Total Back Office Solutions Ltd
Invoice Finance

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Debt factoring and invoice discounting: the basics

Subjects covered in this guide

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How debt factoring works

Advantages and disadvantages of factoring

What makes a business suitable for factoring?

Recourse factoring and non-recourse factoring

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Introduction

Debt factoring involves selling your invoices to a third party. In return they will process the invoices and allow you to draw loans against the money owed to your business. Essentially, these companies provide a debt collection and ledger management service.

It is commonly used by businesses to improve cashflow but can also be used to reduce administration overheads. Businesses that supply this service are called factors or debt factoring companies.

Invoice discounting is an alternative way of drawing money against your invoices. However, your business retains control over the administration of your sales ledger. As well as providing finance, which is probably the main attraction, it offers valuable support services and credit insurance.

This guide gives information on how debt factoring and invoice discounting work, the advantages and disadvantages, different types of factoring and invoice discounting, the cost, and how to choose a factor or discounter.

How debt factoring works

Factoring provides a fast **prepayment** against your sales ledger. It allows you, at a cost, to flexibly increase your working capital and improve cashflow.

Factoring is offered to businesses trading with other businesses on credit terms. It is not normally available to retailers or to cash traders.

When factoring starts

Factors can be independent, or subsidiaries of major banks and financial institutions. Whatever their background, they will want to meet you, visit your business, review your financial situation and study your business plan to evaluate your suitability for a factoring facility.

Credit limits might be required - if so, you must agree how they will operate.

After signing the agreement, the factor will typically agree to advance up to 85 per cent of approved invoices. Payment is usually made within 24 hours. Usually all sales go through the factor.

Check the notification period - most factors require three months' notice to end the service, but some require longer. Negotiate if you are not happy with the notice period.

Factoring is a complex, long-term agreement. It is advisable to consult your solicitor on the legal and financial implications of factoring.

When an invoice is raised

- You raise an invoice, which has instructions to pay the factor directly and send it to the customer. Send a copy of it to the factor.
- The factor pays an agreed percentage of the invoice to you.
- The factor issues statements to the customer on your behalf. It operates credit control procedures including telephoning the customer if necessary.

When an invoice is paid by the customer

- The customer should pay 100 per cent of the invoice directly to the factor.
- The factor pays the balance of the invoice to you. Fees and interest will be deducted from the payment. See the page in this guide on **the cost of factoring and invoice discounting**.

When an invoice is not paid

If an invoice is not paid, responsibility for paying the debt will depend on the type of agreement - either recourse factoring or non-recourse factoring. See the page in this guide on **recourse factoring and non-recourse factoring**.

Advantages and disadvantages of factoring

There are numerous advantages to debt factoring, but also some potential drawbacks.

Advantages

Factoring provides a large and quick boost to cashflow. This may be very valuable for businesses that are short of working capital. A business that is owed £500,000 may be able to get £400,000 or more in just a few days.

Other advantages:

- there are many factoring companies, so prices are usually competitive
- it can be a cost-effective way of outsourcing your sales ledger while freeing up your time to manage the business

- it assists smoother cashflow and financial planning
- some customers may respect factors and pay more quickly
- you may be given useful information about the credit standing of your customers and they can help you to negotiate better terms with your suppliers
- factors can prove an excellent strategic as well as financial resource when planning business growth
- you will be protected from bad debts if you choose non-recourse factoring - see the page in this guide on **recourse factoring and non-recourse factoring**
- cash is released as soon as orders are invoiced and is available for capital investment and funding of your next orders

Disadvantages

Queries and disputes may have to be referred on. For this reason, factoring works best when a business is efficient and there are few disputes and queries.

Other disadvantages:

- The cost will mean a reduction in your profit margin on each order or service fulfilment.
- It may reduce the scope for borrowing - book debts will not be available as security.
- Factors may want to vet your customers and influence the way that you do business.
- It may be difficult to end an arrangement with a factor as you will have to pay off any money they have advanced you on invoices if the customer has not paid them yet.
- Some customers may prefer to deal directly with you.
- How the factor deals with your customers will affect what your customers think of you. Make sure you use a reputable company that will not damage your reputation.
- You have to pay extra to remove your liability for bad debtors.

