

# The Cash Factor

BY JAMES A. WEISEL, CMA, CPA; NEAL HARM;  
AND CASSIE F. BRADLEY, CFP

If you used your credit card to buy gas on your trip to the office this morning, then you understand the essential elements of factoring receivables. The credit card, one of the most common modern personal receivable finance vehicles, is similar to commercial factoring.

A company sells a product to a customer who agrees to pay at some future time. The company “sells” that receivable to a host bank, which collects the full amount and returns it to the company minus a small percentage. (See Figure 1 for an illustration.) Increased convenience, reduced credit risk, and faster cash flow for the company are the primary motivations.

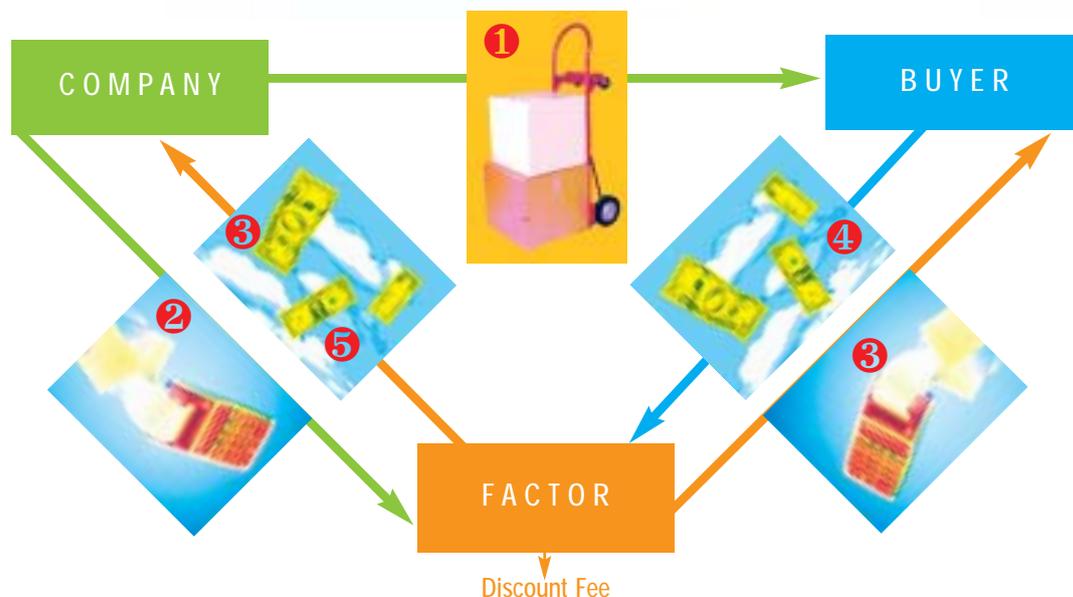


Figure 1: **Where Does the Cash Flow?**

- ① Company sells goods or services to the Buyer on credit for \$1,000. ② Company “sells” receivable to the Factoring Partner at a discount rate of 2%, \$980. ③ Factor advances 85% of discounted invoice, \$833. Factor also sends the invoice to the Buyer. ④ Factor collects \$1,000 from the Buyer. ⑤ Factor remits reserve to Company, \$147.

**Table 1: Characteristics of Short-Term Finance Vehicles**

	<b>FACTORING</b>	<b>ASSET-BASED LOAN</b>	<b>CASH-FLOW-BASED LOAN</b>
<b>Security/collateral</b>	Assets sold to factor; title and risk pass to factor	Assets used as collateral for loan; title and risk remain with company	Assets may or may not be used as security, depending on loan risk factors
<b>Assets involved</b>	Accounts receivable	Accounts receivable and inventory prioritized, with machinery, real estate, patents, trademarks, or other assets where value can be determined	Accounts receivable, inventory, machinery, real estate, patents, trademarks, or other assets where value can be determined
<b>Front-end discount fees</b>	Varies significantly, from 0.5% to 5.0% of receivables, depending on average invoice size, risk, volume, and other factors	Typically 0% of asset face value	Typically 0% of loan value
<b>Interest</b>	Simple interest based on the amount of money advanced on the invoice from the date of purchase until collected	Annual Percentage Rate (APR) based on prime + % charged on average balance outstanding	Annual Percentage Rate (APR) based on prime + % or LIBOR rate charged on average balance outstanding
<b>Advance rates</b>	75% - 90% of receivables depending on concentration, longevity of factor-company relationship, and historical dilution rate	Typically 85% for receivables, 50% for inventories	2 <sup>1</sup> / <sub>2</sub> – 3 times EBITDA
<b>Accounts receivable reporting and management</b>	Large factors can assume full A/R management and provide credit risk protection	Borrowing based on certificates of assets; borrower may need to provide quarterly audits of secured assets	Borrower provides aging of A/R on a quarterly basis

Factoring is defined as the selling of accounts receivable (A/R) at a discounted amount. Accounts receivable is a business asset just like a piece of property. Under a lending arrangement, accounts receivable is taken as collateral against a loan. With factoring, the invoice is sold to the factor. This does not create a loan or an obligation. On the company's balance sheet the receivable has become cash, moving it from a near-liquid to a liquid asset. In some instances, inventory and/or equipment may be taken as collateral.

