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Factoring as Financing Alternative: Reasons for Non Patronage in Nigeria

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Abstract

This paper examined factoring as alternative source of finance and the reasons why it is not patronized in Nigeria. The objective of this paper was to explore factoring as a source of finance an alternative source of finance instead of bank loan with its attendant high interest rate. Factoring makes it possible for business to readily convert a substantial portion of its account receivable into cash. Factoring; the world all over has become a growing source of external finance for corporations and small and medium size enterprise. Depending on the participant, factoring may be domestic or international. There are two principal methods of factoring. Factoring can be with recourse where the client is not protected against the risk of bad debt. Hence, in the case of uncollectable debt, the client bears the loss. The other one is factoring without recourse. Under this scenario, the uncollectible debt is bore by the factor. However, factor should not be seen as debt collector. In the case of Nigeria, this method of finance is not patronized because of the state of the economic situation, incompetence of financial system in allocating financial resources and weak legal system which are features of emerging market. The determinants of the level of factoring activity in an economy depends on first, the availability of financial information about enterprises; and second, the overall level of economic activity. The reasons why factoring as an alternative source of finance is not embraced is simply because Nigeria is an emerging market where our financial system is not efficient coupled with the weak legal system. This is coupled with our political system that do not create an enabling atmosphere for smooth operation of financial institutions and Nigeria legal system.

Keywords

Factoring, Account Receivables, Factoring with Recourse, Factoring Without Recourse, Bad Debt, Emerging Market

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1. Introduction

Factoring is a financial transaction whereby a business sells its accounts receivable to a third party (called a factor) at a discount. Factoring makes it possible for a business to convert a readily substantial portion of its accounts receivable into cash. This therefore makes factoring to be a method of credit management with specialized activity and involves a lot of time effort of a company. For companies, collection of receivables is a bit problematic. It is possible for a company to assign its credit management and collection to specialist organisations called factoring organisations. Factoring is a business involving a continuing legal relationship between a financial institution(the factor) and business concern (the client) selling goods or providing services to trade customers (the customers) whereby the factor purchases the client's accounts receivable and in relation thereto, controls credit, extended to customers and administers the sales ledger (Biscoe, 1975).

Financing is very important in business set up and in expansion of operations, development of new products and investment in new staff or production facilities. There are

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different sources through which businesses can fish for fund. However, it is possible to make a distinction between internal and external financing sources. At the start up, businesses can put reliance on internal sources as well as during their growth and developmental stage. However, there is a limit to which businesses can rely on internal sources during the developmental stage of the business lifecycle. The objective of this paper is to show factoring as an alternative source of finance devoid of administrative bottle neck in terms of processing and why it is not embraced or patronized in Nigeria as result of the weak political, legal and financial systems which are characteristics of emerging market.

2. External Sources of Financing

The external financing sources can take any of the following forms:

Informal financing sources for instance money raised through friends, family. This mode of external financing is for sole proprietorship. Formal sources of external financing that include: traditional debt finance in the form of loans from bank and other financial institutions, lease or hire purchase. Other external sources include risk capital (venture capital, equity financing) which is good for high-growth firm, factoring (the main trust of this paper) and trade credit.

Around the world with the exception of Africa and Nigeria in particular, factoring is a growing source of external finance for corporations and small and medium size enterprise. The development of factoring is dated as far back as sixties of last century in the United State of America where there was extension of purchase of goods on debt (Janekova, 2012).

According to Factor Chains International (FCI), a global factoring trade group, annual global factoring turnover increased from around $384 billion, in 1996, to over $1,276 billion, in 2005. In the work of Bakker, Klapper and Udell, 2004 factoring has emerged as the most important source of working capital for Small and Medium sized Enterprises (SMEs) in many economies. As a result of crisis in the financial sector, this has culminated into the banks being skeptical in extending credit facility in form of traditional financing method. Hence, the attention of researchers has been directed to the mechanics of factoring and the reasons that explain cross country differences in annual factoring turnover (Lotz, 1992; Mian and Smith, 1992; Bakker, Klapper and Udell, 2004; Berger and Udell, 2004; Klapper, 2000, 2006). This paper is set to discuss why factoring as a financing option is not embraced in merging market and Nigeria in particular.

