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Factoring and Reverse Factoring for Culture/Design and Creative Enterprise: A Research Note

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Abstract

The culture/design and creative service industry in Taiwan is still in its infancy. The main obstacles for cultural and creative enterprise to access finance, where the sh are of risk aversion from financial institutions and the difficulty in getting grants acco unts. In this study, I survey robust literatures and suggest the culture/design and creati ve enterprises should use factoring and reverse factoring as their critical fund manage ment. Because factoring allows SMEs to effectively outsource their credit and collectio n functions to their factor. Especially to international design enterprise, these credit an d collection services are often especially important for receivables from buyers located overseas. Also, the main advantage of reverse factoring is that the credit risk is equa l to the default risk of the high-quality customer, and not the risky SME. This arrang ement allows creditors in developing countries to factor "without recourse" and provid es low-risk financing to high-risk suppliers. To the best of our knowledge, this study i s the first paper in Taiwan to assert the usage of factoring and reverse factoring in th e culture/design and creative industry.

Key Words: factoring, reverse factoring, fund management, SMEs

1. Introduction

The Cultural and Creative Industry Policy in Taiwan has delineated the domestic design service industry into three major categories, including Product Design, Visual Communication Design, and Packaging Design. Additionally, according to the 2010 Annual Cultural and Creative Industry Development Report, any occupation related to the planning of product design, product appearance design, structural design, production of prototypes and models, fashion design, patent logo design, brand visual design, print media visual design, packaging design, website and multimedia design, and design consulting are all included in the category. In 2010, Taiwan's design service industry generated 2.208 billion in output value, with product appearance taking the lead with 1.53 billion, accounting for 69.29% of total business volume. However, the design industry has shifted away from the traditional manufacturing orientation to the creative orientation. The elements of the design process have evolved from styling and coloring to newer materials, forms of service, and business strategies.

According to HKU (2010), small and medium sized enterprises and freelancers play a central role in the economy, especially in their role as innovators.　However, the existence of an equity gap – the inability of small firms to access the finance they need to grow – has been a long-term challenge for governments and is a major consideration even in Europe, for its innovative future. Successive administrations have acknowledged the importance of the venture capital industry and implemented various initiatives in support of early-stage venture capital investment, including seed and start-up funding, to support SMEs, and especially cultural and creative SMEs. One characteristic that sets apart the cultural and creative enterprises and, in many ways impedes their access to finance, is the dependency on intangible assets. The creative entrepreneur traditionally combines tangible information and communication technology with intangible information products: cultural qualities and ‘media content’. However, intangible assets such as novelty, soft innovation, copyright and creativity are often not reflected in accounts, although this is slowly changing.

Financial institutions such as banks often fail to sufficiently recognize their economic value. The main obstacles for cultural and creative enterprise to access finance, where the share of risk aversion from financial institutions and the difficulty in getting grants accounts. The supply of debt capital via more traditional credit markets is vital to all entrepreneurial activity. Without a large and efficient credit market to supply firms with efficient debt capital, some entrepreneurs will face a financial barrier making it impossible to seize opportunities. In general, debt financing covers bank loan schemes and insurance schemes. They are, in principle, easier to secure because these financial sources are available to all entrepreneurs. However, the regular financial institutions offer little development assistance or expertise with regards to the cultural/design and creative enterprise. In addition, the nature of cultural and creative enterprises makes it harder to access Finance: businesses' assets are often intangible with copyright difficult to protect for new products and designs; returns are uncertain; and product innovation does not easily translate into formal business structures. In order to develop their company, a mid to long term loan can provide secured investment which is more adapted to the usual long investment cycle that characterizes the cultural and creative enterprises.

Furthermore, due to the financial recession, many banks have become more risk-averse and, as a result, are increasingly less likely to support businesses in the Cultural and creative enterprises due to their high risk qualities. The three most important instruments to increase financial opportunities were seen as public grants, an increase in self-financing and bank loans. The return on investment is considered low and risky for investors. Accordingly, findings from the online survey indicate that the greatest obstacle for organizations to access Finance was risk aversion from financial institutions, followed by difficulty in obtaining grants. Thus, a bank loan guarantee for innovative SMEs and cultural and creative enterprises could help in providing more targeted support. As bank guarantees do not sufficiently target cultural and creative enterprise s, specialized financial intermediaries for cultural and creative enterprises could mediate between them and the banks.

