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Procedia - Social and Behavioral Sciences 44 (2012) 428 – 435

International Conference: Service Sector in Terms of Changing Environment 2011

Factoring in the Changing Environment: Legal and Financial Aspects

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Abstract

In the changing financial environment characterized by the high level of credit, default and liquidity risks, factoring supports firms to manage the required level of liquidity and offers them the advantage of obtaining further price discounts from suppliers. This is particularly important in the service industry due to the particular risks inherent in this sector and because of the lack of sufficient security. The goal of the authors is financial and legal analysis of factoring in the changing environment. The authors analyze the main features, benefits and costs of factoring implementation by small and medium enterprises (with a particular emphasis on the use of factoring in the service sector), and show that the use of factoring can improve profitability, liquidity and cash-flow of business, management of time, credit and default risks. However, the use of factoring is limited because of many restrictions and hidden cost coming from the legal environment. The authors emphasize that the legal environment of factoring is the crucial for the saving of transaction cost and improvement of costs and safety determination process of factoring transaction of each country.

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Key words: factoring; changing environment; risk; contract; assignment of receivables.

1. Introduction

The economic environment has been changing intensively, both quantitatively and qualitatively, for the last two decades. Along to the processes of liberalization, structural reforms, and rapid technological

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growth, the modern companies are faced with the significant increase in mobility of capital, knowledge and technology at the international level. At the same time, with the recent economic crisis, as a consequence of growing credit, default and liquidity risks, volatility in economic performance has sharply increased. In such a changing environment, it is a big challenge, particularly for the companies in the service sector, how to improve the competitiveness in the field of growth financing. Access to finance has been identified as a key element to succeed in the drive to build capacity, to compete, to create jobs, to undertake productive investments and to expand the businesses.

Since credit period usually lasts from 30 to 90 days, and the account receivables represent illiquid asset until payment is received, it is difficult to finance production cycle. The existence of these problems focuses many firms to find alternative forms of short-term financing for their operations. Factoring is a financial technique where a specialized firm (factor) purchases from the clients accounts receivables that result from the sales of goods or the provision of services to customers. In this way, the customer of the client firm becomes the debtor of the factor and has to fulfill its obligations towards the factor directly. The factoring agreement assumes that the whole credit risk, as well as the collection of the accounts, is taken by the factor, which is of high importance in the present financial environment.

Principally, factoring has been used in both developed and undeveloped economies, public and private sector, among domestic- and export-oriented companies, agriculture, and industry and service sector. It may give particularly well results in financial systems characterized by weak commercial laws and poor enforcement. In 2008, total worldwide factoring volume was over €1.300.000 million. According to the Factors Chain International, total worldwide factoring volume increased sharply in 2010 with more than 28% compared to 2009. The world total stands in 2010 at €1,283,559 million [Source: http://www.factors-chain.com]. The factoring industry endured the global financial crises much better than many other providers in the financial and insurance sectors. Even though volumes dropped somewhat in 2009, the 2010 figures far exceeded the 2008 figures.

The aim of this paper is twofold. Firstly, our intention is to analyze the main features, benefits and costs of factoring implementation by small and medium enterprises, with a particular emphasis on the use of factoring in the service sector. In the second place, our aim is to give a review of the legal environment and discuss how the legal relationships in factoring contract enable the assignment of receivables and maintain a fair balance of interests between the different parties involved in factoring transactions.

The paper is organized as follows. Section 2 presents financial aspects of factoring as a tool for improvement of competitiveness of companies in the changing environment. Having reviewed the benefits and costs of factoring, the authors discuss the use of factoring by companies in the service sector. Section 3 explores the legal aspects of factoring contract and discusses balance of interests between the different parties involved in factoring transactions. Conclusions are given in Section 4.

2. Factoring in the changing environment: financial aspects

Corporate practice shows that companies, particularly small and medium ones (SMEs), face problems with regard to raising finance through regular bank borrowing, and to financing the gap between the timing of cash outflows and inflows. Traditionally, external finance, which is predominant source of SMEs financing, has comprised of bank loans and overdrafts. However, due to the demand of the changing economic environment, the prevalence of asset based finance – including factoring – has been increasing rapidly over the past decade.

