STEP

SASKATCHEWAN TRADE & EXPORT PARTNERSHIP

FACTORING

A Guide to Understanding Factoring

CONNECTING SASKATCHEWAN BUSINESS WITH THE WORLD

This manual was created as resource guide for members of the Saskatchewan Trade and Export Partnership (STEP). For more information on these manuals or on STEP membership please contact the Saskatchewan Trade and Export Partnership at the following locations;

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Factoring

In today's highly competitive economic environment, businesses are under constant pressure to tighten operational controls in order to maintain profitability. In many cases, small companies must devote more time to credit and cash flow concerns which shifts attention away from the principal objectives of increasing productivity, sales and marketing efforts.

Cash tied up in accounts receivables can be a permanent problem for smaller companies. As your business grows, additional capital is frozen into accounts receivables. Most companies are growth-oriented, but sometimes so undercapitalized that a strain is placed on the entire firm. Factoring is designed to free up your capital and use it in more profitable areas.

Factoring is a quick and flexible form of financing which substantially improves a company's cash flow. Many companies get into a cash bind by extending credit to their customers for 30 days while having to immediately fund certain costs, particularly payroll. This problem only gets worse as sales grow. With factoring, your invoices are used as collateral for a short-term loan which provides you immediate cash with which to meet these expenses.

What is Factoring?

Factoring is selling the interest in your accounts receivables or invoices to a factoring service provider at a small discount. Sometimes factoring is called "account receivable financing". Factoring provides over 100 billion dollars to industry each year. In fact, factoring is an old financial service used by multi-billion dollar corporations that is now available to smaller sized businesses to which banks are reluctant to lend funds. Factoring is filling a tremendous void that banks have created.

Factoring and/or Accounts Receivable financing works like this, a company sells its accounts receivables (invoice) or (invoices), representing money due from its customers to a factoring company or to a bank, at a discount from face value so that it does not have to wait the normal 30-60 days for its invoices to be paid. In short, factoring helps a company speed up its cash flow, thereby enabling it to more readily pay its current obligations and grow.

Many new and growing companies have trouble obtaining traditional bank financing due to their length of time in business, profitability or financial strength. Factoring allows these companies to convert their accounts receivable into instant cash. Once you have delivered your product or service and generated an approved invoice, you can get your money in as little as 24 hours from a factor. Factoring can help a company stay current with its vendors and other financial obligations such as payroll and taxes.

Other types of financing generally require two years in business and showing a profit. Factoring does not necessarily have this limitation.

How it Works

Factoring works like this:

- Your product or service is delivered to your customer, and an invoice is created
- You provide a copy of the invoice to your factor along with other documentation
- Upon approval the factor advances a certain percentage of the invoice to you
- The factor also holds the remaining percentage of the invoice on paper as a reserve
- The factor assumes the right to receive payment on the invoice
- Your customer then submits payment to the factor

Before any of this happens, however, you will have to go through a brief application process to open an account with a factor. This application process usually takes between 2-10 business days and proceeds as follows:

- The factor reviews your business and its accounts receivable (they will need to see your aging report and, possibly some sample invoices, in addition to basic information about your company.)
- If interested in the transaction, the factor will submit its proposed rates, based on the dollar amount of the invoices you wish to factor
- If you accept the proposed terms, the factor performs due diligence on your customers (some factors require a due diligence fee or application fee to cover this)
- Upon approval and resolution of any due diligence issues, the factor presents you with an agreement to sign, after which you may begin factoring your invoices

Criteria

Typically, Factors look for certain criteria when evaluating an applicant.

Below is a list of qualifications for an "ideal" applicant. Remember that not living up to these ideals doesn't mean you can't factor-- just that these criteria increase your chances of attaining funding:

- Your company generates between $500,000 and $10 million in annual sales
- Your main customers are financially strong and regularly pay within 60 days
- Your accounts receivable are not already pledged as collateral
- Your company is free of liens, judgments, and set-offs

The cost of factoring and percentage of invoice that can be factored varies between service providers.

