales projects become challenging when there is need to secure and raise capital, as such, contractors use several alternative sources of funding, of which factoring is usually used to get the materials needed, in order to sustain financial flow and avoid any dissatisfaction between collaborated partners (Romeli et al., 2016). This is corroborated by the fact that there is no cause for asset risk, credit risk, debt, or sale of ownership (Chirkunova et al., 2016).

Also considering that, on average, 20 to 40 percent of manufacturers have assets locked as accounts receivables (Lin et al., 2018), factoring allows the high-risk suppliers among them to mitigate their credit risk level with that of their high-quality buyers, as the decision of a factor to finance the adherent has more to do with the position of the buyers owing, than the supplier owed (Klapper, 2006). In addition to this, the owing buyer's informational asymmetries and risk become the primary concern of the factor, not the adherent, and even those become secondary concerns if the accounts receivable belong to transparent and large companies (Mol-Gómez-Vázquez et al., 2018). As such, manufacturers' abilities to expand operations or change product offerings in response to changing market conditions are unhindered.

Following these, despite the fact that corporate finance sees the protection of the rights of financiers as essential to mitigating agency problems in SME financing and assuring the flow of capital (Jensen and Meckling, 1976), extant financial literature have stated that not all financial contracts are equally affected by the low quality of laws. Factoring is one of such financial contracts that are less affected by agency problems and inefficiencies in the legal system, regarding the protection of investors, as long as the debtor firms are transparent dealers: this is good news for developing countries which are usually characterized with such inefficiencies. As such, protection of creditor rights and enforcement mechanisms become less important for factors (Mol-Gómez-Vázquez et al., 2018).

On default risk, that is, the risk that the debtor refuses to pay up as at when due, factoring offers an option, "factoring without recourse", wherein the factor assumes the payment risk of the debtor (Rajput et al., 2015). On another hand, in the case of cross-country factoring, the exposure of a firm to foreign-exchange risk can also be mitigated, since the exporter can simply sell receivables to a factor and receive home currency in return (Sirpal, 2009).

The use of factoring has been seen to improve credit and default risks, cash-flow and liquidity, profitability, as well as time management. However, it has also been seen to impose a whole range of costs, mainly coming from both the business and legal environments. From the business environment, the standard costs consist of two main charges - discount charges (based on the interest rate determined by the factor) and service fees. There might also be additional costs for additional requested services, such as credit protection charges for non-recourse factoring agreements, performing credit investigations, guaranteeing commercial and political risks, among others (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012; Rajput et al., 2015).

From the legal environment, the tax treatment of factoring can cause factoring transactions to become excessively expensive (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012; Bernard et al., 2018). For instance, some countries do not allow the interest on factoring arrangements to be tax deductible. Also, when the law sees factoring as a sale and purchase agreement where there is a complete transfer of the receivables' ownership, in the case of bankruptcy, factored receivables would not be part of the property of the bankrupt firm, but the property of the factor. Since the factors know these, it can affect the costing of factoring services, thus making their fees more expensive. There are also a number of additional taxes, as well as legal and regulatory challenges to factoring in many countries (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012).

3.3. Trends in the Factoring Industry

As observed from the FCI Annual Review 2018, this subsection explains the global factoring trends in the last 7 years (2011-2018), highlighting the growths and declines that have taken place in a continental context.