The transition from a one-person enterprise to a multi-person enterprise greatly affects the type and amount of finances required, particularly if additional workers are employed. Similarly, the efficiency of public funds changes between these two levels, with direct subsidies being very efficient at the beginning to support the entrepreneur, but less so at the enterprise level. Since access to finance is important during the early phases of the entrepreneurial life cycle, knowledge and information on the types of financial support available is of corresponding significance.

Factoring is a type of supplier financing in which firms sell their creditworthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash. Factoring is not a loan and there are no additional liabilities on the firm's balance sheet, although it provides working cap-ital financing. In addition, factoring is often done ''without recourse'', meaning that the factor that purchases the receivables assumes the credit risk for the buyer's ability to pay. Hence, factoring is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing. Factoring is explicitly linked to the value of a supplier's accounts receivable and receivables are sold, rather than collateralized, and factored receivables are not part of the estate of a bankrupt firm. Therefore, factoring may allow a high-risk supplier to transfer its credit risk to higher quality buyers.

''Reverse factoring'' may mitigate the problem of borrowers' informational opacity if only receivables from high-quality buyers are factored. Most firms involved in inter-firm trade offer credit to their customers, where trade credit is defined as allowing customers to obtain goods or services and pay at a later date. The management of trade credit (debtors) is, thus, an important facet of short-term financial management and of supplier-customer relations. For instance, for small firms, offering trade credit is an important means of attracting new (large) customers and of `signaling' supplier commitment and financial health (Petersen and Rajan, 1997; and Wilson and Summers, 1998). Wilson et.al (2000) point that there are basically six functional responsibilities associated with extending credit to customers. These involve: (1) assessment of the customer's credit risk; (2) making the credit granting decision with regard to credit terms and, where relevant, credit limits; (3) collecting the receivables (debts) as they fall due and taking action against defaulters; (4) monitoring customer behavior and compiling management information; (5) bearing the risk of default or bad debt; (6) financing the investment in receivables (debtors). Some or all of these activities can be `out-sourced' to specialized institutions that perform the various credit administration functions such as factors, invoice discounters, credit insurers, credit reference agencies and debt collection agencies.

2. Literature Review and Theory Building

Factoring can be done either on a ''non-recourse'' or ''recourse'' basis against the factor's client (the sellers). In non-recourse factoring, the lender not only assumes title to the accounts, but also assumes most of the default risk because the factor does not have recourse against the supplier if the accounts default. Under recourse factoring the factor has a claim (i.e., recourse) against the seller for any account payment deficiency. In developed countries it appears that factoring is more frequently done on a non-recourse basis (Muschella, 2003). But in emerging markets it is often problematic to assess the default risk of the underlying accounts, typically factoring is done on a recourse basis so that the factor can collect from the seller in the case that the buyer defaults. For instance, a survey of factors in eight EU-accession countries finds that most factoring in the region is done with recourse (Bakker et al., 2004).Factoring can also be done on either a notification or non-notification basis. Notification means that the buyers are notified that their accounts (i.e., their payables) have been sold to a factor. Under notification factoring, the buyers typically furnish the factor with delivery receipts, an assignment of the accounts and duplicate invoices prepared in a form that indicates clearly to the supplier that their account has been purchased by the factor.

2.1 Transaction Costs

Smith and Schnucker (1994) consider the decision to use factoring as a decision on vertical integration of the credit function and look at the impact of transaction costs on this decision. If a factor deals with a group of suppliers who have a common pool of potential customers then they will have access to more comprehensive information on each customer than any individual firm could gather cost effectively. The factor can provide this information as an input to their customers' credit granting decisions, thus potentially reducing the firm's information costs. Mian and Smith (1992) point out that this reduction will be greater where there is a low level of repeat business for a particular supplier from an individual customer but there is a high level of repeat business from that customer across a number of suppliers.

It is also suggested that the use of factors can give rise to savings in information costs for the customers of firms which use the factoring service. The factor can be a source of information to potential buyers on the price, quality and other attributes of the firm's goods in a sales situation. As the factor is a source of information on a number of potential suppliers, this reduction in information costs may make the buyer more likely to deal with a supplier who is using factoring services. This could make factoring more attractive for firms whose products are differentiated and where, therefore, buyers would have a greater requirement to assess product characteristics prior to sale. Smith and Schnucker (1994) investigated this effect by looking at the relationship between the use of factors and the extent to which the product line is customized to the seller. For design enterprise, the geographical distribution of buyers can also affect the ease with which a firm can collect information on buyer creditworthiness. Moreover, if the dispersion of buyers is international, additional costs may be incurred in the credit sales process arising from differences in culture, legal requirements or language. Use of international factoring can potentially offset these costs.

