15 Financing and Business Insurance

Overview

Customers often borrow money as a means of financing their operations. These sources of financing such as banks, finance companies, factors and other institutional lenders, usually have first claim on a significant portion, if not all, of the customer's assets by becoming a secured creditor through a filing under the Uniform Commercial Code. The customer's reliance on the lender, and the lender's superior collateral position, make it important for a grantor of unsecured trade credit to fully understand the relationships between the two parties. This chapter explores the various choices available to borrowers, as well as alternative methods of financing.

THINK ABOUT THIS

Q. What financial tools may be used to reduce the credit risk of marginal customers?

Q. How can a creditor reduce its risk exposure without denying a marginal account?

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The basic reasons for borrowing.
- Types of loans and lines of credit from banks.
- Different forms of leasing and leasing arrangements.
- Aspects of leveraged buyouts and what a creditor should know about them.
- How finance companies work and what a creditor should know about them.
- Accounts receivable factoring.
- Types and features of trade credit insurance.
- How a trade receivable put options can protect a single account.

Chapter Outline

Financing Needs

Reasons for Borrowing

A **balance sheet** *is a financial statement that shows a company's assets, liabilities and owners or stakeholders' equity at a specific date.* The balance sheet discloses sources of capital, such as equity contributions by proprietors, partners or shareholders, as well as liabilities, such as debts owed to trade credit, accrued payroll expenses, taxes, capitalized lease debt and borrowed funds.

The reasons most businesses borrow money are to:

- Purchase property, plant and equipment, which often cannot be funded from working capital and require mortgages or other types of long-term debt.
- Borrow under short-term credit facilities to build and finance inventory volumes in advance of heavy selling seasons.
- Take advantage of tax incentives:
  - Interest is tax deductible, whereas profits and dividends are taxable. Therefore, businesses can balance debt and equity for the maximum cash flow or return on shareholder investment. This receives a high level of management attention.
  - Owners often make investments in the form of notes payable to shareholders (payable to themselves) rather than equity.
- Take advantage of payment discounts offered to the company by vendors at rates higher than the lender's interest rates.
- Protect existing ownership positions. Using debt financing, as opposed to allowing equity investments by others, enables existing owners to prevent dilution of their control of a company or corporation and share of profits.

Because lenders provide financing for critical business needs, they are usually able to demand a senior secured position in the debt priorities of a business. Trade debt is often unsecured, making it possible for secured creditors or lenders to strengthen their position by virtue of liens against major portions of a borrower's assets including the inventory supplied by trade creditors. Securitization gives lenders an advantage over trade credit grantors.

Choice of Lender

Trade creditors should be aware of a customer's reasons for using outside financing and for choosing a particular lender. The lending community includes not only traditional institutional sources such as banks and finance companies, but also insurance companies, pension funds, venture capital groups, bondholders, government entities and other sources.

Credit and risk management professionals are encouraged to think like a fixed-income portfolio manager or an investor in the debt of companies: when a risk manager is responsible for $1 of product shipped to a customer on credit terms, the risk manager should consider the transaction as a $1 loan to the customer/borrower.

A formal lender, such as a bank or bondholder, considers each loan to borrowers in terms of risk-adjusted return. Not all borrowers are created equal and a diligent lender is always re-evaluating the risk profile of the borrower and adjusting the rate/price on the loan accordingly, if possible. As a risk manager, it's not always possible to alter the price of product or, even the profit margin to reflect the customer's risk.

Finance companies provide a form of long-term financing through capitalized lease arrangements. Factoring companies provide a form of financing through the outright purchase of receivables.

Lending Relationships

Creditors should also be aware of other important aspects of a lending relationship, which include the:

- Amounts outstanding.
- Terms of repayment.
- Costs involved.
- Collateral pledged.
- Existence of loan covenants or promises, that certain conditions or activities will or will not be met or done, and the possibility of defaults.

It is important for businesses to use the appropriate borrowing mechanism for the intended application of loan proceeds. Short-term borrowing should be used to fund seasonal inventory acquisitions and other short-term assets, while long-term borrowing should be used to fund the acquisition of long-term assets such as major purchases of property, plant and equipment. Any other uses can be a warning signal for the credit professional. A thorough analysis should be conducted on a customer who is unable or fails to use borrowed funds to keep its trade accounts payable current.

Close attention should also be paid to a customer who builds its base of fixed assets by paying its trade creditors slowly, as opposed to seeking long-term financing or borrowing short term in order to meet its current obligations.

Banks

Background

Banks provide a wide array of credit products that satisfy the financing needs of their customers. From small, unsecured lines of credit which may have a credit card feature to very large and complex multi-bank credit agreements that are extended to international businesses, banks are an important commercial funding resource. Many banks have developed a standard credit product set which includes several different offerings with various terms, pricing and loan servicing characteristics. Business borrowers take advantage of direct debit loan payments from deposit accounts, floating to fixed interest rate options and customized loan statement rendering. Special features for lines of credit, such as overnight investments and overdraft protection for primary demand accounts, are readily available. Customized documentation, servicing and pricing features are also available.

Types of Bank Lending

Loans Based on Borrowing Base Certificates

In bank lending, the borrowing firm makes its own sales, conducts its own credit investigations, makes its own credit decisions, approves its own orders, initiates its own collections and absorbs its own bad-debt losses. When a bank extends a business credit line, a loan agreement will be prepared. The agreement will define the maximum amount to be borrowed. Collateral for the credit, such as inventory, contracts and other assets, will be perfected with a security agreement and a UCC filing. The bank loan agreement with the borrower will identify the intervals for required submission by the customer to the bank of the **borrowing base certificate,** *a customer-certified document which details accounts receivable, ineligible accounts based on predetermined aging along with other criteria and amounts available to the collateral pool.* Inventory valuation may also be included in the borrowing base certificate. Also defined in the loan agreement will be *the percentage amounts a bank is willing to lend against qualified receivables, inventory or other collateral,* called the **advance rate.** These will determine the actual amount that can be loaned at any given time. When completed, the borrowing base certificate will assist the banker in determining the amount of available credit per the terms of the loan agreement.

Unsecured Loans

Unsecured loans cover the client's temporary working capital needs, are short term in nature (under one year) and are made based on the client's superior financial condition.

Mortgage Loans

Mortgage loans are usually made on the client's plant and equipment. They are considered long-term debt and are repaid with regularly scheduled interest and principal payments. Often these loans are fixed-rate loans or have an option for the borrower to fix the interest rate at a predetermined interval in the future, generally for a fee. Banks will usually allow a loan amount as a percentage of the property's market value of 75-80 percent. In the event of default, this allows the bank a margin of error on value and expenses.

Lines/Loans Secured by Miscellaneous Assets

Lines or loans are negotiated to meet the particular needs of each client. They may be secured by life insurance policies, deposit accounts, stocks and bonds or any other valuable assets owned by the borrower company, its endorsers or its guarantors. Often these loans are extended for short periods of time, generally for less than one year.