3. Literature Review

This section discussed the conceptual framework to throw more light on the concept of factoring and thereafter existing literatures were appraised to see the direction of current research and the gap in the existing literatures.

3.1. Concept of Factoring

Factoring is a form of commercial finance involving a business selling its accounts receivable (inform of invoices) at a discount. As a complex form of finance, factoring involves participation of three parties. The three parties that are directly involved in factoring are: the one who sells the receivable, the debtor (the account debtor, or customer of the seller), and the factor.

3.2. Operation of Factoring

The following operation is involved in the operation of factoring:

- The existence of receivables which is recoverable by the supplier from his customer;
- The transfer or sale of these receivables to a bank or a specialized financial institution;
- Services provided by the factor in exchange of a fee, which may include the following services: invoices financing; transfer of receivables management; debts recoverable from debtors and hedging against the risk of accounts not being settled.

3.3. Functions of a Factor

- Payment to the client for their invoices as issued by the client;
- Provision of services (collection of payment from the customers, provision of advice to client against bad debts).

The implication is that the benefits of factoring are not limited to immediate cash payment. If the factor provides credit management services too, then there is the prospect of an improvement in the speed at which debts are collected , giving a further positive impact on cash flow, and reduces interest charges.

3.4. Types of Factoring

There are different types of factoring products which is classified from various criteria:

(a)Depending on the method of collection as well as debt management, factoring can be grouped into:

- Partial factoring. Under this arrangement, invoices are selected, that is not all the invoices are accepted for buying; the obligation to cash the invoices belongs to the

customer because the factors do not take their administration;

- Total factoring: All the invoices are taken by the customer and administered by the factor. The factor will cash the invoices from the debtor, finance the operation and cover the credit risk.

(b) Depending on the moment of payment of the debt by the factor. They are the following:

- Old-line factoring (classical factoring): Here the factor pay the invoices in the moment he takes them.
- Materiality financing: The debts of customer are paid in the moment of their maturity
- Mixed factoring: The factor pay a part of the invoices value as advance (not less than 85% from their value), the difference is paid at a later date.

(c) Depending on the participants to the factoring operation, this may take the following forms:

- Domestic financing: This is done on the same country and there is a single factor.
- International factoring: this is the existence of international trade contract. In the operation there will be two factors (the import and the export one). The export factor buys the exporter debts.

(d) Principal methods of factoring:

There are two principal methods of factoring vis-à-vis recourse factoring and non-recourse factoring. Under the former method, the client is not protected against the risk of bad debt. With non-recourse factoring, the factor assumes the entire credit risk.

3.5. Selected Empirical Studies

Mian and Smith, 1992 surveyed firms to study the choice firms make between different account receivable management policies such as factoring, accounts receivable secured debt, captive finance subsidiaries and general corporate credit. The study revealed that size, concentration and credit standing of the firm's traded debt and commercial paper are important in explaining the firm's choices between the alternative policies. The larger more credit worthy firms establishes captives, while the smaller, riskier firms issue accounts receivable secured debt. Each of the specific policies has also been studied.

Sopranzetti, 1998 carried models factoring of accounts receivable with respect to the recourse conditions and finds that high bankruptcy firms may not be able to factor their receivables even with full recourse. In the research carried by Klapper, 2005, the study showed evidence suggesting that lines of credit secured by accounts receivable are associated with business borrowers who exhibit a high risk of default.

In the same vein, Sufi 2009, studies the role of bank lines of credit in corporate finance and finds that these revolving facilities are used as a liquidity substitute only for firms that maintain high cash flows.

Furthermore, Van Horne, 2004 researched into the use of trade credit in 39countries and discovered that trade credit is used as a competitive tool, particularly for small and young firms. Fisman and Raturi, 2003 found that competition encourages trade credit provision in five African countries. In addition, McMillan and Woodruff, 1999 studied the use of trade credit in Vietnam and found out that small firms are more likely to both grant and receive trade credit than large firms. It is clearly evident that small firms in emerging markets generally provide trade credit and hold illiquid accounts receivable on their balance sheets.

