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SPECIFIC FORM OF SHORT-TERM FINANCING

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Abstract
The aim of this paper is to point out the significance and role of factoring as an alternative financing model, and its role in overcoming liquidity problems of business entities due to difficult and late payments as well as long-term billing. Businesses face the challenge of addressing liquidity-related financial difficulties, particularly in the context of dynamic business overruns, financial and economic instability and uncertainty, and difficulties associated with the impossibility of obtaining financial resources. Therefore, this paper examines the significance and role of factoring, through an overview of relevant literature and examples from the business world. The importance of factoring is discussed as an opportunity to overcome the problem of liquidity of business entities and as a model of financing, especially for small and medium-sized enterprises. The paper summarizes the overall effects of factoring, as well as the stated traps of its use. It is not good for businesses to rely solely on credits due to inability to raise funds because it hampers their development and market competitiveness.

Keywords: Factoring; liquidity; solvency, receivables, Croatia.

Jel Classification: G32; G29

INTRODUCTION

Liquidity and solvency problems of business entities and collection of claims in the Republic of Croatia has been present for a long time. Such a state causes the stagnation of development, business, and the overall economic system. To start business, expand business, upgrade or develop entirely new products and/or services, enhance or open new businesses, or for such a purpose, the lack of own financial resources business entities tend to replace it, most often with credits. Subject of this paper is aimed at finding certain solutions or opportunities to overcome the business difficulties that are present. Factoring as a complex financial service can overcome the constraints that are particularly hampered by small and medium-sized businesses in financing business.

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Such a funding model allows inflow of funds before maturity claims, and thus facilitates the increase in current assets, continuous operations, improves cash flow, ensures the smooth functioning, improves competitiveness and collection of receivables and collectability risk as well as exchange rate risk becomes problem that bears factoring company. Thanks to factoring companies, many smaller businesses can engage in international trade, while the credit risk is on factor. (Baresa, Bogdan, and Ivanovic 2012). This paper presents the contribution to the popularization of this financial instrument that has long existed in the world but is not used enough in business as an instrument to overcome the illiquidity of business entities. In this paper there will be also pointed out certain dangers that may arise from its use.

1. LITERATURE REVIEW

Absence of financial resources or weak access to finance can strongly inhibit formal SMEs development. Small businesses, besides that are faced with a smaller approach to formal sources of external financing (Berger and Udell 1998; Galindo and Schiantarelli 2003; Bakket, Klapper and Udell 2004; Beck and Demirguc-Kunt 2006). Credit constraints are specially reflected in modern supply chains, which are characterized by high volumes of orders. In such conditions, obtaining cash-in-time for SMEs key is to continue operating with large buyers. Getting cash-in-time is important for making business without any problems with liquidity or solvency. Often times those large buyers pay their suppliers on 90 or even more days. Auboin, Smythe, and The (2016) consider that factoring can be very good solution for SMEs during their search for immediate cash so they can be able to pay the salaries and inputs. Contrary to traditional lending, factoring is gaining more and more importance, especially lately, so many authors give their contribution to the development of the factoring, and show the state of development and comparison in different countries (Lotz, 1992, Mian and Smith, 1992, Bakker, Klapper and Udell, 2004; Berger and Udell, 2004; Klapper, 2000, 2006; Baresa, Bogdan, and Ivanovic 2012 and many others). Factoring has emerged as the most important source of working capital for small and medium sized enterprises (SMEs) in many economies (Bakker, Klapper and Udell, 2004). Factoring business represents one of the forms which are often used in short term commerce financing (Papadimitriou, Phillips, and Wray 1994 and Muschella 2003). Factoring is "particularly useful as a source of short-term working capital in such economies because receivables are sold, rather than collateralized, and factored receivables are not part of the estate of a bankrupt firm (Borgia et al. 2010, 12; Alayemi, Oyeleye, and Adeoye 2015, 506). As a modern financial product in the form of tripartite contractual relationship between the bank – factors, customer and supplier related to a particual supply chain, reverse factoring appeared in global terms nineties of the twentieth century (Jovic and Vicentijevic 2015, 146). Dzeletovic, Milosevic and Nesic (2016) believe that greater use of factoring jobs, especially for small and medium-sized enterprises, has resulted in solving the problem of non-liquidity. Berger and Udell (2004) note that highly opaque SMEs, which may not have access to loans from financial institutions, can often obtain financing through factoring. They also stated that providing accounts receivable factoring services could be an attractive expansion opportunity for developing country bank or non-bank financial institutions to service the needs of small business clients. This kind of jobs can provide respectable profits. Factoring is particularly appealing in middle-income countries, where it is typically more difficult for firms to raise working capital (Klapper 2000).

