FINANCIAL SERVICES

UNIT-IV AND V

**Venture capital**

(VC) is a form of private equity financing that is provided by venture capital firms or funds to startups, early-stage, and emerging companies that have been deemed to have high growth potential or which have demonstrated high growth (in terms of number of employees, annual revenue, or both). Venture capital firms or funds invest in these early-stage companies in exchange for equity, or an ownership stake, in those companies. Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful. Because startups face high uncertainty,[1] VC investments have high rates of failure. The start-ups are usually based on an innovative technology or business model and they are usually from the high technology industries, such as information technology (IT), clean technology or biotechnology.

A financing diagram illustrating how start-up companies are typically financed. First, the new firm seeks out "seed capital" and funding from "angel investors" and accelerators. Then, if the firm can survive through the "valley of death"–the period where the firm is trying to develop on a "shoestring" budget–the firm can seek venture capital financing.

The typical venture capital investment occurs after an initial "seed funding" round. The first round of institutional venture capital to fund growth is called the Series A round. Venture capitalists provide this financing in the interest of generating a return through an eventual "exit" event, such as the company selling shares to the public for the first time in an initial public offering (IPO) or doing a merger and acquisition (also known as a "trade sale") of the company. Alternatively, an exit may come about via the private equity secondary market.

In addition to angel investing, equity crowdfunding and other seed funding options, venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and early-stage companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the companies' ownership (and consequently value). Start-ups like Uber, Airbnb, Flipkart, Xiaomi & Didi Chuxing are highly valued startups, commonly known as unicorns, where venture capitalists contribute more than financing to these early-stage firms; they also often provide strategic advice to the firm's executives on its business model and marketing strategies.

Venture capital is also a way in which the private and public sectors can construct an institution that systematically creates business networks for the new firms and industries so that they can progress and develop. This institution helps identify promising new firms and provide them with finance, technical expertise, mentoring, talent acquisition, strategic partnership, marketing "know-how", and business models. Once integrated into the business network, these firms are more likely to succeed, as they become "nodes" in the search networks for designing and building products in their domain.[2] However, venture capitalists' decisions are often biased, exhibiting for instance overconfidence and illusion of control, much like entrepreneurial decisions in general.

[Types of Venture Capital Funding](https://www.mycapital.com/resources/articles/types-of-venture-capital-funding/)

The first professional investor to a deal at the start-up stage is referred to as the Series A investor.  This investment is followed by middle and later stage funding – the Series B, C, and D rounds.  The final rounds include mezzanine, late stage and pre-IPO funding.  A VC may specialize in provide just one of these series of funding, or may offer funding for all stages of the business life cycle.  It’s important to know the preferences of the VC you’re approaching, and to clearly articulate what type of funding you’re seeking:

**Seed Capital**.  If you’re just starting out and have no product or organized company yet, you would be seeking seed capital.  Few VCs fund at this stage and the amount invested would probably be small.  Investment capital may be used to create a sample product, fund market research, or cover administrative set-up costs.

**Startup Capital.**At this stage, your company would have a sample product available with at least one principal working full-time.  Funding at this stage is also rare.  It tends to cover recruitment of other key management, additional market research, and finalizing of the product or service for introduction to the marketplace.

**Early Stage Capital**.  Two to three years into your venture, you’ve gotten your company off the ground, a management team is in place, and sales are increasing.   At this stage, VC funding could help you increase sales to the break-even point, improve your productivity, or increase your company’s efficiency.

**Expansion Capital**.  Your company is well established, and now you are looking to a VC to help take your business to the next level of growth.  Funding at this stage may help you enter new markets or increase your marketing efforts.  You should seek out VCs that specialize in later stage investing.

**Late Stage Capital**.  At this stage, your company has achieved impressive sales and revenue and you have a second level of management in place.  You may be looking for funds to increase capacity, ramp up marketing, or increase working capital.

**Bridge Financing**: You may also be looking for a partner to help you find a merger or acquisition opportunity, or attract public financing through a stock offering.  There are VCs that focus on this end of the business spectrum, specializing in initial public offerings (IPOs), buyouts, or recapitalizations.  If you are planning an IPO, a VC may also assist with mezzanine or bridge financing – short-term financing that allows you to pay for the costs associated with going public.

A key factor for the VC will be risk versus return.  The earlier a VC invests, the greater are the inherent risks and the longer is the time period until the VC’s exit.  It follows that the VC will expect a higher return for investing at this early stage, typically a 10 times multiple return in four to seven years.  A later stage VC may be seeking a two to four times multiple return within two years.

