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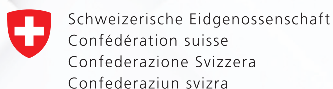
THE ASSOCIATION OF BANKS IN CAMBODIA

FACTORING HANDBOOK

OCTOBER 2023

IN PARTNERSHIP WITH



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ACKNOWLEDGEMENT

Based on the experience of the more developed markets, financing against movable assets is a main way of supporting private sector businesses by financial institutions. This form of financing already exists in Cambodia, but needs to be further developed in order to better promote financial inclusion and expand the business credit portfolios for the sake of economic growth. In this context, and in line with the National Financial Inclusion Strategy 2019–2025, the Association of Banks in Cambodia (ABC) is pleased to release this Factoring Handbook as a reference material for the business lending institutions. The main purpose of the Handbook is to provide technical advice and guidance on the factoring business. It will be a reference point for a number of interested parties including legislators, regulators, lawyers, financiers (both bank and non-bank financial institutions) particularly their factoring operations officers, risk managers and client relations personnel.

We would like to thank the cooperation of the International Finance Corporation (IFC) of the World Bank Group in developing this Handbook together with the Movable Asset Finance & Supply Chain Finance Working Group of ABC and all member Banks and Financial Institutions of ABC for actively providing their inputs and support. We also greatly appreciate the generous support of Japan and the State Secretariat for Economic Affairs (SECO) of Switzerland in funding a project to deepen the movable asset finance market in Cambodia, which helps to make this Handbook possible.

ABC will continue to respond to the demands of its members, and roll out more practice guidelines and sample operations documents. We hope that such materials will help to strengthen the confidence and skills of business lenders and build up common and consistent understanding in various movable asset finance products among the Cambodian financial institutions.

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ABBREVIATIONS

Abbreviations used in this handbook:

A/R	Accounts Receivable
B2B	Business-to-business (trade)
DSO	Days Sales Outstanding
FCI	Global association for factoring and financing of open account trade receivables
IT	Information Technology
JSC	Joint Stock Company
KYC	Know Your Customer
LLC	Limited Liability Company
NGO	Non-Governmental Organisation
RM	Relationship Manager
SME	Small & Medium-Sized Enterprise
SLCA	Sales Ledger Control Account
SCF	Supply Chain Finance
UNCITRAL	United Nations Commission on International Trade Law
VAT	Value Added Tax

2 INTRODUCTION

This handbook concentrates on domestic factoring where trade is between two entities within the same country.

2.1 PURPOSE AND USE OF THE FACTORING HANDBOOK

The main purpose of the handbook is to provide technical advice and guidance on factoring. It is a reference point for a number of interested parties including legislators and regulators, lawyers, financiers (both bank and non-bank finance institutions), management and staff of factoring operations, risk managers and client relations personnel.

The handbook can also be used as an education tool for new employees or existing employees changing jobs within financiers who offer factoring.

The handbook contents will define what factoring is, guide the reader through the practical steps needed to operate as a factor as well as the risks in factoring and how to mitigate those risks.

2.2 TERMINOLOGY

Factoring uses specific terminology and technical terms. These are explained when they first appear in the handbook and are consistent with the Glossary of Terms produced by Factors Chain International ['FCI'], the global association for the industry.

3 DEFINITION OF FACTORING

3.1 SHORT-TERM FINANCE OF RECEIVABLE

Factoring is a type of short-term finance applicable to open account trade between two businesses (i.e., B2B). We'll call the trading parties "Seller" and "Buyer". An open account transaction is a sale where goods are shipped - or services are provided - before payment is due. In the market place, Seller is also often called "Supplier" or "Client" while Buyer is called "Account Debtor" or "Customer".

3.1.1 Receivable

From the point of view of the Seller, the Buyer's obligation to pay, up until the point payment is made, is called a receivable. It is an asset in the Seller's books and a liability in the Buyer's. Receivable is sometimes referred to as "accounts receivable" or "A/R" and can be singular (receivable) or plural (receivables).

Receivables are an example of an asset-class called a financial instrument or intangible asset. They are not physical in nature. You cannot touch or see receivables.

Receivable is also referred to as a type of movable asset.

3.1.2 Cashflow Gap

As we have seen, in open account trade, there is a delay between delivery of the goods or services and receipt of the Buyer's payment by the Seller. This is called "days sales outstanding" ('DSO'), the length of time it takes the Buyer to pay. In other words, for the Seller there is a gap between making the sale and getting the cash.

The Seller may also face a situation where the payment terms it receives from its own suppliers are shorter than the terms it offers to its Buyers. In this case the Seller needs to pay its own suppliers before it gets money from its Buyers, hence there is a "cashflow gap". Factoring finances this cashflow gap by providing finance (cash) as soon as the Seller has delivered.

The tenor of the finance is defined by the payment terms between the two businesses who are trading with each other. Typically, payment terms are in the range of 30 to 90 days but they could be longer.

3.1.3 Parties Involved in Factoring

There are three parties involved in factoring: a creditor (Seller), debtor (Buyer) and a Factor. The creditor is the party that uses the factoring service. The Buyer is the party that has an obligation to make payment for the product that is bought from the Seller. The Factor is the party that provides the factoring services.

3.2 NON-BANK FINANCIAL ACTIVITY

In some markets, factoring is listed as an example of a non-bank financial activity and there may be specific regulations and laws that apply to factors and factoring.

Typically, factoring is offered by both banks and non-bank finance institutions (factoring companies, finance companies, Fintech lenders, etc.).

3.3 ASSIGNMENT OF RECEIVABLE TO THE FACTOR

In traditional civil law jurisdictions, when people refer to "Factoring" they only mean purchase of accounts receivable by the Factor from the Seller ("transfer" of receivables from the Seller to the Factor). In the case of Cambodia where a modern, unitary, functional and comprehensive Secured Transactions Law of 2007 is prevailing, Factors take assignment of account. The word "account" means receivable as defined by the Law. The law also covers "sale of account", meaning the purchasing and selling of receivables as an asset. The seller is the "assignor" while the purchaser or Factor is the "assignee" under the assignment of account.

The more general term "Receivables Finance" includes Factoring, as defined above, but also includes finance where accounts receivable is simply a security (meaning collateral) to the financier, i.e., creditor puts security interest on the borrower's (supplier's) receivables.

In a factoring facility, the Seller assigns its receivables to the Factor. This handbook uses the example of assignment of receivables to the Factor, i.e., sale of receivables by the Seller – which is largely the same as transfer of receivables in civil law jurisdictions. Under the 2007 Secured Transactions Law in Cambodia, the modern concept of assignment of receivables has replaced the old concept of "transfer" of claims. However, for the convenience of drafting, in this Handbook, assignment and transfer are used interchangeably. Readers should be aware that, in Cambodia, Factors should use assignment, as prescribed under the Secured Transactions Law, in factoring transactions.

The receivable is the collateral offered by the Seller to the Factor to secure the finance. A factor might require some sort of credit enhancement to the receivable, such as a guarantee of the payment obligation of the Buyer or underwriting by a credit insurer. In the established factoring markets, however – and often where there is competition amongst factoring providers – more commonly, the only collateral is the receivable with no requirement for additional credit enhancement.

Cambodian Factors should also be aware that their interest on receives need to be registered at the Secured Transactions Filing Office under the Ministry of Commerce. This is for the purpose of establishing the Factor's priority on the assigned receivables against third parties. Such a filing (registration) system is commonly called "collateral registry".

3.4 SERVICES PERFORMED BY THE FACTOR

A factor performs at least two of the following functions[1]:

a) Finance for the seller
b) Maintenance of accounts relating to the receivables (ledgering)
c) Collection of receivables
d) Protection against default in payments by buyers (see section 5.2, Non-Recourse Factoring)

Where finance is one of the services being offered - and it almost always is – it is an advance by the Factor to the Seller of, typically, 80-90% of the face value of the invoice being raised and assigned to the Factor. This advance is usually made within 24 hours after the invoice being assigned, but the timing of the advance depends on the Factor's processes and its requirement for verifying the validity (eligibility) of the receivable.

When the advance is, say, 80%, the additional 20% is known as the 'margin of safety', acknowledging that for various reasons, discussed later, the Buyer may pay less than the face value of the invoice.

Where Buyer payment exceeds the amount previously advanced, the balance is paid to the Seller at the time when the Buyer makes payment, less a fee for the Factor's services.

3.5 DIFFERENCE BETWEEN BANK LENDING AND FACTORING

3.5.1 Source of Repayment

A traditional bank loan is repaid by the party receiving the financing, i.e. the borrower. In factoring the party being financed is a Seller who has sold goods or services to a Buyer. The primary source of repayment of a factoring facility is the payment from the Buyer.

When there is a purchase of receivables, it is clear that the ownership of the receivable and any associated rights, such as claims to be paid by the Buyer, transfers to the Factor. The UNCITRAL Legislative Guide on Secured Transactions expresses it as an "outright transfer of receivables"[2]. The later UNCITRAL Model Law on Secured Transactions indicates it as an "outright transfer of a receivable by agreement"[3].

In civil law countries without a unitary secured transactions law and where factoring is practiced, it is done through a "transfer" of claim. This can be contrasted to the "pledge of receivables" for non-factoring receivables finance. Again, in the case of Cambodia, factoring is done with assignment, and the terminologies of mortgage, pledge, transfer, etc. are no longer in the 2007 Secured Transactions Law in line with the latest international best practice.

A secondary source of repayment *may be* the Seller, depending on whether the factoring facility is with recourse or without recourse (See Section 5 below). However, in the normal course of a factoring facility, repayment is by the Buyer. This characteristic, by itself, makes factoring distinct from a loan and means risk management and operations are very different.

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[1] (UNIDROIT, 1988)
[2] (UNCITRAL, 2010)
[3] (UNCITRAL, 2016)

3.5.1.1 Credit and Risk Focus

Due to the difference in the source of repayment and the nature of the asset being financed, Bank Lending and Factoring take a different attitude towards credit and risk analysis and have different structures in place to ensure their best opportunity for repayment.

In Bank Lending the focus is on the *asset* and *the borrower's* ability to repay. In factoring the focus is on the *asset* and the *Buyer's* ability to repay. A secondary interest is on the Seller because (a) the Factor wants to be confident that the Seller will continue to operate and supply the Buyer (this gives rise to more receivables for the Factor to finance and earn income from); and (b) the Factor may turn to the Seller for repayment under a recourse facility if payment from the Buyer is not forthcoming.

3.5.2 Transfer of Ownership and Factor's Right to Payment from the Buyer

In factoring, ownership of the receivables is transferred to the Factor *together with any rights associated with those receivables*.

The rights referred to above - or enforceable claims - are transferred to the Factor. This means that, for the factored receivables, the Factor has the right to collect payment from the Buyer and the Buyer must pay to the Factor. In many countries, this is explicitly included in the law (e.g., Mongolia, Cambodia, Philippines) whereas in other countries it is not yet (e.g., Indonesia).

3.6 WHOLE TURNOVER OR SINGLE INVOICE FACTORING

A factoring facility may concern the complete portfolio of receivables in the Seller's books or just a part of it:

Factoring Facility	Subject of the Assignment	Risk Implication
Whole Turnover	All invoices raised to all the Buyers	Greatest spread of risk for the Factor
Single or multiple Buyers (but not all)	All invoices raised to just selected Buyers	Concentration risk
Single-Invoice Finance (or 'Spot Factoring')	A single invoice	Greatest concentration risk

From the Factor's point of view, the most desirable facility is the one with the greatest spread of risk, which is the whole turnover factoring. For example, if there are twenty Buyers and no one Buyer represents more than, say, 5% of the Seller's portfolio of receivables, then if one of the Buyers goes bankrupt and cannot make payment, the Factor's loss is limited. Or, quite possibly, there is no loss at all because payments from other Buyers more than cover the amount owed by the bankrupt Buyer (the potential loss has been absorbed by the Margin of Safety).

