

Wells Fargo Capital Finance

Demystifying factoring: The important role it plays for today's businesses

Factoring is the selling of accounts receivable at a discount to a factor in order to obtain cash payment before the accounts come due. This basic definition can be easily found through an internet search, but how factoring works and why it's an important financing option isn't necessarily clear. To uncover the answers, let's begin at the beginning.

How it all started

Factoring has been around for at least 4,000 years when Hammurabi and the Mesopotamians had the first written invoices. The type of factoring found in America today has its roots in the colonial days. Colonists that produced goods to be sold in England had to wait to get paid as their wares were shipped overseas and the payment was shipped back. The factor stepped in to provide payment to the supplier so that the supplier could continue producing goods.

Factoring still plays an important role as goods continue to be bought and sold, and companies need working capital to continue running their businesses. The Commercial Finance Association says factoring has been a growth market since 1976. Many businesses today turn to factoring for start-up, high growth or turnaround cash flow.

Apparel and textile industry businesses are the most active users of factoring, though furniture, electronics, transportation and business services industries are also strong users of factoring.

An explanation in simple terms

A look at some **basic terms** will help in the understanding of what factoring is and how it works.

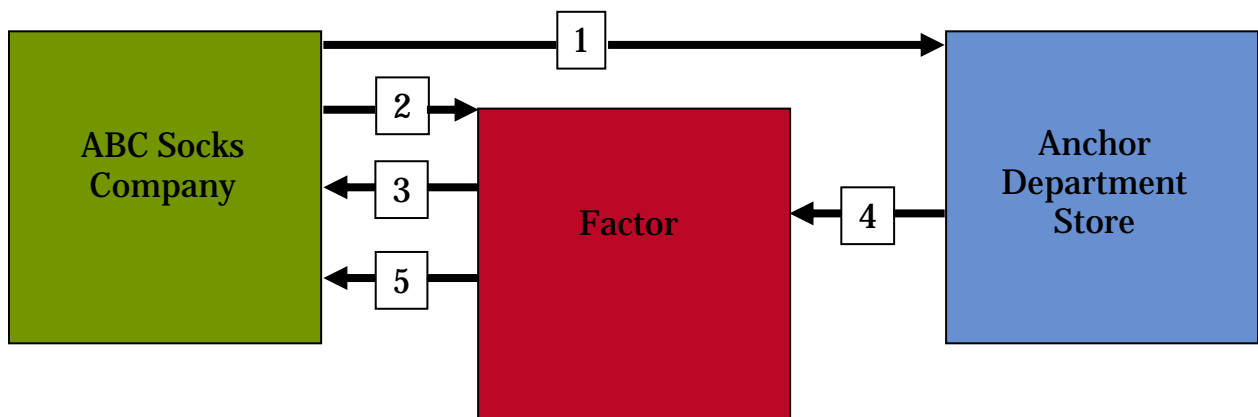
Company: The business that produces the goods and services.

Account debtor: The organization that purchases the goods and services from the company.

Accounts receivable: The amount owed by the account debtor to the company for goods and services provided. Accounts receivable are represented by an invoice.

How factoring works

In this example, the company is ABC Socks Company, and the account debtor is Anchor Department Store. These figures are not necessarily indicative of a typical deal but are simply used to demonstrate the process.



1. ABC Socks Company sells \$100,000 worth of socks to the Anchor Department Store and generates an invoice for the accounts receivable with payment due in 60 days.
2. ABC Socks Company sells the \$100,000 of accounts receivable to the factor.
3. The factor pays ABC Socks Company \$80,000 immediately.
4. In 60 days, the factor collects full payment from Anchor Department Store.
5. The factor sends the remaining \$20,000 to the ABC Socks Company, less the factor's fee.

A sample of additional services that may be included in a factoring arrangement

The flexibility of factoring is a likely reason that factoring has existed for so long and is so widely used. A company may have various business services included as part of the arrangement with their factor. In many of the situations listed below, the company is outsourcing its accounts receivable, reporting and collections to the factor. This can benefit the company by helping them keep staff and systems overhead low.

Non-recourse factoring. The factor provides the bookkeeping, accounts receivable posting and the reporting and collection services. The factor may provide advances or loans against the purchased accounts receivable, inventory or other assets. The factor assumes credit risk of an account debtor's inability to pay the outstanding accounts receivable.

Recourse factoring. The factor provides the bookkeeping, accounts receivable posting and the reporting and collection services. But, similar to an asset-based lending situation, the factor does not assume credit risk of a customer's inability to pay the outstanding accounts receivable. The risk is borne by the client.

Collection factoring. The factor provides the bookkeeping, accounts receivable posting and the reporting and collection services. But, the factor does not offer loan or advance privileges. The factor assumes credit risk of an account debtor's inability to pay the outstanding accounts receivable.

Money or funds in use factoring. The factor provides the bookkeeping, accounts receivable posting and the reporting and collection services. The factor does offer advances and/or loans against the purchased accounts receivable, inventory or other assets. This can be done on a non-recourse or recourse basis.

Non-notification factoring. The client is responsible for collecting the invoice payments from its own customers. Generally, the client is required to direct its customers to remit payment to the factor's lockbox.

The benefits of factoring

The most obvious benefit of working with a factor is the ability to quickly get working capital. The accelerated cash flow a factor can provide may help the success of a start-up, a company experiencing high growth or a seasonal sales spike, or even a business in a turnaround situation.

Factors typically offer favorable advance rates for accounts receivable, inventory or other assets. A factor can also provide credit protection against customer bad debt losses.

An established factor can offer the ability for a client to outsource credit, accounts receivable bookkeeping and collections functions. This typically speeds accounts receivable collections and can free-up additional working capital for a company. It also converts accounts receivable management costs from fixed to variable, and they may be eligible for off balance sheet treatment.

Summary

Given the flexibility factoring offers, it is possible that factoring will be around for another 4,000 years. Though apparel, textile, furniture, electronics, transportation and business services industries have been actively using factoring, other industries such as toys, sporting goods and specialty foods are also recognizing the benefits of factoring.

If you are interested in learning more about how the Trade Capital team at Wells Fargo Capital Finance can help your business, give us a call at 1-866-703-4932.

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