RAMA UNIVERSITY

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# FACULTY OF COMMERCE AND MANAGEMENT

**COURSE: MBA III SEM..**

**SUBJECT: WORKING CAPITAL MANAGEMENT**

**SUBJECT CODE: MBAFM02**

**LECTURE: 38**

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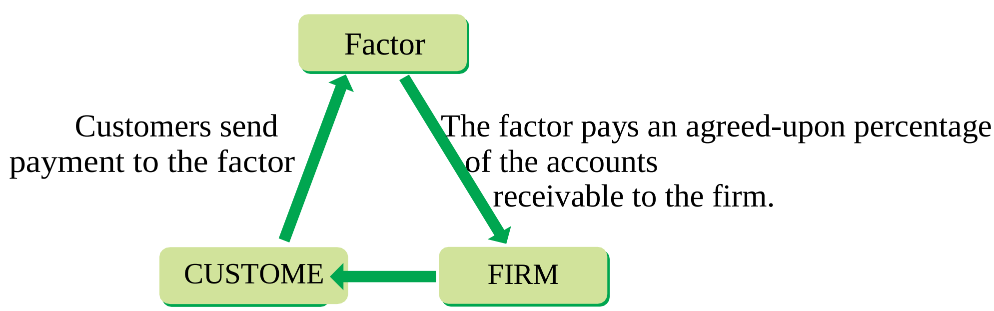
# LECTURE-38

# FINANCING RECEIVABLES

Pledging of accounts receivables and Factoring have emerged as the important sources of financing of accounts receivables now-a-days.

**(i)** **Pledging:** This refers to the use of a firm's receivable to secure a short term loan. A firm's receivables can be termed as its most liquid assets and this serve as prime collateral for a secured loan. The lender scrutinizes the quality of the accounts receivables, selects acceptable accounts, creates a lien on the collateral and fixes the percentage of financing receivables which ranges around 50 to 90%. The major advantage of pledging accounts receivables is the ease and flexibility it provides to the borrower. Moreover, financing is done regularly. This, however, suffers on account of high cost of financing.

**(ii)** **Factoring:** Factoring is a relatively new concept in financing of accounts receivables. This refers to outright sale of accounts receivables to a factor or a financial agency. A factor is a firm that acquires the receivables of other firms. The factoring lays down the conditions of the sale in a factoring agreement. The factoring agency bears the right of collection and services the accounts for a fee.



Normally, factoring is the arrangement on a non-recourse basis where in the event of default the loss is borne by this factor. However, in a factoring arrangement with recourse, in such situation, the accounts receivables will be turned back to the firm by the factor for resolution.

There are a number of financial distributors providing factoring services in India. Some commercial banks and other financial agencies provide this service. The biggest advantages of factoring are the immediate conversion of receivables into cash and predicted pattern of cash flows. Financing receivables with the help of factoring can help a company having liquidity without creating a net liability on its financial condition. Besides, factoring is a flexible financial tool providing timely funds, efficient record keepings and effective management of the collection process. This is not considered to be as a loan. There is no debt repayment, no compromise to balance sheet, no long term agreements or delays associated with other methods of raising capital. Factoring allows the firm to use cash for the growth needs of business.

The basic format of evaluating factoring proposal are given as under:

**Statement showing the Evaluation of Factoring Proposal**

| | Particulars | (`) |
|---|---|---|
| **A.** | **Annual Savings (Benefit) on taking Factoring Service** | |
| | Cost of Credit Administration saved | ……….. |
| | Bad Debts avoided | ………… |
| | Interest saved due to reduction in Average collection period (Wherever applicable) [Cost of Annual Credit Sales × Rate of Interest × (Present Collection Period – New Collection Period)/360* days] | ……… … |
| | **Total** | ………. |
| **B.** | **Annual Cost of Factoring to the Firm:** | |
| | Factoring Commission [Annual credit Sales × % of Commission (or calculated annually)] | ………. |
| | Interest Charged by Factor on advance (or calculated annually ) | ……….. |
| | [Amount available for advance or (Annual Credit Sales – Factoring Commission – Factoring Reserve)] $\times\left[\frac{\text{Collection Period (days)}}{360\ *}\times \text{Rate of Interest}\right]$ | |
| | **Total** | ………. |
| **C.** | **Net Annual Benefits/Cost of Factoring to the Firm:** | |

| | | |
|---|---|---|
| | Rate of Effective Cost of Factoring to the Firm<br>$= \frac{\text{Net Annual cost of Factoring}}{\text{Amount available for advance}} \times 100$ or<br>$\frac{\text{Net annual Cost of Factoring}}{\text{Advances to be paid}} \times 100$<br>Advances to be paid = (Amount available for advance – Interest deducted by factor) | ……….. |

*1 Year is taken as 360 days