Factoring can be regard as a particular form of short-term financing that leads to an improvement of financial competitiveness by the increase of liquidity and enhancement of cash-flow patterns of businesses. Factoring is not a loan. Even though it provides working capital financing, it assumes no additional liabilities on the firm's balance sheet. Moreover, factoring is usually realized ‘‘without

recourse'', which means that the factor is to assume the credit risk for the buyer's ability to pay. Hence, factoring is a wide-ranging financial tool that includes several services provided by the factor, such as: investigation and taking the responsibility of the credit risk of the client's customers, gathering of the client's accounts receivable from customers, accounting services related to accounts receivable, financing, etc.

2.1. Benefits and costs of factoring

Like other traditional forms of commercial lending, factoring provides small and medium enterprises with working capital financing. Factoring is of particular interest for companies that grow faster than their current credit line, especially when have little or no credit history, for firms that don't qualify for conventional bank financing because their financials statements do not reflect their potential or for the other reasons. As it is shown by Smith and Schnucker [5], factoring is a powerful tool for young, small sized and fast growing companies operating in a specific business activity. The empirical evidence on the factoring market done by Soufani [9] also shows that the segmentation of firms using factoring are more concentrate on small firms with turnover between £250,000 and £3 millions, one to five-year-old, limited liability companies in manufacturing, distribution, and transportation. Factoring performs very well in supplying financing to high-risk and informationally non-transparent sellers [7, p. 3112] Since underwriting in factoring is set up on the risk of the accounts receivable before than the risk of the seller, factoring appears to be particularly suitable for financing receivables from large or foreign firms which buyers are more creditworthy than the sellers themselves.

One of the most often cited advantage of factoring is the improvement of financial competitiveness by the increase of liquidity and enhancement of cash-flow patterns of businesses. Companies are faced with liquidity risk, which is with the risk that they would not be able to finance increases in assets and settle obligations at their expiration. Generally speaking, liquidity risk increases because banks are in the business of maturity transformation; they take in deposits that are often repayable on demand or at short notice and use these deposits to fund credit facilities to borrowers over longer periods [6, p. 2]. In such a financial framework, factoring supports small and medium-sized firms to manage the required level of liquidity and offers them the advantage of obtaining further price discounts from suppliers.

Sopranzetti [8] claims that factoring can be used as a tool for the underinvestment problem mitigation. He shows that the underinvestment problem is to be more serious for firms that have constraints on the use of debt in financing new projects (when the firm has maximally explored its debt capacity or in the case of financial distress). Sopranzetti demonstrates that under such circumstance firms are more motivated to sell their accounts receivable in order to lessen the underinvestment problem.

On the other side, the study by Smith and Schnucker [5] concentrates on the complex relation between factoring, vertical integration, transaction costs and credit risk. Their opinion is that factoring is expected when the seller's cost of monitoring of customers is high, i.e., firms use factoring in order to hedge their credit risk. However, this conclusion is open to discussion, since the fact that usually firms are only able to sell their receivables of a highest quality.

The use of factoring can improve profitability, liquidity and cash-flow of business, management of time, credit and default risks, but, on the other hand, imposes a company a whole range of costs. Standard costs are comprised of two main groups of costs - discount charges (based on bank interest, range from 1.5% to 3% over base rate) and service fees (range from 0.2% to 0.5% of turnover). There may be additional costs for additional requested services, such as credit protection charges for nor-recourse factoring agreement (range from 0.5% to 2% of turnover).

The use of factoring is, however, limited because of many restrictions and hidden cost coming from the business and legal environment. Besides from the mention standard costs, there are also a number of

additional tax, legal, and regulatory challenges to factoring in many countries (particularly developing) [8, p. 3115]. What often makes factoring transactions excessively expensive is its tax treatment (some countries do not allow the interest on factoring arrangements to be tax deductible). The legal treatment of factoring plays an important role in the cost determination process. If the law recognizes factoring as a sale and purchase agreement, its importance is reduced. This is because in a case of bankruptcy, factored receivables would not be part of the bankruptcy estate i.e. the property of the bankrupt firm (while the property of the factor). Finally, factoring can be prevented because of an ineffective information infrastructure characterized by the absence of data on payment performance and /or high cost and long time required for the information collection.