Where only one (or a few) invoices to a Buyer are factored, there is greater risk, such as the risk that the Buyer makes a mistake when making payment. Some payments are due to the Seller (non-factored invoices), some to the Factor (factored invoices). Misdirection of payments can occur.
Also, Buyer may simply pay the non-factored invoices but not pay the factored ones.

See Risk Management (section 6) for more details.

3.7 THE VALUE PROPOSITION OF FACTORING

The value that factoring delivers is summed up in the benefits to the Seller:

3.7.1 Benefits for the Seller

Monetisation of receivables	At an early stage of their existence
Improved cashflow	Seller does not have to wait until the maturity date of the invoice (or longer) to get paid. (The maturity date is defined by the payment terms, which could be anything from 30 to 90 days after invoice date or even longer).
Factor performs collections	Seller can divert resources previously allocated to chasing payments from Buyers. Seller no longer needs to employ someone to do collections. May be a cost saving for the Seller.
Factor assesses Buyers for creditworthiness	The Seller does not have to do his own investigations into a potential new Buyer and, if approved by the Factor, can immediately start selling on open account terms.
Bad debt protection	In non-recourse factoring (see section 5.2 below), if the Buyer fails to pay or becomes bankrupt, the Factor covers the loss.
The factoring facility can increase with your turnover	Unlike a loan where it is for a finite amount over a set period, factoring can increase as the Seller needs it, reflecting the Seller’s growing turnover.
Potential to offer longer payment terms to Buyer	This would need to be with the agreement of the Factor.
No additional collateral, in particular no need for real estate collateral	A clear advantage from the Seller’s point of view when compared to other types of financing.

3.7.2 Benefits for the Buyer

Benefits for the Buyer arise from the improved cashflow that the Seller gets from factoring:

Improved stability in the supply chain	Due to the Seller's improved cashflow, the Buyer has greater confidence in the Seller's continuation as a business, and less need to continually consider alternative suppliers or have contingency plans in case where the Seller is unable to satisfy orders.

Buyer's supplier (Seller) is financially better able to supply larger or more frequent orders. Production levels at the Seller may have been limited by available cash. With factoring, Seller can use spare production capacity and increase the size of supplies or the frequency they deliver to the Buyer.

Buyer may benefit from longer payment terms offered by the Seller, thus improving its own cashflows. Buyer can take longer to pay. The improved cashflow arising from advances made by the Factor may (with the Factor's agreement) mean that the Seller will look to attract more business from the Buyer by extending its payment terms.

Buyer may seek to push back warehousing of supplies to the Seller. Buyer may be able to introduce "just-in-time" supplies where the Seller keeps finished goods in his warehouse and only supplies when the Buyer needs goods (Buyer saves on cost of storing goods bought from the Seller).

Buyer may benefit from discounts offered by the Seller	Buyer pays less. Due to its improved financial basis, Seller may be able to offer the Buyer trade discounts (lower pricing) or (with Factor's agreement) settlement discounts for paying early.

Potential for increase in Buyer credit limit over time because of enhanced business relationship with the Seller. Where the Buyer establishes, over time, a pattern of paying on time and without disputes, the Factor may be willing to increase the credit limit on the Buyer, allowing the Seller to do more business with them.

Ultimately, increase in level of business between Buyer and Seller, arising from the situations described above.

3.8 A Note on Regulations

Factoring is a regulated activity in some markets or totally unregulated in others. Depending on the local regulations, it could be a business line of a licensed finance company or a product area of a licensed commercial bank.

Anyone considering operating as a factor needs to find out whether factoring is regulated in their particular market or not, and fully understand those regulations. They typically define who can operate as a factor, whether a factoring licence is required, and what structure and capital requirements are needed.

The very fact that a regulator has determined and published requirements and guidelines for factoring raises the profile of factoring as a business, gives it legitimacy and integrity, and improves the stability of the financial system. It can enhance market confidence and provide a degree of protection for clients (users of factoring).

4 How Factoring Works

4.1 The Basic Workflows

The following graphic shows the four basic workflows in factoring:

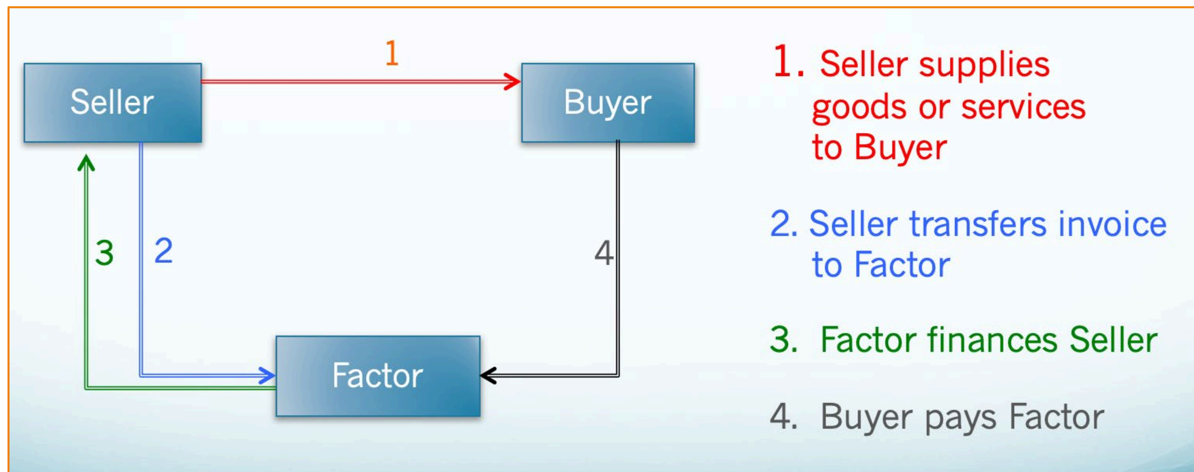


Figure 1 Basic Workflows in Factoring

Many activities take place during each of the workflows:

Workflow	Details
1. Seller supplies goods or services to Buyer	The sale of goods (or services) is on an open account basis with payment terms of, say, 90 days. At the same time as delivering the goods (or after), the Seller raises a sales invoice and sends it to the Buyer. Together with the normal details of a commercial transaction, the invoice also shows a notice stating that the invoice has been assigned to [*name of Factor*] and the invoice can only be settled by payment to the Factor. The notice shows the Factor's bank details for the payment.

2. Seller transfers (assigns) invoice to the Factor	At the same time as sending the invoice to the Buyer, the Seller assigns the invoice to the Factor. This is done by the Seller signing a standard document supplied by the Factor which lists the invoices being transferred – invoice number, date, value, etc. This document, together with the Factoring Agreement between the Factor and the Seller, is, in effect, the transfer agreement. If a register of security interests exists in the Factor's market, the Factor will assert his rights to the receivable by registering his security interest in the receivables. In the case of Cambodia, the Secured Transactions Filing Office under the Ministry of Commerce is the collateral registry. The Factor verifies the receivable by contacting the Buyer. The factor wants to know that the Buyer: i) has received the invoice. ii) has received delivery of the goods. iii) does not dispute the invoice. iv) agrees with the invoice – details of goods supplied and invoice value is correct. v) acknowledges (from the notice on the invoice) that he must pay the Factor.
3. Factor finances the Seller	Once the security interest is perfected (if a register of security interests is available for this purpose) and the invoice has been verified, the Factor will finance the invoice at the request of the Seller. Finance is typically in the range of 80% to 90% of the face value of the invoice.

4. Buyer pays to Factor	Prior to Buyer making payment, the Factor follows a schedule of collection activities which may include all of the following: automated reminders, emails and phone calls. The Factor wants a high level of confidence that the Buyer will pay to the Factor on or soon after the payment due date. Collection activities should reveal whether the Buyer disputes the invoice, in whole or in part, and is therefore likely to pay less than the original face value of the invoice or not pay at all. If the Factor has financed an invoice which subsequently is the subject of a dispute by the Buyer, the Factor seeks to recover its exposure. When payment (of non-disputed invoices) is made to the Factor, the Factor sends the balance over and above the amount originally financed to the Seller less the factoring fee.

The factoring model in the above workflows is Notification Factoring, where the Buyer is aware of the involvement of the Factor because of the notice on the invoice.

There is a variation, called Non-Notification Factoring, where there is no such notice. The Buyer cannot pay the Factor because he does not know there is a factoring arrangement with the Seller. Buyer therefore pays to his supplier (the Seller) who is obliged to transfer the payment to the Factor. You will appreciate that the risks are very different in this case.

In this handbook we concentrate on Notification Factoring.

4.2 Factor's Security Interest in Receivable

Some markets operate a register of security interests where a financier can register its interest in the asset that it is financing and the rights relating to it. In factoring, this is the receivable.

It is highly advantageous to the Factor if he can register his security interest in the receivable. If a Factor cannot do this (if, say, there is no such register) - or can do it but fails to - this can lead to disputes about who has ownership and/or security rights over the receivable and the Factor may be in a weaker position.

CASE STUDY: Double Financing of the Same Receivable

Names are fictitious and bear no relationship to any real entities

Generic Carpets JSC ('GC') is a carpet manufacturer selling to textile distributors and retailers. GC signs a factoring agreement with ABC Factors on 21st January 2019 for the next 12 months for the transfer of all existing and future invoices to buyer Star Markets. Other buyers are not part of the factoring facility. ABC registers its security interest in the receivable (limited to Star Markets only).

The facility works well for three months but then there is a long period with no sales to Star Markets. As winter approaches GC approaches another factor, XYZ, and signs a factoring agreement on 15th September 2019 to cover all their buyers (i.e., 'whole turnover'). In October, they are pleased to get an order again from Star Markets. They sell the Star Markets invoice to ABC Factors, but they make a mistake and also sell the Star Markets invoice to XYZ, along with all the other invoices to other buyers.

XYZ verify a sample of invoices transferred to them. The process hits their target of 60% of total value of invoices verified but it so happens that the sample does not include the Star Markets invoice. XYZ finance all the transferred invoices.

On the maturity date of the Star Markets invoice, XYZ contact them for payment only to be told the invoice has already been paid. XYZ did not receive the payment and they subsequently discover the payment went to ABC Factors. XYZ tell Star Markets that the recent invoice would have had clear instructions on it to pay XYZ but Star Markets say they didn't notice any change on the invoice. XYZ tell Star Markets they have paid the wrong party and must make a second payment to themselves otherwise the receivable has not been settled. Star Markets refuse.

XYZ contact ABC to recover the payment from them. ABC refer them to their factoring agreement with GC dated 20th January which is still active (even though there was a period when there were no invoices to Star Markets) and they say "the October invoice belongs to them". The earlier-dated factoring agreement prevails. XYZ faces a loss of the finance they made against the Star Markets invoice of October.

Findings

XYZ should have searched the Collateral Registry before their factoring agreement with GC. That would at least have told them GC already had some sort of factoring facility in place and they could have questioned GC about it. More comprehensive verification by XYZ should also have revealed the problem.

The sale of the same invoice to two factors may be fraud on the part of a Seller but, as in this case, it could also simply be a mistake.

