

WALDEMAR CZTERNASTY
PAWEŁ MIKOŁAJCZAK

Financing of SME using non-recourse factoring – legal, economic and tax aspects

Introduction

Factoring is currently considered to be a flexible short-term financing source which also represents an alternative to a bank credit. It is also a safe instrument which allows the entrepreneur to improve or even regain financial liquidity. Faktoring is also a very important tool of managing the receivables in a company. In times of recession mostly small and medium enterprises are put at risk of financial liquidity loss due to the lack of payment of a counterparty. A limited access to the traditional current financing in the form of bank credits and a weaker market position of SME, confronting bigger enterprises, decreases the possibilities of obtaining longer payment terms of trade credit. From that point of view, settling the receivables on time and securitization against the default risk of buyers are extremely important and quite often determine the ability of the company's survival in the market (Kreczmeńska 1997, p. 14).

The aim of this paper is to present the full factoring (non-recourse factoring) as a safe and

Prof. Waldemar Czternasty
Poznań University of Economics
Department of Macro and Agricultural
Economics

Ph.D. Paweł Mikołajczak
Poznań University of Economics
Department of Banking

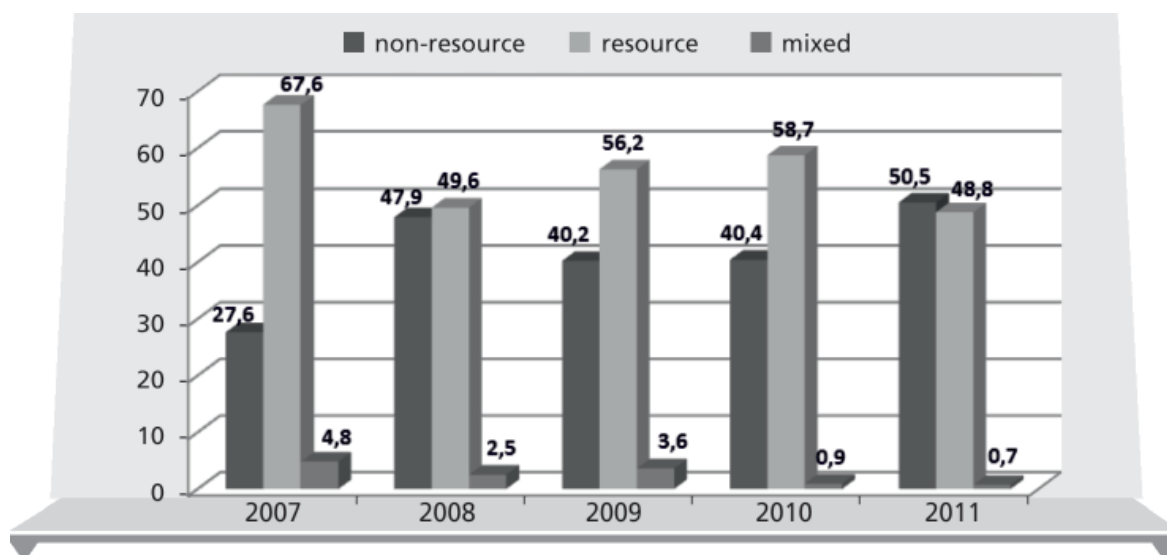
efficient source of financing SME in times of economic recession. Authors attempt to answer following research question: is full factoring use a real alternative in financing current business activity? Therefore, presenting non-recourse factoring was legitimate, not only from the point of view of taxation and civil law but also of its role as a tool of company's financial structure improvement. The applicable character of the paper focuses also on demonstrating tripartite benefits resulting from implementation of special form of full factoring which is a government factoring.

