Before You Take The Bait…

Read The 13 Biggest Pitfalls of Factoring and How to Avoid Them.

Invoice Factoring offers growing businesses a quick and easy way to finance unlimited growth without incurring debt. However, like every good thing, it's vitally important to understand how invoice factoring really works, and how to avoid its potential pitfalls.

To grow and prosper, every business needs a lot of working capital. Without it, businesses fail to realize their full potential. Factoring, a practice dating back to Roman times, is a proven way for small, medium and larger businesses to alleviate cash flow problems caused by delays in receiving payments.

Invoice Factoring, also known as Accounts Receivable Funding, involves the purchase and sale of accounts receivable (invoices) at a discount for immediate cash. Unlike a loan, factoring involves no debt, no liabilities, no personal guarantees, and no long-term commitments.

It sounds great, doesn't it? And it can be, provided you:

- Fully understand how factoring works
- Know who you are dealing with
- Carefully read and fully understand your proposed factoring agreement, and
- Ensure that you don't fall prey to potential pitfalls

The invoice factoring industry is completely unregulated with few constraints on the people who work in the industry. Caveat emptor (buyer beware) clearly applies in this situation.
This white paper will educate business owners about the potential pitfalls of invoice factoring … and how to avoid them.

Pitfall #1 – Working with a factor who you don't Know, Like and Trust
When you enter into an agreement to factor your invoices, you are in essence inviting a new partner into your business – one that you may not know very well at all. Like any partnership, it's better to be involved with people with whom you share similar business and personal goals and values. Otherwise, you may be engaged with people that you don't like, don't want to know, and can't trust but who can ultimately harm your business and your customer relationships.

Successful users of invoice factoring take the time to check out the credentials, the business practices and personal ethics of their potential factoring partner, and thereby minimize the potential for considerable frustration, unhappiness and financial hurt. Since you are entering into a three-party agreement that involves you, your customers and the factoring company, taking enough time to carry out appropriate "due diligence" is critical. Don't be shy about asking for customer references and then be sure to talk with 3-5 of the factor's customers. A good question to ask is, "Knowing what you now know about Company X, would you use them again to factor your invoices?" Listen carefully to the response, and you learn much about your prospective business partner.

Pitfall #2 – Giving the factor too much control over your business
Some factors insist on controlling all communications with your customers concerning your invoices. This gives the factor too much influence over how your customer ends up viewing your company. Most larger companies today are accustomed to working with factoring companies, but they don't like to be badly treated in the process. A Factor's behavior can put at risk your hard-won relationship with your customer.

In some instances, unethical factoring companies have delayed payments to their clients, thus causing financial strain and chaos within the company. In another instance, a factoring company even tried to gain ownership of its client's business through unsavory business practices.

Pitfall #3 – Agreeing to factor all invoices
Some factoring companies insist that all accounts be factored as a way to generate extra fees, or that all of your accounts be run through them even if they are not factored. By acceding to this, you face the following possible consequences:

- Delayed use of funds of up to 10 days
- You place too much control over your business in the factor's hands
- You add an extra step to your collections process.

Ideally, you should work with a factoring company that offers you flexibility on which invoices you want to factor.

Pitfall #4 – Paying a monthly minimum fee
Some factoring companies require that you pay them a specific monthly minimum fee, regardless of the amount you invoice to customers.

For example, if your monthly minimum amount is $50,000, and your actual factored invoices amount to, say $35,000, you would end up paying fees on $15,000 for which you receive no value. Or, if you submit no invoices during the month for factoring, you still end up paying the minimum monthly fee. This is a good deal for the factor, but not for you.

To minimize your factoring fees, do not accept an agreement with a minimum monthly fee component. Ensure that your factoring fee is calculated on the actual amount of your factored invoices.

Pitfall #5 – Accepting excessive clearing days
Clearing days, you might say … what are they? Essentially, clearing days are those days a bank requires to clear a check. In a standard part of a factoring agreement, fees apply during a clearing period. However, clearing periods can vary, pat close attention to these terms. A usual clearing period is 3-7 days, sometimes as much as 10 days. You should avoid anything longer than 5 days.

Some factors use the clearing days period as a way to extend the factoring period into the next "per days period" so they can get more money from you. In your agreement, seek the fewest number of clearing days, since the shorter the period, the fewer fees you pay.

Further, you should seek a factor that does not charge fees on clearing days and terminates all fees the day payment is received from your customer.

