Factoring and invoice discounting

Factoring allows you to raise finance based on the value of your outstanding invoices. Growing businesses, in particular, often find that factoring is a more flexible source of working capital than overdrafts or loans.

Factoring also gives you the opportunity to outsource your sales ledger operations and to use more sophisticated credit rating systems. This briefing outlines:

- How factoring and invoice discounting work.
- Whether factoring is suitable for your business.
- How to choose a factor.

1 Getting started

Different factors will have different criteria. By searching around, it is likely you will find one whose terms suit your business. However, a typical factoring process may involve the following steps:

1.1 The factor **audits** your books and accounts to establish that your sales ledger meets its criteria.

- Most companies which use factoring have a turnover of more than £200,000.
  Some factors will consider start-ups and companies with turnover of £50,000 or less.
- Generally you should not have just a few customers and no one debtor should account for more than 25–40 per cent of your business. Although some factors will take a view where there are only a few customers.
- Factors only provide finance to businesses dealing on trade credit terms.
  Factors prefer businesses which offer customers industry standard credit terms.
- You should be collecting your debts within a reasonable time frame.
  Businesses such as builders and advertising agencies which are paid in stages, and whose bills are often questioned, may not be able to use factors.
- Too many small invoices may make factoring uneconomical.
- Businesses whose sales are declining could find factoring difficult to justify.

1.2 Where **credit limits** are required by the factor, you and the factor must agree how they will be handled.

- For non-recourse factoring (where the factor protects you against bad debts), the factor will usually set credit limits for each customer.

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The factor will use its credit system to determine their creditworthiness.

- Many factors who offer recourse factoring do not agree credit limits.

1.3 Once you make a **sale**, you invoice your customer and send a copy of the invoice to the factor.

- Most factoring arrangements require you to factor all your sales.

1.4 The factor **pays** you a set proportion of the invoice value within a pre-arranged time.

- Typically, most factors offer you 80–85 per cent of an invoice's value within 24 hours.

Invoice discounting

Invoice discounting enables you to retain the control and confidentiality of your own sales ledger operations.

A You **collect** your own debts.

- 'Confidential invoice discounting' ensures that your customers do not know you are using invoice discounting.
- You send out invoices and statements as usual.
- The invoice discounter makes a proportion of the invoice available to you once it receives a copy of an invoice you have sent.
- Once you receive payment, you must deposit the funds in a bank account controlled by the invoice discounter.
- The invoice discounter will then pay you the remainder of the invoice, less any charges.

B The **requirements** are more stringent.

Different invoice discounters will impose different requirements. Typically:

- Your annual turnover must be over £500,000 and in some cases exceed £1 million.
- The invoice discounter will regularly audit your books (usually every three months) to check that your credit control procedures are adequate.
- You must have a minimum net worth of £30,000.
- Your business must be profitable.

The requirements for 'disclosed' (ie non-confidential) invoice discounting are generally less demanding.

You can obtain faster payment with electronic transfers. You may be charged.

1.5 The factor issues statements on your behalf and **collects** payments.

- This includes contacting late payers by phone and pursuing outstanding invoices.
- You remain responsible for reimbursing the factor for bad debts, unless you have arranged a 'non-recourse' facility (see **2.5**).

1.6 You receive the **balance** of the invoice (less charges) once the factor receives payment.

1.7 The factor provides regular **reports** on the status of your sales ledger.

- You should expect regular statements. Many factors can offer you instant online account information.

2 The advantages

2.1 You maximise your **cashflow**.

- Factoring enables you to raise up to 85 per cent or more on your outstanding invoices. An overdraft secured against invoices would only raise up to 50 per cent.

2.2 You negotiate an initial **credit line** which can grow in step with your sales.

- Bank finance, such as overdrafts and loans secured against existing assets, has to be continually renegotiated.

2.3 Using a factor can reduce the time and money you spend on **debt collection**.

- The factor will usually run your sales ledger for you.
  You retain your own sales ledger operations if you opt for invoice discounting (see box).

2.4 You can use the factor's **credit control** system to help assess the creditworthiness of new and existing customers.

- This is especially useful if you do a lot of business with companies whose turnover is lower than £6.5 million and who do not have to file full returns with Companies House.

2.5 You can purchase 'non-recourse' factoring to protect yourself against **bad debts**.

2.6 Factoring can be an efficient way to minimise the cost and risk of doing

business **overseas** (see box).

3 The costs

3.1 Finance charges should be comparable to an overdraft.

- Typical charges on the amount financed range from 1.5–3 per cent over base rate, with interest calculated daily.

3.2 Credit management and administration charges, including the maintenance of your sales ledger, depend on your turnover, the volume of your invoices and the number of customers that you have.

