FACTORING AND INVOICE DISCOUNTING

RELEVANT TO CAT PAPER 10

Following recent exam sittings, it has become clear that candidates struggle with certain parts of the CAT Paper 10 syllabus. This article explores some of these problem areas, with the aim of enhancing students' understanding, thereby improving performance in the future. This first article deals with factoring and invoice discounting. A second article will discuss simple and compound interest rates and the calculation of early settlement discounts offered to customers.

The areas discussed in this article are from study sessions 28 (c), (d) and (e) of the *Syllabus*. In these sessions, it states that students must be able to:

(c) describe how factoring works and the main types of service provided by factors
(d) define invoice discounting and outline how this form of factoring works
(e) calculate the cost of factoring arrangements and invoice discounting.

Each of these syllabus requirements is discussed in detail below.

STUDY SESSION (C)
DESCRIBE HOW FACTORING WORKS AND THE MAIN TYPES OF SERVICE PROVIDED BY FACTORS

Students seem to get thoroughly confused between invoice discounting, factoring, and offering discounts to customers. By giving a more detailed explanation of factoring arrangements, I hope that students will at least remember the basics for the exam. In this section of the article, the organisation providing the factoring is referred to as 'the factor' and the company factoring its debts is referred to as 'the company'.

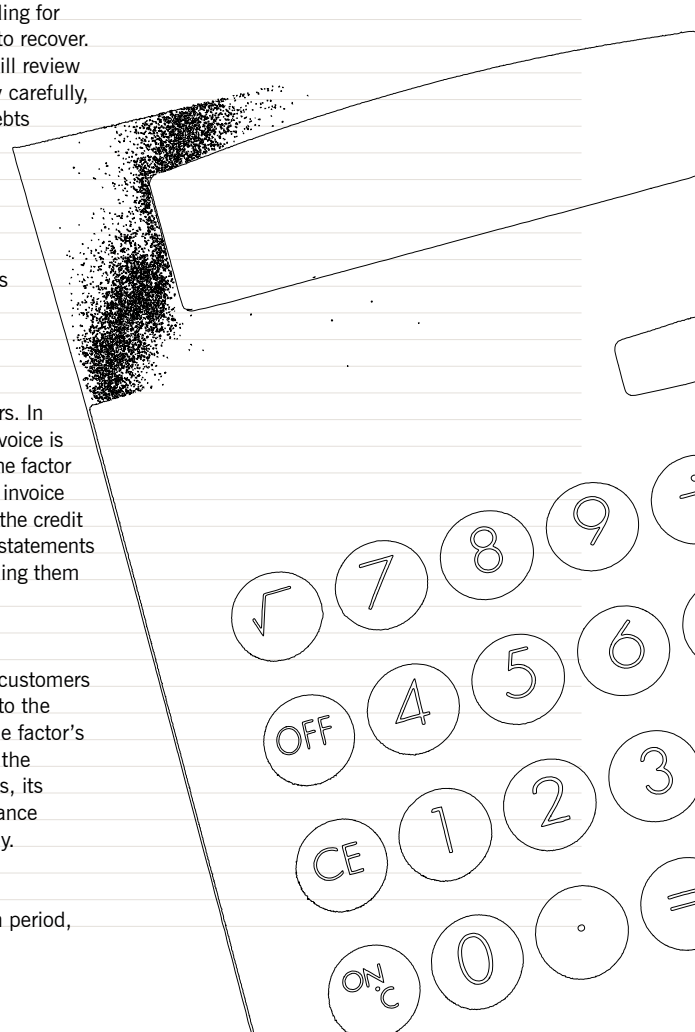
Factoring provides a form of advance against a company's trade receivables. Instead of the company having to wait for cash from its credit customers, the factor agrees to pay for a proportion of the debts upfront. Typically, a factor will pay up to 85% of approved invoices. Factors may be independent organisations but are often subsidiaries of major banks or financial institutions. Whatever they are, one thing is for sure. They will not want to pay out money that they do not think they will get back. Hence, they will want to closely examine the applicant company, assessing the financial stability of the company, its history, and, most importantly, the quality of the company's credit customers.