1. Factoring as a tool of short-term business financing

Factoring is defined as a transfer of short-term receivables of the business (production, trade or service company) to a financial institution called a factor resulting from goods and services supply in return for immediate receivables amount payment (Rutka 2003, p. 6). Depending on the fact which of the above mention entities bears the risk in case of debtor's default we can distinguish a recourse factoring, full factoring (non-recourse) and mixed. The first one consists in a sale of trade receivable to the factor, however with no takeover of a solvency risk of the debtor (the client is liable for payment in the event the customer does not pay). However, in full factoring the factor's responsibility is much wider because in a moment of factorer's receivables purchase towards debtors it is the factor that takes all the risk of lack of payment caused by e.g.: counterparty default or significant delay in payment. After assignment of receivables factor pays the whole amount to the factorer (Czarnecki 2007, pp. 80-91). As a result of signing a non-recourse factoring agreement there is a definite transfer of receivables from business to the factor. An additional protection for financial institution can be a trade credit insurance policy. In case of debtor's payment delay violating acceptable dates, the actions to recover the receivables from the debtor are taken. In case of its actual insolvency or conventional default the loss is covered by the insurance agency (Tokarski 2005, pp. 59-64). If the receivables is not contested, there is no recourse from the invoice issuer which means a full protection of cash flows. Using full factoring to some extent limits also the business risk. In factoring institution practise the full factoring often apply solutions in which factorer gets e.g. 80-90% of the invoice amount and the rest is treated as the entity's own financial contribution. However, on the theoretical basis, such solution must be recognised as a mixed factoring.

According to Central Statistical Office (CSO - GUS) in 2011 in Poland mostly the non-recourse (50,5%) and recourse factoring (48,8%) were used, and mixed

factoring was used only occasionally (0,7%). It shows a significant change in proportion in comparison to 2007 that is before the financial crisis in 2008. According to CSO data non-recourse factoring was at that time used much more infrequently than recourse factoring. Statistical data show that the first mentioned was used in 2007 in less than 1/3 cases (27,6%). However, recourse factoring was used in more than 2/3 of cases (67,6%). In other cases mixed factoring was used (4,8%). In 2008 full factoring popularity rose (47,9%). A close percentage of financial institutions turnover was the recourse factoring (49,6%); in turn much lower turnover was noted on mixed factoring (2,5%). In 2009 and 2010 the share of different kinds of factoring was similar. In 2009 mostly recourse factoring was used (56,2% of turnover), more infrequently non-recourse factoring (40,2%) and occasionally (3,6%). In 2010, likewise in previous year, recourse factoring was the most popular (58,7%), and non-recourse factoring was less frequently chosen (40,4%). Much less popular was mixed factoring (0,9%) (see graph 1).

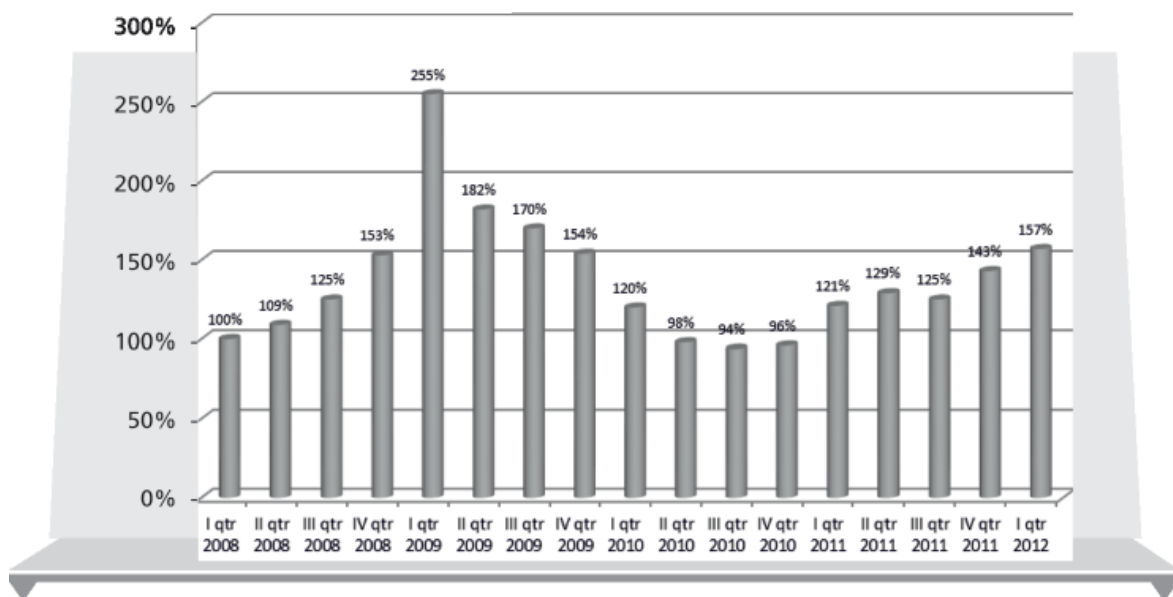


Graph 1. The share of financial institution turnover of recourse, non-recourse and mixed factoring

