Guide from

Think Ahead ACCA

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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.

1. Getting started

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

The factor checks 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 a 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 to 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 timeframe. 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.

You and the factor must agree how any credit limits 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. The factor will use its credit system to determine their creditworthiness.
- Many factors who offer recourse factoring do not agree credit limits.

For each sale, you invoice your customer and send a copy to the factor

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

The factor pays you a set proportion of the invoice value within an agreed time

- Typically, most factors offer you 80 to 85 per cent of an invoice's value within 24 hours.
- You can obtain faster payment with electronic transfers. You may be charged.

The factor issues statements on your behalf and collects payments

- This includes contacting late payers by phone and chasing outstanding invoices (see before you sign up).
- You remain responsible for repaying the factor for bad debts, unless you have arranged a non-recourse facility.

You receive the balance of the invoice once the factor receives payment

- The factor deducts their charges from the amount paid to you

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.

Invoice discounting

Invoice discounting helps you keep control and confidentiality over your own sales ledger operations.

You collect your own debts

- 'Confidential invoice discounting' hides the fact that you are using invoice discounting from your customers.
- 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.

The requirements are more demanding

Different invoice discounters will have 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.

2. The advantages

You maximise your cash flow

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

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.

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.

You can use the factor's credit control system

This helps you 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 £10.2 million and who do not have to file full accounts with Companies House.

You can arrange non-recourse factoring to protect yourself against bad debts

Factoring can reduce the cost and risk of doing business overseas

Export factoring

Export factoring helps you 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.

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 typical annual sales of £500,000 to the USA.

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

- Many customers will prefer quotes in their own currency.
- You can protect yourself against changing exchange rates.

The cost of export factoring compares favourably with the cost of export finance

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

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.

3. The costs

Finance charges should be comparable to an overdraft

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

Credit management and administration charges vary

- Charges depend on what services are being provided, your turnover, the volume of your invoices and the number of customers that you have.
- Typical fees range from 0.75 to 2.5 per cent of annual turnover. A company with 50 live customers, 1,000 invoices per year and £1 million turnover might pay 1 per cent.
- For invoice discounting, where finance alone is provided, administration fees range from 0.2 to 0.5 per cent of annual turnover.

Credit protection charges (for non-recourse factoring) largely depend on risk

- The factor decides how risky they think your business is.
- Typical charges range from 0.5 to 2 per cent of annual turnover.

4. The disadvantages

Unless carefully implemented, factoring can negatively affect the way your business operates.

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.

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 reasonable credit control demands).

You may feel you are paying for collection services you do not need

- Unless your scale of operations if big enough to justify invoice discounting, you may have to use the factor's collection services even if you only want the financing.

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.

Identify possible factors

- There are many independent factoring and invoice discounting companies, as well as subsidiaries of the major banks.
- The Asset Based Finance Association can provide a list of factors with contact numbers, services and turnover requirements (020 8332 9955).
- 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).

Confirm that they offer the services you are looking for, 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.

6. Before you sign up

Once you have chosen a factor, make a detailed check before you commit yourself. Getting out of such an intimate working relationship can be complicated and expensive.

Check 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 system?
- 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.

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 follow up 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?

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 change the services provided by the factor?

Signpost

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