Equipment Loans

Equipment financing enables a company to acquire fixed assets, such as industrial equipment and machinery, and pay for them on an installment basis. Terms are arranged based on the creditworthiness of the borrower and include such considerations as financial strength and cash flow, credit repayment history, the seasonal characteristics of the borrower's line of business and the useful life of the equipment to be purchased. The borrower makes a down payment at the time the equipment is purchased and then pays the balance, including installation, delivery and carrying charges, in a series of installment payments including principal and interest. These may be paid monthly, quarterly, semi-annually or annually. Sometimes payment schedules and amounts are geared to the depreciation charges to be taken on the purchased equipment. The length of the contract should not exceed the useful life of the equipment. Sometimes the company acquiring the equipment can finance it directly with the manufacturer, who takes a secured position in the equipment.

Revolving Lines of Credit

Bank customers often require lines of credit that provide a **revolving credit** feature *whereby amounts may be borrowed, repaid and borrowed again.* The credit underwriting methodology for this credit type is similar to most other bank loan offerings. Loan documentation to evidence the transaction will sometimes include a loan agreement. This agreement will list any special requirements such as cleanup periods when the borrower is expected to rest the line at a zero balance or include loan covenant restrictions. These credit arrangements may have the personal guarantors of company owners and officers and are most commonly fully secured.

Short-Term Loans

Short-term loans or **lines of credit** *are extended to customers to temporarily support working capital.* These credit accommodations can be secured or unsecured and often are evidenced by signing a promissory note. Maturities for short-term loans range from 30 days up to one year. Loans of this nature made to small firms may be secured by the personal guarantee of company principals.

Long-Term Loans

Many firms cannot fulfill their financial needs solely through additional investment and retained profits. Consequently, they may find it necessary to look for long-term financing which often is used for long-term asset acquisition.

Although long-term borrowing cannot be considered part of the owner's investment in a business, the company does have the opportunity to use those funds over a relatively long period of time. These funds are used to purchase machinery, fixtures, equipment, real estate and other assets of a durable nature. This borrowing choice frees the firm's invested capital to carry accounts receivable, pay for inventories and meet the daily cash requirements of the business.

Long-term financing *usually has a maturity date of between three and five years, though can extend to 20 or 25 years for certain types of financing arrangements.* Monthly installment payments are common. Payment arrangements may also be structured for other intervals such as quarterly or semi-annually, depending on the capital needs of the business. Prepayment of the loan is usually allowed; however, prepayment penalties sometimes apply to early payoff of debt and should be considered in the overall cost of any transaction. The prepayment penalty fee is designed to assist the bank in defraying any loss of income due to early retirement of the debt and their loss of income stream. There may be a provision in the loan agreement for the interest rate to change over the period of the loan, and such loans may be tied to a floating prime rate index. Loans may also have fixed-rate pricing throughout their term.

Comprehension Check
List types of loans provided by banks and explain the key points of each.

Restrictive Covenants

In any type of bank lending, it is common for the bank to include **restrictive covenants** in the loan agreement. *Covenants set performance measures that the company is required to meet or the bank is allowed to call or renegotiate the loan.* The more risk taken by the bank, the more restrictive and abundant the covenants are likely to be. Examples of loan covenants are shown in Figure 15-1.

Comprehension Check
Explain **restrictive covenants.**

Figure 15-1 Typical Covenants in a Borrowing or Loan Agreement

The borrower may not pay excessive dividends, borrow from other sources, sell business assets, guarantee the debts of other companies, merge or consolidate with other companies, or buy back any outstanding shares of stock.

The borrower generally is required to maintain an acceptable relationship between current assets and current liabilities (often as a minimum financial ratio, such as the current ratio), maintain the physical and real assets of the company in good condition, employ the proceeds of the loan in the way prescribed, provide adequate insurance coverage on the business, maintain accounting records and have them available for review and submit periodic financial statements to the lender.

Property acquired by the borrower after the agreement is signed may become subject to the terms of the loan agreement by the **after-acquired clause**. *This means that the property is automatically pledged, although the borrower did not own it at the time the loan was made.*

The interest rate may change during the life of the agreement through the use of an escalator clause.

The entire loan may become due immediately if the borrower fails to live up to the agreement. This is called an **acceleration clause.** Where the borrower cannot meet the terms of the note, the lender may institute foreclosure proceedings. The court renders a judgment and orders the property sold to satisfy the claim. If the proceeds of the sale satisfy the amount owed to the creditor, any excess is returned to the debtor. Should the proceeds be insufficient to pay the claim, the creditor may seek a deficiency judgment against the personal assets of the debtor for the difference.

There will also be a **cross-default clause,** *which states that if the borrower defaults on any long-term borrowing agreement, all such agreements will be in default (including the one being negotiated).*

U.S. Small Business Administration

Designed to assist small businesses in financing capital needs for growth and expansion, the **U.S. Small Business Administration (SBA)** *participates in loans made by private lenders*. For business loan purposes, the SBA defines a small business as one that is independently owned and operated, not dominant in its field and meets sales standards developed by the agency. Its clients are businesses that may be undercapitalized, lack sufficient collateral and have not established an operating history. The SBA establishes loan ceilings and provides its clients with free management assistance.

Types of Loans

Of the loans offered by the SBA, the general small business loan, called 7(a), is the most common. Under the **7(a) loan program,** *all funds come from the commercial lender.* The SBA guarantees a portion of the loan with loan amount ceilings that can vary depending on the loan's term and purpose. If the borrower defaults on the loan, the SBA reimburses the bank for its share of the defaulted loan. The SBA doesn't lend money directly to small businesses but rather sets the guidelines for the loans made by the partners who are lenders, community development organizations and micro-lending institutions.

Comprehension Check
Explain the purpose of the U.S. Small Business Administration and what it offers.

Leasing

Background

Leasing is a long-established practice. In the period following World War II, rapid industrial expansion and inadequate depreciation allowances enabled leasing to become widely accepted as a method of acquiring the use of assets. **Lease contracts** *allow use of equipment, buildings and other assets by lessees in return for periodic rental payments to lessors over a specified time period.* They stipulate the number, size and time sequence of lease payments; and include clauses covering cancellation rights, conditions for renewal or, if applicable, a purchase option, the treatment of tax benefits and obligations, and maintenance, insurance and servicing responsibilities of lessor and lessee. Often the lessee is responsible for upkeep, insurance and repairs.

Lessors include manufacturing companies, independent leasing companies, lease brokers, commercial finance companies and many of the large commercial banks. Many equipment manufacturers use leasing as a marketing tool, offering equipment either for sale or on operating leases.

Types of Leases

The **Financial Accounting Standards Board (FASB)**, which provides the Generally Accepted Accounting Principles (GAAP), *sets forth comprehensive guidelines for classifying leases into two broad categories: operating leases and capital leases*.