Source: own study on CSO data 2008-2012

Therefore reasoning that recession in Poland and deteriorating standing of companies manifest themselves, among other things, in problems of settling the liabilities on time, seems to be perfectly legitimate as in 2008 it made the full factoring more attractive for domestic entities than in 2007. 2009 and 2010

brought a relative stabilisation of proportions which reflect the percentage of companies which used particular kinds of factoring, however, in 2011 for the first time non-recourse factoring constituted the biggest share in factoring agencies turnover. According to CSO since the second half of 2011 the number of arrears in companies have increased significantly in comparison to prior-crisis first quarter of 2008. The payment dates extend – actual and contractual. Payment blockage mostly strike at SME drastically deteriorating its liquidity (see graph 2).



Graph 2. The level of overdue receivables of SME in 2008-2012

Source: own study on CSO data 2008-2012

2. Legal aspects of non-recourse factoring functioning

The law in Poland does not determine factoring as a banking activity. Providing such services does not require the permission of the President of the National Bank of Poland (NBP). Factors also do not need any permissions from Polish Financial Supervision Authority (PFSA - KNF). However, financial institutions that enter factoring transactions with their clients, must obey regulations and rules which impose specific rights and obligations. Due to the fact that factoring agreements fall into the category of innominate contracts, the rules of receivables transfers apply, i.e.: article 509-518 of Civil Code and article 410 § 2 which applies

to undue benefits. In turn, the right to sign factoring contract results from article 353 § 1 of Civil Code, which says that there is freedom of contract (the Act of April 23rd 1964 – Civil Code, Dz.U. No 16, pos. 93 with amendments). The basis for factoring activity of banks is article 5 pos. 2 pt. 5 of Banking Act.

In case of non-recourse factoring, the bank or factoring agency by purchasing receivables bears the whole risk of debtor's solvency with which the company signed the sale, delivery or service agreement. Due to the fact that the default risk of debtor rests on the factor, it cannot effectively claim recourse against the factorer. It means the waiver of return claim against the receivables seller when the receivable are not settled by the debtor at the maturity. In the view of the law the consequence of signing full factoring contract is a definite transfer from factorer to factor of receivables along with all other rights connected to them.

On the basis of current law the fact of leaving factoring contract as an innominate contract determines the opportunity of free adjustment of their contents to both parties of the contract and what follows – the individual interpretation made by the court. In economic practise, factoring contracts are prepared by factors. It gives an opportunity to bring in disproportions in the scope of rights and obligations of both parties. It is reflected in records which guarantee the factor an absolute safety in case of any factorer's lapse, at the same time limiting the responsibility of errors made and inadequate service quality. This problem is limited to a significant extent in case of non-recourse factoring, in which the payment of purchase price is performed without claims of recourse, no matter whether the debtor pays.

Imbalance between factor and business can also be the result of market strong position of factoring debtor. In the contract with suppliers it can include a clause of transfer ban or allow factoring only at a chosen factor. In such situation, except an obvious necessity to verify non-course factoring costs, it is necessary to analyse the factoring contract in depth.

3. Economic aspect of non-course factoring and its accounting record

Non-recourse factoring is a financial tool which allows to change the structure of entity's balance (receivables turnover and liabilities ratio), improvement of quick ratio, decreasing of credit risk as well as administrative costs limitation connected with monitoring and vindication of receivables and transfer to the factor. Extremely important advantage of that financing form is also the lack of necessity of putting business into detailed, if any (full factoring), verification of creditability which is significant especially for SME.