Factoring differs significantly from asset-based lending and cash-flow-based loans, and, in today's business environment, it may compare favorably to them. Reasons for

factoring include credit protection, collection service, and improved cash flow. See Table 1 for a summary of the principal differences in the three types of lending.

Asset-based borrowing amounted to \$343 billion in the U.S. in 2000. Since assets are pledged as collateral, title and risk remain with the company. Asset-based loans are typically revolving loans backed by the most liquid company assets—receivables and inventories. Other assets such as machinery, real estate, patents, or trademarks may also be pledged as collateral. The advance rates are typically 85% for receivables and 50% for inventories. Advance rates on other types of assets vary widely depending on valuation and risk assessment.

Like asset-based loans, cash-flow loans are typically established in a revolving account. Unlike asset-based lending, however, specific assets are *not* used as collateral. Rather, the lender loans the company money based on the company's assessed ability to generate cash flow from operations and repay the loan in a timely fashion. In today's tumultuous economy, many borrowers have seen the sources of cash-flow-based loans shrink considerably. Advance rates on these types of loans have gone from four times EBITDA (earnings before interest, taxes, depreciation, and amortization) to two-and-a-half to three times EBITDA in just the last year.

Factoring of receivables is a relatively untapped source of financing in the U.S., accounting for \$87 billion in 2000. Although widely used in the textile, apparel, carpet, and home furnishings industries, factoring hasn't yet hit the mainstream. It suffers from the perception that only companies about to go out of business use it. In fact, just the opposite is true.

Factors generally desire long-term relationships with growth companies. They essentially act as outsourcers for credit management and collection of receivables. There are several significant advantages over the more prevalent asset-based and cash-flow-based lending vehicles.

### FACTORING: THE ADVANTAGES

The advantages of factoring over alternative forms of short-term financing include improved cash flow, reduced credit risk, opportunity cost savings, and an improved balance sheet. For example, a company with an average accounts receivable balance of \$100,000 and annual sales of \$1 million has days' sales outstanding (DSO) of 36.5 ( $\$100,000 / (\$1,000,000 / 365)$ ). If it were to factor all of its A/R with an advance rate of 85% made in three days, the DSO would be reduced to eight days, nearly an 80% improvement in cash flow.

The company is in business to sell a product or service. The seller usually offers these goods under terms for repayment, which creates accounts receivable; the seller has allowed the customer to use its balance sheet to finance the goods.

Under a traditional working capital arrangement, the seller is a de facto underwriter of its customer base and manager of the risk associated with the underwriting and collection of the obligation. Under a factoring arrangement, the company sells the accounts receivable for immediate cash. The underwriting and management of risk associated with collection is effectively outsourced to the factor, reducing the company's credit risk.

**Table 2: XYZ Company:  
Traditional vs. Factoring**

#### BASIC DATA

Annual sales	\$10,000,000
Average DSO	45 days
Average A/R balance	\$1,232,877
Working capital available @ 85% advance rate	\$1,047,945

#### TRADITIONAL LENDING

Annual interest @ 4.25% + 1%	\$ 55,017
Expanded credit collection and management personnel (2 people, salaries and benefits)	\$120,000
Annual write-off @ 1% of sales	\$100,000
<b>Total annual cost</b>	<b>\$275,017</b>

#### FACTORING

Fees @ 2% of sales	\$200,000
Annual write-off	\$ 0
<b>Total annual cost</b>	<b>\$200,000</b>

Several potential areas of reduced opportunity costs exist for companies choosing to factor their receivables. Factoring offers the service of accounts receivable management that will never be provided by a traditional working capital loan. A factor's biggest cost is providing credit, with larger factors possessing larger credit resources. In theory, this should mean better, quicker, and more cost-effective credit decisions. Much of the evaluation of a customer's credit risk is shifted from the company to its factor, creating an opportunity to reduce credit and collections department expenses such as wages, benefits, and infrastructure costs.

