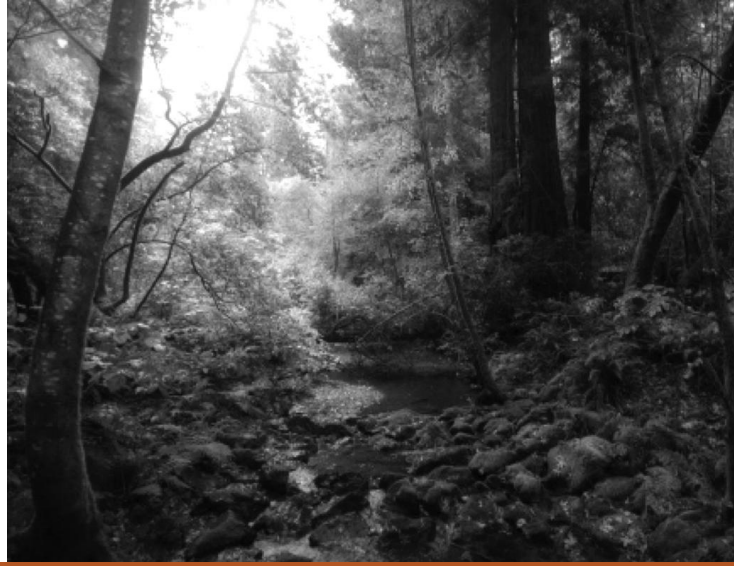




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Factoring

This article includes original and added content from Peter Kemball's Wikipedia entry "Factoring."

Please visit www.wikipedia.org to read the full entry.

Factoring is a word often misused synonymously with *accounts receivable financing*. Factoring is a financial transaction whereby a business sells its accounts receivable (i.e., invoices) at a discount. Factoring differs from a bank loan in three main ways. First, the emphasis is on the value of the receivables, not the firm's credit worthiness. Secondly, factoring is not a loan – it is the purchase of an asset (the receivable). Finally, a bank loan involves two parties whereas factoring involves three.

The three parties directly involved are: the seller, debtor, and the factor. The seller is owed money (usually for work performed or goods sold) by the second party, the debtor. The seller then sells one or more of its invoices at a discount to the third party, the specialized financial organization (aka the factor) to obtain cash. The debtor then directly pays the factor the full value of the invoice.

Why firms use factoring

A company sells its invoices at a discount because it is more profitable for them to use the funds (from selling the invoices) to support their sales growth than 'to be their customer's bank'. This means that the seller can make more money from investing in their growth than from supporting their customer's business by extending them [credit](#) for sixty or ninety days (for example).





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Difference between factoring and bank loans

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Factors make funds available, even when banks would not do so, because factors focus first on the credit worthiness of the debtor, the party who is obligated to pay the invoices for goods or services delivered by the seller. In contrast, the fundamental emphasis in a bank lending relationship is on the creditworthiness of the small firm, not that of its customers. While bank lending offers funds to small companies at a lower cost than factoring, the key terms and conditions under which the small firm must operate differ significantly. Bank relationships provide a more limited availability of funds and none of the bundle of services that factors offer.

From a combined cost and availability of funds and services perspective, factoring creates wealth for some but not all small businesses. For small businesses, their choice is slowing their growth or the use of external funds beyond the banks. In choosing to use external funds beyond the banks the rapidly growing firm’s choice is between seeking angel investors (i.e., equity) or the lower cost of selling invoices to finance their growth. The latter is also easier to access and can be obtained in a matter of a week or two, versus the six months plus that securing funds from angel investment typically takes. Factoring is also used as bridge financing while the firm pursues angel investors and in conjunction with angel financing to provide a lower average cost of funds than would equity financing alone. Firms can also combine the three types of financing, angel/venture, factoring and bank line of credit to further reduce their total cost of funds. In this they can emulate larger firms.

As with any technique, factoring solves some problems but not all. Businesses with a small spread between the revenue from a sale and the cost of a sale, should limit their use of factoring to sales above their breakeven sales level where the revenue less the direct cost of the sale plus the cost of factoring is positive.

While factoring is an attractive alternative to raising equity for small innovative fast-growing firms, the same financial technique can be used to turn around a fundamentally good business whose management has encountered a perfect storm or made significant business mistakes which have made it impossible for the firm to work within the constraints of a bank line’s credit terms and conditions (i.e., covenants). The value of using factoring for this purpose is that it provides management time to implement the changes required to turn the business around. The firm is paying to have the option of a future the owners control. The association of factoring with troubled situations accounts for the half truth of it being labeled ‘last resort’ financing. However, use of the technique when there is only a modest spread between the revenue from a sale and its cost is not advisable for turnarounds. Nor are turnarounds usually able to recreate wealth for the owners in this situation.

Large firms use the technique without any negative connotations to show cash on their balance sheet rather than an account receivable entry, money owed from their customers, particularly when these show payments being due for extended periods of time beyond the North American norm of 60 days or less.





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How It Works

Invoice Sellers.