Later in 2006 Klapper has investigated the determinants of factoring in 49 countries. Klapper found that economic development, growth rate of GDP, the availability of credit information, and weakness in contract enforcement contribute to greater use of factoring. Klapper also notes that while bank loans represent the primary source of SME financing in developed economies, they are often unavailable in emerging markets because they require lenders to be able to file liens against all business assets of the firm and require sophisticated technology and comprehensive credit information on firms.

Some authors examine factoring from the aspect of the financial system in the economy. In economies with a weak financial system, companies are faced with major barriers to getting capital from financial institutions and financial markets. Schumpeter (1911) pointed out that good and powerful financial system is one of the preconditions for technological progress and economic growth. He also argued that the services provided by financial intermediaries-mobilizing savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions-are essential for technological innovation and economic development. Likewise, a respectable number of papers indicate that the development of the financial sector has significant impact on the reduce of information costs and transaction costs in the economy (King and Levine 1993a; Jayaratne and Strahan 1996; Levine 1997; Demirguc-Kunt and Maksimovic 1998 and Rajan and Zingales 1998). Borgia et al. (2010, 20) present evidence that countries with weak governance have higher levels of accounts receivable factoring while the growth of factoring in a country is positively associated with improvement in governance. Close links between development of the financial system and economic development were explored by many authors: Goldsmith (1969) and McKinnon (1973), Jovanovic (1990), Bencivenga and Smith (1991), Roubini and Sala-i-Martin (1992), Levine (1991, 1992), King and Levine (1992; 1993a; 1993b; 1993c), Saint-Paul (1992), Gertler and Rose (1992) and DeGregorio and Guidotti (1992).

The literature suggest two main preconditions, which may affect the level of factoring activity in in a country's economy:

- the overall level of economic development
- the availability of financial information about enterprises;

Framework for understanding the links between the availability of reliable financial information and enterprise level efficiency and firms' choice of financing mechanism was presented by Bushman and Smith (2003) and Bushman, Piotroski and Smith (2004). According to Mian and Smith (1992) and Smith and Shnucker (1994), a factor that is specialized in the industry with many customers and sellers can be able to pool information among sellers to reduce credit risk.

Reasons for making decision on the use of factoring as a specific form of financing for SMEs Klapper (2006) points out three very important characteristics of factoring:

- Factoring is a type of supplier financing in which firms sell their credit-worthy accounts receivable at a discount and receive immediate cash.
- Factoring is not a loan and there are no additional liabilities on the firm's balance sheet, although it provides working capital financing.
- Factoring is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing.

Soufani (2002) in his research which was based on survey of 3805 companies of which 212 were using factoring services, found that purchasers of factoring services in the UK tend to be smaller firms, more likely to be found in manufacturing and associated industries, younger and limited companies rather than partnerships or sole proprietorships.

2. LIQUIDITY IN THE REPUBLIC OF CROATIA

In legal terminology insolvency is the situation when business entity is unable to settle its financial obligations. Liquidity and solvency problems are in relationship with performance of business entity, as one of its most important indicators. The liquidity problem of business entities, is present for a long time in Croatia. In a significant extent liquidity problems are present more in the countries in transition and less in countries with developed market economy. Liquidity problems haves attracted great attention from the scientific and professional public. There is no agreed opinion on its causes and possible solutions. Thus, liquidity, financial management, competitiveness and profitability of the business entity is in direct interdependence with charging claims, which is particularly evident in periods of crisis, i.e. in conditions in which economic growth come to the fore when the difficulties in obtaining additional liquid funds, or because of reduced supply or because of high interest rates (Ivanovic, Bogdan, and Baresa 2011, 164).