Pitfall #6 – Not knowing what services attract extra fees
Certain factoring companies charge extra fees such as: a line of credit fee (1-2% of total amount of available credit), a management fee (1-2% of total amount available for factoring), a new account setup fee, wire transfer fee, per invoice transaction fee, due diligence fee, termination fee, and a number of other fees they can include. Most factors charge a wire transfer fee, but the other incidentals are simply attempts to increase their revenue.

Since these incidental fees can add up, pay careful attention to your agreement to ensure that you are not agreeing to pay fees for normal and customary business expenses that should be part of the factor's general overhead. Some factoring companies charge no extra fees other than for wire transfers.

Pitfall #7 – Not understanding the factoring fee structure.
This is a major pitfall since understanding a factoring fee requires that you know about percentages, appropriate terms, how the fee is applied and the time/value of money. This section and the next will help enlighten you so you can first understand how the fee is determined, and how then to compare differing fees and structures.

By not understanding how a factoring fee is determined, you open yourself up to paying excessive fees, so please take the time to study this section and then work through the examples given below.

The fee structure usually has two components – advanced funding and factoring fee. These are usually determined by the amount you intend to factor and the financial strength and creditworthiness of your customers:

Advanced Funding: When you submit an invoice for factoring, you will typically receive between 60% and 90% of the invoice amount by wire transfer to your bank account within 24 hours after invoice verification. This is your money to use as you wish.

Factoring Fee: Many factoring companies impose factoring fees based on a "per 30 days fee" (such as 2.5% per 30 days). This carries some obvious negatives. Should your customer pay the factor in 33 days, your fee would be: two 30-day periods X 2.5% =5% of the invoiced amount even though your invoice was outstanding for only 33 days. This can prove to be quite expensive.

By contrast, with our program, a "per 5-days fee" of .45% on the above example delivers you a factoring fee of: 7 periods X .45% = 3.15% of the invoiced amount. Generally, the shorter the "per/days" period, the less you will actually pay for the service.

Further information on fee determination is given below under Pitfall #8. Also, please see below Pitfall #11 - the section on Reserve Funds - to learn how all the money is accounted for.

Pitfall #8 – Accepting an initial "teaser" fee.
Some factoring companies promote a loss leader initial "teaser" fee, counting on the fact that many people don't understand how factoring fees work, the time/value of money and when your customer's usually pay their bills. Depending on the number of days your customer takes to pay your invoices and this typically varies, you will usually end up actually paying a higher fee that might be the case under a higher initial fee and a different fee structure.
Here are several examples that you can follow to calculate your actual factoring fee on an invoiced amount of $100,000:

Factoring Fee Offer #1 – 1.65% for first 25 days and 1.5% each fifteen days thereafter.

Days to Clear Invoice	Amount	Rate Calculation	Actual Fee
30	$100,000	1.65% + 1.5% = 3.15%	3.15% X $100,000 = $3,150
41	$100,000	1.65% + 1.5% + 1.5% = 4.65%	4.65% X $100,000 = $4,650
58	$100,000	1.65%+1.5% +1.5% + 1.5% = 6.15%	6.15% x $100,000 = $6,500

Factoring Fee Offer #2 - .45% per each five-day period

Days to Clear Invoice	Amount	Rate Calculation	Actual Fee
30	$100,000	.45% x 6 = 2.7%	$2,700
41	$100,000	.45% x 9 = 4.05%	$4,050
58	$100,000	.45 X 12 = 5.4%	$5,400

You can readily see from the above examples that what appears at first glance to be an attractive fee is actually more expensive when you actually apply the fees for the various "per/day" periods.

Pitfall #9 – Not knowing when your customer's usually pay your invoices
Factoring your invoices involves a significant uncontrollable variable – the usual time period your customers take to pay your invoices. As you can see from the above examples, the shorter the period, the lower your factoring fee.

For example, if your customer customarily pays your invoices in say, 15 days or 35 days, you don't want to agree to a "per 30 days fee". You will pay lower fees by working with a shorter "per days fee", as outlined above.

Be sure to either calculate your actual fee as it applies to your situation or seek absolute clarity about this from your intended factoring company.

Pitfall #10 – Not realizing how aggressively some factoring companies pursue account collection

Another reason to avoid the "per 30 days fee" is that it gives the factor a financial incentive to pursue aggressive account collection. Once the first 30-day period has passed, the factoring company wants to collect the outstanding account as quickly as possible to maximize their own rate of return on the funds advanced. For example, if they can collect payment for your invoice on day 33, you still are charged fees for 60 days while they have freed up funds to generate additional fees during the same period.