**Advantages**

* Business expertise. Aside from the financial backing, obtaining venture capital financing can provide a start-up or young business with a valuable source of guidance and consultation. This can help with a variety of business decisions, including financial management and human resource management. Making better decisions in these key areas can be vitally important as your business grows.
* Additional resources. In a number of critical areas, including legal, tax and personnel matters, a VC firm can provide active support, all the more important at a key stage in the growth of a young company. Faster growth and greater success are two potential key benefits.
* Connections. Venture capitalists are typically well connected in the business community. Tapping into these connections could have tremendous benefits.

**Disadvantages**

* Loss of control. The drawbacks associated with equity financing in general can be compounded with venture capital financing. You could think of it as equity financing on steroids. With a large injection of cash and professional – and possibly aggressive – investors, it is likely that your VC partners will want to be involved. The size of their stake could determine how much say they have in shaping your company’s direction.
* Minority ownership status. Depending on the size of the VC firm’s stake in your company, which could be more than 50%, you could lose management control. Essentially, you could be giving up ownership of your own business.

Bottom line: Would you rather own your own business or partner in a larger, potentially more successful one?

**Deciding Factor**

* Are you open to more active input from a venture capital firm?
* Do you appreciate the additional expertise and resources a VC firm could provide?
* Is loss of ownership and control an issue for you?
* Could you gain through a VC firm’s business connections?
* If you lack experience and could appreciate the additional support, a VC arrangement might work for you.

# 6 Important Factors Venture Capitalists Consider Before Investing

## 1. Character of the business partners

The people behind an idea or company and, more importantly, [their character](https://www.entrepreneur.com/article/277617) is extremely important. You could have the best idea in the world, but it might never get off the ground with the wrong team in place.

“Their reliability, honesty, potential for a long-term relationship and work ethic all come into play. A team who understands their roles and performs them with love and enthusiasm is very hard to beat. I have to feel completely confident in the abilities as well as the character of the team before investing,” says Başel.

## 2. Capacity of the business partners

You can’t just fill startup roles for the sake of creating a team and launching. You need to make sure each person is highly qualified and possesses the ability to take the business to the next level. For example, a CFO with limited financial experience is a disaster waiting to happen, while a CMO with limited marketing experience is a severe handicap.

“There has to be a capable team with potential to grow the business and to carry it to high levels of success,” explains Başel. Experience and past track records play a major role in providing a little more confidence. Building [the right founding team](https://www.entrepreneur.com/article/253596) greatly increases the odds of securing VC money.

## 3. Innovative idea

Every new startup is  something, and it’s played out.

With less than 1 percent of all U.S. companies ever receiving VC money, you need to stand out, and the way to do that is by having something truly innovative and unique. You are only going to attract initial interest if your idea is something that the VC hasn’t been pitched several times already.

Başel elaborates, “It needs to be new and something that no one has ever tried before, or succeeded at before. Something innovative with extensive research and development will pique my interest enough for me to at least look at the pitch.”

## 4. Communal benefit

Startups come and go, and while nobody has an exact percentage, most people put the startup failure rate between 80 and 90 percent. The few startups that experience massive success all solve a problem.

Uber made commuting much easier. Snapchat made communication easier. Airbnb made travel easier. You get the point.

“I like startups that bring value to the community and to humanity in general. Do they solve a large-scale problem? Do they provide a benefit that a large percent of the population will desire to utilize? If the answer to those questions is yes, then they have a much greater chance of attracting interest,” offers Başel.

## 5. Long-term sustainability

“It has to be something with longevity to make it worthwhile from an investor standpoint. A short-term idea might still be viable and profitable, but not typically from a VC point of view,” suggests Başel.

Venture capitalists deploy millions of dollars, wanting [multiple times return on that investment](https://www.entrepreneur.com/article/248377). That is why VCs focus heavily on the long-term sustainability of an idea. If they don't believe the shelf life is large enough, they simply won't invest.

## 6. Financial outlook

VCs invest to make money. There is no other reason. It’s a business.

Başel is no different from other VCs, stating, “The last thing I look at is the financial outlook of the business, determining when it will start becoming profitable.” The deal needs to make financial sense and not tie up money too long. The goal is to recoup the initial investment and re-invest in another project.