Operating Leases

Operating leases *are short-term rentals of property, plant or equipment* where non-financial services such as insurance, delivery, maintenance and repair are usually provided by the lessor. Operating leases do not transfer the risks of ownership from the lessor to the lessee. The lessee often rents the asset for only a fraction of its useful life and deducts the lease payments as an expense. The most significant difference between an operating lease and a capital lease is that operating leases are shorter and the lessee does not record the equipment as an asset or the lease payment stream as a liability.

The FASB updated its accounting standards to recognize lease assets and liabilities on the balance sheet. The core principle of the update is that a lessee should recognize the assets and liabilities that arise from leases with a term of more than 12 months. However, lessor (the owner of the asset to be leased) accounting did not fundamentally change in the update.

Accounting standards have been criticized by financial accountants for failing to meet the needs of users of financial statements because they did not always provide a faithful representation of leasing transactions. In particular, they did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. Moving lease obligations onto the balance sheet could impact debt-to-equity ratios. Under operating leases, usually debt and lack of cash flow to service that debt cause companies to fail.

The new standards will take effect for public companies for fiscal years beginning after Dec. 15, 2018, while the update will affect other organizations for fiscal years beginning after Dec. 15, 2019, and for interim periods within fiscal years beginning after Dec. 15, 2020.

Comprehension Check
What is an **operating lease?**

Capital Leases

The economic substance of a lease contract transfers the asset from the lessor to the lessee. *When substantially all the benefits and risks of ownership are transferred by the lease,* accountants refer to the agreement as a **capital lease.** Terms of capital leases include: (1) the lease term makes up the majority of the asset's life; (2) ownership of the asset transfers to the lessee at the end of the lease term; (3) the asset can be purchased by the lessee for a bargain price; or (4) the lessee's rental payments exceed a significant portion of the asset's value. For accounting purposes, the liability and the asset are recorded for the same amount at lease inception. Theoretically, they are recorded at the lesser of the present value of the total minimum lease payments versus the fair value of the leased asset under the agreement. The leased asset is considered a fixed asset and is depreciated over its useful life. The liability accrues interest at the lessee's borrowing rate over the lease term.

This accounting treatment was designed by the Financial Accounting Standards Board (in their pronouncement SFAS No. 13) to address incomplete disclosure by lessees. Without the recording of the asset and the liability, significant debts would become off-balance-sheet items and would not be revealed to the credit analyst.

With either form of lease, additional charges may be added for services that the lessor is providing. These might include administration, insurance, maintenance and property taxes. In both types of lease contracts, legal title is retained by the lessor. Where no purchase option is provided in a lease contract, residual value reverts to the lessor, which may recoup costs by selling or releasing the asset. Entering into a capital lease has many characteristics of an investment decision in that once the contract is signed, the stream of payments to be made cannot be changed by management's subsequent decisions.

Comprehension Check
What is a **capital lease?**

Sale-Leaseback Arrangement

Sometimes a firm will be in a weak cash position and will enter into a **sale-leaseback arrangement,** *where a company sells property, plant or equipment to an investor and arranges for a long-term lease.* The stream of lease payments represents the amortized value of the asset plus a return on investment for the investor. The liquidity shown on the balance sheet can suddenly improve, but the analyst should recognize that payment obligations increase and profits may decrease. The lessee generally pays all costs an owner would pay, e.g., insurance, property taxes, etc.

Leveraged Buyouts

General Considerations

A leveraged buyout (LBO) *is a special acquisition process that uses borrowed money (leverage) to acquire a company.* Specifically, a management or venture capital group borrows substantial capital by pledging the assets of the company to be acquired as collateral. Simultaneously, the group uses that capital to purchase the equity necessary to acquire and control the company. This is accomplished with only a token amount of capital coming from the buyers. The technique can be used to take a public company private, to purchase a division or subsidiary spun off by the parent company or to fulfill the financial goals of a company owner who may be seeking to retire.

LBOs take advantage of the taxation principles listed in the Reasons for Borrowing section of this chapter. One example of an LBO involves a large profitable public company with thousands of shareholders. Such an entity would pay enormous taxes. When an LBO is performed on such an organization, interest costs dilute the profits, but there are now only a few shareholders among whom to distribute those profits. Also, those shareholders benefit from the tax deductibility of the interest costs. In a successful LBO, the structure allows for a higher percentage return on investment than was achieved under the original structure.

LBOs were popular acquisition techniques in the mid- to late-1980s during which time a tremendous amount of liquidity and equity capital was wrung out of corporate America. During those years, public stock prices were low and other opportunities for lending institutions were limited, providing the fuel for the technique to flourish. While the process is still in use, it has faded in popularity because many LBOs failed due to their inability to service their resultant debt loads. Figure 15-2 presents an overview of the most important considerations for credit grantors where LBOs are concerned.

Figure 15-2 Evaluating Leveraged Buyouts

1. The company must have proven products and markets. Unlike venture capital financing, leveraged buyouts aim for reliability and staying power.
2. Key management personnel must have a proven track record. They must be experienced in production, sales, finance and operating the company or a similar one.
3. Management should have enough of their own cash invested in risk equity to ensure their total commitment.
4. The company must have a steady and reliable cash flow to support the purchase price, carrying charges and related debt.
5. The physical plant should be reasonably modern so that heavy capital expenditures can be avoided during the payback period.
6. The company's industry should not be vulnerable to sudden technological shifts that can cause obsolescence.
7. Preexisting debt should be minor because the leveraged buyout will add a major layer of new debt.
8. The company should be willing to supply sufficient detailed financial information to creditors, to reassure them that the company can handle the heavy debt load.
9. Suppliers should be consulted so that previous trade terms will continue after the buyout. Harsher terms can cause liquidity problems.

An LBO, like any other heavily indebted company, requires in-depth analytical attention by the credit professional. Balance sheets and operating statements should be compared to pre-buyout statements in order to evaluate cash flow and debt effectively. It is best to review at least three years of pre-buyout balance sheets and operating statements and to perform the analysis shown in Figure 15-3. Other factors to be considered include assessments of the abilities of new management. For example, will there be closer and tighter attention to operations helping to offset the higher interest expenses and debt loads? It is important that the credit professional obtain enough information to ensure a thorough analysis.

Investinganswers.com reports that "the world's most famous LBO is the approximately $25 billion takeover of RJR Nabisco by private equity firm Kohlberg Kravis Roberts in 1989. The deal was so famous (and so brazen) that it was immortalized by the book and movie *Barbarians at the Gate.* In those days, *many companies used LBOs to purchase undervalued companies only to turn around and sell off the assets* (these acquirers were called **corporate raiders**). Today, however, LBOs are increasingly used as a way to make an average company become a great company.