What makes a business suitable for factoring?

Factors' requirements vary, so what follows is an indication and not a rigid list. You may find a factor even if the following criteria are not met.

What makes a business suitable for factoring?

Your business may be suitable for factoring if it has:

- an annual turnover of at least £50,000, although some factors will consider start-ups and smaller businesses
- more than just a few customers
- no single customer accounts for more than about a third of turnover
- customers that accept the standard payment terms for the industry
- customers that accept a reasonable period of credit

What makes a business unsuitable for factoring?

Your business may not be suitable for factoring if it:

- sells to the public - factoring is only available for sales to commercial customers
- has too many small invoices
- has too many disputes and queries
- is not a sound, reputable and trustworthy business

- has customers that make part payments or stage payments

Recourse factoring and non-recourse factoring

In recourse factoring, the factor does not risk bad debts. Put another way, the factor will be able to reclaim their money from you if the customer does not pay. The factoring agreement will specify how many days after the due date for payment you must refund the advance.

Whether you refund the advance or not, you will still have to pay the fee and interest. See the page in this guide on **the cost of factoring and invoice discounting**.

Recourse factoring is cheaper than non-recourse factoring and may have fewer requirements concerning your customers and your systems. This is because you are taking the bad debt risk. For example:

- The factoring agreement requires payment to be made in three months. It also states that 80 per cent of each invoice will be advanced.
- On 30 April an invoice for £10,000 is issued and the factor advances £8,000.
- It is down to you to pursue the customer for payment after the three-month period as you have taken on responsibility for the debt. The factor will, as part of their sales ledger management, chase the outstanding payment until the due date for repayment. The factor will not have a claim against your customer and it will be up to you to take measures to recoup the outstanding debt.
- On 31 July, regardless of whether you have received payment from the customer or not, £8,000 must be repaid to the factor and you must also pay the fee and interest.

Non-recourse factoring

In non-recourse factoring, the factor takes on the bad debt risk. It accepts specified risks such as total disappearance, but it does not insure against slow payment. Because of this, non-recourse factoring tends to be more expensive than recourse factoring.

You never have to refund the advance to the factor, but you must pay interest to the factor for the period specified by the factoring agreement.

The factor takes over all your rights to pursue the customer for payment. This includes the right to take legal action.

Invoice discounting

Invoice discounting is an alternative way of drawing money against your invoices. However, your business retains control over the administration of your sales ledger. It can provide a cost-effective way for profitable businesses to improve their cashflow.

Invoice discounting is only available to businesses that sell products or services on credit to other businesses. It is normally only available to businesses with a proven track record and an annual turnover of at least £500,000.

However, it may not necessarily be the cheapest form of finance and can tie you into a long contract.

How invoice discounting works

The invoice discounter will first check the business, its systems and its customers. They may then agree to advance a certain percentage of the total outstanding sales ledger.

You will pay a monthly fee to the invoice discounter and also pay interest on the net amount advanced. This is in addition to advances received or money repaid.

Each month, more money is advanced by the discounter or repaid by you. This will depend on whether the total amount owing has gone up or down.

For example, if the invoice discounter agrees to advance 80 per cent of the total owing and the total of outstanding invoices is steadily changing, then so will the amount you receive. If the outstanding debt drops month on month, you must repay 80 per cent of the fall in debt. If the debt rises month on month, you will receive 80 per cent of the increase.

Features of invoice discounting

- You collect the debts and do the credit control. See our guide on **recovering late payments**.
- Your customers do not usually know about the invoice discounting, although it is sometimes disclosed.
- Annual turnover must usually be at least £500,000, although increasingly smaller businesses will be accepted. Generally, discounters will review the credit history and profit track record of your business. They will have strict rules regarding the quality of sales ledger systems and procedures.
- The invoice discounter will check regularly to see that your procedures are effective.
- You can choose between recourse and non-recourse facilities, determining who is responsible for recouping unpaid invoices. See the page in this guide on **recourse factoring and non-recourse factoring**.