Not every opportunity is going to produce overnight returns, and the risk versus the reward is always taken into consideration. While every deal is different, profit potential and the probability of a return on the initial investment is always analyzed heavily.

Venture Capital Investments In India: Issues And Challenges

I.Introduction

The volume of venture capital investments in India has been increasing steadily. According to the Economic Times (July 2, 2014), the 121 investment deals in early-stage companies and start-ups in the first half of 2014constituted a 40% increase in the number of such deals compared with the same period in 2013.The transaction value of these 121 deals was $605 million (₹36.3 billion)—a 66%increase from the same period in the previous year.Thissurge in early-stage investments has been led by an increased appetite for investments by venture capitalists (“VCs”) in consumer technology (with e-commerce being by far the favorite), healthcare, technology and education.Thestrong appetite for investing in VCs has been hard to satisfy—and competition among VCs for investment opportunities remains high-in part because of a paucity of good-quality deals. This has caused VCs to takemore time to become comfortable with value creation potential and conduct more comprehensive due diligence than before.

The goal of this article is to provide a brief overview of some of the legal and regulatory challenges that currently face VCs in India as they invest in Indian portfolio companies. The article will describethe various stages of the investment process and the key challenges VCs encounter when investing in India.

II.Entry and the Investment Phase

A.Regulatory Valuation Requirements

India does not have full capital account convertibility. Instead, the Indian government imposes extensive foreign exchange control regulations. These include restrictions on pricing for the issue ofshares (including compulsorily convertible preference shares or debentures) by Indian companies to non-residents and transfers of shares between Indian residents and non-residents. Both the issue of shares and the transfer of shares between residents and non-residents, or vice versa, are subject to a floor price, or cap (depending on the counterparties) at the fair value of the shares, determined in accordance with internationally accepted valuation methods certified by a chartered or certified public accountant or a registered merchant banker. These valuation requirements are prescriptive and the valuation certified by such a valuer is typically not examined in detail by the regulators. While these measures are intended to ensure that transactions with non-residents and Indian parties take place at a fair value, the requirements can become contentious, especially at the time of exits.

The Companies Act, 2013 (the “Act”) includes a similar provision, which subjects any preferential allotment by an Indian company to a floor valuation certified by a registered valuer. While these provisions of the Act are not yet in force, the valuation should be certified by a chartered accountant with at least ten years of experience or by a registered merchant banker.

B.Running the Preferential Allotment Process

Currently, company law in India is undergoing a complete change following the enactment of the Companies Act, 2013, which replaces the earlier Companies Act, 1956. The 2013 Act imposes additional requirements for allocating a preferential allotment to a non-resident. This requirement is a clear departure from the earlier regime. Under the Act, Indian companies can make a preferential allotment only after obtaining the approval of 75% of the shareholders present and voting at a shareholder meeting. The Act requires that an offer document that needs to conform to a prescribed format has to be issued to the allottees. This document forms the basis for the allotmentand can be issued to the allottee only after the passage of the shareholders’ resolution mentioned above. This requirement is a complete departure from the earlier regime because: (1) the basis for the allotment was the contractual agreements between the company and the investor; and (2) private companies did not require approval of the shareholders for preferential allotment; approval of the board of directors was sufficient. As a result,co-ordinating executions becomesmore challenging with these additional requirements becausethe corporate approvals from the investee company must be obtained prior to the execution of the definitive documents and there is additionalpaperwork(i.e., the offer document). In a private company, planned coordination can ensure that all of these actions take place sequentially on the date of execution itself, thereby placing increased emphasis on planning out the closing date actions. The coordination required by these new procedures makes the execution process cumbersome.

Given certain ambiguity in the purpose or intent of relevant provisions of the Act, considerable debate exists regarding whether these provisions apply to negotiated investment transactions (such as bilateral investments or co-investments) or whether they areapply to preferential allotments made to multiple unrelated parties (i.e. non co-investments.

C.Finalizing the Capital Structure

For obvious reasons, finalizing the capital structure is another critical aspect of pre-investment. Capital structure changes are attributable to two factors:(i) investment in compulsorily convertible preference shares by the VCs and(ii) employee stock options (“ESOPs”) issued by the target company. While both these situations are well documented, the consequent impact needs to be factored in and handled carefully while finalizing fully diluted ownership of the VCs. While VCs recognize the importance of ESOPs for attracting competitive talent at lower salaries, VCs are reluctant to dilute their equity stake. Consequently, pre-investment discussions on the size of the ESOP pool tend to be long-drawn. The situation gets exacerbated from the portfolio company’s perspective as the vintage of the portfolio company increases because the pool typically reduces on a yearly basis as new ESOPsvest.