The above studies highlight the many differences between the policies as well as the different characteristics of firms using each. These firms are characterized by a wide range of sizes, balance sheet strength and operating results. This study explores whether the firm's information asymmetry characteristic is a common factor that may explain a firm's choice to use account receivable as a financing tool.

Evidence in previous literature finds that trade credit is used more in countries with greater barriers to SME financing. For example, a study by Demirguc-Kunt and Maksimovic (2001) in their work found out that in 39 countries around the world, trade credit use is higher relative to bank credit in countries with weak legal environments, which make bank contracts more difficult to write. Fisman and Love (2003) highlighted the impact of inter- firm financing by showing that industries with higher dependence on trade credit financing exhibit higher rates of growth in countries with relatively weak financial institutions. Van Horen (2004) studied the use of trade credit in 39 countries and finds that trade credit is used as a competitive tool, particularly for small and young firms.

Fisman and Raturi (2004) found that competition encourages trade credit provision in five African countries. McMillan and Woodruff (1999) study the use of trade credit in Vietnam and find that small firms are more likely to both grant and receive trade credit than large firms. This evidence suggests that small firms in emerging markets generally provide trade credit and hold illiquid accounts receivable on their balance sheets. In addition, firms in developed countries often refuse to pay on receipt to firms in emerging markets since they want time to confirm the quality of the goods and know that it could be very difficult to receive a refund from firms in countries with slow judicial systems.

The literature points to two major determinants of the level of factoring activity in an economy: first, the availability of financial information about enterprises; and second, the overall level of economic activity.

Bushman and Smith (2003) presented a framework for understanding the links between the availability of reliable financial information and enterprise level efficiency and firms' choice of financing mechanism. Reliable and adequate information helps to identify promising investment opportunities with less error, lowers the principal-agent problem between shareholders and managers, and reduces the information asymmetry between investors and firms. A lack of adequate financial information, in general, and informational asymmetry between SMEs and financial institutions, in particular, is the most commonly cited reason for the existence and development of factoring. According to Mian and Smith (1992) and Smith and Shnucker (1994), firms factor accounts receivable to better manage their exposure to credit risk. Specifically, a factor that specializes in an industry with many buyers and sellers may be able to pool information among sellers to help reduce credit risk.

4. Determinants of Factoring

In the current literature, factoring is examined in the context of the operation of the financial system in an economy. Schumpeter (1911), in his research pointed out that a well-functioning financial system is vitally important for technological advancement and economic growth. The quality and competence of an economy's financial system in the allocation of financial resources depends on many factors including the following: (a) robustness of its financial institutions and financial markets (b) the strength and integrity of its legal system (c) and the quantitative and reliability of information with which both suppliers and demanders of capital are able to assess risk. In a political system where there are weak laws and/or poor enforcement brings into being an agency problem that tends to water down the efficiency of a financial system. In economies with a weak financial system, firms face significant hurdles in obtaining capital from financial institutions and financial markets, sources traditionally used in economies with more complete financial systems. Factoring is particularly useful as a source of short-term working capital in such economies because receivables are sold, rather than collateralized, and factored receivables are not part of the estate of a bankrupt firm. In addition, underwriting in factoring is based on the risk of the accounts receivables themselves rather than on the risk of the borrower.

As a result of weak laws, poor enforcement, and the associated informational opacity in Nigeria has put companies at a disadvantage as a borrower coupled with poor corporate governance. Daniel, Mushfiq, Traris and Shelton, (2010) in Litan, Pomerleano, and Sundararajan, (2002) opined that when it comes to the working of the financial system, corporate governance problems have added complexities, because they accentuate incentive conflicts and agency problems which are further compounded by government ownership and regulation of the financial institutions. The extent to which poor governance has led to the ascendancy of factoring as the preferred short term financing mechanism is an important empirical question, which is yet to be answered.

