

Beyond the Misconceptions...

Factoring as a Dynamic Tool for Financing and Growth

BY NEVILLE GRUSD

In the early years of factoring, it was mainly confined to the textile and apparel industries. Today, however, all types of companies utilize factoring. In the following article, Neville Grusd at Merchant Factors sets forth to dispel the common myths and misconceptions about this alternative form of financing.



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Factoring is sometimes looked upon as “high-priced borrowing.” There is a misconception that companies that use factoring are financially weak. Nothing could be further from the truth, as some major companies utilize the services of factors to enhance their businesses. Because customers are notified about the factoring of the company’s invoices, and are instructed to make payments directly to the factor, there had been resistance in certain industries to using factoring.

In the early years of factoring, it was mainly confined to the textile and apparel industries. Today, however, it is well known that all types of companies utilize factoring. When notifying customers to advise them of the adoption of the factoring arrangement, it should be presented in a positive way by stating that this arrangement is assisting the company “to enhance its business and support its growth.” Customers should also be advised that, by using a factor, more credit could be granted to them, possibly with more favorable terms.

I have also found from my personal experience as the CFO of a company, that factoring actually improves cash flow by accelerating collections from customers. In paying bills, the CFO will usually pay factored invoices in a timely manner and extend non-factored invoices for as long as possible. Companies reason that if they do not pay a factor on time, it will affect their credit rating and subject themselves to professional collection efforts. Conversely it is perceived that non-factored suppliers “need the business and can be strung out for an additional 30 or more days.”

When Does Factoring Work Best?

Factoring is more advantageous when a company sells to a number of customers and can benefit from the credit checking, credit protection, collection and accounting services offered by the factor. Also, growing companies are greatly assisted by factors that create immediate cash

flow, which would not otherwise be available from banks. In a growing situation, as receivables increase, the availability to borrow automatically increases. Even for growing companies, banks are known to be slow in making decisions based on the size, age, financial condition and operating results of a company; especially when it is growing rapidly. Also, factors generally do not require “clean-ups.” As long as there is eligible collateral available, the client has the ability to borrow.

Various Types of Factoring

- **Discount Factoring.** Under this arrangement, the companies borrow against approved receivables on a formula basis. Generally, advance rates range from 70% to 85%. The amount of the advance percentage is based on the quality and dilution history of the receivables. “Dilution” includes all types of deductions for discounts, allowances, returns, etc., (i.e. what the receivables ultimately realize). When the dilution is 5% or less, it is usual to obtain between 80% and 85% as an advance rate. When the receivables are collected, the net balance after the initial advance and factor’s charges becomes available to the client. Factors also study the concentrations in receivable portfolios. Where there are large concentrations (outstandings in excess of 10% of the total receivables), confirmations of invoices will usually be conducted. Because of these larger exposures, the factor wants to be sure that there are no material disputes or deductions that may impact on the value of the collateral. In some cases, reserves may be set up for significant concentrations.
- **Collection Factoring.** Under this type of factoring, the company uses the services of the factor purely for credit protection, collection and accounting services. The factored receivables can be utilized as collateral for borrowing from other institutions with a tri-party agreement among the client, the factor and the bank. Usually this is done in the case of larger borrowing situations.
- **Recourse Factoring.** Under this arrangement, the factor does not guarantee the creditworthiness of the customers, and will charge-back the invoices to the company, usually if they have not been paid within 90 days. This type of arrangement is more akin to

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straight borrowing, utilizing receivables as collateral, and does not include the credit protection feature.

- **Invoice Discounting.** This is another financing technique that can either include or exclude credit protection. Usually this method is used for smaller situations with companies that have limited financial statements. Generally the costs of invoice discounting are higher than regular factoring but work well where not all receivables are used for financing purposes and the company can pick and choose what invoices to sell to the factor. This latter arrangement is also referred to as "spot factoring."

Requirements of Factoring

In the case of discount factoring, financial statements of the company are usually required, and for larger situations reviewed statements are needed. In addition, the shareholders of the company will be required to provide personal guarantees, backed up with personal financial statements. These guarantees give the factor comfort that the shareholders are standing behind the company and providing only valid invoices to the factor. If this is the case, and the dilution rate is reasonable, then the personal guarantees should be academic.

In the case of collection factoring and invoice discounting, financial statements are usually not required, and in the latter case, tax returns are often accepted.

Unlike bank lending arrangements, there are rarely covenants in factoring agreements. For larger borrowing situations there could be a net worth and/or working capital covenant requirement. There is usually no restriction on the owner of the company withdrawing profits and compensation from the company, as long as the borrowing arrangement is adhered to and there are no events of default.

Conduct

The most important part of the relationship between the company and factor is trust on both sides. The factor must know that the company is adhering to the rules of only assigning invoices for borrowing purposes that are valid and that the goods have been already shipped in terms of the customers' purchase orders. In addition, all collections must come directly to the factor and, in the event of a customer paying directly to the company, such proceeds should be turned over to the factor intact immediately.

On the other hand, the client must know that the factor has the ability to check its customers' credit and provide the financing in terms of the arrangement at all times.

Additional Financing Opportunities

In addition to advancing against receivables, factors can provide other financing including:

- **Letters of Credit (L/Cs).** L/Cs are open to suppliers, preferably for pre-sold goods. Depending upon the strength of the company and the quality of the customer, deposits may not be required for the opening of L/Cs. Where deposits are required, they can range from between 50% and 25% of the amount of the L/C, depending upon the financial condition of the company and the gross margin being earned on the goods.
- **Inventory Financing.** From time to time, particularly in seasonal businesses where inventory is accumulated, factors may make advances against such inventory, especially if it is pre-sold. Usually factors do not make permanent loans against inventory, which is not pre-sold. However, this can be considered if there are strong personal guarantors or outside assets pledged as additional collateral.

- **Purchase Order Financing.** Where the required amount of letters of credit or inventory financing is beyond the factor's comfort level, there are situations where the factor can work with a purchase order financier, where the latter is paid by agreement from the proceeds of the subsequent sales.
- **Over-Advances.** Factors can provide advances above the agreed lending formula, on a short-term basis. The amount of these over-advances will depend on projected sales, orders held, outside collateral, etc.

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Costs

The cost of factoring can vary from case to case, but usually includes:

- **Factoring Commission.** In regular factoring, the commission rate would be about 1% of sales; reducing where there is large volume and increasing for smaller situations. Usually there is also an annual minimum factoring commission charged, particularly where there are lower rates quoted on an expected large volume of business. In addition to the standard commission rate there can be surcharges on certain named customers whose credit is below standard.
- **Interest Is Charged on the Cash-in-Use.** This is when the advances made to the client are reduced by collections. In computing interest, clearance days are usually taken into account. The rate charged for larger factoring situations can be very competitive and on average can be around 2% to 3% above prime.
- **Invoice Discounting.** In these cases, invoices are purchased at a discount off the face value of the invoice, for example, at 2% per month. The exact amount of the discount will depend on expected volume, number of customers and invoices, etc. In these cases, there is no separate factoring commission or interest charged as the discount covers the total compensation to the factor.

Conclusion

A major consideration in deciding whether to use factoring is that factors are usually business people who look at the future growth of the company and the collateral, which they have in order to make credit decisions. Banks tend to base their credit approvals on historic information that is generally not relevant to the future growth of the company or seasonal needs of the business.

Usually the benefits of factoring far outweigh the costs, and it should be seriously considered as a viable and dynamic tool for liquidity and growth. [abfy](#)

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