$$Incremental\ financing\ cost = (Revised\ tr\ rec - Current\ tr\ rec) \times Interest\ expense$$

$$Incremental\ financing\ cost = (802{,}603 - 657{,}534) \times 7\% = \$10{,}155$$

	$
Incremental in interest cost	(10,155)
Incremental administration costs ($6.3m x 0.5%)	(31,500)
Cost of discount ($6.3m x 1.5% x 30%)	(28,350)
Contribution from increased sales ($6m x 5% x 60%)	180,000
Net benefit of credit policy change	109,995

7 Factoring

Exam	Q.no	Requirement	Marks
06/08	Q3:b	Discuss the ways in which factoring and invoice discounting can assist in the management of accounts receivable.	6
12/11	Q2:d	Comment on the financial acceptability of the factor's offer and discuss the possible benefits to Bold Co of factoring its trade receivables.	7

Financial institution providing factoring services is known as factor. Generally, factoring services are provided by insurance companies and banks.

Factor takes over organization's sales ledger administration. Factor performs following tasks on behalf on organization:

→ Assesses creditworthiness of customers both existing and potential.

→ Records sales transaction and raising invoice.

→ Sends out statements of outstanding debts.

→ Sends reminder letters for debts already overdue or close to due date.

→ Prepares customer age analysis to identify late payers.

→ Follow up customers for recovery of debt and may take legal action if they feel necessary.

Usually, factor provides advanced payment of up to 80% against sales made on credit. Rest of the 20% is paid upon receipt of payment from customer. Factor also deducts its flat fee and percentage of interest on advanced payment made by factor.

Factoring transfers control of receivable management from organization to factor. Factor can use its own policies and procedures, which can upset customers, particularly those who have to pay their debt now earlier.

Factoring service is obtained to improve the account receivable turnover.

Factoring is particularly useful for organizations lacking expertise and experience of trade receivable management.

Factoring is suitable for small sized organizations that have not enough resources and expertise.

Factoring allows organization to direct their skills and resources toward core activities such as making sales to customer without having to worry for payment recovery.

Factoring is of two types

7.1 Recourse Factoring

In with-resource factoring, factor does not bear the risk of bad debts.

7.2 Non-Recourse Factoring

In non-resource factoring, factor bears the risk of the bad debts.

Exam Support:

Look carefully in the exam which type of factoring (with recourse or without recourse) is under consideration by looking at the information provided in the scenario.

8 Evaluating Proposal for Factoring

Exam	Q.no	Requirement	Marks
12/08	Q2:c	Evaluate whether the proposal to factor trade receivables is financially acceptable. Assume an average cost of short-term finance in this part of the question only.	8
12/11	Q2:c	Calculate the value of the factor's offer: (i) on a with-recourse basis; (ii) on a non-recourse basis.	7

Performa for evaluating proposal for factoring:

		$
Savings in finance cost of trade receivables (see working 1)		x

Savings in administration cost of sales ledger per year		x
Savings in bad debt expenses (non-recourse) per year		x
Total benefit of factoring	X	
Factoring fee per year (see workings 2)		(x)
Interest cost on cash received in advanced (see workings 3)		(x)
Total cost of factoring	(X)	
Net benefit/cost of factoring	X/(X)	

Formulae:

Working 1

$$\text{Savings in finance cost of trade receivable} = \text{Decrease in tr. rec} \times \text{Current interest rate}$$

$$\text{Decrease in trade receivables} = \text{Current receivables} - \text{Revised receivables}$$

$$\text{Trade receivables} = \frac{\text{Trade receivables turnover in days} \times \text{Credit sales}}{365}$$

Working 2

$$\text{Factoring fees per year} = \text{Credit Sales} \times \%\ \text{fees}$$

Working 3

$$\text{Interest cost} = \text{Revised receivables} \times \%\ \text{of receivables advanced} \times \text{Incremental interest rate}$$

$$\text{Incremental interest rate} = \text{Interest rate chargeable by factor} - \text{Current interest rate}$$

Illustration (12/08, Q2: c):

The following financial information related to Gorwa Co:

	2007 $000	2006 $000
Sales (all on credit)	37,400	26,720
Cost of sales	34,408	23,781
Operating profit	2,992	2,939
Finance costs (interest payments)	355	274
Profit before taxation	2,637	2,665

	2007		2006	
	$000	$000	$000	$000
Non-current assets		13,632		12,750
Current assets				
Inventory	4,600		2,400	
Trade receivables	4,600		2,200	
	9,200		4,600	

Current liabilities				
Trade payables	4,750		2,000	
Overdraft	3,225		1,600	
	7,975		3,600	
Net current assets		1,225		1,000
		14,857		13,750
8% Bonds		2,425		2,425
		12,432		11,325
Capital and reserves				
Share capital		6,000		6,000
Reserves		6,432		5,325
		12,432		11,325

The average variable overdraft interest rate in each year was 5%. The 8% bonds are redeemable in ten years' time. A factor has offered to take over the administration of trade receivables on a non-recourse basis for an annual fee of 3% of credit sales. The factor will maintain a trade receivables collection period of 30 days and Gorwa Co will save $100,000 per year in administration costs and $350,000 per year in bad debts. A condition of the factoring agreement is that the factor would advance 80% of the face value of receivables at an annual interest rate of 7%.

Required:

Evaluate whether the proposal to factor trade receivables is financially acceptable. Assume an average cost of short-term finance in this part of the question only. Evaluation of proposal to factor trade receivables requires cost benefits analysis. Benefits of factoring must exceed cost, if proposal to be accepted on financial grounds.

