Everything you need to know about invoice discounting and factoring (well almost!)

There's a myth in the market that factoring is the financing of last resort and that any business which has to sink this deep is on the brink of failure!

At one time this may have been partly true as banks happily gave overdrafts to anyone who walked through the door with a half decent business idea and a bit of a financial plan. But nowadays, the reality is very different. Invoice discounting and factoring are the primary sources of working capital finance for many businesses in the UK and are often the only way a bank will even consider supporting its SME customers.

Banks now realise that the debtor book is usually a company's best and most easily realised asset, should anything go wrong. For some considerable time now, they have taken the view that they can lend more with less risk by taking control over their customer's debtors in one way or another.

So now that debt factoring has become acceptable – even the norm, rather than the exception – it has become crucial that businesses looking at working capital finance should shop around for the factoring arrangement which best suits their particular situation. Factoring is a sophisticated product these days with many different options available. As with all mature markets, choices have grown and that, the obvious solution is not always the best.

So what are the main choices?

Traditional factoring: Here, the factoring company takes ownership of all your debtors – the debtor book. Although the factor will take control of the whole ledger, certain debtors may be reserved (i.e. excluded so far as lending is concerned) usually because they are too old or the sale contract is not considered strong enough or because of a bad experience the factor has had somewhere else.

The factoring company will then make an amount available to the business based on a %age of the unreserved debtors. The percentage is typically from 70% up to 90% depending on the view that is taken of the strength of the ledger and the underlying business. The factoring agreement usually allows the factor to vary this percentage at short notice.

Invoice factoring companies often take over the complete administration as well as ownership of the ledger, including debt collection and credit insurance in which case the client company sacrifices control of its relationship with its customer once the sale has been made.

Factoring contracts are usually for a minimum period of two or three years with penalties for earlier termination.

© Catalyst IFG 2011

Invoice Discounting: The traditional discount model is very similar to factoring except that the invoice discounter provides a loan to the client - the debtor book acts as security. The amounts available will typically be similar to the debt factoring arrangement.

Generally, in an invoice discounting contract, the client retains control of the ledger and the debtor will often not even be aware of the arrangement (confidential invoice discounting). The administrative burden on the client is often quite high as the discount company requires detailed monthly reports on the state of the ledger and will usually audit the returns for accuracy. Audits can be frequent and errors can result in penalties.

Spot Factoring: Spot factoring differs from traditional factoring in that the provider buys single invoices, rather than the whole debtor book. Each transaction stands alone so there is no long term contract and no standing charges. The client has complete discretion as to when he uses the facility.

As with traditional factoring, the debtor is always aware of the transaction but there are no reporting requirements so management of the facility is very simple. The Spot factor may take a charge over the rest of the ledger but all aspects of its management (including collections) stay with the client and the charge is only of relevance for as long as the particular invoice remains unpaid.

Spot factoring can be thought of as a "pay-as-you-go" option, used as and when it is needed and with no costs when it is not. Agreements are quick and simple to put in place and there is minimal administration at any point in the transaction.

What are the key issues to consider in choosing the best solution for your business?

1) **Cost:**

No one wants to pay more than they have to but beware the headline numbers – they can be misleading.

The traditional factoring and discounting model usually includes an **arrangement fee**, a **service charge** (payable whether or not you use your facility) and **interest** paid on the money advanced. The interest charge is based on a %age over a standard rate, typically bank base rate.

In addition, there can be severe **penalty charges** if you try to cancel the contract before it has reached its end. Also, don't forget the administration coast – you will be required to provide monthly reports on the ledger and the performance of your business, regular reconciliations of trust accounts (special bank accounts set up to receive money) and frequent audit visits from your provider – you may find that your accountant cannot deal with all of this and requires additional help.

It is important to take all these costs into consideration.

The only cost charged in a spot factoring deal is the "discount" taken by the provider – this is the difference between the face value of the invoice purchased and the amount the factoring company pays for it. The charge is a %age calculated daily from the day you get the money until the day the invoice is paid.

The costs of spot factoring rate can appear to be high because all the costs of the service are built into the headline rate. As there are no add-on costs and no internal administration time to pay for, the comparative cost may be quite low. The costs are also easier to control – spot factoring is only used when it is needed. The invoice can be sold when funds are required and paid off once they are not so the amount of time you actually pay for may be much less than with a traditional factor.

In general terms, traditional factoring and discounting will be less expensive in situations where there is a permanent, long term need for working capital finance. A temporary or occasional need for funding will usually be less expensive if spot factoring is used.