The influence of factoring on financial statements of a company depends of its kind. Non-recourse factoring as a definite transfer of receivables to factor (no claim of recourse) is the most profitable for the balance sheets. Since it enables the conversion of receivables into cash. Therefore the stricter of assets improves due to decreasing receivables and increasing cash which affects a better rating of economic information agencies and a better creditability in the financial institution assessment and a better credit capacity that follows. The construction of full factoring also determines increasing the working capital turnover speed which can be also used for the operational activity development of the company and also to increase the level of the quick ratio calculated as the quotient of investments and short-term liabilities.

Therefore full factoring on one hand diminishes the demand for working capital expressed in days through shortening the receivables cycle resulting from the rotation acceleration, on the other hand it also lowers cash demand corresponding the working capital level through receivables minimising (Dulian 2005, p.10).

Full factoring (non-recourse) including debtor's default risk transfer is also a tool which allows to solve factorer's problem (selling goods or services) of trade risk in so-called trade credit. It consists in the lack of payment as a result of the suppliers' default or partner's chronic delay in delivering payment liabilities. Full factoring can also be a problem solving tool connected with the risk of financial liquidity deterioration and problems with short-term financing of company run. The entity is forced to look for additional finance sources, e.g. by taking a short-term credit, loan or other financing forms which can be unavailable. In case when the company's standing does not allow financial institutions to increase short-term capital engagement, non-recourse factoring is the only solution (Sierpińska, Wędzki 2007, pp. 73-75). The above presented advantages of full factoring are connected with relatively high costs. Most of all this is the interest on the granted limit, calculated most frequently as a sum of a WIBOR (Warsaw Interbank Offer Rate) rate and a margin determined by the financial institution. Additionally the company must add up the preliminary fee, commission of taking the risk and commission from each invoice transferred. From the research point of view it is hard to omit the issue of the full factoring accounting. Namely, in accounting records of non-recourse factoring, the business files the receivables transfer to the factor in a nominal value on the accounts Dt 249 "Other settlements" and Ct 200 "Accounts receivables and payables". The received from the factor interest to be paid for credit service and all the commission, it credits them on the receiving date

in the 249 account "Other settlements" and debits an account 751 "Operating costs". In turn the receivables transfer from the factor (or the deposit) after its actual transfer into the company's bank account is credited into the account no 131 "Running account" and debited into 249 "Other settlements".

4. Taxation consequences of full factoring transaction

4.1. Tax on civil law transactions and full factoring

In practise of tax institutions in case of civil contracts, in which receivables transfer is a contract subject, there were specific rules settled. In case, when the contract of receivables transfer is based on the article 509 and following of Civil Code which regulate the receivables transfer and is in the form of any contracts listed in article 1 pos. 1 pt.1 l. a) - k) Act on tax on civil law transactions (upcc), especially the sale contract, there is an obligation to pay a tax on civil law transactions (The official letter of Ministry of Finance of 9th December 1994, p. 7). However, in a situation in which the transfer is accompanied by other actions, determining the fact that the entered contract no matter what its name is can be assumed a factoring contract and the same it does not represent any contract of receivables sale enlisted in article 1 pos. 1 of the Act on tax on civil law transactions, then such a contract is not taxed with a tax on civil law transactions (Kreczmańska-Gigol 2006, p. 40).

The subject of the contract are goods (mobile and immobile) and other property rights. However, factoring focuses only on receivables. The factors, indeed, do not concentrate on the purchase but on benefiting from factoring commission for actions connected with receivables transfer and additional services (Tokarski 2005, pp. 78-79). Despite the fact that factoring contract contain elements of various contracts, it is in fact a homogeneous contract. The same it must be acknowledge that the factoring contract due to the fact that it is not enlisted in civil action catalogue is not taxed with a tax on civil law transactions.