2.2. Factoring in the service sector

Factoring is widely accepted as an alternative financing source, and used in almost every industry that sells business-to-business or business-to-government. Industrialized economies are characterized by a substantial shift from the primary and secondary sectors to the tertiary (service) sector, which has occurred during the last 30 years. Taking into consideration the growing importance of the service sector in the changing environment, one question logically arises: What does make factoring to be a favorable tool of financing of companies in the service sector?

Typically, firms form service industries grow faster that their credit line and have little or no credit history. Service companies tend to be payroll intensive and usually have little proper collateral which can be used to secure traditional bank loans. Furthermore, the enterprises from service sector are becoming more innovative and knowledge intensive, and have high investments in intangible assets. As a consequence, their financials statements do not reflect their real financial potential and they often can not qualify for conventional bank financing.

Table 1. Distribution of factoring services by business sector in some European countries

Country	Top 3 “Factorable” Sectors
Austria	Electrical 35%, Wood, Glass, Chemicals 16%, Rending Services 13%
Belgium	Electronics 14%, Textiles 13%, Building Materials 13%
Denmark	Textiles 15%, ICT 15%, Electronics 10%
Finland	Manufacturing 47%, Trade 28%, Building 23%
Germany	Manufacturing 47%, Trade 40%, Services 13%
Greece	Food 20%, Electrical 10%, Chemical 7%
Ireland	Distribution 40%, Manufacturing 30%, Services 30%
Italy	Transport 19%, Trade 19%,Telecom Services 6%
Spain	Manufacturing 34%, Construction 19%, Transport 13%
Sweden	Manufacturing 50%, Transport 30%, Services 20%
UK	Manufacturing 40%, Services 35%, Distribution 25%

Source: GLE Project Report

The results of the Project Report done by Greater London Enterprise [2] summarized in the table 1 show that manufacturing is the most important “factorable” sector. However, the share of transport, trade and services in the sector distribution of factoring services is in some countries (such are UK, Sweden, Ireland, Italy and Germany), quite remarkable.

The fact is that the use of factoring in service sector across countries depends on the sector composition of each individual economy. Taking into consideration the future growing importance of service sector on one side, and the growing factoring competition in each country on the other side, one would expect the growing share of service sector in the sector distribution of factoring services in the future.

3. Legal aspects of factoring

3.1. Factoring treatment in the law of international trade

The contract law plays an important factor in the organization and in the process of saving and decreasing the transactions costs of the trade operations. Increased needs of the market subjects for loan and credits together with the necessity of transforming contractual monetary claims such as receivables into the mature finance have created the new instruments of the international trade law such as factoring, forfeiting, securitization, invoice discounting, asset-based lending as well as transactions in which no financing is provided. The growing number of legal instruments of the new emerging law of international trade *lex mercatoria* are developing in the last decades which embracing the whole spectrum of the self-regulated legal instrument such as contracts on leasing, franchising, factoring and other legal instruments which was not regulated by the national legal systems.

The essence of the so called international secured transactions is enabling the creditor (supplier) to sell or assign its receivables to a factoring company, charge them to a bank or use receivables as collateral for obtaining a new credit line.

An idea developed about the creation of the uniform law that will defeat the greatest enemy of international business transactions – national borders. The adoption of uniform regulations that are applied to the contracts concluded in different legal, economic and social systems removes the hindrances to running international business transactions, which contributes to the development of the international transfer and the creation of the overall legal security. The unification of the contract law has, therefore, become a constant aspiration of business people, national legislators and legal doctrine.

Despite advantages of those instruments, most legal systems displayed hostility towards security over receivables financing. Most of the restrictions exist in so called civil law countries. Some of the national legislators prohibits or impose restrictions on the assignment of future receivables or the assignment of bulk receivables as well as on the subsequent assignments. Those restrictive practices emanate as imposing notification or specification in transfer of receivables or with the debtor approval requirements. Those different solutions in national legal systems create restrictions to trade and commercial transactions which many times may be regarded as a non-tariff barrier to trade.

