Principles for factoring transactions accounting and tax

Viorel Turcanu
Moldovan Academy of Economic Sciences, Professor, Dr.Hab,
Anna Zachernicinaia
Moldovan Academy of Economic Sciences Doctoral Candidate, auditor

Abstract

The up growth of business rivalry at the consumer and services markets make many of the suppliers grant delayed or deferred payments to their customers and act as creditors who thus accept credit, exchange and interest risks. It results in the suppliers' floating assets withdrawal and has a negative impact upon their financial statements showings. Factoring is one of the ways to release funds that have been frozen on accounts receivable.

Key words: factoring, the adherent, financial risk, accounting tax, financing

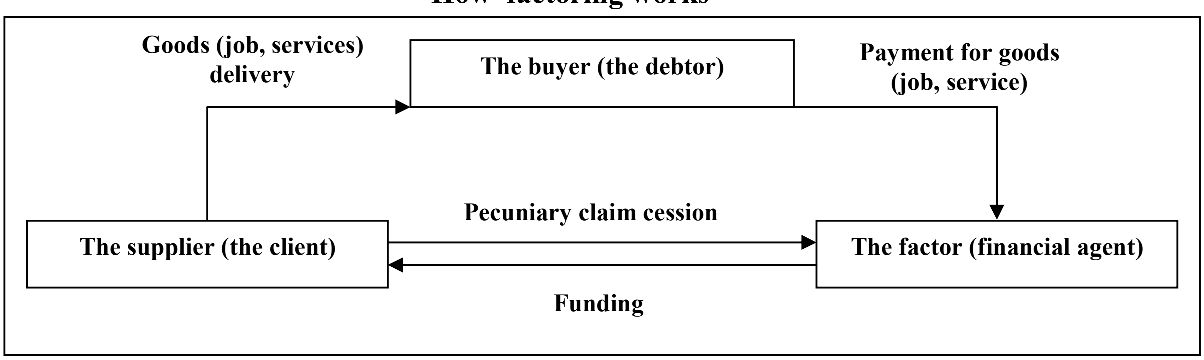
JEL classification: G 32

1. Introduction

Factoring is a kind of financial service that commercial banks or their subsidiaries (factors) render to small and medium business (clients). In factoring operations the client assigns the right to claim debts to the factor and the factor partially pays the client's claims to their debtors about 70 to 90% of the total debt value before the payment is due. The remaining sum, less interest rate, is paid when the debtor pays his debt off.

Chart

How factoring works



2. The history and the mechanism of the factoring

Factoring has its origins in the 17th century as a reseller operation that later on became a form of crediting. Factoring has been widely practiced abroad as a tool to protect civil circulation property and financial interests by factoring banks and factoring companies. Our commercial banks first factoring operations date back to 80s. Today factoring transactions are governed by legislation and are widely practiced in some ex-soviet countries such as Russia, Ukraine and Belarus. Moldovan factoring market is still incipient. Operating commercial banks' licensed activities include factoring transactions however there is actually just one company dealing with factoring transactions in Moldova, NFC-Moldfactor.

The table below summarizes factoring transactions being practiced:

Table
Factoring Types

By compliance with the Accounts Receivable Sales Contract	**By the contractual parties place of performance**	**By the buyer's factoring transaction awareness**
1. Non-recourse (no turnover) - Complies with the contract, the accounts receivable are actually being sold. 2. Recourse (with the turnover) – **does not** comply with the Accounts Receivable Sales Contract. The company that sells the debt assumes liabilities and risks for the debtor's failure to pay the debts and pays the factor's damages.	1. Domestic – sales contract parties and factoring company are residents of the same country. 2. International - the supplier and his client are residents of different countries.	1. Open – the buyer is aware about the factoring transaction and makes payments to the factor's account. 2. Quiet – the buyer is not aware about the Factoring Contract and makes payments to the supplier who in its turn transfers them to factor.

It is reasonable that we shall consider factoring as a method of the company's floating assets management so far as it is being reflected within assets only and never appears among liabilities. In factoring transaction there is a decrease within the Accounts Receivable on the supplier's balance sheet and at the same time an increase within Cash Assets account. Thus factoring changes the floating assets structure: accounts receivable are transformed into cash assets, cash inflows increase and give an opportunity to increase materials and goods purchase that results in production and future sales increase and consequently in the company's profits growth.

First of all the factor's concern is a reward for the factoring service. Factoring fee usually comprises three basic components: fixed processing fee, fixed interest rate from the client's turnover that covers factor's service cost value (control over the due payments, activities for payment delays, accounts receivable current record and due reports to the client) and a reward for acceptance of cash, credit and interest risks.

The basic international act that governs crediting on pecuniary claim cession is the UNIDROIT (International Institute for the Unification of Private Law) Convention on International Factoring that was adopted on May 28, 1988 in Ottawa and took effect in 1995. Moldova has not yet joined this Convention so far.

Our national legislation stipulates factoring in Civil Code article 1290 "under a factoring agreement a party, the supplier of goods and services (adherent), undertakes to assign the existent or future claims under sales, service or production contracts to another party, factoring company (factor), who undertakes to carry out the following two liabilities:

1. Financing the adherent, the loans and the advance payments included;
2. Record-keeping of the claims;
3. Notification and collecting debt payments;
4. Acceptance of risks against the Debtor's insolvency concerning the claims being assigned (del credere)".

Factoring does not appear on Business Licensing Law as a separate activity subject to licensing. However article 26 of the Financial Institutions Law lists licensed financial operations, crediting included (consumer and mortgage loans, recourse and non-recourse factoring, transaction crediting, guaranties and securities etc.). Since under the Civil Code not only banks may practice factoring transactions, any commercial organization that has factoring on their articles of association, as well as sufficient funds and experience, may practice financing under debt claim cession as a financial agent without any license.

