Factoring a Short Term Saviour?

Posted on

Proper use of factoring can provide more flexible funding for growth. Dinesh Weerakkody explains step-by- step what a vital role this facility can play in a firm's financing needs.

In order to carry on a business successfully a company does not have just to invest in capital projects and fixed assets, but it must also invest in and. exercise control over working capital stocks, debtors and creditors. The working capital has an important bearing on a company's cash needs and cash flows, and therefore its liquidity is as important to a business as its profitability. However, it is important to realize that different companies will have different working capital requirements depending on the nature of its business. Also there is no hard and fast rule as to how, ideally, trade debtor's stocks should be financed. Generally, they are financed by a mixture of short-and- long-term funds but again there is no particular right or wrong proportion for this finance. However, when deciding upon the ploy to be adopted by a company to finance its stocks, debtors, the management of the company must balance the cost of finance as against the risk of insolvency. Say that a company's creditors suddenly demanded immediate payment or the bank demands repayment of the company's overdraft. If this happened then the company would be in danger of insolvency unless it is able to realize sufficient of its assets quickly into cash. In reality, trade debtors can be more easily converted into cash than stocks, as stocks have to be sold first to become debtors and those debtors realized in cash. Converting debtors into immediate cash is used widely in international financial markets but hardly used as a financial tool and is called "factoring".

Factoring

Factoring involves raising funds on the strength of a company's debts in order to release working capital tied up in credit to customers for profitable use. There are two types of factoring, "sales ledger factoring" and "invoice discounting". Sales ledger factoring is commonly referred to as factoring, the factor is responsible for the whole of the sales ledger administration and credit protection. In addition, the factor may offer a non-re- course service whereby full credit protection is provided on all approved sales, thereby generating payment in the event of a bad debt. In contrast, the recourse factor will not offer credit protection as part of the service, and in the event of customer default the factor has recourse to his client. The company it self must make the decision on the type of factoring it requires after considering the relative costs and benefits presented by the alternatives and by assessing which system best suits the company needs.

Essence

The essence of factoring is that the seller receives early payment of its debts by receiving an advance from the factor against in- voices accepted for factoring. Up to 80% of the invoice value can be made available immediately with the balance being paid when the customers pay the factor or after an agreed period. The advantage of this operation is that funds are realized more quickly enabling the company to make accurate cash flow forecasting a reality. These funds can then be used to pay suppliers more promptly, thereby improving its credit reputation and enabling it to obtain quantity and financial discounts offered by suppliers. Another way in which factoring can facilitate budgeting is by smoothening out seasonal fluetuations in demands for hard cash. A further advantage of factoring is that as sales increase factored debts automatically increase and advances increase. A more dubious advantage is that factoring represents a form of off balance sheet finance.

Costs

While factoring may save costs of running a sales ledger and generate cash more quickly the factor undertakes these services at a cost. Costs consist of a fee for the services rendered and a separate charge for the finance made available against sales. The service fee is determined for each client and depends largely on the value of sales, the type of business, the average volume and value of invoices, the number of customers and whether credit protection is provided.

Invoice Discounting

The second type of factoring is called invoice discounting and involves a factor providing a cash advance as either all sales invoices or on those selected accounts. The service is normally provided on a recourse basis although non-re- course invoice discounting can be organized in some situations. In practice, this form of factoring is called “confidential invoice factoring” as the client remains responsible for its own accounts collection and also the credit administration. Invoice discounting is a form of off balance sheet finance that is available for firms with good credit ratings. The main charge for invoice discounting is a discount charge linked to a base rate. As with full factoring, the charge is calculated on a day today basis on funds actually used. In addition, there will also be commission levied to cover the administration of the arrangement.

Facility

Factoring is primarily a long term facility. Yet too often entering into a factoring arrangement is driven by short term need or sheer necessity. It is obvious that with this discrepancy between short term and long term need lie most of the reasons for factoring’s less than glowing reputation and popularity. In reality though companies which benefited in the short term by way of improved cash flows, have in the long run tended to get throttled by this facility. Where this occurs within a relatively short period of time after taking out the facility you can only ask, why this facility was taken and where the companies’ advise came from?

Bank owned

Research indicates that in the UK alone Bank owned factoring houses received 70% of their new client introductions from bank branches in a 20 bn Sterling Pound factoring market. Can a bank branch really give independent advise? Doubtful, firstly they will always recommend only their own factoring houses and secondly they have a very close vested interest in the customer finances and the strength of the banks bargaining position. Today financial experts managing company finance suggest that independent consultants services should not be ignored when moving into a factoring facility. They say that this branch of consultants is often overlooked to the detriment of the firm.

Advise

Even if advise is available, should it stop at the initial decision or should the facility be monitored. Research suggests that monitoring is vital for effectively managing the facility. Unlike a Bank loan, factoring is dynamic, growing with the firm expansion but contracting with falling sales or retentions. The expanding company with a good debtor book has nothing to fear and most to gain from factoring; its only concerns need to be monitoring charges and knowing when to stop the facility. turnover declines or retentions rise more strain can be If placed on overdraft facilities, charges in real term rises, and a vicious spiral where only one fatal result can develop-bankruptcy. In the past there have been few tools to help smaller firms in making decisions to factor and thereafter controlling the facility. Today there are a limited number of computer based products available to help small companies to decide whether to factor or not, checks charges and overlooks the management of the facility. Undoubtedly the growth of such tools will lead to a more complete understanding of both strengths and weaknesses of factoring.

Disadvantages

Just for a moment let us pause and consider what the new users of a factoring facility are actually going into? Firstly, they are allowing a third party access to all customers and may lose control over their debtors books. Secondly, as the debtor book is effectively in the hands of the factoring house the available bank security is reduced

which may affect the overdraft facility. Thirdly the factoring house decides which customer is good, and on which customer they will limit their advances. Often this leads to unforeseen retentions. Finally, the services attracts both interest and management charges. In other words factoring, what ever its merits and demerits are, requires a serious management decision.

Conclusion

Firms that are better advised, strategically managed and are in a position to monitor and control their facility with the factoring house are less likely to encounter and experience difficulties. This will eventually ensure that factoring receives the recognition it deserves. In the right circumstance factoring should be an integral part of a firms financing facility, providing flexible funding for growth. Badly advised companies will undoubtedly continue to experience difficulty with this facility and to them, factoring will only be a short term savior, but a long term monster.

Dinesh Weerakkody is manager in a commercial bank. He is the author of Selected Essays on Foreign Affairs Part 1 and Part 2.