Comprehension Check

Define the term **leveraged buyout.**

List nine factors to consider when evaluating an LBO.

List nine important items to analyze when reviewing the financial statement of an LBO.

Figure 15-3 Analyzing Financial Statements for a Leveraged Buyout

1. Examine cash to uncover any seasonal peaks and valleys.
2. Check trade receivables for the average age of past-due receivables and their rate of change. Significant customers that provide 10 percent of sales should be listed. The probability of collecting long overdue accounts needs to be evaluated.
3. Check notes receivable from customers as to nature of loan, terms and history of collection.
4. Examine inventories to determine the current market value, pricing sensitivity and obsolescence factor.
5. Evaluate plant and equipment to assess their remaining useful life by comparing the appraised value with the remaining book value.
6. Check short-term borrowing requirements for peaks and valleys beyond the debt service associated with the buyout.
7. Analyze accounts payable to determine whether there are any payment problems arising from a reduced inventory turnover or slowdown in accounts receivables turnover.
8. Review operating income by product lines, industry segments, geographic locations, trend of major customers, pricing strategies, sales agreements and customer base.
9. Review operating expenses to establish the stability of cost structure by looking into each major element of expense. Lease rates, labor and fringe costs should be checked. Leases need to be examined to see if they are assignable and if they are economically advantageous to the buyer.

Finance Companies

Functions

Finance companies *make loans against pledged or assigned collateral, such as accounts receivable, inventory or fixed assets.* They do not actually purchase receivables or other assets; rather, they make loans based on the value of the asset and expect repayment of the loans by their clients.

Accounts receivable financing was pioneered in the early 20th century as a method to advance operating cash to business, but did not become a significant source of funds until 1941. Now many banks in America have financing operations and many finance companies are subsidiaries of bank holding companies. Many commercial finance companies specialize in accounts receivable financing.

One important result of this evolution is that accounts receivable financing has become increasingly important in the world of finance. The necessity for the use of receivables as collateral arises because the borrower is trading actively on invested capital and needs funds to finance current operations. With the variety of institutional sources available, small businesses as well as mid-sized and large companies are able to obtain funds through receivables financing when they might not be able to obtain unsecured financing.

Accounts Receivable Financing Procedures

A company entering into an **accounts receivable financing agreement** *which is a loan secured by accounts receivable assigned to the finance company,* continues to operate its own credit department as before. It makes credit decisions, maintains customary detailed accounts receivable records and handles its own collections, dealing directly with its debtors. Meanwhile, *the company signs a formal covering agreement with the finance company.* This is known as an **underlying agreement** or **working plan** and is a continuing arrangement for funds to be advanced by the finance company. The lender takes security in the assets by filing a lien using the normal procedures described under the Uniform Commercial Code.

The agreement outlines the overall terms and conditions of the borrowing relationship, such as maximum limit, interest rate, service fee, if any, and the rights and obligations of each party. The procedure for obtaining funds varies according to the agreement. In some instances, the borrower signs a note and submits it with a schedule of specific accounts to be assigned, duplicate invoices and evidence of shipment or delivery. In other cases, invoices and shipping documents are not required, and the borrower continuously assigns its total accounts receivable, which are normally certified by an outside accountant. For the most part, finance companies use the non-notification method, which means that the borrower's customer is not aware that the account has been pledged. Payment is made by the customer to the borrower in the normal manner and, in turn, by the borrower to the lender.

Loans against Inventory by Finance Companies

A finance company may also make inventory loans that are processed in much the same way as a factor or bank. Occasional inventory inspections may be performed by external auditors at the direction of the finance company. This audit would be discussed in the financing agreement.

Evidence of a Financing Arrangement

A company borrowing against receivables should show evidence of this either on the balance sheet or in the accompanying footnotes. Receivables and corresponding short-term loans are often linked together by an explanatory note. If that is not done, the credit professional should look for signs that a financing arrangement does exist. NACM Business credit reports and other sources can also reveal the presence of secured loans. Questions to ask are shown in Figure 15-4.

Comprehension Check
What purpose do **finance companies** serve?

Figure 15-4 Questions to Ask about Arrangements with a Finance Company

An understanding of a customer's arrangement with its finance company may be reached by obtaining answers to the following questions:

1. Is the arrangement normal? With a normal financing arrangement, there is no notification to the client's customer that receivables are being pledged to secure a loan. If the agreement differs from the normal arrangement in that it provides for notification, this should act as a warning that the finance company considers the client a higher than ordinary risk.
2. What is the contract percentage advanced by the finance company against pledged receivables?
3. What is the customer's overall line with the finance company? A finance company will advance a contract percentage against pledged assets, although there is an overall dollar limit to the loan.
4. Does the customer draw the full amount available? Are there any arrangements for advances above the contractual percentage? If the customer does not draw the full loan amount available, this is probably a favorable sign. If it is doing so, it either signals full dependency on the finance company or possibly indicates that finances are in a strained position. On the other hand, overadvances may indicate a great deal of confidence by the finance company. A conclusion as to which way the scale is balanced can only be drawn after all the facts and circumstances are weighed.
5. What is the customer's gross receivables amount and its current loan balance with the finance company? The difference between these two items is the customer's equity. Equity can be diluted by discounts and reserves, contras and concentrations, or delinquent accounts receivable. Discounts and reserves are direct reductions of the face amount. Contras are potential reductions, in that the client's customer may offset an amount owed by the client to the customer. Concentration of receivables from a few large companies poses a danger to those receivables and the market position of the seller. Finally, delinquent accounts are potential bad debts.
6. What is the usual delinquency percentage? The quality of the accounts receivable gains in importance because the company is contingently liable for them.
7. What is the accounts receivable turnover experience?
8. Is there any pledge of the accounts receivable equity to the finance company, the finance company's affiliates or subsidiaries, or to any other third party?

Factors/Factoring

Background

Factoring has its roots in Colonial America, when factors acted as commission merchants, handling goods on consignment. During the late 19th and early 20th centuries, factors generally de-emphasized their roles as sales agents and focused on the buying of receivables.

Factoring *is a transaction whereby a business (seller) sells its accounts receivable to a third party, usually a financial institution (called a* **factor***), at a discount in exchange for immediate payment with which to finance continued business operations.* Factoring services may be provided on a **recourse basis** or on a **non-recourse basis,** *meaning the factor must absorb any loss due to the subsequent insolvency or inability to pay by the customer.* In other words, factoring without recourse means that the factor accepts the risk that the accounts receivable may be uncollectable. Non-recourse factoring costs more than factoring with recourse. Even if the general agreement is non-recourse, any individual sale of receivables could be negotiated between the parties to include **recourse** *(seller risk).* Where recourse is involved, the factor usually handles collections until the account is 60 days past due. If still unpaid after that point, the account is charged back to the seller.

