Commercial invoice discounting: An efficient short-term financing tool

While not well understood in Canada, invoice discounting is a simple, well-accepted business practice in many other countries, notably the U.S. and the U.K. The practice provides an immediate source of working capital, especially for small- to medium-sized businesses, from what is perhaps the largest asset of any enterprise–its outstanding invoices.

By Daniel Buduru, P.Eng.

Imagine that you're the owner of an engineering company that is growing rapidly. Sales are up 20 per cent over last year and your gross profit margin is over 30 per cent. You've just completed and delivered a project to one of your customers. You invoice the customer $90,000 with Net 30 payment terms; however, you have to wait 30 to 60 days or more before receiving the payment. At the same time, you receive a new order from one of your largest customers for $100,000, but have insufficient working capital to take it on. You need a source of quick cash to keep your company on track.

How it works

When timing is of the essence and traditional financing is not an option, invoice discounting can be a solution to keep your business growing. Invoice discounting is the business-to-business selling of commercial invoices (accounts receivables) at a discount. An invoice discounter buys selected quality invoices for your credit-worthy customers, turning them into immediate cash that can be invested back into your business.

The invoice discounter will ask you to send a letter to each customer requesting them to confirm that they will send payment directly to the invoice discounting company. After the invoice discounter receives this payment confirmation letter from your customer, a cheque or wire transfer will be sent to you within 24 hours for 70 to 90 per cent of the total value of the invoice. When the invoice discounter receives the payment from your customer for the invoice you sold, the remaining 10 to 30 per cent holdback (less the discounter's agreed fees) will be paid immediately to you.

You are still in control of the collections of your sold invoices and carry the responsibility of paying the invoice discounter if your customer does not send the agreed payment.

Quick and versatile

After the initial set-up time, which takes up to a week or two, funds will be advanced to you within 24 hours of receipt and verification of the invoice. There is no minimum term contract required; you can sell as many invoices as you require up to the maximum credit limit established in your contract with the invoice discounter.

Invoice discounters are more customer-service-oriented and provide funds quicker than traditional lenders. Invoice discounting companies can also be used in conjunction with your current bank financing. They often provide a new source of cash to your business by working in tandem with the bank as a source of secondary working capital, which can also improve your banking relationship.

Invoice discounting is also becoming an increasingly popular method of financing mergers and acquisitions. Alone or alongside stock finance, term loans and trade finance, invoice discounting offers a full asset-based lending package.

Different from factoring

Although the invoice discounting concept has similarities to the practice of factoring, there are differences between them. Invoice discounting offers the same cash-flow benefit as factoring, but without the need to lose control of your sales ledger and your existing credit and method of collection.

Factoring companies usually look for well-established, profitable businesses with an effective and professional system of sales ledger administration. Invoice discounting companies will primarily look at your overall business and growth potential, as well as at the credit worthiness of your customers.

Both invoice discounting and factoring are widely accepted financing alternatives to traditional funding; however, their concepts and benefits are often misunderstood and not well known in Canada. In fact, invoice discounting and factoring sales worldwide have grown progressively over the last few years: from $275 billion in 1998 to more than $700 billion in 2003. Combined, invoice discounted and factored sales in the U.K. and the U.S. totaled $400 billion in 2003, as opposed to only $4 billion in Canada.

Many advantages

While it may be more expensive than traditional funding, invoice discounting is a great short-term financing tool, especially for small- and medium-sized enterprises. Some of the most important benefits include:

- no loss of business to better financed competitors;
- will not create a debt and will not dilute ownership, because invoice discounting is not a loan;
- converts sales into cash within 24 hours (cash on delivery), but you still give credit terms or offer new credit terms to customers;
- allows you to remain in control of your credit and collection activity;
- enables you to concentrate on growing the business and expanding into new markets, not on cash-flow headaches;
- works well with existing bank financing, and actually improves credit status and relationship with the bank;
- no requirement of two years trading to be considered for finance, for a growing business with a valuable product or service with a good profit margin, good management, and credit-worthy customers;
- improved profit by taking advantage of purchase discounts (i.e. 3 per cent Net 20 days or 3 per cent Net 10 days) offered by suppliers;
- the use of cash to pay off short-term loans and debts and fund growth efforts;
- increased ability to purchase inventory sooner and fill orders faster; and
- ability to fulfill large and/or unexpected customer orders.

Table 1. Profit comparison

	Without invoice discounting	With invoice discounting
Annual sales (to your top three customers only)	$1,000,000	$2,000,000
30 per cent gross profit	$300,000	$600,000
General cost (total)	$100,000	$150,000
Cost of invoice discounting	$0	$60,000
Net profit	**$200,000**	**$390,000**

What's the cost?

The total fees associated with invoice discounting are usually between 3 and 5 per cent every 30 days. Fees are based on the size of the transaction, the size of the invoice discounter, the administration costs of the funding facility, the payment cycle and the credit risk of the client and of the client's customers for the sold invoices. Most invoice discounters have an initial set-up fee, which is usually between $500 and $1,000.

In the example in Table 1, the net profit at the end of the financial year after 12 months and, considering all costs (including the $60,000/12 months estimated invoice discounting cost), there is an extra $190,000 in additional income for your business, which will be reflected positively on your financial statements. Statistically, businesses use invoice discounting on a monthly basis for one year on average, because it is more expensive than traditional funding. After that, they go back to traditional funding and/or continue to use an invoice discounter at lower negotiated rates, or on an as-needed basis.

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Who is a candidate?

In summary, small- to medium-sized growing companies that need short-term financing and do not want to dilute their existing ownership or create a debt can benefit with this financing. Growing businesses with credit-worthy customers, like large public or private companies and government agencies are also candidates. Other companies that may benefit include seasonal businesses with good gross profit margins on their products or services, start-ups with little profit history but with a good product/service and 30 per cent or more gross profit margin, businesses seeking growth or expansion (mergers and acquisitions), or any growing business with a good profit margin and with receivables of 30 or 60 days or more.

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