RECEIVABLES FACTORING AND PERFORMANCE OF PRIVATE FINANCE COMPANIES IN KENYA: A CASE OF PRIVATE FINANCE COMPANIES IN NAIROBI CITY COUNTY

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International Academic Journal of Economics and Finance (IAJEF) | ISSN 2518-2366

Received: 10th August 2019

Accepted: 20th August 2019

Full Length Research

Available Online at: http://www.iajournals.org/articles/iajef_v3_i3_356_368.pdf

Citation: Irungu, J. M., Kibuine, M. & Muhoho, J. (2019). Receivables factoring and performance of private finance companies in Kenya: A case of private finance companies in Nairobi City County. *International Academic Journal of Economics and Finance, 3*(3), 356-368

ABSTRACT

During the past two decades, SMEs have increasingly embraced invoice discounting as a practical source of working capital to bridge the gap between when they sell and collect payment from procuring entities. The objective of this study was to assess the relationship between invoice discounting and performance of private finance companies in Nairobi City County, Kenya. The study adopted descriptive and cross-sectional study designs. This study targeted 15 private financing companies that offer accounts receivable factoring services in Nairobi County of Kenya and four respondents per company thus having a total target of 60 respondents. The 60 respondents included business development managers, finance managers, credit administrators, general managers and CEOs. Primary data was collected using structured questionnaires and diagnostic tests and analysis carried out with the aid of SPSS version 23 to achieve accuracy and fast computing of the data in order to obtain information. A regression model was used to determine the relationship between the independent variables and dependent variable. The findings were presented in form of tables, charts, graphs and figures for easier interpretation. The regression model revealed a positive significant between invoice discounting a performance of private finance companies with a p-value of 0.000 accounting for 87.9% change. The study therefore recommended regulatory framework is developed to protect private finance companies from loss due to the level of risk involved in factoring of accounts receivables in Kenya.

Key Words: *Receivables factoring, performance, private finance companies, Nairobi City County, Kenya*

INTRODUCTION

Although the importance of factoring varies considerably around the world, it occurs in most countries worldwide with usage increasing as it offers several advantages over other types of lending. This can be attributed to traditional banks shying away from risky SMEs due to lack of collateral, coupled with sprouting of many small businesses in the emerging markets. Factoring offers SMEs that are unwilling or unable to get credit from a bank, simple and efficient short term financing based on receivables at certain fees (Ekpu, 2015). Unlike traditional commercial lending, factoring provides SMEs with working capital based on the creditworthiness of the firm's customers rather than the firm's collateral or credit history. Hence, factoring may be especially advantageous for SMEs with difficulties accessing bank loans but supply larger credible customers (Milenkovic-Kerkovica & Dencic-Mihajlov, 2012).

In recent years factoring has experienced phenomenal growth and has become an important source of financing for small and medium-size enterprises (SMEs) and corporations, reaching a worldwide volume of 2,598,298 million Euros in 2017 (FCI, 2018). Factoring services are particularly popular in Europe with up to 67% of the factoring volume in the world (Deutsche

Factoring Bank, 2016). This significant popularity is due to the special nature of the continent's trading including benefits drawn from the European Economic Zone and European Economic Community (Bakker, Klapper, & Udell, 2004).

In Kenya's current economic downturn coupled with the interest rate cap by the Central Bank of Kenya, businesses are finding it difficult to raise money to finance their activities using traditional sources of funds. Faced with this situation SMEs are forced to seek other sources of financing such as receivables factoring to bridge their cash flow gaps. For this to work the procuring entity, needs to be credible and honor the contractual credit period. However, with mega brands like Nakumatt and Uchumi struggling, factoring companies are in dilemma as they are unable to collect from the struggling retailers or recover the funds advanced to SMEs (Sanghani, 2014). This has had an impact on the performance of the private finance companies providing receivables factoring services to SMEs in Kenya.