- Typical fees range from 0.75–2.5 per cent of annual turnover.
  A company with 50 live customers, 1,000 invoices per year and £1 million turnover might pay one per cent.
  For invoice discounting, where finance alone is provided, administration fees range from 0.2–0.5 per cent of annual turnover.

3.3 Credit protection charges (for non-recourse factoring) largely depend on the degree of risk the factor associates with your business.

Typical charges range from 0.5–2 per cent of annual turnover.

Export factoring

Export factoring enables you to minimise the risk of doing business overseas by relying upon a factor to collect payments.

You can use export factoring to bypass the complexities of export finance and offer your customers 'open account' trading.

A The **turnover** requirements are higher than with UK factoring.

- You must have an overall annual turnover of at least £100,000, including both domestic and export sales.
- Within the EU, it is possible to factor debts with relatively small sales to any one country.
- For other countries, higher sales to that country will be required eg typically annual sales of £500,000 to the USA.

B You can choose to invoice in one **currency** and be paid in another.

- Many customers will prefer being quoted in their own currency.
- You can protect yourself against currency fluctuations.

C The **cost** of export factoring compares favourably with the cost of export finance.

- The cost of export factoring is typical marginally higher than the cost of domestic factoring.

D You can minimise the **risk** of non-payment by purchasing credit protection.

- Using an export factor's credit protection systems can be cheaper than using specialised export finance.
- Most factors will insist that you purchase credit protection.

4 The disadvantages

Unless carefully implemented, factoring can have a negative impact on the way your business operates.

4.1 The factor usually takes over the maintenance of your **sales ledger**.

- Your customers may prefer to deal with you rather than a factor.
  However, if the factor's techniques are clearly agreed beforehand, there will usually be no problem.

4.2 Factoring may impose **constraints** on the way you do business.

- For non-recourse factoring, most factors will want to pre-approve your customers, which may cause delays.
  The factor will apply credit limits to individual customers (though these should be no lower than prudent credit control would suggest).

4.3 You may only want the **finance arrangements**, but unless your scale of operations is big enough to justify invoice discounting, you may feel you are paying for collection services you do not need.

4.4 Ending a factoring arrangement can be difficult.

- Your only exit route is to repurchase your sales ledger or to switch factors.
- On a practical level, you need to be able to provide an alternative form of financing to make up for the sudden shortfall in your

working capital.

5 Picking a factor

You will probably want to talk to several factors and get quotes from more than one before you make a decision.

5.1 The Asset Based Finance Association can provide a **list** of factors with contact numbers, services and turnover requirements (020 8332 9955 or www.abfa.org.uk).

There are many independent factoring and invoice discounting companies, as well as subsidiaries of the major banks.

- A factoring broker can advise you and may be able to negotiate a better deal.
  Most brokers do this work free of charge (as they receive commission from the factoring company).

5.2 Confirm that all the factors you are considering offer the **services** you require, at the right price.

- Ask how each factor's credit-control system works.
  Will the factor want to pre-approve future customers? What credit limits will the factor want to set? How quickly will the factor make decisions?
- Confirm each factor's proposed finance, credit management and credit protection charges.
  These will be negotiable and should reduce as your turnover grows.
  Some factors may want to charge you for a survey of your debtor book before they will.

6 Before you sign up

Once you have chosen a factor, make a detailed check before you commit yourself. Extricating your business from such an intimate working relationship can be complicated and expensive.

6.1 Check, as far as you can, that the factor's **performance** is likely to be satisfactory.

- Does the factor (and the individual who will be responsible for your account) have experience of your industry?
- How will you communicate with the factor? What reports will you receive? What information will you have to provide? How often will you and the factor meet?
- How quickly does the factor collect debts? How does this compare with your own debt collection performance?
- How flexible will the factor's methods be? What is the factor's idea of 'quick response', in an emergency? What will happen if customers accidentally breach their credit limits? What will happen if you want a customer's credit limit increased?
- What will happen if the factor's performance is unsatisfactory?
  For example, will you end up paying financing charges for debts the factor has failed to collect?

  Ask for references and telephone some of the factor's existing customers.

  Ask how well the factor has performed and whether there have been any problems.

6.2 Discuss how the factor will handle **debt collection**.

- When will statements be sent out?
- What happens if a customer disputes an invoice?
- How will the factor pursue overdue debts? What letters will be sent and what phone calls will be made?
- What will happen when a customer's payments are seriously overdue?
- What form will the final reminder letter take and when will it be sent?
- What further action will the factor take to collect overdue debts?
- Will a collection agency be used?
- Will legal action be taken?

6.3 Read the factoring agreement carefully, confirm the terms and conditions for **ending** the factoring arrangement and make sure they are clear. If in doubt, take legal advice.

- What would happen if you wanted to change factors?
  There may be a notice period (typically three months) and a fee.
- What would happen if you wanted to alter the services provided by the factor?

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