5. Do Nigerian Business Organisations Make Use of Factoring as Mean of Finance

From available literature as far as factoring as alternative mean of financing is concerned, the authors have not come across 'factor' company in Nigeria. This means this method of finance is totally neglected and not embraced in Nigeria at all. This is evident in Table 1 below where in the whole of Africa continent, there are only five countries namely: Egypt, Mauritius, Morocco, South Africa and Tunisia. The question that readily comes to mind is why is this form of finance not patronised in Nigeria? The reason may not be unconnected with the simple fact that Nigeria is an emerging market where our financial system is not efficient coupled with the weak legal system. The last straw that breaks the carmel's back is our political system that do not create an enabling atmosphere for smooth operation of financial institutions and Nigeria legal system.

Table 1. Total Factoring Volume by country in the last 7 years (in Millions of EUR).

	2007	2008	2009	2010	2011	2012	2013	Var
AMERICAS								
Argentina	362	355	335	350	475	614	856	39%
Bolivia	-	-	18	18	35	35	31	-11%
Brazil	21,060	22,055	29,640	49,050	45,623	43,627	31,552	-28%
Canada	4,270	3,000	3,250	3,723	5,284	7,100	5,680	-20%
Chile	14,620	15,800	14,500	16,422	21,500	24,000	25,500	6%

	2007	2008	2009	2010	2011	2012	2013	Var
Colombia	2,030	2,100	2,392	2,784	4,990	4,562	7,076	55%
Costa Rica	-	-	-	160	30	180	115	-36%
Mexico	9,200	9,550	2,120	14,538	21,074	26,130	28,061	7%
Panama	483	460	500	600	700	852	724	-15%
Peru	648	875	758	2,712	2,461	2,310	8,163	253%
United States	97,000	100,000	88,500	95,000	105,000	77,543	83,739	8%
Uruguay	-	-	-	-	-	61	58	-5%
Total Americas	149,673	154,195	142,013	185,357	207,172	187,014	191,555	2%
EUROPE								
Austria	5,219	6,350	6,630	8,307	8,986	10,969	14,110	29%
Belarus	-	-	-	-	-	-	450	-
Belgium	19,200	22,500	23,921	32,203	38,204	42,352	47,684	13%
Bulgaria	300	450	340	550	1,010	1,500	1,600	7%
Croatia	1,100	2,100	2,450	2,793	2,269	2,269	3,146	39%
Cyprus	2,985	3,255	3,350	3,450	3,758	3,350	2,823	-16%
Czech Rep.	4,780	5,000	3,760	4,410	5,115	5,196	5,302	2%
Denmark	8,474	5,500	7,100	8,000	9,160	8,800	8,932	2%
Estonia	1,300	1,427	1,000	1,227	1,164	1,877	1,899	1%
Finland	12,650	12,650	10,752	12,400	13,000	17,000	17,699	4%
France	121,660	135,000	128,182	153,252	174,580	186,494	200,459	7%
Germany	89,000	106,000	96,200	129,536	158,034	157,420	171,290	9%
Greece	7,420	10,200	12,300	14,715	14,731	12,761	12,094	-5%
Hungary	3,100	3,200	2,520	3,339	2,817	2,676	2,661	-1%
Ireland	22,919	24,000	19,364	20,197	18,330	19,956	21,206	6%
Italy	122,800	128,200	124,250	143,745	175,182	181,878	178,002	-2%
Latvia	1,160	1,520	900	328	371	542	592	9%
Lithuania	2,690	3,350	1,755	1,540	2,134	2,488	2,763	11%
Luxembourg	490	600	349	321	180	299	407	36%
Malta	25	52	105	136	200	240	178	-26%
Netherlands	31,820	30,000	30,000	35,000	46,000	50,000	52,000	4%
Norway	17,000	15,000	15,100	15,075	16,395	18,115	16,296	-10%
Poland	7,900	7,800	12,000	16,210	17,900	24,510	31,588	29%
Portugal	16,888	18,000	17,711	20,756	27,879	22,948	22,303	-3%
Romania	1,300	1,650	1,400	1,800	2,582	2,920	2,713	-7%
Russia	13,100	16,150	8,580	12,163	21,174	35,176	41,960	19%
Serbia	226	370	410	500	926	950	679	-29%
Slovakia	1,380	1,600	1,130	981	1,171	1,024	1,068	4%
Slovenia	455	650	650	650	550	650	626	-4%
Spain	83,699	100,000	104,222	112,909	122,125	124,036	116,546	-6%
Sweden	21,700	16,000	18,760	18,760	29,259	33,149	30,544	-8%
Switzerland	2,513	2,590	5,000	4,000	3,450	3,000	3,100	3%
Turkey	19,625	18,050	20,280	38,988	30,869	31,702	32,036	1%
Ukraine	890	1,314	530	540	955	1,233	1,340	9%
United Kingdom	286,496	188,000	195,613	226,243	268,080	291,200	308,096	6%
Total Europe	932,264	888,528	876,614	1,045,024	1,218,540	1,298,680	1,354,192	4%
AFRICA								
Egypt	20	50	110	200	200	220	450	105%
Mauritius	-	-	121	125	127	128	145	13%
Morocco	660	850	910	1,071	1,406	1,844	2,755	49%
South Africa	9,780	12,110	13,500	15,120	21,378	21,378	19,400	-9%
Tunisia	245	253	276	295	340	357	373	4%
Total Africa	10,705	13,263	14,917	16,811	23,451	23,927	23,123	-3%
ASIA								
Armenia	50	7	7	14	14	0	62	
China	32,976	55,000	67,300	154,550	273,690	343,759	378,128	10%
Hong Kong	7,700	8,500	8,079	14,400	17,388	29,344	32,250	10%
India	5,055	5,200	2,650	2,750	2,800	3,650	5,240	44%
Indonesia	-	-	-		3	3	819	-
Israel	800	1,400	1,400	1,650	1,650	1,422	1,060	-25%