4.3 HEADLINE POLICIES

The Factor needs to formulate and document its headline policies with regard to the following areas:

- Target Market
  - SME or Corporate, or both.
  - Legal status of the Seller (Stock-exchange quoted; JSC; LLC; NGO; partnerships; sole traders).
  - Sellers established for x number of years.
- Business sectors:
  - Preferred sectors and sectors with potential issues affecting factoring (see section 8.4).
- Business sector concentration:
  - No one industry sector should represent more than x% of the whole portfolio of receivables.
- Maximum finance advance percentage:
  - For example, 90%.
- Maximum payment terms between Seller and Buyer:
  - Factor may wish to exclude any receivables where the payment terms are over, say, 90 days.
- Seller concentration:
  - No one Seller should represent more than x% of the whole factoring portfolio of receivables.
- Trading History:
  - Minimum number of years trading between Seller and Buyer.
- Buyer concentration:
  - No one Buyer should represent more than x% of an individual Seller's portfolio of receivables.
  - No one Buyer should represent more than x% of the whole factoring portfolio of receivables.

5 FACTORING PRODUCTS

This handbook concerns Domestic Factoring, that is when trade is between a seller and a buyer who are both in the same country.

5.1 RECOURSE FACTORING

Recourse factoring is where the Seller bears the risk of the Buyer not paying and thus settling the receivable. In other words, the Factor provides the Seller with finance and/or sales administration and/or collection procedures, but not protection against default in Buyer payments (compare to Non-Recourse Factoring, below).

5.1.1 Buyer Delaying Payment

In recourse factoring if the Buyer delays payment significantly beyond the payment terms (sometimes called 'protracted default'), the Factor will exercise recourse on the Seller.
Technically it works like this:

- the factoring agreement between Seller and Factor defines the recourse period (typically 90 days after maturity date of invoice, i.e. the "trigger point").
- when an undisputed receivable (invoice) remains unpaid at the trigger point the factor will:
  a) require the Seller to pay back finance already advanced against the unpaid receivable,
     or (more practical when there is a flow of receivables being transferred to the Factor):
  b) hold back finance on the next batch of invoices transferred to the Factor (see illustration below. MNT is a dummy name for any currency).
- the Factor may charge a "re-factoring fee" when he recourses invoices back to the Seller if this is included in the factoring agreement terms and conditions. The re-factoring charge is a percentage of the value of the recourse invoice.

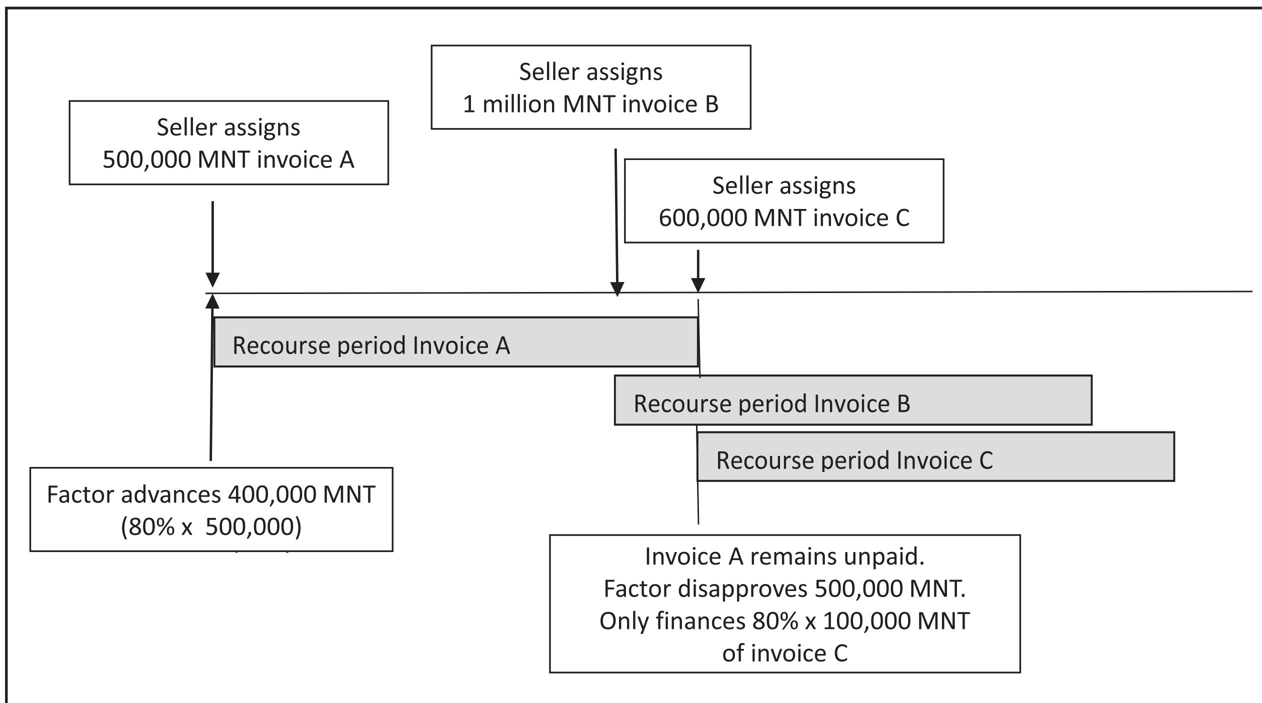


Figure 2 Recourse Factoring

For the purposes of this illustration the finance percentage is 80%. Hence 400,000 MNT finance against Invoice A.

Invoice B is fully financed (i.e. 80% of 1 million MNT) when it is sold to the Factor because at that time the earlier invoice, Invoice A, has not yet aged to its recourse period trigger point. However, when Invoice C is sold to the Factor, Invoice A is past the recourse period, so finance against Invoice C is reduced.

The above process protects the Factor's exposure and is applied automatically by specialist factoring software systems.

The process can be applied on a portfolio level. For example, in the above illustration there are different Buyers of each invoice. However, if it is the same Buyer for each invoice the Factor may decide to stop financing any more invoices (therefore zero finance against C). It depends on the reason why the Buyer is not paying Invoice A. If it is a commercial dispute related to that particular invoice or delivery and it does not affect other invoices, then the factor would finance other invoices to the same Buyer. However, if the Buyer is not paying Invoice A because of financial difficulties that is likely to mean non-payment of the other invoices, the Factor will stop all finance on invoices to that Buyer.

5.1.2 Buyer Bankruptcy

The Factor must continually monitor Buyers for solvency. If the factoring facility is recourse factoring and a Buyer becomes bankrupt, the Factor must immediately exercise recourse to the Seller. Do not wait until invoices have reached their recourse period trigger point.

Recourse factoring may be the preferred product when the Buyer is weak.

Note that the rights of the Factor in the event of bankruptcy (of the Buyer or of the Seller) depend on the country's jurisdiction, and the bankruptcy outcomes can be different for a purchase (assignment) of receivables and an ordinary security interest on receivables. In general, assets already sold should not be part of the bankruptcy estate. When Factor purchases a receivable, it has title to the receivable.

5.2 NON-RECOURSE FACTORING

Non-recourse factoring is where the Factor bears the risk of the Buyer not paying or becoming insolvent. In other words, it is a factoring facility where the Factor provides the Seller with protection against Buyer default.

5.2.1 Providing Protection Against Buyer Default

- Seller applies to the Factor for a credit limit on a specified Buyer.
- Factor assesses the risk of the Buyer and issues a credit limit to the Seller. Assessment is typically through analysis of Buyer financial statements, credit information bureau or a credit insurer. The Factor may also take into account the length and quality of the trading relationship with the Seller and judge whether buyer payments made on time in the past can give them confidence that payments will be good in the future.
- Factor finances transferred invoices up to the level of the credit limit. Any transferred invoices over the credit limit do not receive finance (i.e., are 'unapproved').
- As per the terms of the factoring agreement, Seller can submit a claim to the Factor at a specified time for Buyer non-payment, typically 90 or 120 days past due date.

5.2.2 Risk Mitigation through Credit Insurance

The Factor may mitigate the risk of non-recourse through credit insurance, if it is available in the market. In this case the credit limit issued by the Factor to the Seller would match the credit limit they receive from their insurer.

Note that credit insurers typically offer 90% indemnity whereas Factors typically offer the Seller 100%. The Factor will therefore bear the 10% loss in the event of a claim from the Seller.

Credit insurers typically pay out on successful claims 180 days after due date of the invoice so there may be a gap between when the Factor pays out to the Seller and when the Factor re-claims it from the insurer.

In the case of Buyer failure, Seller can submit a claim immediately the Buyer is declared bankrupt.

5.3 REVERSE FACTORING

5.3.1 Introduction

Reverse factoring is a type of supply chain finance made to suppliers back up the supply chain, hence the use of the word “reverse”. It works in the opposite direction from the ‘classical factoring’ that we have been describing so far in this handbook. See illustration below.

For this section we will refer to the party that is selling the goods as the Supplier.

5.3.2 Characteristics

The characteristics of Reverse Factoring are:

- One large, strong credit-rated Buyer.
- Multiple smaller (mostly SME) Suppliers selling to the large Buyer.
- Factor makes finance available to the Suppliers on the basis of the Buyer approving the invoices he has received. ‘Approval’ means:
    - the Buyer confirms to the Factor that the invoice they received from the Supplier was for the goods or services they ordered, they were delivered, and the quality and quantity of products were good.
    - the Buyer commits to paying to the Factor at maturity date of the invoices (or later, by the agreement with the Factor).
- Buyer, Suppliers and Factor are usually all linked on a digital platform for efficient and prompt online communication of:
    - Invoice.
    - Delivery documents.
    - Buyer’s approval of the invoices.
    - Supplier’s request for finance.
    - Settlement by the Buyer to the Factor.

Reverse Factoring is usually on a non-recourse basis because of the strength of the buyer and the Factor’s reliance on the Buyer’s approval.

5.3.3 Process Flows

See figure below:

1. Suppliers invoice the Buyer and deliver the goods or services.
2. Buyer sends approval to the Factor.
3. Factor offers finance to the Suppliers:
    - In Reverse Factoring the amount of finance can be up to 100% of the invoice value because of the strength of the approval from the Buyer.
    - The Supplier has a choice whether to take the finance at this early stage, or not.
4. At maturity date of the invoice, Buyer pays Factor.

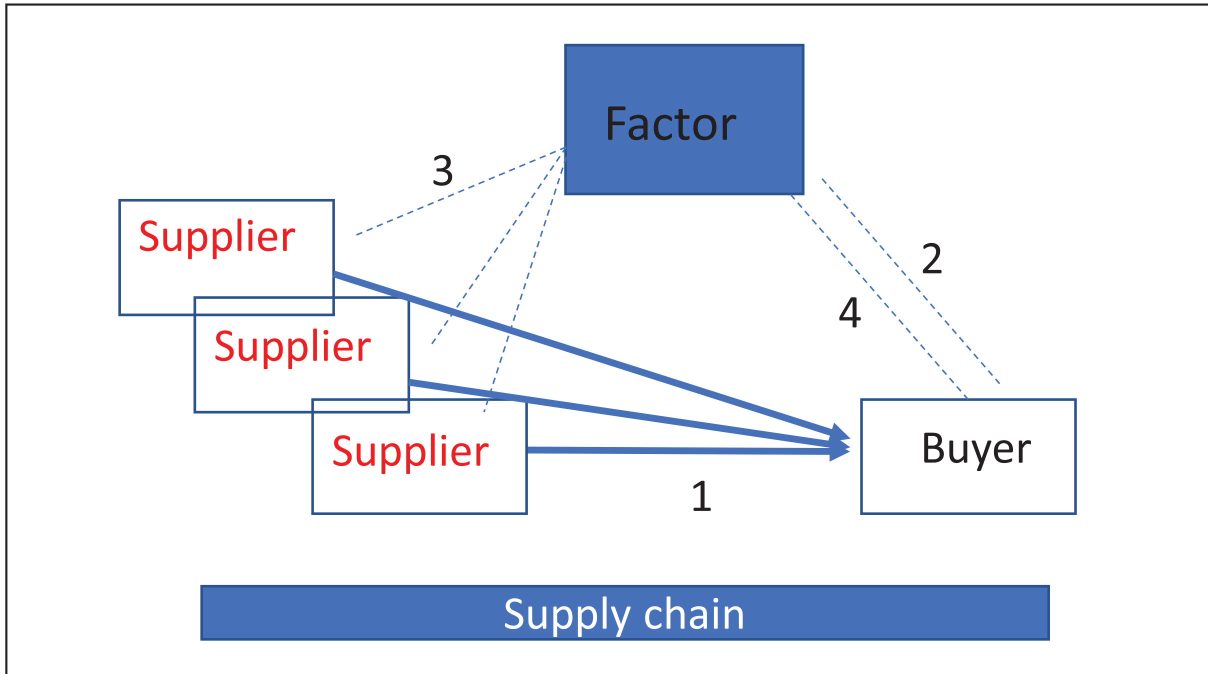


Figure 3 Reverse Factoring Model

It is the Supplier's choice whether he takes the finance or not. The finance is attractive to him because it is priced on the basis of the large Buyer's creditworthiness (this is where the risk lies for the Factor).

