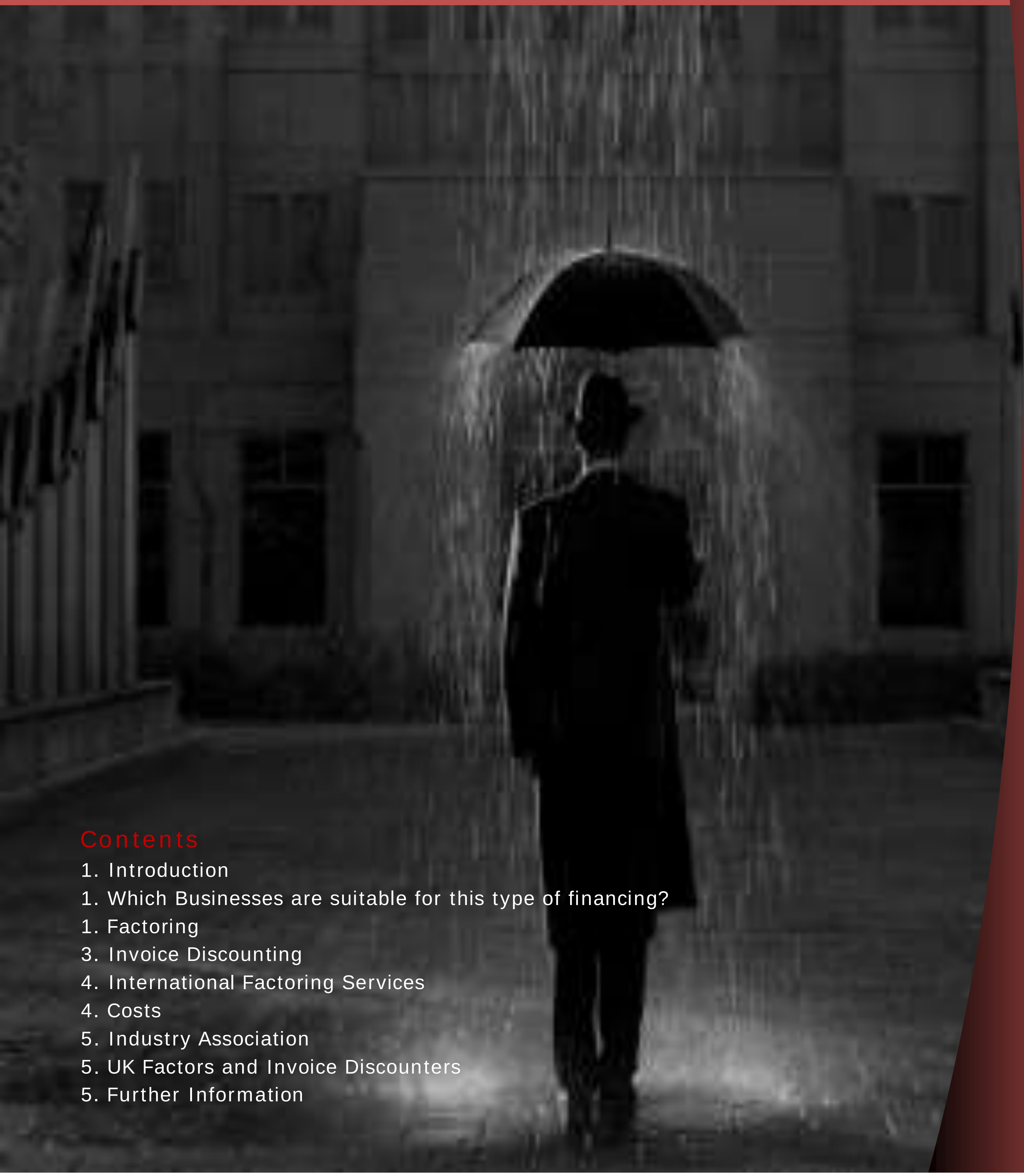
Factoring and Invoice Discounting

Ready-made solutions for the growing business

Expert knowledge means success



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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

The emergence of the factoring industry over the last few years has been in response to the greatest single working capital problem faced by businesses of all sizes – cash flow strains from sales debtor payment delays. Having to wait a long time after an invoice is issued before it's paid can be quite common in today's business environment and for smaller businesses there's the vicious circle of customers seeking to extend the period of credit while suppliers are pressing for prompt payment.