The outlook on the ESOPs and the VCs’ requirement to maintain shareholding may be at cross-purposes requiring careful handling, particularly when a VC exits. Consequently, VCs prefer ESOPs which do not result in accelerated vesting at the time of an exit or sale of the portfolio companies. As a result, ESOPs achieve the objective of compensation and with these clauses, the VCs’ stake does not get diluted upon an exit. However, these discussions tend to be difficult, nuanced, and emotive because the promoters (and the employees) of the portfolio company would like to cash out in a sale transaction at the least. With increasing awareness among employees of this issue, such an approach may be difficult to follow because the employees are likely to demand ESOPs with accelerated vesting at the time of a VC’s exit or a sale transaction (at the very least).

D. Voting Rights

Another fairly common problem regarding the capital structure is linked to voting rights on shares. The Act prohibits holders of compulsorily convertible preference shares from exercising voting rights on these preference shares unless such matters directly affect the rights of the preference shareholders. This prohibition marks a departure from the earlier version of the Act that permitted these arrangements in the context of private companies. Of course, if the company does not pay a preferred dividend on the preference shares for a period of two years or more, then the preference shares will be entitled to voting rights on all matters being decided at a shareholder meeting.

E. Non-compete restrictionson Promoters

Typically, investment transactions imposestrict non-compete and non-solicit obligations on the promoters (i.e. controlling shareholders). Given that VCs will be making investments based on the commitment of the promoter(s) to the target company, the VCs would naturally want the exclusive, ongoing focus of the promoters to be the business of the company. India’s cultural and traditional background of extended families and relations encourages these obligations to be broad and wide (i.e. direct and indirect obligations of the promoters). However, enforcement of these obligations in “indirect” situations, such as, businesses promoted by relatives, remains a massive challenge given the difficulty of proving “indirect” competition by Indian promoters. Consequently, the legal challenge consists of articulatingthese obligations in broad terms to cover indirect competition and taking adequate steps, which impose strong disincentives for breaches, to ensure that the promoters comply with their obligations.

F.Director Liability

Indian law has always recognized the fiduciary duty owed by the directors to a company. However, the Act has changed the role and responsibility of directors by encouraging their active participation in the company’s affairs and increasing director liability aimed at curbing instances of corporate malpractice in India, such as falsification ormanipulation of accounts by promoters and diversion of funds.The Act has extended the fiduciary duty concept and codified the directors’ duty to act in the best interests of not only the company and its shareholders, but also those of the community at large. Even though this list may appear innocuous, it is sweeping and encompasses a diverse set of interests, which the directors may find difficult to balance. Further, there is insufficient guidance on how a director is expected to discharge these duties.This increase in the duties and liabilities of the directors is, however, not accompanied by a concomitant enhancement of incentives to act as a director, thereby igniting a lively debate. Moreover, while the enhanced penalties provided by the act could motivate directors to participate more actively in a company’s affairs, the specter of personal liability can effectively discourage VCs from nominating directors on the board of directors of portfolio companies.

The Act limits the liability of independent and non-executive directors to (i) those acts and omissions that have occurred with the knowledge of these directors, where such knowledge can be established through evaluation of the processes followed by the board of directors;and (ii) a director’s consent or connivance with respect to the proposed corporate action,or failure to act diligently. The Act continues to recognize the right of the directors to record their dissent, which should be diligently recorded to establish a legal defense for mitigating any potential liability. The Act seems to permit a company from indemnifying its directors from any liability incurred on account of negligence, default, misfeasance, or breach of duty or trust, which is a departure from Act’s predecessor. This position seems to be a tacit acknowledgement for permitting directors and officers insurance policies to protect against liability. However, these may not obviate the concerns of VCs when they appoint directors on the board of portfolio companies given reputational and other aspects involved in such sticky situations.

In addition to the increased obligations of directors under the Act, various Indian statutes (such as labor, welfare, and environmental legislation) impose personal liability on directors for infractions by the company. While some of these statutes provide similar exclusions for the liability of directors who can demonstrate that they werenot involved in the breaches by the company, the looming threat of director liability creates significant obstacles for institutional VCs, especially given that these investments typically occur in the early stages of investment.