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The invoice seller presents recently generated invoices to the factor in exchange for a dollar amount that is less than the value of the invoice(s) by an agreed upon discount and a reserve. A reserve is a provision to cover short payments, payment of less than the full amount of the invoice by the debtor, or a payment received later than expected. The result is an initial payment followed by a second one equal to the amount of the reserve if the invoice is paid in full and on time or a credit to the account of the seller with the factor. In an ongoing relationship the invoice seller will get their funds one or two days after the factor receives the invoices.

Astute invoice sellers can use a combination of techniques to cover the range of 1% to 5% plus cost of factoring for invoices paid within 50 to 60 days or more. In many industries, customers expect to pay a few percentage points higher to get flexible sales terms. In effect the customer is willing to pay the supplier to be their bank and reduce the equity the customer needs to run their business. To counter this it is a widespread practice to offer a prompt payment discount on the invoice. This is commonly set out on an invoice as an offer of a 2% discount for payment in ten days. {Few firms can be relied upon to systematically take the discount, particularly for low value invoices - under \$100,000 - so cash inflow estimates are highly variable and thus not a reliable basis upon which to make commitments.} Invoice sellers can also seek a cash discount from a supplier of 2 % up to 10% (depending on the industry standard) in return for prompt payment.

Large firms also use the technique of factoring at the end of reporting periods to 'dress' their balance sheet by showing cash instead of accounts receivable

There are a number of varieties of factoring arrangements offered to invoice sellers depending upon their specific requirements. The basic ones are described under the heading Factors below.

Factors

When initially contacted by a prospective invoice seller, the factor first establishes whether or not a basic condition exists, does the potential debtor(s) have a history of paying their bills on time? That is, are they creditworthy? (A factor may actually obtain insurance against the debtor's becoming bankrupt and thus the invoice not being paid.) The factor is willing to consider purchasing invoices from all the invoice seller's creditworthy debtors.

The classic arrangement which suits most small firms, particularly new ones, is full service factoring where the debtor is notified to pay the factor {notification} who also takes responsibility for collection of payments from the debtor and the risk of the debtor not paying in the event the debtor becomes insolvent, non recourse factoring. This traditional method of factoring puts the risk of non-payment fully on the factor. If the debtor cannot pay the invoice due to insolvency, it is the factor's problem to deal





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with and the factor cannot seek payment from the seller. The factor will only purchase solid credit worthy invoices and often turns away average credit quality customers. The cost is typically higher with this factoring process because the factor assumes a greater risk and provides credit checking and payment collection services as part of the overall package.

For firms with formal management structures such as a Board of Directors (with outside members), and a Controller (with a professional designation), debtors may not be notified (i.e., non-notification factoring). The invoice seller may not retain the credit control function. If they do then it is likely that the factor will insist on recourse against the seller if the invoice is not paid after an agreed upon elapse of time, typically 60 or 90 days. In the event of non-payment by the customer, the seller must buy back the invoice with another credit worthy invoice. Recourse factoring is typically the lowest cost for the seller because the risk for the factor on the funding transaction is lower

Despite the fact that most large organizations have in place processes to deal with suppliers who use third party financing arrangements incorporating direct contact with them, many entrepreneurs remain very concerned about notification of their clients. It is a part of the invoice selling process that benefits from salesmanship on the part of the factor and their client in its conduct. Maladroit tactics such as use of a legal language notice can trigger an adverse reaction. Even more negative impressions are conveyed by a half hearted presentation of the case by the entrepreneur to the supplier.

Invoice Payors (Debtors)

Large firms and organizations such as governments usually have specialized processes to deal with one aspect of factoring, redirection of payment to the factor following receipt of notification from the third party (i.e., the factor) to whom they will make the payment. Many but not all in such organizations are knowledgeable about the use of factoring by small firms and clearly distinguish between its use by small rapidly growing firms and turnarounds.

Distinguishing between assignment of the responsibility to perform the work and the assignment of funds to the factor is central to the customer/debtor's processes. Firms have purchased from a supplier for a reason and thus insist on that firm fulfilling the work commitment. Once the work has been performed however, it is a matter of indifference who is paid. For example, [General Electric](#) has clear processes to be followed which distinguish between their work and payment sensitivities. (GE is also very active in the factoring industry as a supplier of funds.)

Professionals

Financial Internal financial professionals in controllership roles often have not had direct hands on experience with the three party relationship, hence the proper way to record the transactions. This results in unnecessary record keeping expenses or misleading records. One illustration of the latter is showing the invoices sold to the





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factor as accounts receivable from their customer (debtor) and a debt due to the factor. The opposite is the case. The firm has the cash and possibly an amount due from the factor but nothing due from their customers.

It is also quite common for professionals in public [accounting](#) firms not to have had hands on experience with this type of financing. This is less likely to occur in areas and industry sectors where factoring is common place.

Legal Legal counsel are typically more familiar with lending arrangements used by banks than with the sale arrangements used by factors.