Obstacles to Factoring

You may want to reconsider factoring as a feasible or affordable option if:

- Your profit margin is less than 10%
- You are currently involved in litigation
- You send invoices before your service/product is fully delivered (pre-billing)
- Your accounts receivable are already pledged as collateral

Insuring Your Receivables

Accounts receivable can be one of the largest assets on your balance sheet, yet they're often overlooked when it comes to insurance.

There are many advantages to have accounts receivable insurance. Not only does credit insurance protect your company against losses, which will hurt cash flow and could jeopardize your company's future and provide your buyers with more attractive repayment terms but by having your ac- counts receivables insured, Factors are more likely to be willing to buy, especially if you are factoring through a bank.

It is also important to remember that the Factors agreements usually with recourse meaning that if your buyer does not pay the Factor, the Factor can go back to the seller (exporter) for payment on the receivable. By insuring your accounts receivables this risk is eliminated and the Factor will place a claim with the insuring agency.

Advantages to Factoring

<u>Funding Quick Results:</u>

Most qualified applicants will get approval within 10 business days and begin funding immediately.

<u>No new debt, no interest... No money to repay:</u>

Factoring is not a loan-- it is a discounted purchase of your invoices. You collect money from the Factor, and the factor collects from your customers. The responsibility of payment remains that of your customer.

<u>Independent of creditworthiness:</u>

Bad credit doesn't matter. What factors want to know is: Do your customers pay? Factoring depends on the credit worthiness of your customers— the people who repay your Factor.

Lack of hard assets (or asset preservation):

A new business or a business with insufficient hard assets might have trouble qualifying for a loan, but have reputable buyers Factoring is available to businesses that have reputable buyers. It also preserves your hard assets for another time at which you may really need a loan.

<u>Continuous and unlimited access to cash:</u>

The amount of money you can draw from your factor is limited only by the amount of your sales— the more invoices you generate the more money you can be advanced.

Flexibility:
There is no need to sell ALL your invoices. You can use just enough to get you back on your feet, or more in order to fund that expansion-- Factoring is designed to solve the short term cash flow problems. Discuss your goals with your factor or broker so they can cater the agreement to fit your needs.

Control:
You use the funding as you see fit— maintaining control over your company and the management of your receivables. You are not selling shares or ownership. You have the option to handle your accounts receivable yourself, or to turn them over to your factor to administer.

A Factoring Example

Widget Machines, Inc. receives an order from Advanced Factories for 10 machines.

Widget Machines, Inc. produces the machines, and ships them to Advanced Factories.

Widget Machines issues an invoice for $5,000 to Advanced Factories. The invoice states that Advanced Factories has 30 days to pay for the machines.

The next day, Widget Machines receives a new order from Professional Manufacturers for 20 machines. In order to fill the new order, Widget Machines will need to buy new materials to manufacture the new machines, and of course will need capital to pay for it.

Widget Machines does not have enough money to purchase the materials to produce the 20 machines, and Advanced Factories is not due to pay for another 30 days. However, Widget can factor its invoice to Advanced Factories to raise the capital needed.

They send the invoice from Advanced Factories to their factor. The factor gives Widget Machines a cash advance of $4,000 for the $5,000 invoice. (The remaining $1,000 is kept temporarily as a bad debt reserve.)

When Advanced Factories finally pays the invoice in 30 days, the factor sends (or rebates) Widget Machines, Inc. the remaining $1,000, less a $150 fee.

In other words, the factor gives Widget Machines $4,850 for the $5,000 invoice. This is the "discount" at which the factor has purchased the invoice. But again, the newer order from Professional Manufacturers puts Widget Machines in the position to wait to be paid.

Factoring Terms

Account Debtor - The customer of a factor's client. The company owing the money due on the invoices. Also known as the customer.

Accounts Receivable - Trade credits; an amount owed by an account debtor by the act of granting short term unsecured credit in lieu of cash for goods or services. Considered a liquid asset on the balance sheet and generally expected to be paid in less than ninety days.