As a fall-out of these positions in Indian law and with a view to managing the risk of liability of nominee directors, there is an increasing trend for foreign investors to seek the right of appointing directors to the board of directors of portfolio companies as well as non-voting observer rights for attending board meetings. In practice, the VCs seem increasingly content to allow their representatives to attend board meetings as observers and not exercise their rights to appoint nominees on the board of directors.

G. Veto Rights and Control

One of the most critical ways VCs protect their rights is through their ability to veto decisions undertaken by their portfolio companies. The justification for these veto rights is investor protection, i.e., the ability of VCs to determine whether portfolio companies may undertake certain actions that would have an impact on the value of the company. Unlike growth capital or late stage investors, VCs typically obtain veto rights on a few significant items, such as changes in capital structure, approval of the business plan or budget, and appointment or replacement of key managerial personnel.

Section 2(27) of the Act defines “control” inclusively as the right to, directly or indirectly, “control the management or policy decisions” exercisable by a person, either individually or in concert with the other persons, by virtue of shareholding, management rights or shareholders’ agreements, voting arrangements, or in any other manner.The Act imports this definition verbatim from the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the “Takeover Code”), although the context is arguably different. Under the Takeover Code thatis applicable to Indian listed companies (i.e., whose equity shares are listed), a change in control triggers an open offer to the shareholders to acquire at least 26% of the target company. Under the Act, acquiring “control” could make such a person a “promoter” (another new concept under the Act), the identities of whom must be disclosed annually in filings submitted toIndia’s Ministry of Corporate Affairs.

The Takeover Code constructs veto rights and control to mean that any investor with these rights acquires control. If the same interpretation is adopted, VCs whoacquire such veto rights would be adjudged to be in control of the target company, necessitatingtheir disclosures as “promoters” in India on anannual basis. This could potentially trigger consolidation requirements overseas for VCs. Indian lawyers are still considering this issue, and a final answer remains elusive.

III. Exit Related Issues

A.Enforceability of Put and Call Options

The status of put and call options involving residents and non-residents (including VCs) under Indian regulations has been ambiguous for some time. While, under Indian securities law, doubts existed regarding the enforceability of such options on the securities of public companies (including unlisted public companies), the exchange control implications of such arrangements were likewise uncertain. To draw an important distinction, although Indian securities law permitted put and call options for securities of private Indian companies, issues in relation the pricing of these put and call options remained because of foreign exchange control regulations.

Indian regulators have clarified these positions over the past year. Put and call options on securities of public companies in India are now enforceable subject to a holding period of at least one year, and Indian exchange control regulations currently regulate pricing. Interestingly, these changes are prospective and do not apply to earlier investments.

Indian exchange control regulations prohibit fixed price put and call options on securities of Indian companies. However, the regulations permit put and call options based on fair market value at the time of exitat a price not exceeding the price computed under any internationally accepted pricing methodology. In essence, the regulations prohibit guaranteed or assured exit pricingbecause the Reserve Bank of India views such options as guarantees back-stopping debt instruments. While this approach may not be a significant departure from the previous one (being that investors must comply with pricing norms at the time of exit following an option exercise), the most significant question elicited by this change is whether the transaction documents can even set out an internal rate of return based option price.

While some embrace the changes forcreating certainty regarding legal enforcement, others bemoan the lack of contractual flexibility to provide exits to investors in a market where exits are growing increasingly tougher.

B. Buy-back Related Issues

Another typical exit mode for VC investments consists of buying back shares of the portfolio company. Share buybacks in India are heavily regulated and subject to a whole range of restrictions from a cap of number of equity shares that can be brought back (25% of the equity shares) to the quantum of funds that can be utilized for a buy-back (25% of the paid-up share capital and free reserves of the portfolio company) and other considerations that render buying back in India cumbersome and ineffective. An added complication is that Indian regulators view buy-backs as transfers of shares from non-resident to resident Indians and therefore apply the relevant pricing regulations.

C. Capital Markets Related Issues

Preparing for an initial public offering (“IPO”) in India is atime-consuming and painstaking exerciseinvolving investors, the company, promoters, employees, merchant bankers, and lawyers. In most cases, an IPO takes upwards of seven to eight months from start to finish, assuming steady market conditions (a very big ask indeed). However, other complications have emerged recently.For instance, in the Just Dial IPO the Securities and Exchange Board of India, India’s capital markets regulator insisted on a “safety net” for retail investors, which was price protection for a period of sixty days. Under this requirement, Just Dial had to refund retail investors in case of a price fluctuation after this period. One of the reasons set out for this requirement was that the fact that the company was in a “new sector.” Given these sorts of additional requirements, capital market backed exits pose their own set of challenges for VCs and the company.

