Incisive Business Guide to Factoring

Factoring Guide Summary

This guide from Incisive Business outlines the features and benefits for your business from using factoring and invoice discounting services.

Factoring is commonly used by businesses to improve cash-flow but can also be used to reduce administration overheads. Factoring is a flexible source of finance where no other assets are needed to secure the funding. Your business sells it's accounts receivable and the factoring company collects payments directly from your customers.

With Invoice Discounting you sell your accounts receivable without the knowledge of your customers and the credit control and management remains your responsibility.

How can Factoring benefit your business?

- Factoring provides payment certainty. You know when you are going to paid instead of having the insecurity of waiting
- When you use a factoring service you receive a quick cash injection into your business in line with your revenue
- By factoring you could receive up to 90% of the value of your invoices within 24 hours
- Factoring is well priced compare to other sources of business finance and loans
- The company that provided your factoring service will manage and collect your debts on your behalf freeing your time to manage your business.

So what is Factoring?

Factoring is finance based on the value of the sales invoices you issue to your customers. Basically factoring involves selling your invoices to a third party.

For any organisation cash is king and having a healthy cash-flow is the lifeblood of a business. Factoring is commonly used by businesses to improve cash-flow but can also be used to reduce administration overheads. Factoring provides a regular cash input into your business and means that you concentrate on growing your business not spending time chasing payment from your customers.

Factoring is a flexible source of finance in that the amount a business can borrow grows with their sales. This flexibility is often essential to allow companies to fund growth. Additionally with factoring no other assets are needed to secure the funding – your invoices and the "promise to pay" are the asset.

Also known as Invoice Discounting, Debt Financing, Debtor Financing and Asset Based Lending or ABL, factoring is ideal for business-to-business companies that offer goods or services on credit terms i.e. 30, 60 or 90 days.

A factoring company will lend your business an agreed percentage based on the invoices you issue to your customers. The factoring company will then collect the invoice when it's due and subsequently pay the balance back to you. There are usually two charges for this service, which are usually interest and fees.   Interest will be based on the amount advanced and fees are for credit management and administration.

The amount of finance a factoring company will provide against the security of your invoices will vary depending on the company's credit status; however it's usually possible to get up to 85% of the value of the invoices and more depending on your business circumstances. The finance provided through factoring helps you to ensure sufficient working capital to meet cash flow requirements; pay suppliers etc which in turn, will help your business continue to grow.

Today Factoring is popular as an alternative to more traditional methods of maintaining cash flow. In the past companies would rely on banks for small business loans or overdraft facilities or perhaps even used their business credit cards to help pay for materials or even staff wages. Factoring helps to bridge the gap between the time you issue of an invoice and the point at which you receive payment. Also the more invoices you raise, the more case will be made available to your business by the factoring company.

Please remember it is important to make sure you have the right type of facility for your business and the right factoring company for you. Different lenders have very different criteria, approaches and capabilities. Choose carefully and research all the associated costs.

How can I get a factoring service for my business?

Setting up a factoring service for your business can often be done far more quickly than the more traditional forms of business finance and the staff at the factoring companies are often more commercial; working hard to find a suitable solution for you.

To get set up there are a number of things the potential factoring companies will need to evaluate before they can provide you finance.

1. Turnover

The majority of factoring companies will be looking at businesses with a turnover in excess of £100,000 per annum. If you have a turnover below this threshold it may be more cost effective for you to utilise one of the other finance options such as a small business loan or an overdraft facility. Of course there can be exceptions. For example, recruitment businesses; where some factoring companies have specific solutions for this sector with different criteria for accepting business.

2. Industry or Business sectors

Certain industries are less favoured by factoring companies; in particular those that are primarily dealing with consumers; for example retailers and hoteliers.

If you are an export company, with invoices issued to businesses abroad, the factoring company is likely to have slightly different qualifying criteria depending on where the majority of your exports are sold. Here the factoring company might look for a higher turnover. Also if your selling outside the EU, the factoring company may require your business sales to be in the region of £500,000.

Similarly in the construction sector the factoring company may require additional information because with many construction projects there can be a number of disputes often because of the multiple contracts involved. However there are some factoring specialists that should be able to assist you, but you should expect the percentage of factoring finance may be lower, perhaps up to 70% of your outstanding invoices.

3. Concentration Ratio

The factoring company will identify how many clients your business has and examine how your invoices are spread across all your customers with outstanding invoices. If they see that the majority of invoices are with a few customers then this could be an issue as factoring companies will us this concentration of debt to measure their factoring risk.

Once you have been approved by your chosen factoring supplier and you have agreed terms, setting up the process is relatively painless.

What happens once I have a factoring service in place?

Your company must notify all its customers of that the new arrangement is in place. You hand over the task of collecting debts to your factoring company. The start of a new factoring relationship can often result in a substantial payment as the factoring company take on the existing debtors. Now when you raise invoices it will have the instructions to pay your factoring company instead of you.

You send copies of the invoices raised to the factoring company and they will release the agreed percentage of funds directly to your account, often within 24 hours. Future customer invoice statements are issued by your factoring company and sent to your customers on your behalf.