2.2 Asset Specificity

Mian and Smith (1992) argue that if a supplier makes a specific investment in a buyer then they are more prone to opportunistic action by the buyer after contract.

2.3 Economies of Scale

Mian and Smith (1992) note that a factor's credit management operation may be more efficient than those of smaller firms because they are able to invest in specialized personnel and procedures. They suggest that these advantages are intensified when compared to firms with seasonal sales; the factor can maximize the use of specialized investments by covering firms with varying seasonality.

2.4 Product Characteristics and the Value of Goods as Collateral

Mian and Smith(1992) note that if a seller's product is more customized to that seller, then it may have a higher collateral value to them than it would to a third party. Sellers with more customized products might therefore be expected to extend credit themselves rather than use third parties to finance sales, and indeed third parties may be more reluctant to finance such products. Third parties may also be reluctant to finance sales of goods which are complex and technical, and therefore perhaps more prone to disputes. Complex goods and services which are delivered over a period of time can also use staged payment terms, where payment is made based on milestones in the project or a percentage of the estimated time to completion being reached.

2.5 Price Discrimination

The credit terms a firm offers affect the overall price customers pay for the firm's goods. Indeed, Schwartz (1974) sees credit terms as `an integral part of the firm's pricing policy'. Varying terms or enforcement policies can, therefore, provide a means of varying prices between customers in a non-explicit or non-transparent way. Mian and Smith(1992), and Smith and Schnucker(1994) argue that if such price discrimination is a primary motive for extending trade credit then factoring is less likely, as the use of a third party could give rise to higher costs to cover the coordination of the credit and marketing functions. The involvement of a third party such as a factor, in credit management, could leave the firm with less flexibility in the way it sets and varies credit terms between customers for price discrimination or other competitive reasons

2.6 Finance and Cash-Flow Demand

Bickers (1994) suggests that the growth of factoring has been influenced by the problems which small firms have in raising institutional finance, increasing late payment by customers leading to cash flow problems, and the problems of bad debt among small business. Small firms, particularly growing firms, are credit rationed by the banking sector. This arises in part because of the difficulties in risk assessing such firms and setting appropriate risk premiums. A variety of theoretical models have been developed which examine the potential for credit rationing to exist, at equilibrium, in the financial market (see, for example, Jaffee and Modigliani,1969; Jaffee and Russell, 1976; and Stiglitz and Weiss, 1981).If a firm has such financing difficulties, factoring can be beneficial in two ways; firstly by making cash from invoices available more promptly and secondly by making finance available to firms which may not have the requisite level of fixed assets as collateral for loans. Another characteristic of the firm which could influence its decision to factor is its distribution channel. Relative to these other distribution channels, use of factoring by retailers is seemed to be more likely.

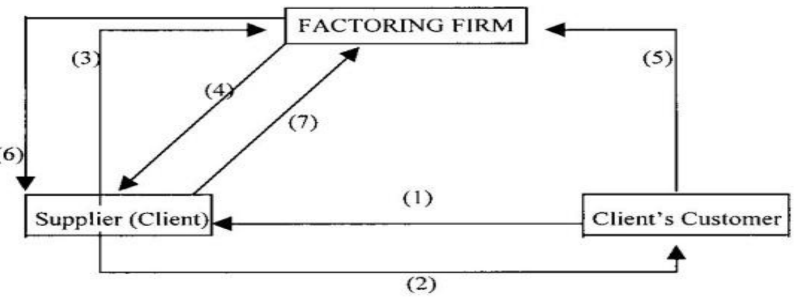
Fisman and Love (2003) highlight the impact of inter-firm financing by showing that industries with higher dependence on trade credit financing exhibit higher rates of growth in countries with relatively weak financial institutions. Van Horen (2004)studies the use of trade credit in 39 countries and finds that trade credit is used as a competitive tool, particularly for small and young firms. McMillan andWoodru (1999) study the use of trade credit 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. Factoring enables the client to meet promptly its own accounts payables and maintain a high credit standing with its creditors, being a marketing-wise solution for sale expansion and profit increase. The main drawback of factoring is the high cost. The factor’s fee is usually arrived at after taking into consideration the volume of sale, terms of sale, class of customer and the average size of invoice. Factoring is a ”silent partner” who invests in the business, implying no management control or share disposal, with the stipulation that silence has always been expensive.(Benea and Duma,2013)