There are two international instruments indented to abolish those restrictions and promote the movement of goods and services across national borders by facilitating increased access to a lower cost credits. The first instrument of unification is the UNIDROIT (International Institute for the Unification of Private Law) Convention on International Factoring (Ottawa, 1988) which is entered into force in 1995 with the ratification of six countries (France, Hungary, Italy, Litua, and Nigeria) and became through that ratification a part of the national legislation of those countries. Under auspices of UNCITRAL (UN Commission for International Trade Law) another instrument of unification has been created in the field of receivables financing. It is the United Nations Convention on the Assignment of Receivables in International Trade which is issued in 2001 and it is open for signature [1].

3.2. Legal obstacles of factoring in national legal context

The factoring agreements as the specific legal instrument emerged in the business practice of the common law countries, based on the institute of assignment, and therefore nowadays the application of this arrangement causes specific problems in the countries with the civil law tradition. The most significant problems are impossibility of transfer of the future or bulk receivables, successive assignment of the receivables, the effects of the contract between the creditor and the debtor on the prohibition of assignment of rights (anti-assignment clause) the effect of informing the debtor of the assignment of rights. Comparative legal approach indicates that in the countries where factoring is regulated by specific legislation that was done after the factoring transactions had been present in the commercial practices for many years and after the big corpus of long judicative practice; although the system of registration of the assignment of the receivables find it ratio in the selling legal nature (approach *in rem*) of the factoring contract in the USA when it originally emerged.

Creditors doing abroad are conscious of the fact that some of his contracts with foreign partners will be governed by foreign law and especially that transfer of property in receivables as intangible goods. The unknown law of foreign country is one of his risks. This risk make him to be unsecured on the foreign market because lack of knowledge of foreign law solutions create high grade of legal insecurity and unpredictability which may keep foreign business away from foreign markets in Europe.

On the other hand the intangible property such as receivables are for the financer the most valuable object of security and could be affected only by legal reasons and not by the factual events. Immobility could lose their values by the changes in real estate market, vehicles could be destroyed or damaged, expensive equipment could lose most of their value through the obsolescence but the debt and receivables deriving from the contract are protected from such factual risks. The biggest risk for that kind of property is sensitive to legal impediments such as risk of mortgage or insolvency of the debtor, or insolvency of the surety, floating charges, frustration of contract or other forms of non-performance of contractual obligation [3]. But the biggest risk is the different treatment of the assignment transaction in different legal systems.

The civil law countries traditionally have not looked very optimistically on the factoring agreement of intangibles such as receivables. There are lot of restrictions which has been settled in order to prevent future assignment, and some of the countries ask notification rules to be fulfilled before assignment is came into the legal force.

In the case of Serbian law of obligation factoring agreement is an anonymous contract and it is possible to conclude it on the rules which regulate assignment of receivables. Those are the transactions which denote change of the person of creditor in the contract, on the basis of separate contract on assignment (*pactum de cedendo*) between an old creditor (*cedent*) and the new creditor (*cessionar*). This contract has the legal effect on the third party which is the debtor from the original transaction (*cesus*). In Serbian law there is no claim for the consent of the debtor for assignment of the rights deriving from original legal instrument (Art .438 par. 1 Serbian Code of Obligation). Differ from the most civil law countries Serbian Code of Obligation (Art.436-445) doesn't put too much requirements for the assignment transactions. There are no form requirements (in Susse Code of Obligation which in the Art.165 par.1 . prescribes the written form for the contract of assignement as form ad solemnitatem) nor the prohibition of the assignment of the future receivables as well as bulk receivables. The only demands which prescribes Serbian Code of Obligation for the legality of the assignment is the notification of the original debtor. Then, transfer of obligation is legal upon debtor receiving the notice of the transfer. On the other side, some assignment transactions are prohibited in Serbian law of obligation such as sovereign receivables, receivables *intuitu persone*, ect. In the case of existing in original agreement the so called *pactum de non cedendo* clause, which obliged the creditor not to assign its rights with the assignment contract, this clause

doesn't have legal effects according to the assignment contracts, it is relevant only for the legal relationships of the creditor and debtor deriving from the original contract.