In 1993 after the stabilization program period, monetary policy was often been subject to public criticism. It was considered that this kind of monetary policy is the main cause of illiquidity in our economy. This was often ignored by a number of factors of an institutional nature (Sonje, Faulend, and Sosic 2001, 1). As the dominant causes of the liquidity problems in Croatia, Sonje, Faulend and Sosic (2001) consider: the problem of restructuring has remained in the transitional period so far, the activities of the state (inefficient judiciary, non-transparent payment, financial non-discipline of a country that does not pay its obligations in time and in full, expansive fiscal policy from the aspect of tax revenues, and from the aspect of expenditure, issuance of state guarantees for individual companies whose efficiency and economic justification is very questionable). There is also a big problem with the “predatory behavior” of individuals who have taken advantage of the existing rigidities and weaknesses of the system, and for the end the problems within the banking system have deepened the problem of liquidity.

According to Croatian Financial Agency—FINA[2], the latest state of affairs in Croatia on February 28, 2017 indicates that 29,056 business entities were blocked due to unforeseen grounds for payment. The total value of non-executed bases for payment of business entities was HRK 16.52 billion. Compared with the previous year's figure, the number of blocked business entities was reduced by 7,423 (20.3%) and the decrease of reported non-executed payment bases in the amount of HRK 5,51 billion (25.0%). If we observe insolvency over the duration of the blockade, in February 2017, business entities in the long-term blockade, (according to their number and the money amount they owe), continue to dominate.

[2] Financial Agency (Fina) is the leading Croatian company in the field of financial mediation and the application of information technologies. It is a unique service provider for market stakeholders, featuring financial intermediation solutions, quality business information, network-based and public services provided electronically or through a well-developed business network.

According to the data from FINA, Table 1 shows the number of blocked business entities and reported non-executed bases for payment by maturity in 2016. and 2017.

Table 1. Blocked business entities and reported non-executed bases for payment by maturity 2016–2017

- in thousands HRK

Maturity	Number of blocked business entities	Structure in %	Amount of reported unpaid payment bases	Structure in %
Balance at 28.02.2017.				
1) more than 360 days	19.163	66,0	13.179.738	79,8
2) 181-360 days	2.616	9,0	1.226.533	7,4
3) 61-180 days	4.045	13,9	1.292.783	7,8
4) 31-60 days	1.053	3,6	629.933	3,8
5) less than 30 days	2.179	7,5	186.952	1,2
Total	29.056	100,0	16.515.939	100,0
Balance at 29.02.2016.				
1) more than 360 days	26.226	71,9	18.004.623	81,7
2) 181-360 days	2.930	8,0	1.391.175	6,3
3) 61-180 days	4.062	11,2	1.824.247	8,3
4) 31-60 days	2.930	2,9	408.182	1,9
5) less than 30 days	2.205	6,0	394.906	1,8
Total	36.479	100,0	22.023.133	100,0

Out of a total of 29,056 block business entities, less than half (39.1%) are legal entities, and they account for the bulk of the total unpaid basis for payment or 64.1%. In the group of business entities which are blocked for a long period of time, over a year, most of them are blocked 5 years or more, which makes 45.1%. The amount of reported non-executed payment bases amounts to HRK 6.9 billion.

Table 2. Blocked business entities up to 360 days and more

- in thousands HRK

Maturity	Number of blocked business entities	Structure in %	Amount of reported unpaid payment bases	Structure in %
Balance at 28.02.2017.				
1) more than 360 days	19.163	66,0	13.179.738	79,8
2) less than 360 days	9.893	34,0	3.336.201	20,2
Total	29.056	100,0	16.515.939	100,0

The Republic of Croatia has adopted numerous laws that contribute to the reduction of insolvency, one of such laws is the Financial Business Act and the new Law on Factoring. Government of the Republic of Croatia has adopted the Regulation on the criteria and procedure for postponement of payment, full or partial write-off the claims.