Your factoring company will also implement credit control procedures to help ensure prompt settlement of the invoices and this will include contacting your customers on your behalf.

Once the payment of invoice has been received by your factoring company the balance of the invoice will be credited to your account minus any agreed charges.

What are the costs associated with factoring?

Generally there are two costs involved in a factoring service.

1. The interest on the funds credited to you

2. The factoring companies fees for providing the service.

The interest rates charged by the factors tend to vary from 1.5% to 3% above the bank base rate. This is daily calculated on the sums advanced to you.

The fees charged are for the credit management facilities and administration carried out by the factoring company on your behalf; these services will include the credit control and the chasing the debts. The main advantage of the credit collection facility is that you have someone else chasing any overdue accounts leaving you time to concentrate on your business. Commonly these fees are based on your company’s turnover and can range from 0.75% to 2.5%.

Invoice Discounting

Invoice discounting is an alternative way of drawing money against your invoices but here your business retains control over the administration of your sales ledger and credit collection. Also your customers will not be aware that you're using a factoring facility as all the invoices will be paid to you in the normal way.

How can Invoice Discounting benefit your business?

- When using invoice discounting services you collect the debts and do the credit control
- Your customers do not usually know about the invoice discounting

Generally Factoring companies have stricter criteria for invoice discounting, compared to factoring. It is only available to business-to-businesses companies that sell products or services on credit. Also the turnover of your company will need to be higher than in factoring; somewhere in the region of £500,000, although recently this has been relaxed by some factoring companies.

Normally a factoring company will want to review your credit history and profit track record. They will have strict rules regarding the quality of sales ledger and the systems and procedures in place. The factoring company will check your company's ledger, the types of customers you deal with and the procedures in place for credit management.

Based on these elements they will agree to advance you a percentage of your total outstanding sales ledger. For example, the total owing on your sales ledger is £100,000 and the factoring company agrees to advance you 80%, therefore the amount available your company would be £80,000.

Every month your factoring company will evaluate your sales ledger, if the total of outstanding invoices increases to £110,000, you will receive 80% of this increase i.e an additional £8,000. Where sales fall to £90,000 you must repay 80 per cent of the subsequent reduction of debt i.e £8,000.

You can choose between recourse and non-recourse options which determine who is responsible for recovering any unpaid invoices. (see below for an explanation of recourse and non-recourse options).

How much will invoice discounting cost?

Usually invoice discounting fees are lower than factoring because only the finance is provided with this service not the credit management and collection. The fees can range from between 0.2% to 0.5% of your company turnover. In addition there is the interest charged on the amount advanced.

What is Recourse and Non-Recourse Factoring?

Basically recourse and non-recourse are different options available to your company depending on whether you want to keep the responsibility for any bad debt customer or pass this to the company providing the factoring or invoice discounting service.

Recourse Factoring

With recourse factoring you remain liable, to the factoring company, for the debt of your customers. In recourse factoring, the factoring company does not risk bad debts i.e they will be able to reclaim monies from your company for bad debt. Your factoring agreement will specify how many days after the payment due date you must make a refund and consequently should your customer fail to pay your business will become liable to the factoring company for this debt.

For example: Your standard terms with your customer are payment in 30 days. You agree with your factoring company a 90 day period for your customers to pay invoices, allowing you an additional two months to ensure payment is received from the customer before you have to pay the factoring company the money advanced to you plus a fee and interest.

Non-recourse Factoring

With non-recourse factoring your factoring company accepts the bad debt risk. For example, where one of your customers becomes insolvent or files for bankruptcy the factoring company will fully accept the financial risk of any outstanding invoices.

However the factoring company does not insure against slow payment and consequently while you won't have to refund the advance; you will still be liable to pay interest until the factored invoice has been paid in full. It is worth bearing in mind, with non-recourse factoring, that should the customer fail to pay the invoice, the factoring company has the right to pursue the debt and any legal action they feel is required.

Questions to ask your prospective Factoring Company:

- How quickly and efficiently do they collect the debts?
- What are their credit collection procedures? Do these suit your requirements?
- What is their business culture? Are they a good fit with your business?
- What experience do they have of your type of business? Can you talk to any of their customers?
- What is their process should a customer exceed their credit limit?
- How will they communicate with your customers? What is their approach? Can you see any scripts or materials they use? Can you listen to some of their calls? (You don't want them alienating your customers)
- How long is their contractual period? What is the notice period? What do you need to do if you want to get out of the agreement?

Definitions:

Factoring Company: An organisation that buys accounts receivable before their due date at a discounted price

Factoring: Short-term financing of accounts receivable

Asset Based Lending: Lending to a business secured by an asset or assets not usually used in other loans. The assets could include inventory, accounts receivable, plant, machinery and other equipment.

Invoice Discounting: Selling your accounts receivable, without your customers knowledge, to an organisation in exchange for cash, where the credit control and management remains your responsibility

For more information please visit the ABFA website:- http://www.abfa.org.uk/public/factoring.asp