Accounts Receivable Factoring 101

Accounts Receivable Factoring is primarily a source of funding for new and rapidly growing businesses. With factoring, the amount of capital available to a growing business is directly tied to its sales. More sales create more invoices, which can be immediately factored to obtain working capital. Factoring is different than **Purchase Order Financing**, which will be discussed in a later article.

It’s important to remember that factors aren’t in the business of lending money. They buy invoices at a discount. Generally, factors don’t prefer to work with failing companies, but they can supply funding when banks won’t if the struggling or growing company has credit worthy customers that pay their invoices on time, and if they believe the company’s long-term potential outweighs its temporary challenges, i.e., they believe in the business, the management team and the company’s strategy for recovery or growth.

If you believe that factoring is “last resort” financing for failing companies, then you would logically believe that your customers would leave you like rats on a sinking ship once they realized you were factoring. However, as stated above, most businesses today use invoice factoring to fund expansion and to take on new business, not to rescue their business from the jaws of insolvency.

The dollar volume of factoring transactions in the United States in 2011 was over $150 billion. Accounts receivable factoring has become a common financial tool used by companies of all sizes to successfully manage cash flow and finance growth without debt. Asking a customer’s accounting department to remit invoice payments to a new P.O. Box is not an unusual request. In fact, it’s quite likely some of your customers are already sending payments to factors on behalf of their other vendors.

Before you begin factoring, your factoring company will send out a *Notice of Assignment* letter on your behalf to each of your customers whose invoices you will be factoring. The letter is sent to the accounts payable manager.

The letter will state that you have been awarded a line of credit from the factoring company to support your business growth. It will also state that because of your rapid growth, you have elected to retain the factor’s professional receivables management services; and the letter will provide your customer with a new address to use for mailing their invoice payments.

The notification letter reassures your customers that your company’s business relationship with them will remain unchanged and that you will continue to provide excellent service and bill them as usual.

The only thing that changes for your customers as a result of your new funding alliance is the remittance address, which is a P.O. Box that the factor sets up on your behalf. Your customers will still write their checks payable to your company, but they will be mailed to a different address.

By positioning factoring in this way, your customers will view your ability to secure your factoring as a positive event, and not as a problem with cash flow. It lets your customers know that you’re better equipped financially to grow and meet their demands. Wouldn’t your customers prefer to continue working with a well-funded company, rather than start a new relationship with another supplier?

On an ongoing basis, as you send your factoring company copies of the invoices you wish to factor, they will call your customers to verify the invoices before they wire advances into your bank account.If that level of communication with your customers makes you feel uneasy, a number of factoring companies today offer a more transparent service, where communication with your customers appears as if it's coming directly from your company.

A factoring company's goal is to help you do more business by improving your cash flow. It's in their interest to help you succeed. The last thing they want to do is be responsible for annoying one of your customers. One of the ways factors improve your cash flow is by providing courteous and professional reminders when invoices are overdue. That way, you and your staff can be free to focus on making money instead of chasing it down.

Most factors employ accounts receivables professionals that are very adept at establishing and maintaining customer goodwill and confidence, while also ensuring prompt, accurate payments. Factors aren't collection agencies, so they won't harass your customers for money. If there's a problem collecting on one of your factored invoices, they will contact you to discuss the issue.

Perhaps factoring companies achieve better collection results because customers realize that if they don't pay promptly it could directly affect their own credit ratings. Maybe it's just a question of having systems, or simply the fact that they ask to be paid!

The cost of factoring is competitive among other financing options. A normal scenario would be an advance of 85-90% of an invoice that has terms up to net 90 to pay. Upon payment by the customer, the balance to to the business would be repaid, minus the discount, typically about 3-5%.

Perhaps the question you should ask yourself is – will factoring help me generate more revenue than it costs? If your business can't qualify for bank financing, or if your request for a credit line increase has been denied, the cost of factoring vs. bank financing becomes irrelevant. In fact, the cost of factoring itself becomes irrelevant if it will help you make more money, i.e., if it will pay for itself.

In other words, if instead of turning away business due to lack of working capital, your business can use the ready cash provided by factoring to fill more and larger orders, it make perfect sense to pay the factoring fee. For example, would you invest 3% of your bottom line to generate a 40% increase in sales? As long as your company's net profit margin is greater than the factor's discount rate, the additional business you're able to generate by factoring your receivables will provide you with additional profit.

Shell Beach Capital is a broker/referral service helping clients find funding for their business and commercial real estate transactions. Bruce McClanahan has over 22 years of experience in the financial services industry, and has held at various time Life/Health and Property/Casualty insurance licenses, and Series 7 and 66 General Securities and Investment Advisor Representative licenses. He can be reached at 805-458-5069, or at bruce@shellbeachcapital.com. His website can be found at www.shellbeachcapital.com.