Table 3. Insolvent business entities and the amount of outstanding liabilities in the Republic of Croatia: 1998–2017.

Month/Year	Number of insolvent business entities	Amount of reported non-executed obligations (HRK 000)
XII/1998	48.894	15.703.456
XII/1999	59.736	28.653.558
XII/2000	64.951	22.634.338
XII/2001	64.742	19.807.964
XII/2002	58.193	16.764.652
XII/2003	45.568	15.088.724
XII/2004	48.887	14.281.128
XII/2005	55.340	14.953.579
XII/2006	60.946	16.624.848
XII/2007	66.849	19.320.171

Table 3. (*continued*)

Month/Year	Number of insolvent business entities	Amount of reported non-executed obligations (HRK 000)
XII/2008	52.386	18.492.246
XII/2009	64.028	27.111.583
XII/2010	75.660	35.819.134
XII/2011	71.028	41.689.207
XII/2012	67.384	42.456.390
XII/2013	62.100	33.450.632
XII/2014	47.870	29.590.682
XII/2015	41.659	25.142.385
XII/2016	30.890	17.807.076
I/2017	29.575	17.483.989

Small decline in the value of non-executed payment bases as well as the number of blocked business entities since 2012 in the Republic of Croatia until today continues. However, monthly observed there is still a large number of business entities entering the blockade (in January 2017 there were 1992), indicating that the problems of mutual payments have not yet been solved.

As one of the possible contributions to solve the problems of liquidity and solvency, become part of everyday life and entered into every pore of society and now is offering alternative way of financing through fees and financing liabilities through factoring (Deletovic, Milosevic and Nesic, 2016). Using this model, a company doesn't have to take credit and go further into debt, what is a good solution to the problem of liquidity and solvency, and allows continuous business cycle and contributes to the improvement in liquidity and business growth and competitiveness in the market (Baresa, Bogdan, and Ivanovic 2012, 164).

3. FACTORING

The emergence of factoring operations reaches deep into history. Some of its tracks are located in the Roman Empire (Rutberg 1994), and some traces are from ancient civilization of Mesopotamia, during the region of King Hammurabi (Papadimitiou, Phillips, and Wray 1994, 11). A first name for the buyer of goods in contracts (*agents and factors*) appears in the 15th century in trade settlements organized by European traders in the colonial countries where merchandise was traded. It was a primitive type of factoring, which initially took the form of commission sales.

Through its historical development, factoring took on different forms and adapting to global changes, the needs of participants in the factoring business, generally economic and political situations and circumstances, thus resulting in different kinds and types of factoring applied in business practice.

Factoring is a contemporary and specific form of short-term financing based on the selling short–term unsecured assets of the company to a specialized financial organization or company that specializes in factoring (factor) to pay certain fees or charges. In other words factoring is the purchase of others' claims (debts) that is a financial instrument that factor (factor-house, factor-company, factor-organization, a bank that has a separate department) financed by the business entity on the basis of future (outstanding) claims arising from the sale of goods or services on the domestic or foreign market for a fee (Ivanovic, Baresa, and Bogdan 2011, 190). Factoring is the business which involves continuing legal relationship between a financial institution (the factor) and business (the client) selling goods or providing services to trade customers (the customers) whereby the factor purchases the client’s accounts receivable and in relation thereto, controls credit, extended to customers and administers the sales ledger (Biscoe, 1975). According to the definition by Alayemi, Oyeleye, and Adeoye (2015, 508) factoring is a short term financing arrangement where companies that are facing a cash flow squeeze and slow paying customers sell their receivables to specialized companies call factors. Factoring has recorded a significant growthin in recent years, especially in transition countries. Factoring has vital importance for small and medium enterprises in the world, it has support from government offices and central banks around the world (Factors Chain International 2012).

4. MOTIVES FOR USE OF FACTORING

Some authors attempted to explain motives of factoring, so Sopranzetti (1999) pointed out that receivable financing could alleviate the problem of SMEs. Sopranzetti (1998) has tested in his paper the determinants of motivation of factoring with or without recourse and established that sellers with a higher percentage of poor credit (with a higher exposure to credit risk) are usually limited to factoring with regression.