But as the difference from the liberal approach of Serbian Law of obligations other civil law countries create a lot of obstacles to the practices of the factoring agreement such as:

- Prohibition of the transfer of the future and the bulk receivables;
- Imposing the concept of obligatory notification of the debtor which is the most of the civil law countries condition for the legality of the assignment contract. In some of the countries, (France CC art.1690) this transfer is create more restrictive- beside notary notification it is also the consent of the debtor an condition for the legality of the assignment contract. In this way factoring is preventing on the basis of the *cessio* contract;
- Imposing the concept on the specification of the assigned receivables. Receivables which could not be specified at the time of the assignment could not be transferred;
- Enacting the rule on anti-assignment clause – *pactum de non cedendo* which prohibited future contract between creditor and the new creditor in any form of transfer of receivables.

Those practices create restrictions which limits the financing possibilities available to many companies. Those restrictions create many additional costs, realizing in loss of time and money and administrative costs, which has impact on the cost on credit, such as costs of describing every receivable, costs of notifying the debtor.

On the other side, common law countries adopt a property approach to receivables or approach *in rem* where the creditor has a property rights on receivables but only in its original collateral then also in the interests (proceeds) which obligation could have in its life cycle. For example, if some equipment was the object of security interest, the sale of this equipment without the consent of the secured creditor, rights of the secured creditor would not only continue on the equipment itself, but according to *in rem* approach security interest will automatically extend to the compensation or sales price which seller will received, independent if those payment instrument is check, letter of credit or cash. Because of the proprietary legal approach to the receivables common law country imposed registration system, where security may be given over existing debts, future debts or both, and independent of the type of receivables , if it is embodied as pure intangible or it is embodied in negotiable instrument such as bill of exchange [3].

The differences among the legal systems prevents use of the instrument such as factoring agreement which is born in Anglo-Saxon contractual practice where transfer of receivables is equally easy as the transfer of any other goods.

The main obstacle to the development of factoring on many civil law countries is inappropriate legislation which does not recognize all aspects of factoring products nor recognize or regulates factoring in detail and homogenous way. Case law of factoring in several countries is not very efficient. For example, The World Bank reported, based on its research for 2009, that laws and court practice in Serbia stipulate 36 court trials demanding face to face confrotation of the parties in dispute and the judge or court officer, in case that the appealer fulfilled in total his part of the agreement and filed for legal action against the debtor(s), in order to collect payment of the debt. According to the same reaserch, 635 days are needed for the settlement of such a dispute, if the legal procedure is started.

Obstacles which create the diffferent legal approach and notion of factoring in civil law countries have a solution in adopting the lex specialis which will in specific way regulate those financial instrument.This is the case in Serbian legal environment which de lege ferenda took the legislation activitiew which will regulate factoring contracs in the future Serbian Civil Code.

Despite, the solutions of adopting and ratificate of the UNIDROIT and UNCITRAL's Convention in national legislations [1] is the possibility which is at the beginning of the process of creating an adequate and harmonized legal system of factoring contracts.

4. CONCLUSION

Factoring is widely accepted as an alternative financing source, and used in almost every industry that sells business-to-business or business-to-government. One of the biggest advantage of factoring is the improvement of financial competitiveness by the increase of liquidity and enhancement of cash-flow patterns of businesses. The legal environment of factoring is the crucial for the saving of transaction cost and improvement of costs and safety determination process of factoring transaction of each country.

Factoring contract emerged in the business practice of the common law countries, based on the institute of assignment, and therefore the application of this arrangement causes specific problems in the countries with the civil law tradition. The most significant problems are impossibility of transfer of the future or bulk receivables, successive assignment of the receivables, the effect of the contract between the creditor and the debtor on the prohibition of assignment of rights (anti-assignment clause) the effect of informing the debtor of the assignment of rights. Comparative legal approach indicates that in the countries where factoring is regulated by specific legislation that was done after factoring had been present in the commercial practices for many years and after the big corpus of long judicative practice; although the system of registration of the assignment of the receivables find it ratio in the selling legal nature (approach *in rem*) of the factoring contract in the USA when it originally emerged. The options present in the 1988 UNIDROIT *Convention on International Factoring* and the 2001 UNCITRAL *Convention on the Assignment of Receivables in International Trade* offer the solution to these problems in the domestic law as well. The ratification of these instruments would be more purposeful then issuing another specific domestic legislation which might lead to toward further particularization of the law of contract and commercial law.

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