So, what's the solution? We call the solution "sales-related" or "sales-linked" finance. It comes in two guises - factoring and invoice discounting.

Factoring and Invoice Discounting – used to be associated with companies in trouble are now regarded as legitimate methods of cash-flow management. Factoring and Invoice Discounting can break that vicious circle, although like any other type of finance, companies should always take care that they can afford the service before they decide to use it.

Today, over 42,000 businesses are using the Factoring and Invoice Discounting industry's products and services to grow their businesses.

Which Businesses are suitable for this type of financing?

Not every business is suitable. You will need to be an established business with a turnover of at least £50,000 to £100,000 before a factoring company will take on your business. For Invoice Discounting, only businesses with a turnover of £750,000 a year or more are usually suitable and they need efficient sales ledger and credit assessment systems in place.

Most business sectors - for example, manufacturing, service and distribution - are suitable for factoring and invoice discounting.

Three business sectors that aren't suitable are:

- Retailers;
- Contractors receiving stage payments;
- Business sectors in which there are commonly a disproportionate level of disputes.

Factoring

Factoring offers a more complete service than Invoice Discounting – it includes finance, credit control sales, ledger administration and credit checking. Invoice discounting is a finance only facility.

Factoring tends to be more expensive than Invoice Discounting, particularly for the larger business. Although generally a more expensive facility, factoring can also give you significant benefits in terms of reduced staff costs, savings on postage and telephone bills and being able to free up management time away from sales ledger administration into productive areas.

Factoring tends to be more suitable for the smaller, less established business while Invoice Discounting has more appeal to the larger business with a longer trading history and more established credit control systems.

The way it works, however, is quite simple.

The business invoices the customer in the usual way but when a business is factoring its receivables, it sends a copy of the invoice to the factoring company and raises money immediately by the factor paying the business up to 85% of the invoice value.

Of course there's a charge, and this is taken out of the remaining 15% which is paid to the business when the factor itself receives payment from the customer.

The legal position about factoring is that you "sell" the sales invoice to the factor - it becomes their property.

The Factoring Company normally sends out the statements, reminders, etc. to the debtors and debtor payments are remitted in favour of the Factoring Company.

What is the difference between Factoring and Invoice Discounting?

Both services normally provide finance against debtor balances outstanding.

Factoring provides the additional advantage of a full sales ledger and collections service under which the Factor takes on the responsibility for your sales ledger.

Under an Invoice Discounting service, by contrast, you continue to administer the sales ledger and the service is usually undisclosed to customers.

There's little doubt that factoring has its attractions, because:

- It turns credit sales into cash sales – when you sell something, you actually get paid for it;
- It releases funds that would otherwise be tied up in debtors (receivables) to develop the business in other ways;
- As the method of funding is related to sales, there are no problems with financing limits being stretched as the business expands – except that some customers may have credit limits imposed by the factoring company.

Examples of the potential cost savings that can be achieved through the use of Factoring are:

- Savings on costs of existing or additional bank overdrafts;
- Reduction or elimination of bad debts;
- Saving of salary/time costs of credit control and bookkeeping;
- Saving of management time;
- Saving of costs of status enquiries on new customers;
- Discontinuation of discounts for early payment from customers;
- Discounts from suppliers for prompt payment;
- Administrative costs such as statements, reminders, postage, telephones etc.

It's important that each business investigates the costs for their own particular circumstances.

Factoring can also include the following:

Collections

As soon as a client business has issued an invoice, the Factor takes over the burden of collecting it. The Factor will agree collection routines at the outset and, if legal action becomes necessary, will inform the client business before proceeding.

With its professional systems and weight in the market, a Factor can often collect debts more quickly than a small business could if it were to act independently.

Credit Management

When a client business invoices a customer, it sends a copy to the Factor.
The Factor then "sales ledgers" the item and handles all subsequent administration, issuing statements and reminders according to pre-agreed procedures and a set timetable. It will provide the client business with regular, up-to-date information on the status of its sales ledger, which can help throw light on problem customers and the degree of credit risk in the client business' spread of sales.