Factoring houses purchase receivables from their clients (debtors) on the basis of documentation proving the existence of claims such as invoices, their specification etc. The factor is the one who takes debtors risk (true factoring), runs accounting, and charges the claims, gives advance payment to the client, issues forms, etc., while the client (or the seller of the claim) pays the fee to factor (factoring cost and factoring rate) for the services rendered. Main reasons for using factoring service can be:

- inability to collect customer receivables,
- liquidity improvement (the need to transform their receivables into cash),
- the sale of discounted receivables to a business entity that has the option of collecting redeemed receivables.

Certainly the most important advantages of factoring are primarily the improvement of the seller's liquidity and the reduction of default risk. Using factoring company client charges most of its receivables before the maturity date. This frees up part of the funds that can finance further growth in sales which is especially important for expanding companies whose work is often limited due to the lack of working capital. There are several types of factoring subdivisions depending on the default criterion. Thus, domestic and international factoring differ. Domestic factoring, as the name itself suggests, takes place within the boundaries of a country where all the participants in factoring business are. The international factoring is intended for exporters and importers, and is a kind of instrument for promoting international exchange. The exporter is able to finance, assure and manage the claims, and makes it easier for the importer to purchase goods from abroad. Factoring can be done either on a “non-recourse” or “recourse” basis against the factor’s client (the sellers). In non-recourse factoring, the lender not only assumes title to the accounts, but also assumes most of the default risk because the factor does not have recourse against the supplier if the accounts default. Under recourse factoring, the factor has a claim (i.e., recourse) against the seller for any account payment deficiency. Therefore, losses occur only if the underlying accounts default and the seller cannot make up the deficiency (Klapper 2005, 4).

In the Republic of Croatia, the number of factoring companies varies widely, as can be seen from the line chart.

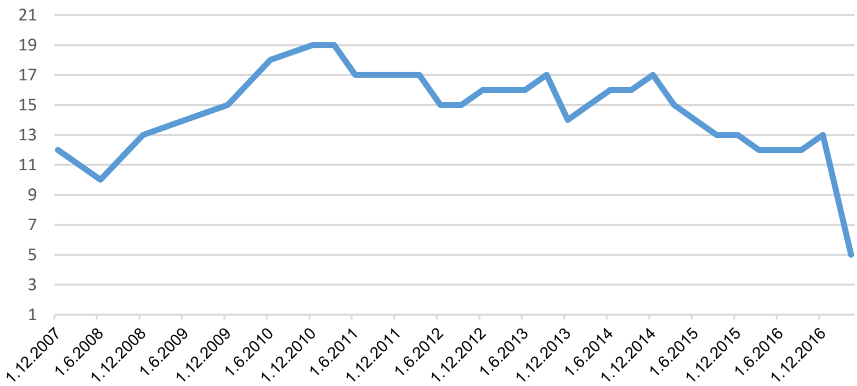

Figure 1. Number of factoring companies in Croatia

Since 03.04.2017, there is a large drop in the number of factoring companies in Croatia, only six companies (one company is in bankruptcy) met the conditions of the new factoring Legal Framework in Croatia. Croatian Financial Services Supervisory Agency (HANFA) approved a license for only six factoring companies. According to the data from the statistical reports collected by the factoring companies, on December 31, 2015, the Republic of Croatia dominated the purchase of bills of exchange. Factoring was dominated by domestic factoring (88.1% of total factoring receivables), whereby invoices were purchased from customers from the Republic of Croatia. For the first time since 2007, factoring transactions were largely concluded without the right of recourse (64.4% of total factoring receivables), whereby the entire charge risk is borne by the factoring service provider and the supplier is not responsible for the receivables (HANFA 2015).