Let's compare the potential annual cost of factoring versus a traditional cash-flow-based loan (see Table 2). XYZ Company, a medium-size firm, is experiencing sales growth of \$10 million in a new product line with an average DSO of 45 days. The company requires \$1 million to support this expansion.

XYZ can borrow the required working capital at prime

(assumed to be 4.25% here) plus one percentage point. It experiences 1% of annual sales write-offs and expands the credit management and collections department. Alternatively, the firm could factor the receivables at an annual cost of \$200,000, eliminate credit write-offs, and avoid expanding the credit/collections department. XYZ's annual cost of factoring of \$200,000 compares favorably to the annual cost of \$275,000 for traditional lending. Obviously, factoring may not cost less than traditional lending in all circumstances, but it isn't necessarily cost prohibitive either.

With a large, professional factor, the dilution rate (uncollectible accounts rate) may actually improve as a result of the management services the factor provides. Many companies, especially small firms, can't devote the resources necessary for adequate receivables management. Let's take the company earning 10% pre-tax return on annual sales of \$1 million with a 5% uncollectible accounts rate and average A/R balance of \$100,000. If by factoring their receivables (at a 1% front-end discount fee) the uncollectible accounts rate is reduced to 3% of sales, the additional collections net of the front-end factoring fees improve pre-tax return on sales to 11%. Large factors can actually eliminate the credit risk entirely by assuming full A/R management responsibilities.

Finally, factoring offers a significant advantage with respect to balance sheet reporting. Instead of creating an obligation, it converts accounts receivable to cash. Standard measures of liquidity such as the current ratio and quick ratio are relatively unaffected. In addition, since factoring can speed up the cash cycle, it can help maintain appropriate balance sheet elements such as minimum cash balances required by loan covenants.

Asset-based loans and cash-flow-based loans simultaneously add to current assets as well as current liabilities. Thus, for any company with current and quick ratios greater than or equal to 1.0, these types of loans immediately reduce these ratios.

## THE COST FACTOR

Annual sales volume, average invoice size, longevity of factor-company relationship, accounts receivable turnover, historical dilution rate, and concentration all impact the terms of factoring. These costs need to be assessed relative to opportunity cost savings as well as to the cost of alternative sources of financing.

In general, greater annual sales volume and larger average invoice size enjoy better terms while the total volume of invoices is inversely related to the cost of factoring. In

other words, a few large-dollar invoices will cost less than a large number of smaller invoices. Clearly, risk assessment, receivables management, and collection of a large number of smaller invoices will consume more resources on the part of the factor, and this will be reflected in its fees.

The longevity of the factor-company relationship affects both the cost of factoring as well as the advance rates. As the partnership matures, the company will likely see front-end discount fees decline and advance rates increase. This reflects a natural progression of the relationship as the factor better understands the company and its operations. Also, the company needs to evaluate the factor and assess its ability to provide needed services.

Accounts receivable turnover, the velocity at which receivables are collected, is also directly related to the cost of factoring. In general, faster turnover lowers the discount rate charged by the factor. The factor, by remitting funds in advance of collections, must consider its own cost of funds and include this in the discount rate.

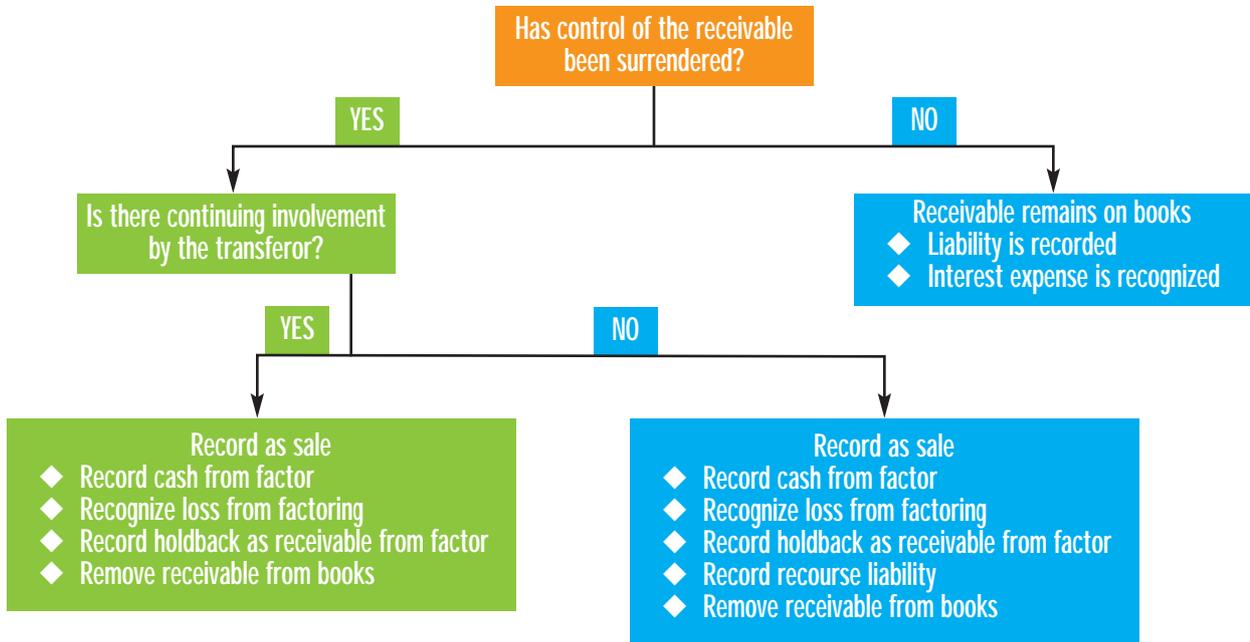
The historical dilution rate (uncollectible accounts as a percent of sales) and concentration (percentage value of receivables associated with one or a few customers relative to the total value of receivables) will impact advance rates. Higher uncollectible accounts will translate into relatively lower advance rates. A company with demonstrable uncollectible accounts of 1% of sales will enjoy better terms than a firm with a historical dilution rate of 5% of sales. Similarly, a factor will hold higher reserves (advance a lesser percentage) for highly concentrated receivables. Although not directly related to the cost of factoring, these issues clearly affect the amount and timing of cash available and are a reflection of higher risk for the factor.