2) Administration

The traditional invoice discounting model requires the greatest administrative effort as the provider has to be given ongoing information on the status of their security. There is also an obligation to submit to audit as required by the provider.

Similarly, traditional factoring takes considerable administrative effort in supporting the factoring company's requirement for information about all elements of the debt book. Where the factoring company takes responsibility for the management of the ledger and debt collection, the administration burden may be reduced but there is of course, a financial cost for this service.

With spot factoring, there is no administration burden other than the submission of the invoice for funding. The relationship with the customer remains very much in the control of the client and collection of the debt remains the client's responsibility.

3) Control of customer relationships

One of the big concerns for many clients is the loss of control over the hard won relationship they have with their customers. The potential risks associated with someone from outside their own organisation being in contact with their customer may be too high to bear.

If this is a critical consideration, confidential invoice discounting is the only option available where the customer will remain completely unaware of the existence of the discounter. The downside for this is that the costs and the administration burden are high.

Under the traditional factoring agreement, the customer always knows that his debt has been sold to the factoring company. Although the invoice will be received in his supplier's name, it will provide the bank details of a third party (the factoring company) on the invoice and statements, reminders and even telephone calls will come from the factor – someone with whom he has no direct relationship. Debt factors sometimes use call centre staff with potentially no interest in the business and whose only concern is getting the invoice paid. The client cannot control the degree of pressure the debt factor may use.

Spot factoring falls somewhere in between these two. Although the customer is required to confirm the validity of the invoice and pay the spot factor direct, rather than his supplier, once this has been done, the spot factor will have no further contact with the customer.

4) Availability of facilities

Traditional factoring companies will consider both the status of the debtor and the potential client's underlying business before extending facilities. Where the business is very young or is going through difficulties it is likely that facilities will not be extended or will be severely limited.

Although a spot factor will examine the underlying business and take account of its future prospects, the main concern is that the invoice being purchased will be paid. As a consequence, very young businesses can often be funded and distressed businesses can also be eligible provided that there is a realistic prospect of impending recovery.

5) **How long do you need the funding**

This may be a crucial question. If the need remains significant for the foreseeable future the obligations associated with a long term contract are easier to justify. Traditional factoring is probably for you.

However, maybe you should also look at other funding options altogether. If there is a long term need to fund working capital, it suggests one of two things – either your business is growing so fast (and your debtor book with it) that you never expect the profitability of your business to catch up with the need for cash to finance all this new business. Alternatively, if your business is not growing, you should perhaps be looking at the profitability of your business – the implication is that either you gross margins are too low or your overheads are too high.

Where the business's need for funds is spasmodic or occasional, then spot factoring may be attractive as you can dip in and out to meet the specific needs of your business on a day to day basis. Supposing your cash flow shows that for most of the time funds will be available but that for just a few weeks or months in the year there will be a shortfall. Spot factoring will iron out these spikes in cash demand without the need for long term lending contracts or running costs which you simply don't need to incur.

Once the initial paperwork has been put in place and the facility approved (which typically takes under a week) then you can normally get the cash on an individual invoice in under two working days. It is this ability to pick and choose when you draw funds, together with the speed and flexibility of operating the relationship and the very light administrative burden which can be attractive to many businesses.

Conclusion

Every business is different and has different financing needs. There is no single solution that suits all these different situations.

In choosing the right working capital finance model for your business, there are many factors to take into account. If the decision seems too hard to make, it may be that your accountant or financial adviser needs to be brought in. But here are a few simple guidelines to think about:

1. If you need continuous long term financial support then one of the traditional models will probably suit you best – being in a long term contract reflects your long term need so the issue of termination will only arise if you are unhappy with the particular provider you have chosen

2. If you need help managing your ledger and are happy for your customer to know about your relationship with the finance provider then Invoice factoring will probably provide the product you need.

3. If it is important that you keep your customer relationships completely in your control, you need confidential invoice discounting – just be ready for the administration burden that goes with that

4. If you only have occasional need for funding or you are not too sure whether when you will need it in the longer term, spot factoring will give you the flexibility to dip in and out of the facility.

5. If you want to keep it simple and have complete discretion over when and whether you use the service, again spot factoring provides this. Using spot factoring can provide a stop gap while you decide which direction your business is moving in.

6. Finally, if traditional sources have turned you down for funding, it is worth speaking to a spot factoring company as there are often situations where they can help when others can't.

For more information or to discuss your working capital finance needs, call Jeremy Lawrence at Catalyst IFG on 0845 528 0788.