If the Supplier tries to source finance from another source on the basis of his own financial statements and risk profile, the finance is likely to be more expensive or perhaps not available at all (the Supplier's credit standing may not fit with the lender's criteria).

5.3.4 Benefits of Reverse Factoring

Party	Benefit
Supplier	• Working capital finance based on the strong credit standing of the Buyer. • Lower cost of capital compared to obtaining finance based on own risk rating. • Improved cash flow. • Alternative funding opportunities may result from increased liquidity through Reverse Factoring. • Can serve the Buyer better and satisfy larger orders. • No requirement to offer real estate or additional collateral.
Factor	• Lower credit risk of a prime Buyer. • High quality transaction due to the approval by the Buyer.

Buyer	• More stable supply chain due to improved cash flow and liquidity of Suppliers. • Buyer may achieve longer payables terms from Suppliers by agreeing with the Factor a later payment date than the original maturity date of invoices. • Buyer makes one payment to Factor instead of multiple payments across all Suppliers.

6 RISK MANAGEMENT

6.1 INTRODUCTION

The overall risk in factoring is the same as for any financial facility – the risk that you lose money. However, in factoring, the approach to risk management is, in many ways, different from traditional bank lending.

As described in section 3.5.1, the primary source of repayment of a factoring facility is the Buyer rather than repayment by the party that receives the finance (the Seller). For this reason alone, there is a lot of work done around risk assessment of the Buyer as well as the Seller. The Factor also needs to understand the risks with the receivable itself.

6.1.1 Spread of Risk

Whereas in traditional bank lending the risk is concentrated in one party, the borrower, in factoring there is the opportunity to spread the risk across a number of parties (i.e., Buyers and, possibly, insurance providers).

Whole turnover facilities have been mentioned earlier as well as single Buyer and single invoice factoring. The more invoices there are and the more Buyers under a factoring facility, the greater the spread of risk for the Factor.

At the other end of the scale, if risk is concentrated in one invoice or just one Buyer, then the impact of non-payment of that invoice or of failure of the Buyer can have a significant impact for the Factor. Risk management in factoring is, therefore, very much guided by how much of the Seller's portfolios of receivables is captured in the factoring agreement and the levels of concentration or spread of risk.

6.2 MACRO-LEVEL RISK

Financiers are familiar with the risk assessment of the wider economic environment and at the business sector level. This also applies to factoring.

6.3 SELLER RISK

The risks in the Seller are:

- Financial risk:
    - The risk that the Seller may fail as a business meaning it will no longer trade or assign receivables and the Factor's income stops. The Factor may no longer have a secondary source of repayment of the factoring facility (recourse to the Seller). When a Buyer's supplier fails, it can also impact on the willingness of the Buyer to pay for the outstanding receivables (because it will now have to find an alternative supplier).
- Operational risk:
    - This is the risk that the Seller's processes, procedures and operations are not complete, effective, or they fail completely. Examples include:

- incorrect processing of an order.
- incorrect invoicing.
- incorrect or late delivery.
- failure to resolve commercial disputes in a timely fashion.
- failure to raise credit memos (deductions from sales amount due to returns, product defects, etc.)
- deductions to invoices because of product defects, shortages, etc.

The Factor needs to be confident in the Seller's processes. If the Seller has a proven record of being accurate and efficient in its sales in the past, then, all things being equal, those qualities should continue during the period when the Factor is at risk while providing finance.

6.4 Buyer Risk

The Factor's risk assessment of the Buyer concerns their ability and willingness to pay. In other words, the timing and likelihood of payment by the Buyer will affect the value of the receivable from the point of view of the Factor.

6.4.1 Buyer's Ability to Pay

The Factor needs to understand the financial performance and liquidity of the Buyer. If the Factor has access to the financial statements of the Buyer, then the usual balance sheet ratio analysis (familiar from bank lending) is applied. In addition, other typical credit analysis on an enterprise is performed (quality of management, environmental and social risks, etc.).

If there have been short payments by the Buyer or overdue payment plans have been accepted by the Seller in the past, the Factor needs to understand why these things happened. It may indicate financial difficulties of the Buyer.

6.4.2 Buyer's Willingness to Pay

In line with the different market traditions in different countries, Buyers typically pay at *x* days past maturity date and not always exactly on date of maturity.

However, the Buyer may have the financial capability to make payments but may be of the mindset that they routinely significantly delay payments (pay much later than the maturity date). They may prioritize their suppliers according to who is more important for them and the Seller who is the subject of the factoring facility may be lower down on their priority list.

If there is trading history between Seller and Buyer, the Factor can assess the pattern of payments in the past - before the factoring facility starts - to see if payments were for full value and on time (at maturity date) or getting progressively later and later.

The Factor should also investigate whether there is a history of disputes raised by the Buyer or whether the relationship between Seller and Buyer has been 'difficult' (meaning it always takes a lot of effort to get payment). When the factoring facility starts and the Factor takes over the collection activity, they may inherit this difficulty, which is not only an element of risk, it will also add to the Factor's costs.

If the Factor uses credit insurance to mitigate the risk, they can rely on the credit limit issued by the insurer. However, it is still advisable for the Factor to understand if issues highlighted above exist because claiming on the credit insurance policy should be regarded as a back-up strategy and not the primary way of getting the receivables settled. Also, multiple claims on a credit insurance policy are likely to result in higher premiums on renewal.

6.5 Risk in the Receivables

Quality of the receivables is extremely important because the receivables are the main - sometimes the only - collateral for the finance.

The risk is that the value of the receivable as shown on the face of the transferred invoice – against which the Factor has advanced finance - may be impaired and consequently the Buyer settles the receivables by paying a lower amount.

6.5.1 Impairments to Receivables

Examples of potential impairments to receivables include:

Impairment	Details
Late delivery (especially of time-critical goods)	For example, just-in-time deliveries for the automobile manufacturing sector. Failure to deliver when required interrupts the production line and incurs additional cost for the Buyer.
Sale-or-return	This may be a formal term in the sales contract or simply a commercial practice tolerated by the Seller to ensure future orders from the Buyer. If the Buyer cannot forward sell the goods supplied by the Seller, they return them and require a credit memo (which has the effect of reducing the value of the original receivable). The Factor needs to examine previous practice between Seller and Buyer to see if sale-or-return might impact on factored invoices. Check the reasons behind past credit memos and look at stock records for the returned goods.

After-sales obligations of the Seller	Examples: • A 12-month warranty on goods supplied. If the Seller fails and cannot honor the warranty (which may be replacement of goods previously supplied), the Buyer is likely to deduct from outstanding receivables the value of the goods being claimed under warranty. • Failure of the Seller to fulfil a maintenance contract (for example for software previously supplied) could result in the Buyer offsetting against outstanding receivable the cost of finding a new contractor to service the software. • Installation. Again, if the Seller fails to perform installation (say he has invoiced for glass windows plus their installation), then Buyer is likely to reduce his payment or offset the cost of a new installer, or possibly not pay at all (glass windows are not much use without installation).
Settlement discounts	Seller may offer Buyer a discount for paying earlier than the maturity date. Factor needs to be aware of this condition in any sales contract before they finance.
Reciprocal (or "contra" accounts)	This is where Buyer also makes sales to the Seller, so the Buyer reduces his payment by the amount due to him (offset).
Retentions	Typical in project work invoiced in stages, such as construction. Buyer retains 5%, say, of the total value of the project and only pays it on the completion of a trial or warranty period. If the Seller cannot complete the project or the closing stages are inadequate, Buyer will not pay the 5%.
Liquidated damages	These are remedies the parties designate in the sales contract for the injured party to collect as compensation upon a specific breach (for example, late performance). Buyer may 'collect' the damages by reducing the payment.
Retention of title	If the Seller's supplier applies retention of title to the goods supplied and if the Seller has not yet paid his supplier, the supplier may be able to trace (and recover) the goods right through to the Seller's Buyer.

Impairment to receivables is also known as "dilution" which can be defined as an amount that the Buyer may deduct from their payment.

Appendix IV at section 8.4 shows business sector characteristics that may affect the quality of receivables and shows many examples of potential impairments or dilutions.

6.6 THE FACTORING AGREEMENT

The factoring agreement between the Factor and the Seller is the first tool of risk management because it sets out the obligations and responsibilities of the parties and the terms and conditions of the factoring facility.

The following are examples of clauses or terms that should be in a factoring agreement:

- Seller warrants that the receivables assigned to the factor are valid and enforceable receivables, and the result of genuine sales transactions for goods or services between Seller and its Buyers.
- Seller must submit to the Factor certified copy invoices and the supporting documents.
- Seller must submit to the Factor any other documents requested by the Factor including proof of delivery.
- The recourse period (if facility is recourse factoring).
- The agreement applies to 'existing and future receivables' (therefore no need for a new agreement each time new receivables are transferred).
- Factor reserves the right to choose which receivables it finances:
    - This is essential, otherwise Seller may only transfer the 'bad' invoices to the Factor.
- Advance percentage ("up to 85%", for example). The Factor must also have the right to reduce the advance percentage at any time if it sees fit. This is a key tool for managing risk.
- Advance payment to Seller is made within *X* days of assignment of the receivable.

6.7 PROSPECT ASSESSMENT

In this handbook, "Prospect" means a Seller that a Factor is considering for factoring, i.e., before the first finance is made.

When a Factor makes initial finance, it is likely to be the largest amount of finance at any one time for that Seller, particularly if the facility being considered is whole turnover.

If a Factor decides (or has a standard policy) to finance any receivable on a Prospect's books that is not yet at maturity date, this also impacts on the size of that first finance. Subsequent financing is for new invoices raised on a daily/weekly basis and will therefore likely be much lower in value.

Therefore, it is vital that the Factor completes a thorough assessment and due diligence at Prospect stage. As we have seen, this assessment includes Seller (at this stage still a Prospect), Buyer and receivables.

6.7.1 Initial Prospect Assessment

The Factor will do an initial and relatively quick assessment of the Prospect from standard information obtained by the Factor's marketing or sales personnel (see below 'Application Form'). This is to decide whether to progress the Prospect to more detailed due diligence. It

may be that one or two things in the information leads the Factor to decide that it is not suitable for factoring and it will not progress.