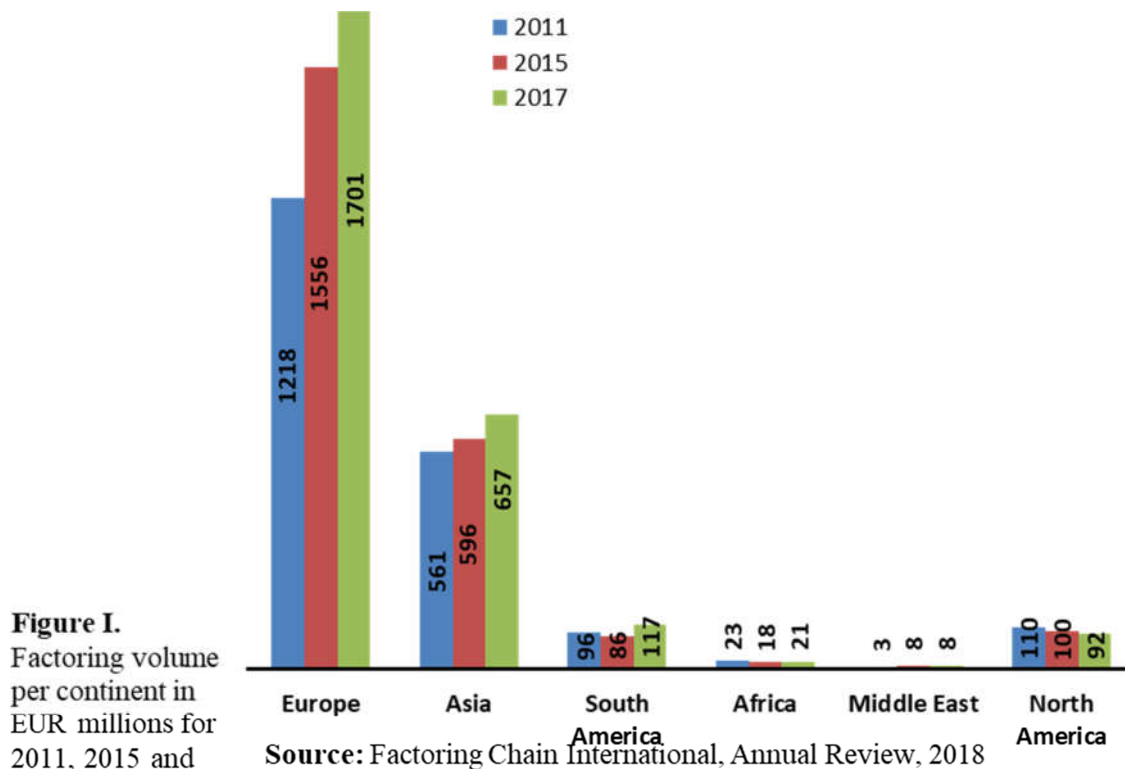


Figure I.
 Factoring volume per continent in EUR millions for 2011, 2015 and 2017

Figure 1. Factoring Volume Per Continent in EUR Millions for 2011, 2015 and 2017

As observed in Figure 1, there has been a steady growth in Europe's factoring volume right from 2011 to 2017, and this is corroborated by the data collected by the EU Federation for 2017, wherein factoring volumes for EU

countries have increased by 7.5% for the 9th year in a row, exceeding EUR 1.6 trillion: today factoring is recognized as a safe short-term source of funding, committed to the real economy and employment in Europe (FCI, 2018). Owing to the sharp rise in China's factoring volume by 34%, as well as the increase in other major markets such as Hong Kong (+10%), Singapore (+9%), and Taiwan (+5%), after declining from 2015-2016, Asia Pacific's factoring volume made a spectacular return with a growth of 18% from EUR 555.55 billion in 2016 to EUR 657.18 billion in 2017 (FCI, 2018).

As of 2017, factoring volumes of Latin America (South America) and Caribbean countries had grown to over EUR 117 billion, from EUR 96.18 billion in 2011. This is a great achievement for the region where it has been a great challenge to proffer a one-off solution to support, provide needed, funds and at the same time mitigate lending risks of young and innovative SMEs. Both international factoring and reverse factoring have proven to be good fits in the region, such that their financial institutions attest to being contented with the results attained so far (FCI, 2018).

In 2017, Africa's factoring volumes increased by 9% (EUR 21.6 billion), surpassing the global average growth of 4%, even after the sharp plunge in 2015 (EUR 18.7 billion) owing to the increased factoring volumes particularly in Morocco (+25%) and South Africa (+9%). However, Africa's share represented only 1% of global figures. The annual review also highlights that in the less developed countries of Africa, factoring has gained grounds. In Nigeria for instance, the Nigerian Factoring Working Group (NFWG) worked actively on the enactment of a factoring law. As such, a new factoring company (Factoring and Supply Chain Finance Limited) obtained regulatory approvals, commenced business, and joined FCI in 2017, while two others were under establishment (FCI, 2018).

It is observed that the Middle East, despite experiencing increase from about EUR 3.8 million in 2011, to slightly above EUR 8 million in 2017, has obtained the least share in factoring volume so far, while North America has not done much better as there has been a decline by at least 3% since 2011 (FCI, 2018).

3.4. Effectiveness of factoring

Financial effectiveness (FE) is the ability of organizations to use the proper choice of activities, efforts, initiatives, strategies and/or policies to generate and maximize long-term sustainable financial performance (Omondi-Ochieng, 2018). As such, it might be safe to say that any financing option that can potentially help an organization to achieve its financial goals is an effective one, and any one that actually succeeds in facilitating the achievement of such targets is efficient: this is as distinguished by Drucker (1977), who associated efficiency to "doing things the right way" and effectiveness to "doing the right things". However, as noted, the financial option must first be effective, which is what this paper is thus concerned with.

Therefore, considering the turns factoring has taken in the past 7 years, seeing as all the other continents asides North America, have seen reasons to increase their factoring volume, no matter how small the fraction, as in the case of the Middle East and Africa, it is safe to say factoring has been effective in meeting the financial needs of organizations in the continents, as if it was not, there would be no need for its increased volume, and no way that countries would have continued to adopt it.