Features of Factoring

Typically, sellers are required to factor their entire accounts receivable portfolio, meaning a factor will not purchase the most risky accounts receivable without including in the purchase higher quality accounts receivable. The factor usually will place caps and limits on the maximum factorable balance from each customer. Under most factoring arrangements, factors do not have a continuing obligation to purchase accounts receivable. For particularly risky customers, the factor may cease purchase-related accounts receivable. Historically, factors have been most active in the retail and consumer goods business sectors. Factoring services are not normally available for a customer operating in bankruptcy. In the case of high-risk customers, factors often levy a surcharge or a deductible on the particular accounts receivable.

Comprehension Check
Briefly describe what a **factor** is.

Business Case for Factoring

Businesses choose this financing tool for various reasons; risk mitigation and administrative expense control are among the relevant considerations:

- Factoring can provide the same benefits as borrowing against receivables. A factor can close the gap between a business's operating cycle and the time allowed for payment by suppliers. For example, factoring is popular in industries where terms granted by suppliers are shorter than terms granted to customers (carpet manufacturing).
- Receivables are sometimes purchased on a non-recourse basis. This insulates the seller from bad debt losses on factored receivables.
- Because factoring involves the outright sale of receivables, it allows a business to avoid some of the costs associated with the collection process. Therefore, businesses that seek to minimize middle management costs sometimes use factoring (smaller apparel manufacturers).
- A factor does not assume responsibility for deductions taken by the seller's customers. Sellers must post to their own records any payments received from the factor against factored accounts receivable. For these reasons, a seller must usually maintain some level of credit and accounts receivable staffing to reconcile records, research and collect deductions and manage any sales made at seller risk. Seller risk includes receivables sold to factors on a recourse basis and credit extensions made by the seller without approval from the factor.

Factoring Procedure

A factor has two primary missions: to recruit new, profitable clients and to successfully collect purchased accounts receivable. The latter calls for the establishment of a credit and collection function quite similar to that of the trade supplier. The factor obtains bank references, credit references and financial information from the client's customers, obtains reports from credit agencies, establishes credit lines for these customers and collects money owed on accounts. Because factoring fees are generally much lower than the profit margins of their clients, factors will often take a more conservative approach to establishing credit limits.

Factoring arrangements are available in a variety of forms and are negotiated based on several variables. The fees paid to the factor are determined by the following:

- The volume of business factored.
- The degree of risk assumed by the factor, determined by the recourse/non-recourse agreements as well as the creditworthiness of the seller's customers.
- The seller's terms of sale.
- The terms for advances made by the factor to the seller, if any.
- Whether payment is made upon collection, based on the obligation's maturity.
- Other factors such as average invoice amount, billing and other services provided by the factor, if any.

The agreement may require a minimum commission to the factor based on anticipated volume. Should that volume not be achieved, the actual rate paid by the seller, as a percentage of factored receivables, will be higher than the contract rate.

Timing of Payment to Seller

There are two timing options; each may also include advance privileges:

1. **Payment upon Collection.** The factor remits payment to the seller upon collection from the seller's customer. In non-recourse factoring agreements, if customer default still exists after a defined period of time, the factor must then make payment to the seller.
2. **Payment at Maturity.** The factor issues payment to the seller upon maturity of the factored receivables according to the terms granted by the seller. Remittance is made monthly on the average due date of the invoices maturing in any given month.

Advance Arrangements

Under either of the timing arrangements, the seller must still wait some period of time to receive payment from the factor, with Payment upon Collection usually being the longest delay. To fully use all the cash flow enhancements of factoring, agreements are often structured to allow the seller to take advances against the balance due for purchased receivables. The factor and seller negotiate an interest rate for these advances. On occasion, the factor may also allow overdraft privileges, but require security in the seller's assets, other than receivables, to do so.

Normally, the seller forwards the invoices and usually receives 85 to 90 percent of the face amount purchased before maturity; *the factor holds back the balance for such contingencies as returns and discounts, disputed receivables and seller's risk receivables.* This reduction is called **dilution.**

The term, **old line factoring arrangement,** still used in many industries, simply means that *the agreement contains borrowing privileges.*

Notification

The seller's customers may or may not be aware that a factoring arrangement exists. Under a notification arrangement, the invoices contain advice to pay directly to the factor, naming the factor as payee.

Under non-notification arrangements, there are two options. The seller's invoice may direct the customer to make payment to a blind lockbox, with such receipts actually being under the factor's control. Or the seller may collect directly from customers and report transactions to the factor monthly, paying fees simultaneously. Under such arrangements, the factor does not actually buy receivables or advance funds but merely agrees to be liable for default of any approved receivables. Under this arrangement, the seller is mainly concerned with risk mitigation. These arrangements bear more resemblance to credit insurance than to traditional factoring.

Order to Order or Credit Line

With order-to-order agreements, the seller obtains factor approval for each transaction prior to shipment. Since factors have their own internal credit limits for acquired receivables, any seller may be squeezed out of its position by other sellers who have obtained previously approved sales to a particular customer. Clients may have agreements with more than one factor to ensure that every invoice can be factored.

Under direct collection arrangements, the factor may authorize the seller to establish its own credit line for each account. In the event of a default, any balances owed in excess of the line become the seller's risk.

Loans against Inventory by Factors

In addition to purchasing sellers' accounts receivable, some factors offer a number of other services, including loans against inventory. This method of secured borrowing is often used by clients to finance temporary needs for working funds. When the seller sells inventory, it turns over the resulting receivable to the factor to repay the loan. Other institutions, such as finance companies and banks, also offer loans against inventory.

Ledger Lines

A business may find itself as a client of a factor and a customer of trade creditors selling their receivables to the same factor. Under such circumstances, the factor may establish a **ledger line.** That is, *the agreement with this business includes a provision that a credit line of some amount, on the part of the factor, will be made available to the other creditors.* If this business also has advance arrangements with the factor, the amount available for advance may be reduced by the total amount of the ledger lines granted.

Factor Guarantees

Occasionally, a factor will assist its sellers in obtaining trade credit by guaranteeing payment of the seller's obligation to the creditor. The amount guaranteed is subtracted from the advance amount made available to the client seller. Any supplier asked to extend credit on the basis of a factor guarantee should ascertain the financial strength of the factor, mitigating the risk that might be associated with such a guarantee.

Comprehension Check

Describe the advantages of **factoring** and how it works.

Considerations for the Credit Analyst

When analyzing a customer's creditworthiness, a trade creditor should be aware of the existence of a factoring agreement and its impact on cash flow. The balance sheet entry, Due From Factor, under current assets, reveals the existence of a factoring arrangement. If all customer receivables have been sold as of the statement date, there will be no entry for accounts receivable. If accounts receivable do exist, they have either not yet been sold or may be client risk. If client risk, the collectability of these may be questionable.