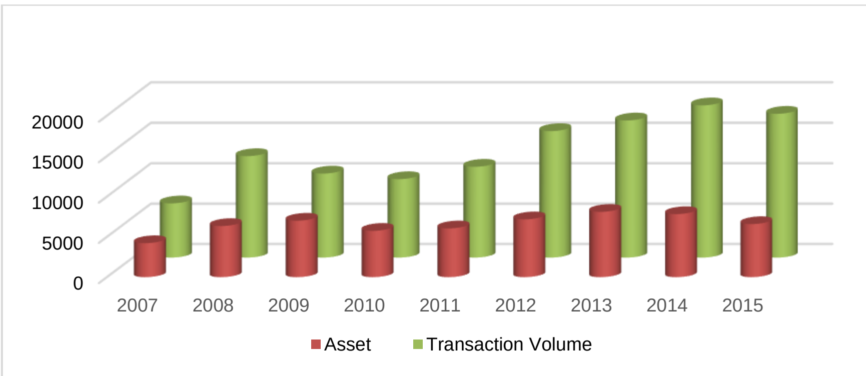

Figure 2. Aggregated assets and volume of transactions of the Croatian factoring companies for the period 2007–2015 (in HRK Millions)

In the observed period, according to the figure 2, the average value of the factoring companies was HRK 6,563 while the average turnover of factoring companies in Croatia was HRK 13,337. Factoring companies had the largest assets in 2013. while the largest volume of transactions was realized in 2014. when the most factoring companies were active (17). According to current events, a fall in the asset value of factoring companies in 2017. and a fall in the total transaction volume of factoring companies is expected, this was preceded by a reduction of factoring companies in 2016.

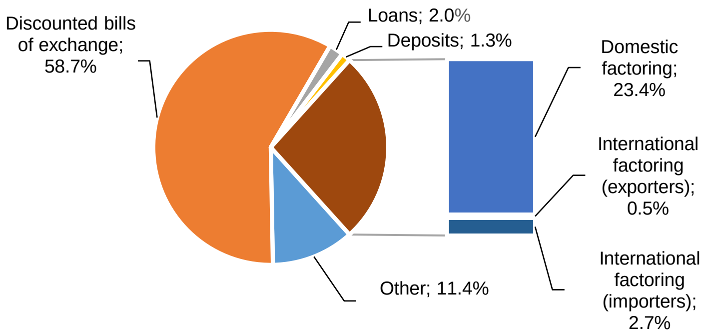

Figure 3. Aggregated data of Asset structure for factoring companies in Croatia, December 31, 2015.

Figure 3. shows that the most of the jobs factoring companies deal with, are related to discounting bills of exchange. Asset structure of factoring companies is divided mostly on discounted bills of exchange 58.7% and on the second place are factoring jobs. Domestic factoring prevails mainly (23.4%), followed by international factoring with import-oriented activities (2.7%) and then international factoring with export-oriented activities (0.5%).

CONCLUSION

As one of the possible solutions to overcome problems with liquidity and solvency of business and improve their competitiveness, factoring has been imposed as an advanced and alternative financial instrument that has been present for a long time and it is continually developing in the world and in the Croatia also. The growing trend of factoring companies' assets in Croatia was present in the period 2007–2009. After falling in 2010, assets of factoring companies are growing again in the period 2010–2013, in order to fall again in 2014 and 2015. Factoring has a big role in the Croatian market, this fact is proved by the annual volume of transactions, that amounts HRK 17.8 billion according to data from FINA in 2015. Since there was a great fall in the number of factoring companies in the last two years, the volume of transactions by factoring companies are expected to decline, which certainly will have negative impact on the market liquidity. According to data from 2015 HANFA reports that for the first time since 2007, factoring transactions were largely without the right of recourse (64.4% of total factoring receivables), whereby the entire credit risk is borne by the factoring company. In emerging markets, where it is often difficult to estimate default risk, most of the factoring transactions are done with the right of recourse. Strategically speaking factoring is very powerful generator of the money circulation speed. As a financing method, factoring has as enormous potential, oftentimes the only and crucial element in the financing of small and medium entrepreneurship. Creating unfavorable conditions and preventing further development of factoring may result in a negative "domino effect" especially when it comes to the development of small and medium-sized enterprises.

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