FACTORING

AN ALTERNATIVE SOLUTION IN TODAY'S TOUGH ECONOMIC CLIMATE

By Don D'Ambrosio

Today, more than ever, businesses are faced with making important operational decisions based upon the availability of working capital. Unfortunately, the lingering credit crisis has created an environment where access to working capital can still be almost nonexistent, forcing many companies to reduce output, cutback staff, and in many cases, close their doors entirely.

Factoring, which is the sale of accounts receivable, is one alternative many companies are finding increasingly popular when they are faced with cash flow needs. Factoring refers to an arrangement whereby a factor purchases an account(s) receivable from a business at a discount to the face value of that receivable.

HOW DOES FACTORING WORK?

A company performs a service and renders an invoice to a customer. The invoice carries payment terms that require the customer to pay in 30 to 60 days. The customer may pay on time or take an additional 30 to 60 days. In the meantime, the company's employees must be paid and overhead maintained.

The factor purchases the company's invoices and then advances the company anywhere from 70 percent to 90 percent of the invoice's face value. The difference or reserve is held by the factor and then rebated back to the company less the factor's fee.

For example, ABC Company has a $10,000 invoice that it wants to factor. Once the factoring company has completed its evaluation of the invoice, including both the company selling the invoice and paying the invoice, it will advance $7,500 immediately and $2,200 when the invoice is paid. Therefore, in this instance ABC Company has received $9,700 for their $10,000 invoice which was due in 30 days.

By factoring invoices, money can be obtained more quickly and provide much needed capital for the day to day operations of the company. Once approved, cash can be obtained for invoices normally in 24 hours or less, and as often as the business needs.

IS FACTORING EXPENSIVE?

Both yes and no. Typically, a factoring company will charge a potential client anywhere from a 2 percent to 5 percent fee for a 30 day invoice. Assuming a 3 percent fee for a $10,000 invoice, the factoring company will receive a fee of $300. Annually that would cost the client $3,600 in factoring fees. Alternatively, if the same client was able to qualify for a $10,000 loan assuming a 10 percent interest rate, the client would pay $1,000 in annual interest costs. However, factoring companies provide services that banks do not. For example, factors handle all collections and give clients important credit information, as well as statistical and accounting reports for their receivables.

WHAT TO LOOK FOR WHEN SELECTING A FACTORING COMPANY

Generally, a good factoring company should be affiliated with the International Factoring Association, which requires its members to adhere to a strict code of ethics which protects both the client and their customers in factoring transactions. Most importantly, you should understand the rules of your agreement, recourse and non-recourse arrangements, and the fees the factoring company is charging for the use of their funds.