D. Currency Related Issues

Although not a legal or regulatory issue, the plunging value of the rupee has sucked out the potential profitability that most VCs expected. This inflation has caused has caused many exit deals to fall through because VCs are betting on a rally by the rupee or better performance by the portfolio company.

UNIT-V

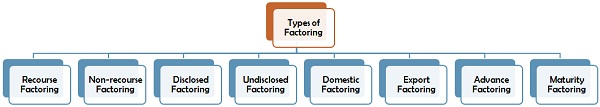
# Factoring

**Definition**: Factoring implies a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables, from a financial institution (factor). It is a financing technique, in which there is an **outright selling of trade debts by a firm to a third party, i.e. factor, at discounted prices**.

Factoring is a financial alternative, in financing and management of account receivables. It states the terms and conditions of the sale in the factoring agreement.

In finer terms factoring is a relationship between the factor and the client, in which the factor purchases the client’s account receivables and pay up to 80% (sometimes 90%) of the sum immediately, at the time of entering into the agreement. The factor pays the balance sum, i.e. 20% of the amount which includes finance cost and operating cost, to the client when the customer pays the obligation.

## Types of Factoring

[](https://businessjargons.com/wp-content/uploads/2017/06/types-of-factoring.jpg)

* **Recourse and Non-recourse Factoring**: In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor.

On the other hand, in non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

* **Disclosed and Undisclosed Factoring**: The factoring in which the factor’s name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.

Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

* **Domestic and Export Factoring**: When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.

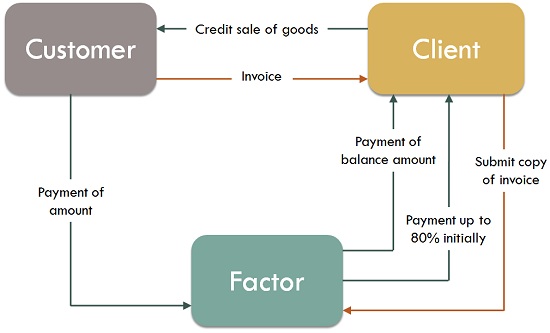
Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

* **Advance and Maturity Factoring**: In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

Based on the factoring type, the collection of the debt is performed by the factor or the client, as the case may be.

## Procedure

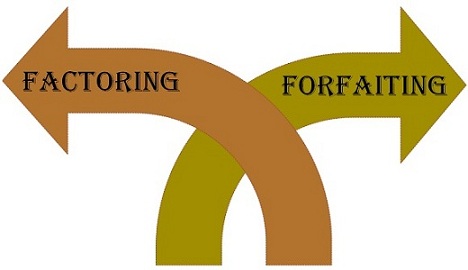
[](https://businessjargons.com/wp-content/uploads/2017/06/factoring.jpg)

*Process of Factoring*

1. Borrowing company or the client sells the book debts to the lending institution (factor).
2. Factor acquires the receivables and extend money against the receivables, after deducting and retaining the following sum, i.e. an adequate margin, factor’s commission and interest on advance
3. Collection from the customer is forwarded by the client to the factor and in this way, the advance is settled.
4. Other services are also provided by the factor which includes:
   * Finance
   * Collection of debts
   * Maintenance of debts
   * Protection of Credit Risk
   * Maintenance of debtors ledger
   * Debtors follow-up
   * Advisory services

The factor gets control over the client’s debtors, to whom the goods are sold on credit or credit is extended and also monitors the client’s sales ledger.

# Difference between Factoring and Forfaiting

[](https://keydifferences.com/wp-content/uploads/2016/01/factoring-vs-forfaiting.jpg)

Since the last few decades, **factoring** and**forfaiting** have gained immense importance, as one of the major sources of export financing. For a layman, these two terms are one and the same thing. Nevertheless, these two terms are different, in their nature, concept, and scope. Factoring is a financial affair which involves the sale of firm’s receivables to another firm or party known as a factor at discounted prices. On the other hand,

On the other hand, forfaiting simply means relinquishing the right. In this, the exporter renounces his/her right due at a future date, in exchange for instant cash payment, at an agreed discount, to the forfaiter.