3. Discussions

A challenge for many small businesses is access to financing. In particular, many firms find it difficult to finance their production cycle, since after goods are delivered most buyers demand 30–90 days to pay. Like traditional forms of commercial lending, factoring provides small and medium enterprises (SMEs) with working capital financing. However, unlike traditional forms of working capital financing, finance from factors is sales related rather than asset related factoring can be beneficial to small firms in periods of growth where the required assets on which other forms of finance are based are not available in sufficient quantity. Mian and Smith also suggest that factoring is more likely among firms with lower credit ratings, which may again relate to the collateral problem given that credit ratings are, in practice, often based largely on the firm's net worth. Factoring is quite distinct from traditional forms of commercial lending where credit is primarily underwritten based on the creditworthiness of the seller rather than the value of the seller’s underlying assets. When factoring is used, effectively the accounts receivable of the firm is being used as collateral.

I suggest that firms with cash flow problems for reasons other than late payment, for example seasonal sales, may be more inclined to use factoring. Smith and Schnucker cite this as a traditional explanation for the use of factors. Mian and Smith predict that firms are less likely to use factors when they have their own sales force, where sales contact takes place at the customer's premises, or where a sales force is motivated to collect credit information. Firms with customized products were found to be more likely to use factoring as expected. Theory suggests that factoring is more likely in an industry with a large number of buyers and suppliers. An obvious sign indicates that firms in markets with large competitors were more likely to use factoring. This result could be related to financial pressure, in that the presence of large competitors may indicate the firm itself is relatively small, and large competitors may both pressure margins down and place themselves higher up in the pecking order for payments from their customers. Small firms are more likely to have financing difficulties, particularly in raising bank finance, and to feel constrained in their potential because of this. Factors, because of their close day to day relationship with the firm and their collection of more detailed information on the market sectors of the firms they deal with, are able to overcome the information asymmetries which otherwise constrain finance availability.

The relationship with the collateral value of the goods is also consistent with this pattern. The negative relationship of factoring with the use of stage payments, while reflecting the factor's preferences, could also reflect a reduced financing requirement from firms who trade on such terms. Factoring allows SMEs to effectively outsource their credit and collection functions to their factor. This represents another important distinction between factors and traditional commercial lenders. To international design enterprise, these credit and collection services are often especially important for receivables from buyers located overseas. For example, ‘‘export’’ or ‘‘cross-border’’ factoring, which is the sale of foreign receivables, can facilitate and reduce the risk of international sales by collecting foreign accounts receivables. The seller’s factor will typically contact a factor in the buyer’s home country (via Factor Chain International, a worldwide association of factoring companies) who will do a credit check on the buyer. If the buyer is approved, the seller’s factor will pay the seller a percentage of the face value of the receivable, and the factor in the buyer’s country, for a fee, will take on the responsibility of collecting the amount due from the buyer. Since the foreign factor is required to do a credit check on the foreign customer before agreeing to purchase the receivable, the approval of a factoring arrangement also sends an important signal to the seller before entering a business relationship. The seller can also improve its own risk management, by reducing its credit and exchange rate risks. This can facilitate the expansion of sales to overseas markets. However, the role of export factoring in both developed and developing countries is relatively small: less than 10% off factoring in developing countries is international, versus about 20% in developed countries.



(1)- Customer Places order to the supplier.
(2)- Firm supplies goods and issues invoices.
(3)- Supplier firm requests financing and provides the debtor book (Sales Ledger).
(4)- Factoring company advances cash against invoices once approved based on the information.
(5)- The customer firm is expected to makes full payment to the factoring company within a stipulated period of time.
(6)- The factoring company charges fees and interest to the supplier.
(7)- If the customer firm defaults on payment, the client firm must repay the factoring firm.

Figure 1 the factoring mechanism

An advantage to factoring is that it's generally linked on a formula basis to the value of the underlying assets, which allows quick credit approval and disbursement. However, this depends on a good technology infrastructure and supporting electronic security laws just as Taiwan that allow the electronic sale and transfer of electronic securities (accounts receivable). The sale of receivables from the supplier to the factor and the transfer of funds from the factor to the supplier are done electronically. Following a factoring transaction, funds are transferred directly to the supplier's bank account, and the factor becomes the creditor (e.g., the buyer repays the bank directly). The factor collects the loan amount directly from the buyer (in 30–90 days). It solves the problem that the design enterprise meets in ordinary trade situation.