Students are often under the misapprehension that factoring is a good way to recover monies relating to debts that have been outstanding for some time and are now proving difficult to recover. This is definitely not the case. A factor will review an applicant company's sales ledger very carefully, and if the factor thinks that any of the debts are doubtful, it will exclude them from its initial prepayment and from its list of approved invoices for future advances. Unlike invoice discounting, which is discussed later, factors are involved in the administration of the company's sales ledger. Their involvement includes:

When an invoice is raised
The company raises invoices itself in the usual way and sends them to its customers. In addition to this, however, each time an invoice is raised, a copy is also sent to the factor. The factor will then pay an agreed percentage of the invoice value to the company. It will also take on the credit control function. This will include issuing statements to the company's customers and telephoning them if necessary.

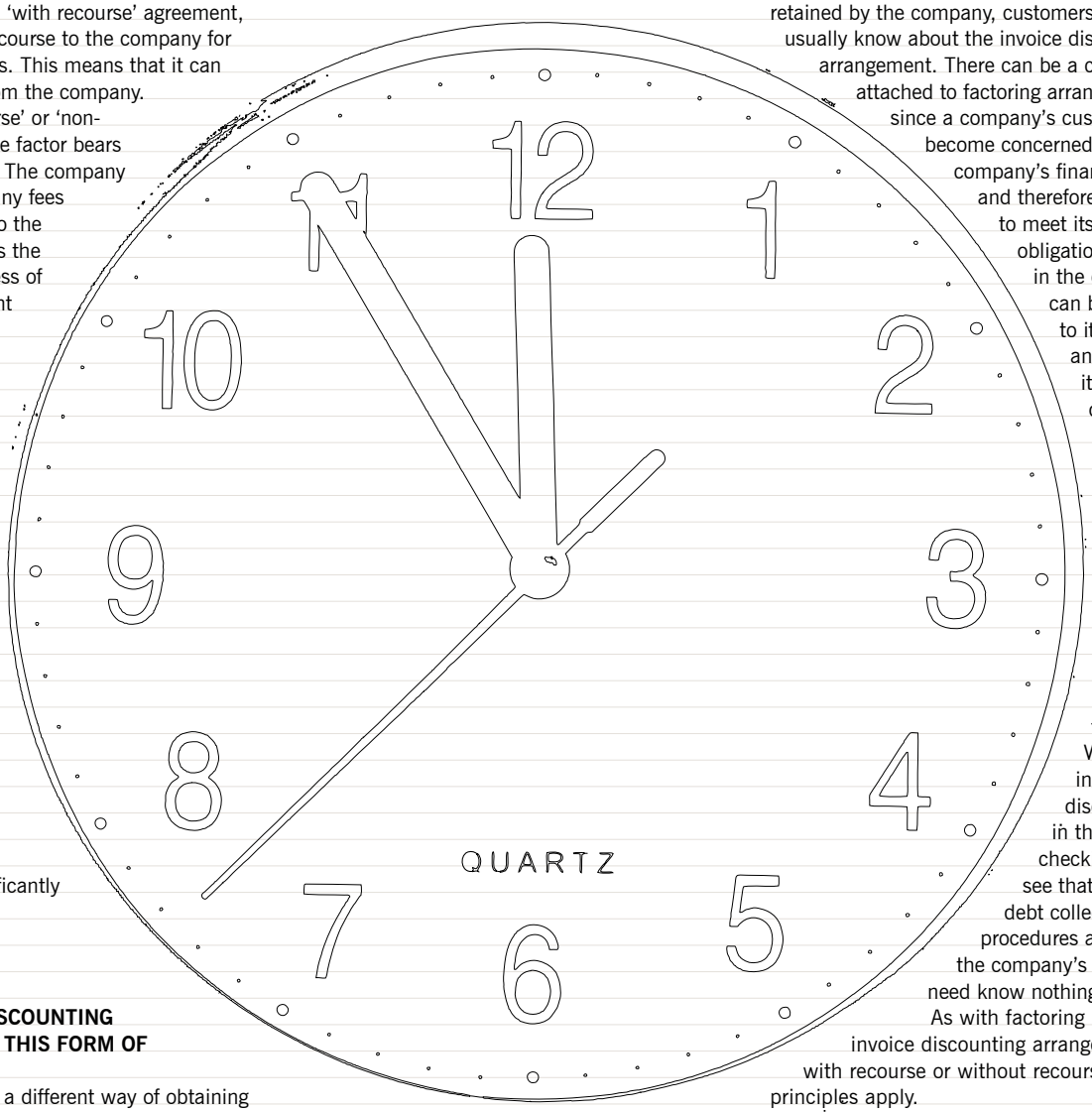
When the customer pays the invoice
When a factoring agreement is in place, customers must pay 100% of each invoice directly to the factor. Each invoice must clearly show the factor's remittance details on it. Having received the money, the factor will then deduct its fees, its interest, and its advance from the remittance before paying the balance to the company.