The first and foremost distinguishing point amidst these two terms is that factoring can be with or without recourse, but forfaiting is always without recourse. Have a glance at this article, to know about some more differences between factoring and forfaiting.

## Content: Factoring Vs Forfaiting

1. [Comparison Chart](https://keydifferences.com/difference-between-factoring-and-forfaiting.html#ComparisonChart)
2. [Definition](https://keydifferences.com/difference-between-factoring-and-forfaiting.html#Definition)
3. [Key Differences](https://keydifferences.com/difference-between-factoring-and-forfaiting.html#KeyDifferences)
4. [Conclusion](https://keydifferences.com/difference-between-factoring-and-forfaiting.html#Conclusion)

### Comparison Chart

| **BASIS FOR COMPARISON** | **FACTORING** | **FORFAITING** |
| --- | --- | --- |
| Meaning | Factoring is an arrangement that converts your receivables into ready cash and you don't need to wait for the payment of receivables at a future date. | Forfaiting implies a transaction in which the forfaiter purchases claims from the exporter in return for cash payment. |
| Maturity of receivables | Involves account receivables of short maturities. | Involves account receivables of medium to long term maturities. |
| Goods | Trade receivables on ordinary goods. | Trade receivables on capital goods. |
| Finance up to | 80-90% | 100% |
| Type | Recourse or Non-recourse | Non-recourse |
| Cost | Cost of factoring borne by the seller (client). | Cost of forfaiting borne by the overseas buyer. |
| Negotiable Instrument | Does not deals in negotiable instrument. | Involves dealing in negotiable instrument. |
| Secondary market | No | Yes |

# [Growth of factoring services in India](http://vinodkothari.com/2018/09/growth-of-factoring-services-in-india/)

Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80% (rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount (Balance 20% minus finance cost minus operating cost) to the client when the customer pays the debt. Collection of debt from the customer is done either by the factor or the client depending upon the type of factoring. We will see different types of factoring in this article. The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring in construction services (in government contracts it is assured that the government body can pay back the debt in the stipulated period of factoring and hence contractors can submit the invoices to get cash instantly), factoring against medical insurance etc. Let us see how factoring is done against an invoice of goods purchased.

# Operational problems in Factoring

The factoring service in India is at a nascent stage. Its quantitative growth is relatively limited. Its future depends on the removal of a number of genuine operational obstacles.

Credit Information: The factors do not have access to any authentic common sources of information. They have to depend on their own data-base for credit evaluation of clients. The system of multiple data bases by individual factors is not only expensive but is also devoid of uniformity and obviously is a serious impediment in the growth of factoring services. The establishment of specialized credit information agency/bureau is urgently called for.

Stamp Duty: The assignment of debt attracts stamp duty charged by the states which is as high as 15 per cent on the amount exceeding Rs 2 lakh. It inflates the cost of operations of service and erodes the profitability of the factors. There is a very strong case for waiving on stamp duty on assignment of debt factors.

Legal Framework: Changes are also called for in other components of the present legal framework to ensure success of factoring in India.

Funding: The factors in India are not allowed access to wider funding sources on scales available to other finance companies. Virtual dependence on equity funds does not permit them optimal funding. For a cost effective financing of these companies, greater access to the debt and the money market like the leasing and other finance companies is an urgent necessity.

Disclaimer Certificate: To purchase a book debt of its clients, a factor needs disclaimer certificate from banks. In the present context they are reluctant to issue such a certificate. The factoring companies should be allowed to purchase book debts without requiring such a certificate from banks.

Limited Coverage: At present only domestic factoring of the advance with recourse is permitted and offered in India. Although the ECGC and SBI FACS have initiated measures for export factoring no headway has been made. It is high time to provide export factoring to Indian exporters.

An overview:

Factoring means the sale of receivables (book debts) by a firm (client) to a financial intermediary (factor) who pays when they are collected, or on a guaranteed payment date. It basically involves transfer of collection of receivables and the related maintenance of records from the client to the factor. In essence, factoring is a source of financing of receivables and facilitates the process of their collection.

Depending on the type of factoring, the main functions of factor, in general terms, are five fold: (1) maintenance of sales ledger, (2) collection of receivables, (3) financing of trade debts, (4) assumption of credit risk/control/ protection and (5) provision of advisory services. For providing these services, the factors levy two types of charges. They charge for collection of receivables and sales ledger administration in the form of a commission/fee payable in advance expressed as a flat percentage of the value of the debt purchased. The charge for short term financing in the form of advance part payment is an interest charge/discount charge for the period between the date of advance payment and the date of collection/guaranteed payment due.