STATEMENT OF THE PROBLEM

As a source of working capital financing, factoring is of particular interest for high-risk and unstructured businesses. Consequently, factoring companies often find themselves in disadvantaged situations such as in cases where the receivables become uncollectable due to returns or supplier colluding with the procuring entity not to remit funds to the factoring company. In extreme cases, the customer may become financially incapacitated and unable to honor payments as in the case of Uchumi and Nakumatt in Kenya. Although the factoring companies have measures to protect themselves against such risks, many a times, the advanced funds are not recovered. This not only affects the performance of the factoring companies but also threatens their survival (Alayemi, 2017). A number of studies have been conducted on the subject of factoring. Alayemi (2017) explored factoring as an alternative source of finance instead of bank loans and found that availability of financial information about enterprises and the overall level of economic activity are major determinants for adoption of factoring. Ngugi (2014) established that written policies and internal operating procedures affect the management of accounts receivables. Odero (2017) on the other hand found out that there exists a strong relationship between information asymmetry and adoption of factoring as a source of working capital financing. Sindani (2018) evaluated the effect of accounts receivable financing practices on the growth of SMEs in Kenya. The findings revealed that accounts receivable financing practices lead to growth when they are adopted by SMEs. The studies mentioned above approach the subject from the issues faced by SMEs leaving out the critical issue of performance of private finance companies that offers factoring services. This study therefore sought to fill this gap by evaluating the relationship between receivables factoring and performance of private finance companies in Kenya.

RESEARCH OBJECTIVES

The general objective of the study was to determine the relationship between receivables factoring and performance of private finance companies in Kenya. The specific objective was to determine the influence of invoice discounting on performance of private finance companies.

THEORETICAL REVIEW

Working capital management is concerned primarily with the management of current assets and by extension the current liabilities of a business. The operating cycle theory by Richards and Laughlin (1980) is one of the very important theories in working capital management that measures working capital management efficiency. It takes into cognizance the receivables and inventories related to working capital. The cycle essentially commences from the receipt of raw materials to the collection of receivables from debtors of the stock sales produced from those raw materials. According to this theory when businesses grant more liberal credit terms to their customers there is a higher tendency of having a bigger, but ultimately less liquid investment (Falope & Ajilore, 2009). However, the operating cycle theory tends to be deceptive in that it suggests that current liabilities are not important in the course of firm's operations.

Mukhoma (2014) anchored his research on the operating cycle theory in an attempt to study how accounts receivable management tries to minimize the amounts of money tied up in form of accounts receivables and thus takes the organization back to its original set goals. Omondi, (2014) also used this theory to research the effects of receivable management practices on receivables impairment in sugar companies in Kenya.

This theory is of significance to this study as it helps the researcher to link the ability of a firm to make collections to its performance. A financing company might experience cash flow problems when the procuring entity becomes financially unstable, in case of collusion between the procuring entity and the supplier and in situations of poor collection policies.

EMPIRICAL REVIEW

Invoice Discounting and Performance

Invoice Discounting is a form of receivables financing whereby an SME whose account receivables are not paid on time approaches a private financing company to purchase them. The financing company then confirms the authenticity of the invoices from the procuring entity that is holding onto the payment prior to discounting. The financing company then advances as much as 70 to 80 percent of the total receivables at the inception of the agreement and promises to pay the balance on collection of the balance outstanding after an interest and facility fee has been deducted. The financing company then assumes the risk and costs of follow up and collection from the procuring entity (Menberu, 2018).

Salaberrios (2016) conducted an exploratory study to examine the effect of invoice factoring of five small business with less than USD 3 million in annual revenues. Respondents were found in six states in the United States of America with data collected through semi structured Skype and telephone interviews. The study revealed three factors including owner eligibility for traditional capital sources, profit margins and third party relationships. The small business owners were not eligible for traditional funding options. Factoring administrators and small business owners cited that companies with better profit margins implemented invoice factoring successfully. Finance managers mentioned that factoring companies acted as a third party to the invoicing and collection processes. Social implications include a contribution to the advancement of small business success rates and to an entrepreneur's preparation to launch a business venture properly.

Kenduiwo (2014) investigated the relationship between alternative sources of finance and financial performance of SMEs in Nairobi County. The study employed descriptive research design. A stratified sampling method was used to collect primary data from eighty-five SMEs in Nairobi County during the year 2013. The study applied regression and correlation statistical tools to analyze data. The results were presented in tables, charts and frequency graphs. The study found out that the correlation between alternative sources of finance and financial performance is 0.762. This is a strong positive relation between the variables, which is consistent with studies done by Adenkule (2012) and Musyoka (2011). T-test found the relationship to be statistically significant of 8.46 at 99% confidence level. It also found out that high interest rates, collateral and guarantor requirement are the major hindrances to accessing mainstream finance. The study therefore recommended use of alternative finance in SMEs in Nairobi since they will lower cost of finance and improve liquidity which will result in improved financial performance.