Some Factors can link up with their larger clients' own computer systems, providing them with instant on-line information about their sales ledger and the performance of their trade debtors. Many smaller companies who feel they cannot afford their own credit management resource can use a factor as a substitute.

Credit Protection

Many Factors offer credit cover against bad debt losses. The Factor will make credit checks on the client business' customers, using established sources of information about their financial strength and credit rating. This allows the Factor to set a rate for the credit protection and to set pre-agreed credit limits for each customer.

Once the Factor has accepted the credit risk, it will pay the client business automatically, even if it hasn't been paid by the customer concerned. Most 'non-recourse' factors - as those providing credit protection are termed - will pay their clients the full value of any credit-approved and undisputed debts that remain unpaid 120 days after their due date.

GLOSSARY

Debtor finance – borrowing against the value of invoices raised.
Recourse factoring – borrowing against invoices where the facility is disclosed to your customers and where the factor manages the company's sales ledger.
Non-recourse factoring – as above but with bad debt protection.
Invoice discounting – borrowing against invoices raised but the facility is generally not disclosed to customers and you retain control of the sales ledger.

Credit Assessment

Whether a Factor is offering credit cover or not, it can advise its client on the creditworthiness of its customers and potential customers. It has access to credit reference databases which many small and medium sized businesses might find expensive to use. These databases may offer useful advice on whether the client business should extend trade credit to a particular customer and if so, how much it should be.

Factors will make continuous assessments of the payment records of their clients'

What are "Approved Debts"?

These are debts which a Factor or Invoice Discounter is willing to finance.

In a non-recourse contract this can mean that they are within customers' credit limits.

In a recourse contract it means that they are within the financing limits applied generally or on specific customer accounts. Disputed debts are normally unapproved, as are recourse debts that are considered stale, usually meaning more than 90 days old.

customers. They will alert their clients if they believe a problem is likely to arise, enabling them to reduce their exposure to, or accelerate payment from, the customer concerned.

Different types of Factoring

There are a number of different types of factoring, depending on your businesses needs:

- Recourse - under a recourse factoring agreement, the business will still bear the ultimate risk if the debt is uncollected – or goes 'bad'. This will mean reimbursing the factor the amount owed.
- Non-Recourse - under a non-recourse agreement, the business can be protected from bad debts, with the factor taking responsibility for all the debt collection and possible legal costs. Not surprisingly, this costs more.

Factors also offer sales ledger accounting services and credit control functions, leaving you free to run your business, and they can also advise you on customers' credit ratings.

Invoice Discounting

Invoice Discounting leaves companies with the full responsibility for collecting their debts. It differs in a number of ways from factoring. The legal principals underlying both are the same (finance through the purchase of debts), however the facilities are separate and distinct and designed for different sectors of the market and for companies with different needs and attributes.

Invoice Discounting is a financial facility, where the responsibility for good credit management and sales ledger administration remains with the business. Factoring is for companies whose internal credit management and administration systems may be unsatisfactory or inadequate.

Invoice Discounting is a working capital facility that provides immediate finance (prepayment) of between 75% and 85% of funds tied up in unpaid debtor invoices. The balance is paid (less costs) as the debtor collections are received. In short, Invoice Discounting is an acceleration of cash flow.

Charges for Invoice discounting comprise an administration charge plus a financing or discount charge. The administration charge may be a flat monthly fee or a percentage of annual turnover. For the finance provided in advance of collections, there is normally a discount charge calculated on day-to-day usage of funds. It is likely to be comparable with normal secured bank overdraft rates.

A popular form of Invoice Discounting is called Confidential Invoice Discounting. As the name suggests, Confidential Invoice Discounting is discreet and the debtors are not aware of the facility. The business collects its own debts and sends the collection proceeds to the bank/invoice discounting company.

As with Factoring, the business sends to a specialist bank/factoring company its invoices on some, or all its debtors, and receives, immediately, a proportion of the invoice value – usually around 75% - but it can be higher. The business then pursues the debt, and sends the money when collected onto the Invoice Discounting company - who then forward back to the business the remaining balance due on the sale of the invoice to it, after it has taken out its charges. This can often form a less rigid method than straight factoring, and the invoices sent can either disclose to the debtors that a factor is involved, or not (i.e. "Confidential") if the business is of a proven financial strength. The charges, too, will depend on the length of time it has taken for the debt to be paid, in other words, the period for which the factor has given credit.