Also, in a study carried out by Bogdan et al. (2018) in Romania, it was highlighted that the financial structuring of enterprises is based on the criteria that such structure can be easily accessed, it can achieve the lowest cost of the capital, and with the most reasonable level of debt to the company. Therefore, the constant preoccupation of managers is finding the financing sources that meet these criteria, for their operations. In the same study, using the genetic algorithms method, the solution generated showed the fact that factoring is a viable financial solution, to the extent to which the particular factoring transaction can be easily accessed and can achieve the minimum level of cost and indebtedness (Bogdan et al., 2018).

Furthermore, despite the obvious and weighty costs that could be incurred upon adopting factoring, many still do not mind as it effectively helps bridge the gap between cash outflows and inflows, without the costs running the business down. Owing to this also, it is quite safe to decide that factoring is an effective financing option.

3.5. Challenges

Selecting factoring, or even any other type of financing option, as effective financing sources for investments is complex because, besides the main criteria concerning the costs of achieving the capital, there are a series of restrictions concerning the access, difficult legislations, the decision of the authorized institutions in approving the usage of these types of financing sources, as well as the financial situation of the company (Bogdan et al., 2018). Capital from factoring does not necessarily translate to the flow of goods between suppliers and recipients as lack of proper marketing techniques, constant defaulting, inconsistencies in deliveries, and so many other factors may militate against successful flow (Hofmann, 2009). Furthermore, successful factoring can be limited because of ineffective information infrastructures characterized by the absence of data on payment performance (as is usually the case in emerging countries), and /or high cost and long time required for the information collection (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012).

Also, despite the fact that factoring is less affected by inefficiencies in legal systems, than many other means of financing SMEs, in a survey conducted by Mol-Gómez-Vázquez et al. (2018), it was discovered that other institutional factors, besides the legal environment, might influence the demand and the supply of factoring. As such, firms operating in underdeveloped economies might still have a reduced use of factoring, despite having a weak legal environment in which factoring does not have a problem thriving.

On another hand, due to the contradictory stands concerning the Shari'ah-compliance and efficiency of factoring, international factoring is possibly one of the most controversial issues in Islamic trade finance. This is owing to the element of bill discounting and interests, on which Islamic finance puts restrictions as directed by the Koran (Gundogdu, 2016).

4. Recommendations

Seeing as selecting factoring as an effective financing option goes beyond the direct costs it imposes, it is advised that corporate organizations do proper studies on the financing options available to them, using capital budgeting tools like Net Present Value, and others to determine if factoring is the best fit for their particular organization, as it may be a viable venture for some, and not for others, owing to the internal, and sometimes external environment they find themselves.

Factoring provides capital almost as soon as it is needed, however, this does not automatically translate to higher sales and profitability, the internal conditions of the organization, such as how the money is managed, the value and quality of products and services, customer relations, proper communication of corporate goals to employees, and so many others, have to be properly handled.

In the same vein, countries, especially developing ones, have to be holistic in their approach towards solving financial problems, which they are usually characterized by, such that the legal system, as well as the political and socio-economic systems will be supportive of businesses, thus helping the economy to grow steadily and eventually develop (restructure for enhanced clarity).

According to FCI, a working group has been established to create an interface agreement which would enable the existing members of FCI to cooperate with Islamic financial institutions. As such, the Global Rules of International Factoring (GRIF) has been revised, and it is believed that signing the Supplemental Agreement for Islamic International Factoring will eliminate the controversies (include reference). It is however advised that FCI be careful in its attempt to draw in more of the Islamic Financial Institutions, as they also risk losing former members who will not like to comply with the new rules.

It is also recommended that corporations also carefully choose the particular customers whose debts they sell to the factors. This is pertinent as some customers will not like to be approached by third parties concerning their debts, and may feel insulted and completely stop patronizing the company. The careful selection will ensure that top-priority customers and clients are not driven away. Lastly, a cost-benefit analysis should be carried out to ascertain if it will be more beneficial to undertake a factoring transaction, than to undertake the other options available to the company.

5. Conclusion and Suggestions for Future Research

Despite the fact that the problem of finance is a persistent one in organizations because there are always more needs than available means of meeting them, factoring has been found efficacious as an innovative short-term financing tool that continues to gain grounds as a working capital financing solution, as it enables businesses to keep afloat and maintain competitive advantage in the ever evolving, not-waiting-for-anyone world we find ourselves, by freeing up cash stuck with the organizations' debtors. Nevertheless, it is worthy of note that when it comes to financing businesses, there is no one-size-fits-all. This means that, since strengths, weaknesses, opportunities and threats vary from firm to firm, managers are to be saddled with the responsibility of critically assessing the various means of funding available to their organizations, so as not to adopt just any one, but the one that best suits theirs: what works for company A might not work for company B.

However, this paper is limited in that, as opposed to the original intent of the researchers, the paper could not rely on just peer reviewed journal articles as points of reference as the number of scholarly articles specifically discussing factoring are meager, and even some of the available ones are neither comprehensive nor holistic enough. It is therefore proposed that potential researchers seize the opportunity to explore the field of factoring, especially at a time like this when it is still a trending topic in the world of corporate finance.

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