

# Debt Factoring: What It Is and Is It Right For Your Business



Every business understands the importance of a healthy cash flow.

We also understand how difficult it can be to maintain that healthy flow.

With the pandemic wreaking havoc on the economy this past year, cash flow has been a hot topic for every business of every size.

Debt factoring has been in conversations and is gaining momentum by the moment.

Before you jump on board, you need to understand what it entails. This article will explain what debt factoring is, the advantages and disadvantages, and how it can help your business.

## Defining Debt Factoring

Debt factoring is the act of selling your unpaid invoices to get cash now without waiting on your customer.

It is sometimes known as accounts receivable factoring and sounds like a fast way

to get your money. It is a little more in-depth than a simple sale of customer invoices. Let's look at how Debt factoring works.

Debt factoring is a loan of sorts. You choose the factoring company and bring the unpaid invoices that you wish to get paid. There is an approval process and if everything checks out, you move on to the factoring agreement, then payment.

The lender will pay you a percentage of the invoice value, often 80-90%. The customer who owes the invoice will make the payment to the factoring company.

They will pay you the remaining percentage, less factoring fees, and an annual percentage rate (APR).

You may find lenders who will cover 100% of the invoice value but those companies often have higher fees and APR. The money you receive can cover any business expense you have, from buying more inventory to paying utility bills. So let's take a look at the advantages of debt factoring.

## **Advantages Of Debt Factoring**

So far, debt factoring services sound like a great way to help a business move forward.

The advantages of invoice factoring can really save a small business from closing its doors permanently. Here are a few reasons why a business will consider a factoring arrangement.

### **Outsourcing Collection**

Staying on top of invoice tracking and payment collection can require extra time that you may not have.

Especially if you are a business that had to downsize this past year, leaving your small team spread thin.

With many folks working from home, it is easy to lose track of an invoice here and there. It is also important for those companies looking to expand but don't have the manpower to handle the expansion and tracking down funds.

Debt factoring gives the lender the job of tracking and collecting payments, while you take care of other things happening in the business.

## **Healthy Cash Flow**

Obviously, the biggest advantage is having an immediate cash flow that works for you. If you can't wait 30, 60, or 90 days for payment, this is going to be the most attractive aspect to moving forward with debt factoring.

You can get your money fast from a factoring company and pay your bills, payroll, and buy necessary supplies and inventory. You won't be sitting back trying to juggle getting paid and paying your own bills.

When companies are juggling too much, that is when late fees and penalties come into play and hurt the financial snapshot.

## **A Flexible Option**

Using traditional loans requires some collateral to secure a loan. If your business is struggling, you may not have the collateral you need. If you want to expand, you may not have the collateral you need to meet the demands of the bank.

Debt factoring is a lot easier to obtain and possibly more affordable than the interest rates on traditional loans.

There is no waiting time for the money either. You can have it within 24 hours. Traditional bank loans take more time with providing all the necessary paperwork and waiting for approvals.

Another convenience is paying for the service. Since fees are subtracted from the final amount owed to you, you don't have to worry about making payments, missing a payment, and incurring interest. It's done for you.

## **Expand Your Business**

Not every business is suffering to the point of needing debt factoring. Some businesses want to expand their services or product lines but don't have enough working capital to do so.

It is a tough spot to be in when you need to grow but you feel your hands are tied.

Increasing your cash flow can get you fast access to capital and catapult your business into a new playing field.

Expand your product line, add more services, improve your e-commerce, and hire more people to help you move forward. A growing business can really thrive with quick cash.

## **Affordability**

This option can be very affordable if your clients pay their invoices on time. While this won't always happen, if you sell the invoices of your reliable clientele, you won't have to pay more than the minimal fees.

Some factoring lenders will offer lower APRs to companies who have used their services and proven to have reliable clientele. So if you need to come back and use the services again, you could potentially save a lot more than with a traditional loan.

*Debt factoring isn't the right thing for all businesses in all situations. Do your research before making any decisions.*

## **Disadvantages Of Debt Factoring**

Just like everything else in life, there is a risk with any choice you make. There are significant downfalls to using debt factoring that is important to understand. If anything sounds too good to be true, it often is.

While debt factoring is helpful, these are the risks you need to take into consideration.

### **Credit-Worthiness Is A Factor**

You may think you can walk into a factoring company and hand over some invoices but there is more to it.

The company is going to check your clients' credit ratings before approving them for payment.

They are a lending company so they want to ensure that they will get paid. They do not want to risk anything going into collections.

Late payments complicate matters but you will pay for those late payments.

Even if your client pays you on time every month, if they are not creditworthy, it won't be approved. Given how the past year has gone, a lot of credit lines are being paid late and dropping credit scores.

## **Customer Relations**

Customer relations can be strained when using a debt factoring lender. If payment processing has gone wrong, your customers don't talk to you. If they have a dispute about the invoice, they don't talk to you.

They will have to discuss everything with the lender. Relationships with your customers can suffer when they have to talk to a third party who doesn't know them. You cannot offer invoice discounting for early payment or the removal of late fees out of compassion.

Many business owners also struggle with the idea that if their customers know they are working with a factoring company, that there is an assumption the business is in crisis. No one wants to give their customers the idea that they are not doing well, it can lead to customers finding a new business to work with.

Relationships are everything to a successful business so this is one of the top reasons to consider when deciding on debt factoring.

## **Profit Loss**

The reality is, you will lose some of your money by selling your unpaid invoices. Yes, the quick cash can help you get through, but you are sacrificing a portion of what you have earned.

There are fees and then there is interest. Even if every customer pays the invoice on time, some of it goes to the lenders.

Customers who aren't paying and are considered bad debt will cost you even more. That also leads to a possible loop of financial stress that leads to dependency.

## **Becoming Dependant**

Some financial experts consider debt factoring to be the equivalent of a payday loan or cash advance.

If you are struggling to keep the doors open, this option can be a lifesaver. However, many businesses end up in a never-ending cycle of consistently borrowing and unable to stop. It is far better to use other options, like traditional loans or liquidating assets, to come up with your cash.

Many business owners will take a pay cut, or not get paid for a while, in order to use the money elsewhere. If you think you could become dependent on debt factoring, then it is something to avoid completely.

## **Long-Term Commitments**

Some debt factoring companies require long-term contracts for ongoing service. This can be detrimental to a business that wants a solution to a short-term problem.

If you anticipate that your business needs a healthier cash flow for a year or longer, then it could be a great fit for you. If you need it for less time than that, you may want to consider another option.

There are government programs for small businesses that can help you move forward through hardship or trying to grow.

## **What Can Debt Factoring Do For You?**

As we have mentioned before, it can be a real helper during trying times. Whether you are expanding the business or trying to recover from the harsh economy, it can be a convenience to keep you going.

Get your cash sooner for paying bills, buying supplies, a new marketing campaign, or improving your e-commerce presence.

It can help you free up capital to take on a larger project than what you are accustomed to.

Coming back from an economic downturn can be tough. Expanding your business can be equally as tough. Having your financial house in order is important to overcome these obstacles.

Financial management is the foundation and there is help. Systems are available to track your invoices, track business loans, and alert you of overdue payments or invoices.

These same systems can also automate notifications to customers, accounts receivable and accounts payable transactions, and generate all the reports you need.

It can be the thing that helps you before needing to use debt factoring to get your business needs met. Contact us today and we can walk you through the options available to manage your finances with ease.

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