The following case study indicates what information is helpful and the decision considerations. Names and information presented are inventions solely for this example and do not represent an actual business.

CASE STUDY: Factoring Application Form

Category	Detail	Factor's Decision Considerations
Company name	Garment Distributors JSC	Legal status of Prospect (here: JSC). Factor may have a standard policy that it accepts stock-exchange quoted businesses, JSCs and LLCs only. If Garment Distributors was a partnership or sole trader it would not qualify.
Date established	2012	Factor may have a standard policy that Prospect must be established and trading for, say, 3 years. There are clearly different risks if Cashmere Distributors were a start-up, new company.
Business sector	Apparel distribution	The nature of what is being sold begins to tell the Factor something about the likely suitability of the receivable. This appears to be 'sell and forget' with no after-sales obligations, however sale-or-return might apply. It is not a deal killer but needs checking during due diligence. Factor may refer to a list of business sectors they regard as unsuitable or with characteristics that may affect the quality of the receivables (see Appendix at section 8.4).
Turnover last 12 months	USD 3.0 million	The Factor may have a standard policy of Seller minimum turnover. If turnover is below this, the Prospect is rejected.
Company address, email, website and telephone	Contact information	Check out the website or other public information services.
Directors	1. Name 2. Name 3. Name	Factor does preliminary investigation on the Directors. An unsuitable director (record of failed businesses; politically-exposed person, etc.) may mean rejection of Prospect.

Funding requirement from factoring	USD 740,000	a) Factor decides how attractive this is in terms of revenue generation. c) May indicate the tenor of the facility, here 90 days, being (0.74/3.0 million) x 365.
Additional information attached	1. List of ten most important Buyers	Factor begins to understand who the main Buyers are. If known problems (might be a problem Buyer on an existing factoring contract), may lead to rejection.
	2. Aged Receivables Report	Factor forms view on: Spread of receivable / concentration. Non performing receivable. Average DSO (how long on average it takes Buyers to pay).
	3. Terms and Conditions of sale	Factor begins to identify any onerous clauses or possible dilutions.
	4. Sample sales invoice	Confirm what is being sold and by whom.
	5. Three years audited accounts	Form your view on historic performance.
	6. Current management accounts	Form your view on recent financial performance.
	7. Budget / forecast next 12 months	Form your view on growth potential.

If the initial Prospect assessment is positive the Factor moves to detailed due diligence. This should take place at the Prospect's administration offices. If the operations are in a different location this also needs to be seen.

6.7.2 Prospect Detailed Due Diligence

This section refers to Factoring only. Reverse Factoring will be different, with more work done on the large Buyer and little due diligence on the suppliers (although KYC on each supplier is still required).

For Factoring, detailed due diligence can usually be done in one day unless there are multiple ledgers and/or multiple locations. It cannot be done remotely from the Factor's office.

The advantage of the assessor performing due diligence at the Prospect's premises is that the assessor can see the Prospect's operation in full and has the opportunity to speak to Accounts, Despatch and Sales staff at the Prospect.

The following table is a guidance on the areas for due diligence:

Areas for due diligence	Notes
Financials	Last three years audited statements trend and ratio analysis.
Sales process	Understand the process of quotation, purchase order, order acknowledgement, packing list, delivery. Record the basis and timing of the invoice particularly in relation to delivery and record the point at which Prospect's terms and conditions are supplied to the Buyer. Record what details appear on invoice: - Cross reference to order number. - Payment terms. - Does invoice show company registration number / VAT number. There have been fraudulent cases where the invoices offered to the Factor are in fact raised by a different entity from the one expected, usually with a very similar name. Record what forms the proof of delivery and where it is kept. Deliveries may be by a third party. The Factor may sometimes need to access proof of delivery documents to support its right to payment from the Buyer. Note: There may be more than one type of sale with different processes.
Sales Ledger Control Account ('SLCA')	The assessor needs to construct an SLCA of the previous 12 month's data around invoicing, credit memos and buyer payments. Figures are obtained from the Prospect's accounting system. The completed SLCA shows patterns in invoicing (for example to identify seasonal trade), the pattern of Buyer payments, and how long, on average, it takes Buyers to pay (DSO). These patterns allow the Factor to form expectations about the performance of the receivable when he is financing. Any significant variance from past history may indicate a change in the risk profile of the facility

EXAMPLE SALES LEDGER CONTROL ACCOUNT

Month & Year	Invoices $	Value of Credit Notes $	Buyer Payments $	Credit Adjustments $	Receivable at End of Month $
January-23	100	10	75	1	134
February-23	150	5	75	0	204
March-23	150	5	100	0	249
April-23	125	0	130	0	244
May-23	100	8	125	0	211
June-23	85	1	85	1	210
July-23	90	1	65	0	234
August-23	100	5	75	3	254
September-23	150	5	83	0	316
October-23	170	7	120	0	359
November-23	175	12	130	0	392
December-23	180	10	149	0	413
Totals:	1,575	69	1,212	5	3,220

Debt Sales Outstanding	**81 Days**
Credit note percentage	**4%**

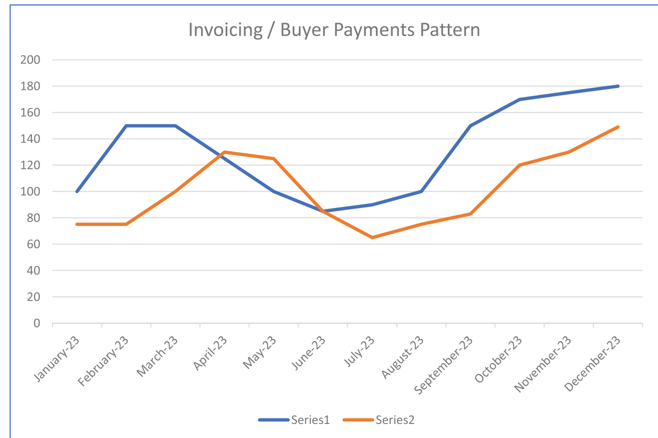


Figure 4 Sales Ledger Control Account

Areas for due diligence (continued)	Notes
Aged receivable report	Analyse the Prospect's aged receivable reports for each of the most recent three months. It shows what proportion of receivable is getting old and if the trend is worsening.
Ten largest Buyers (by amount outstanding)	This is relevant if the proposed facility is whole turnover. Typically, the ten largest Buyers by amount outstanding represent a significant percentage of the whole receivables portfolio. When doing collection activity, the Factor may initially focus on the larger Buyers. The task also reveals Buyer concentration.
Proof of Delivery	On a sample basis, examine invoices, payment terms, proof of delivery (date/signature), and date Buyer paid, noting any reasons for late delivery or late payment.

Dilutions • Credit memos • Terms of Sale	Investigate credit memos if the aggregate (as percentage of sales) is over 3%. The SLCA will show if any particular months have high percentage of credit memos. Also, determine if Prospect is either delaying the raising of credit memos or raises them but does not send them to Factor. The ledger as a whole may be inflated as a result. Identify if terms such as sale or return, retentions, reciprocal trading or marketing contributions exist and if they negatively impact on quality of receivable.
Liabilities • Taxes • Trade creditors (payables)	Examine Prospect's tax records – Corporation and Income tax and VAT – to see if Prospect is behind in payments. Examine the Purchase Ledger to see if there is significant pressure from its own suppliers. Identify if there is the same name on Purchase and Sales Ledger ("contra" trading; another word is "contra account").

6.7.3 Availability Calculation

Due diligence will confirm whether the Factor wants to go ahead and offer a facility. It will also show what risks there are and how, initially, they can be managed through the terms and conditions of the factoring agreement. In particular, risk controls can be put in place in the factoring agreement including:

- Facility limit
- Advance percentage
- Buyer concentration
- Recourse period

Credit Committee will need to refer to the Availability Calculation which is a calculation of how much finance the Factor will offer based on the most recent ledger:

CASE STUDY: Availability Calculation

Availability Calculation	MNT (million)	MNT (million)	Notes
Gross receivables	750		Sales ledger (aggregate receivables) total
Less: Aged over 90 days	(114)		Factor does not want to finance old receivable because it has potential to be bad debt
Less: reciprocal trading	(25)		An example of a dilution
Less: other unapproved receivable ("ineligibles")	(11)		Unapproved means any receivable the Factor does not want to finance. Could be excess over Buyer concentration limit, credit memos, export receivable, sole-trader Buyers, receivable subject to dispute, etc.
Net receivables (eligible receivables)		600	(A)
Advance percentage		80%	(B)
Available finance at start		480	(A x B)

In the above example, the 'headline' advance percentage, as shown in the Factoring Agreement, is 80%. As a percentage of the gross (total) ledger it is 480 / 750 = 64%. Note: MNT is a dummy currency for illustration purpose. It is assumed that 1 USD = 1000 MNT.

An example workflow at Prospect stage, from initial sales lead right through to making the first finance advance, is shown at Appendix II section 8.2

6.8 Organization Structure for Factoring

Typically, three Departments (Units, or vertical lines) are involved in factoring; Marketing & Sales, Operations, and Risk. They are supported by shared resources of Legal, Accounts (Accounting) and IT.

A deep knowledge of how factoring works and the risks of factoring are needed by each Department.

This is not an issue for a specialist factoring company but a bank that offers many finance products including factoring may want to consider designating staff to deal only with factoring and no other finance products.

For this reason, there have been examples of banks establishing a factoring subsidiary with its own specific sales, credit and operations functions and Departments. Specialisation can also be deployed in a factoring department of a bank (as opposed to a subsidiary).

6.9 Day-to-Day Operations and Risk Management

During the life of a factoring facility there are regular operations and risk management tasks.

6.9.1 Factoring IT system

A specialist off-the-shelf factoring IT system (or use from a Cloud on a pay-as-you-go basis) is recommended for any significant volume of receivables going through factoring facilities. It typically features:

- integration with accounts packages.
- integration with third party providers such as credit insurers.
- a 'client portal' through which:
  - the Seller uploads batches of invoices.
  - the Seller requests finance.
  - the Factor provides the Seller with reports on Buyer credit limits, Buyer payments and receivable that is unapproved for financing.
- for each Seller a 'Current Account' showing in real time the outstanding finance (Factor's exposure)
- for each Seller a 'Receivables Purchased Account' showing in real time the value of the receivable sold to the Factor
- for each buyer, a 'Payables Interface' for the buying company to see invoices raised, approve invoices, and track payments
- a summary report (for use by the Factor only) of activities month-by-month:
  - invoices.
  - credit memos.
  - Buyer payments.
  - total receivable outstanding.
  - Unapproved, or ineligible, receivables (receivables not receiving finance).
  - fees (income).
  - days sales outstanding.

6.9.2 Relationship Manager ['RM']

The RM is the front line for managing the Seller relationship and risk.

6.9.2.1 RM responsibilities

- Understanding the Seller's internal structures, mechanisms and procedures that contribute to sales transactions, from purchase order to packing and delivery.
- Identifying any changes in the Seller's risk profile and informing Factor's management and Risk Department accordingly.

- Having a comprehensive knowledge of the factoring agreement, collaterals and any security held relating to the Seller.
- Monitoring the financial performance of the Seller.
- Monitoring the performance of the receivables ledger:
  - Monitoring buyer payments to see that the volume of payments and the timing of payments is as expected from historic data and/or previous months experience with the Factor.
  - Monitoring Buyer concentrations.
  - Monitoring dilutions.
  - Investigating reasons for credit memos being raised:
    - the Seller may be "re-ageing" the debt thus avoiding recourse applied to receivable over, say, 90 days past maturity date. A credit memo is issued by the Seller to cancel an old unpaid invoice, followed immediately by a new invoice for the same value.
  - Monitoring and finding explanation for unusual transactions such as unusually large or round-sum invoices.
- Being aware of anything that may reduce the value of the receivables.
- Ensuring prompt response and contact with the Seller in relation to any risk-related issues or breaches of the factoring agreement.

