The Business Of Factoring & How It Works

Factoring, also known as accounts receivable factoring, is a business term used to describe a method in which companies sell their outstanding receivable invoices in order to gain immediate cash for their business. When a company sells a product or service, an invoice is created stating the amount due and the number of days in which the invoice must be paid. This invoice instantly becomes a part of accounts receivable, which is money that is owed to a business. After the invoice is generated, it must be sent to the customer and the business must wait for the specified amount of time before that invoice is paid. Often times, for reasons of misfortune or lack of attention, a debt may go unpaid and extend past the due date. This presents a problem for the business, which is awaiting payment, in that it interferes with the cash flow when a debt is not collected. This is especially true of new, or struggling, businesses.

The process of factoring works when an institution purchases the invoice for an amount that is somewhat less than the face value of the debt. This amount can be anywhere between 70-90%. The factoring company then proceeds to collect the full amount due for the invoice, which is then delivered to the original business less a factoring fee.

If a business offers credit terms as part of their sales, factoring is one way of eliminating cash flow problems. Many businesses who use factoring receive their money, from the sale of their invoices, within 24 to 48 hours. This unique approach also offers a company with the ability to extend competitive credit terms to their best customers and not have to worry about waiting for the credit payments. By offering attractive credit terms, more customers will be drawn to a business. Most businesses compete in pricing, but a company is much more appealing if they offer financing options direct to their buyers. Many consumers do not have the funds to pay for items upfront, especially if a business markets more expensive sales, but a customer may be able to agree on delayed payments. Therefore, a business offering such a deal would sell more inventory than a company who requires total payment upfront.

It’s important to realize that factoring is not a loan or a debt. In addition, unlike bank loans, collateral is not required. It’s simply the sale of invoices, on which people owe money, to another business for a slightly smaller percentage than the total due. The original business gets immediate cash and, for a fee, the factoring company collects the face value of the debt.

Many businesses, who extend credit, opt for factoring in order to avoid the hassle of trying to collect money. In addition, it costs more to have a billing department who is responsible for creating invoices every month. By factoring, a business eliminates their need for a billing department and saves money on the hassle of attempting to collect debts.

The cash generated from factoring will allow a business to purchase new equipment, pay existing debts, increase marketing efforts, improve planning, process new credit approvals, improve customer relations and save money on accounting procedures.