The cost of factoring and invoice discounting

The costs of factoring are usually reasonable. It's a competitive business with many suppliers so it pays to shop around.

Of course, cost should not be the only consideration. Quality of service is also important.

When signing any agreement check the notification period - most factoring companies require three months' notice if you want to end the service. However, some companies have notice periods of up to a year which could end up being expensive for you. If you are not happy with the notice period don't be afraid to negotiate.

Factoring is a complex, long-term agreement that could have a major effect on the management and development of your business. It is therefore advisable to consult your solicitor on the legal and financial implications of factoring.

Costs arise in two ways - interest and fees.

The rate of interest

Typical charges range from 1.5 per cent

over base rate to 3 per cent over base rate. Interest is calculated on a daily basis.

These rates are roughly equivalent to bank overdraft rates and can even be better.

Credit management fees

There will be a fee for credit management and administration. The amount will depend on your turnover, the volume of your invoices and the number of customers you have.

Typical fees range from 0.75 per cent of turnover to 2.5 per cent of turnover.

For **invoice discounting**, typical fees range from 0.2 per cent of turnover to 0.5 per cent of turnover. These fees are less because only finance is provided.

Credit protection charges

These will be levied if it is non-recourse factoring, where the factor is liable for any bad debts. The amount will largely depend on the factor's assessment of the level of risk.

Typical charges range from 0.5 per cent of turnover to 2 per cent of turnover.

Export factoring

Some factoring companies offer a facility for the financing of international sales. They will typically work with a partner abroad who will be responsible for the collection of payment in the country to which you export. The services of a local agent will prevent any problems that could arise because of differences in laws, customs and language.

In terms of credit limits and process, there is no material difference between local and international factoring and invoice discounting.

Some factors will offer you the choice of being paid in sterling or in another currency. You should carefully evaluate which is to your advantage. If your customer insists on being invoiced in their country's currency, consider investing in protection against currency fluctuations. Factors may approve a lower level of prepayment for export invoices than in local sales.

Requirements for export factoring

- You normally only need to have an annual turnover of at least £100,000. This can include domestic sales.
- Companies based in the European Union (EU) can still factor debts owed from other EU countries if sales within that country are relatively small.
- Outside the EU higher sales to a single country will be required. For the USA annual sales of £500,000 will typically be necessary.

Export factors will usually drive a harder bargain if the volume of sales is low.

Features of export factoring

- You can choose to invoice in one currency and be paid in another. Many customers prefer to be invoiced in their own currency.
- You can be protected against currency fluctuations.
- The cost of export factoring is usually slightly higher than the cost of domestic factoring, but less than the cost of export finance.
- You can minimise the bad debt risk

by purchasing credit protection. Most factors insist on this.

Supplier finance

Supplier finance is when a business provides low-cost finance to its suppliers, as part of a flexible settlement system. It is particularly used in manufacturing production, and improves cashflow for both buyer and supplier.

Sometimes called 'reverse factoring', supplier finance can be an option for businesses that regularly supply a large organisation that has an appropriate arrangement in place.

Early payment is provided - either by a bank or by a factoring company - to a supplier, based on invoices that have been qualified by the buyer.

Once the buyer approves the invoice, the payment - less a fee - is made immediately (and ahead of terms) by the financier. This allows the supplier to receive quick payment and allows the buyer to repay the financier according to the original contract terms.

There are a number of benefits to the supplier:

- all of the invoice value (less the fee) is advanced immediately
- the cost of borrowing is lower than with other methods
- risk is reduced
- cashflow is improved

The buyer effectively uses its stability and financial strength to support suppliers, which keeps the supply chain running.

There may be financial benefits to the buyer such as sharing revenue with the bank or from the supplier's improved margins. 'Soft benefits' include stronger relationships and lower costs arising from increased efficiency.