Factoring transactions record-keeping has been described neither in national accounting guides nor in laws. The example given below is based on international practice and is an advisory opinion.

Example

Factoring transactions record-keeping on supplier's and factor's chart of accounts

Under the Sales Contract the supplier A has shipped the goods to the amount of 120,000 lei, 20,000 lei VAT included, to the buyer B. Under the contractual provisions the buyer B undertakes to pay for the goods within 60 days after shipment. The supplier A signed a Non-recourse Factoring Contract with Factor C and thus assigned the right to claim the due payment for the shipped goods. The seller notifies the buyer about the transaction. Under the contract Factor C first transfers 90% of the shipped goods value to the supplier A and the remaining 10% transfers as soon as the buyer makes the payment, less the factoring fee. The factoring fee amounts to 3% of the transaction value Under the Factoring Contract.

This transaction **on the supplier's A accounts** shall be shown as follows:

1. Showing the debt on sold goods

Dr 221 "Accounts receivable" - 120 000 lei,

Cr 611 "Sales Revenue" subaccount 6112 "Sales Revenue - Goods" - 100 000 lei,

Cr 534 "Taxes Liabilities" subaccount 5342 "Value Added Taxe (VAT)" – 20 000 lei.

2. Showing the assignment of the pecuniary claim to the factoring company C:

Dt 229 "Other debtors" - 120 000 lei,

Cr 221 "Accounts receivable" - 120 000 lei,

3. Funds transferred by the Factor C under factoring contract (initial payment of 90%):

Dr 242 "Bank Account" – 108 000 lei,

Cr 229 "Other debtors" - 108 000 lei.

4. Remaining funds (10%) transferred by the Factor C, the factoring fee included (120 000 - 120 000 x 3% - 108 000 = 8 400) as soon as the buyer makes the payment:

Dr 242 "Bank Account" - 8 400 lei,

Cr 229 "Other debtors" - 8 400 lei.

5. Showing the Factor's C factoring fee:

Dr 714 "Other operating expenses" - 3 600 lei,

Cr 229 "Other debtors" - 3 600 lei.

This transaction **on the factoring company C accounts** shall be shown as follows:

1. Showing the supplier's A assignment of the pecuniary claim:

Dr 229 "Other debtors" - 120 000 lei,

Cr 539 "Other liabilities" - 120 000 lei.

2. Funds transferred to the supplier A under Factoring Contract (initial payment of 90%):

Dr 539 "Other liabilities" - 108 000 lei,

Cr 242 "Bank Account" - 108 000 lei.

3. The buyer's debt payment:

Dr 242 "Bank Account" - 120 000 lei,

Cr 229 "Other debtors" - 120 000 lei.

4. Showing the factoring fee (120 000 * 3% = 3 600 lei):

Dr 221 "Accounts receivable" - 3 600 lei,

Cr 611 "Sales Revenue" subaccount 6113 "Sales Revenue – services" - 3 600 lei.

5. Factoring fee reckoned towards settlements with the supplier A:

Dr 539 "Other liabilities" - 3 600 lei,

Cr 221 "Accounts receivable" - 3 600 lei.

6. Final settlement with the supplier A:

Dr 539 "Other liabilities" - 8 400 lei,

Cr 242 "Bank Account" - 8 400 lei.

3. Conclusions

To sum up the aforesaid it should be mentioned that a company may sign factoring contract with a bank or a factoring company to reduce the client's insolvency risks during the world recession. Bank fee costs may be reckoned towards operating activities costs that shall be deduced for taxes under article 24 "Deduction of costs for running business" of the Tax Code as customary and necessary that have been paid or incurred by the taxpayer when running his/her business. The factoring service benefits are apparent for each transaction party, the supplier, the factor and the buyer. Factoring is the most efficient method both for the suppliers who increase sales and explore new markets and those newly created companies who lack funds due to the payments delays. Factoring is a way to accelerate the exporter's capital turnover. It is common that such companies have an unfavorable balance structure that blocks their access to bank loans. In such a case the factor mediation solves the problem of short-term loans. Besides, through the factoring companies mediation it is possible to cut down the executive expenses and to increase operating efficiency since along with record-keeping the factor company deals with their client's transactions credit control and carries out business analysis, selling strategy analysis and market study. The factor company concern is in the reward first of all. Financial agents not only receive a return on loans and a factoring fee but also a fee for other financial services offered within a factoring transaction. In his turn the buyer is concerned with the commercial credit (the seller ships the goods with an average 3-month payment delay), increases the purchase amount, minimizes the risk of getting faulty goods and accelerates capital turnover.

4. Bibliography

1. Republic of Moldova Civil Code. RM Law #1107-XV dated 06.06.2002.
2. Republic of Moldova Tax Code. RM Law # 1163-XIII dated 24.04.1997.
3. Financial Institutions Law # 550- XIII dated 21.07.1995.
4. Business Licensing Law # 451-XV dated 30.07.2001.
5. Exchange Control Law # 62-XVI dated 21.03.2008.
6. Encyclopedia of Economics.2008. Moscow: Eskimo. Page 816.
7. International Financial Reporting Standards. 2007. Translation of the complete EC official text. Moscow: Askery. Page 1078.
8. Alexander D., Britton A., and Yorissen E. 2005. International Financial Reporting Standards. Moscow: Vershina. Page 886.
9. Agueyeva O.A. 2008. International Financial Reporting Standards. Moscow: Bukhaltersky Uchyot. Page 464.
10. Damian Oleg. 2005. Factoring is tripersonal: Факторинг един в трех лицах: financier, lawyer and insurer. Economicheskoye Obozrenye Logos Press 34 (626).
11. http://factors-chain.com.
12. http://factoring.ru.