The balance of the asset, Due From Factor, is usually the net amount of (a) receivables sold but not yet remitted to the client and (b) advances taken by the client. Dramatic changes in this balance, from one year to the next, may be warning signs for the analyst. A sharp reduction in this amount may mean the customer is strapped for cash and is borrowing more heavily than before.

Comprehension Check

List the important questions to ask about a factoring arrangement.

How do factors differ from finance companies?

Some highlights of a factoring agreement will normally be spelled out in the footnotes to the customer's financial statement. However, details such as advance rates, dilution rates, etc., often require further research. Other considerations and questions to ask about factoring agreements appear in Figure 15-5.

Figure 15-5 Questions to Ask about a Factoring Arrangement on an Advance Basis

It is important to determine whether the factoring arrangement is on an advance basis. If so, the balance sheet of the customer may hide more meaningful data than it reveals, and any figure shown as Due from Factor should not be taken at face value. If the arrangement calls for advances on accounts receivable, the credit department should ask the factor the following:

1. What is the contractual advance percentage? Is it fully used?
2. Are there any arrangements for unsecured overdrafts? If so, what are they? An **overdraft** *is a verbal agreement by the factor to provide funds in excess of the contractual advance percentage on receivables, usually to a stated limit for a specific period of time.*
3. Are there any overdrafts outstanding? If so, how much?

   When an arrangement calls for overdrafts in addition to advances, the reason should be determined. It could indicate that the customer is financially strained, because inordinately high sales would necessitate increased purchases of merchandise. Therefore, it is essential to obtain profit and loss figures to ascertain whether this increased activity yields commensurate profits and does not weaken the firm. In addition, interim trial balance figures are an aid in determining the current profitability of operations.
4. Are the overdrafts stated as an amount over 100 percent of the purchased receivables or over the contractual advance percentage?
5. Have overdrafts been requested but refused or restricted?
6. If the maturity arrangement calls for payment on the average due date, it is essential to determine the following:
   - Is the item Due From Factor pledged to a third party, such as a bank, to secure a loan?
   - Is there an intercompany offset situation?
   - Does the factor have other affiliates or subsidiaries that are suppliers of credit to the customer?

Insurance

The position of the going concern may change radically if something unforeseen happens to its earning power and financial strength. Fire, death of a principal, embezzlement, robbery, business interruption or extraordinary bad-debt losses can change the financial condition of a business overnight. Given that these circumstances can also affect a creditors' position, it is important for creditors to know the types and amounts of insurance carried by their customers.

There is no way to foretell misfortunes that can hit a business. Adequate insurance coverage is available against these contingencies, thereby protecting company assets and earning power as well as creditors' interest. The creditor should be satisfied that major risks are covered.

Although types of insurance differ in detail, they all have points in common: people join together to protect the value of their lives and property, and each participant contributes a relatively small amount in exchange for protection against a disastrous personal loss. The ultimate purpose of insurance is self-protection, but each participant cooperates with all others to carry common risk.

Trade Credit Insurance*

The practice of insuring commercial accounts receivable against default has existed in the United States for more than 120 years. In fact, like many technological and financial innovations implemented by companies globally, credit insurance was invented in the United States. As a risk mitigation strategy undertaken in the normal course of business, the use of credit insurance by U.S. companies pales in comparison to corporations in Western Europe. Easily one-third of European corporations of all sizes have credit insurance; in the United States, it is fewer than 1 in 10 but has grown from 1 in 50 companies since the early 1990s.

From the early 1980s until the mid-1990s, the U.S. marketplace had at most five or six insurance underwriters. In the last 20 years, that number has swelled to at least 13 insurers, excluding the United States Export-Import Bank. During the U.S. market's first century as an oligopoly, companies were usually obliged to cover their entire customer base in order to obtain coverage. Underwriting guidelines have become much more flexible, particularly with the entry of several new underwriters. With a far more competitive marketplace, underwriting standards have now evolved to the point where companies can elect to insure only specific customers or even just one customer. Insureds can now request coverage on their customers based upon a much wider range of selection criteria, such as those buyers within a certain subsidiary, division, size range, distribution channel and even credit quality.

Credit insurance is a risk transfer mechanism. **Trade credit insurance** or **trade insurance** *protects a seller's commercial accounts receivable from loss, whether caused by commercial or political risk events; it protects businesses from non-payment of commercial debt.* Trade credit insurance ensures that invoices will be paid and allows companies to reliably manage the commercial and political risks of trade that are beyond their control. Capital is protected, cash flows are maintained, loan servicing and repayments are enhanced, and earnings are secure from these events of default. The insurer agrees to compensate the seller in the event that its customer becomes insolvent or bankrupt or, in some cases, there is a protracted default of payment on accounts receivable or non-payment after an agreed number of months after the due date.

A credit insurance policy protects against excessive bad-debt losses, promotes safe sales expansion, provides effective collection assistance, strengthens borrowing and purchasing power, improves planning and budgeting accuracy and provides loss prevention guidance on key risks. For a contract of credit insurance to apply, there must be a sale, shipment and delivery; or a service must be provided for which there is a legally sustainable claim against the debtor or the debtor's estate. Generally, coverage is limited to sales on regular terms of not more than one year.

Credit insurance is not a substitute for prudent, careful credit management. Sound credit management practices must be at the foundation of any credit insurance policy and partnership. Credit insurance goes beyond indemnification and does not replace a company's credit practices, but rather supplements and enhances the job of a credit professional.

**Excerpted from "The Five Most Common Misconceptions about Credit Insurance," Trade Credit & Political Risk Practice, Arthur J. Gallagher & Co.*

Limits

Trade credit insurance policies are often cancelable by the insurer upon notice to the seller. Credit insurance policies have total policy limits and also have customer-specific limits. Like other forms of insurance, there are often deductibles and loss-sharing rates, that is, not full-coverage. The **trade credit limit** *is the amount of loss that the insurer will reimburse to the policy holder, prior to any coinsurance or deductible, for a specific customer.*

Terms

The term of a credit insurance policy normally covers 12 months, with annual review and renewal; the arbitrary expiration and renewal date may preclude a seller from taking advantage of low rates when they are prevalent if it doesn't coincide with a renewal period. If there is a particularly risky customer at a renewal date, the insurer can choose to refuse renewal with respect to that particular customer.

Cost

Generally, the cost to insure export receivables is higher than domestic receivables. The risk associated with export receivables insurance is usually greater because of distance and unfamiliarity with the laws and customs of the country or countries. Insuring export receivables not only protects against the commercial risk of slow pay customers or bankruptcy, but also protects against a political event that may impede or completely stop payment. On the other hand, domestic receivables may have challenges within specific industries; other factors are loss experience, existing credit management procedures and personnel. Premiums are generally charged either as a percentage of sales or as a per annum rate on limits.

Premium rates are influenced by various factors including country risk, obligor risk, length of payment terms and loss experience. Premium rates can range typically from .05% to .75% as a percentage of the insured sales. Insurance policies don't usually cover accounts receivable for sales to customers in bankruptcy or operating in Chapter 11.