According to Hamanyati (2017) Africa's participation in the factoring industry remains grossly stunted. Some reasons for this are the lack of an appropriate legal structure and lack of awareness of the financial tool in most African countries. Afreximbank under the auspices of FCI developed a model law on factoring to serve as a prototype for African states to model and enact at domestic level. This paper makes an extensive assessment of the existing legal framework and advocates that Zambia draws important lessons from the Afreximbank Model Law and other jurisdictions to enact its own Factoring Act to ensure that its small businesses can have enhanced access to financing through factoring and can thus operate at their cutting edge.

Kaster (2015) investigated the influence of factoring on access to finance by assessing number of companies that indicated access to finance as an obstacle to operations and expansion. The study adopted a panel regression model taking into consideration indicators of various variables from 23 developing countries for the period between 2009 and 2012. Results from the study confirmed a negative association between factoring and the percentage of financially constrained firms. With stronger relationship recorded in countries with higher values of credit information index, representing to what extent information about the borrower is available to providers of financing.

Farag (2013) through inductive content analysis approach developed and tested different hypotheses suggesting a linear relationship between a company's decision to factor its receivables and company's size, company's exposure to international trade, financial strength, and whether the factoring decision itself is regarded as a basic or a primary source of finance or regarded as an alternative source of finance. To test the hypotheses, the author interviewed the senior decision makers of fifteen Egyptian companies who were all offered the factoring finance option. Results of the study found no linear relationship between a company's decision to factor its receivables and its financial strength. The outcome of the study also showed that factoring in Egypt is also not necessarily a product used by SMEs and that it is more of a finance option available to whoever can yield a surplus profit to cover the financing costs. The Study also found a linear relation between a company's decisions to factor its receivables and its liquidity.

Performance of Private Finance Companies

Performance depends on a number of variables that are both internal and external to the organization. The major factors or determinants of performance are efficiency of capital use, productivity of the total resources employed, sales turnover and operational efficiency, profitability of the operations, return on capital employed, expansion plans and internal reserves built upon tax planning and accounting practices (Mwaura, 2015).

Reddy and Patkar (2005) performed a comparative study of two factoring companies in India. In order to achieve the objectives of the study, secondary data was collected from annual reports of SBI Factor and CanBank factor for the period 1991 to 2001. The variables identified for computing growth rates were reserves and surplus, loan funds, total assets, working capital, total income, total expenses and sales or factored debts. Growth rate analysis was employed to study the changes over a period in the selected performance related to each factoring company. Using regression analysis growth in performance of both factoring organizations in terms of financial parameters was observed as being satisfactory.

Kalaivani (2015) performed an analytical study on performance of factoring services providers. Sample size was seven companies and study used statistical tools such as T test, F test, multiple regression and correlation analysis to identify the relationship between multiple variables. Secondary data was collected for period between 1998 and 2007 from publications and financial statements. The study inferred that the increase in factoring income is less than that of own funds and that the ratio of own funds to factoring income is significantly declining.

RESEARCH METHODOLOGY

Research Design

This research used a descriptive and cross-sectional research design to assess the relationship between accounts receivables factoring and performance of private finance companies offering the services in Nairobi County in Kenya at a point in time.

Target Population

This study targeted 15 private financing companies that offer accounts receivable factoring services in Nairobi City County, Kenya. The research targeted four respondents in each company namely; credit administrator, finance manager, business development manager and general manager or chief executive officer.

Sampling Procedure and Data Collection

This study adopted snowball sampling technique to draw samples from the target population. The study targeted 15 private finance companies but only 9 are known. Therefore, the study used referrals from the known private finance companies to identify, acquire contacts of respondents and gather information about the other 6 unknown private finance companies currently offering factoring services in Nairobi City County, Kenya. Questionnaires were used to collect primary data.

Data Analysis

Data analysis was conducted using a multiple regression model to determine the relationship between the independent and the dependent variables. The overall model can be represented as follows:

$$PF= \beta_0+ \beta_1 ID_1 + \varepsilon.$$

Where: PF = Performance of the private Financing company; ID = Invoice discounting; $\beta_{0,}$ $\beta_{1=,}$ Beta coefficients.

