Title:
Accounts Receivable Factoring - A Viable Cash-flow Solution for Small and Medium-Sized Enterprises

Word Count:
1584

Summary:
This article will look at accounts receivable factoring. A mechanism that helps business to free up cash flow.

Keywords:
accounts receivable factoring, invoice factoring, receivables factoring, factoring company

Article Body:
The pace of change in today's business environment is inarguably staggering. Growth of e-commerce; changes to business structures; evolving relationships; changes to funding arrangements; access to capital and its sources. All occurring at increasingly exponential rates. Fast. The fact that there is more computing power in the average notebook computer today than it took to put a man on the moon should illustrate how fast things change, and whether in senior management or a business owner you need to keep pace.

In particular, you must stay abreast of changes in your competitive environment, and remain fully apprised of mechanisms that will enable a response fast enough to keep you in the game. This article will look at one of those mechanisms, access to capital and through that, free cash flow. In doing so we'll use an intuitive framework, peppered with some economics. Why? Intuitive analysis is ideal for answering specific questions; in this case 'What will best enable my firm to manage rapid changes to competitive economic conditions and stay in the game?' And I'll use economics because of Steven Levitt, America's most outstanding economist under-40, who along with Stephen Dubner considers that 'if morality represents how we would like the world to work, then economics represents how it actually does work.'

By speaking to specific anchor points, strategic issues affecting the access to capital problem can be explored and initiatives developed to allow a timely solution. In short, it's the fastest and most accurate way to answer the question you face, because it's easier to understand and doesn't get bogged down in extraneous, unnecessary analysis.

One of the anchor points in contemporary business is access to capital, especially when it helps maintain free cash-flow. In many respects they are one and the same thing, the difference merely being access to capital is a necessary precursor to free cash flow (you can't use it until you have it). And everyone needs it. Payroll, materials, overhead, and debtors taking anywhere from 45 to 120 days to settle their accounts, using your firm as a surrogate line of credit.

Access to capital becomes an even larger issue in the business environment described earlier, where speed to market and the ability to 'tool-up' (increase production) are crucial to meeting ever shrinking delivery timelines. Many of us have experienced the elation of being awarded a large tender, something that will fill the order book for the next six months, immediately followed by the hangover that comes with the realization that the firm will struggle to fund the project based on existing and forecast cash flow.

Small-to-medium enterprises encounter particular problems when it comes to cash flow and capital access to fund growing operations, to the point where lack of access is an issue that can threaten continuing operations, even in a rising market. Balance sheets take time to build, and it is against this security that banks will lend.

Developing initiatives to tackle this problem involves looking at some existing options and making a comparison, arriving at a decision that best enables a solution to the problem at hand. In this instance, a comparison of bank funding against invoice factoring provides insight into possible solutions for the capital access / cash flow problem.

Everyday economics can inform this comparison, particularly the study of incentives - how people get what they want, or need, especially when other people want or need the same thing. Let's start with banks.

Bank lending requirements are invasive and restrictive. They often engender a feeling that you have to 'bare all' to borrow a nickel. They would naturally dispute this claim, but let's return to the incentives – what is their incentive for lending you money? To earn a return off your efforts. Certainly nothing short of this, and these days they also use lending as a lever to win the biggest 'share of your wallet' from their rivals, trying to have you as a customer for life, 'growing with you and your business.' When you add the fact that a surplus of people requiring credit exist in the market, they can afford to be choosy and do the economically rational thing – be risk averse. Risk aversion drives the mortgage a bank puts on your house to ensure they get paid, and is what drives them to lend against strong balance sheets. They look at balance sheets in an accounting fashion, weighing up tangible, realizable, liquid assets like cash and real property, apply a formula and lend in accordance with how the result stack up against their risk matrix. Your continuing success is of interest to them only to the extent that it enables you to service (and ultimately repay) your debt, generating an ongoing margin on their investment.

An overly simplistic description, the point being to illustrate that all of this takes time, and is structured around heavy regulation and evaluation constraints. Lots of time, and lots of influential rules. First, for you to build your balance sheet, and second, to get it appraised to a point where your banker might open or extend your credit facility. During that time, the window of opportunity to fund that large project, manufacturing expansion, or operations in a rising market quickly passes, leaving you out of pocket your application fee and if successful, servicing an even larger debt you might not need.

Turning to invoice factors, the incentives might seem the same, but how they view obtaining their return is slightly different. While banks rely on their acumen in accurately predicting your ability to repay a debt, invoice factors rely on their skills in accurately assessing the ability of your customer base to pay you. A lower perceived risk aversion with invoice factors plays a small part, but it is how the factor views the overall situation that is different from traditional lending. To begin with, factors recognize your accounts receivables as assets, just like the bank. The difference is that an invoice factor considers your receivables a quickly realizable asset, and is prepared to purchase the rights (and risks) of collecting your outstanding invoices.

Put another way, in economic terms the invoice factor recognizes your receivables as assets with a future value in cash flow terms, and provided their assessment of your customers is favorable, they are prepared to effectively ‘provide a market’ for those assets. This ‘market’ closes with your transaction selling them the invoice however; there is no secondary market like junk bonds or other derivatives.

Access to capital through factors is more expensive than traditional lending, and this is due to the risk premium attached not to you, but your customer base. This is not surprising, and you and I would probably do the same. Returning again to economics and our study of incentives, a rational person requires a premium for every extra unit of risk they take on. A bigger incentive for a perceived higher risk. In the case of factoring, the premium is higher than equivalent bank lending rates, as the risks are considered slightly higher when the security is not real property, rather a first position claim over all of your receivables. Your risk exposure is lower than collecting the receivables yourself (invoice factors are very good at mercantile operations) – the higher fee charged by the factor compared to the bank is simply the premium you must pay to lower that exposure.

The difference that factors provide is speed of access to capital, and what happens when you default. Default on the bank loan, you can lose your business, even the family home. Factoring is not quite as drastic, although the sums of money involved are invariably smaller. There are two types of factoring products available, recourse and non-recourse, and again, the difference comes down to assumption of risk, and the premium asked to assume the risk of non-payment on an invoice. With recourse factoring, you remain liable for non-payment by your customer, and with non-recourse, the factor assumes the risk up to a point, and at a higher premium.

In summary, there are merits and pitfalls in both traditional lending and factoring. These are volatile economic times, and having been burnt a number of times during boom times of the previous two decades, banks are far more risk averse, holding tight reign on their credit standards. So in light of this information, we return to our problem, looking to answer the question: ‘Which of these approaches best delivers the flexibility I require to allow me the opportunity to prosper in a fast-changing business environment?’

For many businesses, the answer lies with invoice factoring, which delivers in excess of $1 trillion in credit across the continental United States. As with all business situations there are caveats, or described another way, arrangements that if not continually monitored can become a comfortable security blanket that might actually be slowly suffocating you.

It is easy to become accustomed to continuing access to cash flow through factoring. It is also easy to feel at ease knowing you are backed by a massive publicly traded institution like your bank. Management and owners of Small and Medium-Sized Enterprises should continually remind themselves that the study of incentives works for them too. Constant review of your capital funding and cash flow arrangements is essential to ensure that the deal you end up with is the best for your firm, and not others. It’s all about getting what you want, or need, especially when other people want or need the same thing.