The RM must learn of any changes in the Seller's management and assess the possible impact on the Seller's operational performance and the facility/relationship with the Factor.

The RM should know if a signatory to the factoring agreement is under significant stress in business or personal life. In times of crisis there is a greater possibility of the Seller's management manipulating the factoring facility to their financial advantage, breaching the factoring agreement or defrauding the Factor.

6.9.3 Checks Before Financing an Active Seller

The following processes seek to ensure that the receivable being financed is valid and enforceable and should be followed when the Seller is active, i.e. the subject of a factoring facility:

6.9.3.1 Verification

Verification implies that the Factor contacting the Buyer by phone to see if the Buyer agrees with the invoice:

- invoice matches goods or services ordered.
- delivery was on time.
- Buyer does not dispute the invoice.
- Buyer acknowledges the need to pay Factor to settle the invoice.

Verification is best performed by the Factor's collections staff making contact with accounts payable staff at the Buyer. Collection means that the Factor collects on receivable on behalf of the Seller. It can mean both collecting regularly on performing accounts or collecting on overdue amounts from non-performing or even bankrupt Buyers.

If the facility is single-invoice or single-Buyer factoring, the Factor should verify every invoice.

If it is a whole turnover facility and the batch of invoices being transferred is multiple invoices to many Buyers, it may not be practical to verify every invoice. It may take a long time and delay the finance to the Seller.

The Factor may therefore want to consider verifying on a sample basis (for example, verify invoices over a certain value or verify a batch of invoices to a prescribed monetary level as per Factor policy, say to 60% of the value of the batch total). Clearly there is more risk the fewer invoices (or lower aggregate value) you verify.

Once you are financing, you may see it as an acceptable risk if you know the Seller well, or if the facility has been operating well for some time and previous verifications with Buyers have all been good. However, circumstances of a familiar Seller can change and therefore your verification policy should be re-examined on a periodic basis.

6.9.3.2 Buyer Acknowledgement

The Factor may wish to consider getting a signed statement from each Buyer every time invoices are assigned to the Factor by the Seller (for reverse factoring or notification factoring). The objective is to:

(a) make clear the Buyer's understanding of the assignment under the factoring facility.
(b) get confirmation from the Buyer that there are no disputes or counter claims that may impact on the receivables.
(c) obtain Buyer's acknowledgement that the only valid settlement of the receivable is by payment to the Factor.

See example Buyer Acknowledgement in the Appendices at section 8.1 The comments above about the degree to which the Factor verifies invoices (i.e., do it every time or on a sample basis) are also relevant for the Buyer Acknowledgement.

6.9.3.3 Re-Calculate Availability

Receivables change from one day to the next, as a result of new invoices being transferred, existing invoices being paid, credit memos issued, etc. Therefore, during the life of the facility, availability is calculated on a daily basis or certainly each time the Seller wants to receive finance from the Factor.
Specialist factoring IT systems automatically calculate availability from the data input. When the Seller logs on to the factoring system he can see how much finance is available and can request it (or a lower amount) with a simple click.

The availability calculation process is the same one used at Prospect stage (see 6.7.3). The same principles are applied whether the facility is whole turnover, single-invoice factoring or single Buyer.

6.9.4 Buyer Risk Management

Buyers must be periodically assessed for risk whether the facility is recourse or non-recourse. The assessment considers:

- Length of trading relationship with the Seller.
- Analysis of historical financial statements of the Buyer (if available).
- Credit bureau and credit insurer ratings (if available).
- Payment history (also take into account payments made by the Buyer to another Seller with a factoring facility with the Factor).
- Number and nature of disputes over the receivables.
- Quality of Factor/Buyer relationship through collection activities and verifications.

6.9.5 Seller Reviews

A Seller Review is a periodic review of the facility with the frequency driven by the risk profile of the Seller and the size of the factoring facility, typically once a year.

The Seller Review is a formal paper submitted to Risk Department where the RM assesses:

- How the Seller has performed against budget.
- How the receivable has performed.
- The adequacy of security interests held.
- Income generated from the facility.
- Risk profile. Any changes since initial finance or previous review.

6.9.6 Administration

Operations Department staff, working under the RM, perform administrative as well as low-to-medium-level risk management tasks. In the following list of tasks, where there is mention of the Buyer, this refers to Notification Factoring:

6.9.6.1 Invoice checks

- To see that Seller and Buyer shown on the invoice agree to the records on the Factor's IT system.
- Invoice is supported by:
    - Purchase Order – and details agree to the invoice.
    - Proof of delivery.
- The Factor obtains a Buyer Acknowledgement for each sales invoice assigned (or on a sample basis).
- Invoice is within agreed credit limit for Buyer.
- Invoice is dated and shows payment terms and/or due date.
- Invoice shows a notice stating it has been transferred to the Factor and shows Factor's bank account where Buyer must make payment.

6.9.6.2 Collection

(a) Establish a relationship and build rapport with the Buyer.

(b) Get verifications from the Buyer - that they have received the invoice and the goods or services, they are happy with the quantity and quality and they acknowledge that they must make payment to the Factor.

(c) If Buyer says there are service or quality issues (Seller performance failures), Operations staff or RM go to the Seller for resolution. It can reveal fraudulent behavior by the Seller

if, for example, Buyer is unaware of a particular invoice or has not even heard of the Seller or gives “too perfect” answers to questions (i.e. all deliveries perfect, never any issues, etc.).

Collections should be organized according to a timetable. Different timetables can be used for different factoring facilities.

Example timetable:

7 days before invoice maturity date	Phone call
At invoice maturity date	E-Mail
Maturity date + 7 days	Phone call
Maturity date +14	Email and Phone call
Maturity date + 30	Referred to a Special Collection Dept.; 7-day legal notice issued + advise Seller of intention to exercise recourse.
Maturity date + 60	Referred to Legal

6.9.7 On-Going Monitoring and Field Audits (Filed Inspections)

During the life of a Seller with a factoring facility, the Factor must monitor the facility closely and compare expectations with what is actually happening. For example, if initial assessment and subsequent experience shows that, on average, Buyers pay ten days after maturity date, but recently that has increased to twenty days, the Factor needs to investigate and understand the reason for the change and adjust the facility, if necessary.

The Factor should also perform regular field audits (meaning at the Seller’s premises – the Factoring agreement must have a clause in it allowing you to do this). Typically, field audits (field inspections) are done every six months for good, existing Sellers with factoring, or more frequently if the risk profile of the Seller has changed.

For Sellers onboarded on new factoring agreements, the field audit may be every three months.

The structure of the field audit is the same as the due diligence done at Prospect stage (see 6.7.2)

6.10 Risk Department

Risk Department manages the risks at portfolio level. It is a separate function from the RM and Operations and does not have direct contact with Sellers or Buyers. It therefore provides an objective view of risk.

6.10.1 Portfolio-Level Risk Management

Portfolio-level risk management in factoring is analysis of the aggregate figures relating to the Factor’s exposure across all Sellers and Buyers:

- Total aggregate receivables.
- Number of Sellers and highest single concentration.
- Number of Buyers and highest single concentration.
- Aggregate DSO.

- Aggregate receivables ageing.
- Aggregate receivables over 90 days from maturity date.
- Aggregate credit memo as percentage of Sellers' turnover.
- Finance (credit) outstanding (exposure).
- Adequacy of provisions for bad and doubtful receivables.
- Other metrics, such as analysis disaggregated by industry and region.

6.10.2 Seller-Level Risk Management

Risk Department gets involved in Seller-level risk management as a result of:

- referral by Operations/RM:
    - a deterioration in the risk profile of an individual facility (significant change in Seller, Buyer or receivables).
- concerns about one particular facility arising from the analysis at aggregate level.

6.11 Recovering Overdue Exposures

You may decide to adopt arrears recovery techniques to recover the Factor's exposure (repay the facility and then stop the factoring agreement with the Seller). This is achieved through one or more (combination) of the following approaches:

- Adopt enhanced, high-pressured recovery activities.
- Put pressure on directors at the Seller to resolve long-outstanding disputes.
- Agree payment schedules with Buyers.
- Reduce advance percentage on new receivables:
    - Staged reductions over a period of time (known as 'managing away' the facility).
- Pressure the Buyer with legal action.
- Advise personal guarantor of intent to call on the guarantee:
    - This will encourage the guarantor to influence the Seller to resolve any difficulties.
- Call on personal guarantee.
- Exercise recourse to the Seller.
- Take legal action against Buyer:
    - This is often the last course to take – legal action is expensive and takes a long time and the publicity may not be good for the Factor's reputation.
- Re-Finance – give notice to the Seller to find another Factor to take over the facility:
    - This can be a viable approach in a competitive factoring market.
- Recovery – collect or manage away the facility over time.
- Repayment from other assets – Factor draws on any other security the Factor has rights over, such as selling Seller's inventory (but beware much lower values if trying to quickly sell specialist, hi-tech or fashionable items).

Where you have recourse to the Seller and the risk situation is because of declining financial performance of the Seller the following can be considered:

- Rehabilitation – Factor works with the Seller to turn the business round.
- Reinvestment – encourage Seller to find source of new money to be invested.
- Restructure – Seller is voluntarily liquidated and the Factor obtains due proceeds from the bankruptcy process.

7 Fraud

Fraud is a risk in any financial facility, including factoring.

7.1 Factoring fraudster profile

A factoring fraudster is likely to be someone with a dominant personality and who has significant level of control over the accounts, operations or any part of their business that deals with Buyers and/or receivables. They are often characterized as believable, likable and appear to be your "best" friend.

7.2 Circumstantial fraud

Circumstantial fraud is when a certain situation arises, for example a tax bill needs paying or a significant Buyer is late in paying and the Seller needs to pay his staff at the end of the week. The fraudster gets finance from the factor with the intention of correcting the situation at a later date.

7.2.1 The Fraud Triangle

Source: (Cressey, 1973)

7.2.2 Motive

Refer figure 5, below. Starting at the dark blue section, the Seller may be under extreme personal or business pressure and his own financial success may be linked to the company's performance. Or the motive might be very short-term: he needs to pay taxes by the end of this week and simply does not have the money to do it.

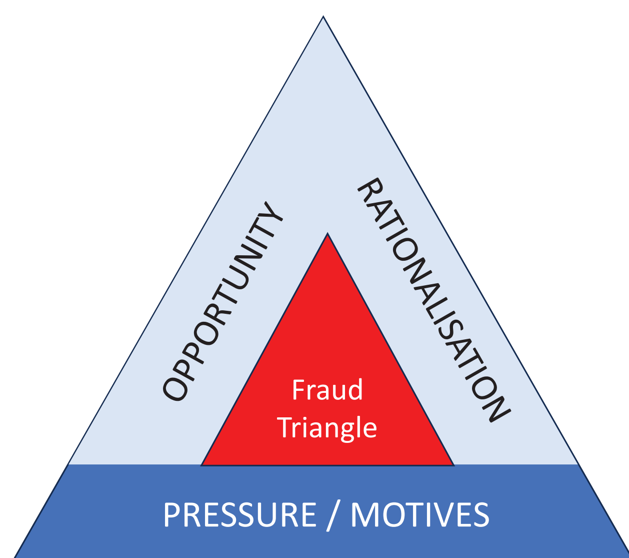


Figure 5 The Fraud Triangle

7.2.3 Opportunity

The Seller sees an opportunity to exploit the factoring facility. For example, he has learnt that the Factor does not verify every invoice that's transferred and therefore takes a chance that a number of small invoices (but adding up to a significant amount) will go through the system and be financed.