RESEARCH RESULTS

The study sought to establish the effect of invoice discounting on performance of private finance companies in Kenya. The regression models reveal a statistically significant positive relationship between invoice discounting and performance with a beta co-efficient of 0.173 and p value of 0.000 (significant as $p=0.000$ and $p<0.05$). The study revealed that SME suppliers have to endure average credits periods of between 60 and 90 days to unlock funds on supplies done to retail and manufacturing procuring entities. Because of this long credit periods SME suppliers have no choice but to discount accounts receivables with private finance companies. This in return has left the private finance grappling with risk exposure, as payment by the procuring entities is dependent on their cash flow position. This study agrees with the findings by Sindani (2018) who found out that the SMEs under study do regularly discount or sell overdue invoices as failure to regularly discount or sell overdue invoices may result to an increase in the volume of bad debts which in return dampens the SMEs growth. The study findings also agree with the results obtained by Kenduiwo (2014).

The study also found out that private finance companies do generate more interest income because of delayed payments by the procuring entities; this cost is borne by the SME whose accounts receivables are factored. This finding agrees with that of Ollows and Moro (2015) who found out that the longer a loan takes to mature the higher the income received by the lender. Further, the study found out that the risk environment does not favour the private finance company. This is represented by the majority of respondents who strongly agreed that there is increase in performance risk having a mean of 4.3, credit risk with a mean of 4.58 and business risk having a mean of 4.5. A majority of respondents also agreed that rate of risk exposure has slightly increased lately; this was indicated by a mean of 3.78. This finding agrees with that of Menberu (2018), who found out that factoring firms assume risk that would however be assumed by the transferee of the accounts receivables in factoring transactions. Kimathi (2017) also concludes that factoring is the outright purchase of credit approved accounts receivables with the factor assuming bad debt losses.

REGRESSION ANALYSIS

The study sought to examine the relationship between invoice discounting and performance of private finance companies in Kenya.

Table 1: Invoice Discounting Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.938a	.879	.876	.51238

a. Predictors: (Constant), Invoice discounting

The results in table 1 above indicate the regression results for the effect of invoice discounting alone on the performance of private finance companies. With an R of 0.938 and R^2 of 0.879, the findings indicate that invoice discounting on its own accounts for 87.9% in the variability in performance of private finance companies. The other 12.4% of the variation can be linked to other factors.

Table 2: Invoice Discounting Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.242	.282		-.858	.396
	Invoice discounting	.173	.010	.938	16.626	.000

a. Dependent Variable: Performance of private companies

The results presented in table 4.16above indicate that invoice discounting alone has a negative effect on the performance of private finance companies with a beta coefficient of -.242 and a P-value of 0.173

The Regression equation is;

$$\mathbf{PF = \beta_0 + \beta_1 ID_1 + \varepsilon.}$$

Where: PF = Performance of the private Financing company; ID = Invoice discounting; $\beta_{0,}$ β_1=Beta coefficients.

Therefore;

Performance **= -0.242 + 0.173 ID**

This means that all factors held constant for every single unit change in invoice discounting, there would be a change in the performance of private finance companies in Kenya by a factor of 0.173.

CONCLUSION

The study has revealed that managers of private finance companies should aim at reducing credit and performance risk through use of risk mitigation measures as they can result in business risk. This is important as factoring occurs in an environment of funding without collateralization and dishonor of accounts receivables exposes the private finance company to losses. They should maintain optimal portfolio balances to allocate limited resources to the right interest bearing factoring product whose level of risk exposure is manageable.

The study also concludes that there is need to optimize collections processes to reduce cost of follow up and time taken to collect payment from procuring entities as this affects income and eats into money retained that belongs to the SME supplier. Credit appraisals of both procuring entities and factoring customers is therefore a core and critical administrative role that every private finance must have within its structure. This is meant to ascertain the financial wellbeing off the borrower as well as the third party from whom payment is expected at the end of the credit period.

RECOMMENDATIONS

It is recommended that a regulatory framework is developed to manage private finance companies. This should be done by the Central Bank of Kenya in order to protect financiers of these companies from loss due to the level of risk involved in factoring of accounts receivables in Kenya. It is also recommended that every private finance company must engage in proactive risk mitigation measures that include proper corporate governance structures to guide policy on lending, formation of credit committees at managerial level to approve all new procuring entities and customers as well as a credit administration department to actively follow up on payments when they fall due. The Government should also fast track enactment of regulation to protect suppliers and by extension accounts receivables factoring service providers from creditors, this will ensure prompt payment of due accounts. Further, it is recommended that private finance companies should form associations that will assist them to share information on delinquent borrowers and defaulting procuring entities. The association is a good avenue to leverage resources and assist the companies to unlock cheaper funds from the market that will translate to scaling of factoring business in Kenya due to services becoming cheaper and affordable to SME suppliers.

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