How to choose a factor

There are a variety of factors to choose from. Some are subsidiaries of major banks and financial institutions, others are independent.

You need to be able to make an informed choice, so it's worth approaching more than one factor before making a decision.

The Asset Based Finance Association (ABFA) will supply a list of factors, and also give details of their turnover requirements and the services they offer. **Find details about factoring on the ABFA website - Opens in a new window**. You can also **compare factoring quotes on the Simply Business website - Opens in a new window**.

There are a number of factoring brokers that will negotiate on your behalf. They may not charge you as they will receive commission from the factoring company.

Recommendations

Factoring companies should be willing to let you talk to some of their customers.

The best recommendation of all is one from someone that you know and trust. General reputation is also important.

Questions to ask

- What is the factor's record in collecting debts quickly and efficiently?
- How exactly does the factor operate? What are the procedures in detail and do they suit you?
- How does the factor handle disputes and queries?
- As the factor will become an 'insider' and be in frequent contact with you and your staff, do you see eye-to-eye on issues that are key to your business? Do you have a good initial rapport?
- Does the factor have experience of your industry?
- How is the factor likely to communicate with your customers? Can you be sure that they will not alienate them and lose your hard-earned business?
- What will happen if a customer goes over the credit limit?
- What happens if you want to end the agreement? What period of notice must you give?

The last point is often overlooked and it can be important.

Here's how debt factoring improved my cashflow

Barnaby Smith

Media Drive

Barnaby's top tips:

- "If you think your company could benefit from factoring, do it sooner rather than later."
- "Choose a factoring company that understands your business and make sure it's a member of the ABFA."
- "Communicate your decision to customers in a positive manner. If they're confident that factoring is part of a sound financial strategy, you're unlikely to meet any resistance."

Oxford-based company Media Drive provides an innovative vehicle wrapping service that allows commercial fleet owners to advertise their products and services on their own vehicles. When Media Drive started up in 2003, the company took on the services of a debt factoring company as a positive step towards generating a healthy cashflow. Director Barnaby Smith explains the advantages.

What I did

Make factoring a positive choice

"Like many businesses starting up, we didn't expect to make profits immediately so managing cashflow was vital. We also knew that we needed to release as much cash as possible for capital investment in our production facility.

"We were wary of debt factoring at first, but our bank talked us through the process and we began to see its benefits as a finance solution. The bank put us in touch with a company called Eurofactor. Their recommendation, plus the fact that Eurofactor is a member of the Asset Based Finance Association (ABFA), gave us confidence to take things further."

Build a relationship

"Before we signed an agreement, we visited our factors at their premises to find out more about how they operated and to meet the team we would be working with. It's important to have trust and a good rapport with your factors, since they will become closely involved with your business. Not only are they handling sensitive financial information, they are also in direct communication with your customers.

"Any debt factoring company worth its salt will want to know about your business too. They can help you assess if your operation is right for factoring or not. Eurofactor looked at our business plan in detail, visited our premises and talked to us about our growth plans before agreeing to work with us."

Calculate costs

"Factoring obviously involves a cost to the business, but in our experience it was good value when compared to the advantages gained. Our factors calculated an initial fee based on turnover. On top of that we negotiated what percentage of any cash advanced would be payable to them. In the early days, the fee and percentage reflected the risk that the factoring company was taking on with a fledgling business. Over the last four years, both the fee and percentage have come down as our business has grown.

"Factoring means we can access the cash owed by customers almost immediately - within 24 hours of an invoice being submitted if necessary. The money is drawn down electronically from Eurofactor, at up to 75 per cent of the invoice value.

"Factoring is a good business discipline for us too. Each month we know we have to plan ahead and make decisions about how much we need to draw down. It keeps financial planning at the top of our agenda and makes us review all our financing arrangements regularly. We see factoring as one of our financial options."

What I'd do differently

Do it even sooner

"We made the decision to use factoring very early in our business' development. Looking back, we should have included it in the business plan from day one."

Helplines

ABFA Enquiry Line

020 8332 9955

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