7.2.4 Rationalization

The Seller justifies to himself what he is intending to do, saying "it's only to allow me to survive a short-term problem"; "later I'll cancel the invoices with credit memos or somehow pay them myself"; "the Factor won't lose money in the long run".

7.3 Premeditated fraud

Premeditated fraud is where the intention from the very start is to defraud the Factor. At Prospect stage, the fraudster presents to the Factor a very believable business, with a list of Buyers and existing receivables. Some of it, or in the worst cases *all* of it, is fictional. The

Factor advances finance to the Seller but finds out reasonably quickly (probably in the first 4 to 6 weeks) that there will be a significant shortfall in recoveries. The Seller disappears, never to be seen again.

In the above there is no genuine sales transaction behind the receivables. If the Factor does not have effective checking processes or does not follow his procedures completely (which can happen in a competitive factoring market when the Factor is under pressure to add new business), the Factor can lose money very quickly.

7.4 FACTORING FRAUD RISKS

Risk	Detail	Steps to minimise the possibility of Fraud
Manipulation of Invoices	No sales transaction behind the invoice ("fake" or "fresh air" invoice).	• Before financing: o obtain full supporting documents for the transaction. o Verify the invoice with the Buyer.
	Same invoice transferred to two different Factors.	• Check Collateral Registry for any existing assignment of the receivables to another Factor (if such a register of security interests exists in your market). • Speak to the Buyer to verify the invoice and confirm Buyer will pay you.
	Seller transfers invoice to the Factor before delivery.	• Before financing, obtain full supporting documents for the transaction including proof of delivery signed by the Buyer.
	Transfer of losses to new contracts. A credit memo which should be applied to Invoice A is applied to the next invoice, B, (which may not be factored).	• Factor speaks to the Buyer to understand why he is making a payment less than the full value of Invoice A.

	Seller raises an unrequested credit memo just before the recourse period, then raises an identical invoice (effectively re-ageing the receivable).	• Investigate reason for credit memos that are raised just before recourse period to see if valid or not. • Communicate with Buyer.
Manipulation of Buyer Payments	Seller tells the Buyer to pay to his bank account instead of the Factor's.	• Factor needs good communication with the Buyer. • Factor must know or anticipate when a Buyer payment is planned and check its appearance in his bank account. • If payment does not appear in the Factor's bank account, speak to Buyer and Seller.
	Seller receives payment from Buyer and delays transferring it to the Factor.	• As above. • The factoring agreement should include the Seller's obligation to transfer any Buyer payments they receive immediately to the Factor. Often at the start of a new factoring facility, Buyer payments can go to the Seller. It can take time for the Buyer to change their payments system to show the Factor's bank account.
	Seller intercepts a Buyer payment and allocates it to another Buyer account to clear a fake invoice (or a real invoice which is about to recourse).	• Factor must have good communication with the Buyer to know what is being paid and when.
	Seller and (genuine) Buyer collude: • No genuine sales transaction but Buyer "verifies" the receivables. • A genuine transaction but the invoice is deliberately inflated	If the Buyer gives answers during the verification that are too perfect, be suspicious. If this happens with any frequency, the Factor must investigate reason for credit notes.

	in value and is settled by a smaller payment and credit memo.	
	Seller sets up fake Buyers.	Check each Buyer before financing. There have been examples of the Seller providing the Buyer's phone number to the Factor but when the Factor calls it goes to one of the Seller's family members who, of course, give all the "right" answers. Checks should be done using third party information sources.

Field audits should be able to uncover most frauds, but where your audits are, say, every six months, you need to be vigilant against fraud in the interim period between audits.

A common theme above, and relevant for Notification Factoring, is the fact that the Factor must have good, effective communication with the Buyer, both before and after providing finance. This is an absolute necessity in factoring because the Factor's first source of repayment of a facility is the Buyer's payment.

8 APPENDICES

8.1 APPENDIX I: BUYER ACKNOWLEDGEMENT

EXAMPLE BUYER ACKNOWLEDGEMENT

We…………………..………..(“the Buyer”) have been notified by ……………………..……………..(“the Seller”), and we acknowledge and confirm our consent to the transfer of claims as per the Factoring Agreement dated…………………between the Seller and [name of Factor]. We acknowledge that the Factor becomes the new creditor.

The claims relate to the following invoices which were transferred (assigned) by the Seller to the Factor on ……………………. [date]:

No.	Invoice number, goods description, order number, etc.	Invoice value (claimed amount in MNT	Maturity Date
1			
2			
3			
4			
5			
	Total claims amount		

We hereby irrevocably declare and confirm that:

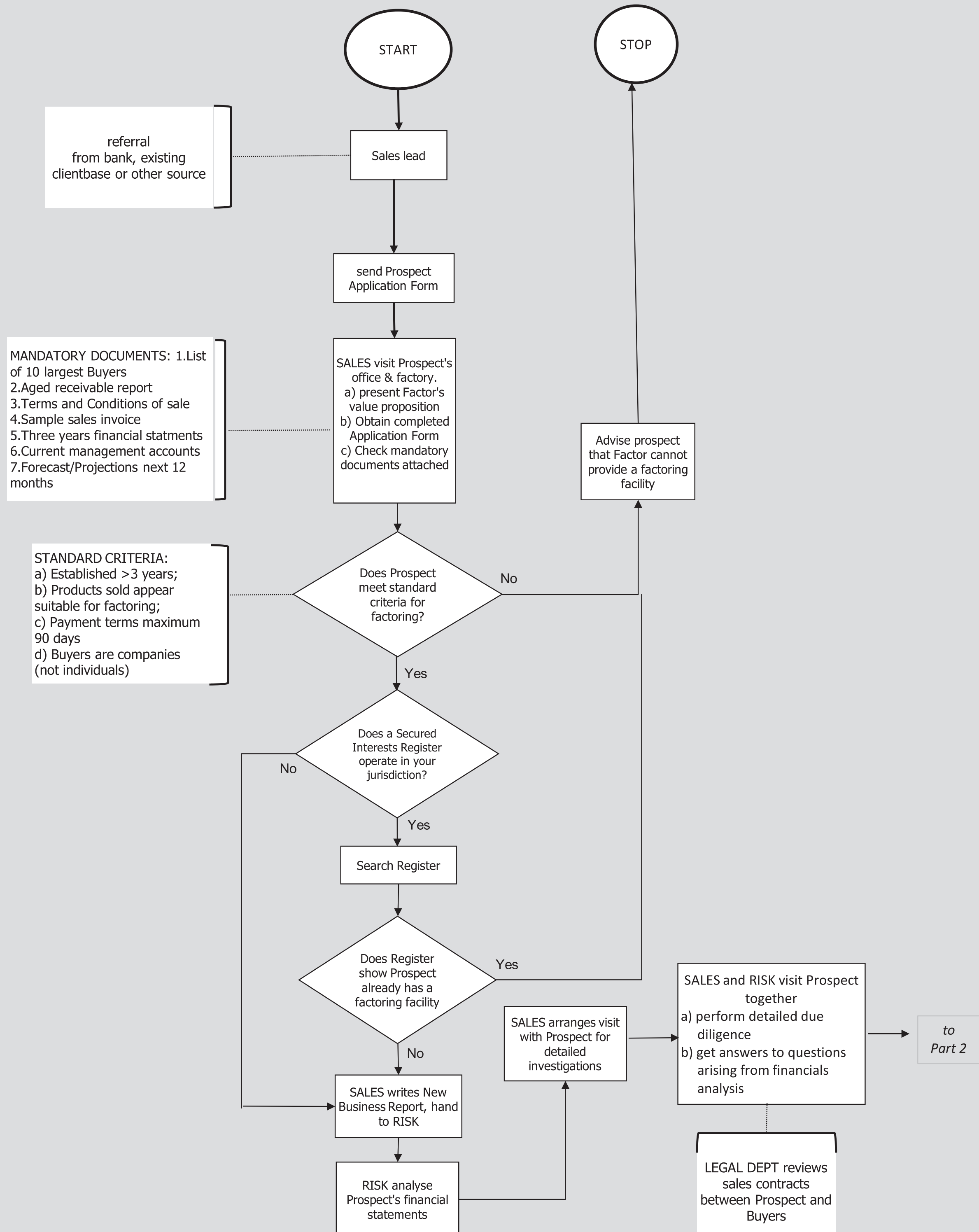
- We are aware of the intention of the Seller to transfer the above claims to the Factor and we consent to this transfer (assignment).
- The Seller’s claims listed above are not disputed from our side, they are existing claims and are valid.
- There is no contract or agreement between us as Buyer and Seller that would render impossible or prohibit transfer and collection of the above claims.
- We have no objections, disputes or counter-claims from our relationship with the Seller and we shall not raise any towards the Factor.
- We have not transferred any claims to the Seller that we received from third parties.
- We respect the transfer of claims and shall settle them in the total amount of …………..………MNT within the maturity period by payment to the Factor’s bank account no. …………………………………

Name and role: …………………………………………….. (print).
…………………………………….. (signature)

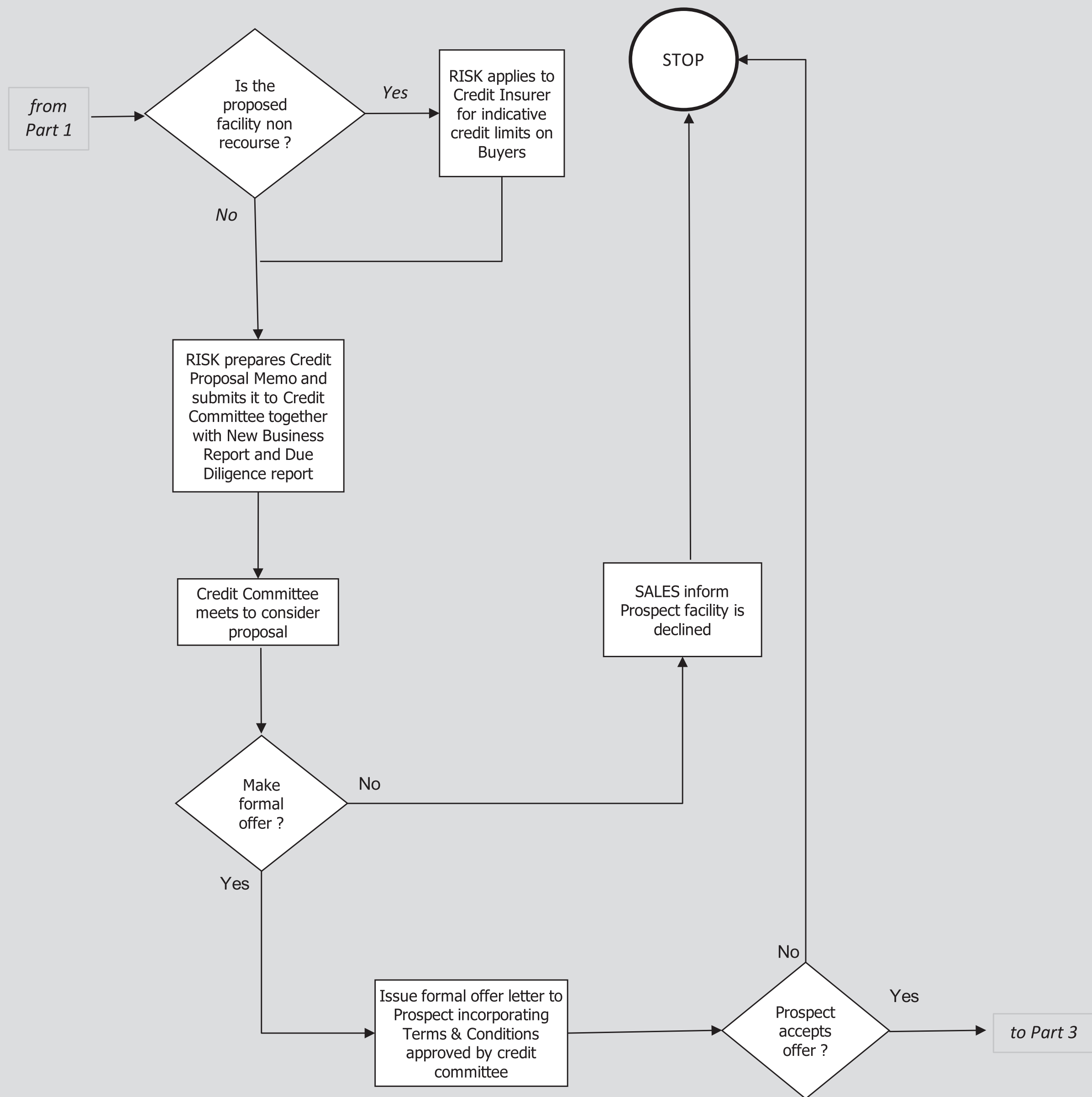
Seal and signature of the authorised person of the Buyer.