One consequence of professionals not having direct experience with factoring arrangements is that they will compare the dollar costs of a factoring arrangement with those of a banking arrangement. However they often do not recognize that the arrangements are quite different with factoring suited to some firms, particularly rapidly growing ones and some turnarounds. The comparison often made by such professionals is based on thinking that different means to the same end should cost the same, even if the value offered differs.

Credit Insurers and Brokers There are now a number of suppliers who compete to provide companies insurance against the insolvency and bankruptcy of their customers or in some instances plain refusal to pay. Access to such companies is typically through brokers just as it is with the more familiar life insurance or property insurance products.

Factoring History

Factoring’s origins lie in the financing of trade, particularly international trade. Factoring as a fact of business life was underway in England prior to 1400.¹ It appears to be closely related to early merchant banking activities. The latter however evolved by extension to non-trade related financing such as sovereign debt.² Like all financial instruments, factoring evolved over centuries. This was driven by changes in the organization of companies; technology, particularly air travel and non-face-to-face communications technologies starting with the telegraph, followed by the telephone and then computers. These also drove and were driven by modifications of the common law framework in England and the United States³.

Governments were latecomers to the facilitation of trade financed by factors. English common law originally held that unless the debtor was notified, the assignment between the seller of invoices and the factor was not valid. The Canadian Federal Government legislation governing the assignment of moneys owed by it still reflects this stance as does provincial government legislation modelled after it. As late as the

¹ Four Centuries of Factoring; Hillyer, William Hurd; Quarterly Journal of Economics MIT Press 1939

² Bankers and Pashas: International Finance and Economic Imperialism in Egypt; Landes, David S.; Harper Torchbooks 1969

³ Factoring, Jones, Owen; Harvard Business Review February 1939 and Factoring as a Financing Device, Silverman, Herbert R.; Harvard Business Review, September 1949





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current century the courts have heard arguments that without notification of the debtor the assignment was not valid. In the United States it was only in 1949 that the majority of state governments had adopted a rule that the debtor did not have to be notified thus opening up the possibility of non-notification factoring arrangements⁴.

Originally the industry took physical possession of the goods, provided cash advances to the producer, financed the credit extended to the buyer and insured the credit strength of the buyer.⁵ In England the control over the trade thus obtained resulted in an Act of Parliament in 1696 to mitigate the monopoly power of the factors.⁶ With the development of larger firms who built their own sales forces, distribution channels, and knowledge of the financial strength of their customers, the needs for factoring services were reshaped and the industry became more specialized.

By the twentieth century in the United States factoring became the predominant form of financing working capital for the then high growth rate textile industry. In part this occurred because of the structure of the US banking system with its myriad of small banks and consequent limitations on the amount that could be advanced prudently by any one of them to a firm.⁷ In Canada, with its national banks the limitations were far less restrictive and thus factoring did not develop as widely as in the US. Even then factoring also became the dominant form of financing in the Canadian textile industry.

Today factoring’s rationale still includes the financial task of advancing funds to smaller rapidly growing firms who sell to larger more creditworthy organizations. While almost never taking possession of the goods sold, factors offer various combinations of money and supportive services when advancing funds. Today, the credit insurance function is performed by large specialist insurers, particularly for smaller factoring operations and coverage can easily be and is purchased by companies to protect their equity.

Factors often provide their clients four key services: information on the creditworthiness of their prospective customers domestic and international; maintain the history of payments by customers (i.e., accounts receivable ledger); daily management reports on collections; and, make the actual collection calls. The outsourced credit function both extends the small firms effective addressable marketplace and insulates it from the survival-threatening destructive impact of a bankruptcy or financial difficulty of a major customer. A second key service is the operation of the accounts receivable function. The services eliminate the need and cost for permanent skilled staff found within large firms. Although today even they are outsourcing such back office functions. More importantly, the services insure the entrepreneurs and owners against a major source of a liquidity crises and their equity.

⁴ Silverman, Herbert R.; Harvard Business Review, September 1949

⁵ Hillyer

⁶ Hillyer

⁷ Silbert HBR Jan/Feb 1952





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In the latter half of the twentieth century the introduction of computers eased the accounting burdens of factors and then small firms. The same occurred for their ability to obtain information about debtor’s creditworthiness. Introduction of the Internet and the web has accelerated the process while reducing costs. Today credit information and insurance coverage is available any time of the day or night on-line. The web has also made it possible for factors and their clients to collaborate in real-time on collections. Acceptance of signed documents provided by facsimile as being legally binding has eliminated the need for physical delivery of “originals”, thereby reducing time delays for entrepreneurs.

By the first decade of the twenty-first century a basic public policy rational for factoring remains that the product is well suited to the demands of innovative rapidly growing firms critical to economic growth.⁸ A second public policy rational is allowing fundamentally good business to be spared the costly management time consuming trials and tribulations of bankruptcy protection for suppliers, employees and customers or to provide a source of funds during the process of restructuring the firm so that it can survive and grow.

⁸ Good Capitalism Bad Capitalism and The Economics of Growth and Prosperity; Baumol, William J., Litan, Robert E., and Schramm, Carl J. Yale University Press 2007