	2007	2008	2009	2010	2011	2012	2013	Var
Japan	77,721	106,500	83,700	98,500	111,245	97,210	77,255	-21%
Korea	955	900	2,937	5,079	8,087	8,000	12,343	54%
Lebanon	176	306	420	450	327	301	352	17%
Malaysia	468	550	700	1,058	1,050	1,782	1,782	0%
Qatar	-	-	23	23	75	75	88	17%
Singapore	3,270	4,000	4,700	5,800	6,670	8,670	9,970	15%
Taiwan	42,500	48,750	33,800	67,000	79,800	70,000	73,000	4%
Thailand	2,240	2,367	2,107	2,095	3,080	4,339	3,348	-23%
United Arab Emir.	340	1,860	1,910	2,000	1,750	2,900	3,500	21%
Vietnam	43	85	95	65	67	61	100	64%
Total Asia	174,294	235,425	209,828	355,434	507,696	571,516	599,297	5%
AUSTRALASIA								
Australia	33,080	32,546	39,410	44,915	57,491	49,606	62,312	26%
Total Australasia	33,080	32,546	39,410	44,915	57,491	49,606	62,312	26%
TOTAL WORLD	1,300,016	1,323,957	1,282,782	1,647,541	2,014,350	2,130,743	2,230,479	5%

Source: Factors Chain International (FCI)

6. Reasons for Non-Patronization of Factoring in Nigeria

The Nigerian economy is mono economy where dependence is on one product that is, crude oil. In this type of situation, where the government is exporter, there is no need of factor in an arrangement of this. As shown in Table 1 above, the total factoring volume by countries from 2007- 2013 in Millions of EUR are: 1,216,438; 7,613,842; 126,197 and 319,360 for Americas, Europe, Africa and Australasia respectively. The Total for the Africa continent is the lowest and Nigeria is conspicuously missing. The indication is that Nigeria is not part of the country that patronizes factoring as alternative financing source.

7. Conclusion

Factoring is a short term financing arrangement where companies that are facing a cash flow squeeze and slow paying customers sell their receivables to specialized companies call factors. The companies using factoring embrace it because; they get money quickly rather than waiting for the usual 30 or 60 days for payment. As good as the arrangement is, from the empirical studies surveyed, it was discovered that this financing method is not patronized by Nigerian companies. From Table 1, it was discovered that there are no factor company operating in Nigeria. In Africa, there are only five countries; namely Egypt, Mauritius, Morocco, South Africa and Tunisia according to Factors Chain International (FCI). The reason for this ignorant neglect is due to the level of development of capital market, weak political and legal system symbolizing characteristics of emerging market.

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