Policy Purchasers

The ideal purchaser of credit insurance is either:

1. A seller seeking to protect itself from unforeseeable catastrophic risk (for example the bankruptcy of a key customer without any warning or tell-tale signs, which would normally alert the insurer to the risk and cause the insurer to cancel the insurance as it relates to such customer); or
2. A seller that cannot afford the resources to perform in-house credit analysis and prefers to outsource the credit risk management to an insurer (for example, the monitoring of 50,000 small customers).

Policy Coverage

Credit insurance is available only to firms engaged in manufacturing, wholesaling and certain service businesses. It is written with deductible and primary loss provisions, and may provide for coinsurance. In every policy, the insured and the insurer agree on a maximum amount of coverage, which is the policy amount. It is the maximum amount the insured can recover for all covered losses sustained during the one-year term of the policy.

With a **coinsurance type policy,** *the insured company participates in a percentage of the bad-debt loss sustained on a debtor.* This coinsurance feature causes the insured to participate in each loss. A higher premium is charged if the insured wants a policy without coinsurance.

With a primary loss policy and because credit insurance is not intended to eliminate all credit risk, a **primary loss policy** *covers losses over and above an agreed-upon annual deductible.* This deductible is based on the normal expected loss for the business and the overall risk to be insured. *This initial deductible loss is termed the* **primary loss** *and is not reimbursed to the insured.* It is set as a percentage of sales, but in no case is less than a stated dollar amount.

A number of endorsements can be made to the credit insurance policy to cover particular situations, including the following:

- **Bank Endorsement.** This endorsement is used when an account uses its receivables as collateral for bank borrowing. It gives the lending bank the right to file accounts in the same way as the insured does. Not all insurers give the beneficiary the right to file, but all have the right to proceeds.
- **Construed Coverage.** In case a customer's credit agency rating is changed downward between the time an order is accepted and the merchandise is shipped, this endorsement provides coverage at the higher rating for up to 120 days after the order is accepted. This is generally being replaced by Delayed Effect of Cancellation which has less conditionality to it and offers more protection to the insured.
- **Interim Claim Settlement.** This endorsement allows the insured to request three interim settlements within 60 days after filing a claim rather than waiting until the end of the policy term. Most insurers have automatic claim settlement.
- **Claim Settlement.** Within one month after the expiration of the insolvency period of the policy, the insured submits a Final Statement of Claims listing all claims to be included in the loss settlement. A settlement date is made with the insured within two months after receipt by the insurer of the Final Statement of Claims, at which time the amount ascertained to be due the insured will be paid.

Cancelable Versus Non-Cancelable Limits

A number of trade insurance companies offer both cancelable and non-cancelable limit type trade credit products. Both products have been sold successfully in the United States for many years, and in a sense, each tends to service a different constituency. Some insurers went through a credit limit withdrawal exercise for some of their cancelable limits during the financial crisis. The magnitude and frequency of the withdrawals, if any, were driven by each insurer's risk assessment and underwriting models, business decisions and the characteristics of its policyholder's base.

Under a **cancelable limit,** *the insurance company may, at its discretion, amend or withdraw coverage attaching to future transactions between the policyholder and its specific customers.* Each insurer typically has conditions about how much notice may be given prior to withdrawal and whether there are any exemptions or appeals that may apply to the withdrawal. While the policy language allows the insurer to amend coverage at its discretion, limit reductions or withdrawals will typically be the result of a serious deterioration in the risk being insured, such as the credit quality of the policyholder's customer. Such heightened risk may arise from factors specific to that customer, such as a serious breach of loan covenants or material cash flow deficits, or by virtue of an industry-wide or country-wide problem that suggests a loss event is likely within the policy period.

Policyholders who opt to purchase a credit insurance program with cancelable limits often use credit insurance more holistically than for reimbursement of a loss. Some companies perceive value in having the insurer serve as an adjunct to their own internal credit management function and an early warning beacon about problems associated with their customers, in addition to helping manage and avoid potential losses.

In simple terms, under a non-cancelable limit, the insurer may not amend or withdraw a limit, once issued, for the duration of the validity period of that limit. Most policies typically have conditions that can cause coverage not to attach to future transactions between the policyholder and its customer if a dangerous adverse circumstance occurs. Such situations are that the customer is becoming bankrupt, is in grave financial difficulty, is more than a certain number of days overdue on existing, undisputed obligations, or other known facts that reasonably may be expected to cause a loss under a policy.

Purchasers of non-cancelable limits value the fixed certainty of the limit, but understand that these limits are not intended as a carte blanche or free pass coverage, irrespective of circumstances. As managers of the risk, the policyholder accepts the responsibility, in the event of a claim, to have demonstrated proper effort, due diligence and expertise. Similar to policyholders with cancelable limits, the non-cancelable limit policyholder must be aware of their duty to behave prudently and to handle their customers as if they were uninsured. Certainly, there are many reasons why companies buy a non-cancelable limit policy and often it can relate to the overall insurance program being offered.

Comprehension Check
What are the advantages of **trade credit insurance?**

Trade Receivable Put Options

Trade receivable put options, or puts, protect a seller's accounts receivable on a single-account, non-cancelable basis in the event that the seller's customer files for bankruptcy during the period of the put. **Receivable puts** *amount to a promise by one party to buy a seller's trade receivables claim in the instance of a buyer's default or bankruptcy.* In a put, a seller delivers a product to their customer and undertakes that receivable, then purchases the right to put those outstanding receivables to, for example, a financial institution in the instance of a credit event, meaning either a bankruptcy filing or a liquidation. When that credit event occurs, the put is triggered, and pays the seller a predetermined level of protection on the claim.

When a credit event takes place, the seller is able to deliver its accounts receivable that it had with its now defaulting customer to the financial institution, which has to confirm the validity of the trade claim before making any payout to the seller. It's important to note that a put doesn't require the seller to deliver its outstanding receivables to the financial institution; it gives them the right to do so, meaning that a seller could pay a put fee and never cash anything in because their customer succeeds, or because they would rather not, for whatever reason, in the instance of the customer's liquidation or bankruptcy.

A put can be a more effective hedge than other potential trade financing options, such as factoring or credit insurance, mainly due to the fact that puts offer a bit more flexibility in terms of tenor, meaning how long the instrument provides coverage. Whereas factoring and trade insurance typically have minimums of six months or a year, puts can be structured for short-term coverage, up to three years.

Comprehension Check
What is a trade **receivable put?**

Distinguishing Factors

Puts are offered on a single customer, in contrast to factoring and credit insurance, which are normally available only on a portfolio basis. Moreover, puts are routinely offered on financially-distressed customers and, therefore, tend to be more expensive than factoring or credit insurance on a per-customer basis. Puts are non-cancelable and not modifiable by the seller of the put. Puts are available on varying tenors; normally, they are offered on periods of time spanning three months to 12 months. Puts are effective immediately on all the outstanding accounts receivable from the subject customer. Also, puts are offered on customers operating in bankruptcy and under Chapter 11. Finally, puts don't have a deductible, although, in certain cases, the purchase rate may be less than 100%.