Accounts Receivable Aging Report - A report showing how long the invoices from each customer has been outstanding.

Accounts Receivable Financing - A short-term financing technique for working capital purposes, loans to a company are collateralized by a security interest in a company's account receivables. Ac- count receivables serve as collateral, and loans are made on a percentage of eligible assets pledged.

Acquisition - A loan to assist in acquiring the assets of a business.

Asset Based - A business loan where the borrower pledges as collateral for the loan any assets used in the conduct of his or her business. Funds are used for business related expenses. All asset- based loans are secured.

Credit - A privilege granted for the purpose of extending time to make payment on a debt. Customer - The client's customer. The company which pays the money due under the factored invoice. Also known as the account debtor.

Dilution - The amount of risk associated with collection of the accounts receivable. It can include re- turns, charge-backs, trade allowances, concentrations, slow pay, bad debt and other perceived risk.

Due Diligence - Background check and research conducted by the factor to assess validity of a prospective factoring client and that client's customers.

Factor - The funding source for the client. The company which purchases the accounts receivable (invoices) from the client.

Factoring - The selling of a company's accounts receivable to a third party, in order to obtain funding.

Factors Acknowledgment Form - A form sent to the client's customer by the factor, confirming that the client's invoice does exist and that the customer will remit the payment due under that invoice to the factor.

Factors Advance - The money the factor sends to the client up front, after the verification process is complete, and before the factor receives its money from the client's customer. The advance is figured as a percentage of the face value of the factored invoices.

Factors Charge-Back - An amount of money that is owed to the factor and is deducted or Charged-

Back from the reserve or availability of the line due to an agreed upon non-payment by debtor clause in the Factors contract.

Factors Client - The business which sells its accounts receivable to the factor.

Factors Fee - The fee the Factor Charges for funding the clients A/R. Also known as the discount at which the factor purchases an invoice.

Factors Reserve - A deposit maintained by the factor, to guard against disputes between the client and the customer, and to guard against bad debt losses due to customer non-payment. This is the money retained by the factor when the advance is sent to the client. The Reserve is sent to the client after the customer has paid the factor the money due on the invoice.

Factors Reserve Release - The amount of money released from the Factors Reserve once payment has been received and credited. The Reserve Release may be less any charge-back or fees associated with the services.

Factors Services - Credit Analysis, Credit Guarantees and Collection Management.

Factors Verification - Process by which the factor verifies that the product or service provided by the client was received and accepted by the customer, and that the customer intends to pay the factor the money due under the invoice. This process takes place before the factor sends the advance to the client.

Invoice - An itemized list of goods or services sold or delivered to a buyer, including all prices, charges, and payment terms.

Lien - A claim on the property of another as security for the repayment of a debt, judgment, mort-gage, or taxes.

Rebate - The amount of the reserve account that is remitted to the client upon payment of an in- voice.

Recourse - In this type of factoring, the risk of customer non-payment remains with the client. If the client's customer is financially unable to pay the money due under the invoice, the factor has re-course against the client for that money. The factor is protected against customer non-payment.

Reserve or bad debt reserve - The amount a factor holds in its account to cover a potential non-payment. After payment is received, the factor rebates the reserve to the client less any fees or delinquency charges.

Term - The period of duration of an invoice. The time allowed for the payment of bills.

Working Capital - Loans for business expenses such as, advertising, wages, rents, and other operational costs. Often these loans are secured by tangible assets or, in the case of long-standing good credit, by the "full faith and credit" of the company.

Service Providers

Examples of factoring service providers:

Montcap Financial Corporation	www.montcap.com
Maple Trade Finance	www.mapletradefinance.ca
Liquid Capital Corporation	www.liquidcapitalcorp.com
Mercantile Finance	www.mercantilefn.com

For links to financial service providers, please visit Saskatchewan Trade and Export Partner- ship's membership showcase at www.sasktrade.sk.ca.