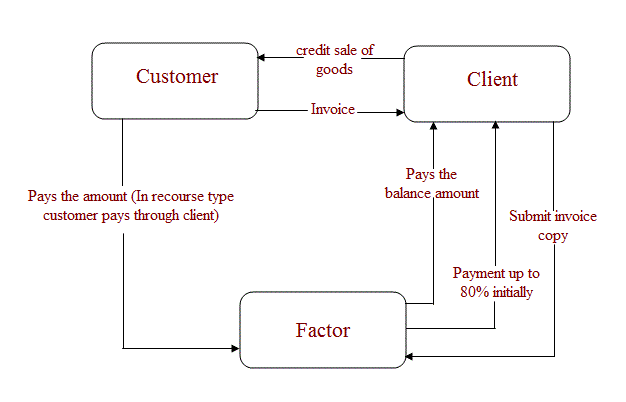
On the basis of the features built into the factoring deal to cater to the varying needs of the trade/clients, there are different types of factoring. The main classification of factoring arrangements is: (1) recourse and non-recourse based on the assumptions of credit risk associated with the collection of the receivables. (2) advance, maturing and participation factoring related to the time of payment on account of receivables by the factor, to the client, (3) full factoring, (4) disclosed and undisclosed factoring on the basis of the disclosure/non-disclosure of the name of the factor in the invoice, (5) domestic and export / cross border / international factoring based on the domicile of the parties involved.

There is no codified legal framework to regulate factoring in India. The legal relationship between the factor and the client is governed by the provisions of the factoring contract.

Domestic factoring as a fund based service, differs from bills discounting, and export factoring from forfaiting which finances deferred credit transactions related to exports.

Factoring offers several advantages to a client including: (1) off-balance sheet financing, (2) reduction in current liabilities, (3) improvement in current ratio; (4) higher credit standing (5) improved efficiency, (6) reduction of costs (7) additional sources of funds and so on. However, since it involves a cost in terms of fee and discount charge and evaluation of factoring should be done as a cost benefit analysis resorting to factoring.

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**Characteristics of factoring**

Usually the period for factoring is 90 to 150 days. Some factoring companies allow even more than 150 days.

Factoring is considered to be a costly source of finance compared to other sources of short term borrowings.

Factoring receivables is an ideal financial solution for new and emerging firms without strong financials. This is because credit worthiness is evaluated based on the financial strength of the customer (debtor). Hence these companies can leverage on the financial strength of their customers.

Bad debts will not be considered for factoring.

Credit rating is not mandatory. But the factoring companies usually carry out credit risk analysis before entering into the agreement.

Factoring is a method of off balance sheet financing.

Cost of factoring=finance cost + operating cost. Factoring cost vary according to the transaction size, financial strength of the customer etc. The cost of factoring vary from 1.5% to 3% per month depending upon the financial strength of the client’s customer.

For delayed payments beyond the approved credit period, penal charge of around 1-2% per month over and above the normal cost is charged (it varies like 1% for the first month and 2% afterwards).

**Different types of Factoring**

Disclosed and Undisclosed

Recourse and Non recourse

A single factoring company may not offer all these services.

**Disclosed**

In disclosed factoring client’s customers are notified of the factoring agreement. Disclosed type can either be recourse or non recourse.

**Undisclosed**

In undisclosed factoring, client’s customers are not notified of the factoring arrangement. Sales ledger administration and collection of debts are undertaken by the client himself. Client has to pay the amount to the factor irrespective of whether customer has paid or not. But in disclosed type factor may or may not be responsible for the collection of debts depending on  whether it is recourse or non recourse.

**Recourse factoring**

In recourse factoring, client undertakes to collect the debts from the customer. If the customer don’t pay the amount on maturity, factor will recover the amount from the client. This is the most common type of factoring. Recourse factoring is offered at a lower interest rate since the risk by the factor is low. Balance amount is paid to client when the customer pays the factor.

**Non recourse factoring**

In non recourse factoring, factor undertakes to collect the debts from the customer. Balance amount is paid to client at the end of the credit period or when the customer pays the factor whichever comes first. The advantage of non recourse factoring is that continuous factoring will eliminate the need for credit and collection departments in the organization.