The ideal purchaser of accounts receivable put options is either:

1. An experienced in-house credit team that doesn't use credit insurance or factoring and doesn't want to lose profit from sales to a risky customer, which would otherwise be avoided or limited due to credit risk (e.g., distressed, concentration, in bankruptcy); or
2. A seller desiring to supplement its factoring arrangement or credit insurance (e.g., credits not covered/dropped by factoring/insurance, seasonal spikes).

Figure 15-6 Comparison of the Features of Factoring, Trade Insurance and Put Options

	Factoring	Trade Insurance	Put Option
Flexibility	• Normally, requires entire portfolio of accounts receivable • Retail and consumer goods focused • Minimum receivables thresholds for primary factors • Caps and limits for maximum exposure to particular companies • Only protects prospective (new) accounts receivable incurred after the coverage becomes effective	• Normally, requires entire portfolio of accounts receivable • Caps and limits for maximum exposure to particular companies • Only protects prospective (new) accounts receivable incurred after the coverage becomes effective • Usually limited to annual policies with limits decided by the insurer (annual cycle renewal constraints open clients to undesirable pricing to market risks upon renewal)	• Available on a single customer basis, rather than a portfolio of accounts receivable • Focus on high-risk and distressed accounts receivable • Effective immediately on all outstanding accounts receivable to the customer (not just new receivables incurred after put option is purchased) • Range of variables for put options (e.g., expiration date, amount, etc.)
Modification and Termination	• Generally, factor may modify or terminate coverage	• Normally, cancelable on notice at the will of the insurer • Triggered on a default (bankruptcy) or failure to pay	• Non-cancelable • Triggered on a bankruptcy filing
Product Availability	• Not normally available in bankruptcy	• Not normally available in bankruptcy	• Available before bankruptcy and during (in) bankruptcy
Pricing/Cost	• Only available to fully cover outstanding receivables (cannot protect cost only) • Surcharge or deductible added to high-risk accounts	• Only available to fully cover outstanding receivables (cannot protect cost only) • Deductible costs must be considered. Surcharge added to high-risk accounts	• Can be structured to protect sale-price (with your profit), or to cover only cost of goods sold • No deductibles or surcharges or other additional costs

Key Terms and Concepts

Comprehension Check

1. List types of loans provided by banks and explain the key points of each.
2. Explain **restrictive covenants.**
3. Explain the purpose of the U.S. Small Business Administration and what it offers.
4. What is an **operating lease?**
5. What is a **capital lease?**
6. Define the term **leveraged buyout.**
7. List nine factors to consider when evaluating an LBO.
8. List nine important items to analyze when reviewing the financial statement of an LBO.
9. What purpose do **finance companies** serve?
10. Briefly describe what a **factor** is.
11. Describe the advantages of **factoring** and how it works.
12. List the important questions to ask about a factoring arrangement.
13. How do factors differ from finance companies?
14. What are the advantages of **trade credit insurance?**
15. What is a trade **receivable put?**

Summary

- Customers often borrow money as a means of financing their operations. These sources of financing such as banks, finance companies, factors and other institutional lenders, usually have first claim on a significant portion, if not all, of the customer's assets by becoming a secured creditor through filing under the UCC.
- There are a variety of reasons way a business may **borrow money**. Here are a few:
  - **Purchase of property or equipment**
  - **Build inventory before a heavy selling season**
  - **Tax advantages**
- The securitization of loans gives lenders an advantage over trade creditors.
- Important aspects of the lender relationship that a creditor should be aware of include:
  - Amount outstanding
  - Terms of repayment
  - Costs involved
  - Collateral pledged
  - Existence of loan covenants or promises
- Loan types differ greatly, and if a bank feels as though they are taking on more risk, it may include restrictive covenants in the agreement. Types of **bank lending** include:
  - **Loans based on borrowing base certificates**
  - **Unsecured loans**
  - **Mortgage loans**
  - **Loans secured by miscellaneous assets**
  - **Equipment loans**
  - **Revolving lines of credit**
  - **Short-term loans**
  - **Long-term loans**

- The **U.S. Small Business Administration (SBA)** assists the growth and expansion of small businesses in the United States. The SBA helps small businesses to obtain loans from financial institutions and in many cases insuring the banks from any defaults on those loans.
- **Leases** come in several forms. The major difference between a capital lease and a operating lease is that operating leases are shorter and the lessee does not record the equipment as an asset or payment stream as a liability. However, the FASB is in the process of updating the accounting standards associated with leases. A sale-leaseback arrangement is another type of lease that a creditor should be aware of because of its effect on the balance sheet, which may look favorable, but may ultimately spell out a greater risk to the creditor.
- **Leveraged buyouts (LBOs)** were very popular tools used by financial institutions in the late 1980s. A leveraged buyout is when a company borrows money in order to acquire another company. Leveraged buyouts should be evaluated in depth using financial statements of at least three years prior to the buyout.
- **Finance companies** make loans against pledged or assigned collateral, such as accounts receivable, inventory or fixed assets. There are several questions a creditor may want to ask such as, is this a normal arrangement?, or what is the contract percentage advanced by the finance company against pledged receivables?, but ultimately signs of borrowing against receivables should show up in the balance sheet or in its accompanying footnotes.
- **Factoring** can occur on a recourse or non-recourse basis. Typically sellers are required to factor their entire accounts receivable portfolio. Some benefits of factoring may include:
  - Insulating the seller from bad debt losses on factored receivables
  - Avoiding some costs with the collection process
- Fees that are paid to the factor are determined by many considerations including the volume of the business factored, the degree of risk and the seller's terms of sale. Timing of payment may either be upon collection or at maturity. Advanced arrangements can be made with the factor in accordance with the various payment methods.
- Because the financial condition of a business can change overnight, it is important for the credit manager to know the types and amounts of insurance carried by the customer. **Credit insurance** is a risk transfer mechanism. Policies have evolved to where companies can insure individual customers. The ideal purchaser is:
  - Protecting itself from catastrophic events
  - Unable to afford in-house credit management
- Several **endorsements** can be made to the credit insurance policy to cover specific circumstances, including:
  - **Bank endorsement**
  - **Construed coverage**
  - **Interim claim settlement**
  - **Claim settlement**
- Trade insurance may also have cancelable or non-cancelable limits.
- Another option to protect the account receivables for a single-account is **put options.** These are non-cancelable and tend to be more expensive than factoring or credit insurance. Ideal users include:
  - Experienced credit staff that do not use credit insurance or factoring
  - Those using it as a supplement to factoring or credit insurance

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