Unpaid invoices
If an invoice remains unpaid for a certain period,



as specified in the factoring agreement, the legal position as regards who bears the loss depends on whether the factoring agreement was a 'with recourse' agreement or a 'without recourse' agreement. If it was a 'with recourse' agreement, then the factor has recourse to the company for all the advanced debts. This means that it can reclaim the money from the company.

In 'without recourse' or 'non-recourse' factoring, the factor bears the loss of bad debts. The company will still have to pay any fees and interest relating to the invoice. This is always the case anyway, regardless of whether the agreement is with or without recourse. With non-recourse agreements, however, the factor will take over all rights to pursue the debt through the usual legal channels. Hence, it becomes clear that non-recourse factoring is not just an advance of monies and an abdication of the function of credit control; it is also a transfer of risk from the company to the factor. Because of this, non-recourse factoring will be significantly more expensive than recourse factoring.



STUDY SESSION (D)
DEFINE INVOICE DISCOUNTING AND OUTLINE HOW THIS FORM OF FACTORING WORKS

Invoice discounting is a different way of obtaining an advance on invoices, albeit not radically different. Many finance organisations actually offer the alternatives of factoring or invoice discounting. In this section of the article, the organisation providing the invoice discounting service will be referred to as the 'invoice discounter' and company requiring the service will be referred to as 'the company'.

With invoice discounting, an advance on invoices is paid by the invoice discounter in a similar way to an advance paid by a factor. A fundamental difference, however, is that with invoice discounting, the company retains control over the administration of its sales ledger.

As with factoring, the invoice discounter will firstly perform rigid checks on the company, assessing its credit history, its systems, and its customers. It may then agree to advance a certain percentage of the total outstanding sales ledger value. In return, it will demand a monthly fee for the service and interest on all amounts advanced.

Then, each month, money will either be repaid by the company to the invoice discounter, or the invoice discounter will advance more money to the company. Which of these is the case depends on whether the total amount owing to the company by its credit customers has gone up or down.

For example, at the beginning of the invoice discounting agreement, the invoice discounter may have paid 75% of the sales ledger value to the customer. If the total amount outstanding from receivables at this time was $1m, then the invoice discounter would have paid $750,000 to the company. If, one month later, the total value on the sales ledger has fallen by $100,000 to $900,000, the company will have to repay 75% of that decrease of $100,000 back to the invoice discounter. In this case, the amount to be repaid will therefore be $75,000.

One of the advantages of invoice discounting is that, because control of the sales ledger is retained by the company, customers do not usually know about the invoice discounting arrangement. There can be a certain stigma attached to factoring arrangements since a company's customers may become concerned about the company's financial stability and therefore its ability to meet its contractual obligations. This doubt in the company can be harmful to its reputation and hence, to its likelihood of success. With invoice discounting, on the other hand, the company continues to collect its own debts and perform its own credit control functions. While the invoice discounter will be in the background, checking regularly to see that the company's debt collection procedures are effective, the company's customers need know nothing about this. As with factoring arrangements, invoice discounting arrangements can be with recourse or without recourse. The same principles apply.

Probably the biggest misconception students have as regards invoice discounting is the belief that it is a form of discount offered by a company to its customers. Invoice discounting is in no way similar to offering an early settlement discount to customers. It is a term with a specific meaning, as detailed above.

STUDY SESSION (E)
CALCULATE THE COST OF FACTORING ARRANGEMENTS, INVOICE DISCOUNTING AND CHANGES IN CREDIT POLICY

When calculating the costs of factoring or invoice discounting arrangements, there will be two main costs involved – interest and fees. Typical interest charges range from 1.5% to 3% over base rate. As regards charges, there will be an

administration fee for both invoice discounting and factoring. However, since factoring also involves the factor performing the credit control function for the company, its fee will also involve a charge for credit management. Typically then, a factor will charge fees ranging from 0.75% to 2.5% of turnover. An invoice discounter, on the other hand, will usually charge from 0.2% to 0.5% of turnover.

In non-recourse agreements, there will also be a credit protection charge, whereby the factor or invoice discounter reflects the cost of bearing the risk of bad debts. The charge depends on the level of risk assessed by the factor/invoice discounter, but will typically be from 0.5% to 2% of turnover.