Whether the factor does this aggressively or not, depends on the factoring company. However, it's not an unknown practice in the industry. While good for the factor, a "hard-nosed collections" approach can negatively affect, even perhaps ruin your relationship with your customer. This is another good reason to seek a shorter "per days fee", and to examine how your proposed factoring company typically handles this situation.

Pitfall #11 – Reserve accounts are abused.
Reserve accounts are common to the factoring industry. They serve as a security deposit to protect the factor against short or no payment on invoices. Some factors hold a certain percentage of each invoiced amount in their Special Reserve Fund for just this purpose.

However, since reserve funds are really your money but under the factor's control, they are sometimes misused. Therefore, it's important that you understand how your intended factoring company handles your reserve account.

Pitfall #7, mentioned before, outlined the structure of a factoring fee. The Reserve fund is the remaining part to this discussion.

To review, let's say the factor advances you 80% of your invoiced amount immediately upon receiving your invoice. When your customer pays your invoice, the factor places the remaining 20% into your Special Reserve account. Once the payments clear, the factor subtracts his fee and remits to you the difference. At least that's how it should work.

Sometimes, a factoring company insists on maintaining a permanent reserve account of 5 – 10 percent of your monthly invoiced amounts. This procedure is good for the factor, but not necessarily for you because:

- The factor denies you full use of your funds
- Funds may be extracted from the permanent reserve to pay monthly minimums, should they be required
- The factor may delay returning your funds upon agreement termination, or sometimes only after a struggle

The better deal is to work with a factor that remits all of your reserve funds upon invoice clearance less the agreed factoring fee.

We urge you to clarify with your prospective factoring company:

- How they set up a reserve account
- Do they require a permanent reserve
- What terms and conditions govern how they disburse funds from the reserve during relationship and at its termination

Again, carefully read your proposed agreement to understand fully how the reserve account is treated. This will tell you a great deal about the business practices of the factoring company, and also possibly save you much grief if the relationship proceeds.

Finally, you are better off working with a factoring company that does not maintain a permanent reserve fund, but since each situation varies, this is not a hard and fast rule.

Pitfall #12 – Inadequate reporting procedures

Since cash flow and knowing about it is the lifeblood of any business, you would think that all factoring companies would be set up to provide proper, easily understood reports on your accounts receivable activities. However, this may not be the case.

Therefore, you really need to understand a factoring company's financial reporting procedures and processes to ensure that they will work for you.

In any relationship with a factoring company, you will benefit by having ready-access to current and easily understood, verifiable financial reporting about your accounts receivable transactions. This allows you to operate your business successfully, while preserving your peace of mind. Ideally, you want to have 24/7 access to your account information and know that your reports are current all the time. In addition, having a verifiable audit trail is also advantageous.

Pitfall #13 – Not Understanding Your Agreement
As you can see from the above, the future of your business can hinge on how well you understand the terms, intent and language of the factoring agreement you are considering. A bad agreement can lead to an overly expensive or truly bad experience that could end up costing you a great deal as outlined in the examples above.

Since factoring arrangements differ in their language and their intent, you want to read your proposed contract very carefully and thoroughly understand your intended factor.

SUMMARY ACTION LIST:
Having read this far and worked the examples, you should now know what pitfalls exist out there in the factoring industry. To be sure, ethical factoring companies do exist, ones who share your values and ethics, and who see themselves as a valuable partner in the growth of your business.

All you have to do is find one and then perform your due diligence. As always with financial matters, it's much better to do this before you desperately need funds so you have a relationship already in place that allows you to comfortably and confidently plan your growth. Apart from what is presented above, here are some useful guidelines:

1. Work with an ethical factoring company that has a verifiable track record.
2. Ask for and check client references.
3. When talking to current or past clients, ask them, "Knowing what you now know about company X, would you use them again to factor your accounts receivables?" Then, listen carefully to the response.
4. Have a personal conversation with the people at the factoring company who will administer your account, and have them confirm the accuracy of the information from the sales staff.
5. Ensure that the factor's reporting system operates in real-time via the Internet to give you current information on your accounts receivables, etc.
6. Ensure that you fully understand how each fee is determined to avoid being surprised by excessive fees in the future.
7. Read the language of your proposed agreement very carefully and seek clarity on anything that you don't understand.
8. Before signing on the dotted line, be certain you really know the deal you are getting with all of its ramifications.

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