4.2. Full factoring in the view of the Act on the goods and services tax (VAT)

In the contents of the Act on the goods and services tax (art. 41 pos. 1 of the Act on the goods and services tax of 11th March 2004, Dz. U. of 2011 no 177, pos. 1054 with amendments) and in secondary legislation to an Act there are the actions which are taxed on the reduced rate or exempt from the goods and services tax. In case of factoring the regulation in art. 43 of the Act on the goods and services

is crucial. This regulation presents a lot of tax exemption rules for financial intermediary. However, art. 43 pos. 15 of the Act on the goods and services shows that those exemptions do not apply to vindication including factoring. On the basis of the European Union (EU) rules, the above presented tax exemption was included in art. 135(1)(d) of the Directive 2006/112/WE of the Board on common VAT tax system. It shows that the EU member states exempt from the VAT tax only “transactions, including financial intermediary, which concern deposits, current accounts, payments, debts, cheques and other transferable financial instrument, excluding debt collection”. The above reasoning was also confirmed by the Court of Justice of the European Union in the sentence of 26th 2003 in the case C 305/01, in which while defining factoring it was stressed that business within which the economic entity buys receivables, taking over the risk of the debtor’s default and in return issuing the invoice on commissions, is an activity connected with debt collecting reckoned in the directive and therefore it is excluded from the exemption defined in that regulations (website: http://www.podatki.biz/artykuly/4_16832.html (19.02.2013 - access date).

Therefore, non-recourse factoring is a financial service and its providing is an activity which is taxed (VAT) on factor’s side. Factoring is not exempted from financial services taxation. It seems vital that the exemption does not concern only the basic form of factoring – so-called full factoring. A turnover, in case of VAT, should acknowledge not only commissions but also a bank discount calculated while buying the receivable, i.e. the difference between nominal value of the receivables and the price which factoring agency paid for it. However, selling receivables within the full factoring contract, similarly in case of receivables transfer, does not create goods and services tax obligation on seller’s side.

4.3. Income tax in factoring transactions

Income tax effects in factoring contract should be analysed separately for the factorer and factor. Tax obligation at factor’s side due to factoring contract emerges in the moment of debtor’s payment of receivables. The income of financial institution is the difference between the income received from the debtor (which includes the nominal value of the receivables and possible penalty interest added for the delay in receivables payment) and the amount paid to the factorer in exchange for receivables. Factor does not include accrued but not received interest of factoring receivables, according to art. 12 pos. 4 pt. 2 of The Legal Persons’ Income Tax Act (updop) (respectively art. 14 pos. 3 pt 2 of the Natural Persons’ Income Tax Act (updof).

The factorer's income of the factoring contract is the receivables' value expressed in the price in sale contract and the cost of gaining that income is the expense of commission and discount interest and the nominal value of receivables which decreases the seller's assets. When those costs exceed the income so when one sells the receivables below its value, the factorer has a loss. It can be the tax deductible expenses on the basis of art. 16 pos. 1 pt. 39 of The Legal Persons' Income Tax Act on the condition that the receivables sold was beforehand recorded as a revenue due on the basis of art. 12 pos. 3 of The Legal Persons' Income Tax.

4.4. Government factoring as a specific form of full factoring

Government factoring significantly gained popularity due to increased investments of the State Treasury and territorial self-government (local and regional authorities), especially in the field of infrastructure of Poland. Building roads, motorways, bridges etc. are included in local and regional budgets and quite often payments dates due to investment completion are deferred for few months after completion of particular investment stage. An important reason of self-government factoring popularity is also a fact that traditional sources of financing the investment by the local and regional authorities decreases their investment possibilities because one-time budgetary expense in one investment year is limited by the acceptable budget deficit, the overall debt of local and regional authorities and the amount of running the investment in following years. Financing in the form of factoring is beneficial from the accountancy point of view. Financing is recorded as a off-balance sheet item and it does not increase the debt ratio of local and regional authorities (Kupisz 2011, pp. 77-78).

Table 1. Chosen benefits resulting from entering the government factoring contract

Party of transaction	benefits of entering the government factoring contract
Factorer	<ul style="list-style-type: none"> • Limiting the risk of the investor's delayed receivables payment (receiving the invoices' amount before the due date) - improvement of financial liquidity of the company • Financing up to 100% of gross value of the receivables (reduced by possible guarantee or deposit etc.) • Without creditability assessment on the factor side (possibility to finance start-ups). • Lack of any securing except the transfer of receivables of the investor's contract.