Businesses most likely to be suitable for Invoice Discounting are those that:

- Are profitable;
- Sell on credit to other businesses (not direct to the public);
- Demonstrate positive net worth;
- Have clean debts which do not have phased payments or retentions applying;
- Have a good spread of debts with no debtor concentrations; and
- Carry on business in the manufacturing/service/distribution sectors.

In summary, Invoice Discounting is suitable for businesses that are profitable, are competently managed and have efficient sales administration and credit management systems.

What is the difference between Recourse and Non-Recourse Factoring?

Recourse Factoring excludes bad debt protection. The risk remains with you and if the customer fails to pay, the factor will seek repayment of the amount financed against that debt.

If bad debt protection is included, the service is called Non=Recourse Factoring. This means that if a credit-approved customer fails to pay an undisputed debt, the Factor will credit you with the amount of the debt.

International Factoring Services[1]

A number of financial packages have been developed for exporters wishing to sell their goods overseas - or for importers seeking to minimise exposure to trade risk. As well as the full range of services offered in the UK domestic market, export services will usually include:

- Advice on trading terms in export markets;
- Local collections and assistance with the resolution of disputes;
- Protection against risk when invoicing in a foreign currency;
- Swifter transfer of funds to the UK;
- Expert local knowledge of overseas buyers' creditworthiness;
- Financial facilities available in sterling or major currencies.

Details

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

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 for local sales.

Requirements for export factoring

You normally 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 charge more 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.

Costs[2]

Discount charges

Discount charges work in exactly the same way as bank interest.

Typical charges range from 1.5 per cent over base rate to 3 per cent over base rate. The discount charge is calculated on a daily basis and usually applied monthly.

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, fees are typically lower than for factoring because you will still collect and manage debts yourself. They generally range from 0.2 per cent to 0.5 per cent of turnover. These fees are less because the level of service provided is significantly lower than with factoring.

Credit protection charges

These will be levied in non-recourse factoring arrangements, 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.

Industry Association

The Asset Based Finance Association (ABFA) comprises several of the UK's largest factoring and discounting firms, representing a large percentage of the market. As well as representing its members, the ABFA has a code of conduct that ensures its members provide the highest standard of service to their customers.

The contact details for ABFA are:

The Assets Based Finance Association (ABFA)
Administration Office, 2nd Floor, Boston House, The Little Green, Richmond, Surrey TW9 1QE
Tel: +44 (0)208 332 9955
Web: http://www.abfa.org.uk/

UK Factors and Invoice Discounters

NOTE: The following list of UK Factors and Invoice Discounters was prepared in August 2008. Providers change regularly as well as their contact details.

A brief list of UK Factors and Invoice discounting firms is as follows:

- Barclays Asset & Sales Finance
  www.barclaysassetandsalesfinance.co.uk
- Bibby Financial Services
  www.bibbyfinancialservices.com/
- Burdale Financial (part of Bank of Ireland)
  www.burdale.co.uk
- Davenham Trade Finance
  www.davenham.co.u
- Eurofactor (UK)
  www.eurofactor.co.uk
- Fortis Commercial Finance
  www.fortiscomfin.com
- GE Commercial Finance (including Five Arrows Commercial Finance)
  www.gecommercialfinance.co.uk
- GMAC Commercial Finance
  www.gmaccf.com
- HSBC Invoice Finance (UK)
  www.hsbc.co.uk
- Alex Lawrie Factors
  www.alexlawrie.com
- Lloyds TSB Commercial Finance
  www.ltsbcf.co.uk
- RBS Invoice Finance
  www.rbsif.co.uk
- Venture Finance
  www.venture-finance.co.uk

Further Information

This guide[3] is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Important Notice

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Acknowledgement and References

[1] Source: http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1073791098&r.i=1073791097&r.l1=1073858790&r.l2=1084596842&r.l3=1073924180&r.s=sc&r.t=RESOURCES&type=RESOURCES

[2] Source: http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1073791097&type=RESOURCES

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