This all looks fairly straightforward as regards calculating the cost of factoring or invoice discounting, but what makes exam questions more difficult is the fact that, in real life, there will often be a change in the sales level from one year to the next. Also, by using the services of a factor, a company's receivables days may be reduced. Both of these aspects need to be incorporated into calculations. Finally, if a factor is used, the company may save on the salary of a credit controller, for example. Let us refer to the question in the December 2007 exam as an example. Extracts from it are detailed below.

Waste Co is a waste management company, with one sole shareholder/director, Mr Trusty. It collects two types of waste from businesses – recyclable waste and confidential waste. Since companies have increasingly become aware of both the need for recycling and the need to protect confidential information, Waste Co's client base has expanded rapidly over the past two years.

As the business has expanded, Mr Trusty has had less time available to focus on credit control. This has resulted in a steady deterioration in accounts receivable collection and a rapid increase in Mr Trusty's overdraft, despite high profits. Mr Trusty's bank has now refused to extend his overdraft any further and has suggested that he either employ a credit controller or factor his accounts receivable.

The following information is available:

1. *Credit sales for the year ending 30 November 2007 were $2,550,000, and average accounts receivable days were 60. Sales are expected to increase by 25% over the next year.*
2. *If Mr Trusty employs a good credit controller, the cost to the business will be $47,000 per annum. It is anticipated that the accounts receivable days can then be reduced to 40.*
3. *A local factoring organisation has offered to factor the company's accounts receivable on the following terms:*
   - *An advance of 80% of the value of sales invoices (which Mr Trusty would fully utilise).*
   - *An estimated reduction in accounts receivable days to 35.*
   - *An annual administration fee of 1.3% of turnover.*
   - *Interest charge on advances of 12% per annum.*
4. *Current overdraft rates are 10% per annum.*
5. *Assume there are 365 days in a year.*

Calculate whether it is financially beneficial for Waste Co to factor its accounts receivables for the next year, as compared to employing a credit controller.

When answering this type of question, the best approach is to have two distinct calculations – one which calculates the cost of factoring and one which calculates the cost without factoring. Then, the difference between the two calculations will be the cost/benefit of factoring.

Cost of factoring

The first calculation that needs to be made is of the new sales level for the coming year. Since sales are expected to increase by 25%, just take the current sales level and multiply by 125%. Having done this, a new receivable days calculation can be performed by taking the new sales figure, dividing it by 365 days and multiplying it by the new receivables days of 35. It will be this figure that forms the basis for calculating the interest on the amount advanced by the factor: take the receivables amount and multiply both by the amount advanced by the factor and the interest rate charged by the factor. Similarly, the amount not advanced by the factor will give rise to bank interest, so this remainder needs to be multiplied by the current overdraft interest rate. Finally, don't forget the administration fee of 1.3%. This needs to be applied to the whole **turnover** figure. Students often mistakenly apply this percentage to the receivables figure. Hence, your calculation for the cost of factoring should be this:

New sales level =	
$2,550,000 x 125%	$3,187,500
Accounts receivable reduced to 35 days:	
$3,187,500 x 35/365	$305,651
	$
80% advanced by factor at 12%:	
$305,651 x 80% x 12%	29,342
20% still financed by overdraft:	
$305,651 x 20% x 10%	6,113
Admin fee: $3,187,500 x 1.3%	41,438
	76,893

Cost of not factoring

In order to calculate the costs without factoring, another receivables level, still based on the increased turnover figure calculated above, needs to be calculated. The process will be the same as above, only this time a figure of 40 is used rather than 35 to reflect the slower debt collection period without a factor. Having performed this calculation, the cost of financing receivables by overdraft can be calculated by applying the overdraft rate of 10% to this figure. Finally, include the credit controller costs of $30,000 and the sales ledger clerk costs of $17,000. Your answer should then look like this:

Accounts receivable reduced to 40 days:	
$3,187,500 x 40/365	$349,315
	$
Overdraft cost	
$349,315 x 10%	34,932
Credit controller costs	47,000
	81,932

Since the cost of factoring is $5,039 less than the cost of not factoring, your answer should state that it is financially beneficial to employ the services of a factor.

SUMMARY

This article aims to improve students' understanding of some of the key areas in Paper 10 that have been poorly answered over recent sittings. The level of detail given about factoring and invoice discounting goes beyond what students would be expected to produce in the exam. I hope, however, that this background knowledge will enhance students' understanding of these areas so that they remember enough of the basics to produce better answers in future exams.

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