## FINAL CONSIDERATIONS

In May 2002, Standard & Poor's released a list of highly rated companies that it felt had a reasonable probability of facing a cash crisis. It was touted as a way for investors to better predict looming financial problems. Some of the companies have been in the headlines for misleading financial reporting (e.g., Tyco), while others, such as Dominion Resources (S&P debt rating of BBB+), haven't experienced any adverse publicity.

There are many ways to shore up a balance sheet—for cash, in particular, companies can decrease outflow by increasing the accounts payable cycle. AMR Corporation increased accounts payable from \$1.27 billion in 2000 to \$1.78 billion in 2001, resulting in additional cash flow of \$517 million. In addition, companies can increase cash flow by factoring receivables. By securitizing receivables,

Figure 2: Reporting Guidelines for Transfers of Receivables



TRW, Inc. increased cash flow by \$327 billion in a year where earnings dropped precipitously. The accounts payable approach shores up the cash-flow statement but increases the total liabilities, while the accounts receivable approach has the advantage of providing an influx of cash with no corresponding effect on liabilities.

New rules for reporting occurred with the September 2000 release of Statement of Financial Accounting Standards (SFAS) No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125.” The Statement, applied prospectively, is effective for transactions occurring after March 31, 2001. Additional disclosure requirements and collateral recognitions apply for fiscal years ending after December 15, 2000. The primary reporting issue is whether the transfer of the receivable is a sale of an asset or simply the creation of an asset-based loan. The determining factor of classification is control. See Figure 2 for an illustration of the reporting guidelines for transfers of receivables.

Keep in mind that factoring may cause a disconnect between a company and its customers as a result of outsourcing the credit collection and management process. The unregulated nature of factoring, relative to the more conventional asset-based and cash-flow-based loan arrangements, complicates comparisons of alternative financing. Nevertheless, factoring holds numerous advan-

tages over alternative short-term financing. Improved cash flow, reduced credit risk, opportunity cost savings, and an improved balance sheet are several benefits of factoring.

A factor is a reflection of you, so you must perform a serious evaluation of the factor beforehand. Look for a factor capable of handling your needs in a professional manner. Consider issues such as the size of the financial services firm or depository institution, knowledge of your industry, ability to handle export receivables if appropriate, and membership in a trade association such as Factors Chain International. ■

*James Weisel, CMA, CPA, DBA, an associate professor of accounting in the Stetson School of Business & Economics at Mercer University in Atlanta, Ga., is president of SCM Consulting, Ltd. You can reach him at [weisel\\_ja@mercer.edu](mailto:weisel_ja@mercer.edu).*

*Neal Harm, international portfolio manager for GMAC Commercial Finance, Commercial Services Division in Atlanta, can be reached at [NHarm@gmaccf.com](mailto:NHarm@gmaccf.com).*

*Cassie F. Bradley, CFP, Ph.D., is an assistant professor of accounting in the Stetson School of Business & Economics at Mercer University and president of Market Results, Inc. You can reach her at [bradley\\_cf@mercer.edu](mailto:bradley_cf@mercer.edu).*