Factor	<ul style="list-style-type: none"> • Lack of the default risk of the investor. • Lack of taking over from the factorer any assumptions towards investor. • Takeover of all rights connected with the receivables purchased from the factorer (mostly claims of overdue interest).
Investor (local and regional authorities)	<ul style="list-style-type: none"> • Guarantee of refinancing the investment by the factorer. • Possibility to execute more investments and expanding their range - lack of factoring influence on the debt ratio of local and regional authorities as an off-balance sheet liability. • Possibility to extent invoice payment date. • Settling financial possibilities of local and regional authorities by the factor and assistance in optimisation of payment schedule.

Source: own study

Self-government factoring is a tool of local and regional authorities receivables financing which can be used by the companies entering the contract with the State Treasury, local government or other office of local and regional authorities. It means a complete takeover of the client's default risk by the factoring institution (Wrzosek 2011, p. 377). Due to the fact that local and regional offices are regarded as the entities which cannot go bankrupt then government factoring is a perfect tool which fully satisfies all parties of the transaction. Table 1 presents most significant benefits of government factoring from the point of view of the factor, factored and local and regional authority (investor).

Conclusions

Non-recourse factoring is a significant alternative to working-capital credit. It is a service which enables to sustain financial liquidity of the company by flexible management of its receivables. Using this instrument allows the company not only to accelerate due cash collection but also leads to the improvement of many economic ratios, alongside increasing the creditability when assessed by financial institutions. So non-recourse factoring plays a very important role, especially in times of recession in which one of the most severe problem for SME is to collect the receivables on time.

On the basis of the above deliberation included in that paper a few conclusions, which are significant for businesses which want to use that form of financing, can be formed.

1. Despite the fact that many financial institutions offer non-recourse factoring, it is in fact a mixed type. The pure form should characterise with no own contribution. Factor buys up the whole receivables, at the same time accepting the whole risk of payment lack e.g. resulting from partner's default or significant delay in payment.
2. Full factoring play especially important role in SME sector in times of recession. Financial institutions, making a decision of granting non-recourse factoring assess the standing of the debtor and not the factorer. It gives the opportunity to use this instrument even by starting companies. However, the fact of relatively high costs of that form of short-term financing seems important. Full factoring is more expensive source of capital gain in comparison to working-capital credit. Therefore, the decision of implementing factoring should be preceded by full economic analysis.
3. Economic downturn in Poland determines also the difficulties in settling the receivables of local and regional authorities on time towards the entities performing the contracted investments. Due to its specific interpretation in the field of tax and civil law it can on one hand be a flexible and extremely efficient tool of financing investment needs of local and regional authorities, and on the other, it can guarantee safety and financial flexibility of SME.

Summary

Financing of SME using non-recourse factoring – legal, economic and tax aspects

Specific character of SME determines a limited access to short-term capital which is essential for running the business. A financial tool which on one hand enables small entities to improve their financial liquidity and, on the other, to limit the risk connected to delays in settling the receivables, is non-recourse factoring. Both, its construction in the legal, tax and financial context, as well as the procedure of granting it by financial institutions make this instrument gain more and more popularity among the companies in Poland.

Key words: *Non-recourse factoring, small and medium enterprises (SME), financing sources, liabilities, financial liquidity, taxes.*

Streszczenie

Finansowanie małych i średnich przedsiębiorstw w postaci faktoringu pełnego aspekty prawne, ekonomiczne i podatkowe
Specyfika małych i średnich przedsiębiorstw determinuje ograniczony dostęp do kapitału krótkoterminowego, niezbędnego do finansowania ich bieżącej działalności. Finansowym narzędziem umożliwiającym niewielkim podmiotom poprawę płynności finansowej z jednej strony i ograniczenie ryzyka związanego z nieterminowym regulowaniem zobowiązań z drugiej jest faktoring pełny. Zarówno jego konstrukcja w kontekście przepisów prawnych, podatkowych i finansowych, jak i procedura jego przyznawania przez instytucje finansowe sprawiają, iż instrument ten cieszy się coraz większą popularnością wśród przedsiębiorstw w Polsce.

Słowa

kluczowe: *Factoring pełny, małe i średnie przedsiębiorstwa, inwestycje, źródła finansowania, zobowiązania, płynność finansowa, podatki.*

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