Solution (12/08, Q2: c)

NOTE: Make you are comfortable with theory such as recourse and non recourse factoring.

		$
benefits → Savings in finance cost of trade receivables per year (see working 1) this calculation is most complex and attract more marks.		76,300
Savings in administration cost of sales ledger per year		100,000
Savings in bad debt expenses per year (non-recourse)		350,000
Total benefit of factoring per year	526,000	
cost → Factoring fee per year (see working 2)		(1,122,000)
Interest cost on cash received in advanced per year(see working 3)		(49,184)

Total cost of factoring per year	(1,171,184)	
Net benefit/cost of factoring per year	(644,884)	

Factoring is not worthwhile on financial grounds because cost of factoring exceeds benefits.

Explanation:

In addition, non-financial aspects of factoring are also necessary to be considered such as impact on customers and reaction of shareholders. Shareholders may perceive factoring as lack of expertise of management in controlling trade receivables.

Working 1

$$Revised\ trade\ receivables = \frac{Trade\ receivables\ turnover\ in\ days\ \times Credit\ sales}{365}$$

$$Revised\ trade\ receivables = \frac{30\ \times \$37{,}400{,}000}{365} = \$3{,}074{,}000$$

follow the highlighting to determine the flow of numbers.

Trade receivable balance under factoring proposal

Explanation:

Factor has claimed that they will reduce credit period to 30 days. Therefore, we needed to determine new receivable balance for this new credit period.

$$Decrease\ in\ trade\ receivables = Current\ receivables\ - Revised\ receivables$$

$$Decrease\ in\ trade\ receivables = \$4{,}600{,}000\ - \$3{,}074{,}000 = \$1{,}526{,}000$$

Given in question in current assets

Explanation:

Factoring is always expected to decrease in trade receivables. If factoring is expected to increase trade receivable period then factoring is obviously worthless.

Exam Support:

You may consider using stars☆to guide the marker on flow of calculation.
However, do not use symbols that take time and seem as mathematical sign.

$$Savings\ in\ finance\ cost\ of\ tr.receivables = Decrease\ in\ tr.rec \times Current\ interest\ rate$$

$$Savings\ in\ finance\ cost\ of\ receivables = \$1{,}526{,}000 \times 5\% = \$76{,}300\ per\ year$$

Savings made at the rate of overdraft

Explanation:

As discussed earlier, receivable requires to be financed somehow. Therefore, it incurs finance cost, which is the interest payable on overdraft at 5%. That is why; any reduction in receivable balance under this new credit period is savings to the organization. Interest will be saved at 5% because organization will no longer be required to pay interest on amount saved.

Working 2

$$Factoring\ fees\ per\ year = Credit\ Sales \times \%\ fees$$

$$Factoring\ fees\ per\ year = \$37{,}400{,}000 \times 3\% = \$1{,}122{,}000\ per\ year$$

Explanation:

Factor has demanded 3% of credit sales as factoring fee. It is possible to come across question in the exam in which factor would demand flat fee.

Working 3

$$Interest\ cost = Revised\ receivables \times \%\ of\ receivables\ advanced \times Incremental\ interest\ rate$$

calculated above

$$Interest\ cost = \$3{,}074{,}000 \times 80\% \times 2\% = \$49{,}184$$

advance paid by factor

$$Incremental\ interest\ rate = Interest\ rate\ chargeable\ by\ factor - Current\ interest\ rate$$

$$Incremental\ interest\ rate = 7\% - 5\% = 2\%$$

Demanded by factor — overdraft rate

additional interest rate charged by factor than interest rate payable to finance trade receivable using overdraft. 5% rate is payable regardless of factoring. it is irrelevant

Explanation:

5% of interest rate already been charged by the bank, it has to be incurred regardless of factoring proposal is accepted or not. Therefore, 5% of interest rate is irrelevant for decision-making purpose. Rise in interest rate due to factoring is 2% only not 7% and this 2% is relevant for evaluating proposal for factoring.

After factoring average receivable balance of $3,074,000 will be outstanding during the year. Factor will advanced 80% of receivables on which interest is charged at 2% per year.

Average receivable balance means receivables balance during the year will rise and fall such as due to seasonal demand for goods or services. However, if we take the average of those balances, then it will be equal to $3,074,000.

Reduction in financing cost	2
Admininstration cost and bad debt savings	1
Factor's fee	1
Interest on advance	2
Net cost of factoring	1
Conclusion	1
	8

Exam Support:

If you are stuck at any stage of the solution, then you should left it and move to the next question. Doing so will only result in loss of 1 or 2 marks; you can still earn marks to pass the question. Doing panic will not earn you any marks, it is better to earn marks from elsewhere in that time. This applies all whole F9 Financial Management paper.

9 Invoice Discounting

Exam	Q.no	Requirement	Marks
06/08	Q3:b	Discuss the ways in which factoring and invoice discounting can assist in the management of accounts receivable.	6

Invoice discounting is raising cash through pledging sales invoices. In other words, invoice discounting is raising short-term loan by providing sales invoices (Receivables as an asset) as security to the invoice discounter (lender).

Invoices are used to raise cash at discount. It means cash received will be lower than the total value of invoices. Usually, up to 75% of the invoices value can be received in cash.

Invoice discounter pays rest of the amount when customers settle their debts and charges a percentage of interest on cash advanced.

To be benefit from invoice discounting, organization must have good quality invoice. It is because invoices represent the security to the invoice discounter.