8.2 APPENDIX II: EXAMPLE WORKFLOW – PROSPECT STAGE

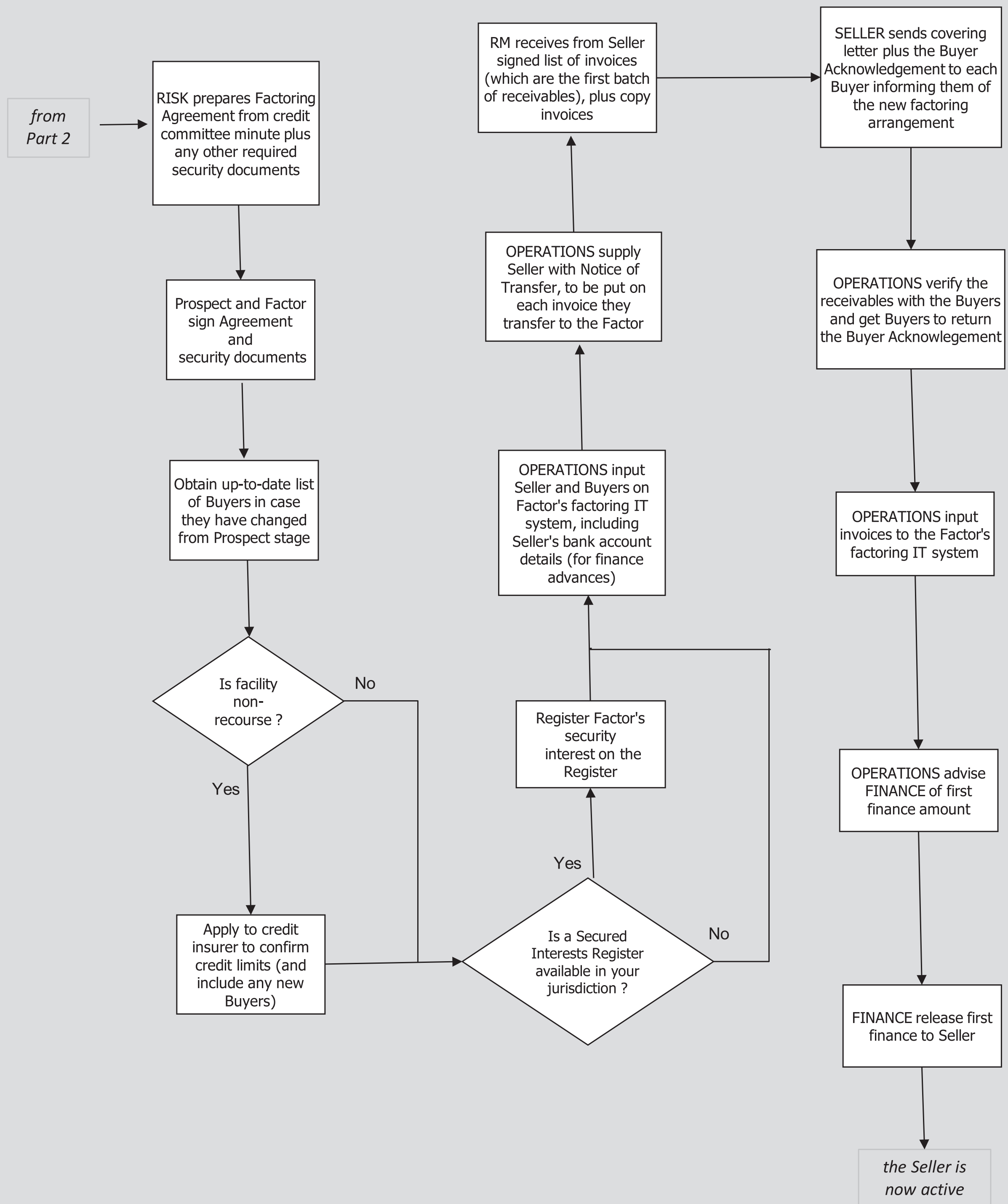
Prospect stage (Part 1)



Prospect stage (Part 2)



 Prospect stage (part 3)



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8.3 Appendix III: Notice of Transfer (or Assignment) of Receivables

This is a generic example of the notice that goes on each of the Seller's invoices that are transferred to the Factor. The key elements are:

- It tells the Buyer that the Seller is using factoring.
- Existing and future receivables are transferred to [name of Factor].
- Payment must be made to [name of Factor].
- Details of Factor's bank account.
- The arrangement remains in place until the Factor tells the Buyer otherwise.

You are recommended to take legal advice on the correct and most effective wording and format for use in your jurisdiction.

NOTIFICATION OF TRANSFER (OR ASSIGNMENT) OF RECEIVABLES

We have retained the services of XYZ Factors to optimize our financial management. Through their factoring facility, XYZ has purchased and we have transferred (assigned) to them all of our right, title and interest in all current and future receivables from your company.

We request that all payments be made to:

XYZ Factors ("XYZ")
1 Main Street
Capital City
Tel 012-34567

Bank account 98765432

This notice of transfer (assignment) of receivables and the payment instructions will remain in full force and effect until XYZ advises you otherwise in writing. Please note that their receipt of payment is the only valid discharge of the receivables and that XYZ's interest has been registered on the Collateral Registry.

8.4 APPENDIX IV: BUSINESS SECTOR CHARACTERISTICS THAT MAY AFFECT QUALITY OF THE RECEIVABLE

The following industry characteristics, which may or may not apply in individual cases, may affect a Factor's desire to offer factoring to a Seller:

Business sector	Characteristics
Advertising	• Campaign media advertising can feature stage invoicing / stage payments plus other contractual obligations and discounts. • Television, media or public relations can feature high value contracts with deposits and stage payments.
Builders Merchants (businesses selling trade goods to small builders)	• Low average invoice values can mean high workload for the Factor and therefore needs to be reflected in the Factor's fee. • Sale or return (either stated in the contract or simply habitual practice). • Cash sales as well as credit sales. • Sales to private individuals (not factorable).
Chemicals	• Can feature retention of title. • Safety-related obligations (transport, storage).
Textiles and garments	• Seasonal trade. • Can be poor quality at the lower-end of the industry resulting in disputes, stock returns and/or credit memos. • Buyers may be sole-trader boutiques (generally higher risk). • Sale-or-return common in this sector. • Samples may be invoiced but Buyer will refuse to pay for them. • Cash sales as well as credit sales. • Subcontracted tasks may bring quality issues or late completion of work (e.g., cutting and stitching). • Fashion items can lead to redundant inventory.
Computers	• Hardware and peripherals may be very suitable for factoring, but this can be a high-volume/low margin business. • The sale may involve leasing (double financing if also factored). • Software and/or maintenance contracts relating to the hardware can compromise the Receivable: o Lengthy maintenance contracts. o Project based leading to stage invoices.

Construction	• Lengthy projects. • Retentions. • Deposits and stage payments. • Buyer may have tax obligation for hired labour, reducing its payment to the Factor by the tax due. • Self-billing from large construction Buyers. Self-bill amount may differ from Seller's invoice.
White (Electrical) Goods	• Sale or return. • There may be cash-on-delivery terms. • Hi-tech goods may be difficult to sell if this is only route for factor to exit (when Seller fails). • Deposits. • Installation.
Electronics	• Free issue materials (property of Buyer) can feature in manufacture. Buyer may offset value of the materials when settling the receivables. • Bill-and-hold. Seller has invoiced the Buyer but stores the goods in his own warehouse. Buyer offsets cost of transporting the goods in event of Seller failure. • Subcontracted work can mean quality issues. • Project-based design work.
Engineering	• Free issue materials can feature. See comment above. • Tooling – Seller's manufacturing process involves tools such as moulds supplied by and owned by the Buyer, leading to potential offset • Bill-and-hold. See comment above. • Precision engineering goods difficult to sell if this is Factor's recovery strategy.
Logistics	• Contra (reciprocal) trading – trucks delivering to a Buyer will transport something in reverse, leading to potential offset. • Disputes over quantities delivered. • Warehouse storage - Buyer may apply offset if he cannot access his goods (in the case where Seller fails).
Furniture	• Sale-or-return can feature. • 6-week lead time before delivery - Seller may invoice in advance. • Quality issues - Goods damaged during delivery. • Free issue materials. • Discounts claimed by large furniture retailer.

Giftware	• Seasonal trade. • Novelty goods can very quickly go out of fashion. • Sale-or-return • Poor quality/small retail Buyers. • Samples invoiced by Seller but Buyer refuses to pay. • Cash sales as well as credit sales.
Paper	• Retention of title common. • Bill-and-hold. • Deposits. • Contra trading.

Plastics	• Design project-based.
	• Tools provided by Buyer can lead to offset.
	• Contras can feature:
	  o Buyer supplies plastic granules to Seller.
	  o Seller buys scrap from Buyer for recycling into the manufacturing process.

Printing	• Known industry for quality issues. • Can feature extended payment terms.
Soft Food and Drinks	• Hygiene regulations failures. • Goods past their sell-by dates. • Getting proof of delivery can be a problem when deliveries are to hotels and restaurants (delivery is too early in the day for someone to sign or person on site not authorized to sign for delivery). • If Buyer only operates in the evening, difficult to contact for collection purposes. • Bonded warehouses may involve Buyers paying taxes to release the goods.
Staff hire / Recruitment	• Generally good for factoring with reliable proof of delivery - signed timesheets for work completed. • Withholding tax - authorities may require Buyer to reserve part of the invoice value for submission to tax authorities. • Supply of permanent staff can lead to credit memos if operative fails in standard of work.
Steel Traders	• Contra trading. • Direct deliveries from Seller's suppliers to end Buyer. • Seller's supplier applies retention of title which can apply all the way through to the Buyer.
Timber	• Agency arrangement ("Del credere") where the Seller is not the principal in the contract but acts as agent and

	does not have ownership of the timber he "sells" to the Buyer. • Seller's supplier's retention of title may apply especially if importing timber from overseas.
Waste Disposal	• Licenses required for disposing of certain types of waste. • Invoicing often based on weighbridge calculations – can result in disputes.

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