For large buyers, the benefit is that the factor manages their accounts payable payments and the buyer often develops stronger relationships with its suppliers. For instance, buyers decrease their administrative and processing costs by electively outsourcing their payment department, e.g., the buyer writes one check to a factor rather than to multiples of suppliers which can lead to increases in competition and improvements in the quality of goods. For the factors, which are mostly banks, factoring is a way to develop new relationships with suppliers – banks can use factoring to build a credit history on firms, including information on their cash, accounts receivable and inventory turnover, and cross-sell other products such as credit cards, truck financing, payroll, etc. In addition, because reverse factoring only includes high quality receivables, banks can increase their operations without increasing their risk.

The main advantage of reverse factoring is that the credit risk is equal to the default risk of the high-quality customer, and not the risky SME. This arrangement allows creditors in developing countries to factor ‘‘without recourse’’ and provides low-risk financing to high-risk suppliers. Reverse factoring may be particularly beneficial for SMEs for a number of reasons. First, as previously discussed, ordinary factoring requires comprehensive credit information on all the seller’s customers, which may be particularly difficult and costly to deter-mine for SMEs in countries with weak credit information systems. Second, reverse factoring makes it possible for firms to factor without recourse, which allows SMEs to transfer their credit risk to the factor. Another advantage of reverse factoring is that it provides benefits to lenders and buyers as well. In many countries factoring is offered by banks. In this case, factoring enables lenders to develop relationships with small firms (with high quality customers) without taking on additional risk.

This may provide cross-selling opportunities and allows the lender to build a credit history on the small firm that may lead to additional lending (for fixed assets, for example).The large buyers may also benefit: by engineering a reverse factoring arrangement with a lender and providing its customers with working capital financing, the buyer may be able to negotiate better terms with its suppliers. Ordinary factoring requires lenders to have timely and comprehensive credit information and suppliers to have sophisticated technology and management information systems (MIS). However, reverse factoring only requires complete credit information on one or more creditworthy firms. There are potentially advantages for all participants: For the factor, who benefits from low information costs and credit risk; for the (high-risk) seller, who benefits from access to short-term, working cap-ital financing; and for the (creditworthy) buyer, who benefits from the ability to outsource its receivable management and negotiate better terms with its suppliers. Also, reverse factoring transfers the credit risk of the loan to the suppliers’ high-quality buyers, factors can offer factoring without recourse to design enterprise, even those without credit histories. This allows design enterprises to increase their cash stock – and improve their balance sheets – without taking on additional debt.

4. Conclusions and Suggestions

The global pattern of factoring suggests that it may have an advantage compared to other types of lending, such as loans collateralized by fixed assets, under certain conditions. Factoring appears to be a powerful tool in providing financing to high risk informational opaque sellers. Its key virtue is that underwriting in factoring is based on the risk of the accounts receivable themselves rather than the risk of the seller. For example, factoring may be particularly well suited for financing receivables from large or foreign firms when those receivables are obligations of buyers who are more creditworthy than the seller itself. The virtue of factoring in a weak business environment is that the factored receivables are removed from the bankruptcy estate of the seller and become the property of the factor.

However, factoring may still be hampered by weak contract enforcement institutions and other tax, legal, and regulatory impediments. Weaker governance structures may also create additional barriers to the collection of receivables in developing countries. For instance, it might be more difficult to collect receivables from state-owned companies (i.e., where state-owned companies are the buyers) then from other companies. Factors may also face difficulties collecting receivables from multi-nationals and foreign buyers. Factors prefer firms who sell business to business, those whose products and services allow for an outright sale discharging the obligations of the supplier and those who do not use stage terms. The general quality of the customer base needs to be acceptable and risk needs to be spread, with the sales ledger not dominated by an individual customer. As Wilson et.al (2000) asserted the industry sector will be a big challenge to factoring usage.

Factoring has traditionally been associated with certain industries, for example textiles, although in recent times factors have been expanding their range to include other industries. It may be that firms in industries where factoring is more established and accepted are more likely to use factors. It is also likely that the industries where factoring was originally established have characteristics that fit the factor's preferences or are in other ways predisposed to use factoring. What is unique about factoring is that the credit provided by a lender is explicitly linked on a formula basis to the value of a supplier’s accounts receivable and is less dependent on the supplier’s overall creditworthiness. Therefore, factoring may allow high risk suppliers to transfer their credit risk to their high-quality buyers. Reverse factoring might also mitigate the problem of sellers’ informational opacity in business environments with poor credit information infrastructures if only receivables from high-quality buyers are factored.

From the viewpoint of macro-economy, it might be the case that more firms use factoring for working capital financing when their stock of receivables and number of customers increases (Klapper, 2006).

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